Seminar Paper Collection

Knowledge Partnership Project

The Economic Crisis and Restructuring in Korea

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Korea Development Institute (KDI)

Cairo University

Korea International Cooperation Agency (KOICA)

Foreword

In worldwide recognition that knowledge is a crucial factor to economic and social development of all the developing countries, the Korean government has entered into a new phase of official development assistance via the Knowledge Partnership Project. The Knowledge Partnership project aims at helping the economic development of all the countries through narrowing the gap by sharing experience and know-how of Korea's development with the developing world.

Given this spirit, this collaboration of the joint seminar on "Economic Crisis and Restructuring in Korea" was sponsored by Korea Development Institute and Cairo University on January 23, 2003, in Cairo, Egypt. Senior government officials and leading scholars from Egypt shared a diverse range of professional opinions on economic development models of Korea and Arab countries and also discussed various reform policy issues of Korea to give some policy implications on Egyptian economic transition to market economy.

This collection includes all the papers presented at the seminar and complete transcript of all presentations and discussions. In particular, the transcript offers more wide ranges of development alternatives and policy options for economic restructuring and smooth transition to free market economy for Egypt. Furthermore, in this collection, the readers will encounter Islamic perspectives on economic development such as westernism, statism and external *rentierism*.

We at KDI would like to express our sincerest appreciation for the close cooperation shown by Cairo University, particularly Dr. Mohammad Selim, Director, and the Center for Asian Studies, Cairo University, as well as thank numerous experts who have contributed extensively by preparing these materials. This volume will serve as another token to overall economic development and international cooperation between Korea and the Arab World.

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Session I

Korea's Economic Development*

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* Prepared for the Joint Seminar on Economic Crisis and Restructuring in Korea organized by Korea Development Institute and Cairo University to be held on January 22nd and 23rd, 2003.

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CHAPTER 1
Introduction

The Korean economy has achieved an unprecedented growth in the last three decades or so. Between 1965 and 1995 Korea's per capita GNP increased from US$105 to over US$10,000 while the share of agriculture in GDP decreased from 38% to less than 7% during this period. Exports recorded a substantial increase from US$0.2 billion to US$125 billion.

Many factors have contributed to Korea's rapid economic growth. The first is a literate population capable of learning skills quickly, which played a key role in export-oriented labor-intensive industrialization during the earlier phases of development. Workers have been hard-working and disciplined in their drive to improve their socio-economic status.

Secondly, a strong leadership committed to economic development and capable bureaucrats have also been critical. The military government led by General Park, which came into power by a coup in 1961, promised to Korean people liberation from poverty. With the success of government-initiated economic progress, public confidence in the government has been strong in Korea.

Thirdly, credit may also be given to entrepreneurs. Korean entrepreneurs have proved themselves to be very dynamic and forward-looking. They have aggressively exploited overseas markets for trading, local construction and investment more recently. Despite high domestic market concentration, business groups have competed severely among themselves, not incurring much cost to consumers.

Finally, Korea's economic performance owes much to government policies. The takeoff of the Korean economy started with the export-oriented industrialization strategy in the early 1960s. This strategy enabled Korea to utilize its available resources to its fullest potential which was mainly labor, and overcome the limitation of the small domestic market.

Since the mid-1980s, a favorable external environment, particularly the strong Japanese yen, resulted in rapid export growth and a sizable surplus in the current account. The surplus, however, invited strong foreign pressure to further open the domestic market and appreciated the Korean won. The June 29 Declaration of Democratic Reform in 1987 unleashed workers' demand for wage increases and better working conditions. Substantial wage hikes coupled with strong domestic demand and progress in import liberalization worked together to deteriorate Korea's current balance.

Korea's international competitiveness began to deteriorate in the early 1990s due to the amassed structural deficiencies within the Korean economy. A major shock to the Korean economy occurred as a result of the terms of trade shock in 1996. The terms of trade deteriorated by approximately 20 percent in the 1996-97 period, the largest drop since the first oil shock of 1974-75. The terms of trade shock put extremely heavy pressure on the thin profit margins of firms.

Another big shock to the Korean economy occurred with the bankruptcy of Hanbo Group in January 1997. Four others of the thirty largest chaebols also went bankrupt in 1997: Sammi, Jinro, Haitai and New-Core Groups. The failure of these chaebols revealed problems with low profitability and excessive leverage ratios in the corporate sector and faulty corporate governance in Korea.

Foreign investors had already become increasingly skeptical of the government's willingness and ability to implement economic reforms and serious structural adjustment. In addition, the unanticipated intensity and power of contagion, first from Thailand and then Indonesia, came to bear its effects on Korea. This contagion coincided with a period of structural adjustments as well as a cyclical downturn in the Korean economy.

In November 1997, less than a year after its accession to the OECD, Korea experienced a severe financial crisis. With its useable foreign exchange reserves nearly exhausted, the Korean government formally requested assistance from the International Monetary Fund to mitigate the external liquidity shortage and regain the confidence of international investors.

A complicated and often opaque combination of macroeconomic distortions and financial fragility were at the core of the economic crisis in Korea. These include an inefficient and distorted financial sector, weak supervision and prudential regulation, and a corporate sector burdened with high levels of short-term debt.

In the financial sector, structural defects were deeply rooted and endemic as a result of the extensive use of credit restrictions as a primary tool of economic development in the past. Protracted periods of interest rate control and selective credit allocations gave rise to an inefficient distribution of funds. Short-term foreign debt of financial institutions increased significantly to finance the strong investment demand of the corporate sector as the economy entered a boom in 1994.

Since December 1997, the nation has embarked on a comprehensive program for economic reform and recovery, which is already producing fruitful results in terms of rectifying the causes of the crisis.

CHAPTER 2

Development Strategies

1. Export-Oriented Strategy in the 1960s

Korea launched its First Five-Year Plan in the early 1960s. At that time, Korea's economic conditions were similar to those of any resource-poor, low-income developing country today. With an annual population growth of nearly 3%, there was widespread unemployment. Underemployment was rife in the agricultural sector, which constituted nearly two-thirds of the population. Domestic savings were negligible and the per capita income was a meager $80. In 1961, Korea's total exports were only $43 million, less than one quarter of its imports. Preoccupied by the reunification issue, President Rhee Syngman showed little interest in developing Korea as an independent economic entity during his rule from 1948 to 1960.

In contrast, the political leadership that came into power in 1961 was strongly committed to economic development and adopted an outward-looking growth strategy. This export-oriented development strategy was an appropriate choice for a small economy lacking in natural resources but abounding in labor which could be easily mobilized to produce simple, labor-intensive manufactured goods for the overseas market.

To implement this strategy, a strong central planning agency - the Economic Planning Board - was organized, and institutional arrangements were established to mobilize what resources were available. The nation's tax administration was strengthened and official interest rates were drastically raised. These measures eliminated the fiscal deficit and dramatically increased savings deposits in the banking system. The government also provided repayment guarantees to foreign lenders in order to encourage foreign capital inflow.

To promote exports, the government adopted a uniform exchange rate system in 1964 and devalued the Korean won by nearly 100%. In addition, short-term export credit was made available at a preferential rate and tax rebates were allowed on raw materials imported for the production of exports. A number of free trade zones were also established and customs procedures were simplified. All of these measures enabled Korean exporters to do business, in effect, under a free trade regime. The international environment during the 1960s was also highly favorable to the growth of Korean manufactured exports. World trade was expanding at an unprecedented rate as the major industrial nations were still adhering to the original GATT rules.

The results of the outward-looking development strategy surpassed all expectations. Exports at current prices rose at an annual rate of 40% between 1962 and 1971. Propelled by the rapid growth in exports, the gross national product grew at an annual rate of over 9%.

Table 2-1 The Korean Economy

	1965		1975		1985		1995		2000
GDP ($, billion)	3		21.1		93.4		489.4		457.4
Per Capita GNI ($)	105		592		2,229		10,823		9,628
GDP Growth (real, %)		8.5		6.7		7.7		4	
Employment Growth (%)		3.7		2.5		3.1		0.6	
Industrial (Employment) Structure (%)									
Agriculture, Forestry & Fishery	38.0 (59.0)		27.5 (45.9)		14.1 (25.2)		6.8 (12.4)		5.1 (10.9)
Manufacturing	18.0 (9.5)		28.4 (18.7)		32.6 (23.7)		32.2 (23.5)		34.9 (20.2)
Construction & Services	41.9 (31.5)		44.1 (35.4)		53.4 (51.2)		61.0 (64.1)		59.9 (69.0)
Commodity Exports ($, billion)	0.2		5		26.6		124.6		175.8
Total Exports / GDP (%)	9.5		28.5		35.5		31		45.0
National Savings Rate (%)	13.2		19.5		31.1		35.5		32.3
Foreign Savings Rate (%)	0.2		9.6		-0.6		1.8		-3.5
Tax Burden / GDP (%)	8.6		15.3		17.1		19.1		18.7
Consumer Price Inflation (%)		14		12		5.8		2	
Won / US$ (year-end)	273		484		890		775		1,265

2. Promotion of Heavy and Chemical Industries in the 1970s

By the end of 1970s, the Korean economy was suffering from serious internal and external macroeconomic imbalances. Inflation had accelerated, and the second oil price shock dealt a heavy blow to the balance of payments, which had already been deteriorating due to weak exports.

Under these circumstances, the government thought that promoting the heavy and chemical industries (HCIs) would help develop an indigenous defense industry, and at the same time, upgrade the export structure. The overriding objective of the tax, credit, interest rate, and trade policies of the 1970s was to promote HCIs, including the iron and steel, non-ferrous metal, shipbuilding, general machinery, chemical and electronics industries.

While tax incentives for exports were actually reduced in the early 1970s, the tax incentive policy played an increasing role in affecting the resource allocation among industries. Korea's trade policy was also geared to protect favored industries by limiting the import of competing goods. The government used credit allocation through the banking system as its most powerful means of supporting favored industries. In order to finance large-scale HCI investment projects, a National Investment Fund was set up in 1974 by mobilizing public employee pension funds and a substantial share of banking funds. Because these funds proved insufficient, the banks, which were practically owned by the government, were directed to make loans to "strategic" industries on a preferential basis. During the latter half of the 1970s, the share of policy loans in domestic credit extended by deposit money banks rose steadily, from 40% to the 50% level.

Owing to this strong and concerted support given by the tax, trade and credit policies, manufacturing investment during the late 1970s was predominantly directed to HCIs. Such disproportionate incentives, together with over-optimistic assumptions regarding world trade prospects led to excessive investment in some areas. In order to correct this situation, the government intervened in 1980 and coordinated negotiations among firms for the relinquishing of projects or reduction of capacity. In addition to creating inefficiencies in investment, the HCI promotion policy gave rise to serious sectoral imbalances and complications in macroeconomic management.

With the promotion of heavy and chemical industries (HCIs) in the 1970s, policymakers had to tighten their control over finance to allocate resources to the heavy industries, since private firms were reluctant to undertake investments with a long gestation period and uncertain rates of return. To induce private investment in these industries, the government had to provide more and more incentives in the guise of preferential loans. To facilitate such a resource allocation, monetary authorities had to keep nominal bank lending rates below the market level and intensify credit rationing, resulting in a negative real interest rate and rapid expansion of the curb market.

During the 1970s, the share of policy loans[1] in domestic credit rose steadily form less than 50% to reach 60%. During the latter half of the 1970s, bank rates for export-related loans and equipment investment loans in key industries averaged 8% and 13%, respectively, compared with 17% for general bank loans and the PPI inflation rate of 16%.

3. Development Strategy and Monetary Policy

A Financial system can influence the allocation of real resources by intermediating financial resources between surplus and deficit units. In addition, a financial system can be used to channel financial resources to certain favored deficit units that are expected to use the resources for specific purposes, or the terms on which the financial resources are provided can be manipulated to influence the decisions of the potential users.

Few governments in developing countries seem to believe in the allocational efficiency of the financial system. As studied by Shaw[2] and McKinnon[3], the financial sector is perhaps one of the most heavily regulated industries in the developing countries. The governments in these countries intervene extensively, allocating credit and setting interest rates on both deposits and loans. The Korean government was no exception.

For the government-led, high-growth development strategy of the early 1960s, various policy instruments were necessary. The policy instruments may be divided into two types: fiscal and monetary policy tools.

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1) Policy loans include those extended to earmarked sectors at preferential or non-preferential rates and unearmarked loans extended at preferential rates with policy considerations.

2) Shaw, Edward S., *Financial Deepening in Economic Development*.

3) Mckinnon, Ronald I., *Money and Capital in Economic Development*.

The fiscal tools had limitations, however, that arose from low income levels and their corresponding inability to raise significant tax revenues at the time we launched our economic growth plan. Consequently, monetary policy tools became more important.

Governmental controls over credit allocation in Korea were initially exercised through a system of guidelines that established loan priorities for different sectors and within each sector. Beginning in the early 1960s, the government assumed a more active role in guiding resource allocation through the formulation of both five-year economic development plans and annual overall resource allocation programs. As part of this leadership role, the government increasingly interfered with the allocation of credit.

Medium- and long-term facility investment financing has mainly been provided by specialized financial institutions. The Korea Development Bank has extended credits primarily to key manufacturing industries, with government funds and borrowing from the National Investment Fund (NIF) and foreign sources.

The Export-Import Bank of Korea finances medium- and long-term trade, overseas investments and major overseas natural resource development projects. The necessary funds are mobilized by borrowing from the NIF and foreign or domestic banks and by issuing debentures.

Since 1974, deposit money banks have contributed to the National Investment Fund. The NIF makes funds available to specific projects by pooling financial resources contributed by financial institutions and deposits from public organizations and funds. NIF funds have mainly been provided to the heavy and chemical industries, and the electricity generating industry.

Other preferential loans for small and medium-sized firms, housing, agriculture and fisheries are supplied from government and banking funds, primarily through specialized banks. All commercial banks are required to maintain their loans outstanding to small and medium-sized firms above 35% of their total loans outstanding.

4. Interest Rate Reform

In September 1965, the Korean government implemented a major financial reform, which drastically increased interest rates on time deposits in commercial banks. The interest rate on one-year time deposits jumped from 15% to 26.4%. The government aimed to attract into banking institutions private savings that had been deposited in the informal money market or used for accumulating inventories and other real assets to guard against inflation.

Combined with the sharp drop in the inflation rate, this readjustment increased the real interest rates on those deposits to a positive 20% in 1965 from a negative 15% in the preceding years and maintained them between 17% and 20% for the following four years. These changes were accompanied by some increases in lending rates, but had little impact on the volume of loans since the new interest rates were still not high enough to affect the demand for bank loans when compared to the curb market interest rates, and rates of return on capital. In addition, the increase in loan rates applied only to some loans and did not affect the low rates for export producers, farmers, and many categories of investment loans by the special banks.

The financial reform in 1965 seemed to open a new era, moving the economy from financial repression toward financial liberalization, and helped the financial sector grow rapidly. Over the next five years, total bank deposits rose nearly seven-fold. As a result, commercial and special banks were recognized as important mobilizers of savings. The interest rate differential between domestic and foreign capital markets, together with government repayment guarantees, induced a massive inflow of foreign capital in the form of trade credit and direct investment.

The interest rate reform and accompanying policy measures contributed significantly to economic growth. Domestic savings relative to GNP more than doubled, form 7.5% in 1964 to 18.8% in 1969. This increase in domestic savings, together with massive inflows of foreign capital, stimulated investment and financed a large part of the corporate capital investments during this period.

In the case of Korea, where informal financial markets were competitive and efficient, it would be reasonable to conclude that the 1965 interest rate reform promoted the transfer of funds form the informal financial market to the formal financial market. Furthermore, the high domestic real interest rate induced an inflow of foreign capital, which expanded the amount of funds available.

The major financial reform during this period was the substantial increase in interest rates. This, however, did not lead to full financial liberalization. Rather, the adoption of the high interest rate schedule was a government measure designed to mobilize funds needed to finance capital investment. The government channeled the higher domestic savings and the inflow of foreign capital to exporters. Led by the high rate of investment, the average growth rate exceeded 10% during this period. This was due primarily to the expansion of exports, which recorded more than a five-fold increase over this brief period.

CHAPTER 3

Economic Stabilization and Liberalization

1. Economic Stabilization and Liberalization since the 1980s

The second oil price shock in 1979 exposed Korea's string macroeconomic imbalances. With the overvalued exchange rate, fixed to the U.S. dollar from 1975-79 despite a large disparity between the two countries' inflation rates, exports in 1979 recorded negative growth in real terms. Faced with both high inflation and a widening deficit in the balance of payments, Korea chose to tackle the problem of external imbalance by substantially depreciating the exchange rate and by adopting a flexible exchange rate system in the early part of 1980. Also, in the spring of 1979, the government adopted a comprehensive stabilization package including restrictive fiscal and monetary policies and investment adjustments in the heavy industries.

In the early 1980s, Korea's economic policy gave top priority to fighting inflation. In the belief that restrictive demand management alone would be overly depressive, the government relied on incomes policy as well. The realistic exchange rate management had a favorable effect: the current account deficit dropped substantially starting from 1982. Consumer price inflation also decreased considerably from an annual rate of 25% during 1980-81 to 7% in 1982.

There is no denying that economic liberalization increases efficiency by promoting competition and eliminating distortions in the allocation of resources. After the problems caused by the government's overzealous promotion of HCIs in the 1970s, Korean policymakers understood the need for trade and financial reforms as well as the realignment of other industrial incentives. In pursuing economic liberalization, a step-by-step approach was adopted, phasing in specific liberalization measures according to their degree of urgency or usefulness, and the seriousness of existing constraints, as perceived by policymakers.

Emphasis on liberalization was continued in the 1990s as well. The new government, which took office in 1993, prepared the Five-Year Plan for the New Economy, 1993-97. The Plan claims that as government guidance and control is no longer effective, a new engine for growth is needed. The Plan finds this new engine in fostering voluntary participation and creative initiatives in the private sector. Along these lines, major areas emphasized and identified for institutional reform included the fiscal system, the financial sector, and administrative regulations.

1-1. Financial Liberalization

Between 1981 and 1983, the government divested its equity shares in all nationwide city banks, transferring ownership to private hands. Financial services provided by different intermediaries were diversified and were made increasingly to overlap. Furthermore, entry barriers into financial markets were lowered, making possible the establishment of new nation wide city banks, commercial banks specializing on small and medium-sized firms, and many non-bank financial institutions.

Progress has been made in the monetary and credit management. The relative share of policy loans has declined since the government has reduced the National Investment Fund (NIF) and, more recently, the automatic short-term export credit. In 1984, financial intermediaries were allowed to determine their own lending rates within a given range, according to the creditworthiness of the borrowers.

Reforms in the 1990s have mainly focused on relaxing regulations on the operation and business boundaries of financial intermediaries and on foreign exchange and overseas capital transactions. The four-stage interest rate deregulation plan announced in 1991 has been seriously implemented, so that interest rates are now determined autonomously by individual intermediaries. The burden of providing policy loans by commercial banks has also been reduced, as specialized banks with the support of the government become mainly responsible for them. The growing size of non-performing loans and the poor governance structure of commercial banks, however, have constrained more ambitious financial liberalization.

Financial deregulation has led to an irreversible transform action of the domestic financial environment. The deregulation process, however, involved transitional risks and costs. Weaknesses in the structure and performance of the corporate governance of commercial banks and big business groups have surfaced with the Hanbo Group loan scandal in 1997.

CHAPTER 4
Financial Crisis of 1997

Korea's sustained growth came to an end by the financial crisis of late 1997. The crisis was the combined result of unfortunate external shocks, and the inadequate management of foreign debt, foreign exchange reserves and the exchange rate, together with weak domestic financial system and corporate structures.

1. Fragility of Chaebols and the Financial Sector

The Korean crisis was triggered by a series of corporate bankruptcies in 1997. A big shock to the Korean economy occurred with the bankruptcy of Hanbo Group in January 1997. Four others of the thirty largest chaebols also went bankrupt in 1997: Sammi, Jinro, Haitai and New-Core Groups. The failure of these chaebols revealed problems with low profitability and excessive leverage ratios in the corporate sector and faulty corporate governance in Korea. None of the 30 largest chaebols had gone bankrupt for a decade preceding the crisis, enough to cause people and foreign creditors to believe that they are "too big to fail". The chaebol bankruptcies, therefore, were quite a shock to the market. The terms of trade deteriorated by approximately 20 percent in the 1996-97 period, the largest drop since the first oil shock of 1974-75. The terms of trade shock put extremely heavy pressure on the thin profit margins of firms.

The fragility of chaebols is caused by the high debt-equity ratios, the practice of extensive cross repayment guarantees among affiliated firms of large business groups, and inefficiencies of corporate investments resulting from poorly conducted project evaluation. As some of the subsidiaries of a business group face financial distress at the same time, the whole business group was in jeopardy due to the close financial link among subsidiaries resulting from their cross repayment guarantees.

As a result of a series of large corporate bankruptcies that year, there was a rapid increase in non-performing loans among Korea's banks and merchant banking corporations, which, in turn, destabilized the financial market and made Korea exceptionally vulnerable to a currency crisis. In addition, many of Korean financial institutions suffered from huge losses from their overseas financial operations as well as their net borrowing position in foreign exchange. In the process of financial liberalization, prudential regulation over financial institutions should have been strengthened, but turned out to be grossly inadequate.

2. Mismanagement of Foreign Debt and Foreign Exchange Reserves

Korea's total foreign debt of U.S.$159 billion, though large, was not overly burdensome at about 36% of GDP, or 93% of the annual earnings of foreign exchange. However, a large share, 39.9%, was short-term debt. The high short-term debt ratio has been partly attributable to the cheaper cost of borrowing short-term and remaining restrictions on some long-term borrowing like commercial loans.

On the other hand, foreign exchange reserves, which used to be maintained over US$30 billion or roughly 205 months of imports, decreased rapidly at the beginning of the crisis. Much of the foreign exchange reserves were lost in the futile attempt to defend the exchange rate of Korean Won. When foreign investors began to cash their investment and leave the market, while the supply of foreign exchange was almost discontinued, it was beyond the capacity of the Bank of Korea. Furthermore, a substantial portion of the foreign exchange reserves was lent to overseas branches of Korea banks in order to prevent them from defaulting on their borrowings. The "usable " foreign exchange reserves dropped to a mere US$7 billion by the end of November 1997. With its useable foreign exchange reserves nearly exhausted, the Korean government formally requested assistance from the International Monetary Fund to mitigate the external liquidity shortage and regain the confidence of international investors.

While the structural weakness in the financial sector and chaebols provided the root cause, it was the large corporate bankruptcies and the inadequate management of foreign debts, foreign exchange reserves and the exchange rate policy that touched off the crisis.

Table 4-1 Korea's Total External Liabilities

(US$100 million)

	End '97	End '98	End-Dec. '99	End-Dec. 2000	End-Dec. 2001
Long-Term Liabilities (I+II+III)	957	1,180	978	921	859
I. Public Sector	223	365	295	279	225
II. Financial Sector (A+B)	475	520	610	512	464
A. Domestic Financial Institutions	703	571	473	380	338
B. Branches of Foreign Banks	196	139	137	132	126
III. Domestic Operations	471	412	466	572	580
Short-Term Liabilities (I+II)	636 (39.9%)	307 (20.6%)	392 (28.6%)	442 (32.4%)	411 (32.4%)
I. Financial Sector (A+B)	424	189	225	238	221
A. Domestic Financial Institutions	272	113	127	137	122
B. Branches of Foreign Banks	152	76	98	101	99
II. Domestic Operations	212	118	167	204	1914
Total External Liabilities	1,592 (100.0)	1,487 (100.0)	1,371 (100.0)	1,363 (100.0)	1,270 (100.0)
Total External Assets	1,052	1,285	1,454	1,669	1,618
Net External Assets	-540	-202	83	306	348

CHAPTER 5

Concluding remarks

The development strategies that made possible a sustained growth and structural transformation since the early 1960s, as well as the characteristics of development patterns resulting from them, may be summarized.

Korea has followed an export-oriented industrialization (EOI) strategy for economic growth. Import-substitution industries were promoted on a selective basis in the 1960s and on a more expanded scale through the development of heavy and chemical industries in the 1970s. The strategy of government-led economic development has been followed as demonstrated by government's intervention in the market economy. Some cases of such intervention were economic planning, industrial policy or government-guided industrialization and intervention in the market price system.

Government economic policy during the first two decades of rapid growth in the 1960s and 1970s was skewed toward the interventionist approach. But Korea was able to make this approach work. The targeted interventions of the HCI drive succeeded in helping create the foundations for current competitive heavy industry sector. In the 1970s, the major emphasis of Korean government policy was placed on promoting heavy and chemical industries. Although this effort produced some side effects, it significantly contributed to upgrading Korea's industrial and export structure.

The "growth first and distribution latter" strategy was followed until around the mid-1980s, but thereafter gradually changed to policy considerations to the issue of distributive equity. The growth strategy emphasizing the efficient use of available human resources has been pursued in the course of implementing EOI strategy. The strategy has been pursued to maximize growth potential by making the pattern of factor use consistent with the country's factor endowment conditions.

Korea's high growth was accompanied by an increased concentration of economic power in the hands of a small number of business groups, since the government generally gave preferences to large firms in the course of promoting industrialization.

Korea economic development paved the way for political democratization beginning in late 1980s. The Korean experience displays the case of political democratization led by economic development.

Government's directed credit allocation may lead to better economic performance than a market-based financial system under certain circumstances. The chance of success should be high when the economy is in its early stage of development, with capable bureaucracies and a political leadership strongly committed to economic development. Nevertheless, the incentive structure imposed by the government should deviate as little as possible from the market-based system, and it should supplement the market system by redressing its shortcomings.

Policy emphasis since the 1980s has shifted to promoting the role of the market in resource allocation by reducing direct government intervention and fostering competition. As Korea's economic structure became more like that of other industrialized economies in the 1980s and 1990s, the Korea government moved toward indirect macro management of the economy. Trade in goods was significantly liberalized. But, political pressures and nationalist sentiments played a role in slowing the pace toward full liberalization, particularly in restrictions on foreign direct investment and financial services. Political sentiment and democratization made specific intervention in support of individual business group unacceptable.

Current economic difficulties will prove to be a valuable lesson for Korea and will promote the fundamental restructuring to strengthen the market mechanism in the Korean economy. Many existing problems of the Korean economy are deeply rooted in the lack of market discipline. Both businesses and financial institutions will have to take the lesson seriously to survive in the long run. A fundamental economic reform and restructuring of financial institutions are required to revitalize the financial industry and the Korean economy as a whole.

Economic policies should be geared to structurally reform the Korean economy over the next few years. It will also be necessary for the government to overhaul the exit mechanism in the corporate sector in order to facilitate mergers and acquisitions and restructuring troubled companies.

We should have a clear vision in overcoming the current difficulties and achieving a successful transition toward a truly open market economy.

Figure 5-1 GNP Per Capita and Growth Rate

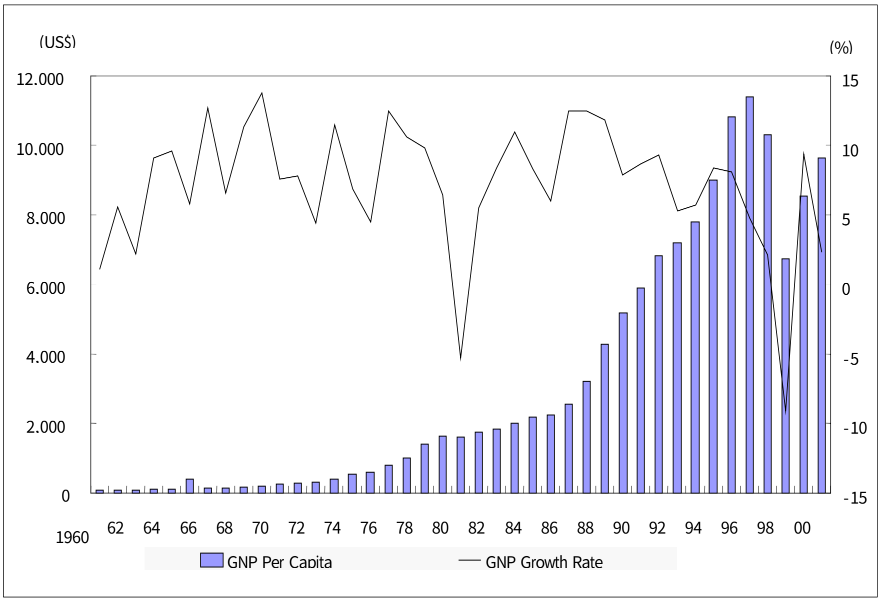


Figure 5-2 Interest Rate Trend

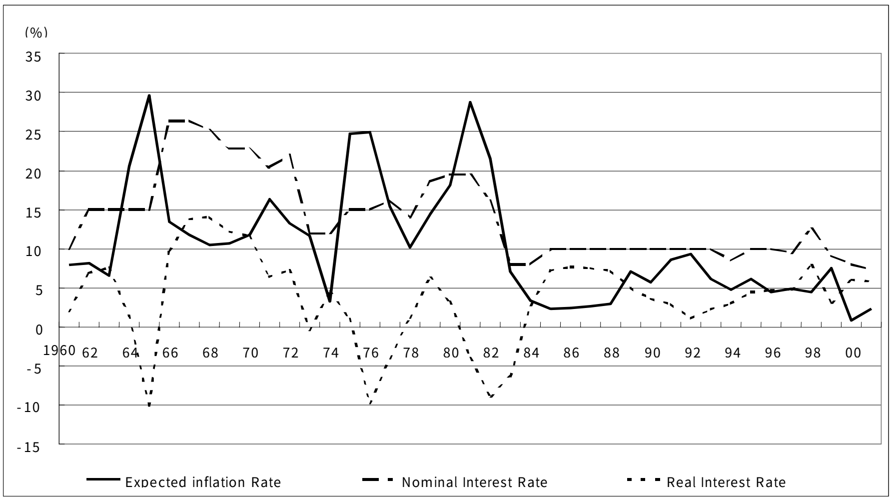


Figure 5-3 Inflation Rate (CPI)

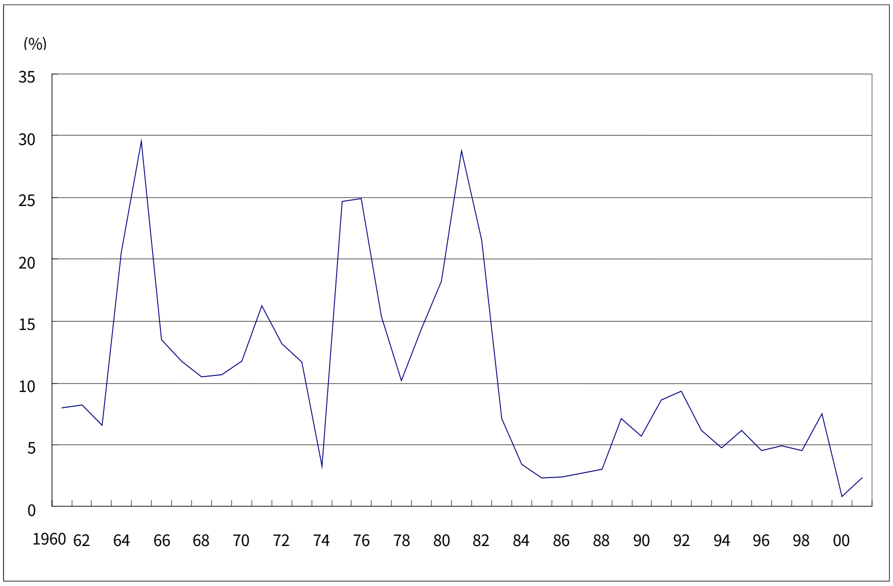
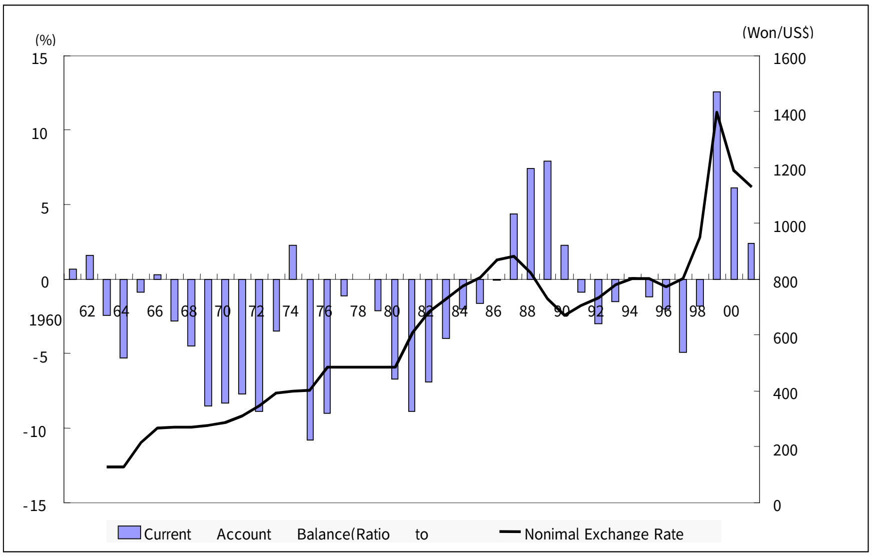


Figure 5-4 Exchange Rate and Current Account Balance



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Session I-I

Models of Development in the Arab World

January 2003

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Contents

CHAPTER 1

Introduction

Of all the world regions, the Arab world has had the longest and most varied relations with Europe. Throughout the millennium after the advent of Islam, this area was on the ascent. The Arabs developed a thriving civilization, which they passed on to Europe. The Ottoman rule in the Arab world, which began in the first half of the sixteenth century, heralded the beginning of a long cycle of societal decay and isolation from the emerging European Renaissance. During the centuries-long Ottoman rule the interaction between the Arab world and Europe was disrupted, and there was a decline in the level of technological development and scientific knowledge. For example, when the Ottoman Sultan Selim I invaded Egypt in 1517, he forcibly deported all the technical strata to Istanbul, thereby disrupting the normal development of the country. However, the Ottomans succeeded in protecting the Arab world from the Spanish and Portuguese onslaught after the fall of Arab rule in Andalus in 1492 and the subsequent scramble over imperial control of Africa and Asia. As a result, the Arab world was the last region to fall under Western imperialism. This process began to occur with the French intrusion into Egypt in 1798, but gained momentum in the fourth decade of the nineteenth century.

Contrary to the widely held belief that the advent of the French campaign, when Napoleon invaded Egypt, represented the beginning of the modernization process in Egypt, the Arab world was already experiencing a process of civil revivalism motivated by the weakening of the Ottoman Empire. On the Arabian peninsula, and what is known now as Libya, the Wahabi and Sanoussia movements respectively succeeded in unifying the tribes under one single authority and establishing a viable model of the Arab Muslim state. In Lebanon, Prince Bashir II, who ruled between 1788 and 1840, achieved significant progress in rejuvenating Lebanese society. Furthermore, during the first four decades of the nineteenth century, the Arab world witnessed numerous projects to make up for the weakness of the Ottomans by building modern states. These projects relied mainly on local resources, and to a lesser extent on European technology, without sacrificing Arab Muslim culture. The most important of these was the Egyptian project led by Mohammad Ali between 1805 and 1841. Mohammad Ali was able to achieve the difficult task of modernization without dependence on the West. The conclusion to be drawn from this review is that when forces of imperialism began to descend over the Arab world, this area was already experiencing radical national projects.

By the 1830s, European imperialist powers began to extend their domain to Arab world. In 1820, Britain forced the tribal heads in the coastal areas of the Arabian Gulf to concede to its influence, and in 1853 they were forced to accept British political supremacy in the Gulf. In 1827, France invaded Algeria, where it was confronted with national resistance lasting for almost thirty years; and in 1839, Britain occupied the port of Aden. But more importantly, Britain, in cooperation with the Ottoman Empire and the Great powers, was able to bring the Mohammad Ali modernizing state to an end in 1840, and to restore the Ottoman markets, over which Mohammad Ali had control. After the fall of Mohammad Ali's national project, the European imperialist scramble over the Arab world began. In 1881, France occupied Tunisia and Egypt, which was extended to Sudan, fell to British occupation in 1882. In 1907, Persia was divided between Britain and Russia according to the Russo-British Agreement of 1907, and in 1911 and 1912 Italy and France formally occupied Libya and Morocco, respectively. After the First World War, the Arab East was divided between France and Britain according their secret deal of 1915 known as the Sykes-Picot Agreement, and Zionist colonization of Palestine was formally acknowledged.

The conservative western school argues that the late arrival of western imperialism into the Arab world meant that the region came to experience "halfhearted pussy-footing imperialism," an imperialism that would neither create nor tolerate stable and orderly institutions. This school goes even further to argue that western imperialism has introduced and reinforced forces of modernism into the Arab world.[1] The radical and liberal schools contended that imperialist control of the Arab world had disrupted the national development projects and turned Arab societies into dual societies dependent upon Europe in terms of technology and culture. The national modernizing projects were forcibly reversed and new models of dependent development and dual societies were imposed.[2] These contending views reflect the mixed impact of imperialism on the Arab world. Imperialism introduced some Arab world societies to modern technology and helped them to build modern infrastructures. However, such introduction occurred mainly at the cost of subjecting local economies to the interests of imperialist ones, destroying the local technologies, eroding the independent bases for self-reliant development, and in many cases destroying national cultures.

After the First World War, present day Arab world states began to emerge. Egypt, Saudi Arabia, and Iraq emerged as independent states during the 1920s. The process of independence slowed down in the inter-war period but accelerated after the end of the Second World War.

The Arab world's newly-independent countries were confronted with the agrarian trap whereby the economy is mired in the production of cheap agricultural commodities, a system of production that denies modern skills to all but a privileged few, and the forcible integration of their agrarian economies into an unequal global trade system and international division of labor. Nevertheless, they purported to achieve the tasks of economic development and social equity under conditions of scarcity of resources and post-colonial indirect control. Throughout this process, they adopted different strategies of state building and development. The objective of this paper is to twofold, (i) to review the development models pursued by Arab world countries since the end of World War I, to assess their viability as means of development, and to outline the present attempts to re-structure them given the global pressures for privatization and structural adjustment; and (ii) to assess the impact of these models on the processes of democracy at the domestic level and integration at the regional level.

CHAPTER 2

Arab World Models of Development

Despite the drastic variations of the models of development adopted by Arab world countries after World War I, these models shared certain common characteristics, namely, Westernism, statism, and external rentierism. A brief review of these characteristics may be in order.

1. Westernism

Because of their Western colonial legacies and Western-educated and oriented elites, virtually all Arab world developmental models purported to emulate the Western experience in some way or another. Despite their emphasis on cultural authenticity and self-reliance, the goals of development were clear, i.e., to achieve what the West had already achieved, at least in the area of economic development. The quest was towards emulating the secular ideals and values to the detriment of the traditional ones. In the case of the Arabian Gulf states, the entire development process occurred under Western supervision. Quandt described the Saudi development model as an "economic enterprise under American political supervision."[3] In the cases of Morocco, Algeria, and Tunisia, the French model is viewed as the ideal one. Despite the anti-Western foreign policy orientations of some other Arab world states, the objective of the development process was to re-incarnate Western economic achievements. This was clearly articulated by Nasser when he emphasized in the early 1960s that "our objective was to achieve in 30 years what Europe had already achieved in 300 years." It is important to notice that the decisions of some Arab world countries to resort to the Soviet Union for developmental assistance were made only when the Western options were exhausted. The only exception to the Westernist orientation was the former Marxist regime of Southern Yemen.

However, contrary to the Turkish model under Ataturk, there was no deliberate attempt to secularize or to a remove the traditional system and replace it by a Western one. There was an interest in emphasizing that Westernism is merely an economic project, rather then a socio-cultural one.

2. Statism

Arab world models of development were characterized by the legitimacy of the central role of the interventionist state. States monopolize resources, control large investment budgets and the nation's infrastructure, and employ large numbers of people. The state plays a number of functions related to social engineering and economic development. Ideologies vary but not the crucial role of the interventionist state. Arab world people view such states as legitimate. They may question the legitimacy of a particular regime, but they agree that the state and its leaders have a right and an obligation to set a course for the society and to use public resources to pursue that course.

The emphasis on state interventionism may be deeply embedded in the geopolitical setting or national cultures. But it gained momentum after independence because of the high magnitude of the colonial legacy of underdevelopment and dependency as well as the scarcity of resources relative to the requirements of development. Throughout the region it was assumed that the private sector could not be relied upon to undertake the crucial functions of resource mobilization and planning. Reliance on private entrepreneurs and market forces to allocate scarce resources would not achieve development and social equity.

Statism in the Arab world was borrowed from the Turkish concept of state interventionism in the development process. In 1931, Ataturk, the founder of present day Turkey, issued a manifesto that contained six principles. Among these was the principle of etatism. Ataturk defined this principle as meaning that “the government takes an active interest especially in the economic field, and to operate as far as possible in matters that lend themselves to the safeguarding of vital and general interests.”[4] Within a few years of the enunciation of these principles, Turkey established a planned development model in its first five-year plan in 1934. The model focused on the creation of a large public sector and import substitution under the auspices of the state. During the 1950s, the victory of the Democrat Party ushered in a liberal anti-etatist phase. After the 1960 military coup, Turkey returned to etatism.

The emphasis on the role of the state in development was echoed by other models, which were later on adopted by Arab world countries. Some of these countries, such as Egypt (1957-1974) and Syria (1963-present) adopted socialist models, which explicitly emphasized the central role of the state-led public sector. Others such as Saudi Arabia, Kuwait, and Jordan pursued market economy approaches. Despite these ideological differences, in all cases the state dominated the development process. The private sector in the Arabian Gulf states is an extension of the state. Its very survival depends on the subsidies provided by the state through oil revenues.[5]

Consequently, regardless of the ideological slogans, the development process in the Arab world countries took the form of state capitalism. This term refers to a process in which the state enterprise controls economic interactions. In this respect, one may distinguish between two major variants of state capitalism in the Arab world. The first was a model whereby the state supports the private sector by providing the infrastructure, raw materials, semi-manufactured goods, financial support, and protective legislation, while absorbing major risks. However, the state transfers external rents to expand its own activities. This was the model pursued by Morocco, the Gulf Co-operation Council (GCC) states, and Egypt after 1974 when the Economic Open Door policy began, as well as Tunisia after 1969. The second model of state capitalism was one in which the state dominated all aspects of resource allocation, and captured the social surpluses and external rents. The state controlled the economy through a master central plan, which identified certain goals to be achieved within a specific time frame. Turkey in the 1930s, Egypt between 1957 and 1974, Algeria since 1962, and Libya and Tunisia between 1964 and 1969 adopted this model. In most of the cases, this model had an explicitly socialist and redistributive feature in which equity issues took precedence over profit-loss criteria in assessing state activities. It also focused on the pursuit of an import-substituting industrialization strategy.

State capitalism was mostly applied within an authoritarian framework of power. The state controlled and/or monopolized economic and political power, with few exceptions such as Lebanon, Israel, and Sudan in the inter-coups eras. Democracy was viewed either as a constraint on resource mobilization, a facilitator of foreign intrusion, a Western concept that contradicted traditional cultural values, or simply as a luxury. Ruling traditional or military elites decided the main components of their variant of state capitalism, and de-politicized the masses while mobilizing them to accept such a variant. The masses were rarely involved in the decision-making process leading to the adoption of a specific development model.

Richards and Waterbury differentiated between three main categories of regimes in the Arab world – the socialist republics, the liberal monarchs, and the pluralists.[6] The socialist republics, such as Egypt under Nasser, Tunisia under Bourgiba, and Iraq and Syria since 1963, created single party systems of political mobilization and mass de-politicization. The liberal monarchs, such as Morocco and Jordan since independence, Iran under the Shah, and Saudi Arabia, created paternalistic regimes in which the monarch played the role of arbiter and supervisor of the distribution of patronage. The only differences between the socialist republics and the liberal monarchs are the ideological framework and the source of political legitimacy. However, the two categories are quite similar as far as the structure and exercise of power is concerned. The only variants of pluralism in the Arab world existed in Lebanon, and in Sudan during certain periods (1956-1958, 1964-1969, 1985-1989). However, these variants could not be considered as manifestations of genuine political participation. The Lebanese variant was ridden with forces of political sectarianism, which resulted in its collapse during the civil war (1976-1989). Sudan's political regimes since independence in 1956 oscillated between cycles of military rule and political pluralism.

Authoritarian state capitalism constrained the ability of Arab world states to achieve meaningful regional integration. The dominance of state bureaucracies and enterprises linked political relations with socio-economic transactions. Accordingly, crises in political relations spilled over to non-political transactions. Projects to create an Arab free trade area, which started in the mid 1960s, were caught in the "Arab Cold War" and economic reprisals were the traditional response to any political crisis in inter-Arab relations. For example, some GCC states withdrew their contributions to the Arab Organization for Industrialization, a promising framework for the integration of Arab defense industries, when Egypt signed the peace treaty with Israel in 1979. One may cite many other cases in which Arab state bureaucracies utilized economic integration as a means to subdue their political rivalries. Further, regional integration could hardly occur under conditions of political authoritarianism. Authoritarian regimes lack the traditions of bargaining and compromise, which are prerequisites for the resolution of the integration crises.

However, these were not the only factors that delayed the creation of a single economy in the Arab world. The competitive nature of Arab world economies played a major role in such delay. Most of these countries produce and export raw materials and import manufactured goods. Almost 92% of the exports and 65% of the imports of the Arab states in the Arab world take the form of raw materials and manufactured goods, respectively. Under these conditions, it was difficult to increase inter-Arab trade beyond its low level of 5-7% of total Arab foreign trade. Further, the Arab-Israeli conflict proved to be a major obstacle to the creation of a single economy in the Arab world through which Arab and Israeli economies would integrate. For the past fifty years it was, and in my judgement still is, impossible to enter into meaningful Arab-Israeli economic co-operation because Arab-Israeli relations were always characterized by the presence of major territorial disputes and strategic disequilibrium. Under these conditions, integrative ventures would be viewed as a means to reinforce the status quo. One may recall that when Western Europe began the integrative process in 1949, these two conditions were not present.

3. External *Rentierism*

The concept of external *rentierism* refers to the accumulation of externally generated income constituting a large portion of the national income without corresponding local productive sectors. External rent becomes the main generator of domestic economic activities.[7] After the 1974 “oil boom” almost all Arab world countries have become *rentier* states either directly through the exportation of oil (mainly the GCC and Libya) or indirectly through remittances and financial assistance (i.e., Egypt and Syria).

External rent reinforced the role of the state in development as the state became the only recipient and distributor of external rent. It also weakened the relationship between income and effort, as it became possible to obtain huge revenues without a corresponding effort. Although the inflow of external rent has helped the GCC states to jumpstart the development process, most of the development achieved relied mainly on external human skills and, as such, lacked any indigenous and durable roots. This was in contrast with the Israeli case in which external rent was used to create locally generated infrastructures.

External *rentierism* has not only reinforced state capitalism, but also constrained the creation of a single economy in the Arab world. Granted that the flow of external rents has led to the rise of new forms of socio-economic transactions (such as labor migration), which linked most Arab world economies more than ever before, it also led to the emergence of the process of status inconsistency, especially in inter-Arab relations. Status inconsistency refers to a process in which states do not possess equal shares of the elements of power or status in a regional system, such as when a state possesses high economic but limited military capabilities. This process characterized inter-Arab relations after the flow of the oil rents in 1974. Egypt lost its leading economic regional role, which was captured by some other oil exporting Arab states. However, it continued as the leading Arab power in military, social, and cultural terms. Consequently, Egypt lost its ability to steer inter-Arab relations in the direction of integration, and new Arab economic powers began to claim Egypt’s role, which, in turn, led to the intensification of inter-Arab rivalries.[8]

CHAPTER 3

Arab World Development Models: The Record and the Future

State capitalism, as a model of development was an extension of the deeply embedded historical traditions of state control in the Arab world region. It was also a response to the colonial legacy, which required a model of development that would enable Arab world countries to jumpstart the development process and achieve a structural transformation in a limited time frame. To what extent were the two variants of state capitalism able to achieve the goals of development? In answering this question one must recall that in most cases Arab world models of development were applied under crisis conditions. The region has been an arena for regional wars and great power rivalries, which made it one of most over-armed regions by all accounts. Military expenditure has traditionally represented between 10% and 50% of GNP (compared with the global average of 5-6%), and the Arab world's contribution to global military expenditure is almost four times its contribution to global GNP. The Arab world's high military expenditures and over-armament reinforced the underdevelopment dilemma, and the numerous regional wars led to the waste of valuable resources.[9] Further, the sudden oil boom of the 1970s has led to the rise of serious social dislocations and deformities. The infusion of tremendous external rents especially led to the rise of a social money-hunt since it became easy to accumulate wealth without any corresponding developmental achievement.[10] It also led to a deeper penetration into the Arab world by Western powers in their quest to re-circulate the petro-dollars through arms sales. So, one may argue that the Arab world's development models were never put to a real test.

Considering these constraints, Arab world development models have achieved a great deal in terms of structural transformation. Both absolute and per capita national output grew at reasonable rates in most countries of the region even before the oil boom, the share of manufacturing industries in output and employment also grew, and literacy and education rates improved. This performance was no easy achievement in view of the speed of population increase and the constraints on the application of the models, which we have just mentioned. Meanwhile, there were some basic failures. The state-led growth model suffered from the problems of allocative and bureaucratic inefficiencies. Industries were created to generate jobs and / or to substitute imports without regard to cost-benefit economic considerations. Inefficient bureaucracies that led to the waste of scarce resources dominated state enterprises. Further, many countries in the region tried to invest more resources than were saved domestically, which led to external indebtedness. Further, because of the lack of genuine mass participation, political corruption increased and the regimes failed to achieve the goal of equitable income distribution.

These problems were exacerbated in some Arab world countries by declining terms of international trade as a result of the increase in the cost of energy importation and increase of social expenditures due to the high levels of population growth. All of this led to problems of debt default and chronic balance-of-payment deficits. In order to deal with these problems, especially those related to debt default, many WEANA countries resorted to the World Bank and the International Monetary Fund (IMF). Between 1956 and 1984, fourteen Arab world countries (such as Turkey, Egypt, Syria, Morocco, Iran, Tunisia, and Israel) entered into agreements with the IMF calling for reductions in government spending and increases in interest rates in order to stimulate savings and dampen inflation rates. By the mid-1980s, the IMF was calling for the introduction of a new development model that evolved around the notions of “structural adjustment” and “privatization.” The new model advocated by the IMF called for the reduction of administrative interference in pricing mechanisms and allowance of supply and demand to determine price levels, the phasing out of subsidies of consumer prices and inputs in the manufacturing sector, educing government spending, revising terms of trade prevailing between the agricultural and non-agricultural sectors, and streamlining the public sector while stimulating the private sector. Later on, the last element was modified to mean phasing out the public sector — that is, dismantling state capitalism through privatization.

The IMF formula was presented to all Arab world countries as a prescription to bail them out from their economic troubles, regardless of their different socio-economic backgrounds and problems. The basic assumptions of the formula are that the lesser the role of the state, and the more integration into the world capitalist economy, the better the economic performance. Historical record tells us that there has never been a single model of development that could be applied across the board and to all countries. Further, the experience of the East Asian states during the last thirty years shows that the state has played a crucial, but different, role in the development process. The East Asian state did not own the means of production, as was the case in Arab world states. Instead, it played a crucial role in indicative planning, persuading the private sector to move into urgently needed areas of production, and preventing local capitalism from becoming an agent of foreign capitalism. In our judgement, the emphasis of the IMF on privatization and integration into the world economy is part of a strategy to make sure that Arab world countries would be able to re-pay their debts and that their markets would be open to the manufactured goods of capitalist countries. This is the logic underlying most neo-regional projects in the post-Cold War era, including the Euro-Mediterranean project submitted to most Arab world countries in 1995. This project envisages the establishment of a free trade area in the Euro-Mediterranean world in which only manufactured goods will be traded freely. Agricultural commodities, in which Arab world countries enjoy a relative advantage, will not be included.[11]

Most Arab world countries accepted the IMF’s new model with some reservations. However, after the global transformations of the early 1990s, which led to the demise of the Soviet Union and the dominance of the capitalist Western coalition, virtually all Arab world countries have fully endorsed the IMF structural adjustment and privatization programs. For example, in 1991, Egypt devised a comprehensive structural adjustment program, which was supported by a standby arrangement with the IMF and a structural adjustment loan from the World Bank. The application of this package has resulted in noteworthy achievements in the areas of current account balance, budget deficit, inflation rate, and nominal exchange rate. However, as one Egyptian economist argued, it had generated a recessionary trend and negatively influenced most real variables such as the growth rate of GDP, GDP per capita, consumption per capita, merchandise exports, unemployment, and real wages per employee in the public sector.[12] The Egyptian experience is typical of the experience of other Arab world countries.[13]

Given this experience, Arab world states are not likely to withdraw from the social functions as envisaged by the IMF. They will attempt to reconcile the IMF demands with their own social redistributive and allocative responsibilities. At the moment, there is a great deal of interest among Arab world countries in the East Asian models of development. Further, the East Asian economic crisis has shown Arab world countries the limitations of integration into the global economy. What is likely to emerge from these soul-searching processes and crosscutting pressures is a new model of development, which takes into account the special socio-economic characteristics of Arab world societies.

Will the acceptance of the market economy model by Arab world countries result in increased democratization? In answering this question one can identify two main schools. The first school argues that economic liberalization in the Arab world will lead to a corresponding democratization. The logic of this school is derived from the traditional modernization theory, which contends that after a certain critical threshold, increased development will create new economic forces, which will then induce more political participation. Further, economic liberalization cannot be sustained without corresponding political liberalization. The second main school contends that, notwithstanding economic liberalization, Arab world countries will continue to maintain their authoritarian structures given the traditionally powerful role of the state and the prevailing political cultures, which tend to de-emphasize the values of political participation. Thus, Arab world countries are expected to develop into a sort of “authoritarian capitalism” reminiscent of the fascist Italy.

In our judgement, the image portrayed by the second school is unrealistic. Arab world countries are already experiencing tremendous social pressures for expanded political participation. These pressures result from the revolution of mass communications, the deteriorating ability of the ruling elites to deliver social goods, and the global trends toward democratization. Further, Arab world countries have already achieved certain levels of democratization which, given the post-Cold War environment, cannot be removed without high social and political costs on society.

Endnotes

1. Bernard Lewis, "Democracy in the Middle East, its state and prospects," Middle Eastern Affairs, 6 (4), April 1955, p 105. This view is also shared by Dankwart Rustow, "Modernization, oil, and the Arab countries," in Ibrahim Ibrahim, ed., Arab Resources, the Transformation of a Society, (Washington, D.C., Center for Contemporary Arab Studies, Georgetown University, 1983), p. 269.
2. Galal Amin, al-Mashrek al-arabi wa al-Gharb (The Arab East and the West), (Beirut: Center for Arab Unity studies, 1981), p.17
   Albert Hourani, A History of the Arab Peoples, (New York: Warner Books, 1991), pp.295ff.
3. William Quandt, Saudi Arabia in the 1980s: Foreign Policy, Security, and Oil, (Washington, D.C., the Brookings Institution, 1981).
4. Quoted in Alan Richards and John Waterbury, A Political Economy of the Middle East: State, Class, and Economic Development, (Cairo: The American University in Cairo Press, 1991), p. 189.
5. Israel was no exception from such statist developmental orientation. It was Ben-Gurion, the first Israeli Prime Minister, who developed the doctrine of etatism (in Hebrew mamlachtitut) and subordinated to the state his Labor Party and its powerful trade union affiliate, the Histadrut. The end result was a "large, paternalistic welfare state with vaguely socialistic objectives and extensive public ownership. In this system, the citizen would be perceived as an object available for the activities of the state and its bureaucracy."
   Ibid, p. 213.
6. Hazem al-Beblawi, "The rentier state in the Arab world," al-Mustakbal al-Arabi, (Beirut), no. 109, September 1987, pp. 65-77.
7. Alan Richards and John Waterbury, A Political Economy of the Middle East, (Cairo: The American University in Cairo Press, 1990), pp. 301-302.
8. Ali Dessouki, "The crisis on inter-Arab politics," The International Relations of the Arab World 1973-1982, Joint research Program Series, No. 39, (Tokyo: Institute of Developing Economies, 1983), pp.149-150.
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10. Ali Khalifa al-Kawary, Development of Loss or the Loss of Development Opportunities, (Doha: Mimeo, 1995), in Arabic.
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12. Alia El-Mahdy, "The economic reform in Egypt after four years of implementation," in Alia El-Mahdi, ed., Aspects of Structural Adjustment in Africa and Egypt, (Cairo: Center for Developing Countries Studies, Cairo University, 1996), pp. 15-56.
13. Nazih Ayubi, "Etatisme versus privatization: The changing economic role of the state in nine Arab countries," in Heba Handoussa, ed., Economic Transition in the Middle East, Global Challenges and Adjustment Strategies, (Cairo: The American University in Cairo Press, 1997), pp. 125-166.
    The Yemeni case of economic reform began in 1995. For an assessment of its impact on Yemen, see Mohammad al-Afandi, "Economic reform program in the Republic of Yemen: An

evaluative study of the results of monetary reforms," Arab Economic Journal (Cairo), 10, winter 1997, pp. 93-128.

Session II

Transition from Authoritarianism in Egypt and the Republic of Korea

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Introduction

Does it make sense to compare political change in the Republic of Korea and Egypt? The validity of any comparison depends on the presence of some relevant common features between the units to be compared as well as significant differences related to the object of comparison. The answer to this question is therefore a positive one since the two countries share a number of features quite relevant to the study on their processes of political change. Yet they differ with regard to the distance they have traveled along the path described by political scientists as the "transition from authoritarianism."

Indeed, the two countries share highly important features in terms of their societies, histories, international status and nature of their political systems. Unlike many countries of the three continents, Korea and Egypt have highly homogeneous societies. Despite the presence of religious minorities in the two countries, such as Copts in Egypt and Christians in the Republic of Korea, such minorities share all other elements of the national culture with the rest of population and do not suffer, with few exceptions, any discrimination in terms of the law.[1] The two countries also possess an old tradition of statehood, having been united for over five millennia in the case of Egypt.[2] The two cannot be described as new states, as are many other countries of the three continents.

Though located in two different parts of the world, one in the Far East and the other in the Middle East, international rivalries and foreign intervention have cast their heavy shadows over domestic political developments of the two countries. The two opposing sides of the then bipolar international system fought one of their battles on Korean soil from 1950 to 1953. The legacy of this confrontation has been the division of Korea into two states, each siding with an opposing ideological camp. A similar confrontation also took place in the Near East, but the two superpowers of that hi-polar system fought their battles by proxy. This confrontation temporarily cost Egypt an important part of its territory, namely Sinai, between 1967 and 1982, which only able to be regained after paying a price in terms of limitations on the presence of Egyptian armed forces in Sinai and complete normalization of relations with the former enemy (i.e., Israel). National security considerations loom large over both the design of foreign policies of the two countries as well as the management of their domestic politics.[3]

Finally, and of more direct relevance to the objective of this study, the state has always enjoyed a high degree of autonomy in the two countries, with society having to acquiesce to the projects of the state. With occasional outbursts of frustration and acts of rebellion, society has never been able to establish a healthy balance with its leaders and institutions. This omnipresence of the state has been sanctioned in the two countries by a political culture described as authoritarian – for example, Pharaoh, the head of state in the hydraulic society of Egypt, had been viewed in Egyptian mythology as at least a half God

[1] Korean Overseas Information Service, A Handbook of Korea, KOIS Seoul, 8th Edition, 1990, pp. 47-49.
[2] A Handbook: Ibid, pp. 57-121, Shakhseyyat Misr, ibid, pp. 87-115.
[3] Donald Stone Macdonald, The Koreans, Contemporary Politics and Society, Westview Press, Boulder, San Francisco and Oxford, 1990, pp. 44-52.

or as Hores, the son of God, source of all good. Following the pharaonic era and until the mid-twentieth century, rulers of Egypt had been foreigners or of foreign descent, over whom the Egyptian people had no control.[4] The legacy of that ancient past did not disappear completely after the assumption of the government of their own country by native Egyptians. Anwar el Sadat, the former president of Egypt, used to call himself the last of the Pharos, implying that he was exercising an absolute power in the same way as the ancient rulers of the country.[5] The Confucian concept of authority, a fundamental component of traditional Korean culture, is definitely open to different interpretations, but it has been almost universally perceived as stressing the importance of hierarchy, deference to superiors as well as necessity of consensus.[6] An American author has enumerated elements of the Confucian concept of authority as understood by the Korean people. In this view, they include the following, among other elements.

- Loyalty of subject to the ruling person, rather than to the whole of the state
- Acceptance of the hierarchical relations among the people within the society and among the nations, so that everyone was inferior or superior to everyone else except for friends of the same age.
- A view of the ruler as responsible to heaven for the order and well-being of all aspects of his kingdom - political, economic and social – and possessing the mandate of heaven to rule so long as he fulfilled his responsibility.[7]

This autonomy of the state has been concretely manifested in the two countries after independence by the predominant role of the army in their politics. Following a brief period of civilian government, less than thirty years in Egypt and less than thirteen in the Republic of Korea (R.O.K.) young army officers with radical ideas about development seized power directly, in 1952 in Egypt and in 1961 in Korea. And although the period of full-fledged military government in the two countries has ended, the political role of the military establishment continues to be a fundamental feature of their political systems.[8]

Thus, the ruling group in both Egypt and Korea continues to be a coalition of the military and civilian technocrats, which, combined with other features of the political system, would justify describing it as bureaucratic-authoritarian, according to the perceptive, though controversial analysis of the Argentine political scientist Guillerurmo O'Donnel.[9] In Egypt, the populist phase of the military-dominated regime under Nasir was characterized by the inclusionary policies of agrarian reform, import-substitution, industrialization and a corporatist political structure. This gave way to a post-populist phase since the 1970s that was characterized by the exclusionary policies of opening up the economy to the world market, accompanied by a shift from full-fledged corporatism to what Egyptian political scientists describe as limited pluralism, with the restoration of a multi-party system and a considerable degree of respect for civil and political rights, though in a highly selective manner. Egyptian officials hoped that the new policies would enable the country attract sufficient Arab and foreign investments to enable it to

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[4] Dr. Kamal el-Monoufi, Al Thakafah al Siyasiyya lil Fallaheen al misereyyin, The Political culture of Egyptian Peasants, Dar Ibn Khaldoun, Beirut, 1980, pp. 46-156.

[5] Lutfi al-Kholi, Madrasat al-Sadat al Siyasiyya wa al Yassar al Misri, Sadat's Political Doctrine and the Egyptian Left, Kitab al-Ahali, Cairo, 1986.

[6] Wanne J. Joe, Traditional Korea, A Cultural History, Chjung'ang University Press. Seoul, 1972 pp. 87-142, 389-416.

[7] Donald Macdonald, op. cit., pp. 117-118.

[8] Ahmed Hamroush, Mujtama Abdel Nassir, Abdel Nassir's society, Cairo, Dar al-Mawqef al-Arabi 1982. pp. 271-273 Donald S. Macdonald, op. cit. pp. 138-140, 143-144.

[9] Guillermo O'Donnel, "Reflections on Patterns of Change in the Bureaucratic-Authoritarian State," Latin American Research Review, vol. 12, no. 1, 1978, pp. 3-38.

move on to the phase of deepened industrialization. Brazil, and later on Korea and other Asian Tigers, were perceived as successful models to be emulated.[10] The bureaucratic-authoritarian regime in the R.O.K. has tackled the same problem faced by its counterpart in Egypt, although it made the transition to the bureaucratic-authoritarian phase directly from a liberal regime, without passing through the populist phase as was the case in Egypt.

In fact, some of the policies of the populist phase were either adopted under the liberal regime, i.e., agrarian reform completed by 1952 under American occupation, or even under the bureaucratic-authoritarian regime itself such as import-substitution, which characterized the early five year plans of the military regime.[11]

For these reasons, the dilemma of the transition from authoritarianism is identical in the two countries. How does such transition take place under a highly autonomous state with a political system dominated by the military establishment? How profound is this transition? What are the specific problems associated with it? Although the two regimes seem to be satisfied with one answer to these questions, namely replacing the single-party system with the dominant party (called the National Democrats in Egypt or Democratic Liberals in Korea), the two regimes differ in other important respects. Fair elections, in which the government could lose the absolute majority, have become a reality in the R.O.K., an achievement that does not seem likely in Egypt at present. The Egyptian regime, on the other hand, seems more capable of finding a way to accommodate ideological divergences, including radical opposition, much more than the South Korean regime is willing to do. However, despite such similarities between the two countries, they differ enormously in other respects. South Korea has managed to make the transition from the periphery to the semi-periphery, getting very close to the center, by using the language of the dependency school. Moving from a gross domestic product of nearly US$9 billion in 1970, it has reached an astounding GDP figure of almost US$300 billion in 1992, a nearly thirty-fold increase. Comparable figures for Egypt were US$7 billion and US$34 billion, respectively, a nearly five-fold increase during the same period. Thus, the per capita income of the citizens of the two countries stood at US$6,790 for the R.O.K. in 1992 and only US$610 for Egypt, or less than one tenth of the former in the same year.[12]

In fact, the Egyptian economy has moved in the opposite direction as that of Korea during the same period, with Egypt falling from the ranks of low-middle income countries to those of low income countries. At the same time, the R.O.K. has made the transition from the company of low income countries to that of the upper-middle income group and is now closing in on the ranks of high income countries thanks to the heroic labor of her own people and the carefully designed policies of her leaders, and not to the vagaries of the world market, as was the case with some petroleum exporting countries in the Gulf region.

A process of far reaching social and perhaps also cultural change has been taking place in the R.O.K. during the last three decades, altering the social structure of the country from being predominantly poor and rural to that of an urban middle class society.

The motivation for a comparison is to discern the relevant differences between the two cases and to gauge the causes behind such differences. This is what the next two sections will purport to do.

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[10] John Waterbury, Egypt Under Nassir and Sadat, The Political Economy of Two Regimes, Princeton, Princeton University Press, 1983, pp. 57-205.
[11] Alice H. Amsden, Asia's Next Giant, South Korea and Late Industrialization, Oxford University Press, New York and Oxford, 1989.
[12] World Bank, World Development Report, 1994, Oxford University Press, New York & Oxford, 1994, pp. 162-167

CHAPTER 2

Dimensions of the Transition from Authoritarianism

Although it is difficult to define one moment in the recent history of the two countries that marks the start of a process of transition from authoritarian rule, keen observers of the political scene in both Egypt and the R.O.K. agree on one significant date for each country. 1976, the year of the first competitive elections since 1950 in Egypt, and 1987, the year of the sixth amendment to the Basic Law, which ushered in the Sixth Republic of Korea, are seen as important markers along the path of political liberalization in the two countries. The 1976 legislative election in Egypt paved the way for the promulgation of the Law on Political Parties a year later, which authorized – under relatively severe conditions – the formation of opposition political parties. The constitutional amendments of 1987 in the R.O.K. echoed demands of opposition leaders that presidential elections should be held in a direct fashion, not through an electoral college or the legislature, as was the case since 1972.[13] The two countries had been ruled by uniformed army officers in Egypt roughly between 1952 and 1956 and in the R.O.K between 1961 and 1963. Former military officers continued to occupy important government posts after these dates. It would be important, therefore, in assessing the scope of transition from authoritarian rule in the two countries to measure the movement of their political systems along two dimensions – the extent of the disengagement of the military from politics and the distance traveled by these two political systems along the path of democratization.

The following criteria can thus be proposed for assessing the entire process of transition from authoritarian rule.

1. Effective disengagement of the military from the decision-making process at both the national and provincial levels
2. The move towards democratization
   (1) Respect for civil and political rights and autonomy of civil society organizations
   (2) Political pluralism
   (3) Accountability of rulers through the presence of strong legislatures
   (4) Organization of fair elections as one method of expressing the popular will
   (5) The possibility of a peaceful transfer of power

In applying these criteria to the political systems of the two countries, an initial finding is the ambivalence of the military disengagement from politics in both countries. It is true that the military establishment, i.e., military officers in active service, was not directly involved in domestic politics and that apart from national defense issues, strictly-defined, the military of the two countries confined their activities to their professional duties within the barracks. However, it is also true that until 1992 the heads of state in the two countries were former prominent officers of the armed forces. Former army officers continue to be present among top officials of the two countries, though their numbers have decreased since the late 1960s in Egypt and since 1992 in the R.O.K. No figures are

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[13] For Egypt, Afaf L.A. Marsot, op.cit., pp. 107-146. For R.O.K., D.S. Macdonald, op. cit., pp. 56-61 and A.R. Banks, Political Handbook of the World, 1993, pp. 447-453.

available to compare the two countries in this regard. It is a safe conclusion to state, nevertheless, that former army officers are still to be found in state agencies, public corporations, regional and local administration and even among leaders of opposition parties in both Egypt and the R.O.K.[14]

However, with the election of a civilian as a head of state in the R.O.K. in December 1992, the country took several steps further in this regard than Egypt, where such development has not yet taken place.

Two major events signaled the beginning of effective disengagement of the military from direct political involvement. The military defeat of June 1967 and the serious blow it dealt to the image of the armed forces as a competent modern institution paved the way for ousting politically ambitious army officers from the public scene in Egypt. In the R.O.K., widespread protests against the continuation of a military dictatorship in 1987 paved the way for the political reforms introduced by Kim Young Sam, the first civilian head of state in the country since 1961, who aimed at curtailing the power and reducing the status of top military commanders.[15]

As for the second dimension, a similar conclusion could be reached – namely, that the two countries have made some progress along the path to democratization. But none of the aforementioned criteria have been fully met in either country, with the exception of fair elections in the case of the R.O.K. There are also considerable differences between the two countries with respect to the extent to which any of these criteria have been fulfilled.

The two countries' human rights records leave much to be desired. Prisoners of conscience and the exercise of torture on students, intellectuals and human rights activists are two major items highlighted in reports of highly credible international human rights organizations. Trade unionists figure prominently among such victims in the R.O.K. more than they do in Egypt in the last few years. However, victims of human rights violations are estimated by Amnesty International to number in the hundreds in the R.O.K. and in the thousands in the case of Egypt. The Egyptian Minister of the Interior himself admitted in the summer of 1994 that political prisoners in Egypt numbered slightly below ten thousand. Moreover, although there are indications that torture of prisoners, particularly political prisoners, was widely practiced in the two countries, police officers accused of this practice have been put on trial and condemned in the R.O.K. No such punitive action has yet to take place in Egypt.[16]

Freedom of association has been recognized by the governments of the two countries as one of the fundamental human rights guaranteed by their constitutions. This freedom is a basic prerequisite if a truly civil society is to emerge in any country. In practice, such freedom is limited in the both countries. There are several indications of the interference by Egyptian authorities in the internal affairs of professional associations and trade unions. A new labor code is currently being debated in the country, which would presumably lift many restrictions in labor laws on activities of trade unions. Such restrictions were the object of complaints by Egyptian trade unionists and critique by experts of the International Labor Organization. Professional associations, some of which have become strongholds of opposition Islamist groups, cannot entertain the hope of a more liberalized law governing their affairs as the government has imposed on them an electoral law which they have vehemently rejected. When the government realized that provisions of this law were not sufficient to ensure electoral defeat of Islamist candidates for the leading posts in councils of professional associations, it resolved to postpone such

[14] Ibid.

[15] Banks. Ibid., The World of Information, Asia & Pacific Review, The Economic and Business Report, 1991-92, pp. 97-99.

[16] Amnesty International, Amnesty International Report, 1992, A.I. Publications, London, 1992, pp. 106-108, 162-164.

elections for the time being.[17] In the R.O.K., the heaviest restrictions on associational activities fall on trade unions. A show of solidarity by workers in one factory for their striking colleagues in another factory, even in the same industry, is a strong enough reason to prosecute such workers. Relevant provisions in labor laws limit the possibility of the emergence of powerful trade unions in the country as well as the defense of the rights of several categories of workers who did not benefit much from the increased prosperity of the country.[18]

Political pluralism is another element in liberal systems that is inconceivable if freedom of association is not effectively respected. In this regard, a multi-party system does exist in the two countries, with opposition parties espousing different ideals of the political system. However, the range of ideologies articulated by political parties in Egypt is much more varied than in the R.O.K., with liberal, Islamist, nationalist and socialist views expressed mainly through opposition party newspapers. Fourteen political parties are authorized in Egypt at present. However, only five of them could count as representative of important ideological currents in the country. The ruling National Democratic Party currently stands for economic liberalism along the lines recommended by the International Monetary Fund, and follows a step-by-step approach with respect to political liberalization. In fact, it would be more correct to describe its approach with regard to the last issue as that of one-step forward, two-steps backward. The New Wadf Party stands for both the economic and political liberalism platform. The Arab Democratic Nasserist Party defends the legacy of the Nasserist period while the Tajammo' Party, or the Progressive Unionist Patriotic Rally, is led by a coalition of Nasserists, Marxists, and so called progressive Islamists.[19]

Korean political parties do not exhibit a similar variety of ideological positions. National security laws penalized the expression of socialist thought, or even certain nationalist feelings, if sympathy towards North Korea could be conceivably motivated by a wish for rapid reunification of the Korean nation. Leaders of political parties and even the political parties themselves often change their position as well as their names. The most notable ideological divergences observers could discern at the present time would be different positions on a liberal spectrum. The ruling Democratic Liberal Party takes a conservative stand on this spectrum, while both the opposition Democratic Party and the Unified People's Party take more radical stands, with the first stressing political liberalism while the second espouses economic liberalism.[20]

There are serious limitations on political pluralism in the two countries. Certain groups are not allowed by law to have authorized political parties. Those excluded from the legal arena of politics include the socialists in the Republic of Korea, and both the Islamists of the Muslim Brotherhood and the communists in Egypt. Legal restrictions on the formation of political parties based on religion or an atheist ideology did not prevent the Muslim Brotherhood or the communists from participating openly in the country's politics via other political parties. In contrast to modest moves along all these indicators, the Republic of Korea has come close to meeting the fourth criterion, namely the holding of fair elections, even under military dictatorship, and the ruling party did lose its absolute majority. President Park Chung Hee's Democratic Republican Party failed to capture the plurality of votes in the legislative election of July 6, 1978. This failure of the ruling party to get a majority of votes in the country or in the National assembly has

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[17] Egyptian Organization for Human Rights, Defa'an an Hugug al-Insan, In Defense of Human Rights, EOHR, Cairo, 1993.

[18] Amnesty International, op. cit., pp. 162-164.

[19] A profile of Egyptian political parties is to be found in Markaz al-Dirasat al-Siyasiyya wal Estratigiyya, Center for Political and Strategic Studies, Al-Tgir al-Estrategi al-'Arabi, Arab Strategic Report, MDSE, Al-Ahram, Cairo, chapters in several issues on the Egyptian political system.

[20] Banks, op. cit, Korean Overseas Information Services, op. cit., pp. 284-288.

become a familiar event since the 1980s. Roh Tae-woo, a former president, won the election of 1987 with only 35.9% of the popular vote and was able to rule thanks to divisions among opposition leaders Kim Young Sam and Kim Dae-jung, who won 27.5% and 26.5% of the popular vote, respectively. In the following legislative election in April 1988, the then ruling Democratic Justice Party captured a majority of seats (125 out of 299) and had to rely on the support of the conservative New Democratic Republican party, with its 35 seats, to get its laws approved by the National Assembly. In the last presidential election, Kim Young Sam, the candidate of the newly founded Democratic Liberal Party, won the election with only a 42% share of the popular vote. His party retains a plurality of seats in the National Assembly (149 seats).[21]

In Egypt, there have been no true elections for the president since only one candidate is presented to the electorate. The lowest share of votes obtained by a president in such referenda was 85% -- the share obtained by President Sadat in the referendum which followed the death of Nasser in November 1970. Since then, the share of votes attributed to the president was in the range of 98%. Similarly, the ruling National Democratic Party never obtained less than 69% of the popular vote (in 1987). Seats occupied by its members in the council of the people, Egypt's lower house, never fell below 79% of all seats (in 1987). The election of the National Assembly in 1984 was declared fraudulent by the judiciary in 1987. Election returns in many districts have often been contested in the courts, but court decisions have not been always accepted by the Assembly.[22] The ultimate test of genuine democratization is, however, the plausibility of a peaceful transfer of power to the opposition, if it manages to win the electoral majority. Such alternation has not taken place yet in the two countries.

It is true that the power of the national assembly over the government has been recently strengthened in the R.O.K. and it could therefore remove the prime minister in a vote of confidence.[23] Such dispute between the cabinet and the council of the people is inconceivable in Egypt since the two are represented by the same party, which has massive control over the assembly. In the unlikely case of such a dispute, the matter would be referred to the President of the Republic who could either dissolve the assembly or order resignation of the cabinet. However, the key government figure in the two countries is the President of the Republic, directly elected by the people and who cannot therefore be removed by the National Assembly. No opposition leader has ever been elected as President in the Republic of Korea.[24] Kim Young Sam, a former opposition leader was able to assume the presidency since his Unification National Party merged with both the ruling Democratic Justice Party and the New Democratic Republican Party. He contested the presidential election of December 1992 as the candidate of the ruling Democratic Liberal Party. If the different factions of the Democratic Liberal Party remain untied, the possibility of a peaceful transfer of power to the opposition through the ballot box would seem remote, at least in the foreseeable future. The merger of these three parties turned Korea toward a situation similar to that which characterized Japan for most of its post-war years, with its disparity between the ruling Liberal Democratic Party and the opposition Socialist Party. Neither the Democratic Party of Kim Dae Jung or the Unified People's Party seem to now be in a position to challenge the Democratic Liberal Party's hold over power in either the presidency or the National Assembly.

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[21] Banks Op.cit 447-49.

[22] See books ublished by the Center of political and Strategic Studies. Intkhabat Majlis al-Sha'ab, 1976, 1984, 1990. MDSS.

[23] Banks. Op.cit KOIS. Handbook. op. cit., pp.270-273.

[24] Al-Hay' Akal-'Amma Li-Sheoun Al-Matbe Al-Amiriyya. Dostour Jumhuriyyat Misr Al-'Arabiyya. Constitution of the Arab Republic of Egypt. Cairo. HASMA. 1991 article 127, pp.25-26.

CHAPTER 3

Process of Transition from Authoritarianism

Despite the fact that the criteria for a full transition from authoritarian rule, including military withdrawal from politics, are not fully met in the two countries, the R.O.K. progressed further along certain key indicators of this process – namely, fairness of elections and respect for human rights. One could also argue that peaceful transfer of power is more likely in R.O.K. than it is under the present political system of Egypt. After all, the "two Kims" together won 53% of the popular vote in the presidential election of 1987. Had they put their hands together and agreed on one single candidate for the liberal opposition in that election, it would have been possible to defeat Roh Tae-woo, the candidate of the then ruling Democratic Justice Party, and bring about a peaceful transfer of power to the opposition. Moreover, given divisions existing within the ruling Democratic Liberal Party (DLP), as well as the endemic factionalism in Korean politics, opposition parties supported by a dissident faction within the DLP may be able to capture the post of president in the future. Such a scenario does not seem likely to happen in Egypt at the current time.

How could this larger distance along the path of transition from authoritarianism by the South Korean regime be explained? Political scientists usually offer an explanation for the variation among countries in terms of levels of democratization based on three factors – namely, the level of development of socio-economic modernization, the nature of political culture, and perceptions and decisions of political leadership.

Table 3-1. Economic Development in Egypt and Korea, 1992

Country	GDP (US$ million)	Distribution of Agriculture	Gross Domestic Industry	Product % Manuf.	Serv.
Egypt	33,553	18%	30%	12%	52%
R.O.K.	296,136	8%	45%	26%	47%

Source: World Bank, World Development Report 1994, Table 3, pp. 166-167.

Table 3-2. Human Development Indicators for Egypt and Korea, 1992

Country	Rank on H.D.	Life Expectancy	Adult Literacy Rate	Mean Years of Schooling	Liter. Index	Sch. ind.k	Educ. Attain.	GDP Per Capita (US$)
R.O.K	32	70.4	96.8	9.3	0.97	0.62	2.55	6,350
Egypt	110	50.0	3.0	0.50	0.20	1.20	1.20	610

Source: UNDP Human Development Report, 1994, Table 1 & 2, pp. 130-133.

The first factor is suggested by the observation that highly developed countries in Europe, North America and Japan all have liberal political systems while nearly all authoritarian systems are found to be in the south among developing countries. The transition to freely elected governments in Eastern and Central Europe supports this observation, since these countries, despite their present economic difficulties, had achieved higher levels of socio-economic modernization under socialist regimes.

All indicators of economic development, or socio-economic modernization, show that the R.O.K. has definitely accomplished more advances than Egypt in this regard. A brief examination of the achievements of the two countries in terms of economic development and broader aspects of human development support this conclusion.

The first table shows that industry, particularly manufacturing, contributes more to the gross domestic product of Korea than it does in Egypt. The share of manufacturing in the R.O.K. is more than double that of Egypt. On the other hand, agriculture provides nearly one-fifth of Egypt's GDP, while it accounts for less than one-tenth of Korea's GDP. More importantly, with a relatively smaller population (43.7 million) the people of South Korea produce nearly nine times the volume of the Egypt's GDP, even with its larger population (54.7 million).

This gap between the two countries in terms of economic development is clearly related to human development. Life expectancy is the best summary indicator of the success of human development, which requires the basic needs of the population including decent employment and income, adequate education, health care services, food and housing. In this respect, the population of the R.O.K. lives ten years longer than the Egyptian population on average. Another vivid demonstration of the gap in human development between the two countries is the comparison of both literacy rates and mean years of schooling. Whereas illiteracy has almost disappeared in the R.O.K., which offers its population an average of nine years of schooling, half the Egyptian population is illiterate and the country is capable of offering its citizens only three years of schooling on average. With all these gaps in terms of structure of production and education, it is not surprising that per capita income in Egypt is a mere US$610.[25]

How does economic development impact the transition from authoritarianism? Two linkages between the two processes are relevant in this case. The first linkage is the emergence and empowerment of certain social groups, as a result of economic development, who would challenge the monopoly of power by the military technocratic elite of the bureaucratic-authoritarian regime. The Unified People's Party, launched by Chung Ju Yung, founder of South Korea's second largest business conglomerate Hyundai, calls for a lesser degree of government involvement in the economy and is a vivid illustration of this link between economic development and generation of pressure leading to a transition from authoritarianism.[26]

The other linkage between economic development and political change is mediated by education. The higher stage of economic development emphasizing growth of high tech industries, as is presently being experienced by South Korea, requires an educated and well-trained labor force. The nearly complete literacy of the Korean people and their impressive level of educational attainment endow them with political awareness as well as a feeling of competence, one psychological requirement for political achievement. A study of a sample of young people in the R.O.K. found a strong correlation between levels of education and political involvement. It also found a strong correlation between

[25] United Nations Development Program, Human Development Report 1994. Oxford University Press. New York and Oxford, 1994. Table 1,2,5.pp.129-139.
[26] Banks Op.cit. pp.453.

higher levels of education and liberal political attitudes, in the order of 0.40. The correlation was found to be stronger among young people. The findings of this study help explain the active role played by students in pushing forward the process of transition from authoritarianism since their repeated revolts have preceded the shift of the South Korean regime to more liberal policies as was notably the case in 1987.[27]

Education is also important in effecting changes in values that motivate people's political behavior. In this sense, the prevalence of a traditional culture perceived to be authoritarian in nature is not an insurmountable barrier against the diffusion of liberal values. More educated people would reinterpret their culture along new lines. If education is effective in transmitting new values, it could weaken the hold of certain components of the traditional culture over the minds of adherents to this culture, at least in areas that do not seem to them to be contradicting the basic tenets of this culture. Without this understanding of the role of education, it would be difficult to comprehend the process of cultural change, a phenomenon experienced in all societies.

The American scholar Samuel Huntington has also offered a culturalist explanation of manifestations in what he described as "Democracy's Third Wave" in the R.O.K. He suggested that the Third Wave occurred mostly in Christian countries or in countries where influence of Christian churches has increased, pointing not just to the strong association between Protestantism and liberal ethics, but also to changes in the outlook of the Catholic church towards democracy and social change in the wake of the Second Vatican Council between 1963-1965 and the transformation of national churches from defenders of the status quo to opponents of authoritarianism and proponents of social, economic and political reform. He supported his views in this regard by citing figures on the expansion of Christianity in the R.O.K. where adherents to Christianity increased from 1% of the total population at the end of the Second World War to nearly 25% in the 1980s, four-fifths of whom were Protestants while the others were Catholics.

The fact that Democracy's Third Wave occurred mostly in Christian and particularly Catholic countries in Latin American and Southern Europe, and given the powerful role played by the church in countries of Central and Eastern Europe in pushing for democratization, lends some support to Huntington's thesis.[28]

It is important, however, to note that Huntington did not explain the rise of the Third Wave in terms of just one variable – change of values, but rather he used five variables in total including unprecedented economic growth, role of external actors, deepening legitimacy crisis of authoritarian regimes and the "snowballing" or the demonstration effect of successful democratization in the countries that were the first to embark upon this process.[29]

During the same period, Muslim countries including Egypt have witnessed the emergence of Islamist movements as principal actors on their political scene. However, the so-called Islamic resurgence was not associated by renewed emphasis on the compatibility between Islam and a democratic political system. Democracy was denounced by some spokesmen of Islamist movements as one manifestation of Western cultural imperialism to be rejected together with other Western institutions.[30] As for Huntington, he did not see such incompatibility between Islam and the emergence of a democratic political system but suggested that pursuit of socio-economic modernization

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[27] Aie-Rie Lee, "Cultural Shift and Popular Protest in South Korea," Comparative Political Studies, Vol. 26, no.1, pp. 63-80.

[28] Samuel P.Huntington, The Third Wave, Democratization in the Late Twentieth Century, University of Oklahoma Press, Norman and London, 1991, pp. 72-84.

[29] Ibid., pp. 40-46.

[30] For a survey of Islamist movements see Shireen Huntered, The Politics of Islamic Revivalism, Indiana University Press, Bloomington and Indianapolis, 1988.

in some Arab countries would bring them closer to a transition from authoritarianism.[31]

Finally, transition from authoritarianism also owes much to beliefs, perception and decisions of political leaders. In 1981, President Husny Mubarak of Egypt could have decided to pursue the same harsh authoritarian policies that characterized the last years of his predecessor's rule. Roh Tae-woo could have decided also in 1987 to reject demands of opposition leaders for constitutional amendments providing for direct election of the president. However, in these two cases, both opted for a more liberal approach. It is true that they were faced by a situation in which pursuit of harsh authoritarian policies would have required a heavy price in terms of repression of the opposition. It was to their credit that they decided to save their countries from paying such a price. The important difference between the two countries in this regard was the high level of mass mobilization in the R.O.K., particularly among students, in the name of democracy. Now such mass mobilization is taking place in Egypt, and whatever pressures President Mubarak was subject to during his thirteen years of rule were not exercised in the name of democracy, but rather in the name of the establishment of an Islamic political order with no specific place for democracy. It is for this reason that Egyptian leaders do not feel any pressure to pursue any transition along the path of democratization at the present time.

[31] S. Huntington, op. cit., pp. 307-311.

CHAPTER 4

Conclusion

Despite a considerable degree of political liberalization in both Egypt and the Republic of Korea during the last decade, their two regimes continue to share one important feature with all bureaucratic-authoritarian regimes – namely, the exclusion of the so-called “popular sectors” made up of lower-middle class people, the working class, and the urban and rural poor, This exclusion is manifested in the two countries by restrictions on activities of trade unions and the effective ban on political parties that could express the aspirations of at least segments of these sectors such as socialist organizations in the R.O.K. and Islamist organizations in Egypt.

The two regimes are currently under pressure to maintain their exclusionary policies toward these sectors. Concerned with not losing its competitive edge vis-a-vis newly industrialized countries of East and South-East Asia, albeit with their much lower levels of wages, the South Korean regime is reluctant to make the economic and political concessions, without which the integration of the popular sector into the arena of organized policies would be meaningless. The Egyptian regime, on the other hand has to apply a package of economic measures recommended by international financial institutions in the name of structural adjustment, whose major burden lies squarely on the shoulders of salaried and wage workers as well as the urban and rural poor.

Frustration of the popular sector in Egypt is expressed indirectly via the Islamist movement, which is legally banned, though its peaceful activities are ill accommodated within the present political structures of the country.

The process of political liberalization in the two countries has stopped short of ensuring peaceful alternation of power to opposition groups. However, under these restrictions imposed on representatives of the “popular sectors,” any transfer of power would be to the benefit of another segment of the economic and social elite of the two countries, and therefore would not amount to a genuine democratization of the political system.

Failure to resolve this dilemma has produced a “crisis of legitimacy” in the two countries, manifested in low turnout rates in elections, and may lead segments of the opposition to resort to radical activities through mass protests by students and workers in the R.O.K. and armed struggles by certain factions within the Islamist movement in Egypt. Unless the causes of this crisis of legitimacy are addressed, political stability of the two regimes will continue to be an open question in the near future.

Session II-I

The Causes and Consequences of Korean Economic Crisis*

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CHAPTER 1

Introduction

Korea's international competitiveness began to deteriorate in the early 1990s due to the amassed structural deficiencies within the Korean economy. A major shock to the Korean economy occurred as a result of a term of trade shock in 1996. The terms of trade deteriorated by approximately 20 percent in the 1996-97 period, the largest drop since the first oil shock of 1974-75. The terms of trade shock put extremely heavy pressure on the thin profit margins of firms.

Another big shock to the Korean economy occurred with the bankruptcy of Hanbo Group in January 1997. Four others of the thirty largest chaebols also went bankrupt in 1997: Sammi, Jinro, Haitai and New-Core Groups. The failure of these chaebols revealed problems with low profitability and excessive leverage ratios in the corporate sector and faulty corporate governance in Korea.

Foreign investors had already become increasingly skeptical of the government's willingness and ability to implement economic reforms and serious structural adjustment. In addition, the unanticipated intensity and power of contagion, first from Thailand and then Indonesia, came to bear its effects on Korea. This contagion coincided with a period of structural adjustments as well as a cyclical downturn in the Korean economy.

In November 1997, less than a year after its accession to the OECD, Korea experienced a severe financial crisis. With its useable foreign exchange reserves nearly exhausted, the Korean government formally requested assistance from the International Monetary Fund to mitigate the external liquidity shortage and regain the confidence of international investors.

A complicated and often opaque combination of macroeconomic distortions and financial fragility were at the core of the economic crisis in Korea. These include an inefficient and distorted financial sector, weak supervision and prudential regulation, and a corporate sector burdened with high levels of short-term debt.

In the financial sector, structural defects were deeply rooted and endemic as a result of the extensive use of credit restrictions as a primary tool of economic development in the past. Protracted periods of interest rate control and selective credit allocations gave rise to an inefficient distribution of funds. Short-term foreign debt of financial institutions increased significantly to finance the strong investment demand of the corporate sector as the economy entered a boom in 1994.

Since December 1997, the nation has embarked on a comprehensive program for economic reform and recovery, which is already producing fruitful results in terms of rectifying the causes of the crisis.

CHAPTER 2

Economic Crisis

1. Development of the Economic Crisis

1-1. Weak Banking System

There was evidence of deterioration in the balance sheets of Korea's commercial banks up to four years before the crisis. In 1997, however, this trend took a turn for the worse, as can be seen in Table 1

Table 1 Non-Performing Loans of Commercial Banks

(Ratio to Total Loans, %)

	1994	1995	1996	1997	1998	Sept. 1999
NPL Ratio	5.6	5.2	3.9	5.8	7.4	6.2

Source: Financial Supervision Information, Vol. 99, No. 4, Financial Supervisory Service, March, 1999.
Note: 1) End-1996 figures on include the Housing and Commercial Bank,
whereas end-1997 figures and on include the Long-term Credit Bank
and not the five closed banks and include.
2) Non-Performing Loans (NPL) = Substandard + Estimated Loss + Doubtful.

As a result of a series of large corporate bankruptcies that year, there was a rapid increase in non-performing loans among Korea's banks and merchant banking corporations, which, in turn, destabilized the financial market and made Korea exceptionally vulnerable to a currency crisis. Strong depreciation pressure on the Korean won began to develop in the foreign exchange market in September 1997. The government and the Bank of Korea, however, made a futile attempt to defend the currency by selling U.S. dollars and purchasing won in the foreign exchange market. In November 1997, the foreign exchange authorities abandoned this operation in favor of widening the daily fluctuation bandwidth to 10 percent from 2.25 percent.

In November and December of 1997, Korean banks and merchant banking corporations (MBCs) experienced a large-scale run by foreign creditors. Many merchant banking corporations heavily mismatched foreign currency denominated assets and liability positions. Fifteen merchant banking corporations were suspended in December 1997, and thirteen of them were closed in early 1998. Also, the government intervened and rescued two troubled banks (Seoul Bank and Korea First Bank) in December 1997.

In 1997, the Korean won depreciated sharply -- as much as 50 percent against the U.S. dollar. The Korean stock price index (KOSPI) plunged 42 percent to 390 in December from 669 in January 1997. Market interest rates surged with the sharp fall in currency value and the yield on three-year corporate bonds reached 24.3 percent in December 1997.

1-2. Deficits in Balance of Payments

The current account deficit recorded US$23.0 billion (4.9 percent of GDP) in 1996 and decreased to US$8.2 billion in 1997. The real effective exchange rate had been below 100 for the period from the first quarter of 1995 to the first quarter of 1997, indicating overvaluation of the won[1] (Figure 1). In Korea, the real effective exchange rate tends to lead the current account balance by two to three quarters. The current account deficit was reduced in 1997 as the real effective exchange rate rose to the 100 level during the period.

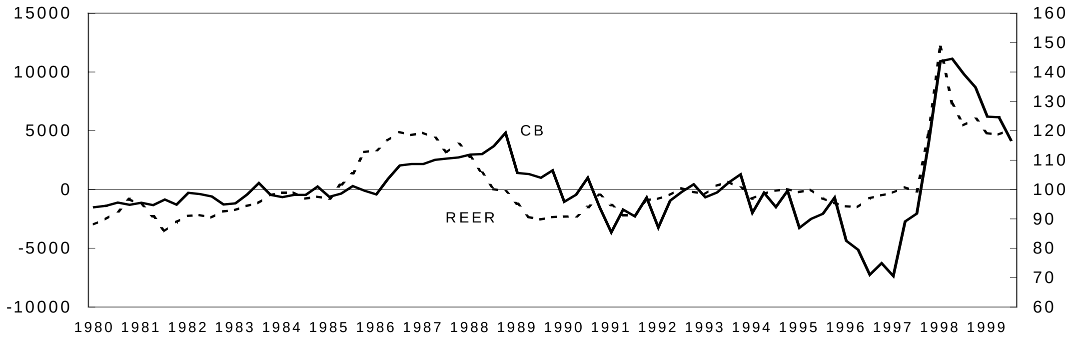
The Korean economy was severely hit by unfavorable external shocks in 1996. The terms of trade deteriorated approximately 20 percent in 1996. It was the largest external shock since the first oil shock of 1974 in Korea. International prices of major export goods such as semi-conductor chips, steel and chemical products dropped considerably in 1996. For example, the unit price of the semi-conductor chip fell by more than 70 percent in 1996.

Continued intervention by the Bank of Korea in the foreign exchange market depleted a significant portion of the country's official foreign reserves. Foreign investors became increasingly concerned about Korea's ability to service huge short-term foreign debts.

Total external debt had been increasing rapidly since 1994 with comprehensive financial deregulation and liberalization of capital controls. Most of the increase in Korea's foreign debt was due to a substantial surge in borrowings from the international capital market by big business groups and financial institutions to finance their investments. The rapid increase in short-term external debt, in particular, was an ominous signal to a possible external liquidity problem in the near future. The share of short-term debt to total external debt reached 58 percent at the end of 1996.

Disruptions in financial markets occurred in the last quarter of 1997. The pattern of rising interest rates and a declining stock price index in the midst of an increase in the number of default incidences had already been in place as early as September. Interest rates jumped to an unprecedented level in December, while credit flows to the non-financial sector was abruptly interrupted. Both of these events led the ratio of dishonored bills to reach 2.09 percent in December 1997, while the stock price index plunged to 390.3, down from 494.1 in November 1997.

Figure 1 Real Effective Exchange Rates and Current Account Balance



[1]) The real effective exchange rate was constructed against currencies of major trading partners eight by relative trading volumes. The index value equals 100 for the base year 1993, when the current count was nearly balanced.

1-3. Growth in Foreign Debt

The external liquidity ratio (ELR), which assesses the ability of the economy to repay the external debts, jumped to 922.4 percent in 1997 from 342.3 percent in 1996 (Table 2).

External Liquidity Ratio =
(Short-term External Debt + Current Account Deficit) / Foreign Currency Reserves.

Table 2 External Liquidity Ratio [1)]

(unit: %)

	1995	1996	1997	1998	1999	2000	2001
External Liquidity Ratio	259.9	342.3	922.4	- [2)]	17.7	34.5	31.5

Note: 1) Calculated as (short-term external debt + current account deficit) / useable foreign currency reserve.
2) The surplus in the current account of US$40.6 billion in 1998 exceeded the short-term external debt of US$30.7 billion.
Source: Bank of Korea, BOK Information, March 1999.

Figure 2 Trends in Terms of Trade

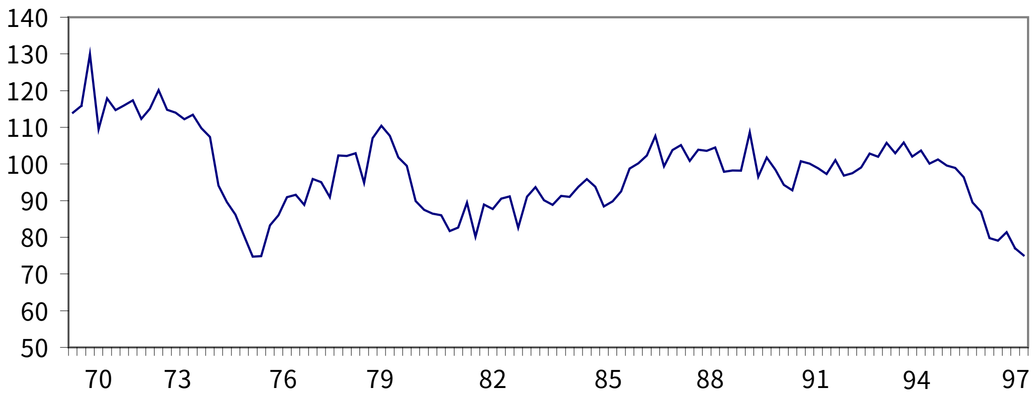


Table 3 Korea's Total External Liabilities

(US$100 million)

	End '97	End '98	End-Dec. 2000	End-Dec. 2001	End-Nov. 2002
LONG-TERM LIABILITIES (I+II+III)	956	1,180	838	778	786
I. PUBLIC SECTOR	223	365	283	208	193
II. FINANCIAL SECTOR (A+B)	475	520	508	450	537
A. DOMESTIC FINANCIAL INSTITUTIONS	703	571	378	333	361
B. BRANCHES OF FOREIGN BANKS	196	139	130	117	176
III. PRIVATE SECTOR	471	412	526	530	574
SHORT-TERM LIABILITIES (I+II)	636 (39.9%)	307 (20.6%)	479 (36.3%)	410 (34.5%)	519 (39.8%)
I. FINANCIAL SECTOR (A+B)	424	189	257	222	179
A. DOMESTIC FINANCIAL INSTITUTIONS	272	113	153	131	340
B. BRANCHES OF FOREIGN BANKS	152	76	104	91	145
II. PRIVATE SECTOR	212	118	222	188	195
TOTAL EXTERNAL LIABILITIES	1,592 (100.0)	1,487 (100.0)	1,317 (100.0)	1,188 (100.0)	1,305 (100.0)
TOTAL EXTERNAL ASSETS	1,052	1,285	1,647	1,654	1,816
NET EXTERNAL ASSETS	-540	-202	330	466	511

1-4. Corporate Failures

Firms depended heavily on external borrowings to finance investments and other expenditures. The debt / equity ratio of the 30 largest business groups is higher than that of manufacturing industries (Table 4).

Table 4 Debt/Equity Ratios of 30 Largest Business Groups

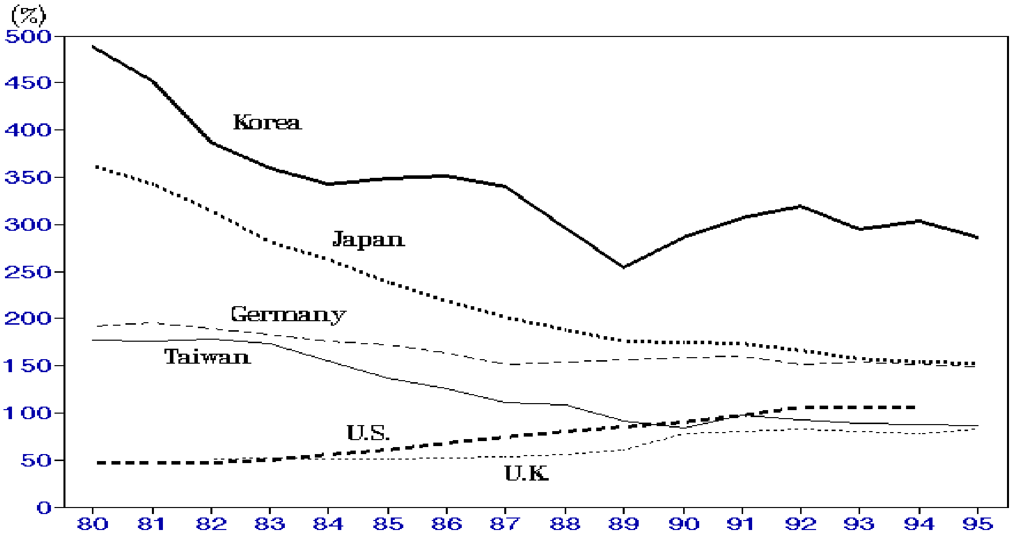
(unit: %)

	1996	1997	1998	1999	2000	2001	2002
All Corporations	335.6	-	-	-	-	-	-
Manufacturing Industries	-	396.3	303.0	214.7	210.6	182.2	135.6
30 Largest Business Groups	386.7	502.9	369.1	-	-	-	-

Source: Bank of Korea, Financial Statement Analysis for 1997.
Fair Trade Commission, Financial Structure of Business Groups, 1997.
Financial Supervisory Board, Press Release, 1999.

Korea's financial crisis originates not only from cyclical downturns but also from structural deficiencies and delayed policy responses. As the Korean economy slid toward a stage of slower economic growth in recent years, firms had to change their business strategies from being volume-oriented to profit-oriented. Recent successive failures of large business firms revealed, however, that many firms including big business groups neglected or failed to undertake restructuring efforts in the rapidly changing economic environment. Faced with slower economic growth, it was particularly important that big business groups reduce excess capacity and their high debt leverages.

Figure 3 International Comparison of Debt/Equity Ratio (%)



Note: 1) Korea, Japan, Taiwan : Debt / equity ratios of manufacturing industries.

Investors as well as lenders failed to subject investment decisions to a true market test or due diligence. Many commercial banks and merchant banks extended asset-based lending to large business groups without prudent and proper credit assessment, presumably based on the "too-big-to-fail" argument, while profitability of the corporate sector was declining. The number of firms filing for bankruptcy surged from 11,589 in 1996 to 22,828 in 1998.

CHAPTER 3

Resolution of the Economic Crisis

1. Facilitation of External Financing

In resolving the financial crisis, external financing has been one of the most pressing issues for Korea. Therefore, one of the primary goals of the government has been to encourage the flow of foreign capital into Korea. The Korean government and the IMF agreed on a financial aid package on December 3, 1997. The IMF, the World Bank and ADB promised to provide US$21 billion, US$10 billion and US$4 billion, respectively. The combined total of financial assistance received by Korea was US$16.1 billion and US$12.6 billion in 1997 and 1998, respectively, from the IMF, IBRD, and ADB. Improvements in the roll-over of credit and the opening of new lines of credit by some commercial bank creditors have also been effective in halting outflows of foreign capital, thus helping to stabilize the Won's currency value.

Korea's short-term debt difficulties have been further ameliorated by the New York agreement in January 1998, where a total of US$21.74 billion in short-term debt of Korean banks was refinanced and converted into medium-term debt with a maturity of one to three years. In the first week of April 1998, the Korean government successfully reentered the international capital market by issuing sovereign global bonds worth US$4 billion.

Table 5 Balance of Payments

(unit: US$ billion)

	1996	1997	1998	1999	2000	2001
1. Current Account	-23.01	-8.17	40.56	24.48	12.24	8.62
Goods Account	-14.97	-3.18	41.63	28.37	16.87	13.39
Services Account	-6.18	-3.20	0.63	-0.65	-2.89	-3.53
Income Account	-1.82	-2.45	-5.05	-5.16	-2.42	-0.89
Current Transfers	-0.05	0.67	3.35	1.92	0.68	-0.36
2. Capital Account	23.33	1.31	-3.25	2.04	12.11	-3.58
3. Increase in Reserves	(1.39)	(-11.92)	(30.98)	(22.98)	(23.77)	(-7.71)
4. Error & Omissions	(-1.07)	(5.07)	(6.33)	(-3.53)	(-0.58)	(2.68)

Source: Bank of Korea.

Table 6 Foreign Currency Reserve Balance

(unit: US$100 million)

	End-Dec. '97	End-Jun. '98	End-Dec. '98	End-Dec. '99	End-Dec. 2000	End-Dec. 2001	End-Dec. 2002
Foreign Currency Reserve balance (A)	204.1	409.0	520.4	-	-	-	-
Holdings of Korean Banks' overseas Branches (B)	113.3	36.6	33.3	-	-	-	-
Others (C)	2.0	2.0	2.0	-	-	-	-
Usable foreign Currency reserve A- (B+C)	88.7	370.4	485.1	740.5	962.0	1,028.2	1,214.3

Source: The Bank of Korea

Korea's current account balance has improved substantially. The current account surplus was recorded as US$40.6 billion and US$25.0 billion in 1998 and 1999, respectively. The current account surplus, coupled with portfolio capital inflows and the improved rollover of current bank credit, has significantly expanded the usable foreign exchange reserves as shown in Table 6.

2. Market Opening and Capital Market Liberalization

The government's schedule of capital market liberalization has been drastically accelerated. The direct borrowings of the corporate sector and foreign equity participation have been substantially liberalized.

The new market-opening measures include the complete removal of investment ceilings and restrictions on foreign investment in the bond and equity markets. In 1998, short-term money market instruments, such as CDs and RPs, were also opened to foreign investment, and the money market was fully liberalized. Hostile takeovers by foreigners were allowed so as to encourage the development of Korea's market for mergers and acquisitions (M&A).

In addition, the Korean government has taken significant steps to accelerate the liberalization of foreign exchange transactions. Through legal enactment in September 1998, the Foreign Exchange Management Act was replaced by the new Foreign Exchange Transaction Act. The primary objectives of this new act centered on fully liberalizing the capital account and developing the foreign exchange market. The first round of liberalization measures in the new act took effect on April 1, 1999, and the second round took effect by the end of 2000.

3. Reforming the Financial Sector

3-1. Legal and Institutional Framework

Prior to the crisis, the Korean government was already aware of the need to undertake reform in the economy. In September 1997, legislative measures were prepared for strengthening the function of the central bank and financial supervisory bodies. It was not until after Korea signed the bailout agreement with the IMF in December 1997, however, that the National assembly passed 15 financial reform bills, embodying a wide spectrum of measures to transform the institutional and regulatory basis of the financial system. The aim has been to move toward an efficient market-based financial service industry that is in line with accepted best practice in major financial system.

The reform bills included an amendment to the Bank of Korea Act. The objective of the central bank was solely defined as maintaining price stability. In view of the financial crisis as well as the government's program for carrying out financial reform, it was crucial for the central bank to be better equipped to maintain a stable currency value. To this end, the independence of the Monetary Board, the supreme policy-making body of the Bank of Korea, was significantly strengthened.

The prudential supervision standards themselves were also strengthened to fully meet the Basle Committee's 25 core principles of banking supervision. The National Assembly enacted the Financial Industry Structure Improvement Act (FISIA) in 1997, and stipulated the prompt corrective action provisions in the FISIA. The FISIA links the intensity of supervision to the capitalization of banks. Although the ladder of graduated responses is based on the Basle capital adequacy ratios for credit risk, it has the potential to enhance the credibility of regulatory intervention.

Prompt corrective action reduces the likelihood that a failing financial institution will engage in risky and potentially expensive gambles for redemption if it is permitted to continue in business. The regulatory authorities could build up a reputation for tough supervision by acting promptly and stringently in any case of financial problems. This would appropriately influence any expectations of the financial market.

The accounting and disclosure standards have been upgraded by redesigning the accounting system of banks to meet the best international practices. An important step in upgrading supervision was the introduction of the mark-to-market accounting system, which values securities at fair market prices at the time of financial reporting. Financial institutions will be required to comply with the disclosure requirements of the International Accounting Standards (IAS) regarding off-balance sheet transactions, including derivatives, asset classification and special disclosure items. The frequency of regular disclosure has been increased from once to twice a year; quarterly disclosure has been required of banks since September 1999, and was required of the listed and registered companies beginning in 2000.

3-2. Consolidation of the Financial Supervision System

Also among the financial reform bills was the Act on the Consolidation of Financial Supervisory Agencies. In April 1998, a consolidated independent financial supervisory agency, the Financial Supervisory Commission (FSC), was launched under the Prime Minister's Office to ensure an effective supervisory system that was more closely in line with universal banking practices. The FSC acts as a financial safety device by enforcing prompt corrective action and prudent portfolio management by financial institutions. In addition, the FSC oversees the Financial Supervisory Service (FSS), which was established in January 1999 as a consolidation of four different supervisory institutions. The

Securities and Futures Commission (SFC) was also established to oversee market practices, including those connected with securities and exchange-trade derivatives.

3-3. Restructuring of the Financial Sector

Due to high interest rates and the severe recession, about 3,000 firms filed for bankruptcy every month in the first half of 1998. As a result, the flow of bank credit came to a virtual stop. The dishonored bill ratio jumped to 1.49% in December 1997. The dishonored bills ratio declined to around the 0.4% to 0.6% level during the first half of 1998, and then tapered off to 0.20% in November 1998.

Table 7 Number of Bankrupt Companies and Dishonored Bill Ratios

(unit: %, billion won)

	1990	1993	1995	1996	1997	1998	1999	2000
Number of Bankruptcies	4,107 (-)	9,502 (6)	13,992 (5)	11,589 (7)	17,168 (58)	22,828 (39)	6,718 (· ·)	6,693 (· ·)
Dishonored Bills Ratio	0.04	0.13	0.17	0.14	0.40	0.38	0.33	0.26

Note: Figures in parentheses denote numbers of bankrupt large enterprises.
Source: The Bank of Korea.

Yet the credit crunch problem could not be resolved without first promptly addressing the issue of insolvency of the financial institutions themselves. Any delays in financial sector restructuring would undermine the soundness of the whole banking system, which, in turn, could lead to serious damage to the fundamental economic base of the nation.

It is generally considered important that a financial crisis be resolved quickly to minimize the adverse effects that ensue from distorted incentives due to insolvency problems. Depending on the nature of the crisis, authorities can apply a number of selected support measures. In the case of the financial crisis in Korea, which was characterized by widespread insolvency problems, a more active role of the government has been required.

On April 14, 1998, the Korean government announced a basic plan for financial sector restructuring with the objective of rebuilding a competitive and sound financial system. The restructuring plan has been pursued in two phases, with priority placed first on the banking sector, followed by non-bank financial institutions.

The government has provided fiscal support to help financial restructuring, in particular for: (1) the disposal of non-performing loans (NPLs); (2) recapitalization of viable financial institutions; and (3) depositor protection and pay-outs to depositors in the process of closing non-viable financial institutions. Further deterioration of the financial system has been prevented by applying appropriate, prompt and corrective actions. For viable financial institutions, incentives have been provided, such as allowing a broader business scope, to encourage voluntary mergers. Financial institutions have also been encouraged to raise new capital through foreign capital inducement.

With regard to the actual strategy for financial restructuring, the government formulated a detailed plan to facilitate financial institutions' restructuring and financing means of fiscal support. This has involved the establishment of a new institution, the Korea Asset Management Corporation (KAMCO), modeled after the Resolution Trust Corporation in the United States. KAMCO purchases non-performing assets at estimated market prices through public bond issues. KAMCO has played a critical role by ensuring that the resolution of non-performing loans operates under an explicit mandate, that impaired assets are resolved as quickly as possible, and that the process runs consistent with high rates of asset recovery.

Through KAMCO, the government set up the special Bad Debt Resolution Fund to finance the operation, and then expanded its size to 20.5 trillion won to expedite the settlement of bad debts by issuing bonds and asset-backed securities and selling real estate. The Korea Deposit Insurance Corporation (KDIC), also newly established, covers any shortfalls in the net worth of transferred assets and liabilities, also through the issuance of public bonds. In both cases, the government has provided a guarantee on the bond issues and is lending interest costs.

To support the disposal of NPLs and the recapitalization of viable institutions, the government mobilized fiscal resources in the amount of 50 trillion won. Including those bonds already issued, the total amount of government-guaranteed bonds reached 64 trillion won, 14.2% of 1998 GDP (449.5 trillion won). Of this total, 20.5 trillion won was directed toward the purchase of non-performing loans by KAMCO, while 43.5 trillion won was set aside for recapitalization and depositor protection through KDIC. An additional 29.7 trillion won in public funds was injected into financial institutions in 1999.

Table 8 Breakdown of Public Fund Used in Financial Restructuring : by Financial Institutions Supported (Nov. 1997 - Mar. 2002)

(unit: trillion won)

	Equity Participation	Contri-butions	Insurance Claim Payments	Purchase of Assets	Purchase of Distressed Assets	Total
Banks	33.9	13.6	-	14.0	24.5	26.0
NBFIs	26.3	2.8	26.0	0.9	11.9	67.9
Securities Companies Investment Trust Companies Insurance Companies Merchant Banking Corporations Mutual Savings Banks Credit Unions	7.7 15.9 2.7 - -	- 2.7 - 0.1 -	0.01 - 17.2 6.6 2.2	- 0.3 - 0.6 -	8.3 1.8 1.6 0.2 -	16.0 20.7 21.5 7.5 2.2
Overseas Financial Institutions	-	-	-	-	2.3	2.3
Total	60.2	16.4	26.0	14.9	38.7	156.2

Source: Public Fund Management Committee, Ministry of Finance and Economy, White Paper on Public Fund, 2001.

3-4. Foreign Direct Investment

The government has also taken steps to facilitate foreign direct investment. In November 1998, the government enacted the Foreign Investment Promotion Act (FIPA) in order to remold completely the legal basis for making foreign direct investments into Korea, such that their previous regulatory and administrative nature was changed to a promotion and support-oriented system. As for the acquisition of land and facilities, virtually all restrictions have been lifted so as to guarantee national treatment to non-residents. The previous positive list system for businesses open to foreign entry was changed to a negative list system in May 1998.

The government vigorously encouraged inflows of foreign direct investment and reduced remaining legal restrictions. Consequently, annual inflows of foreign direct investment rose from US$3.2 billion in 1996 to over US$15 billion in both 1999 and 2000, as shown in Table 9. In 2001, however, FDI decreased by 24.4 percent. FDI rose considerably from 1.46 percent of the GDP in 1997 to 3.42 percent of the GDP in 2000. The rise in FDI was significant in the service sector including financial businesses.

Table 9 Annual Foreign Direct Investment Trends

(unit:US$ million, %)

	1995	1996	1997	1998	1999	2000	2001
Investment Amount	1,941	3,203	6,971	8,852	15,541	15,690	11,870
(Rate of Increase)	(47.4)	(65.0)	(117.6)	(27.0)	(75.6)	(1.0)	(-24.4)

Note: Figures in parentheses are compared to the previous year

CHAPTER 4

Social Welfare and Social Safety Nets

1. Income inequality and Poverty

1-1. Income Inequality

The economic crisis has affected income distribution through various channels. An increase in unemployment resulted in many households without labor earnings, worsening the overall size distribution of income. In addition, wages declined substantially among those with jobs. The decline in labor earnings due to increased unemployment and reduced wages widened the income gap between wage earners and asset holders. Moreover, as the change in labor demand is reflected not only in employment changes but also relative wage structures, the incomes of those who remained employed were unevenly affected. Production workers and laborers were most affected by the crisis in terms of decline in wages. In addition, young workers and less educated workers were affected more adversely than older and more educated workers, increasing the age differential and therefore inequality.

These factors contributed to the deterioration of labor earnings inequality in the labor market and reversed the past trend of narrowing wage differentials between skilled and unskilled labor, between the less educated and the highly educated, and between men and women. Moreover, mostly small- and medium-size firms went bankrupt, and the labor demand in the SME sector has declined quite rapidly. The corporate sector restructuring pursued by the government mainly targeted larger firms with huge bad debts, but the credit crunch during the process hurt smaller firms more. Furthermore, the income gap widened even further as wealthier households benefited from high interest rates, which reached an annual rate of nearly 30 percent in early 1998.

So far the only available statistical data on changes in income distribution is the urban workers' household income and expenditure survey reported monthly by the National Statistical Office. Income inequality increased sharply since the outbreak of the crisis. During the first quarter of 1998, households belonging to the first and ninth decile experienced a reduction in average income compared to a year ago, and the degree of reduction gets larger as the income level decreases. The income share of the bottom 20 percent of the households surveyed, most of which comprise less educated and unskilled production workers, declined to 7.2 percent compared to 7.9 percent a year ago. This implies that the poor and the nearly poor were affected most severely by the crisis through wage reductions and increased job instability.

In contrast, the average income of the top 10 percent of households actually rose by 3.2 percent during the same period. As the market interest rate was extremely high during the first quarter of 1998, this rise in income was mainly attributable to the increased return from their financial assets. Consequently, the economic crisis deteriorated income distribution to a substantial degree by severely affecting the poor while increasing the income of the richest. The Gini coefficient rose from 0.3005 to 0.3222 during the same period.

The distribution of income among urban workers' households deteriorated further by the third quarter of 1998 as the unprecedented economic contraction continued. The income of the lowest decile declined by 22.0 percent compared to the prior year, while households in the top tenth decile experienced a 3.6 percent decrease on average. Accordingly, the Gini coefficient rose further to 0.3238 from 0.2873 the year before.

1-2. Poverty

Measuring poverty is difficult since there is no unanimously set criteria for determining who is poor, and the amount of absolute poverty may vary depending on the definition of the poverty line. Nevertheless, there is no doubt that the abrupt rise in unemployment and decline in real wages (especially among low income groups), caused by a prolonged economic contraction and increased layoffs, have resulted in a rapid increase in the number of those living in absolute poverty. Reduction in overall income level and the deterioration of income distribution acted together to increase substantially not only the number of urban poor but also the severity of poverty. The crisis is probably the biggest setback for poverty reduction progress during the last 30 years of economic development.

2. Government Responses

Since the outbreak of the economic crisis, the Korean government has initiated policy measures to mitigate the deleterious social consequences. Main emphasis was placed on protecting the unemployed and the poor by providing them with temporary relief programs and by strengthening the social safety nets. These include, among others, expansion of unemployment insurance, temporary aid programs, and reform of the livelihood protection program.

2-1. Unemployment Insurance

Unemployment insurance, which was first introduced in 1995, underwent a series of expansions after the crisis. Initially covering firms with more than 30 regular employees, it was expanded to cover companies with more than 10 regular employees in January 1998, and firms with more than five regular employees as of March 1998. From October 1998, all workplaces including firms with less than five regular employees and temporary/part-time workers became eligible for unemployment insurance. The minimum benefits were raised as well to a level of 70 percent of minimum wages. In addition, the minimum benefit period was doubled to 60 days in 1998, and a longer duration for benefits will be offered when unemployment exceeds a certain level.

Due to the expansion of the coverage, the number of insured firms rapidly increased from 47,000 in 1997 to 309,000 in November 1998. The number of beneficiaries also rose significantly in 1998 due to both the increased layoffs and the expanded coverage. In 1998, it is estimated that a total of 0.8 trillion won was paid to 441,000 people in unemployment benefits. As benefit payments increased substantially, it was necessary to raise the contribution rate from 0.6 percent of wages to 1 percent of wages, divided equally between employer and employee, since January 1999. As of June 1999, the ratio of unemployment benefits recipients to the total number of unemployed stood at 13 percent.

2-2. Public Works

Public works programs are very effective means of providing temporary income support to the unemployed without distorting their work incentives since workers are paid for their productive work. As the unemployment rate soared in early 1998, the government implemented a wide variety of public works programs for the poor unemployed who were not eligible for unemployment benefits. Local governments provided temporary jobs for the unemployed in their respective regions, which included street cleaning, traffic control, parking guides, forest conservation, etc.

In 1998, a total of about one trillion Korean won was allocated for public works programs, and about 438,000 people participated in these programs. The government increased the budget allocation to 2 trillion Korean won to provide work opportunities to 400,000 participants in 1999 as the unemployment situation was expected to worsen. In addition to public works programs, separate work projects were implemented for the elderly and women who are unable to perform hard labor. Projects by local governments such as environmental protection programs were carried out with a budget of 40 billion Korean won in 1998, with 40,000 people participating for 6 months.

2-3. Legislation of the Minimum Living Standards Security Act

The Minimum Living Standards Security Act (MLSSA) was legislated in August 1999 in response to social demand for reform of the former Livelihood Protection Act. Passage of the reform act marked a transformation in the direction of welfare policies from a policy of simple giving of alms, as provided by the Livelihood Protection Act, to a policy stressing national responsibility based on the rights of welfare recipients. Starting from October 2000, the government ensures that basic needs, including food, clothing, housing, education, and healthcare, are met for all people living below minimum living standards. In other words, all households, whose incomes do not meet the minimum cost of living, will receive welfare benefits from the government that equal the difference.

MLSSA laid a firm foundation for a more systematic social safety net by encompassing all those who need livelihood protection. The current temporary assistance programs for the unemployed will be phased out and integrated into this new program. With the enforcement of MLSSA on October 1, 2000, coverage guaranteeing subsistence living standards will be expanded to 1.54 million beneficiaries (about 3.3 percent of the total population), compared to 0.54 million in 1999. The maximum benefits will also be raised from 178,000 Korean won to 205,000 Korean won per person. The government estimates that the new program will cost 1,298 billion Korean won in 2000.

CHAPTER 5

Concluding Remarks

The Korean experience reveals that if economic incentives are distorted by policy measures and by the inherent structure of the financial sector, then a negative shock may put the stability of the financial system at risk. In the absence of strengthened prudential banking supervision, these incentives coupled with expectations of government intervention in the event of a crisis induced many banks and merchant banking corporations to expand their credit excessively and thus led to a loss of efficiency in the allocation of capital. It is also evident that policy-makers did not take sufficient measures to minimize the adjustment costs in the aftermath of the financial deregulation. The authorities failed to tighten prudential bank regulation and to establish an adequate supervisory framework.

Thanks to the appropriate policy responses for rectifying the causes of the economic crisis, Korea has accomplished remarkable progress in many critical areas. Korea turned the economic crisis into an opportunity to remold the basic underpinnings of its economy. Korea's comprehensive series of reforms have been directed toward firmly establishing market principles.

The following lessons can be learned from Korea's dealing with economic crisis. Korea's recent experiences demonstrate the importance of decisive restructuring efforts based on social cohesion. The speedy containment of systemic risk and the domestic credit crunch problem with the injection of large public funds for bank recapitalization was a critical step toward normalizing the financial system and market.

Despite its fast recovery and brightened economic picture, Korea is far from adopting a complacent stance. A wide range of structural reforms is required to revitalize the Korean economy as a whole. The most important decisions involve measures to rehabilitate the commercial banking system. Banks operating on market principles are vital to a modern market economy. The ultimate goal of bank rehabilitation is the emergence of viable banks that can play an active role in credit allocation and exercise discipline over the corporate sector[2]. The privatization of commercial banks and the development of a market-oriented financial system should be a priority.

There is also need for reform in the capital markets. Now that numerous firms are faced with a compelling need to expand their equity base, the equity market will have to take on a more active role in corporate finance and monitoring. One of the factors that contributed to the financial crisis was the weak development of a direct financing mechanism. The investor base in the stock market was not deep enough to facilitate active equity issues by domestic companies, hindering the companies' improvement of the financial structure.

It will be important to successfully conclude economic restructuring. Successful restructuring will increase the amount of public expenditures that can be recuperated[3]. Corporate restructuring should be promoted, in part through permitting non-viable firms

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[2]) OECD, *OECD* Economic Surveys: Korea 1998, p.81.

[3]) OECD, "Economic Surveys of Korea," August 2001, Republic of Korea Economic Bulletin , Ministry of Finance and Economy and KDI, Vol.23 No.8, August 2001, pp.40-41.

to exit. Restructuring of a big business group like Daewoo Group has not been and will not be an easy task.

Restoring flexibility in the labor market is critical to the successful restructuring of businesses and financial institutions. However, the restructuring process and the improvement of labor flexibility will bring about social tension and resistance. Continued improvement of the social safety net is needed to facilitate financial and corporate restructuring. Swiftly implementing restructuring policies, safeguarding stability in the financial market, and prescribing the right macroeconomic policy mix are major challenges to Korean policy-makers.

The reform measures taken so far have been limited largely to the institutional level, and have been driven by the government. Korea's next task is to extend the government-driven reform to self-generating reforms by the private sector.[4] Business practices and people's way of thinking has not fundamentally changed yet. Continued progress in upgrading factor-market flexibility and implementing reforms in key sectors is prerequisite to the success of the new market-oriented framework.

[4] Ministry and Finance and Economy, G-20 Report: Korea's Crisis Resolution and Its Policy Implications, Final Draft, December 1999, p.59.

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Session II-II

Corporate Restructuring and Governance Reform in Korea

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CHAPTER 1

Introduction

The corporate sector deficiency was blamed as one of the main causes of the Korean economic crisis. In this respect, the Korean government has been undergoing major reforms in corporate governance, finance and investment behavior since these three elements are closely interlinked.

The purpose of this paper is to briefly review the major characteristics of the Korean corporate financial and investment behaviors and their financial performance. The paper will try to link these characteristics with the agency-theoretic view of incentive problem in corporate governance.

After a brief summary of Korea's corporate restructuring and governance reform efforts thus far, the remaining issues with regards to corporate governance will be further discussed.

CHAPTER 2

Corporate Finance, Investment and Performance of Korean Firms

The major cause of Korea's corporate crisis has its deep root in the fragile capital structure, inefficient investments, and poor financial performance of the corporate sector. However, we can find fundamental weakness in corporate governance as the underlying cause of corporate sector deficiency in Korea.

1. High Growth, Excessive Debt, and High Financial Risk.

The Korean economy had shown rapid growth, at a rate of over 8% in real terms, since the early 1960s. At the same time, the Korean manufacturing sector had grown in its assets size at the rate of 22.3% during 1971-1997.[1)]

The investments for the super-growth of the business sector were backed through heavy external debt financing. The short-term borrowings took the lion's share in total debts. Table-1 clearly shows the heavy reliance on debt by Korean firms.

The excessive financial leverage of Korean firms was cited as a main cause of the Korean economic crisis and it led to the massive bankruptcy of a large number of firms, including many conglomerates in Korea.

Table 1 Debt/Equity Ratios of Korean Firms (%)

	1985	1990	1995	1996	1997
Manufacturing sector	349	286	287	317	396
Top 30 Chaebols	383	343	348	-	519
Jinro*	-	-	-	3,756	-
Hanra*	-	-	-	2,066	-
New Core Dep’t Store*	-	-	-	1,226	-

* These are examples of the firms that went bankrupt in recent years.

[1)] The nominal growth rate of corporate assets for Japan was 7.6% during the 1971-90 period and 14.5% for Taiwan. For USA and Germany, the growth rates were 8.1% and 5.2%, respectively, during 1981-1990. This comparison clearly shows the super high growth of the Korean manufacturing sector in the past.

2. Poor Financial Performance of Korean Firms

The EVA (economic value added) is defined as operating profit less the cost of all the capital employed to produce these earnings. The EVA is considered as a true measure of corporate performance[2)]

According to estimations by the Korea Stock Exchange (KSE), the Korean manufacturing industry recorded a significant negative EVA for many years. As shown in the following Table 2, the firms included in the study recorded negative EVAs on average for the years 1992, 1993, 1996, 1997, 2000 and 2001.

More surprisingly, even in the years when the average EVA was positive, only about one third of the sample firms earned positive EVAs. For the year 2000, for example, the total EVA of 468 firms in the sample was –1,775.4 billion won (approximately -$379 million), and –3.8 billion won (-$3.2 million) per firm on average. Only 38 percent of the sample firms earned a positive EVA in the year 2000.

This indicates that most of the public companies earn rates of return that are less than the firm's cost of capital[3]. For example, while the weighted average cost of capital (WACC) in 1999 was 10.0%, the average manufacturing firms in Korea earned only 9.2% gross rate of return on their capital investments. Thus the Korean firms have been earning substantially negative net return from their businesses.

2) The EVA tells us whether the return on invested capital (ROIC) is higher than the weighted average cost of capital (WACC). Its magnitude shows whether a firm is managed profitably or efficiently. More specifically, EVA is defined as EVA = (rate of return - cost of capital) x invested capital.

3) See Table 2 for the comparison of the weighted average cost of capital (WACC) and the return on invested capital (ROIC).

Table 2 EVA of Korean Listed Firms

(unit: billion won, percent)

	Total EVA	Average EVA	Percentage of Firms with Positive EVA	Return on Invested Capital	Weighted Average Cost of Capital (WACC)
1992	-563.8	-1.1	35.4	10.2	n.a.
1993	-507.4	-1.0	33.9	10.7	n.a.
1994	358.9	0.7	31.1	9.9	n.a.
1995	1,595.8	2.9	29.1	9.6	n.a.
1996	-2,785.1	-5.0	29.1	8.1	n.a.
1997	-14,666.8	-28.3	20.1	5.0	n.a.
1998	2,565.2	5.2	33.5	9.8	n.a.
1999	1,177.3	2.5	39.5	9.2	10.0
2000	-1,775.4	-3.8	38.0	8.2	9.5
2001	-570.6	-1.2	45.8	7.4	7.9

Source: Korea Stock Exchange

3. Low Efficiency of Corporate Resources

The Korean manufacturing sector showed a decreasing trend in the sales / assets ratio or assets turnover ratio. This indicates how efficiently the firm employs its resources. Korea's asset utilization ratio of the manufacturing sector was the lowest compared with companies in the US, Japan, or Germany (see Table 3). While the assets turnover ratios of these countries are higher than 1.0, the Korean ratio is declining to below 1.0 (to around 0.9 recently). In comparison, the ratio is 1.5 for Germany.

Table 3 Productivity of Corporate Resources

Manufacturing Sector	Korea ('90-95)	Korea ('96-'99)	USA ('90-98)	Japan ('90-'98)	Germany ('93-'96)
Assets Turnover Ratio (Sales / Total Assets, %)	0.98	0.87	1.07	1.09	1.50

This low productivity of corporate assets reflects not only inefficient use of corporate resources in projects with low returns, it also shows the tunneling (or transfer) of corporate assets to affiliate companies or for private use by the controlling owners / managers.

As a matter of fact, the portion of "investments and other assets"[4] in the assets side of the balance sheet of Korean manufacturing sector was 14.9% as of 1996. This indicates the wide spread practice of tunneling corporate assets in the past from one company to another within a conglomerate business group (*chaebol* in Korean)[5].

The high growth of the Korean corporate sector in the past four decades was supported by the massive input on their financial resources. Thanks to the continued "input-driven" growth strategy, Korea could have achieved a remarkable advancement in the major industrial sectors competing in the world markets.

However, as the growth was not sustainable due to the poor financial performance, the Korean corporations and the nation's economy as a whole had to go under the major readjustment process in 1997.

4. Widespread Practices of Mutual Loan Guarantees

Since the loan guarantee is a contingent liability, it incurs an implicit cost to the guarantors[6]. In most cases, however, loan guarantees were provided without any guarantee fees or compensation paid to the guarantors. Therefore, a loan guarantee was a useful indirect way of transferring corporate wealth of the guarantor company to the guarantee recipient.

Thanks to the virtually unchecked loan guarantee practices of the chaebols, they were able to successfully obtain massive loans from the banks, and consequently they had excessively high leverage. Table 4 shows the debt to equity ratios and the relative magnitude of loan guarantee to total equity of the conglomerate groups that went bankrupt during the crises.

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4) The major portion of this item on the corporate balance sheet represents investments in the affiliate firms and lending to the owner, managers or employees of the firm.

5) Through the wide spread practice of share-cross-holdings among affiliate companies of chaebols, each member company holds substantial amount of investment account in its balance sheet, inflating the size of the equity capital of chaebols.

6) The cost of loan guarantees to the guarantor is the expected value of the payment the guarantor has to make to the creditor when the guarantee (the borrower) defaults and fails to meet the debt obligation. Therefore, the guarantee cost is a function of the bankruptcy probability of the borrower and the size of debt payment by the guarantor. In return for providing a guarantee and thus undertaking the contingent liability, as a general rule, the guarantor should generally be paid guarantee fees. Guarantees without reward reduce the wealth of the guarantor and increase the wealth of the beneficiary of the guarantee. See Young Ki Lee, Geumyung hyoyulwhareul wihan jigub bojungui habrijok unyong (Policy proposal for effective use of loan guarantees), Policy Study Series 2000-03, KDI, 2000.

Table 4 Financial Leverage and Loan Guarantee of Failed chaebols

(unit:%)

	Hanbo	Sammi	Jinro	Kia
Debt/Equity Ratio	675	3,244	3,746	517
Loan Guarantees / Total Equity Capital	309	741	473	111

The prevailing practice of mutual loan guarantees in the past was a useful way for chaebols to mobilize bank loans and transfer corporate wealth from one company to another. While the controlling shareholders would benefit from such deals, outside shareholders, creditors and even employees of the guarantors had to suffer from serious (and real) potential loss of wealth.

No directors, shareholders or even creditors of the guarantor company paid due attention to the loan guarantees until the contingent liabilities became realized when the guaranteed affiliate company went bankrupt.

CHAPTER 3

Link between Corporate Governance, Finance and Investment Behaviors, and Performance

Conventional finance textbooks tell us that maximizing the firm value is the prime objective of the corporate manager. In the real world, however, this may not be always true. Managerial decision-makings on corporate financing and investments may not always be aimed at increasing the firm value.

How corporate decisions are made is closely linked with the corporate governance structure. I.e., depending on who controls the firm, corporate strategic and operational decisions can be seriously affected.

Jensen and Meckling[7] focused on the agency cost of a firm due to the separation of ownership and management. The divergence of interests or conflict of interests between managers and shareholders has a significant impact on the firm's choice of financing, investments, and performance.[8]

In an ideal world of symmetric information, aligned interests between managers and shareholders, and no transaction costs, there would be no serious agency problem. However, in the real world, theses assumptions are violated when the interests of the principal and the agent diverge. Managers, or the agent of the shareholders in the principal-agent framework of interest conflicts, do not always make corporate decisions that maximize the share values of their companies.

By understanding that managerial incentives can differ from those of shareholders, and by identifying the resulting deficiencies in corporate management in Korea, we will be able to define more clearly the scope and area on which the good governance should focus to correct such deficiencies.

1. Managerial Incentive and Capital Structure

The Modigliani and Miller proposition of capital structure irrelevance indicates that under simplifying assumptions of no tax and no bankruptcy costs, changes in the leverage do not affect the value of the firm[9].

With the corporate income tax introduced, however, the corporate value increases with a greater use of debt, which generates a benefit through an interest tax shield. More use of debt will also increase the cash availability of the company, which will enhance the manager’s discretionary power in corporate management. However, the high leverage will raise the bankruptcy probability.

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7) Michael Jensen and William Meckling, "Theory of the Firm; Managerial Behavior, Agency Costs, and Capital Structure," The Journal of Financial Economics, 1976

8) The conflict of interest does not only exist between shareholders and managers, but also between such diverse corporate stakeholders as shareholders, large shareholders, small shareholders, debt holders, managers, employees, customers, suppliers, the government, and the community.

9) Modigliani, Franco, and Merton Miller, “The Cost of Capital, Corporate Finance and the Theory of Investment,” American Economic Review, June 1958.

Therefore, managers will try to balance the benefit of debt in terms of increased cash availability with the cost associated with debt especially in terms of increased probability of bankruptcy.

Managers, without a substantial portion of equity shares of the company, may prefer a less than optimal level of debt because additional debt would increase the risk of bankruptcy and limit the managers' discretionary power with larger free cash flow.

However, the existence of manager-cum-controlling shareholders will affect the firm's financing behavior and capital structure. Shareholders have the incentive to increase the firm's leverage in comparison with the level preferred by managers.

Therefore, firms tend to be more highly leveraged if they are managed by the major controlling shareholders, who have a strong incentive in improving share value through the tax shield of interest payments. Firms will also have more debt if they are monitored by large shareholders who have such interests.[10)]

The existence of controlling shareholders in Korean firms, the conglomerate network nature of the Korean chaebols, which increases the firm's debt capacity risk shifting and risk pooling among the affiliate firms, and the weak monitoring role of lenders, might have contributed to their heavy reliance on debt relative to US firms.

An interesting study on the relationship between corporate governance and firm's financing behavior in Asian countries shows that firms with weaker corporate governance will tend to be more indebted. This correlation turned out to be stronger when country-level institutions protecting investors are weaker. The weakness in corporate governance and the excessively leveraged capital structure contributed to the crisis.[11)]

2. Managerial Control and Distortions in Investment Choices

In the principal-agent framework of corporation with separated ownership and management, the managers have an incentive to maximize the benefits associated with the allocation of corporate resources and the selection of investment projects.

With a different incentive structure, managers' discretionary decision-makings may seriously depart from those that would best fit shareholders' interests. Examples of such manager's discretionary decision making for their own benefits include[12)].

Managers may prefer to build a large and diversified corporate empire, not only to reduce bankruptcy probability through diversification and thus the risk of unemployment, but also to maximize the salary and the social prestige of CEO of a large firm as well.

Managers may opt to take on investment projects even with negative net present value (NPV) when such projects are seen as providing job security for the managers. For example, managers have a tendency to choose projects for which they have a particular expertise, so that they become indispensable to the company in the future.

Managers (or the controlling shareholders in case of Korean chaebols) show a tendency towards investing in business areas related to the managers' personal interests or benefits.

Managers with short time horizons (in terms of retirement age or performance based

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10) Mehran, Hamid, "Executive Incentive Plans, Corporate Control, and Capital Structure," Journal of Financial and Quantitative Analysis, December, 1992

11) O E. Friedman, S. Johnson, and T. Mitton, "Corporate Governance and Corporate Debt in Asian Crisis Countries," in Korean Crisis and Recovery, ed. by D. T. Coe and S. J. Kim, IMF and KIEP, 2002

12) For further discussions, see Grinblatt, M. and S. Titman, Financial Markets and Corporate Strategy, 2nd ed. McGraw Hill, 2002.

compensation) will have incentive to choose projects with shorter payback period even if these projects are expected to generate low or even negative NPV.

3. Free Cash Flow Theory and the Incentive Problem

Managers in mature industries have a tendency to hoard capital and to reinvest corporate earnings in less profitable projects rather than paying them out to shareholders.

Michael Jensen's free cash flow (FCF) theory[13] can explain the expansion of the US leveraged buyouts in the 1980s. According to the FCF theory, highly leveraged acquisitions of companies were adding value to the firm by squeezing excess cash out of firms with few profitable growth opportunities and putting the money into the newly acquired businesses with better prospects.

The use of debt rather than equity may lessen the free cash flow problem by converting discretionary dividend payments into fixed amounts of interest and principal payments to the creditors and thus reducing the aggregate cash available for the managers.

In this respect, the massive substitution of debt for equity during the active leveraged buyout in the US in the 1980s helped reduce management's discretionary use of free cash flow and thus mitigated the agency problem.[14]

How would this theory apply to Korean firms? The very low level of dividend payments of Korean firms reflects the managerial incentive to maximize free cash flow for expansionary investments during the super growth period of the Korean economy.

In a sense, the excessive leverage of Korean firms of around 400% of the debt to equity ratio before the crisis might have helped to discipline the manager (controlling owner of Korean firms) by reducing free cash flow.

The debt/equity ratios of the Korean manufacturing sector have shown a substantial decline in recent periods,[15] and the trend for slower growth of both the nation’s economy and the corporate sector alike seems likely to persist in the future.[16] This may have a significant impact not only on the corporate financial and investment pattern but also on the corporate governance framework.

With the slow growth of the economy and the corporate sector, firms will require less capital. Especially for mature industries, the size of free cash flow will increase substantially due to low capital needs. The increased free cash flow of the corporate sector in Korea in the future will create a serious FCF problem as witnessed in the American and Japanese firms.

4. The Monitoring Role of Creditors

The free-rider problem keeps minority investors (outside shareholders and bondholders) from conducting proper monitoring of management. In general, however, creditors such as banks have an incentive to closely monitor their borrowers to ensure the full recovery of their loans. Bank lending in this regard has the advantage of serving an

[13]) Michael Jensen, "The Agency Cost of Free Cash Flow; Corporate Finance and Takeovers," American Economic Review, 1986

[14]) The Link Between Capital Structure and Shareholder Value, in Discussing the Revolution in Corporate Governance, ed. By D. H. Chew, Blackwell, 1998

[15]) The leverage ratio came down to about 130% this year.

[16]) Korea Development Institute (KDI) predicts that the potential growth rate of Korea’s GDP will be about 4.8% per year for the next decade until 2012, substantially lower from 7.8 % during the past 4 decades. This trend of slower growth is expected to continue in the long run.

effective monitoring function. Therefore, the existence of such creditors helps reduce the free-rider problem in corporate monitoring.[17]

The monitoring of management by creditors also reduces the asset substitution problem.[18] However, if the influence of creditors is much stronger than that of equity holders, management may choose projects with lower risk at a cost to equity holders' wealth.

The main banks in Korea,[19] however, have failed to carry out their monitoring role. Both the existence of controlling shareholders in Korean firms and the weak monitoring role by creditor banks have helped promote Korean chaebols' aggressive or speculative projects with massive debt financing.

The disciplinary power of debt was significantly lessened because the creditors were lenient in their role to monitor the borrowers. The disciplinary power of debt further weakened because the myth of "too-big-to-fail" prevailed and, accordingly, the government had frequently stepped in to rescue troubled firms in financial distress.

As Jensen argues, while the use of more debt among US companies may help discipline corporate managers by reducing free cash flows, the use of debt in Korea increased discretionary power of the owner/manager, thanks to the weak monitoring role of the creditors and the "too big to fail" myth.

The lack of incentives for banks to monitor the borrowers and the "too big to fail" myth have a common root in the implicit government insurance of the financial institutions and big chaebols. In this respect, one can find the root of the deficiency of the Korean corporate and financial sectors in the long history of the government's deep involvement in the market.

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17) The main bank in the Japanese keiretsu system is seen to be a good way to monitor member firms in the absence of a well functioning capital market.

18) The asset substitution problem addresses the incentive of a corporation to choose risky projects that transfer wealth from debt holders to equity holders.

19) The main bank is the lead creditor bank.

CHAPTER 4

Korea's Corporate Sector Reform after Economic Crisis

1. Major Goals of Corporate Restructuring

Right after the outbreak of the economic crisis in December 1997, the new government requested (or, according to official terms, "made an agreement with") the top 30 conglomerate business groups (*chaebol* in Korean) to reform the corporate sector.

The Korean government set five major goals for corporate reform in order to cope with the economic crisis. The reform policy was aimed at establishing an economic environment compatible with market principles and at enhancing the standards of business practices in financing, investment and corporate governance to global standards.

The five major goals of corporate reform were:

- Transparency of corporate management
- Elimination of cross-loan guarantees
- Improving capital structure
- Concentration of chaebol on core businesses
- Enhancing accountability of controlling shareholders and managers.

In addition, the government revised legal arrangements for bankruptcy and corporate reorganization procedures.

2. Strengthening Corporate Transparency Requirement

In order to enhance the transparency of corporate management and to prevent the opportunistic behavior by controlling shareholders (the chaebol owners) in which they exploit corporate assets for their own benefit to the detriment of outside investors, new rules were introduced for all listed companies to set up an independent nomination committee of outside auditors (as of April '98).

In addition, since 1999, the top 30 largest chaebols were subjected to produce combined financial statements for their conglomerate group.

3. Improvement of Corporate Capital Structure

Various measures have been taken in an effort to reduce excessive financial leverage in the corporate sector. First, the affiliates firms of top 30 chaebols were required to reduce their debt to equity ratios to 200% by the end of 1999.

To force corporations to improve their capital structures, the government introduced a limit on the interest tax deduction on corporate income. Under the new ceiling, the government allows debt up to three times of the company's equity capital to be eligible for deductions of interest expenses from its income for tax purpose[20].

To support the corporate effort for capital structure improvement, the government provided tax incentives by exempting the firm from any tax obligations when the firm sold its assets, or when the controlling shareholders raised personal assets to pay back the company's debt.

4. Restriction of Cross Loan Guarantees

Effective since April 1984, loan guarantees among affiliate companies within a chaebol were prohibited, while all existing loan guarantees were ordered cleared by March 2000.

5. Concentrating on the Cre Businesses

In order to curb the chaebols from expanding their business operations into a wide variety of business areas, Korean government implemented an informal policy called "big deal" by forcing the chaebols to swap their business lines among them. For example, a leading semiconductor company of one chaebol was allegedly forced, indirectly by the government, to sell off the business to its competing company.

Out of the 9 big deals attempted, including the example of the semiconductor companies, 7 deals were completed by the end of December 1999. However, since the reshuffling of the business lines among the chaebol were not supported by market principles or reasoning, the big deal has been blamed as a case of government intervention in the market.

6. Restructuring Financially Distressed Firms

The main creditor banks were responsible for restructuring financially distressed borrowing firms based on the evaluation of their long-run viability. Using the projected business viability and debt service capability, the borrowers were classified into different classes: bank-initiated workouts, sell-offs, court-ordered liquidations, compositions, or receiverships.

Of the 324 firms belonging to the top 15 chaebols or to medium-sized firms, 76 were placed under the workout program for recovery from financial distress, with concession in interest payment, and/or with a dept-to-equity swap under a stringent condition of "self-help effort" of the firm and its controlling shareholders[21]. Another 249 firms were forced to sell-off their businesses, liquidated, merged, or placed under court receivership.

In August 1999, the affiliates of the Daewoo group (one of the top 5 leading chaebol in Korea) firms were put under the workout program. In May 2000, a serious liquidity crisis hit the Hyundai Group (another leading chaebol). The group was ultimately forced to dissolve into smaller groups to be eligible for debt restructuring, including debt-to-equity swap and interest payment concession.

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20) The limit on the maximum debt eligible for interest tax deductions was initially set to 500% of the company's equity capital from the year 2000. The limit was reduced, however, to 400% since 2001, and then to 300%, effective from 2003.

21) By the end of June 1999, the total number of small- and medium-sized firms that were put under the bank-initiated workout program was expanded to 277 due to the increasing number of financially troubled firms.

7. Measures to Facilitate Corporate Restructuring Efforts

Various measures have been provided or newly introduced to speed up corporate restructuring. Table 5 shows Korea's strenuous efforts to carry out economic restructuring as speedy and efficiently as possible.

Table 5 Schemes to Facilitate Corporate Restructuring

Schemes or Acts	Date
REVISION OF BANKRUPTCY ACT	Feb. 1998
INTRODUCTION OF WORKOUT PROGRAMS	June 1998
INTRODUCTION OF ASSETS-BACK SECURITIES	Sept. 1998
INTRODUCTION OF CORPORATE RESTRUCTURING FUNDS	Sept. 1998
INTRODUCTION OF MORTGAGE-BACKED SECURITIES	Jan. 1999
REVISION OF KAMCO* ACT	Dec. 1999
REVISION OF BANKRUPTCY ACT	Jan. 2000
INTRODUCTION OF CBO* FUNDS	Aug. 2000
ESTABLISHMENT OF CRVS	Oct. 2000
ESTABLISHMENT OF M & A FUNDS	Dec. 2000

* KAMCO: Korea Assets Management Corporation
CBO: Collateralized bond obligations

By allowing the establishment of corporate restructuring vehicles (CRVs) in October 2000, the government expected to facilitate and to increase the efficiency of corporate restructuring, since CRVs could take over the nonperforming loans in the form of debt claims or equities of insolvent borrowers, and professionally manage the troubled firms for quick recovery.

The government introduced the "Law to Promote Corporate Restructuring" in September 2000 to provide support for large firms with more than 50 billion won in bank debt. When the credit bank consortiums found firms that were financially troubled in the short-run, but viable in the longer-run, they would restructure their loans and place the firms under bank-initiated management.

8. Financial Restructuring with Public Funds

Most importantly, the massive injection of public funds (about 157 trillion won altogether since the outbreak of the crisis) to restructure the failed banks and other financial institutions in Korea has helped financial institutions such as creditor banks be aggressively involved in the bank-centered corporate restructurings of troubled private companies.

CHAPTER 5

Major Characteristics of Korean Corporate Governance Reform

With the problems inherent in the corporate governance structure and practices recognized as a main cause of the deficiencies in the corporate sectors, the governance reform in Korea was initiated before the outbreak of the economic crisis at the end of 1997. In early 1996, the Korean government put forth a series of policy actions reshaping the legal settings[22].

Although the initial efforts for governance reform in Korea had faced strong resistance from the business sector, the outbreak of the crisis in 1997 enhanced the importance of good corporate governance and thus accelerated the speed of the governance reform. As a matter of fact, the package requested by the IMF for corporate governance reform in Korea was greatly in line with the reform package Korea had been pursuing until then.[23]

Korea's reform for better corporate governance covers the measures aimed at enhancing corporate transparency and strengthening the internal monitoring mechanism and market discipline. The reform measures included the introduction of an outside director system, selection of auditors independently from the controlling shareholders, stricter disclosure requirement, enhancement of minority shareholders' rights, and liberalized M&A market to strengthen market discipline.

1. Enhancing Corporate Transparency

To reduce the information asymmetry between management and outside investors, major changes have been made in the accounting and disclosure requirements for corporations.

Korea's financial accounting practices were revised to meet international standards. Companies listed on the stock exchange and those registered with the KOSDAQ (Korean NASDAQ) are now required to file quarterly financial statements.

Since 2001, asset revaluation practices for the purpose of inflation adjustment have been prohibited. Chaebols had to produce combined financial statements since 1999 in order to provide investors with comprehensive corporate information on their affiliate companies as a whole.

The corporate disclosure requirements were strengthened: forward-looking information, such as corporate strategies, future risk factors, and business project evaluations are to be included in the regular financial statements, registration statements, prospectuses, etc.

Timely disclosure of information on investments or loan guarantees to affiliate

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[22]) For further discussions on the background of the corporate governance reform in Korea, see Young Ki Lee, “Corporate Governance: The Structure and Issues in Korea,” in Korea’s Choices in Global Competition and Cooperation, East-West Center, University of Hawaii, July 1995. and Young Ki Lee, Global gyongjeng sidae ui hanguk giop soyu jibae gujo (in Korean), KDI, April, 1996.

[23]) Korea’s governance reform is also in line with the OECD guidelines on corporate governance.

companies, as well as on business transactions with controlling shareholders is also required. Effective April 1999, the penalties for unfaithful or fraudulent disclosure or external auditing were raised substantially.[24)]

Recently, the government put forth a new proposal to enhance the credibility of corporate financial reports. The proposal requires chief executive officers (CEOs) and chief financial officers (CFOs) to personally attest to the accuracy of their financial reports beginning in 2003[25)].

In addition, civil liability will be imposed on majority shareholders as well as CEOs and CFOs in an attempt to secure accounting transparency. In order to enhance the independence of external audits, accounting firms will be barred, according to the proposal, from assuming the dual roles of auditing and consulting

2. Strengthening Market Disciplines

The Commercial Code was amended in 1998 to promote M&A market in Korea by making M&A procedures easier and by shortening the appeal period for mergers from two months to one month.

In line with this goal, the requirement for mandatory tender offers has also been eliminated. Previously, if an outsider intended to purchase more than 20% of the outstanding shares of a company, more than 50% of those outstanding shares needed to be purchased through a tender offer.

Along with liberalized M&A regulations, the restriction on corporate share repurchases was lifted. A corporation may now buy back equity shares equaling the amount of earnings available for the dividend payout.

Hostile takeovers by foreigners have been fully liberalized since 1998 after the requirement for obtaining approval from the company board of directors was abolished.

3. Strengthening the internal control and monitoring system

The role of the board of directors has been strengthened and expanded as of February 1998. Starting in 1999, at least one-quarter of the board members for listed companies were required to be composed of outside directors. The rule was later revised to require companies listed in the stock exchange or in KOSDAQ with assets size of more than two trillion won to have a number of outside directors that comprises more than 50% of the total board members.

The Financial Supervisory Commission (FSC) of Korea required that large financial institutions have outside directors comprising over half of the total number of directors in their boards (with a minimum of three outside directors).

To guarantee their independence, outside directors cannot represent the controlling shareholders or managers, or anyone affiliated with them. The role and power of outside directors was strengthened to carry out the function as a check and balance mechanism

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[24)] Under such new legal framework, a number of external auditors and managers were indicted and/or jailed for unfaithful or fraudulent accounting.

[25)] This proposal is similar to the US Sarbane-Oxley Act to improve credibility of corporate information.

for management[26].

Cumulative voting system was introduced in the commercial codes to facilitate the election of board members representing minority shareholders. However, as firms are allowed to exclude the cumulative voting system in their company charters, only a few companies chose the system in which minority shareholders can easily elect their representatives to the board.

The independence of auditors for all listed companies and the affiliate companies of the top 30 business conglomerates has been enhanced. Large companies with more than 2 trillion won of assets must have an audit committee, which must be chaired by an independent outside director.

Effective 1998, external auditors must be chosen by an independent selection committee consisting of internal auditors, outside directors, large creditors and the two largest non-controlling shareholders.

4. Strengthening Management Accountability

In 1998, the legal liabilities of the controlling holders were strengthened to increase their accountability when they are involved in management in any form.

To improve the management accountability, the obligations of de facto directors will be placed in the hands of the controlling shareholders. In the financial sector, there have been recent court rulings against misdeeds of the managers of banks.

5. Strengthening Minority Shareholders’ Rights

As of April 1998, the minimum shareholding requirements to exercise shareholders' rights, such as the right to file derivative suits, to request dismissal of directors and internal auditors, to review accounting books, or to call for a general shareholders meeting (GSM), were drastically reduced.

For example, according to the Securities and Exchange Act, minority shareholders previously had to hold at least 1% of the total shares outstanding to file a derivative suit against loss caused by mismanagement. This requirement was lowered to 0.01%[27]. Additionally, minority shareholders now have the right to propose the agenda for GSMs. (see Table 6)

Steps have also been made to enhance the monitoring role of institutional investors. Traditionally, institutional investors in Korea were banned from exercising their voting power in the general shareholders' meetings.

Instead, institutional investors were allowed only to exercise voting rights in neutral ways so that they should not influence the voting by other shareholders, except in the case of mergers and business transfers.

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[26]) One episode: A newly elected outside director of a chaebol company was visited by a company manager and was asked to sign a document to approve a proposal to invest 60 billion won (US$50 million) of funds to an affiliate company of the group. The outside director asked why the company should invest that amount and what the expected return from the investment would be. He also proposed that the matter be discussed at the board meeting. The company manager seemed quite surprised to see such a rejection from the outside director to an investment proposal that had been directed by the group chairman (the controlling owner). Prior to the outside director system, the board, which was composed of the members promoted internally, would have rubber-stamped such a proposal without giving it any due consideration.

[27]) For financial institutions, the minimum shareholding requirement for derivative suit is set at 0.005%.

Table 6 Minimum Requirements of Shareholdings

(percent of the total outstanding voting shares)

Types of shareholders' right	Commercial Codes		Securities and Exchange Act	
	Before	Revised	Before	Revised
– TO FILE DERIVATIVE SUITS	5.0	1.0	1.0 (0.5)	0.01
– TO REQUEST DISMISSAL OF DIRECTORS OR INTERNAL AUDITORS	5.0	3.0	1.0 (0.5)	0.5 (0.25)
– TO REQUEST FOR INJUNCTION AGAINST DIRECTORS' ILLEGAL ACTIONS	5.0	1.0	1.0 (0.5)	0.5 (0.25)
– TO REVIEW ACCOUNTING BOOKS	5.0	3.0	3.0 (1.5)	1.0 (0.5)
– TO CALL FOR GSM	5.0	3.0	3.0 (1.5)	3.0 (1.5)
– TO PROPOSE AGENDA FOR GSM	–	3.0	–	1.0 (0.5)

* The Codes and the Act were revised during 1997-1998.

However, since the institutional investors are growing larger and more sophisticated, their role as monitors of corporate management have become more important. Therefore, institutional investors have been allowed to exercise their voting rights since 1998. Effective since that year, banks are allowed to exercise voting privileges for the shares in their trust accounts.

6. Liberalization of Foreign Equity Ownership

In December 1997, the ceiling on foreign equity ownership was raised from 26% to 55% of total shares outstanding. This ceiling was completely eliminated in May 1998.

The requirement that foreigners had to obtain board approval if they wanted to own more than one-third of the outstanding shares was eliminated. The remaining restrictions on M&As by foreigners were completely lifted in 1998.

With their increased equity participation in Korean companies, foreign investors will have a greater voice in demanding improvements in transparency and governance practices, while their participation in corporate boards will increase. This will have a great impact on the way the Korean corporate governance is practiced in the future.

7. Other Reform Measures

In order to facilitate the restructuring of Korean chaebols, the Korean government revoked the previous legal restriction with regard to holding companies, which had been prohibited in the past. Consequently, a number of financial as well as non-financial holding companies have been established in Korea.

Additional measures are currently in the process of being adopted. For example, the class action suit is currently a hot issue of debate. The business sector is strongly against the introduction of class action suits while the proponents for better corporate governance are pressing the government for laws in favor of the class action suit.

While the class action suit should be favorably considered to effectively protect investors, appropriate measures, such as an arbitration mechanism, should also be provided to prevent or reduce abuse of the legal actions.

CHAPTER 6

Evaluation of the Corporate Reforms in Korea

1. Evaluation of Corporate Restructuring

A substantial progress has been made in corporate restructuring so far. Corporate capital structure has shown significant improvement after the outbreak of the Korean crisis. As shown in the following Table-7, the debt-to-equity ratio of manufacturing firms was "dramatically reduced" to less than 200% in 2002 from 396% at the end of 1997.[28]

Of course, there remains a great room for debates on the government-driven policy for leverage improvement and the uniform guideline of 200% debt/equity ratio set for all firms ignoring firm- or industry-specific nature of the optimal capital structure.[29]

The cross loan guarantees among chaebol affiliate firms were totally eliminated by the end of 2000 from its level of 33.6 trillion won (28 billion US dollars) in 1997.

Table 7 Corporate Financial Ratios

(manufacturing sector, %)

	1980 -'89	1990 - '95	1996	1997	1998	1999	2000	2001	USA (2001)	Japan (2000)
D/E RATIO	361	299	317	396	303	215	211	182	159	160
BORROWINGS/ TOTAL ASSETS	44	45	48	54	51	43	41	40	27	30

Recognition of the importance of corporate transparency and the prudential financial regulation was greatly enhanced and it is an important lesson we have learned from the painful experience of financial and corporate crises. The belief of "too-big-to-fail" that had previously prevailed in the Korean economy was shattered after the massive collapse of a number of leading conglomerates and financial institutions.

The business corporations and managers became more aware of the importance of sound corporate capital structures and also of the managerial responsibility to outside investors. Financial institutions and regulatory authorities became more aware of the crucial importance of credit evaluation and prudential financial regulation.

In addition, thanks to the massive reform measures in the corporate and financial sectors, the Korean economy has shown a strong recovery from its sharp decline in 1998.

However, despite the progress in reforms made by the country, Korea is still facing challenges and tasks in transforming its economic system into one that is truly compatible with market principles.

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[28]) The expression, "dramatically reduced" takes its relevance since various government policies to reduce corporate financial leverage have been mostly ineffective during the period of super-growth economy.

[29]) Discussion on the issue of optimal capital structure requires a separate paper.

For example, many commercial banks were practically nationalized in the process of financial restructuring. With massive capital injection by the government to recapitalize the troubled banks, the government became the major controlling shareholder.

With government-controlled banks as witnessed in the past, it will be unlikely that the financial market fully operates based on the disciplinary market principles in the future. Therefore, the privatization of the government-owned financial institutions has to the government's goal with the highest priority.

2. Evaluation of Corporate Governance Reform

We have seen dramatic changes in Korean corporate governance system. There is increased recognition of the importance of corporate transparency, enhanced accounting standards and introduction of independent outside directors.

Most importantly, the business sector has come to realize the significance of corporate governance in securing investors' confidence, in mobilizing financial capital at lower cost, and in increasing the firm value.

Unless a company is able to meet the expectations and demand for improved transparency and governance, financing and investments for continued growth will be very much limited.

A significant and important change in shareholders' attitudes is being seen in Korea. Minority shareholders are becoming more active in monitoring corporate performance and business conduct, and in demanding firms to improve their management practices.

This new phenomenon of shareholder activism became possible after the drastic reduction in the minimum requirement needed for shareholder representation

One distinctive characteristic of shareholder activism in Korea is that it is led by a non-governmental organization called "People's Participatory Coalition." While large institutional investors such as the CalPERS are leading the shareholder activism in the US, this NGO represents a group of minority shareholders in specific cases of alleged corporate malpractices.

However, once the institutional investors, foreign as well as domestic, become more concerned and active in their role in monitoring corporate performance, there will be less need for minority shareholders to act directly and actively due to the substantial cost, explicit or implicit, involved in such activities.

3. Further Issues in Corporate Governance Reform

3-1. The Role of the Board of Directors

The board of directors can be a very effective and efficient system to mitigate the agency problem in modern public stock companies. This is why even the New York Stock Exchange in the US, where the governance system and practices are viewed as the most advanced, submitted a proposal to strengthen the role of the board of directors.

The board of directors system in Korea is now a transitory period from its previous function as "rubber stamp" toward a newly strengthened governance mechanism. However, the outside director system is new in Korea and neither the directors nor the companies are yet accustomed to the desired functions.

By focusing the role of the board on a few clearly defined areas such as maximizing firm value and protecting shareholders as well as other stakeholders, the board can operate more effectively and efficiently. The board's role can be more specifically defined to mitigate the agency problem by monitoring manager's misdeeds or their self-interested behaviors in corporate decision-makings.

For an example, the board may be required to report to the general shareholders' meeting about their assessment of the impacts of the corporation's decisions on corporate as well as on shareholders values. The board should also report on management transparency and compliance with laws. With such a clearly defined role and function, the board's check and balance function will be strengthened.

3-2. The Role of Institutional Investors

The size and number of institutional investors have been increasing very rapidly around the world. They will play crucial roles not only in securities trading, but also in corporate governance.

Institutional investors are legally obliged to manage prudently their trust assets for their investors. Institutional investors are so large that it will be increasingly clear that their oversight of the portfolio firms is not only cost effective but a more reliable investment than just active trading.

Institutional investors have large and well-diversified portfolios that are held by a large number of investors. Therefore, institutional investors will represent the interest of the general public. Pension funds could especially represent public interests better than other institutional investors, such as banks or insurance companies.[30]

Due to their long-term time horizon, pension funds and life insurances do not have to buy and sell their asset holdings frequently for short-term performances. Rather, they have greater incentive to invest with longer-term perspectives and have incentives to watch their portfolio companies with less cost. In this regard, they are in better position for active involvement in corporate governance and monitoring.

Portfolios of many institutional investors' are increasingly indexed to the market portfolio. This makes them universal in representing the market. In addition, holding a market portfolio does not require them to buy and sell any specific shares frequently. They are virtually permanent shareholders.

Therefore, the signal that institutional investors send to the capital markets through their portfolio mix will have a profound influence on the performance of portfolio firms.

We have so far discussed the merit of the role of institutional investors in corporate governance. However, their role in corporate governance raises new questions.

- Are the trustees of pension funds genuinely accountable to their own beneficiaries?
- Who monitors the institutional investors, especially pension funds that are virtually owned by employees? Will the "pension funds capitalism" or "employee capitalism" be a dominating form of capitalism in the next millennium as Peter Drucker predicts?

Despite of these problems associated with the role of institutional investors, they are better positioned in terms of scale and information for active and effective corporate monitoring activities as seen in the cases of the shareholders activism led by institutional investors like CalPers in the US.

3-3. Facilitating Chaebol Reform through Market Disciplines

The corporate governance system is the rule of games in the financial market that

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30) R. Monks & N. Minow, Corporate Governance, 1995, Blackwell, p118

supplies financial resources. With a well-functioning governance system in place, many current problems with Korean chaebols will be corrected through fair competition in the financial market.

In this regard, enhanced transparency, strengthened board system, high level of auditors' independence, and enhanced minority shareholders rights will effectively work to prevent business wrongdoings and to reduce agency problems.

When managements are effectively monitored and internal check and balance system works effectively, the agency problem will be much less serious and there will be less rooms for managers or controlling shareholders to pursue self-interested behaviors at the expense of outside investors.

3-4. Corporate Governance and the Role of Government

Since corporate sector deficiencies in Korea have roots in the government-led development process of the past, the best way to facilitate corporate reform is to set up appropriate market disciplinary systems, including corporate governance mechanism. In order to foster the true and efficient functioning of the market mechanism, the government should stay away from the market.

Financial institutions such as banks are the key players not only in the financial market but also in corporate governance. The way financial institutions behave gives a tremendous impact on how borrowers behave in their financing and investments.

Should the management of financial institutions not be governed by market principles, should their governance structure not be properly established, their role in monitoring the borrowers will be less effective as we had seen in the past.[31)]

In this respect, the earlier privatization of government owned banks should be the priority job of the government, since financial institutions play a significant and influential role in disciplining financial market participants such as firms.

Furthermore, previous practices of government involvement in the market should also be ceased. The government bailout of troubled banks and corporations or the public measures to boost the bearish stock market should only be a tale of the past since such practices will surly weaken investors' to monitor the companies they invest.

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31) We have seen that the fundamental cause of the most of the corporate failures in Korea including the cases of chaebol collapse such as Hanbo Group due to excessive borrowings can be found in the poor monitoring role of banks under the direct or indirect influences from the government and, ultimately, from the political circle.

Session III

Financial Restructuring in Korea*

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CHAPTER 1
Korea's Financial History

The Korea's modern financial history since the second World War has often been divided into four sub-periods: (1) the period of financial system establishment (1945-1960), (2) the period of economic development assistance (1961-1979), (3) the period of financial liberalization (1980-1997), (4) the period of financial reform (1998-present).[1] This classification reflects on both political events and economic policy guidelines in each period. In the first period Korean economy staggered along just after the sovereign independence and war recovery. The Korea's financial sector was at the infant stage with other unsettled system.

It is from the second period that the financial sector attracted policy makers' attention. At that time, as in many other developing countries, the single most important policy objective in Korea had been focused on speedy economic growth by all means.[2] The financial policies, in turn, had been designed so that financial intermediation was to channel available resources into presumably productive sectors.[3] Financial institutions and markets were established and/or developed to comply with these purposes. The government intervention toward economic growth achieved its initial objective at the sacrifice of distortions in resource allocations and prices, which would constrain further growth. On top of these imbalances the second oil shock in the late 1970s exposed the extreme weaknesses of the Korean economy,[4] especially the financial sector.[5]

Under the circumstances where the industry-specific incentives were phased out, the new Korean government shifted financial policy objectives toward financial liberalization in the early 1980s.[6] Financial liberalization efforts included the elimination of many administrative controls on banking, privatization of nationwide commercial banks, reduction in entry barriers and diversification of financial services. Because of these measures along with the efforts to curb inflation and to improve the industrial incentive system,[7] interest rates were less repressed financial development accelerated, and efficiency of credit allocation increased.[8]

Another important policy change in the third period was to open capital markets and foreign exchange transactions.[9] Foreign investment ceiling on individual stocks had been

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1) See Kim (1995) for the classification of the first three periods.

2) As a result Korean economic growth averaged around 8% per year in the real term since the early 1960s until the currency crisis in 1997 brought its brisk prosperity to an abrupt end.

3) Nam and Kim (1995) reported that the ratio of policy financial arrangements relative to total loans was about 50%.

4) Inflation accelerated, and many heavy and chemical industrial projects suffered from weak export competitiveness, overcapacity and large operating losses.

5) In the planned economy the financial sector served as a shock absorber against losses from the real side.

6) In the 1970s outstanding academic achievements in economics such as rational expectations contributed to stressing economic stability instead of growth. This trend was reinforced by policy arena like in Federal Reserve Board in the United States as Mr. Volker was appointed to be its chairman.

7) In the early 1980s, promotion of strategic industries with preferential credit and tax treatment gave way to a more indirect and functional support of industries.

8) See Nam (1994).

9) While the internal financial liberalization was driven in the 1980s, the so called *internationalization* including capital market liberalization and elimination of barriers in foreign transactions progressed in the mid 1990s.

adjusted upward so that the foreign shares were attributable to 26% of all listed companies in market capitalization around November 1997. But corporate bond markets were still *de facto* inaccessible to foreign investors until the late 1990s. Whereas personal foreign transactions were strictly regulated, borrowing of domestic financial institutions from foreign ones became fully deregulated in the mid 1990s. This type of deregulation along with imprudent financial supervision is one of the important origins of the crisis afterwards. The following section will continue to deal with the inherent problems in the Korea’s financial sector before the crisis.

CHAPTER 2

Financial Origins of the Crisis

1. Financial Instability in 1990s

This section describes the problems of the Korea’s financial system before the currency crisis in 1997. Both in and out liberalization in the financial sector was an inevitable choice in view of the economic development stage and foreign environments. Even though Korea suffered from massive outflows of foreign reserves, it is hard to observe macroeconomic imbalances such as excessive credit explosion.[10]

As for the credit expansion, however, the distribution, not the level, of the credits should be taken into careful account. During this third period direct financial instruments such as long-term bonds and short-term commercial papers (CP) flourished. In Figure 2-1 shows the growing trend of direct financing. In addition the size of financial intermediation by non-bank financial institutions (NBFIs) had grown tremendously (see Table 2-1). Also, Corporate debts had become shorter in maturity until the currency crisis broke out. The sharp rise in commercial paper financing implied that not only the corporate balance sheet but also the maturity structure of corporate debt had deteriorated substantially in the pre-crisis period as shown in Figure 2-2. According to Figure 2-3, corporate sectors mobilized more than half of funds from NBFIs in the mid 1990s. From these three graphs in Figure 2-1, 2-2 and 3, the financial activities in the 1980s and 1990s are summarized as follows: conventional banking sector shrank and direct capital markets and NBFIs replaced part of its role.

Table 2-1 Liability Composition of Financial Institutions

(unit: %)

	1972	1980	1985	1990	1995
Banks	91.5	65.7	47.8	45.8	51.2
Insurance Companies	4.4	6.5	13.1	14.5	11.9
Merchant Banks	0.3	12.0	13.1	11.6	10.3
Investment Trust Companies	0.0	3.6	10.8	12.1	10.8
Mutual Savings	1.6	5.6	5.8	6.2	6.4
Credit Unions	0.0	2.3	5.2	4.6	4.5
Others	2.2	4.3	4.2	5.2	4.9

Source: Presidential Committee for Financial Reform (1997)

[10]) Both money (M2 or M3) growth rate and asset growth rate of financial institutions were very stable throughout the 1990s before the crisis. See Shin (1998).

Figure 2-1 Share of Direct Financing in Total Corporate Financial Liabilities

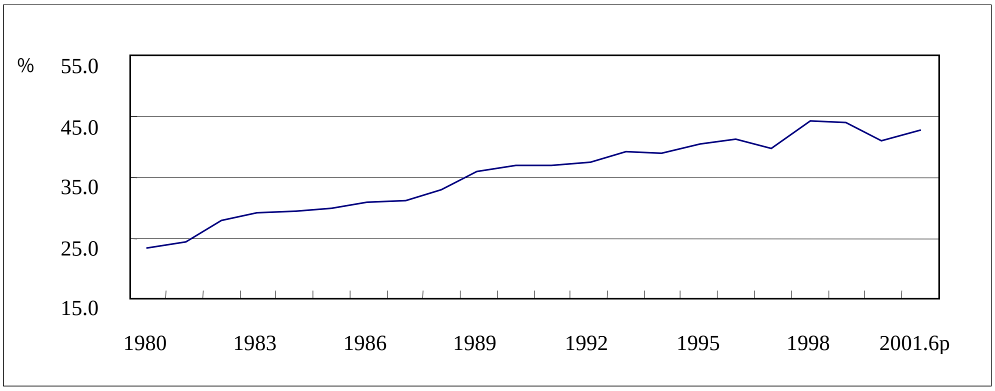


Figure 2-2 Share of Short-Term Financing in Corporate Direct Financing

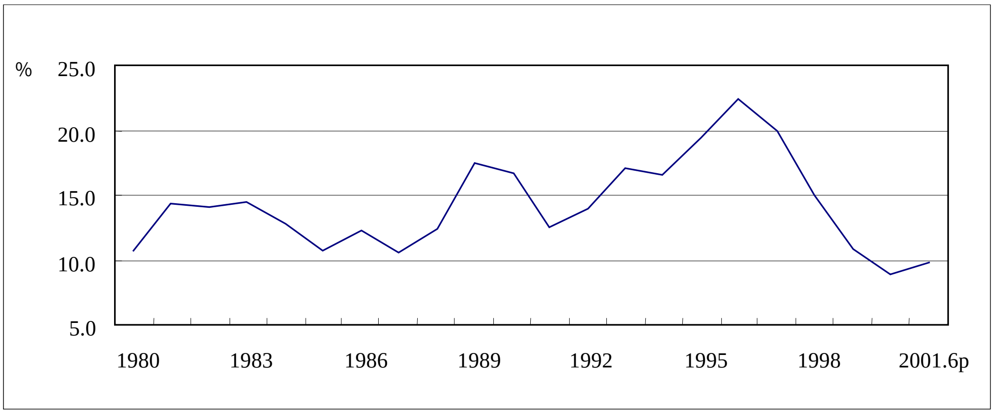
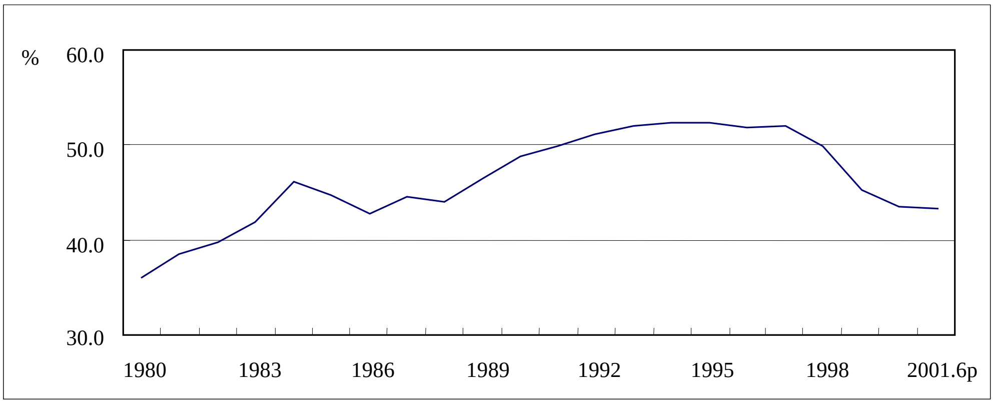
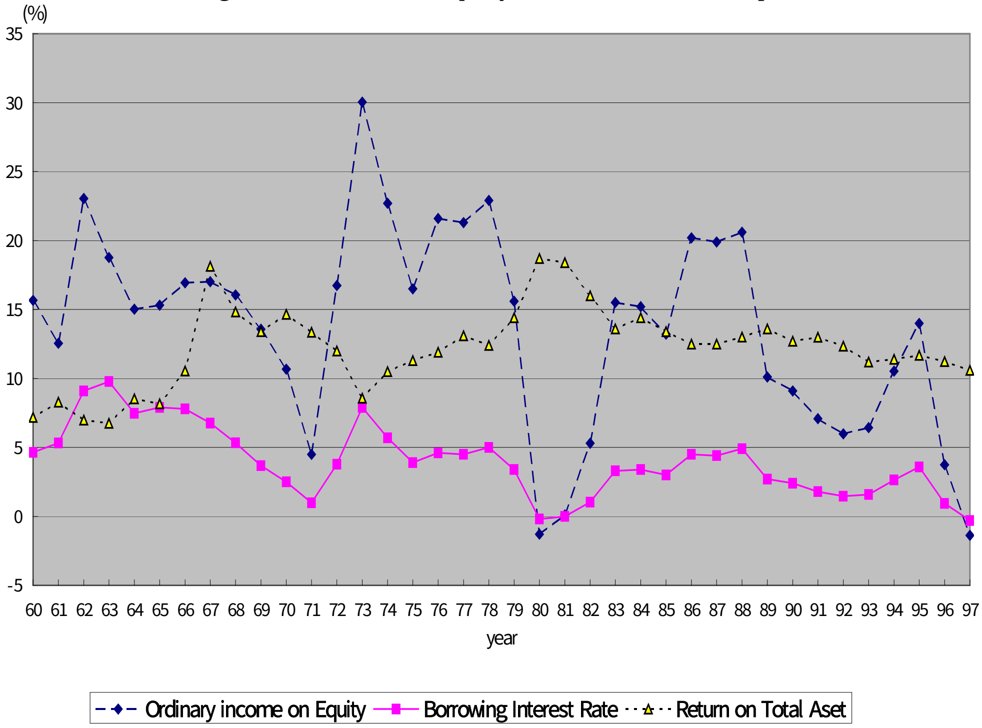


Figure 2-3 Share of NBFI Borrowing in Corporate Indirect Financing



This change in credit supply structure is not necessarily understood as being negative. Instead, it might reflect on the deepening of financial markets and diversification of financial instruments. The relevant question then would be whether this change was accompanied with proper risk management of both credit suppliers, especially NBFIs, and demanders, or corporations. The answer to this question, unfortunately, is quite negative. The emergence of the NBFIs and increasing ownership of them by *chaebols* (large business conglomerates in Korea) implied that, faced with tight controls over commercial bank credit, the NBFIs served as an alternative financing source for the *chaebols* along with direct financing vehicles such as commercial papers and bonds.[11] Therefore, credit risks of the entire financial system became more and more heavily dependent upon liquidity and solvency of the corporate sector. Briefly put, Korean financial institutions were not able to properly control and absorb borrowers' risks in 1996 and 1997.

Figure 2-4 Debt to Equity Ratio of Korean Corporate Sector

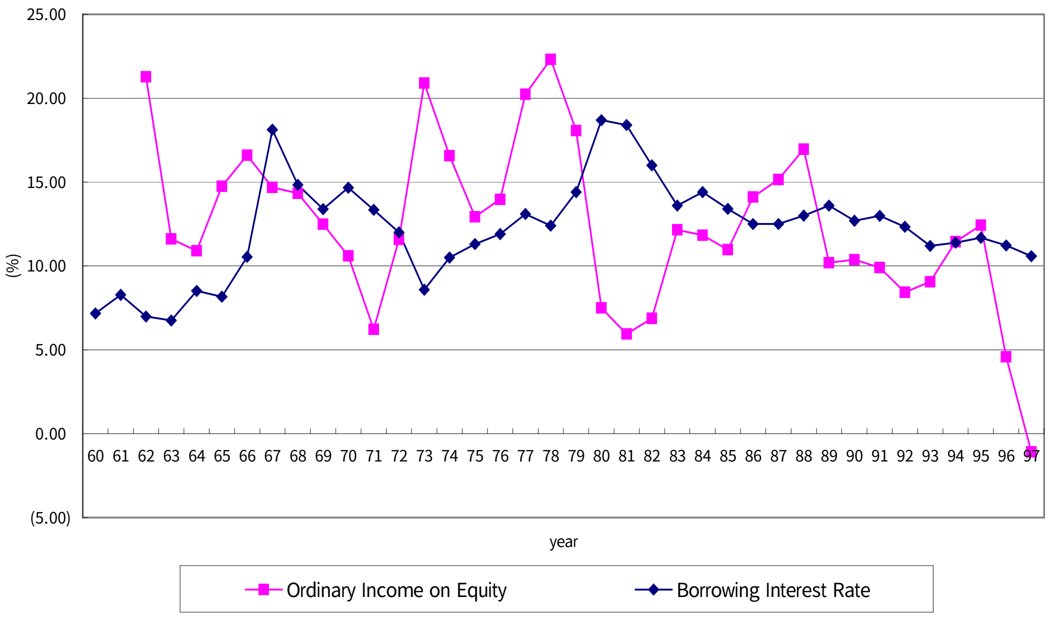


The corporate sector had become less and less profitable ever since the early 1990s. As shown in Figure 2-4, Korean corporations had always been highly leveraged.[12] With the

[11]) As noted by Hahm (2002a), the availability of bank credit for the *chaebols* was gradually limited as the government tightened its control over bank credit. Throughout the late 1980s and early 1990s, small and medium-sized enterprises (SMEs) received an increasing share of commercial bank loans, which implied that the *chaebols* needed alternative sources of financing. During this liberalization period, commercial papers, corporate bonds and borrowing from NBFIs emerged as increasingly important vehicles.

high debt-equity ratios, they were expected to yield high profitability on their equity. However, Figure 2-5 shows that average rate on equity (ROE) was sometimes lower than the prevailing interest rates applied for loans. On average the return on capital had been lower than its opportunity cost for almost ten years before the crisis.

Figure 2-5 Profitability of Korean Corporate Sector



SOURCE : Financial Statement Analysis, various issues

More problematic was lack of understanding about the seriousness of both corporate and financial distress inside the policy making entities, especially financial supervisory authorities. Table 2-2 shows the official non-performing loans announced before the crisis.

Table 2-2 Non-Performing Loans before the Crisis

(unit: %)

	1991	1992	1993	1994	1995	1996
Korea	6.6	6.7	7.0	5.6	5.2	4.1
U.S.A	4.2	3.7	2.5	1.6	1.3	1.2
Japan	-	-	2.5	2.4	4.9	4.2

Furthermore, financial supervisory agencies were ill prepared for opening financial markets. As Korea became affiliated with OECD in 1996,[13] domestic financial institutions and markets could not be protected any longer. Then they should have been equipped

[12]) Joh (2000) argued that it is difficult to say that a sudden credit expansion and lending boom caused the 1997 crisis.

[13]) It is also worthwhile to note that the share of foreign borrowing increased rapidly during the 1994-96 period, reflecting the acceleration of capital account liberalization to qualify for OECD membership.

with correspondingly high-level risk management expertise,[14] but took even higher risk with understanding under the old regime. These practices acquiesced in the conventional supervision.

Vulnerability of financial institutions resulted partly from regulatory asymmetries. As Hahm (2002b), Lee et al. (2000) and Choi (2002) argued, the first asymmetry was unbalanced deregulation between the commercial bank and non-bank financial industries. NBFIs were allowed much greater freedom in their management of assets and liabilities. Not only were the NBFIs not adequately supervised as commercial banks but also they often engaged in risky businesses. Therefore, the increasing share of intermediation through NBFIs caused a substantial shortening of corporate debt maturity, exposing both corporations and financial institutions to a substantial degree of financial risk (see Figure 2-2 and Figure 2-3).

The second asymmetry was unbalanced deregulation of capital accounts, which was accelerated in 1993. While the foreign borrowings of financial institutions were comprehensively liberalized, foreign borrowings of non-financial firms, especially the long-term borrowing were tightly regulated. The asymmetric treatment of financial institutions and non-financial firms was partly due to the recognition of the government that the access by *chaebols* to low cost foreign capital would cause economic power to become further concentrated in the hands of the *chaebols* (Choi (2002)). External borrowing through financial institutions was also preferred to direct opening of the domestic capital markets because the government was concerned about possible macroeconomic imbalances arising from volatile capital flows. Furthermore, gradual deregulation of trade related short-term corporate borrowings, and aggressive short-term borrowings of NBFIs such as merchant banking corporations that were not supervised tightly also caused a rapid increase in short-term external debt, which exposed both the corporate and financial sectors to a substantial degree of foreign exchange risk. Table 2-3 shows the external debts before the crisis.

Table 2-3 Long-Term and Short-Term External Debts

(unit: %)

	1991	1992	1993	1994	1995	1996	1997
Long-Term	56.0	56.8	56.3	46.6	42.2	41.7	42.4
(Growth Rate)	(25.9)	(11.0)	(1.6)	(7.3)	(24.9)	(32.0)	(17.2)
Short-Term	44.0	43.2	43.7	53.4	57.8	58.3	57.6
(Growth Rate)	(20.3)	(7.6)	(3.8)	(58.3)	(49.0)	(34.7)	(14.1)

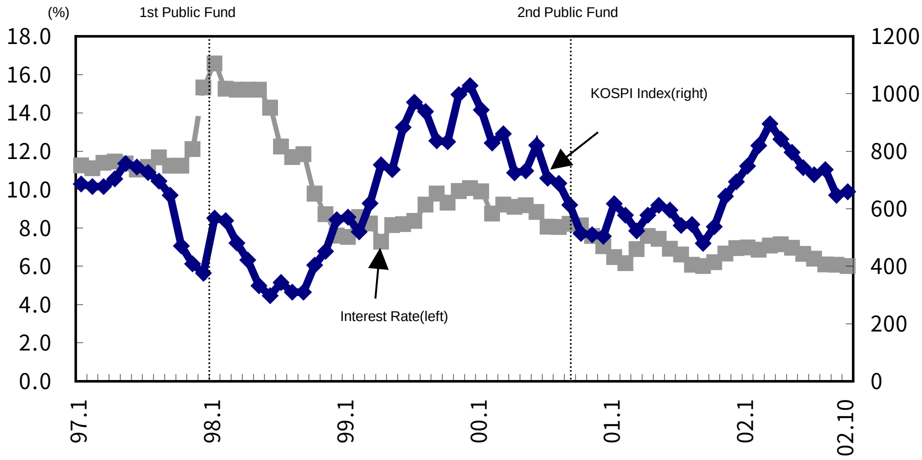
In summary, in spite of dramatic change in financial environments, financial supervisory agencies were not fully aware of their policy responses under paradigm in the old regime. In the absence of considerate financial supervision most domestic financial institutions took excessive, but not so perceived, risks to make additional profits. Now it is well known that prudential regulation and supervision is a prerequisite for financial liberalization and entry into global financial markets in order to avoid serious turmoil, but it is only a hindsight lesson.

14) Obviously Korean government tried to consider malfunctions and adverse side effects potentially caused by financial market globalization. Its response was to give more discretion to commercial banks that were relatively sound in health. But financial regulators were not aware of the danger of excessive borrowing by foreign branches of domestic commercial banks. As a matter of fact, redemption pressure was highest in these foreign branches under the crisis.

2. Outbreak of the Currency Crisis

By the time the financial pinch had made itself known, corporate bankruptcies had begun to multiply, further distressing a financial sector overburdened with bad loans and unmanageable credit risks. Inadequate bank supervision also played a role in so far as the problem was not identified before it reached crisis proportions. International investor confidence in Korean prospects evaporated as current account deficits mounted and inefficient investment became apparent. The rapid withdrawal of foreign funds from Korea increased sovereign liquidity risks, worsened by a high short-term external debt ratio, while real estate and stock prices plummeted (see Figure 2-6). In the end, the Korean government decided to seek emergency loans from the IMF on November 21, 1997.

Figure 2-6 Stock Price and Interest Rates in Korea



Initially the problematic symptoms took place in foreign exchange transaction, but affected both financial and real sectors sequentially. Thus it is understood as a currency crisis at first and then propagated to be a financial crisis and even a systemic one.[15] Because the capital inflow problem was aggravated by almost fixed exchange rate policy, economic uncertainties pushed capital flows outward, which in turn brought about the currency crisis. As the domestic currency got severely depreciated, the balance sheet of domestic financial institutions deteriorated since they had enormous external debts after the financial liberalization policy. Capital inadequacy of the financial institutions would invite further speculative attacks. To cope with this problem, the central bank boosted up short-term nominal interest rates, which further deteriorated once impaired balance sheet of the financial institutions. This could ignite bank-runs[16] over all financial industry. Once the problem got worse up to this situation, it might be called a financial crisis.

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15) To see the propagation of financial crises, see Hahm and Mishkin (2000).

16) Runs on banks usually involve the withdrawal of domestic deposits and cuts in domestic interbank and international funding lines. Runs also can involve the withdrawal of funds that are placed in off-balance-sheet instruments known as trust accounts, money desks, mutual funds, and the like, but that have deposit-like characteristics. See Scott (2002).

To overcome the 1997 financial crisis, Korea made every effort to resolve a shortage of foreign currency liquidity and to prevent bank-runs in financial institutions. The process began by securing US$ 35 billion in loans from such international institutions as the IMF, ADB, and IBRD. This was followed by the conversion of US$ 23 billion in short-term external debt into mid- and long-term debt. In order to stabilize the liquidity the Korean government issued extensive bank liability guarantees.[17] In November 1997, it fully guaranteed all bank deposits for a period of three years.[18] In effect, however, it guaranteed virtually all subordinated liabilities in financial intermediaries, including life insurance companies. These measures, among others, constituted first-aid treatments against the financial crisis. The following section will discuss reforming measures in the financial sector.

17) Prior to the currency crisis, it guaranteed banks' international liabilities in August 1997 in response to cuts in international funding lines.

18) At the beginning of 2001, the blanket coverage of deposit insurance was replaced with a system in which coverage is limited to KRW 50 million (principal and interest) per deposit in insured financial institutions, in the aim at enhancing market discipline.

CHAPTER 3

Financial Restructuring after the Crisis

1. Overall Strategy

While making macroeconomic policies advised by the IMF and IBRD, the Korean government tried to take microeconomic reforming measures in all fields and financial restructuring was one of the areas. After emergency treatments were made for the five months since the outbreak of the currency crisis, the overall plan for financial restructuring was envisaged around May 1998.

Principles

The overall principles at the foundation of Korea's economic reform after the crisis are soundness, transparency and market discipline. By applying the principles, Korea sought to maintain reform credibility and to minimize the costs. Economic rationale centered on the full liberalization of the financial markets, overhauling of the prudential regulatory system, corporate debt reduction and business restructuring, and strengthening transparency standards.

Compatible with the overall principles, the financial restructuring plan was engineered to achieve sound, transparent and market-disciplined financial system. Initially such messes in the financial sectors as insolvent and non-viable financial institutions and non-performing assets should be removed. Also introduction of advanced financial supervision and regulation on the one hand and risk management system of individual financial institutions on the other was necessary to stop further deterioration and to prevent the economy from hosting another crisis in the future. All of these tasks were so formidable to proceed at the same time that the government should set up agenda.

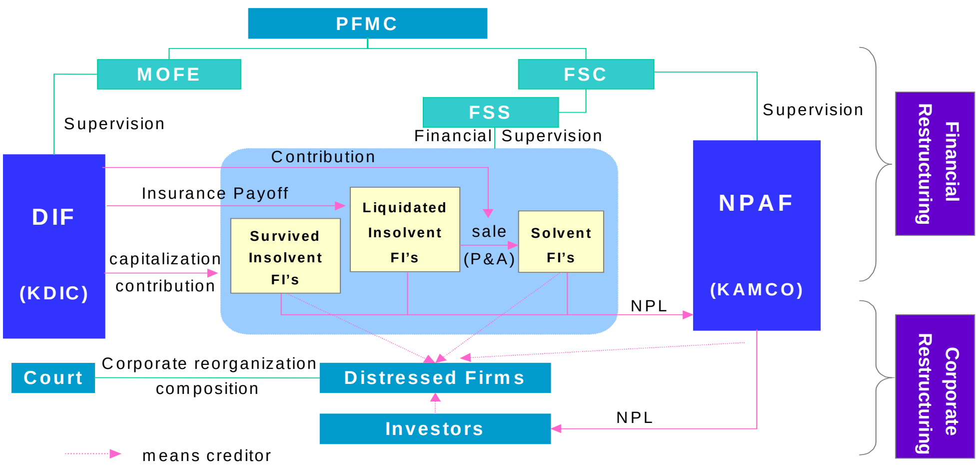
The first priority went to revitalizing the banking sector. Rationale for rescuing the banking sector first was quite clear. In general, financial institutions produce semi-public goods, whereas individual companies private ones. If financial system does not function properly due to bank failures, no one is willing to bear the costs except for government, even though the entire nation would be beneficial to its resumption. Because of market failure in public goods sector after the currency crisis, the imminent policy was rightly focused on rehabilitating banking sector, including deeply problematic merchant banks, and then non-bank financial intermediaries such as securities, life insurance and investment trust companies.

There had been arguments over the sequence of restructuring in financial and corporate sectors. In general distress of the corporate sector is the fundamental cause of that of the financial sector. Then without being heavily involved in corporate restructuring such as liquidation of non-viable firms and rehabilitation of viable firms, financial system cannot resume functioning. Korean financial institutions, however, were not financially strong enough to lead corporate restructuring against their borrowers. In addition to the constraint, corporate restructuring would have stricken sluggish economy once again that was already damaged by the crisis. For these reasons corporate sector restructuring was postponed for a while until financial institutions could get at least partial recovery.[19]

Crisis Management Team

After finishing urgent steps to stabilize liquidity, the government needed to lay foundations for managing the crisis in the early 1998. The task that might involve years of work had better be taken to ensure that appropriate institutional arrangements are in place for competent crisis management team. It is important to strike a balance between the political and technical work of crisis resolution, including the delegation of authority and responsibility to technical experts. This balance can be achieved by forming a special purpose crisis management team with adequate skills, experiences, capacities and funding.

Figure 3-1 Depicts the Organizational Flowchart of the Financial and Corporate Restructuring in Korea



The Figure 3-1 depicts the organizational flowchart of the financial and corporate restructuring in Korea. Since restructuring in the financial and corporate sectors is involved in both sides of the same token, the sectors could not be separated each other, though ordered in sequence, in the restructuring processes.

Before the enactment of the Public Funds Management Special Law in December 2000, Financial Supervisory Commission (FSC),[20] a single consolidated financial regulator established in April 1998, orchestrated the entire financial restructuring with the help of Ministry of Finance and Economy (MOFE). The two major implementation agencies were Korea Deposit Insurance Corporation (KDIC) and Korea Asset Management Corporation (KAMCO). Even though its primary aim lies in the protection of depositors, KDIC has

[19]) In the official announcement (Lee [1998]), corporate restructuring over large conglomerates was executed in tandem with financial restructuring, but its performance was limited to relatively sound and viable companies. The importance of financially distressed corporate sector restructuring came in forefront in the early 2000. Financial institutions were reluctant or at least passive in corporate debt rescheduling due to the regulatory conditions against weakly capitalized ones. They began to actively clear the bad loans after the second-round *Public Funds* were injected and the financial supervisory authorities removed some hurdles on loan write-offs.

[20]) After the *Public Funds* Management Special Law was enacted, the Public Fund Management Committee (PFMC) has become fully responsible for every operation of financial restructuring that asks for the usage of the *Public Funds*.

played a role of pay-box in the course of financial restructuring such as closure of insolvent financial institutions by deposit insurance pay-out, participation in recapitalization of inadequate financial institutions, etc. The fund used in this process, Deposit Insurance Fund (DIF), was mobilized through government guaranteed bond issuance. The main job of KAMCO in financial restructuring is to purchase non-performing assets from not only insolvent but also solvent financial institutions. The fund utilized in this process is called Non-Performing Asset Management Fund (NPAF). This kind of restructuring framework is not unique in Korea. Table 3-1 compares the crisis management team in four crisis-hit Asian countries. Overall structure of financial restructuring in all countries is quite similar. Public AMCs were set up to resolve non-performing assets and the deposit insurance entities, or other funds led by the central banks if not available, treated ailing financial institutions. Private organizations closely monitored by the financial regulators and/or central banks mediated corporate restructuring from the perspective of financial restructuring.

Table 3-1 International Comparison in Crisis Management Team

	Corporate Restructuring	NPL Resolution	Ailing FI's Resolution
Korea	CRCC → CRASC	KAMCO	KDIC
Thailand	Corporate Debt Restructuring Advisory Committee (CDRAC) → Thai Asset Management Corporation (TAMC)	• Financial Sector Restructuring Authority (FRA) • Asset Management Corporation (AMC) → Thai Asset Management Corporation (TAMC)	Financial Institutions Development Fund (FIDF)
Indonesia	Jakarta Initiative Task Force (JITF)	Indonesian Bank Restructuring Agency IBRA)	Indonesian Bank Restructuring Agency (IBRA)
Malaysia	Corporate Debt Restructuring Committee (CDRC)	Danaharta	Danamodal

Public Funds

When the government tried to salvage the financial system and to protect depositors, the central bank (Bank of Korea) and the deposit protection entity (KDIC) did not have sufficient resources to absorb the costs. Therefore, the government had to arrange a financial package, called the *Public Funds*. The *Public Funds* were required (1) to purchase non-performing assets from financial institutions, (2) to pay out deposit insurance against insured deposits of failing financial institutions, (3) to participate in capitalization on financial institutions whose balance sheet was weak, (4) to make contributions to acquiring banks of closed banks, etc.

The government should ensure that the *Public Funds* be of sufficient size to be credible to the markets, while maintaining the flexibility to provide additional financing. The early task was to assess the scope of the problem facing individual financial institutions and the entire financial system. Table 3-2 shows the initial estimate of non-performing loans in the financial sector as of the end of March 1998. Under the international standard where three months overdue loans are classified as non-performing, KRW 118 trillion, or US$ 98.3 billion, of loans were problematic. With this estimate, the government built up the first-round *Public Funds* of KRW 64 trillion, of which KRW 43.5 trillion was mobilized as DIF bonds issuance and 20.5 trillion NPAF bonds.

Table 3-2 Volume of Non-Performing Loans (as of March 30, 1998)

(unit: KRW trillion)

Section	Substandard Loans	Cautionary Loans	Total
Commercial Banks	40.0	46.0	86.0
Non-Banks	28.0	4.0	32.0
Total	68.0	50.0	118.0

In retrospect, then existing accounting and regulatory information was quite misleading. There are two reasons. First, the government did not recognize the nature of the financial crisis in that occurrence of new non-performing assets grow faster than the resolution of existing ones at the early stage of the crisis. This fact is related to bankruptcies of many firms at the margin of viability. Thus, initial assessment was biased downward. Second, the default of the Daewoo group whose total liabilities amounted to US$ 58.3 billion was unexpected. Everyone knew that the Daewoo was too highly leveraged and weakly profitable to survive. Nevertheless, no one was suspicious of its solvency due to “Too-Big-To-Fail” myth. In August 1999, however, 12 Daewoo subsidiaries entered into the Workout Program[21] after the declaration of moratorium. This event asked for additional funding arrangements and the second-round *Public Funds*, KRW 40 trillion, were mobilized.[22]

Table 3-3 summarizes the source and usage of the *Public Funds*. Out of the total amount of KRW 156.3 trillion, a majority of the *Public Funds* were spent on commercial banks but significant amounts were also used for non-bank institutions such as investment trust companies, merchant banks and insurance companies. In terms of usage, equity participation in viable financial institutions, KRW 60.2 trillion or 38.5%, takes the largest portion and NPL Purchase, KRW 38.7 trillion or 24.8%, follows.

[21]) The Corporate Workout Program in Korea was initially prepared for restructuring financially unhealthy medium-sized *chaebol* companies, especially targeting for 6-64 largest conglomerates in asset size, but extended to the Daewoo subsidiaries because in-court rehabilitation was not a feasible solution.

[22]) According to the *Public Funds* Management Special Law, other funds and assets from the government and the Bank of Korea and recycled funds are defined as part of the *Public Funds*.

Table 3-3 Assistance and Funding Source of the *Public Funds*

(unit: KRW trillion)

	Section	Equity Participation	Contribution	Insurance Payout	Asset Purchase	NPL Purchase	Total
Assistance	Banks	33.9	13.6	-	14.0	24.5	86.0
	Securities	7.7	-	0.01	-	8.3	16.0
	Insurance	15.9	2.7	-	0.3	1.8	20.7
	MBC	2.7	-	17.2	-	1.6	21.5
	MSFC	-	0.1	6.7	0.6	0.2	7.6
	Credit Unions	-	-	2.2	-	-	2.2
	Overseas	-	-	-	-	2.3	2.3
	Total	60.2	16.4	26.1	14.9	38.7	156.3
Source	Bond Issuance	42.2	15.2	20.0	4.2	20.5	102.1
	Recovered	3.9	1.2	6.0	4.4	16.7	32.2
	Gov't Assets	14.1	-	0.05	6.3	1.5	22.0

2. Hardware Restructuring

Resolution of ailing financial institutions by way of their closure and merger & acquisition (M&A) to others and disposition of non-performing assets away from the balance sheet of financial institutions are understood as hardware financial restructuring. The first financial industry that was subject to being restructured was merchant banks, for which were most exposed to exchange rate risks under the currency crisis situation. Out of 30 merchant banks in 1997, most of them were closed down and only three ones survive (see Table 3-9). The other financial industries were heavily restructured as well. Banking sector, most importantly, has become reshuffled toward enlargement through purchase & assumption (P&A). As for relatively small financial institutions in asset size like mutual savings & finance companies and credit unions, closure and M&A have been popular methods of resolution. As a result of the heavy hardware restructuring, more than 630 ailing financial institutions were removed.

In general huge amount of non-performing loans seem to be one of the direct causes of most financial crises. NPLs of KRW 118 trillion that amounted to almost 15% of annual GDP was not the manageable size by the internal capital of the financial institutions. Resolution of NPLs asked for special expertise, but Korean banks did not have relevant experiences and skills as well as incentives. Furthermore, the quality of the NPLs has a tendency to deteriorate unless they are carefully managed. These constituted the reasons why the public Asset Management Corporation (AMC) that specialized in NPL disposition was introduced and KAMCO took this job.

Coincidentally, almost at the same time of the currency crisis, NPAF was established and its management was trusted by KAMCO. KAMCO purchased NPLs from all financial institutions near at the fair market price, or with heavy discount rate applied.[23)] Since the transaction of NPLs and thus the relevant market price were not existent during the crisis, actual transactions between the financial institutions and KAMCO could not help being led by the government. FSC came here to qualify the NPLs for transaction and mediate the price based on loan recovery rate, default rate, auction discount rate, etc.

Table 3-4 KAMCO's Acquisition and Resolution of NPLs (as of June 30, 2002)

(unit: KRW trillion)

Classification	Purchased		Resolved	
	Face Value	Purchase Price	Face Value	Recovery Value
Ordinary Loans	29.8	9.2	24.0	10.4
Corporate Loans under In-Court Restructuring	41.1	17.0	33.5	15.4
Corporate Loans under Private Restructuring	34.5	13.2	4.2	2.6
Total	105.4	39.4	61.7	28.4

Table 3-4 shows that KAMCO has acquired NPLs of KRW 105.4 trillion, or US$ 87.8 billion, in face value at the purchasing price of KRW 39.4 trillion, or US$ 32.8 billion, for the four and half years of operation. Out of the acquired assets, KAMCO has disposed of KRW 61.7 trillion, or US$ 51.4 billion, at the selling price of KRW 28.4 trillion, or US$ 23.7 billion. Table 3-5 shows details in NPLs resolution by methods. Note that various kinds of methods and techniques have been employed depending on the quality and characteristics of the NPLs. Figure 3-2 summarizes the resolution process.

[23)] As of October 2002 the average discount rate for all acquired NPLs is 63%, or the price of NPLs is 37 cents per a dollar.

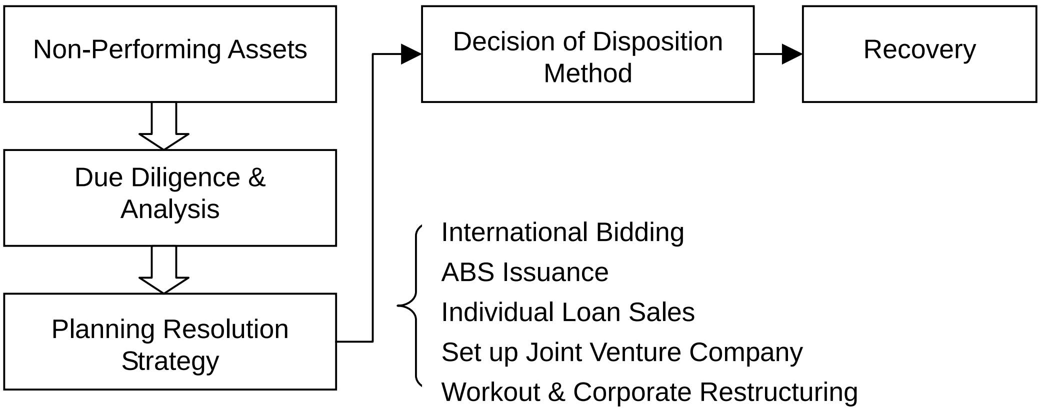
Table 3-5 KAMCO's NPL Resolution by Methods (as of June 30, 2002)

(unit: KRW trillion)

Classification	Accumulated Resolution			
	Face Value	Purchase Price	Recovery Value	Profits
International Bidding	6.1	1.3	1.6	0.29
ABS Issuance	8.0	4.2	4.1	-0.08
Sale to AMC	2.6	0.7	0.9	0.26
Sale to CRC	1.8	0.4	0.7	0.31
Individual Loan Sales	2.0	0.5	0.6	0.14
Court Auction, Public Sales	8.2	2.5	3.1	0.57
Collection	10.6	3.6	5.0	1.41
Others[1)]	2.2	1.5	1.9	0.32
Sub Total	41.5	14.7	17.9	3.23
Recourse & Cancellation	18.1	9.7	9.7	-
Total	59.5	24.4	27.6	3.23

Note: 1) CRV resolution, recovery by restructuring plan, etc.

Figure 3-2 NPL Resolution Processes



Adoption of the market price vis-à-vis NPLs has an important policy implication on KAMCO's disposition of the acquired assets. Since KAMCO purchased NPLs at close-to-market-price, it could make profits if it was able to add values through restructuring and/or pooling the loans, for example. Otherwise, it would have made losses whatever efforts it had devoted, for the all NPLs could not restore to be performing again. This approach removed the binding constraints on selling prices from the viewpoint of

KAMCO. Actually KAMCO has performed quite successfully, making KRW 2.4 trillion profits so far. However, KAMCO is facing formidable challenges in resolving remaining assets, of which the quality is poorer on average than the already resolved, because good NPLs go first. That means that KAMCO will make overall losses in the end. According to Korea Institute of Finance (2002), the losses of NPAF are estimated to reach KRW 2.4 trillion without consideration of interest payments of the NPAF bonds. If this estimate will come true, we may judge the performance of KAMCO to be quite successful.

Corporate Restructuring

As stated before, corporate restructuring is another face of financial restructuring as long as most of NPLs originate in corporate distress. In other words, problems in the financial institutions stemmed ultimately from the corporate sectors so that restructuring policies should handle not only ailing financial institutions but also insolvent corporations in order to end up with sustainable economic system. In that principles, methods and performances of corporate restructuring has greatly affected on the performances of financial institutions, it is useful to check out corporate restructuring in order to understand financial restructuring in Korea.

The Corporate Workout Program is the most exemplary way of corporate restructuring in Korea. The Workout Program was based on voluntary agreement on promoting corporate debt restructuring among domestic creditor financial institutions in June, 1998, targeting for financially unhealthy medium sized *chaebol* companies, especially targeting for 6-64 largest conglomerates in asset size. However, the Daewoo group, the second largest conglomerate in asset size, entered into corporate workout program later in 1999 due to infeasibility of court advised restructuring that would have led entire economy into turmoil. It is this event that made the nature of the Korean corporate workouts clear. The Korean corporate workouts is defined as not only a corporate sector restructuring program aiming at resolving corporate distress, but also a subsidiary one to support financial sector restructuring. As a matter of fact, the latter objective was in forefront, for a priority of policy considerations should be given to rescuing hard-hit financial system by the crisis.

Out of 106 applying companies for workouts, 97 ones were accepted and their debts financially restructured by the creditors committee based on the Agreement. Total amount of debts within the workouts reached KRW 98 trillion (see Table 3-6 and Table 3-7 below). In 1998, 83 companies applied for the workout program and 21 and 2 more companies did in 1999 and 2000, respectively. The number of manufacturing firms was the highest, 70. 17 Construction and 11 retail & wholesales then followed. Around two third of the debt amounts under the program was attributable to 12 Daewoo subsidiary companies. Interest forgiveness, KRW 20.9 trillion, such as maturity rescheduling from short-term to long-term and reduction in interest rates was the major vehicle in debt restructuring. However, substantial amount of principal payments, KRW 16 trillion, was relieved by way of debt-to-equity swap. In addition, KRW 9 trillion was supplied as fresh loans. As of the end of 2001, 22 companies were under the program. This year 6 companies have graduated from the program successfully. There are 16 companies are still under way as of November 2002.

Table 3-6 Financial Restructuring for Distressed Companies under the Korean Corporate Workouts (as of the End of 2001)

(unit: KRW trillion)

Fresh Loans		Amount of Debts	1st Round			2nd Round		
			Debt Equity Swap	Interest Forgiveness	Fresh Loans	Debt Equity Swap	Interest Forgiveness	Fresh Loans
Daewoo Subsidiaries		62	5.3	19.7	6.3	N / A	N / A	N / A
Others	6-64 Group	25	3.8	0.8	2.1	6.1	0.4	0.2
	SMEs	11	0.4	0.0	0.4	0.4	0.0	0.0
Sum		98	9.5	20.5	8.8	6.5	0.4	0.2

Table 3-7 Companies under the Korean Corporate Workouts (as of the end of 2001)

(unit: no. of companies, KRW)

Section		Applicants	Rejection	Workout	M&A	Success	Suspension	Under Way	Amount of Debts
Daewoo Subsidiaries		12	-	12	-	4	1	7	62 trillion
Others	6-64 Group	49	5	44	13	15	6	10	25 trillion
	SMEs	45	4	41	3	28	5	5	11 trillion
Sum		106	9	97	16	47	12	22	98 trillion

It may take more time to evaluate the performance of the Korean Workout Program because some of the applicants are still collectively managed by the creditors based on the Corporate Restructuring Promotion Act, a successor to the Agreement. Furthermore, most of debt reduction and debt-to-equity swap were executed in the first half of 2001 so that we need more time to evaluate the performances by looking at turnarounds of the once distressed companies. Nevertheless, from the creditors' perspective loan recovery rate increased through the workout program. The expected recovery rate is 50 to 70 percent, which is higher than the formal court advised restructuring. If liquidation had been forced on many insolvent and invisible firms at the very beginning of the crisis, the expected recovery rate would have been below 20 percent out of nominal debt amounts. Along with the financial sector reform, the corporate sector restructuring including the workout program has contributed to asset price recovery and health of financial institutions (see Figure 3-3). If the Korean corporate workouts intended to support financial sector restructuring, it worked quite well. Korean corporate sector maintains high debt level relative to GDP. Once reached to near 180 percent during the crisis era, it isw now at 150 percent. About 25 percent companies in terms of number and debt amounts are not profitable enough to make interest payments (see Figure 3-4). Therefore, Korean corporate sector still needs to be restructured.

Figure 3-3 Time Series of Corporate Sector Debts in Korea

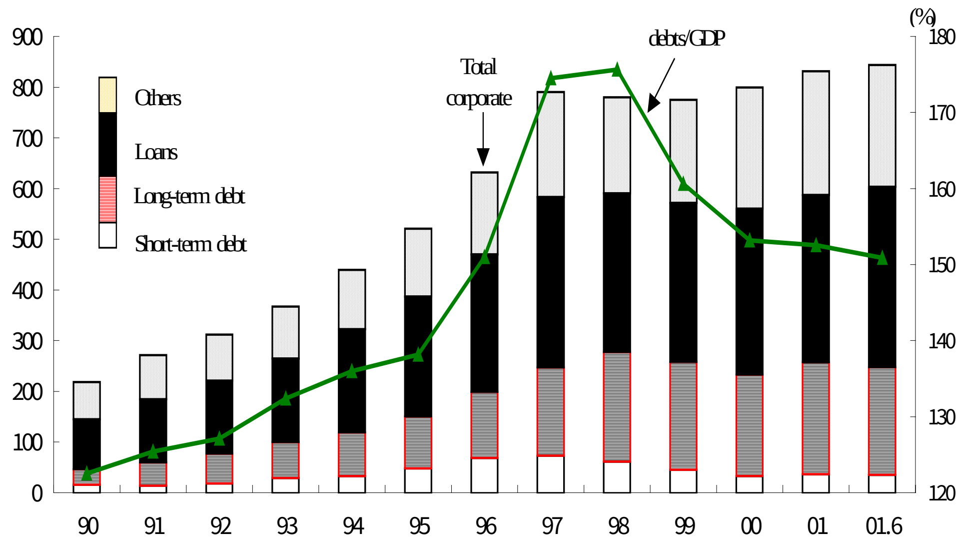
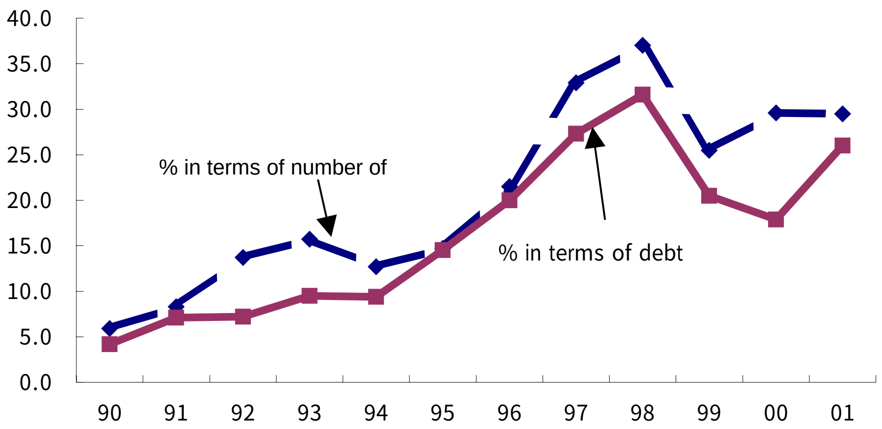


Figure 3-4 Korean Stock Exchange Listed Companies Whose EBIT<1



3. Software Restructuring

To improve the financial supervisory framework, the Financial Supervisory Commission, a unified body covering baking, insurance, non-banks and capital markets, was established. Key elements in strengthening supervision and regulation included a prompt corrective action (PCA) to deal with financial institutions failing to meet prudential standards and a new loan classification system based on forward-looking criteria (FLC). Other measures are summarized in Table 3-8. As a result, the supervision of domestic financial institutions has been made more sound by the adoption of advanced corporate credit evaluation standards and additional responsibility for credit decisions.

Table 3-8 Major Steps Taken to Upgrade Prudential Supervision in Korea

- A unified supervisory body, the Financial Supervisory Commission, was created in April 1998.
- Accounting and disclosure standards were brought closer into line with International Accounting Standards.
- A “Prompt Corrective Action” framework has been introduced.
- A “forward-looking loan classification” system has been implemented.
- To supervise banks, the so-called “CAMELS” system has been put in place.
- The calculation of BIS capital adequacy standards has been improve.
- Exposure limits on banks’ lending to individual companies and to chaebol were tightened.
- In the insurance sector, a solvency standard based on that used by the European Union was introduced.
- Mark-to-market valuation is now required for ITC funds.
- A partial deposit insurance scheme has been implemented.

Source: OECD (2001)

Because credit risks of the financial sectors depends upon corporate information, reforming measures have been taken on the corporate accounting standards. Transparent and responsible management can be made more likely through the obligatory publication of combined financial statements and institutionalizing the appointment of outside directors that aims at sweep away obsolete dictatorial management practices.

4. Performance

Significant restructuring and injection of the *Public Funds* laid the ground for a healthy and efficient financial system. In the course of restructuring, around 630 non-viable financial institutions closed their doors (see Table 3-9), while the Korean government pumped approximately KRW 157 trillion in the *Public Funds* into ailing institutions. The speedy and resolute settlement of bad loans reduced NPLs in the banking sector from KRW 61 trillion by the end of June 2002, the equivalent of approximately 2.4 percent of total lending (see Table 3-10, Table 3-11 and Figure 3-5).[24]

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[24]) Macroeconomic performance over the last five years is summarized in the appendix.

Table 3-9 Number of Financial Institutions

(unit: %)

	Market Share[1]	Number of Institutions				
		1997	1998	1999	2000	2001
Banks	54	33	25	23	22	20
Merchant Banking Corporations	9	30	14	10	10	3
Securities Companies	4	36	31	32	43	46
Insurance Companies	12	45	40	40	34	33
Investment Trust Companies	11	31	25	23	27	30
Mutual Savings & Finance Cos.	4	231	211	186	147	122
Credit Unions	2	1,666	1,740	1,444	1,317	1,268
Leasing Companies	4	25	25	21	15	16
Total	100	2,097	2,111	1,779	1,615	1,538

Note: 1) Share of total assets as of the end of 1997.
Source: Financial Supervisory Commission

Table 3-10 Non-Performing Loans of Financial Institutions in Korea (as of June, 2002)

(unit: KRW trillion, %)

Section	Banks	Nonbanks Depository	Insurance	Securities & ITC
Total Loans (A)	603.2	113.3	47.8	8.5
Substandard Loans (B)	14.2	11.8	2.2	3.9
Uncovered Substandard Loans (C)	7.3	3.7	0.9	1.2
Substandard Loan Ratio (B/A)	2.4	10.4	4.6	45.9
Uncovered Substandard Loan Ratio (C/A)	1.2	3.6	1.9	20.7

Before the crisis, ROE had been always lower than interest rates and it went down to be negative (-52.5% in 1998). The main factor that eroded banks' profitability was high loan loss provision burden. After the restructuring financial institutions improved credit risk management system, political loan arrangement practices disappeared, and enormous amount of the previous NPLs were removed with the *Public Funds*. All of these contributed to regaining profitability so that ROE in the banking sector soared up to near 16% on average in 2001 and even higher expected in 2002. The profitability of Korean banks is quite comparable to that of advanced countries', though still behind that of leading banks (Table 3-12).

Table 3-11 Capital Adequacy of Commercial Banks

(unit: %)

	1997	1998	1999	2000	2001	2002. 6
ROE	-14.18	-52.53	-23.13	-11.9	15.88	-
ROA	0.93	-3.25	-1.31	-0.57	0.76	-
BIS Ratio	7.04	8.23	10.83	10.53	10.81	10.60
NPL Ratio	6.0	7.4	8.3	6.6	2.9	1.9

Figure 3-5 NPL Ratio and BIS Capital Adequacy Ratio of Korean Banks

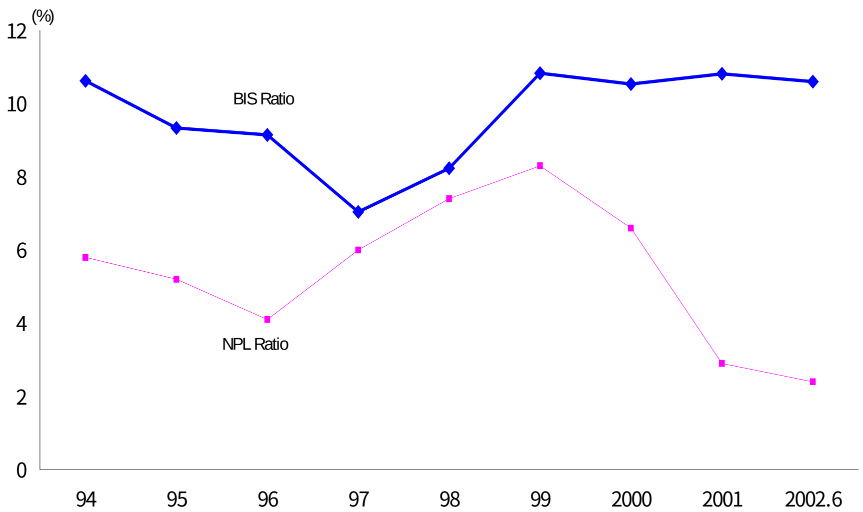

Table 3-12 Profitability across Countries (Per Banker)

(unit: million won)

	Total Assets	Income before Loan Loss Reserves	Net Income	General & Administration Expenses	Labor Costs
KOREA	9,391	152	58	62	31
AMERICA	4,597	77	40	123	51
JAPAN	20,890	128	37	212	103
ENGLAND	5,959	90	54	106	56
FRANCE	11,857	62	42	150	85
GERMANY	9,635	74	26	162	83
CITY	5,100	N/A	68	N/A	N/A
BOA	5,766	N/A	63	N/A	N/A
HSBC	7,528	N/A	111	N/A	N/A
SG	7,623	N/A	45	N/A	N/A

Source: Ministry of Finance and Economy (2002)

Why has Korea been relatively successful in the financial restructuring? As for reforms, democratic leadership is crucial, given that the political economy of reform is social pressure stemming from the painful shift in privileges and interests. At the beginning of the crisis and thereafter for a while, Korea had effective leadership that was not only fully committed to reform but also able to manage the social fallout from reform since the political agenda was also favorable to the reform. Only 20 days later after the outbreak of the crisis, the new president was elected for five-year term so that his administration could make a long-term plan for the reform.

Under the strong political leadership, Koreans were so cooperative and harmonious as to yield substantial results. One of the typical examples is the *Gold Collection Movement* in the late 1997 and early 1998. Even though only gold worth of US$ 2.2 billion was collected under the campaign, it shows Koreans' coalition under the crisis that has been a long tradition found in the history.

Preemptive, but not expected, institutional building shortened fair amount of time on making arguments and plans over restructuring. For example, the consolidated Financial Supervisory Commission (FSC) started just at the same time of financial restructuring with the preparation in advance. Non-performing Asset Management Fund (NPAF) was founded before the crisis and Korea Deposit Insurance Corporation was established a year ahead. All of apparatus played crucial roles in the restructuring.

Lastly, but not least, timely international assistance prevented the financial crisis from amplifying up to country default.

CHAPTER 4

Future Agenda

Five years of structural reform and new sources of economic growth have made it possible for Korea to overcome its financial crisis. Even though the necessary revisions to laws and regulations have been made to ring in a new era of economic growth and prosperity, significant reform is still needed. Structural reform has to be an ‘on-going’ process if market discipline is to become en entrenched part of the Korean economic system. Targets to aim for as reform continues would include making accounting standards violations and false disclosures subject to class action lawsuits, to bring the industry in line with global standards. Eradicating the practice of financial window dressing audit results would be another move in the right direction.

To put a financial system in place that can bolster economic development and international competitiveness, accounting standards and credit risk analysis will have to improve. Banks must become more active in developing and marketing new financial products to meet the diverse demands of customers. The government should expedite the privatization of all banks that have received infusions of the *Public Funds* and closely monitor the repayment process to ensure that no setbacks occur. With regard to sharing the burden of unrecoverable portion of the *Public Funds*, the government proposed their redemption plan that the financial sector be required to assume responsibility for KRW 20 trillion, while the remaining KRW 49 trillion should be covered by the government budgets.

Future challenges lie mostly in software reform since the major hardware reform is made. The purpose of software reform is to enhance business practices and techniques to the international level. To this end, financial companies will be encouraged to take software reform measures with a view to broadening profit bases, strengthening risk management capability, improving managerial skills and lending practices, and embracing other innovations and advances. Deregulation is another area of the major policy aims. While prudential regulation will be further reinforced by taking new steps such as the implementation of new capital adequacy rules reflecting market risks, regulations that impede market competition should be abolished.

As for the transition process, the financial crisis was a blessing in disguise in that it provided a catalyst for change. With a clearly forward momentum, Korea has been applying comprehensive economic and financial reform in order to achieve a full paradigm shift. Despite the relatively successful financial restructuring, Korea should put more emphasis on developing a sound and transparent financial system based on international best standards and promoting the financial industry as a core knowledge-based industry.

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Appendix: Economic Indicators over Last 5 Years

	1998	1999	2000	2001	2002
GDP Growth (%)	-6.7	10.9	9.3	3.0	6.0 (p)
CPI (%)	7.5	0.8	2.3	4.1	2.6 (Jan.-Oct.)
Fiscal Account (trillion won)	-18.8	-13.1	6.5	7.3	28.1 (Jan.-Sep.)
Public Debt / GDP (%)	18.1	20.4	21.3	22.4	-
Foreign Reserves (US$ billion)	48.5	74.0	96.2	102.8	117.0 (Oct.)
External Liabilities (US$ billion)	148.7	137.1	131.7	117.7	129.8 (Sep.)
Net External Assets (US$ billion)	-20.2	8.3	33.1	45.2	46.0 (Sep.)
Non-Performing Loans (trillion won)	-	61.0	42.1	18.8	14.2 (Jun.)
Debt to Equity Ratio (%) - Manufacturing Sector -	303.0	214.7	210.6	182.2	135.6 (Jun.)

Flexibility, Instability and Institutional Insecurity in Korea Labor Market

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ABSTRACT

This study argues that, in countries having institutional insecurity, policies for labor market flexibility may cause the employer opportunism to rise and that as a consequence, gains in efficiency are lessened. This study provides empirical examination of two cornerstones in the Korean government's policies on labor market flexibility; the deregulation of dismissal law and the liberalization of the legal restraints for hiring irregular workers. As for the deregulation of dismissal law, the initiative was introduced in order to relax limitations on employers' use of discretion in relation to employment adjustment. We demonstrate that the disorderly manner in which this change was introduced, may in fact have led to employer opportunism. The other cornerstone in government policy for labor market flexibility was the liberalization of the legal restraints for hiring irregular workers. Institutional insecurity in Korean irregular employment provides essential loopholes that enable employers to exploit or evade their legal obligations. These loopholes, a poor monitoring system and ill-defined legal terms loopholes appear to provide an excellent breeding ground or “hotbed” for extensive opportunism. The analysis in this paper may be useful in the development of policy guidelines for other developing countries which seek to promote flexibility. Any institutional insecurity paves the way for opportunism on the part of either employers or employees, and raises transaction costs in the labor market.

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CHAPTER 1

Introduction

A flexible labor market contains several elements. First, the impediments to market entrance must be lowered to allow a higher degree of mobility. Second, labor market information should be easily accessible to workers as well as employers. Third, education and training programs should be improved to help the jobless move quickly back into work. Finally, unemployed workers should receive basic protection through social insurance or a social safety net.

An important but less often emphasized aspect of labor market flexibility is institutional security. Institutional insecurity embraces elements such as labor market flexibility. As with institutional security in non-labor institutions, institutional security in the labor field comes from the coherence and transparency of the institutional framework. Lack of coherence and transparency paves the way for opportunism on the part of employers or employees; raises transaction costs in the labor market and dissipates economic efficiency. For instance, poor monitoring systems and a combination of ill-defined legal terms and legal loopholes may provide an excellent breeding ground for extensive opportunism. Furthermore, a lack of inter-temporal coherence in the institutional framework leaves private agents confused and inclined to interpret policy in an arbitrary fashion. Lack of coherence and transparency paves the way for opportunism as seen from the employers or employees, raising the transaction costs in the labor market and dissipating the economic efficiency. For instance, poor monitoring system and the combination of vaguely defined legal definition and hotbed of loopholes may provide excellent breeding ground for extensive opportunism. Furthermore, lack of inter-temporal coherence in the institutional framework makes the private agents confused and interpret it arbitrarily.

This study argues that, in countries having institutional insecurity, policies for labor market flexibility may cause employer opportunism to rise and that, as a consequence, gains in efficiency may be less than expected. This study examines two key aspects of the Korean government's policies for labor market flexibility; the deregulation of dismissal law and the liberalization of legal restraints for hiring irregular workers.

The Korean dismissal law (Labor Standard Act, Article 31) strictly and explicitly prohibited unjust dismissal and stated: "*an employer shall not dismiss, lay off, suspend, transfer a worker, or reduce wages, or take other punitive measure against a worker without a justifiable reason*." In 1996, the ruling political party passed an unpopular bill that removed limitations on employers' discretion in the reduction of employment. In the following year, 1997, the bill was amended to become effective two years later. This amendment came about due to significant pressure from the opposing political party and the labor unions. In 1998, Korea experienced a financial crisis that necessitated a "bail out" by the IMF. Due to pressure from the IMF, and consensus in the Korean Tripartite Commission, the bill was again modified to become effective immediately on February 20, 1998 (*i.e.*, 10 months earlier than originally decreed). At the onset, and throughout this turbulent deregulation process, many Korean scholars pointed out (*e.g.*, Ku, 1999; Park, 2002; Cho and Keum, forthcoming), that the labor law had already lost its rigor at the time of enactment of the 1996 bill.

Employers surely support this deregulation trend, arguing that greater freedom to make employment adjustments creates more jobs, which will eventually benefit employees. As expected, labor committees and unions in Korea strenuously oppose this trend; they further argue that, due to this legal transition, wrongful discharges have become more prevalent, and that the labor market accordingly has become more unstable.

Empirical analysis in this paper indicates the existence of negative consequences of the inter-temporally inconsistent deregulation of Korean dismissal law: less than expected gains in efficiency following the introduction of market flexibility, and an increased tendency on the part of employers to engage in the practice of unjust dismissal. This study has evaluated some of the potential causal factors in relation to these intriguing phenomena. These have included the change in employer opportunism, differing interpretations of the deregulation of dismissal law on the part of the courts and employers, and intensified competition in the global market.

The second key aspect of the Korean government's policies for the labor market flexibility is the liberalization of the employment law for irregular workers.[1)] The institutional insecurity in Korean irregular employment provides the loophole that enables employers exploit or evade their legal obligations. In the case of Korea, businesses with 5 or less employees represent loopholes for employers to evade their legal obligations. These businesses, which are not subject to the Korean Labor Standard Act, provide a hotbed for unlawfulness and the situation offers little or no protection for irregular employment. If the employment rules explicitly stated under the current Korean Labor Standard Act as they relate to businesses employing 10 employees or more were to be extended to cover these smaller businesses, it would encourage more transparent work practices in the field. Also lack of a workable definition of irregular employment Is necessary to enable laws to be properly drafted and enforced, and to prevent the misclassification of workers, and the subsequent denial of their rights. This paper will provide empirical support for the existence of Korean employers' exploitation of institutional insecurity in the hiring of irregular workers.

Results of the analysis of the Korean situation contained in this paper may be useful in helping developing countries choose flexibility policies. Any institutional insecurity may cause unintended negative effects and lessen efficiency gains expected as a result of labor market flexibility. In chapter 2, we will examine how the stability or instability has been changed after the 1997 financial crisis. In the first part of chapter 3, we will address institutional insecurity associated with the deregulated dismissal law by examining court cases concerned with unjust dismissals. In the second part of chapter 3, we will deal with institutional insecurity in relation to irregular employments. Conclusions are presented in chapter 4.

[1)] For instance, Korean Act on Protection for Temporary Help Employees was enacted to liberalize the temporary help work on February, 20, 1998 immediately after the financial crisis in the late 1997 burst.

CHAPTER 2

Instability in Korean Labor Market: Comparison Before and After the 1997 Financial Crisis

1. Changes in the Korean Labor Market

Due to rapid economic growth and increasing demand for labor for more than three decades, Korea experienced labor shortage as it approached the financial crisis in November 1997. The unemployment rate remained at less than 3 percent for more than 10 consecutive years. During the 1990-1997 period, the average growth rate of nominal wages was around 13 percent. Real wages almost doubled from 1987 to 1997. Wage growth far outstripped productivity growth, undermining the competitiveness of Korean goods at the global marketplace.

The financial crisis of late 1997, which was followed by structural reforms and macroeconomic stabilization programs, had significant impacts on the labor market. In 1998, the number of employed fell by 1.1 million and the unemployment rate reached 6.8%, with the number of unemployed exceeding 1.4 million. Most job losses occurred in the construction, trade, and manufacturing sectors. After the financial crisis, the proportion of regular workers in total employment decreased, while that of non-regular workers--such as temporary and daily workers--increased.

The Korean economy rapidly recovered from its deep recession mainly owing to painful efforts of economic restructuring after the financial crisis. Economic growth resumed as both consumption and exports increased. As a result, real GDP grew by 10.9 percent in 1999. Although the unemployment rate remained at as high as 6.3 percent in 1999--largely due to lagging effects of business cycles on the labor market--it started to decrease significantly in 2000. The unemployment rate in 2001 was 3.7 percent, with 819,000 unemployed.

Since the financial crisis of the late 1997, most workers in Korea have experienced a rise in job instability. When compared to the period prior to the economic crisis, this rise in job instability has been most significant among employees with non-regular employment arrangements, women and older workers. Despite the need to study the level, variation and underlying causes of job instability in the Korean labor market, there has been little empirical research on the issue.[2)]

Using data sets from the Korean Labor and Income Panel Study (hereafter KLIPS)[3)], this

[2)] The concept and measures of job instability have not developed clearly until the early 1990s. Gottschalk and Moffitt (1994) measured job instability as the instability of working hours, while Farber (1993) and Boisjoly *et al.* (1994) measured it as the temporary layoff or the number of lockouts. In 1997, the concept based on tenure with one's current employer was constructed by Diebold *et al.* (1997), and tenure was measured by job retention rates. The *t*-year retention rate is the probability that a worker will have an additional *t* years of tenure. Previous research using the CPS, PSID, and NLSY data in the U.S. have failed to provide a clear evidence on increased job instability for all workers. However, it has been found that job instability has been increased for some groups of workers, especially for young, less-educated, and Afro-Americans.

[3)] The Korean Labor and Income Panel Study (KLIPS) is a longitudinal household survey conducted by Korea Labor Institute. It is designed to measure changes in the well-being of individuals and families over time and the determinants of the well-being. The target population for KLIPS is all persons living in urban area, excluding people in Jeju Island and residents of institutions. The first reference year of the survey was 1998, and individuals selected for the survey are interviewed once per year. For the first panel, around 5,000 households were included as samples, composed of about 13,300 adults aged 15 years and over. In the first year of the survey, the KLIPS section examines changes in job instability in the Korean labor market since the mid-1990s, and compares them with the trends in the U.S. labor market which is known as the most flexible labor market. To compare job instability trends in both the U.S. and Korea, it is necessary to explain the comparative systems of the two labor markets. The OECD (1999) has reported that the U.S. had been the easiest country among 27 OECD countries in dismissing regular workers by the management. The U.S. had maintained such reputation since the second half of the 1980s and throughout the 1990s, indicating that the paradigm of the U.S. labor market remained stable for over a decade. On the other hand, however, the paradigm of the Korean labor market has experienced an especially rapid change during the economic crisis and continues to make major shifts. The OECD (1999) has reported that Korea ranked second, only to Portugal, in the late 1990s as a country where the management encountered difficulties in dismissing their employees. It should be noted that recent deregulation of the Korean dismissal laws[4] in 1998 had been incorporated in these indices.

According to the OECD indices, Korea is one of those countries having very rigid labor markets, while the U.S. is a country with a very flexible labor market. With such information, a question naturally arises as to why the level of job instability in Korea has abruptly soared after the economic crisis in 1997, in spite of those well-designed employment protection programs against rampant dismissals by the management. In fact, those OECD indices do not explain appropriately different impacts of the Korean labor law on large and small firms.

At the workplace level of small-and medium-sized enterprises, where the union power has been traditionally very weak and the industry-level union has rarely been developed, workers have been practically defenseless against management's search for short-term quantitative labor flexibility. In fact, with a dual structure of the Korean labor market, deregulation of the Korean labor law has lead to different consequences--having a more adverse effect on the job stability of workers in small-and medium-sized enterprises as compared to that of workers in larger companies.

Different wage systems in the U.S. and Korea seem to affect firm's incentive to acquire greater labor flexibility. Whereas performance-based wage scheme has prevailed in the U.S., seniority-based wage scheme--where after a certain year of tenure the gap between labor productivity and wage increases monotonically with each worker's tenure--has traditionally been adopted in Korea. This seniority-based wage scheme did not function well in motivating or sorting workers within the local labor market (Cho and Keum, 1999). When the economic crisis of 1997 pressured firms to reduce costs under such pay system, companies found themselves with greater incentive to lay off long-tenured workers, who had larger gaps between productivity and wage than the short-tenured workers had. As a result, the job instability of long-tenured workers increased markedly during the economic crisis.

Also, it seems that Korean workers find greater opportunities in the non-wage sector than U.S. workers do. In 2000, the proportion of workers employed in the non-wage sector in Korea was 38.3%, compared to 8.2% in the U.S. Because of such large proportion and influence of the non-wage sector in Korea, many Korean wage workers are observed to

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collected retrospective data on work experience in the past. It aimed to get an approximate measure of total work experience by asking respondents to recall their total work history in broad terms, using a series of questions such as the starting and ending dates, industry, occupation, and employment type.

4) Pertinent to massive dismissals, the Korean dismissal law requires the management to provide immediate and concrete justification, exert efforts to avoid massive dismissal, communicate faithfully with union or work representatives, and finally select dismissing workers with a fair set of criteria. However, these vague procedural requirements were less likely to be complied by the management in small-and medium-sized enterprises, where the union traditionally had had little bargaining power. In fact, in 1998, only 115 firms notified their plans to lay off 12,000 workers; whereas, the Korea's Employment Insurance System reported that, during the same period, the total number of dismissals reached 140,840. It clearly suggests that most dismissals did not comply with the required procedures.

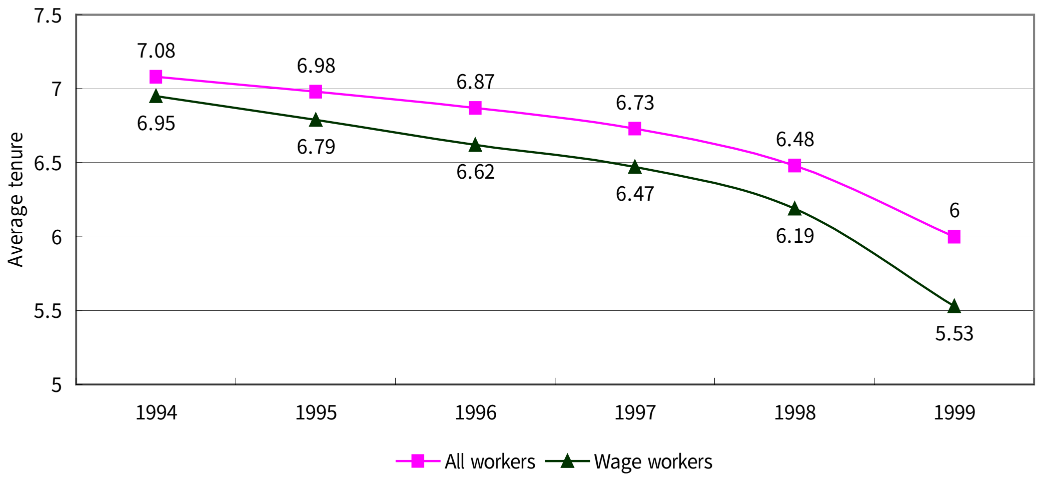
start their own businesses in their 40s or 50s. It indicates that there is a clear tendency in Korea for workers to start as wage workers in their early years of employment and then to begin their own businesses when they have gathered enough work experience and personal assets.

The research methods used in this section are similar to those employed by Jaeger and Stevens (1999), Neumark *et al.* (1999), and Bernhardt *et al.* (1999). In order to measure job instability in the U.S. labor market, Jaeger and Stevens (1999) examined changes in the share of workers with 1-year-or-less of tenure and in the share of workers with less than 10 year of tenure. While Neumark *et al.*(1999) estimated job retention rates using data from the U.S Current Population Survey (CPS), Bernhardt *et al.* (1999) empirically investigated the determinants of 2-year job separation rates using data from the U.S. National Longitudinal Survey (NLS) and National Longitudinal Survey of Youth (NLSY). In this article, job retention rates and job separation rates are estimated for the Korean labor market and they are compared with those in the U.S. labor market.

2. Change*s* in Tenure

Changes in average tenure can be used as an indicator of increased job instability in Korea after the financial crisis of the late 1997. Although some studies have already pointed out the limitations of these indicators in measuring job instability in the labor market,[5] our empirical research in this section will start by examining the significant changes in average tenure. Job retention rates will be estimated in the next chapter in order to measure job instability in the Korean labor market.

Figure 2-1 Changes in Average Tenure



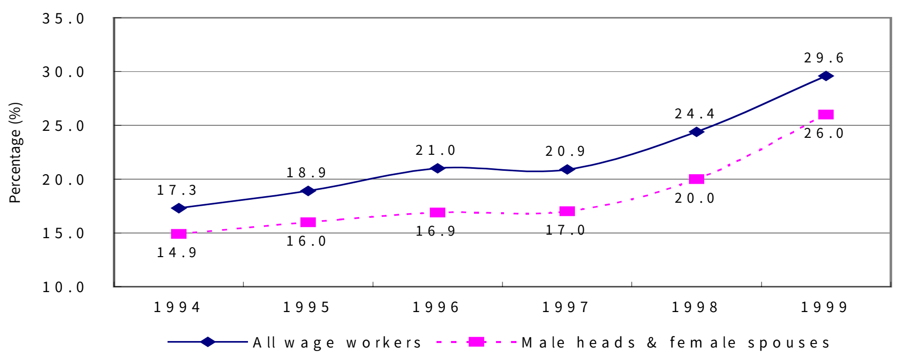
[5]) For instance, Auer and Cazes (2000) pointed out that the declines in average tenure may be attributable to strong employment creation, rather than structural changes in the employment relationship. They suggested that most of the declines in average tenure can be explained by a reduction in the tenure of young workers. Because most firms offer only temporary contracts to new labor market entrants, young workers are more likely to change their jobs after entering into the labor market.

The average tenure calculated from the KLIPS tended to fall from the mid-1990s. The tenure of all workers has declined from 7.08 years in 1994 to 6.00 years in 1999 (see Figure 2-1). Worth noting is the significant decrease in the tenure of Korean wage earners, whose tenure has decreased by as much as 20.4% over the period.[6] Clearly, job stability has been deteriorated more for wage earners than non-wage earners during the financial crisis. In addition, the gap in average tenure between all workers and wage earners has also widened significantly during the same period.[7]

3. Trends in the Share of Workers with 1-Year-or-Less Tenure

In order to compare with the analysis based on PSID, Jaeger and Stevens(1999) drew on the representative sample of male heads of households and their spouses (hereinafter the householders) from the CPS data. By examining trends in the fraction of employees with 1-year-or-less tenure and in the fraction of employees with less than 10 years tenure, they examined changes in job instability in the U.S. market over a certain period of time.

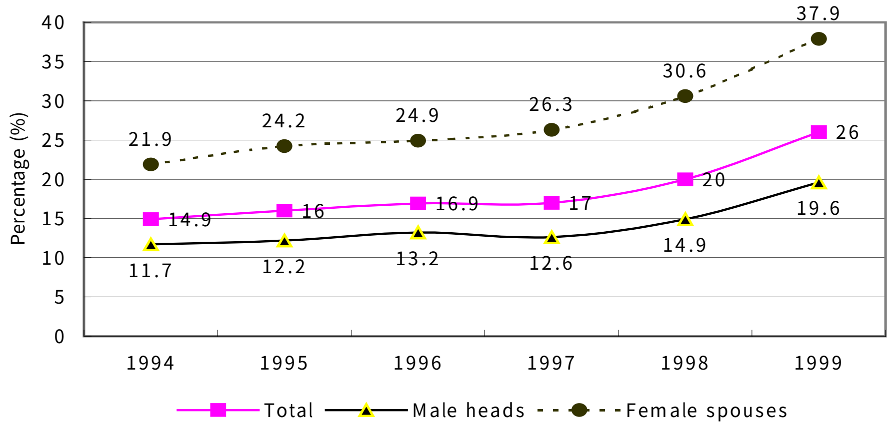
Figure 2-2 Trends in the Proportion of Employees with 1-Year-or-Less Tenure



[6]) Even prior to the financial crisis, one of the major causes for the drop in average tenure was the continuous increase in the number of employed. According to the panel data, the number of the employed increased from 6,074 in 1994 to 6,273 in 1995, and further to 6,581 in 1996, and 6,704 in 1997. However, the number of the employed in 1998 fell to 6,555. Although it further fell to 5,983 in 1999, it is hard to directly compare the number of the employed in 1999 with those in other years, in part, due to the sample attrition. This change in total employment did have an effect on the distribution of the number of years employed as well as the number of average years employed. To solve this problem, the concept of historical retention rate described later is used.

[7]) There was evidence on declines in the average tenure for males and females, and that of male workers was remarkable during the 1998-1999 period. In particular, the difference in the average tenure between regular and non-regular workers increased rapidly since 1997. This reflects the fact that the employment adjustment by firms during the financial crisis was more focused on non-regular workers. In addition, new recruitment opportunities were also more concentrated to those workers.

Figure 2-3 Changes in Gender Distribution of 1-Year-or-Less Tenured Employees



This study sampled the KLIPS in the same way as Jaeger and Steven did. Figure 2-2 demonstrates changes in the proportion of those with tenure of 1-year-or-less over the 1994-1999 period.[8] The share of employees with 1-year-or-less tenure increased from 14.9% in 1994 to 17% in 1997 just before the financial crisis, indicating that the proportion has started to increase from the mid-1990s. However, it should be noted that the proportion has increased significantly from 20.0% in 1998 to 26.0% in 1999. This is largely due to the rapid economic recovery during the period, with many of those unemployed in 1998 getting back to work in 1999. It is also interesting to note that the share of employees with 1-year-or-less tenure is relatively high when non-householders were also included in analysis. It rose from 17.3% in 1994 to 20.9% in 1997, and further increased to 29.6% in 1999. While the proportion of 1-year-or-less tenured employees in householders was 20.0% in 1998 (see Figure 2-2), the proportion of those in non-householders was as high as 37.3 %. However, it should be noted that most workers in their 20s, whose employment duration is relatively short and who are less likely to be heads of households, are included in the sample of those who are not householders. Thus, the demographic composition of the sample seems to have contributed to increasing the proportion of 1-year-or-less tenured employees.

[8]) Young workers under age 20, older workers aged 60 and over, and those working in the primary industries (such as agriculture, fishing, forestry, quarrying, mining, *etc.*) were excluded in this paper, but only wage earners aged between 20 to 60 were included.

Figure 2-4 Changes in the Proportion of 1-Year-or-Less Tenured Employees by Age Cohort

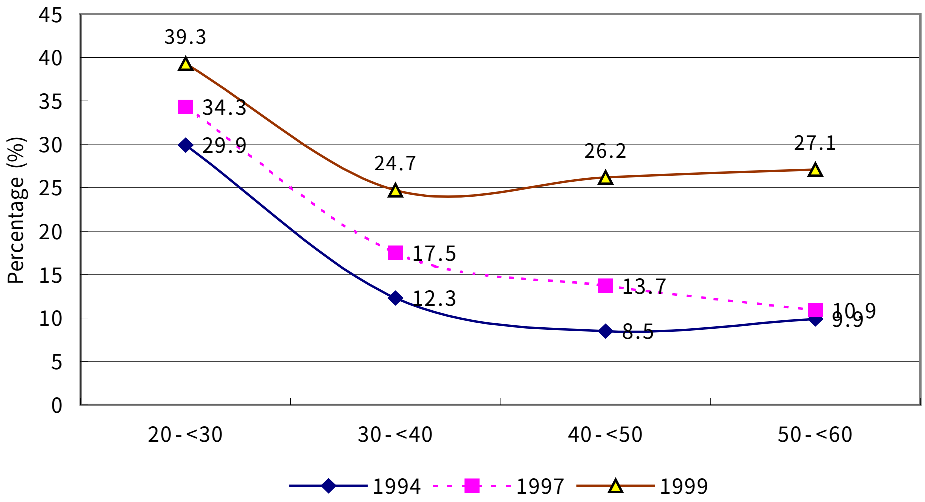


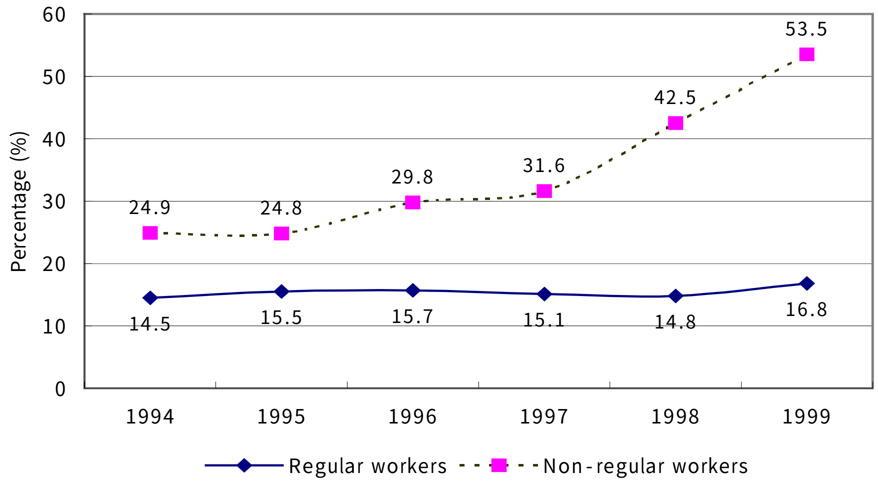
Figure 2-3 illustrates changes in the proportion of employees with 1-year-or-less tenure by gender since the mid-1990s. The proportion of employees with 1-year-or-less tenure is lower for male heads than female spouses over whole periods. The proportion of male heads rose slightly from 11.7% in 1994 to 12.6 % in 1997, and further increased to 19.6% in 1999. The trends for women also show a similar pattern, with the proportion rising from 21.9% in 1994 to 26.3% in 1997, and further to 37.9% in 1999. It is important to note that such kind of large change in the proportion of employees with 1-year-or-less tenure has never been observed in the U.S. labor market, in which the proportion has relatively stabilized within the range of 20 25% (Jaeger and Steven, 1999).[9] Changes in the proportion of short-tenured employees before and after the financial crisis can further be observed by analyzing variations across age cohorts. While the number of 1-year-or-less tenured employees decreases with age, the difference in the proportion between age cohorts increases with age (see Figure 2-4). Figure 2-4 also indicates that job instability did indeed increase for the middle-aged and older workers during the financial crisis.

Figure 2-5 illustrates the year-to-year change in the proportion of employees with 1-year-or-less tenure by employment type. There has bee little change in the proportion of regular workers with 1-year-or-less tenure, despite a slight increase in 1999. In contrast, the proportion of non-regular workers with 1-year-or-less tenure started to increase from 1994, and soared during the financial crisis. In 1999, 53.5% of non-regular workers were employed for less than 1 year. This significant increase in 1999 can be explained largely by the flow of the unemployed and new labor-market entrants into non-regular employment

9) According to the OECD Employment Outlook (1995), the average monthly job turnover rate in the U.S. (job turnover rate : [(number of entrants + number of separation) over number of the employed]) 100) was about 10% in the early 1980s, while the corresponding figure in Korea was 5% in the early 1990s. Korea ranked at the bottom among OECD countries except Holland and Japan. However, a more reliable analysis of the turnover should be based on research on turnover by cohort. American workers show high turnover in their adolescence, while they enjoy long-term employment in the middle- and old-aged. The research confirming this result has already been presented in the 1980s. For example, Hall (1982) discussed the importance of long-term employment in the U.S. labor market, presenting evidence of low turnover in middle- and old-aged cohort. Kazuo Koike (1978) has also announced that the proportion of the long-term employed with tenure of 15 years or more is much higher in the U.S. than in Japan.

such as part-time work.

Figure 2-5 Changes in the Proportion of 1-Year-or-Less Tenured Employees by Employment Type



4. Changes in Job Retention Rates

Job retention rates provide measures of job instability in the labor market. Specifically, the *t*-year retention rate, *R(t)*, is defined as the probability that a worker will have an additional *t* years of tenure. The *t*-year retention rate may be defined for any subgroup of the population. Denoting current tenure by c, and other characteristics by x, the job retention rate may be defined as $R^0_{xc}(t)$ in the base year (year 0). The sequence of retention rates, $R^0_{xc}(t)$; t=1,2, …, is the survival function, which provides the probability distribution of eventual tenure.

Hall (1982) estimated current retention rates, providing that the survival function and arrival rate are constant over the time. Using the 1978 CPS data, he calculated the contemporary retention rate $R_{xc}(t)$ by dividing the fraction of workers with $t+c$ years of tenure by the fraction of workers with c years of tenure. The problem with this method is that if demographic or employment structures have changed over time, the contemporary retention rate would not reflect the actual job retention rate. The calculation of historical retention rates, however, helps to overcome this problem because the estimation of historical retention rates is based on the panel data. In this section, historical retention rates are calculated by using the KLIPS. This study also investigates variations across cohorts and their annual changes in order to measure changes in job instability in Korea after the financial crisis.

Let us define N^0_{xc} as the number of workers with c years of tenure in the panel of base year (year 0), and $N^{0+t}_{x,\,t+c}$ as the number of workers with characteristics x and with $t+c$ years of tenure in year t. The historical job retention rate is defined as follows:

$$R^0_{xc}(t) = N^{0+t}_{x,\,t+c} \,/\, N^0_{xc} \qquad (1)$$

The job retention rates by gender, employment type, age, industry and occupation are shown in Table 2-1 and Table 2-2. In the U.S., because the Current Population Survey does not provide annual data on tenure, the 4-year job retention rate is used for comparison between the period 1983-1987 and 1987-1991 (*e.g.*, Neumark *et al.*, 1999; Diebold *et al.*, 1997). For example, Neumark *et al.* (1999) estimated the 4-year job retention rates for 1983-1987, 1987-1991 and 1991-1995, as well as the 8-year job retention rates for 1983-1991 and 1987-1995, and then compared them in order to investigate the temporal evolution of job instability in the U.S. labor market.

The primary advantage of using the KLIPS data is that it does not have the problem of heaping and rounding effect as the Current Population Survey in the U.S. has. However, there are still difficulties in comparing the 4-year job retention rates of two different periods as Neumark *et al.* (1999) did, due in large part to the short period of data cumulation in the KLIPS. After estimating the 4-year job retention rates for the period 1995-1999 in Korea, they are compared with the 4-year job retention rates for 1983-1987 and 1987-1991 in the U.S. estimated by Neumark *et al.*. Furthermore, by estimating and comparing 2-year job retention rates for the period 1995-1997 and 1997-1999, this study attempts to measure changes in job instability in the Korean labor market after the financial crisis.[10)]

Table 2-1 shows estimates of job retention rates for selected tenure, gender, employment type, and age subgroups in Korea. The 4-year job retention rate of Korean workers was 47.4% for the period 1995-1999, lower than that of workers in the U.S. for any period examined. According to Neumark *et al.* (1999), the 4-year job retention rate of American workers was 56.6% for the period 1983-1987, 54.5% for 1987-1991, and 57.1% for 1991-1995. By tenure, the 4-year job retention rates in Korea show a reversed U-shape with a plateau at the tenure cohort of 9-15 years. This is similar to the pattern observed in the U.S. labor market.[11)]

Panel B of Table 2-1 shows disaggregated results by gender. The 4-year job retention rate of Korean male workers was 47.4% for the period 1995-1999, lower than that for males in the U.S. in any period. The 4-year job retention rate of American male workers was 60.1 % for the period 1983-1987, 56.0% for 1987-1991, and 56.8% for 1991-1995. The difference in job retention rates between the U.S. and Korea is much larger for females. The 4-year job retention rate of American female workers was 51.4 % for 1983-1987, 50.9% for 1987-1991, and 53.2% for 1991-1995, much higher than the 33.6% of Korean female workers.

The distribution of job retention rates by age group, instead of by tenure, is shown in Panel D of Table 2-1 and Figure 2-6. A reversed U-shape with a plateau at the age cohort of 40-<55 was observed in both Korea and the U.S. However, it is important to note that these increases in age-specific retention rates were more significant and larger in the U.S. than Korea during this period. The 4-year job retention rate for 1991-1995 period in the U.S. increased to 29.6% for 16-25 age group, 58.0% for 25-40 age group, and 68.3 % for 40-54 age group. This empirical research stands in sharp contrast with our perception that job retention rates increase with age more rapidly in Korea than in the U.S. and indirectly supports the results of Hall(1982) and Kazuo and Koike(1978).

Table 2-2 shows estimates of job retention rates for selected industries and occupation subgroups in Korea. By occupation, the 4-year job retention rate of managerial and professional workers is the highest among all occupations. It is similar to the pattern observed in the U.S. According to Neumark *et al.* (1999) the 4-year job retention rates of U.S. workers was 53.1% for production workers, 70.1% for managerial and professional workers,

10) Only wage earners aged 16 and over were included in the analysis, while those working in the primary industries were excluded.

11) Before the financial crisis, the 4-year job retention rate for the Korean worker was 60.9% for the period 1993-1997. There exists a possibility that the retention rate was over-estimated, since short-term work experiences have not been reported in the panel survey. However, the estimated result of 4-year job retention rate for the period 1993-1995 suggests that job instability of the Korean labor market before the financial crisis was not higher than that of the U.S. Widespread bankruptcy and structural reform of Korean corporations following the financial crisis had been major causes of increased job instability.

50.9% for clerical workers, and 38.8% for service and sales workers. These figures, however, were all higher than those of Korean workers. The 4-year job retention rates of Korean workers during the 1995-1999 period was 37.8% for production workers, 56.3% for managerial and professional workers, 47.8% for clerical workers, and 26.7% for service and sales workers. The notion that the job instability of production workers is higher than that of clerical workers and that the job instability of manufacturing sector is lower than that of non-manufacturing sector has not been observed in the U.S. labor market.

In order to see the impact of the 1997 financial crisis on job instability in the Korea labor market, this study estimates and compares the 2-year job retention rates for the period 1995-1997 and 1998-1999. As seen in Figure 2-7 and Figure 2-8, the declines in 2-year job retention rates occurred in all tenure cohorts during the financial crisis, indicating the severity of the impact of the financial crisis on job stability.

From the period 1995-1997 to 1997-1999, the 2-year job retention rate fell from 68.8 % to 54.5%. Figure 2-7 demonstrates changes in 2-year job retention rates by tenure. Over the 1995-1997 period, the 2-year job retention rates increased monotonically with tenure. However, it is interesting to note that it shows a reversed U-shape during the financial crisis, The difference in 2-year retention rates between 1995-1997 and 1998-1999 increases with tenure, suggesting that long tenured employees were the most affected by the financial crisis.

Table 2-1 Estimated Job Retention Rates for Selected Gender, Employment Type, and Age Subgroups

(In percentage)

Specification and Initial Tenure Group		4-Year Job Retention Rates (1995-1999)	2-Year Job Retention Rates	
			1995-1997	1997-1999
A. Tenure	0-<2	30.6	55.9	41.9
	2-<9	47.2	70.9	61.1
	9-<15	51.3	80.1	65.9
	15+	49.1	82.8	59.5
	Sum	42.6	68.8	54.5
B. Gender	Female			
	0-<2	28.2	50.2	34.9
	2-<9	35.0	60.6	55.9
	9-<15	43.5	75.9	57.7
	15+	52.5	79.5	62.5
	Sum	33.6	58.2	46.2
	Male			
	0-<2	32.6	61.0	48.7
	2-<9	54.4	76.9	64.2
	9-<15	53.6	81.3	68.6
	15+	48.7	83.3	59.0
	Sum	47.4	74.5	59.3
C. Employment Type	Regular Job			
	0-<2	31.8	56.9	45.3
	2-<9	49.3	69.8	63.6
	9-<15	53.4	79.0	69.7
	15+	53.3	82.9	64.7
	Sum	44.6	68.4	58.2
	Non-Regular Job			
	0-<2	25.5	52.0	31.3
	2-<9	37.7	76.1	49.6
	9-<15	41.9	85.2	51.2
	15+	37.1	82.6	43.3
	Sum	34.1	70.3	41.3
D. Age	16-<25	27.1	44.6	41.7
	25-<40	47.7	71.8	59.4
	40-<55	48.0	78.3	57.9
	55+	23.5	68.9	36.9
	Sum	42.6	68.8	54.5

Table 2-2 Estimated Job Retention Rates for Selected Industry and Occupation Subgroups

(unit: %)

Specification and Initial Tenure Group		4-Year Job Retention Rates (1995-1999)	2-Year Job Retention Rates	
			1995-1997	1997-1999
A. Industry	Manufacturing			
	0-<2	27.7	55.6	43.9
	2-<9	44.8	68.9	57.6
	9-<15	45.6	73.1	62.4
	15+	33.9	77.2	47.7
	Sum	38.1	65.9	52.5
	Non-Manufacturing			
	0-<2	31.8	56.2	41.3
	2-<9	48.6	72.2	62.7
	9-<15	54.7	83.3	68.2
	15+	53.5	84.8	62.5
	Sum	44.8	70.3	55.5
B. Occupation	Blue-Collar			
	0-<2	29.3	60.3	40.3
	2-<9	42.6	70.6	56.5
	9-<15	44.1	77.5	55.8
	15+	36.1	79.3	46.9
	Sum	37.8	69.5	49.6
	Managerial and Professional			
	0-<2	37.9	59.6	50.2
	2-<9	60.2	76.9	71.8
	9-<15	70.5	90.8	83.5
	15+	66.7	88.0	74.4
	Sum	56.3	76.1	67.1
	Clerical			
	0-<2	31.2	50.4	42.9
	2-<9	53.8	71.5	67.1
	9-<15	64.6	85.0	80.8
	15+	57.7	84.6	70.4
	Sum	47.8	67.1	60.5
	Service and Sales			
	0-<2	22.4	46.1	35.2
	2-<9	28.9	58.4	47.1
	9-<15	23.1	58.5	44.8
	15+	52.0	83.9	51.9
	Sum	26.7	54.3	41.3

Figure 2-6 Estimated Job Retention Rates by Age Subgroups: 4-Year Span

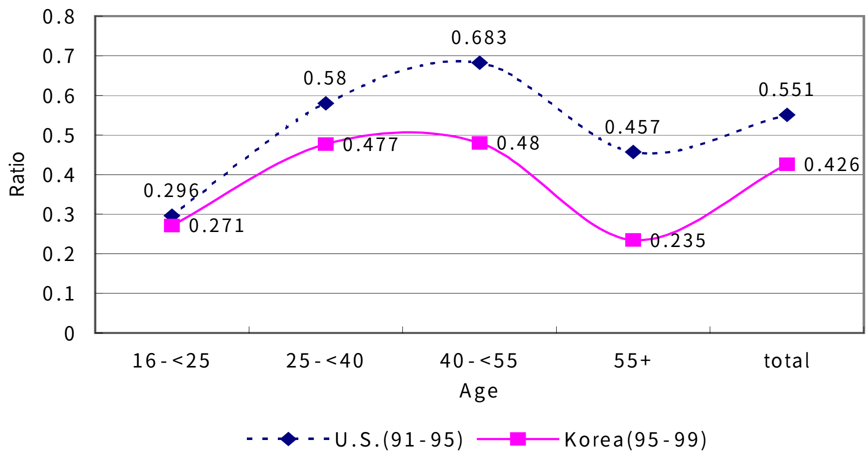


Figure 2-7 Changes in 2-Year Job Retention Rates by Tenure

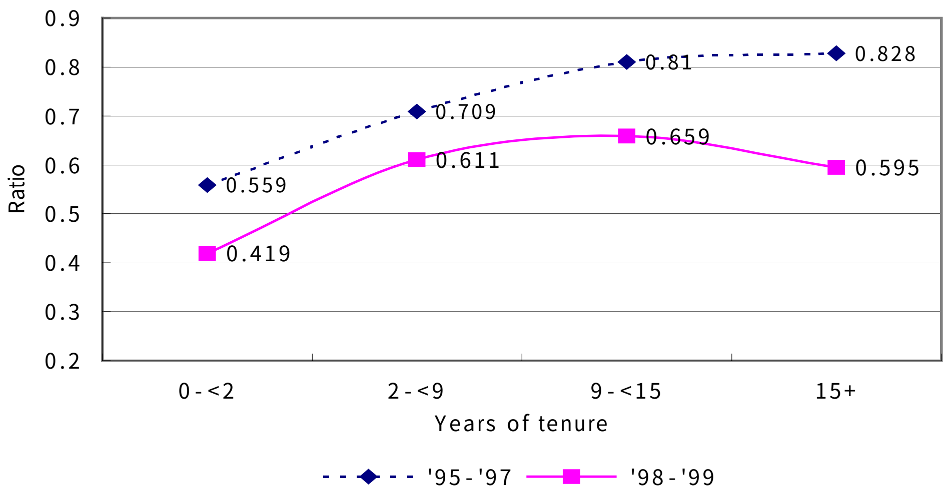
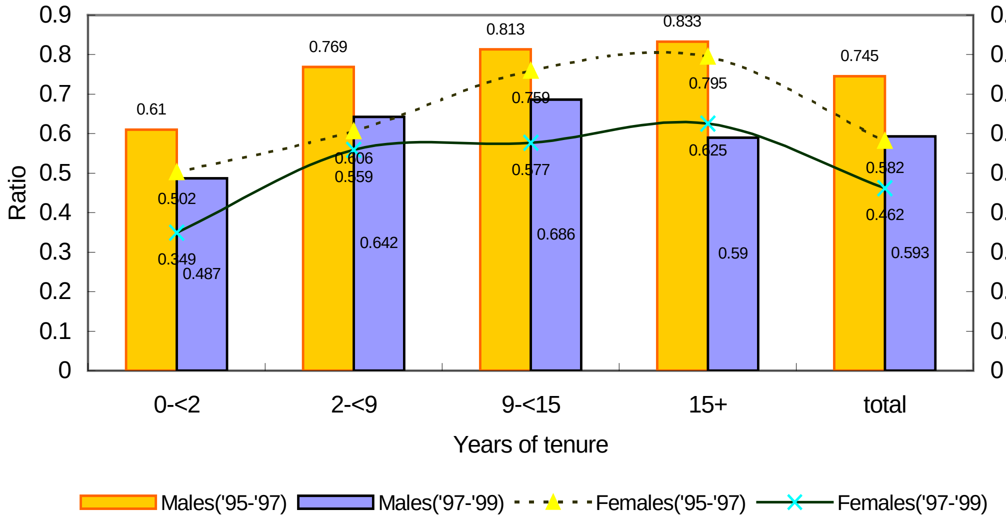


Figure 2-8 Changes in 2-Year Job Retention Rates by Gender and Tenure



The 2-year job retention rate for women decreased from 58.2% in 1995-1997 to 46.2% in 1997-1999, while men experienced a drop from 74.5 % to 59.3% over this period. An analysis of gender gap in job retention rates shows that the-2-year retention rates for men were higher than women across all tenure cohorts over the 1995-1997 period (see Figure 2-8). However, note that this picture of gender gap in job retention rates has changed during the 1997-1999 period. For long-tenured employees with 15 or more years of tenure, the job turnover rate for male employees decreased sharply after the financial crisis. Over the 1997-1999 period, the 2-year job retention rate was lower for men than women (59.0% and 62.5%, respectively), among those with tenure of 15 years or more.

When we look at job retention rates by employment type, we can find that the financial crisis had a greater impact on job instability of non-regular employees. Over the 1995-1997 period, there was little change in the 2-year job retention rates for both regular and non-regular employees. However, over the 1997-1999 period, the rate for non-regular employees decreased sharply to 31.3%, compared to a decrease to 45.3% for regular employees. It is clear that those with non-regular employment arrangement experienced the largest declines in job stability during the financial crisis (see Table 2-1).

By occupation, the visible reduction in the 2-year employment span of blue-collar workers was the greatest--whereby production workers accounted for a drop of 19.9 percentage-points, which was followed by a drop of 13.0 percentage-points for service and sales workers. By contrast, the rates of decrease were relatively lower for managerial and professional workers and clerical workers. The analysis indicated that, by having to face vastly aggravated job instability, workers with 9 or more years of tenure in the production, service, and sales sectors had been the most adversely affected by the economic recession that followed the 1997 financial crisis. Although all work groups had been adversely affected by the financial crisis, analysis of job retention rates by tenure showed that workers with 9 to 15 years of tenure had encountered the largest decrease. Similar analysis of job instability showed that those more negatively affected were non-regular workers--when considered by employment types; older workers--when considered by age groups; and production and service workers--when considered by occupation types.

CHAPTER 3

Institutional Insecurity in Korean Labor Market

1. Institutional Insecurity in the Deregulated Dismissal Law

1-1. Deregulation of Korean Dismissal Law

By examining Korean court cases, this section will examine how deregulation of the dismissal law in Korea affected the employers' tendency to carry out unjust dismissals. It will interpret the findings, first by presuming that the court adjudications for employers' unjust dismissals are a good proxy variable representing the incidence of employers' opportunistic breaches of the law, or in other words, the employers' opportunistic dismissals. Next, this study will consider possible alternative causative factors in relation to the increase in the incidence of employers' unjust dismissals.

Between March, 1987 and June, 1999, there were 815 court cases dealing with unjust dismissals.[12)] There are two ways for employees to be protected from unjust dismissals. One way is to submit a remedial application for unjust dismissal to the Korean Labor Commission. The plaintiffs or defendants may appeal to reverse the adjudication of the Labor Commission to the courts. Of the 815 cases, 399 involve this option. Alternatively, employees may go directly to the district court. The cases may later be appealed to higher courts. The parties in the residual 416 cases took this route. Overall, 459 cases out of the 815 have been appealed to higher courts. Cases at the low levels of the Korean Labor Commission, or at lower courts, have been sorted out from the final data set to avoid any double counting.

Our empirical study follows the conventional category of dismissals (*e.g.*, Collins, 1991; Gwyneth, 1993); disciplinary, economic, and public right. This study focuses on the disciplinary and economic dismissals, which can be relatively easily exploited as ways for employers to opportunistically breach. Table 3-1 summarizes the descriptive statistics for the variables used, WIN is the fraction of the plaintiff's winning cases. WTENURE is the average value of tenures of plaintiffs on their winning cases.

This study takes the proxy variables for the employer's opportunistic dismissals; WIN and WTENURE.[13)] By analyzing the period change of these variables, the change in the employer's opportunism over periods is evaluated.

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12) In order to scrutinize all cases of unjust dismissals, two references for unjust dismissal cases were used. The first one is the literature survey on *the Collection of Cases of the Korean Labor Committee, the Collection of Cases of the Korean District and High Court* and *the Collection of Cases of Korean Supreme Court*. They provide the whole contents of cases. The second sources are internet cites such as Lex, Kingsfield and Net-Law, which were useful in searching the lower court cases matched with the Supreme Court case.

13) We may borrow the recent empirical studies for the deferred wage scheme to defend WTENURE as a proxy variable for the employer's opportunism. Idson and Valletta (1996) and Valletta (1999) found evidence suggesting that involuntary separations of long-tenured employees may reflect employer's opportunistic breach of implicit employment arrangement. Furthermore, under the seniority-based compensation scheme prevailing in the majority of Korean firms, the employee's tenure reflects the predetermined scale of wage increment rather than the employee's productivity. If the productivity increase is less than the scale, the employers may have incentive to dismiss their employees to avoid the promised wage payment. Under any circumstance, the employees' average tenure on unjust dismissal cases (*i.e.*, WTENURE) will reflect the employer's opportunism. However, this study will also probe on factors other than the employer's opportunism.

Table 3-1 Descriptive Statistics of the Major Variables

Variable	Total	Disciplinary	Economic
Number of Cases	815	526	66
WIN (Plaintiff Winning Fraction, %)	37.1	40.1	33.3
WTENURE (Average Tenure of Plaintiffs on Winning Cases, Year)	5.9	6.5	8.6

Figure 3-1 displays the period change of WIN. In Figure 3-1, WIN has a tendency to decline between 1988 and 1990, reaching its lowest value of 24.6% in 1990. In 1991, when the Supreme Court made a final adjudication on *Dongbu Chemical Corp v. Choi*, this declining tendency was reversed, increasing to 38.9% in 1992. It subsequently stabilized between 35% and 40% before 1998. However, during the economic crisis followed by the IMF rescue package in 1999, this stable trend was broken, and WIN soared to 62.5%. We can question whether these trend changes can be attributed to judicial change.

Figure 3-1 Time Trend of WIN for Unjust Dismissals: 1987-1999

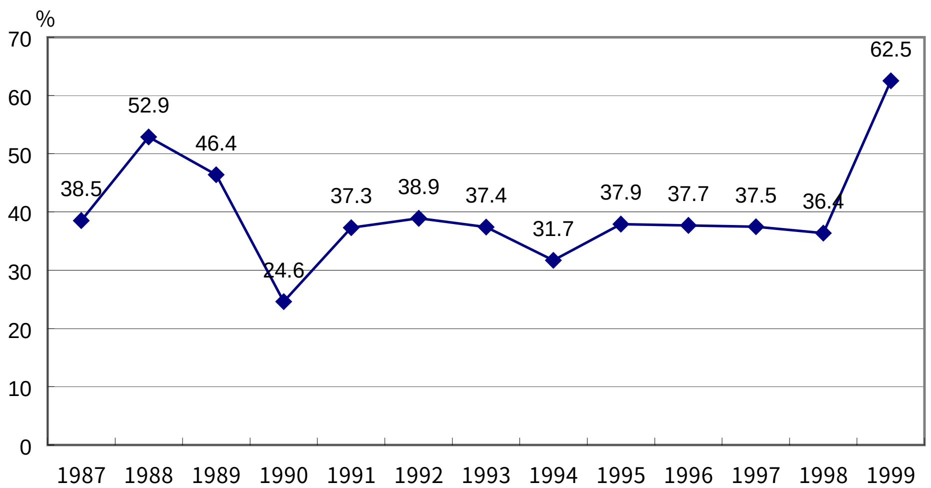
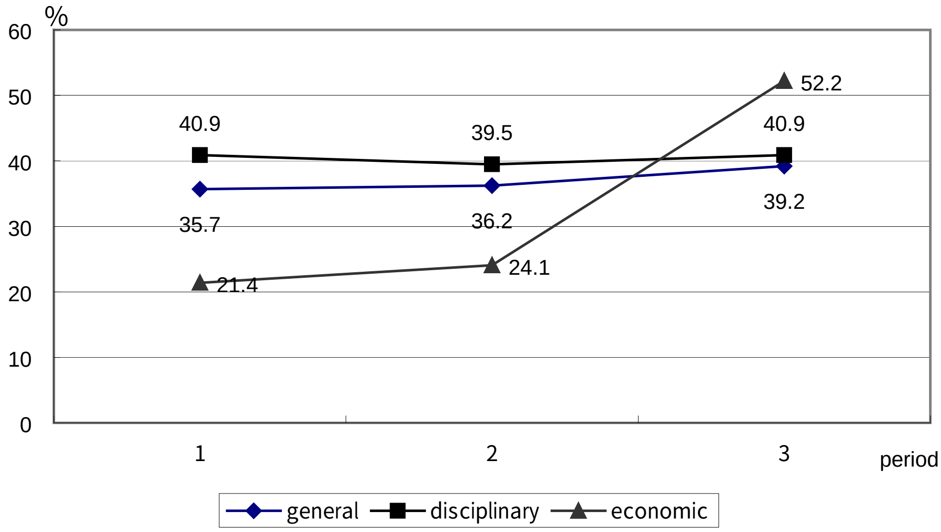


Figure 3-2 Changes in WIN by Period



1-2. Empirical Investigation by Sub-Periods

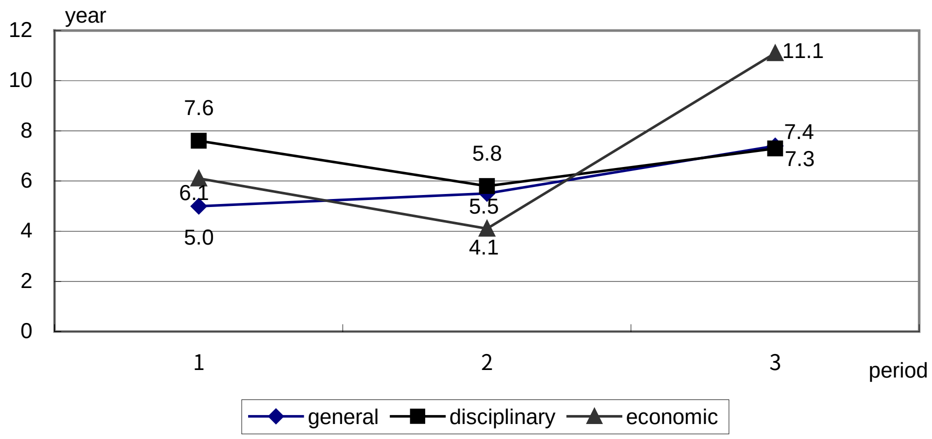
For analytic purposes, this study divides the court cases into three sub-periods of four year intervals. This allows us to analyze a longer-term trend in employer's opportunism as it is affected by legal changes. The first period covers the years from 1987 to 1990, during which the Korean civil movement of demanding democratization stimulated labor disputes to soar. Of the 815 cases, 115 belong to this period. The second period covers the years from 1991 to 1994, during which the Supreme Court decision on *Dongbu Chemical Corp. v. Choi* broadened the scope of just reasons for economic dismissal. This period encompasses 450 cases. Finally, the third period covers the years from 1995 to 1999, during which the disorderly deregulation process has been initiated. More specifically, article 31 of the Labor Standard Act was first revised for the purpose of relieving the limitation on employer's discretion in employment adjustment (1996) and the economic crisis took place (1997). This period encompasses 250 cases.

The change in WIN will be affected not only by the change in the employer's opportunistic breach, but also by the change in the employees' labor intensity. The increase in WIN in disciplinary dismissals may be caused by a higher effort by employees without any change in the employer's opportunism. However, unlike disciplinary dismissals, economic dismissals are based purely on economic reasons, and are less reliant on the employee's effort. When this fact is taken into consideration, it is hypothesized that the increase in WIN for economic dismissals is more likely to reflect an increase in the employer's opportunistic dismissals. Figure 10. shows that the increase in WIN for economic dismissals in the third period is prominent.

In Figure 3-3, WTENURE takes the V-shape in general. The V-shape of WTENURE in economic dismissal is more prominent than in other categories. On the contrary, the change of WTENURE in disciplinary dismissals turns out to be insignificant.[14] As explained, the increase in the employer's opportunism is confirmed by the increases of WIN and WTENURE for economic dismissals, which are less reliant on the employee's effort.[15]

Next, the WTENURE variable is considered as another proxy for the employer's opportunistic dismissals. A longer WTENURE signifies the employer's unjust termination of a labor contract with a longer tenured employee. It will thus reflect a higher level of the employer's opportunistic dismissals when all the other conditions remain the same.

Figure 3-3 Changes in WTENURE by Period



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[14] The statistical value z of the standardized normal distribution is calculated according to the following equation:

$$Z = \frac{WTENURE_{t+1} - WTENURE_t}{\sqrt{\frac{S_{t+1}^2}{n_{t+1}} + \frac{S_t^2}{n_t}}} \quad (t = 1,2)$$

In the above equation, *WTENUREt* denotes the average job tenure of the plaintiff at period t and *St* is the standard deviation. With the value of *Z*, the significance level of period change has been calculated. The period changes between the second and third period have been significant for the general unjust dismissal and the economic dismissal (the general unjust dismissal: 5%, the economic dismissal: 1%). However, the period changes between the first and the second period turn out to be insignificant for all kinds of dismissals.

[15] One commenter suggests that the change of average tenure of plaintiffs (TENURE) is compared with the change of WTENURE (WTENURE). WTENURE-TENURE is calculated between the second and third period, since TENURE was significant only between the second and third period (the general unjust dismissal: 1%, the disciplinary dismissal: 1%, the economic dismissal: 5%). Observing a positive sign only for economic dismissal (the general unjust dismissal: -0.3 year, the disciplinary dismissal: -0.9 year: the economic dismissal: 1.7 year), it is conjectured that an increase of the effort with a longer tenure may reduce the chance of being unjustly dismissed and thereby cause a slower increase in WTENURE for disciplinary dismissal than for economic dismissal.

Figure 3-4 Changes in WIN for Large and Small Firms

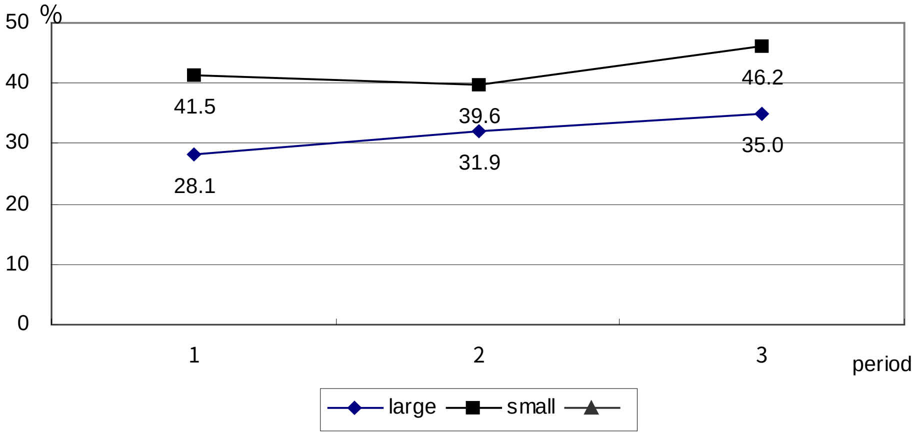

Figure 3-5 Changes in WTENURE for Large and Small Firms

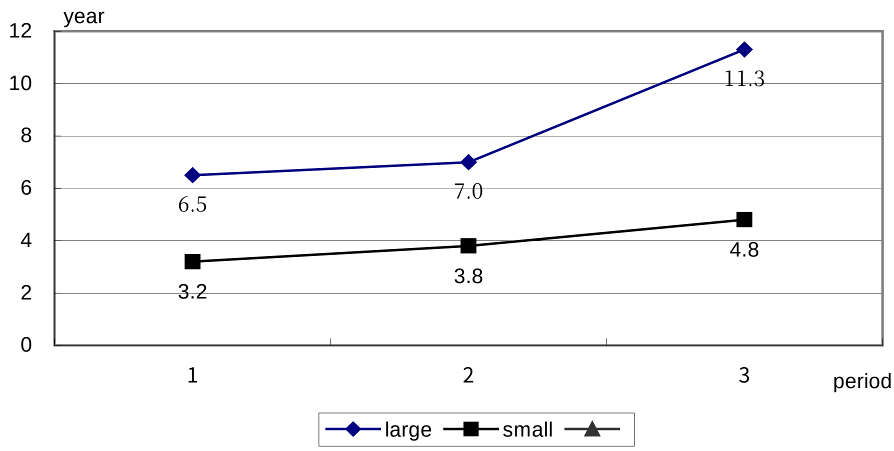

Figure 3-4 displays the period change in WIN for large and small firms.[16] The higher WIN for small firms over three periods reflects that the employer's opportunistic breach took place more often in these firms.[17] The slightly decreasing tendency of WIN for the

[16]) As 30 cases involving government-owned firms, 21 for hospitals, 11 for nonprofit organizations, and 40 cases for educational institutes are excluded from the 815 cases, 713 cases of profit making firms are exploited to examine the trends of differently sized firms. The size of firms are classified according to the total employees working in the regular jobs. Small firms are defined as ones having fewer than 300 employees, while large firms are ones with more than 300 employees

[17]) In small firms facing the labor market with a relatively high turnover rate, reputation is less likely to work as a market discipline and the employers in those firms may be more tempted by opportunism. See, for example, Idson and Valletta (1996). Also the low rate of union organization in small firms may contributes to greater opportunism. Among the union members in Korea, the members who work in the establishments with employees

small firms was reversed in the third period, and WIN increased to 46.2%. For the large firms, WIN tends to monotonically increase.

Figure 3-5 also shows the period change in WTENURE for different sized firms.[18] In Figure 3-5, it is found that the change in WTENURE between the first and second periods is small,[19] but the increase in the third period is significant, especially for large firms.[20] Unless the employee's effort increases more rapidly in large firms than in small firms, this implies that the employer's opportunism increased relatively more in large firms.[21]

1-3. Alternative Explanations for Rising Unjust Dismissals

Even though both WIN and WTENURE appeared to increase, it is not certain whether this occurred solely as a result of the rise in employers' opportunistic dismissals. Two alternative factors may explain this phenomenon. The first is the courts' and employers' differing interpretations of the labor law. For example, the employers' interpretation of the deregulation may be more optimistic than courts. Differing interpretations may occur when revisions to the law are ambiguously worded in the legislation. In these circumstances, employers may not fully understand the changes, and courts may not have a workable definition of these changes. However, empirical observations of the data do not support the notion of differing interpretations of the law being responsible for the observed increase in the incidence of dismissals. If the rising WTENURE occurring during the third period was caused by employers interpreting the law differently, then a higher degree of optimism in dismissing long-tenured employees rather than in dismissing short-tenured employees should have been evident. Furthermore, in order to explain the data, it would have to be assumed that employers in large firms must have had a higher degree of optimism in dismissing their employees than those in small firms. Neither of these explanations is persuasive.

An alternative factor is the increased competition in the global market place. The particular wage system operating in Korea seems to affect a firm's incentive to develop greater labor flexibility. Traditionally, Korea has adopted a seniority-based wage scheme. This creates conditions where, after a certain period of tenure, the discrepancy between labor productivity and costs increases monotonically with increased tenure. This seniority-

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larger than or equal to 1,000 occupy 63% and the members in the establishment with employees larger than or equal to 300 occupy 78.3% (The Survey of National Union Organization, the Korean Ministry of Labor, 2000).

18) Idson (1996) advanced and tested the hypothesis that large employers have an inherently greater capacity to establish long-term relationships with their employees due to their larger internal job markets and higher survival probabilities. As a result, the expected returns to on-the-job training are greater, leading to higher levels of training, internal job mobility, employee selection with an eye toward hiring those people who exhibit both a capacity for training and relatively stable employment histories, and mobility-inhibiting wage premia and nonvested fringe benefits (Idson, 1996, 299). Fehr *et. al.* (1999) also suggest that the implicit transaction is more likely to take place in the core labor market with well developed internal labor markets. All these aspects will cause the WTENURE for large firms to be greater than for small firms, and thus we might not be able to claim that a greater value of WTENURE in large firms necessarily implies a greater opportunism. Therefore, it will be more persuasive to focus on analyzing the period change of any given sized firm.

19) The changes in WTENURE between the second and third period were significant for both large and small firms (the large firms: 1%, the small firms: 10%), while the changes between the first and the second period were insignificant.

20) The changes in TENURE between the second and the third period were also significant for both large and small firms (the large firms: 1%, the small firms: 10%), while the changes between the first and the second period were insignificant. WTENURE-TENURE is calculated as 1.5 years for large firms and -0.2 year for small firms. Unless the employee's effort increases more rapidly in large firms than in small firms, it also implies that the employer opportunism increases relatively more in large firms.

21) Long-term employment generally involves significant investments in training employees. If the effectiveness of training depends on the employee's effort, shirking may thus be more costly to the larger firms and the incentive schemes to prevent shirking is more likely to be exploited in large firm than in small firms. Then, the liberalization of dismissal law may cause the employer's opportunistic breach to increase more rapidly in the large firms than in the small firms.

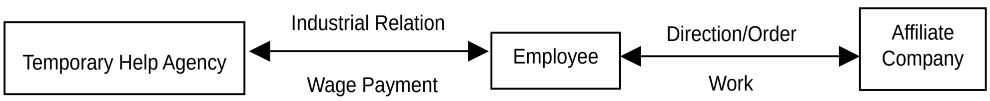
based wage scheme does not function well in motivating workers or in identifying efficiencies in the workforce. (Cho and Keum, forthcoming). Thus, when increased global market competition pressures firms to reduce costs under such a pay system, companies have greater incentive to dismiss long-tenured workers, rather than short-tenured workers. Under such circumstances, rises in WIN and WTENURE may be seen to take place as a result of market competition itself, and not necessarily due to any deregulation in the dismissal law. However, as global competition presumably increased monotonically throughout the entire decade of the 1990s, this factor alone cannot successfully explain the V-shape of WTENURE. It is more reasonable to suggest that the negative effects of intensified market competition aggravated the existing effects of deregulation in the third period.

2. Institutional Insecurity in Korean Irregular Employment

2-1. Temporary Help Work

Under Korean labor law, temporary help refers to an ordinance by which a temporary help agency dispatches employees to another company where they engage in work in compliance with that company's directions and orders. (Korean Act on Protection for Temporary Help Employees enacted on February, 20, 1998; hereafter the temporary help law). In other words, an agency first hires workers and then dispatches these workers to affiliated companies for a specific period of time. Employees work under the affiliates' directions or orders, and the affiliate companies pay the dispatch (service) charge directly to the temporary help agency rather than to the employees. A typical dispatching contract in Korea can be summarized as Figure 3-6.

Figure 3-6 Korean Temporary Help Contract



The biggest issue for the Korean temporary help market is that temporary help is not used in a constructive way to cope with the uncertainty of demand in fields requiring professional skill, but is instead used to replace those in regular employment, and tends to be concentrated in low-income and low-skill areas (Lee, 2001).

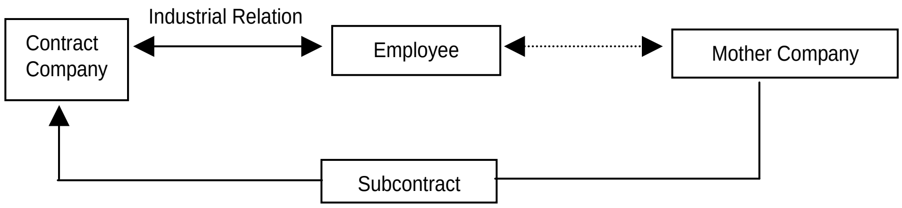
Law dodging or illegality is frequently observed in instances where temporary help is employed. Law dodging occurs when affiliate employers use temporary help workers in order to dodge standard labor law and union law. The current temporary help law in Korea details the obligations of affiliate employers and temporary help agencies in Article 2 and 3. Article 2 states the obligations in temporary help agencies; temporary help agencies should provide appropriate education and training opportunities for their, employees, and should seek appropriate ways to improve their working condition and job stability. At the same time, Article 3 states that the affiliate employers should use temporary help in appropriate manner. However, there is no article that specifically states a definition of "appropriateness" nor is there any article outlining the means of monitoring or enforcing such directions, or for imposing penalties for breach of this law Article 2 and 3.[22] This law is ambiguously worded, and allows affiliate employers to avoid their obligations in relation to temporary help employees. The ambiguity in this law allows temporary help agencies to avoid the obligations of substantial employers. Instead they tend to concentrate only on receiving brokerage fees for the provision of labor exchange.[23]

In some cases of illegality, workers maintain their legal status as temporary help employees while performing duties for affiliate companies where they work jobs other than those on the legal list.[24] In such cases, and during the two-year period that is the limit of the dispatch, workers are more accurately described as substantial regular employees. The worst cases of illegality occur when there is no substantial employment relationship between the temporary help agency and dispatched employees, and the recruitment or dismissal is performed by the affiliate companies. The most exemplary case of this practice in Korea is that of D-Industries (see www.workingvoice.net and Lee, 2000). Other kinds of illegality are associated with the legal limit of two-year dispatch period. In many cases, the temporary help employees were dispatched to affiliate companies for a period longer than two years (also see www.workingvoice.net and Lee, 2000).[25]

2-2. Contract Company Work

In Korea, when companies subcontract labor to a large firm (Parent company), work performed by employees is referred to as contract work. Subcontractors typically retain the means of production, and direct their own workers. Figure 3-7 below, represents the subcontract. There is a considerable difference between this and the temporary help contract in that substantial industrial relationship between the employer and worker does not exist.

Figure 3-7 Contract Company Work



[22]) For example, the Korean temporary help law states no explicit obligation for temporary help agencies during periods when the workers are not dispatched. In many cases, the temporary help agencies did not pay any wages during these periods and thereby the temporary help services then became degraded into illegal job placements. Furthermore, the law had no article on who should be under obligation to pay the legally mandated welfare benefits such as national pension, national medical insurance and unemployment insurance *etc.*

[23]) Entering into a complex 'triangular relationship' involving the affiliate firm, the temporary help agency, and the worker, the temporary help worker has little leverage to negotiate. When given an assignment, the temporary help worker lacks essential knowledge about pay scales and work requirements. Gonos (1997) reports that the average mark-up of the temporary help agency (the difference between what a temporary help agency charges an affiliate firm to provide temporary help work, and what it pays the temporary worker for that work) in U.S. is 30-50% of wages for every hour worked.

[24]) On legislation of the temporary help law, the dispatch is being allowed only in 26 categories of jobs such as secretary, typist, office worker, mailman, cashier, phone operator, gas station worker, phone sales representative, nursing person, scrubber, *etc.*

[25]) In Korean temporary help work market, the dispatch period should not exceed one year, except in the event of agreement between a dispatch agency, dispatch employer and dispatched worker. In this case, the duration can be extended beyond one year, however, even then it is only allowable on one occasion. In addition, it is prescribed that temporary help agency and affiliate company do not treat the dispatched worker comparing in a disadvantageous manner when compared to other employees undertaking similar tasks (Article 6, Korean Act on Protection for Temporary Help Employees).

There are two forms of illegal contract. One occurs when the contract company (subcontractor) places any person (not necessarily their employees) in the workplace of the mother company. The contract company then receives most of the contract payment but does not pay the due amount to workers. If most of the payment the contract company receives is to cover wages, then the contract company clearly exploits the workers.

The second type of illegal contract occurs when the industrial relationship between contractor and worker is very weak. In this case, the purchaser of the service plays a substantial role as an employer, at the same time avoiding his/her legal obligations as mandated by Korean labor law. A case which exemplifies this form of illegality is that of a contract worker in an SK-company (see www.workingvoice.net and Lee, 2000), where the subcontractor was the branch company of SK, and the substantial industrial relationship existed between the worker and the subcontractor. The contracted workers organized a union, and the SK-company threatened to terminate their contracts. Another example of this form of illegality is seen in the case about D-Foods (see www.workingvoice.net and Lee, 2000). This company established a camouflaged contracting company (S-Industrial) and D-Foods was in charge of direction and orders. The substantial industrial relationship existed between D-Foods and the contracted workers.[26)]

Table 3-2 Irregular Employment and Compliance Rate of Legally Mandated Benefits

Variables	Definition of Variables	Average (%)
PREG	Irregular Employment Type	41.4
PENSY	Compliance Rate to National Pension	60.8
MEDIN	Compliance Rate to National Medical Insurance	63.5
EMPIN	Compliance Rate to Unemployment Insurance	53.1
PRET	Compliance Rate to Legally Mandated Retirement Grants	60.9
PSWG	Payment Rate of Bonus	60.6
POWG	Compliance Rate to Legally Mandated Overtime Payment	50.3
PHOL	Compliance Rate to Legally Mandated Monthly and Yearly Leaves	49.9
PBAB	Compliance Rate to Legally Mandated Maternity Leave	21.2
PTEN	Application Rate of Seniority Based Wage Payment	49.8

2-3. Employer's Opportunism in Observing the Legal Welfares for Irregular Workers

In order to examine whether irregular employment increased in the course of employers' bypassing the legal regulations, the relationship between compliance in relation to legal regulations and the employment type is examined. Since most of legally mandated **welfares** are applied to businesses with 5 or more employees, data is selected according to

[26)] Another quite unique example of this, was a case where a company that had originally signed employees to irregular contracts, tried to transfer these employees to alternative contracts which would have rendered them subcontract workers. The company's motive was to avoid its obligations to temporary workers under the Korean Labor Standard Act. These efforts were illegal since direct management would have been performed by the mother company even after it became the contractor (www.workingvoice.net).

this criterion of legal threshold from *the Supplementary Survey of Economically Active Population of Korea* (2000, total samples 18,557). Table 3-2 shows the compliance rates in relation to various legally mandated welfare benefits such as national pension, retirement grants, overtime payment, and monthly and yearly leaves *etc*. The compliance rate of medical insurance was greatest and stood at 63.5%. Compliance in relation to paid maternity leave regulations is only 21.2%, and this is the lowest rate.

Table 3-3 shows correlation coefficients for irregular employment and compliance rates in relation to legally mandated welfare benefits. High correlation rates can be seen for compliance in relation to the various legal benefits. This suggests that the irregular employment decreases with an increase in compliance rate in relation to legal benefits. As for the correlation coefficients for the irregular employment and the various compliance rates of legally mandated welfares benefits, the correlation coefficient for retirement grants was highest (-0.7104). Compliance rates in relation to the various legally mandated welfare benefits were also highly correlated as indicated by the significantly high correlation coefficients.

Table 3-3 Correlation Coefficients between Irregular Employment and Compliance Rate of Legal Welfare

Classification	PREG	PENSY	MEDIN	EMPIN	PRET	PSWG	POWG	PHOL	PBAB	PTEN
	1,0000									
PENSY	-0.-6839 <.0001	1.0000								
MEDIN	-0.6981 <.0001	0.9048 <.0001	1.0000							
EMPIN	-0.5115 <.0001	0.7049 <.0001	0.7029 <.0001	1.0000						
PRET	-0.7104 <.0001	0.7991 <.0001	0.8095 <.0001	0.6158 <.0001	1.0000					
PSWG	-0.6927 <.0001	0.7403 <.0001	0.7575 <.0001	0.5693 <.0001	0.8414 <.0001	1.0000				
POWG	-0.5798 <.0001	0.6210 <.0001	0.6255 <.0001	0.4560 <.0001	0.6702 <.0001	0.6759 <.0001	1.0000			
PHOL	-0.6284 <.0001	0.6561 <.0001	0.6559 <.0001	0.4779 <.0001	0.7020 <.0001	0.6968 <.0001	0.7048 <.0001	1.0000		
PBAB	-0.3632 <.0001	0.3642 <.0001	0.3703 <.0001	0.1999 <.0001	0.3941 <.0001	0.3895 <.0001	0.4225 <.0001	0.4839 <.0001	1.0000	
PTEN	-0.6229 <.0001	0.6403 <.0001	0.6407 <.0001	0.4527 <.0001	0.6911 <.0001	0.6907 <.0001	0.6629 <.0001	0.7018 <.0001	0.4646 <.0001	1.0000

Figure 3-8 Fraction of Irregular Employment and Compliance Rate of Legal Retirement Grant over Industries

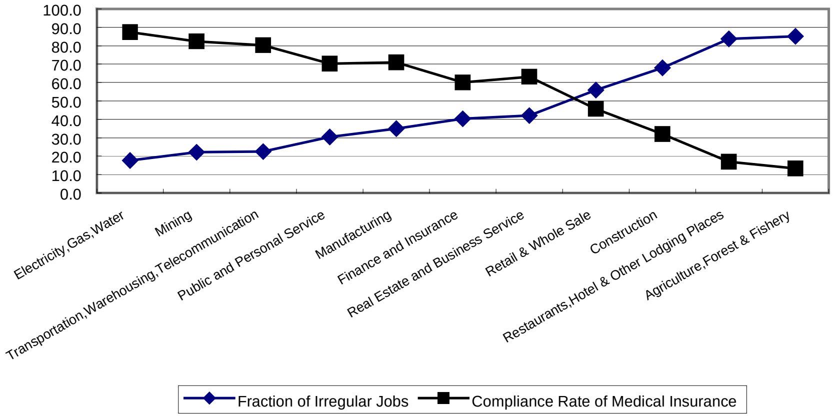


Figure 3-9 Fraction of Irregular Employment and Compliance Rate of Medical Insurance over Industries

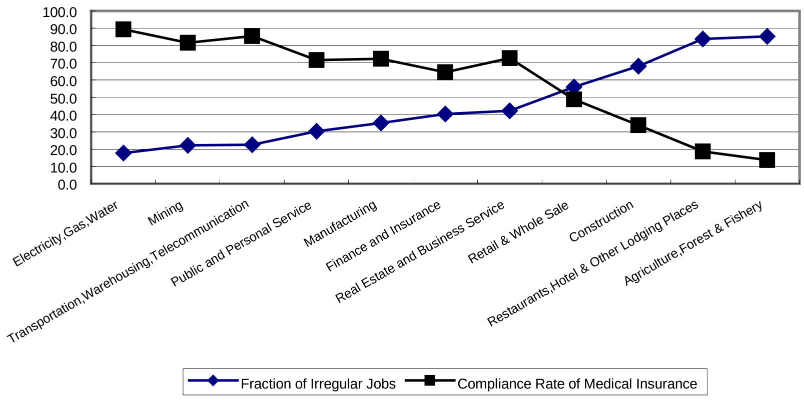
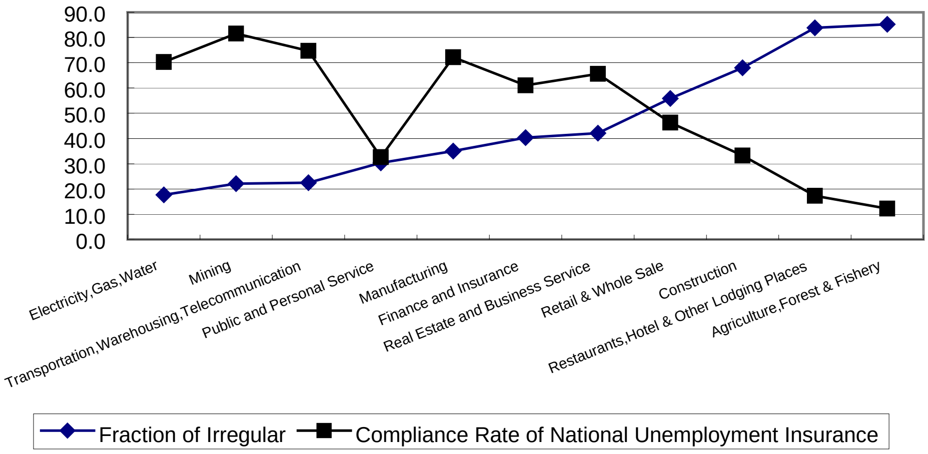


Figure 3-10 Fraction of Irregular Employment and Compliance Rate of Employment Insurance over Industries



Figures 3-8, 3-9, and 3-10 investigate the relationship between the fraction of irregular employment and legal benefits such as retirement grants, medical insurance and employment insurance over varying industries. All of them suggest that a negative relationship exists.

CHAPTER 4

Conclusion

This study argues that, in countries having institutional insecurity, policies for labor market flexibility may cause employer opportunism to rise and that as a result, expected efficiency gains are lessened. This study provides an empirical examination of two key aspects of the Korean government's policies for labor market flexibility; the deregulation of dismissal law and the liberalization of legal restraints for hiring irregular workers.

Our empirical analysis suggests the occurrence of negative consequences of the deregulation of Korean dismissal law. It suggests that there has been a reduction in the efficiency gains that might have been expected as a result of increased market flexibility. Specifically deregulation has tended to increase the incidence of employers' unjust dismissals. Potential causal factors for this intriguing phenomenon are evaluated. These include: the change in employers' opportunism, differing interpretations of the legislation on the part of courts and employers, and intensified competition in the global market. This study draws the tentative conclusion that the effects of intensified market competition aggravated the effects of disorderly deregulation.

The second aspect of the Korean government's policies for labor market flexibility, under examination is the liberalization of legal restraints for hiring irregular workers. Institutional insecurity in Korean irregular employment represents the loophole employers can exploit to evade their legal obligations. In the case of Korea, businesses with 5 or less employees represent loopholes for employers to evade their legal obligations. These businesses, which are not subject to the Korean Labor Standard Act, provide a hotbed for unlawfulness and the situation offers little or no protection for irregular employment. If the employment rules explicitly stated under the current Korean Labor Standard Act as they relate to businesses employing 10 employees or more were to be extended to cover these smaller businesses, it would encourage more transparent work practices in the field. Also lack of a transparent and workable definition of irregular employment Is necessary to enable laws to be properly drafted and enforced, and to prevent the misclassification of workers, and the subsequent denial of their rights. This paper provides empirical evidence of opportunism on the part of employers when hiring irregular workers.

The analysis of the Korean situation contained in this paper may provide useful guidelines for other developing countries that seek to choose flexibility policies. Any institutional insecurity paves the way for opportunism on the part of either employers or employees, raising the transaction costs in the labor market, and dissipating economic efficiency.

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Appendix: Seminar Proceedings

Appendix: Seminar Proceedings

Dr. Mohammad Salim, Director, The Center for Asian Studies

Good morning ladies and gentlemen, Dr. Kamal El-Menoufi, dean of the faculty of Economics and Political Science, his excellency Minister Kim of the Korean Embassy in Egypt, Ambassador Sharif Holi, the head of the Department of Japan and Inter-Korean affairs at the Foreign Ministry, my dear colleague Dr. Keesung Roh, the director of the international exchange program and the Korea Development Institute, ladies and gentlemen.

On behalf of the Center for Asian Studies, let me welcome all of you to this highly interesting seminar on the Asian Financial Crisis and its implications for Korea and the strategies used to deal with that crisis. As you all know, this crisis was a major watershed in Asian development during the 1990s, but, thank goodness, most Asian countries were able to deal with the crisis in different ways. For example, whereas Korea signed an agreement with the International Monetary Fund, Malaysia did not, but at the final analysis both countries and most other countries were able to deal with the crisis using different strategies depending on the impact of the crisis on them.

The Korea Development Institute is one of the major think tanks in Asia and certainly the major think tank in Korea specializing in studying developmental issues in Korea, and recently embarked upon an ambitious program called the Knowledge Partnership Program.

The Knowledge Partnership Program, through which the knowledge which the Institute develops concerning Asian issues and Korean issues would be shared with other countries in Asia, Africa, Latin America, Europe as well. This is a noble cause through which other countries would be able to share your findings and maybe benefit from the techniques that you have used in order to make these findings, and maybe this can be a springboard to embarking on projects between this institution, including our institution and the Korea Development Institute. I have visited the Institute a few years ago and was very much impressed by the high quality work of the Institute, and some of the major publications of the Institute. Also to receive the annual book of the KDI and the CD that summarizes that annual book.

The cooperation between the Center for Asian Studies and Korean Institution goes back many years, and I'm glad to attribute a great part of this cooperation to someone who is present with us this morning Dr. … our present ambassador to Korea and a very good friend of ours. He has established these things between us and the Korean institution. We have an ambitious program of cooperation with Korea, with the Korean Institute for the Middle East and Africa, KIMA, headed by the able scholar, Dr. Keesung Roh, so far who has attended six annual conferences in Egypt and in Korea. Also we have initiated seven projects in Arabic and Korean, and Egyptian and Korean relations in Arabic and English. So this is quite an elaborate program, and we are glad also to report that we have very good cooperation with the Korea Foundation. Last year we were visited by the able chairperson of the Korea Foundation and very much appreciate that cooperation.

Now for the KDI, it is a welcome development, Mr. Keesung Roh, and we very much appreciate your concern and your decision to initiate to that cooperation. Also I have to thank someone who is not with us in this room but who was instrumental in initiating this cooperation, that is our able ambassador in Korea, Amb. … I have to thank him for establishing that link. Despite some discussions about the modalities of the conference, thank goodness finally we are here and I am quite sure the conference will be a great success. I would like also to thank the Center for Asian Studies and the Department of Japan and the two Koreas for their tremendous support for the Center for Asian Studies.

And most importantly to Mr. Kamal El-Menoufi, who worked very hard with us in order to make this seminar a success. I really have to tell you that without his support and involvement, this conference would not have been held. So I thank him sincerely for his contribution and I thank all of you. I have also to welcome the Korean delegation to the Center of Asian Studies. They have been touring Egypt for the last two days. In conclusion let me also express my thanks to the chairpersons and discussants to this conference. Thank you very much and now I give the floor to my colleague, Dr. Keesung Roh, the director of the International Exchange Program of the Korea Development Institute.

Dr. Keesung Roh, director, the International Exchange Program, KDI

Thank you very much, Dr. Salim. Dr. El Menoufi, dean of the faculty of Economics and Political Science, and Dr. Salim, director of the Center for Asian Studies of Cairo University, distinguished participants and ladies and gentlemen.

First of all, on behalf of KDI, I would like to express my sincere thanks to the Center for Asian Studies, Cairo University and Dr. Salim, in particular for their preparation on this joint seminar on the economic crisis and restructuring in Korea. Many of you have worked honestly and efficiently, and I am most grateful for all your endeavors. Before we begin our in-depth discussion, I would like to share with you some thoughts on the process of the Knowledge Partnership Program, which makes us this seminar here possible.

The overall aim of the Knowledge Partnership Program is not only to share knowledge of economic development with developing countries but also to promote economic cooperation in today’s globalizing world. In particular, Korea seeks to share its experiences derived from Korean economic development over the past several decades, and from overcoming the recent economic crisis.

We have witnessed the painful, painful recovery of most Asian economies since the breakout of the crisis in 1997. The crisis provides an opportunity to rethink, reinterpret and reevaluate Korea’s growth and industrialization experience, especially the role of the government in the process of economic development. In this respect, Korea’s industrialization and development experience, its success and failures, also has a bearing on those transitional economies not going through the crucial junction of reconstruction and reform, according to market principle.

Today, we are eager to share with you our knowledge and also vice versa, learn more about the models of development in other countries. I believe through joint seminars such as this, we will be able to strengthen our partnership and future cooperation in this continuously changing and globalizing world. It is my hope that we will be able to exchange candid opinions about each other’s economic development policies as well as broaden our horizons through learning about diverse knowledge.

I would like to close by expressing my appreciation to all the participants and staff. I believe this joint seminar will be held in a timely manner and will be very good. Lastly, I look forward to our further efforts that will follow this seminar in strengthening our pride, share our knowledge, experiences and spirit. Thank you very much.

Ambassador Sharif Holi, chairman of the Department of Japan and the two Koreas, Egyptian Foreign Ministry

Distinguished guests, it is an honor and a privilege to be here today at this important event, which we consider part of the cordial relations that exist between Egypt and Korea. I wish to convey the greetings of his Excellency Ambassador … who wishes all the best and the conclusion of a successful conference today.

In brief, I would like to emphasize the fact that this conference symbolizes the vast pool of bilateral relations that exist and are flourishing in all directions between Egypt and Korea. It is worth mentioning this seminar, which is a combined effort of all the participants, is a new step on the course for establishing a solid base for the cooperation between the two countries in the cultural and academic fields.

I would like to thank the Center for Asian Studies, Dr. Salim, and the college of economics and political sciences, Dr. Kamal El-Menoufi, for hosting this important event. Also I would like to thank the Korean delegation led by Dr. Keesung Roh, for assisting us in trying to have this seminar. In conclusion I would like to wish the participants all the best for this important event. Thank you.

Ambassador to Egypt Kim *(Speaking in Arabic)*

Ladies and gentlemen, it gives me a great honor to welcome you all on behalf of the … We are delighted to have a combined activity between the Korea Development Institute and the Center for Asian Studies on very important topic which is the Korean development model, the economic crisis and restructuring processes. Indeed, this topic is crucial of importance to economic development and this topic has raised many problematic issues.

One, Korean economic progress and overcoming the economic crisis. It is said it is important to encourage people with initiative and allow of a fair share of ethics to develop and flourish. It is also said that the market economy cannot function properly and effectively without good governance and efficient institutions.

Two, the necessity of political reform for economic advancement. We know that Korea has done a lot in terms of economic growth under authoritarian regimes, we also know that sustainable development requires decision-making, accountability and transparency. Some claim the transformation to a free market economy may open the road to corrupt practices. In order to contain and fight such practices, democracy is a must.

Three, the paramount importance of the human character for a speedy economic process. The people as you know, are instrumental in economic development, but unless they are better educated, well equipped and physically fit, development plans are doomed to failure. This explains why all developed countries old and new put a great emphasis on uplifting human resources through education and health care.

Four, the foreign contribution to Korean economic development. No one can deny or ignore the American and the Japanese impact on the Korean economic growth. We have learned from development experience in many parts of the world that direct foreign investments and foreign trade are essential elements of a successful development strategy.

Ladies and gentlemen, it is my pleasure to invite you all to this workshop to engage in discussion and come up with fruitful conclusions, policy and recommendations. Finally let me welcome and thank again our distinguished guests from Korea. Let me also express deep thanks and gratitude to my colleague Mohammad Salim for his perseverance dedication and devotion. I look forward to a lively and productive workshop, not only for our intellectual enterprise but also for those who wish life, love and prosperity for Egypt and Korea.

Dr. Mohammad Salim

I would first like to congratulate our Korean guests on the outstanding performance of the Korean soccer team in the World Cup. Here in Egypt, we felt that whenever the team scored a goal for Korea, they scored a goal for Egypt as well. Also I would like to say I am impressed by the wonderful presidential campaign that saw the victory of Mr. Roh, and I am looking forward to five years of prosperity and peace on the Korean Peninsula. These are both great achievements. Now we will begin the first session immediately. Chairman Professor Samir Toubar. Prof. Samir is a professor of economics, former vice president and former chairperson of the economic commission of the ruling Democratic Party. Thank you very much.

Dr. Samir Toubar, Chairman

First, an assessment presented by Mr. Moon-Soo Kang on the Korean development model, then we will have two discussions by Dr. Hazem Hosni and Dr. Mohammad Saffey El-Din. We will give each speaker 10 minutes to present his paper, and 10 min for each discussion and then we will open the floor for discussion.

Dr. Hazem Hosni

Good morning. I am very happy to be with you at this important meeting. And I must start by expressing my admiration of the Korea Development Institute. I know of the very important role played by this institute in designing plans for the economic development of Korea.

During my only visit to Korea so far the Institute was not included in our program, but I insisted on at least having the opportunity of looking at the institute and I went there, and though I did not see anyone I was happy to see this institution, which played an important role in the development of Korea. I admire many features of the modern development of South Korea and teach my students these and I insist on this in my presentation.

I would like to talk about the Egyptian model of development and I am going to focus on this in order to understand this field. Some people believe we are living under a different model of development, others believe that in fact it is the model that governs Egypt. So I start by inquiring about the definition of the model. What I mean by the model is the general features of the way a country moves from one phase to another, and the model of development is according to the national features of business and economic and social changes in the country.

I start the examination of the model of development in Egypt at present by looking at what happened since 1952, and I'll divide the theories of development into 1952-1973 and then 1973 until the present time, and I'll look at the economic political and social features of each model.

Now if we start with the three models, it is important to note that the driving force for development at the time was the group of Army officers who took over the government on July 23, 1952. This marked a very important political change in Egyptian modern history because those Army officers came from the middle ranks of the Army from the middle classes and they had ideas that were different from the ideas that influenced the development of Egypt before 1952.

During this period they started with the belief that through the encouragement of the private sector and the encouragement of the foreign investments, Egypt would grow. And for this reason they adopted a model of foreign investments that allowed foreign companies to have a majority share in joint ventures with Egypt and they encouraged these ventures. However, they were not satisfied in just waiting for the private sector and foreign investments to push economic growth in the country. So they established the National Council for Production and the National Council for Services, and they put these two councils together and these two councils were the mechanisms through which the government established some important industrial projects. And some people consider this to be the beginning of active state involvement in the economy. Later on, they moved to planning, partial planning, central planning with the adoption in 1957 of the first five-year industrial plan and this was succeeded in 1960 and 1961 by the first five-year social-economic development plan in the country.

So, we see a kind of progression from modest intervention of the government to what we call central planning. Now if we try to look at the economic features of this model -- I'll talk about four points, the pattern of ownership of resources, the methods of management of resources, the strategies for … and the strategies for economic development.

Now if we look at the pattern of ownership of resources we find that in the beginning, private ownership was the rule. There was no public ownership but with the project established by the national council for production the state started to own the newly established companies. But since 1956 the state started to own productive enterprises, and the beginning was the nationalization of the ... company and on the 26 of July, 1956 following the tripartite migration, the military attack by Great Britain, France and Israel in Egypt in October 1956, the Egyptian government began to nationalize in fact foreign enterprises in the country, British and Belgian and Greek, et cetera. This is known as the policy of Egyptianization, a policy of nationalization, and this was the beginning of the public sector in Egyptian economy. Later on, in 1960, 1961, 1964, the government shifted its policy toward the nationalization of Egyptian private enterprises. In 1960 the two major private banks in the country -- the National Bank and the Bank of Egypt -- were nationalized. In 1961, the major part of the organized sector of the economy, medium-sized and large-sized companies, were nationalized. So this is known in Egypt as socialist theory. The official name of the ideology of the country was Arab Socialism.

So this was the beginning of the ownership of resources. The government started to own large parts of the organized facets of the country. The management of resources, I think in the beginning it was the encouragement of private sector companies to go to areas that were important for the development of the economy. Then this was followed in 1956, 1957 by the adoption of planning, central planning for industry and then in 1960, 1961 by central planning which was supposed to be comprehensive, covering everything, all sectors of the economy and social services. But this was, in effect, for only five years, and after this period, Egypt would enter its second five-year plan. So instead of a five-year plan until 1982, we have just annual plans, but no medium-term plans.

The strategies for ... organization. In the beginning it was hoped that foreign capital would help bridge the gap between savings and investment. But this was not the case. So, the government tried to increase savings by using profits of nationalized companies and also by using revenues from agricultural exports, but the problem of economical development in Egypt is the problem of generating sufficient savings or the investments of the company, so we continue to have a gap between savings and investments. The highest rate of savings would be achieved in the country with 15 (maybe 50) or 16 (maybe 60) percent of the GDP for economic development.

Touching on economic development, I would say it was mostly balanced growth. It was balanced growth in the sense that the government aimed to develop all sectors of the economy -- traditional agriculture and modern agriculture, manufacturing, industries and services. So, it was a strategy of balanced growth.

Commenting on the economic features of this period, I would say that the most important difficulty was failure to generate efficient savings and turn these savings into investments. We relied on foreign aid, and during the first five years of the 1960s, we were getting a substantial amount of Soviet economic assistance and we were getting assistance from other socialist countries, but we succeeded also in getting assistance from Western countries. The United States was providing Egypt with food aid. However, this food aid was used as an instrument of political pressure, so in 1964, 1965, Egypt tried to get sufficient food and at the end the US provided Egypt with food but this was deemed inefficient of the plan.

After 1966, relations between the U.S. and Egypt became quite tense as this food aid was stopped. In 1967, Egypt tried to show solidarity with Syria, which was threatened with a military invasion and this led to the war of 1967, and as a result of this war Sinai was occupied, Egypt lost an important source of revenue petroleum from Sinai. Also the Suez Canal was blocked from 1975-1976, so Egypt lost the resources from the Suez Canal. So it was not possible to pursue the ambitious second five-year plan, which aimed at strengthening the foundation of Egypt. And the rate of growth in the country went down, it averaged something like 5.6 percent during the years of the five-year plan, but after that in 1967, the rate of growth went down, in 1968 it was almost a stagnant economy but economic development pursued in 1969 and 1970, and then it started to go down again during the first three years of the 1970s.

The political features of this period of the … organization, mass organizations. Political parties were outlawed and were replaced by a … organization. Anyone who was interested in being involved in politics has would have to a member of this kind of organization. But none of these organizations were successful. We experimented with three mass organizations, the Liberation Body, from 1953-56, the National Union from 1956-61 and the Arab Social from 1964-76. Socially, there was what is called a populist social contract through which the government would provide free services. The people would be provide with education, rent for houses was lowered, et cetera in return for their support for the political system. So these are the features of this period.

Now I am going to discuss the aims of the Egyptian government during this period, the economic stagnation at the end of this period and how to proceed with economic development. One alternative was to deepen socialism to get the people more into the economy, and to get people who had higher incomes to pay for economic development of the country. Another alternative would be to abandon completely the statist economic development model and to rely again on the private sector and foreign investments. This was the more popular alternative, but the structure of the country at the time did not allow for this complete abandonment of the socialist model. So the government decided to go gradually and instead of calling the new strategy “capitalist development strategy,” the new strategy was called the “open door” policy.

Egypt was lucky during this period because the encouragement of the private sector and foreign enterprises coincided with a favorable regional situation. The Arab oil-exporting states in 1973, 1974 paid the price of oil, and Egypt is not an oil exporter, so this was good for Egypt. Many Egyptians went to work in Arab oil-exporting countries and they sent money to Egypt, so in the 1970s until 1983 got large amounts of foreign currency due to the migration of Egyptians abroad and rise in oil prices of 1973, 1974, and 1983.

This enabled the government to increase investments, and these went up to sometimes 30 percent of the GDP and the Egyptian economy grew at a rate that was sometimes 14 percent. This was not due to the expansion of commodity-producing sectors it was not the expansion of agriculture and industry, it was really the rise in the value petroleum exports and the migration of Egyptians abroad.

We can divide this period after 1974 into two periods. From 1974-81 we call it consumerism, the open door policy. Not much emphasis was put on expanding the various capacities of the country, and the massive flow of foreign currency was squandered on imported consumer goods. We consider this to be a lost period for the Egyptian economy.

So after 1981, the emphasis shifted, consumerist open door policy to productive open door policy. Egypt was back to planning but not in the same way as before. The emphasis was on building infrastructure and also on encouraging the private and foreign sectors. However there were problems faced by the Egyptian economy during this period. The Egyptian economy suffered still from the gap between savings and investment. There was a gap between the maximum savings we could mobilize in the country, and the required level of investment. We needed at least 30 percent, and the most we could get was something like 23 percent with the help of foreign aid and investments.

The second problem was imports and exports. Now this gap is like 9 billion dollars. We export something like \$6 billion dollars and we import something in the range of 16 billion dollars. The gap in fact shrank because of the recession of the economy, because we are importing less.

The third gap, particularly in the 1980s, was between state revenue and state expenditure. As a result of the populist system, the government continued to spend on services and food subsidies. In fact the expenditure on subsidies increased in the 1970s and 1980s. The government just could not balance its budget. It tried to deal with the crisis through shock therapy, by increasing consumer prices by withdrawing subsidies, but this was met with a popular revolt. So it abandoned this shock therapy, but it could not deal successfully with the problem of subsidies. So we continued to have a big gap between state revenue and state expenditure.

Next was the supply for labor and the demand for labor. The labor market increased by something like 500,000 people a year to around 800,000 people a year, but the Egyptian economy does not create so many jobs. So this leads to a large number of unemployed people and, we are unable to overcome this crisis.

Finally, in the 1980s, the gap between interest rates paid by banks and the real interest rate. The one paid by banks was much lower than the real interest rate and this led to the emergence of so-called investment companies getting people to pay interest rates that were much higher than the rate paid by banks. It was not easy to deal with this crisis until 1991.

Following Egypt's participation in the Gulf War led by the United States, Egypt was rewarded for this by dropping Egypt from its debt and Egypt got an accord with the IMF and was committed to implement economic reform and structural readjustment program. This program succeeded in eliminating some of the gaps in the Egyptian economy and the most important was the gap in government budget. So the gap was reduced to something like 2 percent.

We would say that the reform program signed with the IMF was successful only in the monetary and fiscal area. But it was not successful in promoting economic development in Egypt, so we continue to have consistent resource gaps between savings and required investments. We have a deficit in the state budget which is estimated to be about 4.2 percent of the GDP, there is our failure to increase our imports, there is pressure on the rate of exchange of the Egyptian pound. There is a gap between the exchange rate in the banks and the exchange rate on the black market. There is a deficit in our foreign trade and there are no good prospects for resolving the unemployment problem.

The political dimension is the shift from the singular mass organization regime to a multiparty system. The most important political actors are excluded from this system, and they are the Islamists, who are the most successful of all opposition groups who are not allowed to have either a political party or an association. The social dimension was a retreat from the social contract. Some elements would remain, but it no longer realistically exists. Perhaps there are some goods subsidized by the government but their number has shrunk. We say we have free education, but families rely on private tutoring. We have free medical service, but if you want good medical service, you go to a private company.

I come to my last point, which is a general assessment of this model of development. The major questions we should deal with. First of all, the gradual approach of economic reform. People say that this approach did not yield good results and that we should move, not to shock therapy, but to a more radical approach. Major industries are still owned by the government, they refuse to play an important role in the economy, so some say we should follow the policy of privatization more aggressively, we should lift all restrictions on private and foreign investments, we should change the framework of the economy in order to allow free movement of capital.

The second question is what kind of economic reform. There are voices which question the current plans of reform. Some question the wisdom of privatization and devaluing the Egyptian pound. Some say we should not proceed with the program required by the IMF. The third question is about the Islamists. Should the Islamists be included in the political system as a legitimate political force or should they continue to be excluded? And the fourth question is what should remain of the social contract. Should we continue to have free education and continue to provide services such as subsidized rents and health care? Thank you very much.

Dr. Samir Toubar, Chairman

Our next speaker will give us a chance to think about Korean economic development. (To Moon-Soo Kang) As a member of the central bank, I would like you to share with us your experience in dealing with these large non-performing loans and bank assistance.

Dr. Moon-Soo Kang

Thank you, Mr. Chairman. Good morning, distinguished guests, ladies and gentlemen. It is an honor and a privilege to participate in the joint seminar with the renowned Cairo University. This morning I would like to share with you how Korea's economic development has been implemented since the 1960s.

In 1961, after we had an initial endowment, initial conditions which were very similar to other undeveloped countries in the 1960s. We had new leadership, Park Chung-hee, who came to power in a military coup. The per capita GDP was $80 per year, and Korea did not have oil reserves to export like many Arabian countries. Korea depended heavily on foreign aid, mostly from the United States. Korea had one good initial condition—literate people. When Korean policymakers studied how to design development strategy, they considered these initial conditions.

The development strategy that was questioned in the 1960s was infrastructure policies. The government then development an economic planning board, chaired by the minister of economic planning, who was also the deputy prime minister, as its chief and main strategist. The government also established the KDI, as its economic think tank. The government then implemented five-year development plans.

The first was in 1962, and the new government took a different approach from other developing economies in the 1960s. They aimed to adopt outward-oriented policies, export-oriented policies, rather than infrastructure policies. Based upon the initial endowment of literate workers, most of whom were unemployed, strategies targeted light industries. These industries were adopted and upgraded, not only for the domestic market, but also for the export market. But because the country was so poor, the dilemma for the development strategists was how to finance ambitious industrial strategies. Korea has no resources to export, it only has a well-educated populace.

So the export-oriented industrial strategies were a success for the last 40 years, and this strategy is still maintained today. Back then, the economy was too poor to collect taxes and finance this project. So the government can own financial policies to finance these strategies. These policies, especially the fiscal policy, had a strong influence on Korea's investment allocation because of the poor initial conditions.

The Ministry of Finance and the central bank exerted strong influence in order to finance these projects. The first step was to nationalize the commercial banks, with the government as the largest shareholder. But the commercial banks just financed short-term capital, which was not enough to finance the building of new factories. So the government had to establish long-term financial institutions, and set up a number of specialized banks, which provided longer-term loans to businesses. Some of these banks were the Small and Medium Industry Bank for small- and medium-sized businesses, the Citizen National Bank, for households, National Agricultural Federation for farmers, KEB for foreign trade, Korea Housing Bank to finance the construction of homes and apartment complexes, Export/Import bank to finance big projects. All these special banks were owned and directed and regulated by the government. This is a unique characteristic of Korean development in the early 1960s, as this was a different direction from other developing economies of that time.

In rearranging these financial institutions, the government pursued two objectives. The prime objective was to mobilize financial resources as much as possible from people with incomes of just $80 per year. The government encouraged the establishment of provincial banks by private businessmen. In the 1960s, ten local banks, one for each province, were established, but they were less regulated by the government. The government also tried to introduce foreign capital in order to compensate for the lack of capital to finance these investment projects. The government also wanted to hire foreign bankers to train Koreans in banking. In 1967, Chase Manhattan was the first foreign bank to establish branches in Seoul. This was a part of financial policy instrument adopted by the Korean government in the 1960s.

The other part is tax policy. The government's main source of revenue is tax collections, but since the income was $80, the government did not collect much in taxes. So the government established the National Tax Office to collect more taxes, and imposed heavier taxes on luxury items used by relatively wealthy people and businesses. The government also imposed bigger taxes on high-income people and inheritance. The government also abolished tax exemptions on public enterprises. So tax revenue rose from 9.7 percent of GNP in 1961 to 14.8 percent in 1970. In order to induce people to voluntarily pay taxes, incentives were given. So by doing this, the government was able to collect more taxes and finance investment projects.

The next policy was how to encourage foreign investors and foreign financial institution to provide more capital to the Korean economy. So the government amended the foreign capital inducement law in 1960, and the central bank, began to provide payment guarantees on behalf of commercial banks and government banks because foreign lenders were reluctant to provide the short-term and long-term loans to Korean businessmen, the Korean commercial banks. So this was an unusual policy taken by the central bank. Korea had a big financial gap, a very high investment ratio, but Korea had difficulties in financing those ambitious projects.

Therefore the next policy pursued by the government was how to mobilize domestic private savings to finance these investment projects. One major policy in operation in the 1960s was interest rate reform for saving obligations. The government controlled the interest rate, so Korean people did not have much incentive to put their money in banks and financial institutions. They lent in the unofficial market, which charges higher interest rates. So the government raised the interest rate on one-year return deposits from 15 percent to 26 percent. With this high interest rate, savers could really earn. By doing so, savings deposits increased 50 percent within just three months and continued to double every year from 1966 and 1969. The total amount in the bank deposit account rose from 6 percent of GNP in 1964 before reform measures, to 29 percent in 1969. This was an unusual policy reform measure that provided a shock to Korean savers.

These policy measures carried a cost, however, they played a role in changing people's mindset. They used to keep their money in the closet, or under the bed, or lend to their relatives. They did not go to the bank because it was less profitable. But with this shock therapy, Koreans started going to the bank and putting their money there because it was much more profitable and it was safer.

Next was, how to promote exports. To the exporters, the Korean government provided bold financial and tax incentives. This also changed the mindset of Korean businessmen. Koreans were not so active in the early 1960s, because we did not have high technology, it was not profitable for them to seek the overseas market. But with these incentives, Korean entrepreneurs became bolder and sought new overseas market.

These policies continued for about 20 years, until the late 70s. But now we have newcomers that chased behind Korea, such as South Asian economies, so now Korea had to move to a higher level of industrialization. These policies, (HCI policies) began in the late 1970s, requiring a lot of capital and carrying with them side effects. However, despite huge side effects and costs, these policies provided the foundation for the present Korean economy -- the automobile industry, shipbuilding industry, electronic industry, for which some Korean businesses -- Hyundai, Samsung, bankrupt Daewoo, and LG. However, those policies created many difficulties with high inflation, government budget deficit, and high-rising wage rate. And these policies are still a topic of debate among Korean policymakers and particularly among scholars.

Let me now conclude my presentation by categorizing major aspects of Korean economic development: Strong leadership of late President Park Chung-hee, an able bureaucrat who was instrumental in moving the Korean economy out of poverty. Industrial policies, financial repression to mobilize resources. The government began to move toward indirect control. Policy A was aimed at promoting small- and medium-sized firms. And Korean economic policy is based on borrowing from abroad rather than FDI policies. Since the 1960s, Koreans have been wary of foreign domination because of the unhappy colonization by the Japanese. So Korean policymakers decided to rely on borrowing with Korean ownership rather than FDIs since the 1960s. Koreans adopted a policy of growth first and distribution later. And Korean policymakers seek to improve distribution with growth and with more jobs. So we had the side effect of slow social welfare until the 1980s. And we also suffered from inflation because of this high industry ratio and high economic growth. And we also experienced the domination of the large business groups, called “chaebol” in Korean, such as Samsung, Hyundai, Daewoo. And with these side effects we came to the economic crisis in 1997.

And I will conclude with the following short remarks. People have a different opinion of the Korean development model based upon their philosophies or their own economic endowment. Korea succeeded until the 1990s, but we suffered from smaller prices, such as the oil price shock, and political instability. However we recovered from the 1997 economic crisis. So after that shock, the Korea development model has changed. We will have an opportunity for that discussion in the afternoon session. Thank you very much.

Dr. Samir Toubar, Chairman

Thank you, Mr. Kang, now we turn to an overall assessment of the Arab development model.

Dr. Mohammad Selim

Thank you very much Mr. Chairman. In this presentation I will expand on the Arab development model and the many challenges that face it and what can be learned from the Korean experience in assessing these models of development. There are certain common features between the Arab and the Korean development models. One, Korea and Arab states more or less gained independence at the same time in the post-WWII era. However, the Korean economy started from a much lower point than Egypt at the time. Korea’s economy was in rougher shape, but in 30 years’ time the balance was tipped in favor of Korea. Some statistics to back up my point: in 1960, the GNP per capita in Egypt was $200, in Korea it was almost $75. But by 1974, the GNP in Egypt had increased to $280, and in Korea it had reached $475, an increase of almost 600 percent. By 1995, the GNP per capita was $730, an increase of almost 30 percent.

There are three main characteristics that cut across all Arab development models. One, Westernism, number two statism, and number three emphasis on external rentierism. Westernism means that the Arab development models were more or less pro West, they purported to emulate the West. That was mainly because of the Arab historical legacies and Western colonialism. And despite our emphasis on cultural authenticity and self-reliance, the goals of development in virtually all Arab countries were simple and clear, to achieve what the West has already achieved, at least in the area of economic development. It was clear for the Egyptian state and it was even clear in the case of the socialist model. Nasser once said that we want to do in 30 years what Europe has done in 300 years. Despite the socialist ideological slogan, Egypt and other Arab countries wanted to emulate the West and do what it has already done. The exception was Marxist Yemen.

However, Westernism meant economic development, and there was no emphasis on the social and cultural dimensions, which put it in contrast to the Turkish model, which was a comprehensive Western model with its economic, cultural and social foundations and which was clearly exhibited in trying to build a secular regime in Turkey. This did not happen in our country, what did happen was the division into the economic aspects, which we accept, and social and cultural aspects which we do not accept.

The second dimension is statism. Most of the models of development in the Arab world are characterized by the legitimacy of the interventionist state. States monopolize resources, control investment budgets and the infrastructure is also controlled by the state. States employ large numbers of people and play the roles of social engineering, economic development and cultural change. Ideologies may vary but not the crucial role of the interventionist state. Our peoples accept the interventionist state as a legitimate one, they may question the legitimacy of a particular regime, but they agree that the state has a right and an obligation to set a course for the society and to use the public resources to pursue that course.

This emphasis on state interventionism is deeply embedded in cultural and geopolitical factors. But it was clearly reflected in the process of state capitalism. But before I go into that, I have to point out that statism in our country was more or less adopted from the Turkish model, which was based on six principles.

One of these principles was etatism, with the emphasis on the interventionist role of the state. The state in the Arab model owns the means of production, and that is the main difference between the Arab model and the Korean model. In the Korean model the state did not own the means of production. They tried to pave a road for the private sector, encouraging the private sector but it never owned the means of production. In the case of Arab countries, regardless of whether it is Saudi Arabia or Egypt, regardless the ideology, the state owned and controlled a large portion of the public resources of society. Even though it was pursuing market economy approaches, the government controlled the private sector and provided the private sector with money and without that intervention the economies of these countries could never survive.

There are two variants of statism in Arab countries, the first is a model whereby the sate supports the model whereby the state supports the private sector by providing infrastructure, raw materials semi-manufactured goods, financial support and protective legislation, and absorbs major risks. However it transfers external rent to the state to expand its own activities.

The second is the model that was dominant in the GCC states, Saudi Arabia, Morocco and so on. This was the one that was pursued by Egypt until 1974 was the economic open door policy. The second variant is one in which the state dominated all aspects of resource allocation, captured the social surpluses and external rent and controlled the economy through a master central plan, which identified certain goals to be achieved within a certain timeframe. Egypt is the major model of this, in which the state owned and developed major industries, established public industries and also controlled most of the resources of the country. State capitalism in Arab countries was pursued in an authoritarian way. The state had economic and political power despite ideological differences—whether a socialist republic liberal monarchy, or pluralist such as Lebanon or Sudan.

The third characteristic is external rentierism, which refers to the generation of externally generated income constituting a large portion of the national income without corresponding local productive sectors. External rent was the main generator of domestic economic activities, as it was after the 1974 oil boom, in which almost all Arab states became rentier states either through the exportation of oil or through remittances and financial assistance, especially in the case of Egypt and Syria. External rent reinforced the role of the state in development and the state became the only recipient and distributor and weakened the relationship between income and effort as it became possible to obtain huge revenues without the corresponding effort. Although the inflow of external rent helped the GCC states to jumpstart the development process, most of the development achieved relied mainly on external human skills and as such lacked any indigenous and durable roots.

Again external rentierism reinforced state capitalism but constrained the ability to create a single Arab economy. The emphasis on external rent and the emphasis on the intervention of the state, these two factors, in addition to other factors, such as the structure of the Arab economy, all of these factors constrained the ability of Arabs to create a single Arab economy, so today the total trade among our countries is no more than 7-8 percent of the total foreign trade of these countries.

After 1975, the Arab model of development began to confront a major crisis, resulting from the Arab-Israeli wars, from the oil boom, and from the non-oil exporting countries—some of whom tried to invest more than they were able to save, which put the countries, especially the oil-importing countries, into serious foreign debt. This debt became quite serious with the rise in the price of oil in the mid 1970s, and necessitated all of them to sign agreements with international institutions, especially the IMF.

The IMF, as you know, required them to pursue certain economic policies. These policies took the form of structure adjustment and privatization. This model, which was submitted to Arab countries, was submitted as an across-the-board model that should be obliged regardless of the differences. It focused on the reduction of the administering of laws of the state and the reduction of the pricing mechanisms, allowing supply and demand to determine price levels, the phasing out of subsidies of consumer prices and input in the manufacturing sector, and also reducing government spending, revising terms of trade prevailing between the agricultural and non-agricultural sectors, streamlining the public sector and stimulating the private sector. These are the main elements of the structural adjustment package submitted to these countries. Some of them strove to stick to the terms of the IMF, such as Egypt, and began to pursue these policies. However, by the end of the 1990s, it became evident that this had not been able to achieve was it was aiming to achieve in 1975.

Here are some statistics from the Arab Human Development Report of 2002. Literacy is almost 60 percent compared with Korea, which is almost 100 percent. The total GNP of the 22 Arab countries is less than the GNP of Spain, and the population of our countries is almost 280 million people, Spain has 40 million people and they produce more than 280 million people in our countries. We spend on scientific research almost 1.4 percent of our GNP, and Cuba pays 1.62 and in the case of Korea, it could go as high as 2.5 percent of their GNP. If you take all these indicators, it means that Arab countries are facing a real economic crisis, especially after Sept. 11.

Today, I would say that Arab countries are facing three major challenges. The first challenge is identifying the exact role of the state in the development process. We have not been able to achieve the exact formula or the exact balance between the guiding role of the state and the interventionist role of the state. In Korea, the state was, at the beginning, able to pursue a different model, a model in which they played a crucial role. But that role was not to own the means of production, but to guide the private sector, and make sure that the private sector produced technology.

Number two, the relationship between political reform and economic reform. This is a big debate in our countries. Should we pursue both reforms simultaneously? Should we begin with political reform or with economic reform? The dominant view in the ruling league is that economic reform should come first. Could the East Asian model be achieved in our countries? This is a matter of debate in our countries today.

The final challenge is the relationships between the neo-regional organizations, such as the European Partnership, in which 8 Arab countries are participating, and the Gulf-Europe partnership, and what impact would this have on the Arab economies. Also the impact of these projects on the inability of our countries to form a single Arab economy. Would these neo-regional projects, the Gulf-Europe project or the Euro-Mediterranean project, would these reinforce Arab integration or would it constrain Arab integration? I think this a major challenge, In my judgment, these agreements will end, for a certain number of years, the ability of the Arabs to establish a single Arab economy. However policymakers and Europeans will say the contrary, they will say 'no this will allow the Arabs to establish integration,' – two different points of view that can be debated later on. Thank you very much, Mr. Chairman.

Chairman Dr. Samir Toubar

Thank you, Prof. Salim. Now we invite Dr. Hosni to take the floor.

Dr. Hozem Hosni

Thank you, Mr. Chairman. The link between all presentations today was that they were all about development models. But I think there is some confusion about models and sets of measures. We take the set of measures as the model, but in my opinion this is not true. Measures are very important, they necessary, but they are not efficient. The same measures can be applied in two different environments and can yield different, even opposite results. Of course we are talking about something like Egypt and Korea, we have strong leadership, we have bureaucracy, but this doesn't mean exactly the same thing. Allow me to tell a story to illustrate this point.

Last autumn, Dr. Salim gave me the opportunity to go to Korea. I went shopping and I found two beautiful statues, one was of a traditional Korean picture and one was of a traditional Korean warrior. And I asked the old lady about the prices and I found that the price of the first statue was about 74,000 won. And the second statue of the warrior was about 180,000 won. I was shocked and I asked the lady, 'why should I pay about $100 more for the second statue? They are almost they same size and have almost the same complexity.' And the old lady very politely said 'sorry, sir, this is not a soldier. This is Yi Sun-shin.' And she then directed me to the original statue of Yi Sun-shin. I though it was a magnificent statue. But I was captured by the story of Yi Sun-shin when I read it on a memorial wall. So I went to the lady and here young daughter and I bought both statues. And for some reason, the old lady considered me a new fan of Yi Sun-shin, so she decided to give me a special price of the two statues.

I told you this story because it is significant. Why do the Korean people, and here I am talking about the old lady and her young daughter—two different generations, why do the Korean people, who are seeking economic development share the same positive feelings toward this historical warrior, to have this kind of patriotism. But it is a special kind of patriotism, peaceful patriotism, calm, wise. I call it genuine patriotism. Some other models in some countries think that when sacrificing patriotism, you can't have economic progress. Koreans did not sacrifice patriotism, and they do have good relations with Japan. If they had applied the same model as some other countries, they would forget everything about the historical animosity toward Japan, and consequently they would forget everything about Yi Sun-shin. But this is not the case. But I try to distinguish what I call genuine patriotism and pseudo-patriotism. If you want to know the difference, think about this story about this woman and her feelings for Yi Sun-shin. He died for his country, and when you read his story, you will know genuine patriotism.

In the statue I bought I saw the Korean model of economic development, of not sacrificing the Korean kind of patriotism. I think this a very important fact to take into consideration when we make the comparison between the two models and not just to compare the two sets of measures. Thank you very much.

Dr. Samir Toubar, Chairman

Thank you.

Question from the audience

I would like first to welcome our Korean friends, hoping for everlasting and fruitful relations between the two sides. I think in this regard the Center of Asian Studies has succeeded tremendously in achieving and fulfilling this goal. First of all, I would like to say how happy I was to see the Korean ambassador speaking Arabic in such a marvelous way. I must say I feel fortunate to be participating in this conference dealing with one of the major and crucial issues, which is economic development in both Egypt and Korea.

I am interested in the Korean experience, either on the economic or the political level but especially on the cultural level, which I have studied myself thoroughly in one of my researches. I am not a specialist in economics, but since the papers dealt with Egyptian and Korean development experience, I can shed light on some of the effects and some of the similarities between Korea and Egypt.

First, both Korea and Egypt are witnessing, or have witnessed liberalization in several domain, including the political and economic fields within a political regime that does not accept many democratic values, due of course to the dominant and prevailing view in both countries.

Second, both Egypt and Korea trying hard to face the risks of globalization especially on the economic level. Of course the risks facing Egypt are greater.

Third, both Egypt and Korea have witnessed military regimes, both of them reluctant to accept political concessions from the part of the political regime. I would like to discuss this with our Korean friends.

Four, concerning the economic experience, there is no doubt that Korea has achieved an economic development greater than the case of Egypt, but it still faces many obstacles such as the distribution of wealth and income among Korean individuals.

Five, both the Korean and Egyptian experiences rely somehow on foreign aid, which has had a great impact on the development experiences in both countries. If we examine the two experiences, we will see that both of them rejected the modernizing theory, which would have afforded the total implementation of the Western recipe for development during the ‘60s and ‘70s and the late ‘80s. In this regard, I would like to raise questions for the Korean and Egyptian side. First, what about the role of the state?

I also have other major questions I hope our Korean friends will discuss with me, concerning human rights in both countries, concerning the prospects of the future of development in each country.

Dr. Samir Toubar, Chairman

We turn now to the discussion, but we have a problem because we only have 25 minutes at our disposal. So we will entertain question for 20 minutes and the other 5 minutes for answering these questions. And if you don’t mind, I have one. Nowadays we are facing the problem of non-performing debts, and the Koreans faced the same problems and we would like to learn from your experience on how to tackle this problem. And the second question I had is that our development models have very much emphasized the social aspects and I would like to touch on this and know if we succeeded and if we haven't, why?

Dr. Joon-mo Cho, Labor Research Marketing in Korea

A week ago, I received Prof. Salim's note. I read it very carefully and learned about the Arab economy and especially the Egyptian development phases. Prof. Salim detailed the three characteristics of the Arab model of development. He also pointed out the conflict between the role the IMF suggested that the government play and the traditional role of government.

There seems to be some similarities between Egyptian economy and Korean economic history. Like most Arab countries, Korea experienced colonization by Japan for 36 years, and also experienced military regimes. Dr. Kang spoke about how Korea's economy could have grown so much in such a short period of time, and we should be thankful to former President Park Chung-hee. But nowadays human rights issues, sustainable economic growth and quality of people's lives are issues that are raised. So pros and cons exist for the contribution of former President Park. And as we all know, at the end of 1997, we received IMF rescue packages and we tried to have structural reforms, like downsizing our public sector.

So after looking at these two kind of developmental stages, I see three conflicts. The first one is the conflict between efficiency and equity. Government intervention tends to sacrifice efficiency. The second thing is global-market politics and local politics. The third one is globalization and Korean or Arab traditional values.

Between 1995 and 1997, 158 cases of foreign exchange crises occurred in the global village, many governments facing such crises tried to privatization, downsizing, liberalization and those kinds of policies. But no one can say that all the government's efforts have been successful. So nowadays, Korean scholars are looking into how those kinds of reform can be successful. We say these reforms by the IMF are "hardware reform," and for this to be a success, we need "software reform."

The content of software reform can be summarized in three points. First, state government capacity. Political instability may sacrifice transparency of economic institutions or it may lose the trust of the people or foreign investors. Risk management ability or learning capacity is becoming more important. For example, e-government can enhance the trust in government, improve on transparency and reduce the corruption rate. The second market capacity—economic freedom and discipline. Without institutional discipline, the market economy could degenerate. Third is civil confidence. Good quality-education is truly important. With a poor education system, an IMF-style hardware reform has no guarantee for success. So qualitative reform should follow hardware reform to resolve the conflicts I have mentioned. So once again I appreciate the participants' presentations.

Dr. Samir Toubar, Chairman

Thank you very much and now I open the floor up to discussion. We will have the first question here.

Question from the audience, 1:

First of all, I would like to welcome our friends from Korea. And I would like to thank Dr. Keesung Roh for his presentation. And from his presentation I would like to raise three points. I would like to hear about the agricultural distribution of food after the reform of the early 1960s. The second is about the government raising the interest rate. The third is about foreign debts.

Question 2:

Thank you very much. I am an assistant teacher. My question is about the IMF.

Question 3:

I would like to ask about the social role of government in Korea, for example the health system.

Question 3:

I have a comment, not a question. I would like to raise two comments for Dr. Mustafa. The problem of political factors over economics factors in Egypt and other Arab countries. The second one is about transparency. The last one is one of the lessons we can get from the Korean experience is developmental resources and subsidies. And I would like you to elaborate on these three drawbacks.

Question 4:

Thank you very much, gentlemen, my name is Hussein, I am from Singapore. Two questions: one is the present emphasis adopted by the World Bank, and by international organizations about issues of sustainable development and human development. To what extent are Korea and Egypt prepared to adapt to this new emphasis of development for the future. Or do they regard them as irrelevant in the context of the cultures of the countries. My second question, to what extent is defense expenditure in Korea, in Egypt, a proportion of the GDP.

Dr. Samir Toubar, Chairman

Thank you very much. Now we turn to the speakers to answer the questions. Dr. Kang, please.

Dr. Moon-Soo, Kang

Let me first answer the question posed by the participant, 'what is the role of the government?' People's confidence in the role of the government in the 1960s was not so high in Korea. People tended to think as officials as inefficient and that some of them were corrupt. This is similar to other developing economies in the 1960s. But after Park Chung-hee staged a coup and took over power, he promised he would lift Korea out of poverty. So after the government successfully implemented the development program, the Korean people's confidence in the government improved. And that economic success, which lasted for three decades until the late 1990s, laid the foundation for the political democratization of Korea. And now, as we have a better educated, wealthier middle class, that provided the impetus for the liberalization in the political arena and social areas.

After Korea achieved a higher-income class status, the social economic development emerged. Then we introduced the insurance program, expanded the unemployment program from the 1980s. However, since the private sector has become more successful, there have been continued criticisms of the government. From the early 1980s, Korea was led by another general, and he also promised economic development.

From the 1980s, the Korean government began to adopt privatization policies of public enterprises. And there was a question about the social policy. From the 1960s to the 1980s the "growth first, distribution later" strategy was followed. From the 1980s, the Korean people began to ask for more social protection for less privileged people—workers and unemployed people. So the government began to expend coverage for the national health system and the insurance system, particularly after the economic crisis.

The crisis was a shock to the Korean policymakers and people, so the strategies changed, from growth to the protection of unemployed people to workers to poor people. For example now even in small business where there are less than five employees, no all those employees are covered by insurance. The Korean government introduced a new law to protect unemployed elderly people and poor people. It is called the MSLS Act, the Minimum Social L Standard Act, which was implemented in the New Year 2000.

And one of the floor participants asked me about the role of women, the government policy toward women. In Korea, traditionally, women have not been as productive as men. But during the government of Kim Dae-jung, who came into power in 1998, after the crisis, the government established a ministry, the Ministry of Gender Equality. Korea is the only government perhaps that has such a ministry. So the government is now pledging allocation of the minimum quota for the civil servants, for women. President Roh pledged a quota system for students from local universities. He is more concerned about opportunities for people from various regions. These kind of new social demands, for underprivileged people in Korea, such as women, have been increasing so the government policies also changed to address those issues.

For the NPL problem posed by our dear chair, we can't ignore the problem before a crisis. We strongly suggested to the government before a crisis, we had addressed this long ago. For example, the ministry of economic planning board said financial problems have to be solved by the sectors themselves, "we do not have money to solve NPL problems." That was their basic attitude. The fiscal policymakers tried to keep the government budget balanced. So they refused to provide fiscal resources to solve fiscal problems. So before the crisis, the NPL ratios at commercial banks reached to about 6 percent. However, the IMF asked Korea to revise these criteria more strictly, so it went up as high as 9 percent of the total banking assets.

To solve these problems, the government put in 156 trillion won, about 15 percent of GDP, to solve these problems. About the banking situation, we have a very militant labor union. So commercial banks and major corporations could not lay off workers even though they have problems. However, after the crisis, Korea was subject to the IMF policy prescriptions, in return for the IMF rescue package. So the government reduced the number of commercial banks to by one third and the number of employees at banks were reduce by one third, about 38 percent. And there were mergers between strong and weak banks, mergers between troubled banks. So there has been acquisition in the financial sector, and some of them were purchased by foreigners. Farmers are relatively poor, so this policy was a tough agenda from the government.

Many products were protected by the government until some years ago, but President Park and subsequent governments tried to increase the production of rice by improving technology, so Korea achieved sufficiency in rice production. We had more rice than we consumed. However, we import many other food products from all over the world, and we are a major importer of farm products these days. Now we have to protect farmers, who are losing an income source from this liberalization. So the government provided a huge grant in return for this liberalization. So the government has been reforming some of their agricultural production facilities. The government now pledged to reduce the arable land for rice production, in return for the subsidies for the rice farmers, because we have to import now.

As Korean economy grows, the proportion of military expenditures has been reduced to around 3 percent of GDP, it used to be much higher, but after the Korean economy grew it had to be reduced so that we could manage it. That's it. Thank you very much.

Speaker

The role of the state, political factors and international influences. As for the role of the state, it is concerned about economy. So what has been happening in South Korea is that the state has been withdrawing from banks and other entities but the state continues to influence policy through monetary and fiscal tools. So the state never retreats from the economy. The Egyptian state did spend a lot on social services, educational services, it was committed to provided employment to graduates of universities and high schools. I think this was manageable in the 1960s, but this became a burden on the economy in the 1970s because of many things, one of which is the number of goods to be subsidized by the government had increased.

The second is the prices of imported goods, particularly wheat, went up in the international market.

The third is that in order to finance these social services it was important for the economy to grow to provide the state with the resources from which it can spend. Economic growth has been quite sluggish, and as a result of this, the state did not have the means to continue to provide these services. Also, it started to reduce expenditure on food subsidies. So now there are only three goods that are subsidized by the government, wheat, sugar and edible oil. But we are being encouraged to stay away from subsidized goods because they are of very low quality.

So there has been shrinking from subsidies and there has been withdrawing from the commitment to provide full employment, and the expenditure on education, no matter how much it is increased, the quality of formal education is very bad. Egyptian parents often rely on private tutoring. Same with health services, they are bad, and one should go to a private clinic for good services. So there has been the withdrawal of certain services by the government, but the quality of the remaining services is very bad. But the government says they continue to provide the public with services.

On the position of women, I think the government has always been committed to gender equality, but there are conservative trends. But I think Egyptian women made large advances in employment. There are social pressures, but there are advances as well.

Political factors of course influence economic development in Egypt as well as Korea. But one big difference between Egypt and Korea is that there is continuance of economic policies in Korea. In Egypt, we can talk about personalization of politics. Politics influence development in another way and here I talk about security. We fought many wars, and we suffered from the Gulf War and we are going to suffer from this upcoming war. We lost many resources between 1967 and 1973.

As for defense expenditure, I think it has gone down. I think it would be about 6 or 7 percent of the GDP. Other countries, like Syria, spend much more. The final question is the international dimension. We always manage to take the middle way and we claim to defend human rights, but you will find that some of them are not fully respected in Egypt.

Dr. Mahmoud Abdel-Fadil

I have one brief comment on Hussein's question concerning military expenditures. The average military expenditures in Arab countries are higher than the global average. India and Pakistan are below that global average. Virtually all our countries are higher but in Egypt it is a little bit higher than 6 or 7 percent. This can go as high as 8 or 9 percent. During the height of the Iraq-Iran War, Iraq spent 50 percent of its total public expenditure on the military. The question of military expenditure is not the volume, the total amount.

There are two major questions here, the first is how do you spend this money? Do you spend it on arms, or to manufacture arms? If you import arms, it could become a waste of resources, like in the GCC states. But if you manufacture them, this becomes an industry. The second question is one of public control over military expenditure. Is it a secret budget or is it scrutinized by the parliament? In Egypt, this budget is a big secret, but it is not so in other countries. I think more scrutiny of the military budget is important. The final issue is, should we get rid of this military budget and be protected by the United States or Israel? This is a serious proposition that is under discussion. Thank you very much.

Speaker

… This was our location for the economic development in the 1960s and 1970s. As you can see, therefore, the average deficit ratio of Korean manufacturers in sectors was over 300 percent in 1985, and in 1987 it was almost 400 percent. But for the top 40 chaebol, the liberalization was much higher than for example the Board of Corporate Finance, which went bankrupt during the crisis with a deficit ratio of over 1000 percent.

In light of the high leverage, Korean firms were operating very inefficiently. Spanning the whole list of companies involved in Korean financing, for most of the years Korean manufacturing companies produced a negative EVA (economic value added). That means they earned returns less than their total capital.

Table 3 shows us the inefficiency of corporate costs. This is the ratio of sales finance over total assets. Compare these units to Japan and even Germany, which have asset turnover ratios (that is the sales finance). For these countries these ratios are much higher than 1, but for Korean firms the ratio is far less than 1.

So Korean firms used their assets inefficiently relative to other countries. And in fact, we've seen a tremendous growth in Korean firms, including Hyundai, Samsung and Daewoo, but this growth was backed by debt financing. Although they have produced some leading brands including automobiles, ships and mobile phones, their efficiency is far less than the international standard. Just as the Korean economy has grown based on input systems, Korean firms have grown on the basis of huge finances, which have been managed inefficiently.

These Korean borrowings were backed by so-called mutual loan guarantees among affiliated firms using "chaebol," or Korean conglomerate groups. These mutual loan guarantees permitted firms to borrow more and more debt from banks.

I would like to make a link between the corporate government and finance and investment behavior, but in the interest of time I can't go into too much detail. Anyway, with the separation of auditory management according to theories of corporate behavior, came a relative infinity of managers and investors, like shareholders.

But once more with Korean corporations there is this precipice of the infinite between controlling shareholders, or debt holders, and the general public investors. In running the chaebol, the foreign owners had an incentive to use those resources, to borrow the money, along with equity capital generated by the general public. They might have different incentives to use these resources for their own purposes rather than for the benefit of general investors.

In medical-powered corporations, managers control the corporation and managers have less of an incentive to have high leverage in their firms, in order to reduce the possibility of bankruptcy. In the event of bankruptcy, they might lose their jobs.

But in the case of Korea, the firms, which are run by controlling owners, have incentives to borrow more money because the government may bail them out (especially the larger firms) when they are in financial distress. And, in fact, the government has bailed out many major chaebol in the past four decades.

As for the monitoring of creditors, lenders of banks have a strong incentive to monitor whether their borrowers use the firm efficiently. But in the case of Korea, banks are mostly controlled by the government, directly or indirectly, even after the progress made by liberalization in the 1980s. The bank presidents, or CEOs are monitored directly or indirectly by the government or through political instruments. They have less of an incentive to run the bank most efficiently, or to monitor closely the borrowers, especially the large chaebol.

So we have the so-called main bank system to monitor the large borrowers, including chaebol, but the main bank does not work well, which is why large Korean firms have been able to borrow too much money.

Amid these underlying problems the government tried to reform the corporate system after the economy was hit by the crisis in 1997. These are the main goals of corporate reform the government has undertaken. One is to enhance the price ability of corporate management. The second one is to eliminate the foreign long-term fees. The third is to improve the capital structure, to lower the debt/equity ratio. The fourth is to induce chaebol to concentrate on pure, core businesses rather than expand their business lines to available sectors including industries from A to Z. The fifth is to increase the accountability of managers and controlling shareholders.

As for corporate dealings, the semi-conductor company within the AP group was transferred to the Hyundai group. There are many other cases of fixed deals. About nine lines – nine business lines – were subject to big deals, which were successfully completed. Although the government said such big deals were caused by – opposed - action by the corporate sector, these deals were later criticized as a failure of the government policy.

The main creditor banks were responsible for restructuring the corporate sector. And the type of restructuring included the bank-initiated walkout. Then the creditors could be arranged for debts.

A second factor is the sellout of business lines and the third is the high-brow liquidation of private companies or putting the private fund into composition – composition is the type of bank-ordered management of private companies.

Next is court receivership. The court-managed private companies realized that sometimes the court will order the credit bank to postpone the payments on a payment of debt or to review interest payments. Of the 324 public funds, 76 were put on the World Cup program initiated by creditor banks. And these World Cup programs were subject to very stringent bank-linked efforts by the private companies. Another 449 firms were forced to sell off their business lines, or liquidate, or were forced to merger with other, large firms.

In August 1999 one of the leading top five chaebol, Daewoo, was placed under a World Cup program. And in the year 2000 Hyundai was placed under the bank management system and these groups were restored.

Thanks to these efforts to restructure the corporate sector and other government actions to facilitate the corporate structure, such as the government intervention to revise the many acts and laws to facilitate the corporate structure, including the bankruptcy act, the situation improved.

In fact many of these new schemes had been proposed in order to facilitate this exile, or action, for private firms before the crisis, but once the economic crisis broke out, the government could easily introduce some of these schemes.

The debt-equity ratio of the financial levels of firms was reduced to 180 percent one year ago, in 2001. That is far below the previous level of 350 or 400 percent. So we witnessed a dramatic change, or improvement, in the financial sector of Korea. Another important factor was that the financial institutions and corporations became much more aware of the importance of financial leverage. They also realized why capital structure was so important in many ways when creditors extended their loans from the crisis point to bankruptcy. And financial institutions and private bodies became aware of the paramount importance of preventable (sic) financial leverage. Prior to these prices we had talked of the importance of preventable leveraging but the argument for the previous leveraging was not put into effect.

We have gone through the major government reforms and this is summarized with regard to the aforementioned reforms. We strengthened the auditors in order to make the corporate report accurate. And we have strengthened shareholders' rights in terms of monitoring the corporation managers. And what's more we had to introduce an outside director system – members of the board of directors within a company were dependent on controlling shareholders. But as of 1998 the use of several executives became independent and nominated by this special committee.

We have held many individuals accountable, and when managers are responsible for wrongdoing in a corporation they may be jailed or fined heavily. We have also fully legalized foreign ownership. A company may be owned 100 percent by a foreign owner. We have also fully legalized new markets, marking yet another dramatic change in the corporate government.

We have been able to engage in corporate restructuring, putting in huge amounts of money to the corporate and financial sector. We have put in about 150 trillion won (120 billion dollars).

The Korean corporate crisis transformed the huge reliance on debt in the private sector and private companies, but the restructuring was successful because the government was able to put huge amounts of public money in as it had maintained very sound fiscal spending. Many firms in the corporate sector that were ravaged by debt could have been saved by soundness in the fiscal sector, but the problem is that the fiscal sector became increasingly leveraged, and highly indebted, but that is another issue.

Chairwoman

Here is Professor Moon-Soo Kang to discuss the first statement.

Dr. Moon-Soo Kang

We have some questions or some arguments to raise. The first asks if the South Korean crisis is a pure financial crisis or a real one or a combination of the two? I think from his presentation, he mentioned the reasons for causes of the crisis – a weak banking system, deficit in the balance of payments, foreign debt in the corporate sector – that led to the financial bite.

But what about the real economy? What was the real performance? When we ask these questions we learn a lot about the South Korean experience and economic development. How was the Korean economy taken so much by surprise? Were there any early warnings in the systems giving rise to predictions of such a financial crisis?

The second point asks if it was related to higher importer prices; was the government ignoring declining exporter prices?

The third one is that the capital account shows a negative slide, which means there was a capital outflow during the first year.

Number four covers how in 1961 the Korea development plan relied on external loans and foreign bank investment. This caused a rise in the total external debt and debt service, and we don't know up till now how this—on the back of a reliance on external loans and low foreign body investment—effected the total foreign debt and debt service. It is part of the problem.

These followed Korean steps toward an unhappy, unfortunate scenario. At the beginning of 1997 we began to have a corporate failure, that is the failure of large corporations, and that invited an accumulation of (FPN?) Banks were still hit by these problems after the restructuring of all financial institutions and big corporations.

However, we had created level markets, which troubled the big corporations and banks could not lay off workers or restructure themselves to avoid the torture of bankruptcy.

Unfortunately we had a financial crisis starting from Thailand, in early 1997, and creeping through Indonesia. Amid escalating doubts, the investors began to withdraw from this region.

So what were the major problems in Korea's commercial banks? In 1990, Korea deregulated its exchange rate control and many other controls, thus influencing some of the major corporations. Many banks and non-bank corporations began to borrow heavily from international markets, so we had a huge jump in the external debt-asset ratio, which measures the short-term external debt and current convective divided by the low foreign reserves.

Also in 1996 the quota prices of Korea's major export items such as semi-conductors, and field prices dropped, generating a huge negative account and creating about a $25 billion deficit in the balance of payments, so our Korean economic ratio jumped from 260 in 1995 to over 900 percent in 1997.

And also corporations relied heavily on warnings rather than equity "I" in this development. We had major corporations that have high reservations, and high debt to Korean corporations, much higher than Japan, Germany, Taiwan and the UK. So when there was a financial crunch, a great crunch in the market, many of them were subject to problems and bankruptcy. However, the IMF asked for very restrictive monetary and fiscal policies in return for its cooperation. With its high debt ratio, that policy prescription resulted in huge numbers of bankruptcies for large and small corporations due to the high monetary policy enforced by the IMF in return for its recovery of corporations.

The IMF promised to provide about 35 billion dollars, and Korea received about $29 billion from this package. In 1997 and 1998 the Korean government went to the negotiations with foreign creditors on behalf of Korean commercial banks and provided a guarantee on behalf of Korean central bank. They converted about $22 billion for some foreign loans into medium company loans. The Korean government issued about $4 billion to pay off debt and increase the foreign active reserves, thus improving the confidence in the Korean economy of foreign creditors.

In order to deal with the liquidity crisis, and other connected crises, Korea took the IMF prescriptions with its high-interest policy, high-monetary policy and high-fiscal policy and with all these prescriptions Korean bank accounts improved substantially in 1998 and 1999 with balances of $40 million in 1998 and $24 million in 1999. In order to encourage foreign capital into Korean markets, Korea lifted debt-equity on capital markets. With all this price-based effort, Korea's collected reserves lifted $121 billion at the end of December last year.

Korea's total actual liabilities have been reduced from $160 million to $130 million. So this helped Korea overcome an astronomic financial crisis. And the balance of payments' $23 million deficit in 1996 rose to a surplus of $41 billion, and $4 billion and $8 billion. And this turnaround helped Korea deal with economic-related problems.

So at the end of December 1997, when Korea was subject to this crisis, the usual connection reserve of the central bank was reduced to about $8 billion, now it has to be closer to about $121 billion. In order to deal with those economic-related problems, Korea had to open up all the capital markets as required by the IMF in return for the rescue package, but even the half-priced takeover of Korean transport was allowed in 1998. Korea also did away with almost all foreign controls in order to increase the foreign capital inflow into Korea.

In December 1997, the Korean National Assembly passed about 15 financial reform bills and consolidated financial supervisory agencies. We had about four different financial regulators to fix prices, before we consolidated them into one body governing financial services. And at the common level we separated financial regulations from the Ministry of Finance and set up the financial supply commission under the prime minister's office.

Although it will be discussed in the next section, I will briefly mention that in order to solve the economic problems, the government had to rely on the government budget as a last resort. The government also pledged a blanket guarantee of all depositors that federalized financial markets, and federalized the banks because all the money had gone to banks that were amplified or protected by the government.

The Korean government also established a special agency to deal with Amoco's effects, which was a specialist on this capital issue. Then it extended this Korean deposit corporation to protect the creditors and deal with bankrupt commercial banks and non-bank financial intermediaries. So as I mentioned, about 156 billion won was spent in solving this Amoco problem, and the major players in this market – in this operation – were the Korea Deposit Corporation, Amoco and the government. However, the royal bank was also very big.

What happened to the financial sector after the crisis? The number of commercial banks were reduced from 33 to 22. The number of financial centers dropped from 2,100 to around 1,600. And about 38 percent of those employees had to lose their jobs.

But after the financial crisis of 1997, Korea changed its tariffs on FDIs (foreign direct investment). Now Korea-controlled banks could not borrow from abroad because of prices. Instead, Korea now expanded their equality to match worldwide foreign investment programs in 1998. So, previous postulated systems were beginning to open to all foreigners now, changing to negative systems. The annual inflow of equity lines moved from over $3 billion in 1996 to $60 billion in 1999 and the year 2000.

Levels of FDI moved from 1.46 percent of GDP in 1997 to 3.4 percent in the year 2000. The rise in FDIs was uniform in the service sector, including financial services. It was this trend that showed the increase in FBI for the year 2000 followed by about $11 billion in FDI in the years 2000 and 2001.

After the crisis many workers found themselves impoverished and unemployed. This inequality slowly increased from 0.28 in 1997 to 0.32 in 1999. The inequality problem challenged government responses, resulting in new civil policy measures, and with its help the economy in Korea became more efficient with levels dropping to 0.31 in the year 2000.

More policy problems led to ever-new government responses. The first policy was extending unemployment insurance coverage from more than 130 employees to less than 500 employees. All allowed services have since been comprehensively extended.

In the arena of public work, we can learn from the example of the Egyptians in 2400 B.C., when we employed new workers provided them with temporary work, public work programs and thus furnished them with jobs and incomes.

In 1999 about 2 trillion won was allocated for public programs and about 400,000 workers participated in these programs. In order to permanently address these problems, the Korean National Assembly staff had only a minimal amount of time to react in 1999.

By this time the program was ineffective in Korea and the level had increased from 180,000 per person to 200,000 per person. So, a new program laid out 1.3 trillion won in the year 2000. All these programs imposed constraints on government projects. Fiscal policies were a last resort to avert financial suffering and strengthen political networks, which resulted in government budgets being substantially increased.

In order to address these issues, first the government needed to set parameters by laying off some civil servants and by reducing the size of the public sector, then raising taxes on gasoline and incomes from deposits at commercial banks. Despite all these efforts, the government guaranteed special bonds issued by the Korean depositors' corporation and the Korea asset management corporation.

All of these things required an increase in government debt. If KEAP or Amoco failed to repay these debts, the government may have had to accept liability. So the central government debt doubled from about 8.8 percent of GDP in 1996 to 16 percent in 1998. And some of the central government-guaranteed liabilities saw increased growth from 14 percent of GDP in 1997 before the crisis to 39 percent of GDP in 1999. So this table shows clearly the jump in public debt from 1997-99.

And this figure shows how the composition of foreign capital into Korea has changed. Before the crisis most of the foreign capital appeared as debt instruments – foreign banks lending to Korean banks and firms – but after the crisis Equity "I" became the major component of foreign capital. This problem also highlights how the current account balance has shown a significant turnaround after the financial crisis. Thank you.

Chairwoman

Thank you for the very comprehensive presentation, but I was wondering why did the banking corporations get so highly in debt? Was it because the banks were part of the chaebol, and they had influence over the banks or bank directors, or is it a case of corruption? I would like for you to comment later on why the debt in corporations rose so highly and was not averted by the banks at an earlier stage.

Now we have a presentation by Dr. Young Ki Lee, who is going to be discussing corporate restructuring in Korea. He is a professor at the school of public policy and management, which is part of the Korea development institute.

Dr. Young Ki Lee

I will make my presentation as brief as possible. If you cannot hear me clearly you can follow the blue highlighted parts on your paper.

As Dr. Kang mentioned the corporate sector deficiency was probably branded one of the major causes of the Korean internal crisis. So I would like to present my summary of the major transitions of corporate financial investment behavior and the financial components.

This essay also strives to shed some light on the behavior of corporate sectors with regard to agency security dues. After summarizing Korea's effort of totally restructuring government reforms, if time is available, I will discuss the remaining issues.

The major cause of the Korean corporate crisis had its deep roots in the fragile capital structure, as Mrs. Chairperson asked about the high debt record ratio inefficiency in general and the poor financial performance. But behind the whole financial labyrinth and poor investments lies the corporate government, so I would like to combine all these issues for discussion.

You might have heard of many leading Korean firms like Samsung, Hyundai and Daewoo, all of which have shown tremendous growth in the past four decades. Accordingly, the Korean corporate sector has also grown at an impressive rate, and these high growths were led by the debt financing providing them with a high leverage. Our education system market was less developed and in fact the government was surprised when it appeared in the early 1980s.

So we are subject to a retort at the appropriate time. We have founded official reforms, but the government, except the central government, hasn't founded much of the reforms required. So we are critical against the poor performance of public social reforms.

With regard to the questions relayed by this discussion … O.K. … there are various ways of majoring financial leverage including the debt act ratio in all for reducing short-term debt. In fact, short-term debt in the Korean corporate sector has a large share, more that 50 percent of total debt. So, in either way, measuring the capital structure with total debt or short-term debt we can see that the Korean companies have very high, dangerous leverage. With regard to the efficiency of measurement of efficient corporate sources, I use sales of total assets, but you may also use sales over some fixed asset, including equipment and so forth which generates sales. These ratios are also very low relative to other countries. With regard to the structure of Korean corporations, we have a very dispersed share origin of large Korean conglomerate shareholders. For example, the controlling shareholders in general, including Samsung or Hyundai or LG, the controlling shareholders including his or her family own much less than 10 percent, on average maybe 5 percent these days. But the major company, a previous company, revealed in general, hold almost 50 percent, or depending on the time period, 40 percent. So each forum within this control each other. So the controlling owners in general can control all the lender companies through this mutual shareholding. So because of direct ownership by general owners, shares are very much dispersed. But the controlling power is enforced by the mutual shareholder. It is very different from the features of Western companies.

The role of the government with regard to corporate structuring. As I mentioned before the government took the initiative in massive corporate structuring. But actually the financial sector of structuring was indirectly through the banks and financial institutions in this structure of the corporate sector. The government has provided various main objectives, including the introduction of new bankruptcy acts, introduction of new research including corporate structure research or reinforcing the system of corporate deposit insurance in Korea and so and so forth. So that is one common goal. Another is to provide an environment that is compatible to the pure market system. Many mentioned causes of the Korean economic crisis -- we have mentioned the deficiency in the corporate sector, deficiency in the financial sector, the foreign exchange crisis and so and so forth. In fact, the underlining cause of the Korean crisis can be found in Korea's failure to transform our economic system to truly compatible one to a market system. We have pursued transformation of our economic system from previously state controlled economic system to a market system since early 1980. We have the conservation and liberalization of the financial market including interest rates, including privatizing the commercial banks. But we have failed in transforming our economic system software-wise or hardware-wise until the outbreak of the economic crisis. For example, the previous government tried to reform the financial system including the reform of financial institutions between banks and between companies and so and so forth. And also the government tried to reform financial credential regulative system, but we have failed in achieving those reforms due to the strong resistance from invested institutes. In fact we have tried to reform the financial system, the labor market system, the public sector system, but those efforts were fruitless before the crisis broke out. So a friend of mine in the U.S. said "well, it's really hard to do reform before we see such collapse of the system.” So we have to pay a huge cost because we have failed to do the reform in advance before we see the year of crisis. So I think that the role of the government should be to build the pure market system and to provide new rules of constituents in the market. So I think that this is one side of the government role especially since we have failed in that aspect.

With regard to the size of firms the government thought that the top five chaebol could make this structure by themselves and the government forced the top five chaebol to restructure with their own efforts and their own resources. But out of the five, from the top six to the top 30 chaebol, the government placed them under bank initiated work out programs as I mentioned before or placed them under corporate issues. Especially, small- and medium-sized firms were placed by primarily in corporate issues and work out programs.

The fourth question, the last question, “Do you think that we need to reassess this experience, we need to reform the forms of corporate structure to get some work education for the developing candidates of the Egyptian economy?”

Well, I hope that no other country experiences a crisis like Korea. And also our system is quite unique. So experience cannot be directly applied to other countries. But the political conflict of interest including the parties and labor parties and the common sectors, all those parties have different interests. In fact as I mentioned the workers are resistant to the restructuring and foreign official buyers of Korean firms were reluctant to buy Korean firms and restructure them because of the resistance from the workers. That’s why the sales of Daewoo Motor Company took so long time to resurface. So those kinds of interest conflict delayed the restructuring. And also some political incentive also played in that restructuring. So we are very sorry that we have this kind of delay, and also those delays aggravated the Korean economic conditions in 1998 and 1999. So I wish we did not have the problem, then we would be more successful in restructuring. Thank you.

Thank you Dr. Kang. Before adjourning, I’d like to invite you all to have public sections

… you're all invited to the guesthouse. We are meeting next door to have lunch. Please stretch your legs because within an hour the next section is going to star. One last comment one sees that economics are much more positive than political sciences are, which is next on the list in this section. Thank you all again.

Chairman Mustafa El-Saeed

Ladies and gentlemen, we have the great pleasure to have our Korean friends here for our standard for Asian studies and the experience of Korea during 1997 crisis is really relevant to our experience in Egypt now. In this section we have two papers, one on financial restructure and the other on instability and institutional insecurity in the Korean liberal market. May I invite Dr. Kang to start by presenting his paper on financial structure in Korea?

Dr. Dong-soo Kang

I am very happy to be here in Egypt where the people treat us well and I am very honored and privileged to share these experiences with these scholars. Before entering into the presentation I want to briefly discuss the Korean economy. One of the important exported merchandise in Korea is semiconductors, a memory device that is called VERAN. VERAN is the combination of cyanic and retinal memory. And I think that this dynamic, random, well characterized Korean economy. Korea is very, very dynamic. Korea has been growing at 7 percent annual rate for the last 40 years. You know the 7 percent growth in 10 years means doubling of the economy's size. So that in the end, Korea has grown 16 times in the last 40 years. So this is very, very high. But maybe in a few months this is an old fashioned idea. And Korea is also very random in the fact that we have lots and lots of services. We are heavily dependent on the outside world, so the outside world cannot be fully controlled by us. So this will characterize not only the Korean economy but also the necessity of overcoming financial crisis. We cannot settle down so we have to overcome, we have to meet the international standards in order to survive. We are not a self-sufficient economy we could use you help in understanding about the Korean economy. Let me start the presentation.

Basically restructuring is a big game with a lot of people involved in every situation. So as a policymaker, as a consumer, as a firm manager, as a banker, everybody has their own stake to say about restructure. So because everybody is involved, financial restructure must be carefully analyzed in 1997. In the previous presentation, Dr. Kang and Dr. Lee have explained the origins and causes of the crisis, so I don't want to go over that again. At that time we faced two things basically. The first one was lots and lots of non-preferred amounts. Secondly we have very, very rich financial institutions. That's because of the huge NPL. The NPL size was nearly 100 billion U.S. dollars of NPL existing at the time. The financial institutions of highly leveraged companies by nature sell loans from the corporate sector has automatically become a problem of the financial sector. So how to cope with this kind of situation? I mean how to revitalize the financial situation and how to remove the NPL from the book of financial decisions? These are the two main questions.

So we put this position of NPL as related to the disposition of NPL, and we have a rotation of financial institutes as related to the quaternary structure. And on top of that we are attempting to build a kind of crisis proof financial system, which is related to the hardware/software institute. So to combat the financial crisis, mainly there are 2 jobs. The first one is to be equipped with well-organized teams. And the second is money. The first one is organization and the second is money. This shows the organizational picture of the financial and corporate restructuring. Usually the corporate restructuring is another side of the financial restructuring because corporate debt is the original source of the debt threat. So if the corporate sector is healthy, there is more chance that the financial sector won't have any problems. We restructure this corporate sector by way of, by using the financial decisions as Dr. Lee said. The government injects money in the financial institutions to do the corporate restructuring. Because in Korea, the government does not have any stake in the corporate debt, it is illegal to do the corporate restructuring directly. These financial institutes have some assets in the corporate sector's companies. So because this corporation did not make payment on principle interest, so obviously you know the loan becomes a swap. And the financial institutes are infinite (compulsory for) to do the corporate restructuring.

Here, as I said, is a financial supervisory commission. The Financial Supervisory Commission is a kind of control tower, orchestrating all the financial restructuring and corporate restructuring. And below the Financial Supervisory Commission is the Financial Supervisory Services, which is a consolidated regulatory agency from Korea. And this too, DIF, deposit insurance funds, and NPAF. These are the two public finds, to do the restructuring. And using this Deposit Insurance Fund KDIC creates deposit insurances, injects money to the financial institutions like contributions, insurance payoffs, or capitalization and so and so forth.

And then this NPAF, non-performing asset fund. KAMCO (Korea Asset Management Corporation) purchased NPAF from the financial institutions. For this purchase the after market price was applied. That is very, very important. Because this loan is non-performing, it must be discounted. So even though the normal amount is 100, it is traded at the price around 38 in Korea. So this was the original price and maybe in the paper page 17 there is a table about the public funds - this is table 6. So this upper part shows the assistance items. So in paramount, what they spend was 156 trillion Korean won, that is around $123 billion. And most of the money was injected in the banking sector, the banks, 86 out of 156. The rest goes to insurance and merchant banks. The source is mobilized by the bond insurance. There are 2 parts; government guaranteed bonds, which is called a public fund, and the other is recycled money and other government assets. So this process is quite clear.

To observe the successful financial restructuring, there are many difficulties. The main difficulties come from the long-term objectives rather than the short-term objectives. Restructuring is not a popular policy at all. Everybody knows the advantages of the restructuring in the long-term, but nobody wants to get restructured in the short term. It involves heavy cost. Say for example, corporate restructuring involves massive layoffs. So unemployment goes up and for the time being in the firms not produced under the tide of restructuring. So economic growth rates coincide. So as a policymaker, it is a big burden. So this is not a popular policy at all. Even the workers -- they have the potential danger to be laid off. And as a manager -- they have the potential risk to lose their position. Even the financial institution, they have to reveal the real health of the financial institution. So nobody wants to do it. And this restructuring process is related to redistribution in general. In the capitalist countries redistribution occurs from the haves to the have-nots. In the socialist countries the initial distribution is equal, but ends up being from the people in general to the people of expertise and knowledge. So nobody learns from this kind of profit. And also there are huge incentive problems. The restructuring is ideally from the long-term perspective but it is actually not made because of the short-term problems.

So how to cope with these problems in Korea? As I told you at the beginning of this presentation, Korea is a very dynamic and random society, so Korea cannot survive alone. They have to make themselves to comply with the international rules. So at the time we had a kind of urgency and under the recognition that prevailing systems are not viable any longer, we felt desperate. We need to change. Plus we had a very fruitless political agenda at the time. In 1997 around November 21st, the currency crisis broke out, but coincidentally the following month there was a presidential election for five years. That means that the new president got the full period of five years to produces change. That means the political research was important at the time. If the current classes had broke out say like in the 1995 when the presidency period lasted just 2 years, then I don't think that the thing would have worked. And another thing is a kind of national coalition. If you watch the World Cup soccer game in Korea then you might see some hug spectators in the street to watch the game at the same place. More than 5 million people watched the game at the same place. So the two years did not recognize that many people gathered together to watch the game. But say in a crisis situation or under high urgency Korean people cooperated with each other. But in normal times they are quite different people. Another example is the Gold Collapse Movement. Just after the break out of the financial crisis around $128 billion worth of gold collapsed. Under crisis times, you know the currency is very, very unstable and nobody wants to see their very stable wealth in gold. But in Korea people sacrificed themselves in order to overcome the financial crisis. The amount is quite minimal but that is a good sign for the Korean condition. Under national sentiment, the political leaders should work very well.

And another key success factor is a pre-prepared plan for the restructuring. I showed the flow chart beforehand. The main structure has to be prepared before the outbreak of the financial crisis. Which means in 1996 and early 1997, the Korean government helped build up the financial supervisory condition and set up the KAMCO and NPAL resolution and Korea's deposit insurance corporation. But in late 1997 the currency crisis broke out and we did not have to spend much time discussing how to co-overcome this crisis -- everything was ready, just implementation right away -- that's it. So we didn't have to spend much time on the various places feeling the depression. So we just follow the rules. We did not expect the currency crisis to continue at the point of summer 1997. But we had some kind of risk so we wanted to change / shift a little bit. That's good preparation in hindsight.

So I think the Korean crisis in 1997 was a kind of blessing in disguise. It was a very painful event, but without this event the Korean economy would not have changed very much. Actually Korean wanted to change itself for a very long time. In the 1960s and 70s Korea was a spirited economy under a well-organized plan. But from the early 1980s Korea wanted to change themselves to a free centralized economy from the centralized economy. Korea has spent 20 years providing gain. And this financial crisis made things change. And so in that time the financial crisis blackened the Korean economy.

So I though about what will be the relevance to the Egyptian economy then? It's very hard because I don't know the Egyptian economy very well. Well, I will give one kind of textbook style explanation or advice to you. Borrowing is a fundamental source of the financial crisis. If you do not borrow, nothing happens. If you borrow then there is a chance or risk of being exposed to the currency crisis or the financial crisis. But we cannot live without borrowing in some sense, if you want to develop your economy in a very speedy way. You may end up involving foreign borrowing. So in order to shave it down, there are three sources basically: capital, reserve, and technology. Capital means that if you do not have enough then you have to borrow from outside under their heavy control of the capital market. You do not want to borrow this much because of the international adhesion or the opening of the proper market. If the firms are free to borrow the money from outside then probably the foreign capital rushes in to take it. And the firms are willing to borrow money because the interest rates are quite moderate. Then the economy goes for the time being and probably the economy is faced with some difficulties. The foreign owners are very wise. They want to extract money from Egypt. If the money goes out then maybe the currency crisis happens. So things get worse and worse.

For high corporate discounting, very strong or very prudent reservations in the financial market. In Korea the same thing happened. In 1996 and 1997 to open the possibility of a problem, foreign capital went out. So foreign resources dried up in the Korean economy and we faced financial crisis. So the functioning of the provincial regulation of the financial sector may be another cause of the Korean financial crisis. So these things happened all the way and everywhere in Thailand, in Indonesia, in Malaysia, everywhere. So if you open up the financial market in order to boost up the economy of Egypt, then you have to be very careful about this issue. This is the end of the presentation and I would like to answer questions afterwards.

Chairman Mustafa El-Saeed

And many thanks, Dr. Kang. Actually some of this discussion can make a big difference to Egypt and helpful towards managing the markets. There are a few things I would like to mention. Firstly, the debt to equity ratio increased and all the symptoms of bad management of the financial sector were there. And then the crisis occurred, and as is clear the financial structure and the corporate structure concurred in order to overcome the obstacles. And now I give over the floor.

Discussant

Thank you, Chairman. This is an interesting topic. The good and bad side of the corporate financial crisis often pretends that financial crises are good. But because of these countries and financial restructuring, we can learn from it. And if the country's institutions are restructured in the proper way then it might avoid crisis. This I believe or have the feeling for the Asian economy and for Korea in particular. The reason behind this is that the Korean economy before the crisis was already doing well as a strong exporter. The sector in other words had no problems and reached this high performance compared to other countries or other developing markets. So to a large extent the investment environment in Korea is such that if it is exposed to an external shock or internal problem, it can recover. It can come out of these financial problems in a relatively short period of time and strongly. This is quite evident if you look at the non-performing assets. For example, before the crisis it was around 4 percent and after the crisis it immediately dropped to 2 percent. This is a very positive time.

Another good thing about the Korean experience is that they noticed that if they wanted to financial restructure they should start with the corporate sector. This may involve labor layoffs. This may involve a slowdown in economic activity for some time. However, if you really want to cure the problem in the financial sector you need reassignment of the funds. Korea recognized this and also their restructuring of foreign policies in the banking sector by keeping an eye on their restructuring in the corporate sector.

I think I have listed the important things for countries to try to get out of their financial crisis. Like for example administrative measures like reducing the stake or revaluing the currency. I hope this will bring some short-term gains. Again, political gains more than actual economic gains for the countries. In the case of Korea, they had a viable corporate sector before the crisis, yet when they faced problems they went back to the fundamental economy. There was something wrong with the corporate sector. They needed to remove the task from the corporate sector like the US did in the 1980s and Europe in the 1990s. And I think that Korea and other Asian economies emulated that towards the end of the 1990s.

And I would like to just mention a point about what Mr. Kang mentioned about borrowing. Of course if you don't borrow you reduce your exploitative advantages and potential for loss. However it depends on the rates. For a strong export tax economy like Korea with the ability to penetrate foreign markets, they have a smaller risk involved in borrowing in the private sector than other countries. The corporate restructuring is more of an Egyptian problem except maybe in the last year when we started an internalization program. There are many different ideas for the different approaches to crises. Korea knew exactly where there were problems and they responded to that. They came out of it stronger and more confident. In the case of other countries, this really effected the corporate sector and investment environment, the labor skills, and the labor market. I think that it really enabled the country to be in a better off position under globalization and so on and be prepared for the risks to come. In other countries including Egypt, they are faltering about policies and temporary remedies for problems, so they face the same problems again and so on. So I think that from the experience we have a lot to learn for our emerging markets and as I said, we have kept things viable with strong foundations for the labor market skills, the corruption side, and so on.

I think that the main approach to the problem of foreign policy was enforcement in Korea. We have the better ability than Korea has I think. It's not that the rules are more advanced but I think that our control by the Central Bank of Asia is by some extent thicker than what we see in Korea. Korea has also worked on that and we can see from the capital requirement agreement, the increase in the capital requirement program to 10 percent. Financial restructuring is something to keep an eye on. This is a subject for the political incentive scheme. It's a lot of work. We have to get on with that and reform the developing country faster. But for developing countries in general, again the starting point for all this is internal control. Because the banks that are strong, internal control is first defense line against these advancing crises. These are the main issues I wanted to talk about. It was a very well written paper, I enjoyed reading it and there are lessons to be learnt from it. Thank you.

I think that it is better to avoid the crisis rather than have the crisis in order to learn how to strengthen the institutions and authorities. But we'd rather say that the crisis had some benefits, the conviction is there, but it is better not to have the crisis. Now I think that because the two subjects in this section are completely different, financial on one side and the labor market on the other side, it is better to have the discussion on this topic now to finish with the financial restructure. And then come to the second topic of labor. So if there are any questions or comments about what was said about financial restructure in Korea, it would be very welcome. So the discussion of the two topics, labor on one side and financial on the other side, will be separated.

Question:

So what was the main lesson learned from this crisis?

Answer:

Korea has tried to interfuse the centralized market based economy for a long time, since 1980. The economy cannot survive forever, cannot sustain economy growth forever, as we tried unsuccessfully before the financial crisis. Everybody knows the necessity of the decentralized economy with reallocation of the financial management and also the financial market. But because of the financial crisis now outside groups like IMF brought financial advice too. The Korean government should follow their advice. And their advice is the same as the previous plan. But inside nobody wants to introduce that kind of a system. So with the help of outside money, Korea effectively introduced this long wanted plan and long wanted economic system. It's kind of ironic. And after the successful popular restructuring, we have, that is the Korean economy is now equipped with the culture of restructuring. Beforehand, nobody wants to restructure unless they're pushed. But nowadays people feel the possibility. Restructuring now is better than restructuring in two years, so let's do it now.

There is a market for the non-performing assets. As I told you the non-performing assets should be traded at the discounted price. Obviously the seller wants to ask a very high price close to the normal value. But the market, the people who want to buy these non-performing assets should apply say 10 percent or 20 percent because it's non-performing, it's junk. If the difference between the bid price and the asked price widens, then there will be no conjecture. It means that there is no market. The reason is that both parties think a total different way because there is no true fault accounting the financial situation. So in the course of the financial restructuring, corporate restructuring, one of the achievements is to set up the economic center for the distressed company. So there is a clause. There is a wide divergence about the price in the case of the assets. So this clause was made a year ago. A year ago the price was say 100, now it is in the top of the factory, then it's going to be say 30. It was discounted over 70 percent.

So the corporate restructuring job is a very tedious job to establish economic standards in view of market demand and supply. That is the kind of culture we have accomplished. So, if we face another crisis we will shorten the period of time to restructure again. That will be the miracle.

Question:

If another financial crisis hit suddenly the economy of South Korea, actually I am not convinced that it is not about countries. If you are not reasonable or suitable in this case, that means that if something wrong happens in Indonesia or Thailand or other countries in Asia, we'll see the crisis again in Korea. Could you make it clear how to avoid such financial crisis like that in the future? Thank you.

Answer:

Well it is certain in the sense that the North Koreans quite activated the outbreak of the financial crisis in 1997. But it is not certain in the sense that the proximity of the corporate sector has been prominent since the early 1990s. So in seven years of the lower proximity of the corporate sector was staked in the financial crisis. So in hindsight we can say that it is quite obvious that Korea will face a financial crisis but at that time in 1996 and early 1997, we had some problems but not ones that would lead to the financial crisis. If we expected it, then we would prepare for the crisis, but we didn't. So every crisis cannot be anticipated beforehand fully. Every time there is a risk of the financial crisis, so our job is to minimize the likelihood of the financial crisis, not to remove the chance of the financial crisis. So every economy is vulnerable to the crisis, that's a fact. The thing is how to prepare for the crisis, how to cope with the crisis, and how to reveal the probability of the attack. So hindsight evaluation is not so fair, if everybody knows it then I can make the best plan ever. But at that time, nobody knew and this policy is a kind of expected thing not to defend instantly.

Usually the expectation is not like this. The expectation is like the purpose. The purpose of the outbreak of the November crisis was say 70 percent or 30 percent or something. The chance goes up from 30 percent from 70 percent, not from 0 to 100, so everything is a kind of an expected plan. Obviously financial institutions feel the higher risk of the financial crisis, they are not fully sure about the outbreak of the financial crisis. But on the surface, if the financial institutions observe the occurrence of the financial crisis in a month, they cannot stop. They cannot change all of their sudden actions because there is no way to be exposed to the crisis even if you knew about it.

Question:

But if you look at the 1, 2, 3, 4, 5 annual papers … couldn’t you predict?

Answer:

Before the financial crisis there had been no crashes in the Korean economy, even if the corporate debt accurate ratio was say over 500 percent. Financially desperate companies are usually in bad health before bankruptcy. You know why? They try to pay back their liabilities, but if they cannot pay back again, then they are bankrupt. So say five months or one year ahead of the bankruptcy their financial fitness was even worse than the time of the bankruptcy.

Chairperson

Any other questions?

Question:

I think that this is a very good discussion of the two questions. If you could not predict the next financial crisis and if we know that there could be no fire without smoke. There was no smoke before the fire. Would that be due to certain conditions, as was said before, that things were going all right until the financial crisis broke out. And for some external factor that was totally unexpected. As was pointed out, some international fear has many creators. The East Asian market, in order to achieve certain objectives, they are going to bargain harder. Now I know, this comes from the office of the former Deputy Finance Minister of Japan. How do you account for that, because I see from your discussion that this kind of argument is subject to be secluded from the argument for our Korean friend?

Answer:

It is significant in 1, 2, 3, 4, 5 in the paper. If we can study the development, we will have to anticipate something to happen.

If you truncate the graphs at the time of 1996, can you expect the crisis? I mean the trend goes up, forward, it may happen, so nobody knows.

Question:

Just let me develop a question and then I'll shut up and I'll redirect your answer. I want also to compare your response to the financial crisis with the Malaysian response. Two different responses. You tried to embark on corporate restructuring, Malaysia opened its arms to this control over the exchange rate, rather than corporate restructuring. How do you account for two different approaches, when both faced the same Asian financial crisis? And Malaysia was also able to achieve a relative success in overcoming financial crisis. What conclusions can you draw from these two different experiences?

Answer:

For the first question, let me answer the question from the policymaker's point of view not the economist's point of view. I think that the policy is a tradeoff between risk and return. If you want to make the economy grow very rapidly, you have to take a risk. Borrow money from the outside and pump it as capital in the industry. This borrowing is obviously is related to the risk. There is a tradeoff always. What is the right balance of the risk and return? That is the question. So the answer quite varies depending on the health of the economy and the objective of the economy and so and so forth. So I cannot give you the exact formula but I can give you some principles.

The second question is the difference between Malaysia and Korea. There are many differences. The first thing is, well this may be a minor thing, but the corporate debt accurate ratio in Korea at the time of the current crisis was over 300 percent, in Malaysia below 100 percent. So Malaysia is liable to their debt according to the book, if the book is true. But in Korea, they were very highly leveraged and assets had depreciated in a speedy way so Korean corporations could not pay back their liabilities. And physically Malaysia is a self-sufficient country. If they do not trade with the outside, there is no chance that the people in the country will starve to death. But in Korea we don't have many raw materials; the only option we have to take is trade with others. So we have to keep the market open to the outside. But in Malaysia they can close down the market because the penalty is less severe. But in Korea the penalty is extremely severe. We may go back to the days in the 1970s. But in Malaysia it was totally different. And in Korea, we have a relatively well-developed capital market so we can use the market approach better than Malaysia. So there are many differences, so I cannot mention everything.

Question:

To what extent is Japan connected to Korea or affected the coalition negatively in the Korean society and financial sector and property?

Answer:

It is a very long story -- ever since the development age. The economic development in a very stable way should invite market distortion. If the market is not distorted then the economy should follow a normal pace like economic potential, say 3 percent or something. But we want to achieve speedy economic goals like 7 percent per year. Then how to do that? Distort the market. Say we need the capital -- the capital is a very variable input, then price higher on capital rather than the labor. So capital is a very valuable source. We give more favor to the corporations and obviously the corporations make a huge profit because the borrowing cost is very low and the working labor is very cheap. So there is no way to avoid making profit. With that profit they can accumulate capital and further inject it into the production of economy growth factor. But the economy is subjected to risk. Sometimes they have enormous risks, so even if they make a huge investment, maybe the return won't be immediate. And this will hurt the books of the corporations and, in turn, the books of the financial institutions. So obviously, there will be some attraction. The management of the corporations wants to borrow more from financial institutions in order to pay back the interest, not the principle. They have become highly leveraged. But this kind of relationship is reinforced by political problems in the military period of the political leadership. Maybe they are quite trapped by doing this kind of favor for the management in return for some sponsorship, financial sponsorship.

Chairperson

Again the subject is very interesting. So many thanks and we turn now to the second paper on the labor markets in Korea. I invite Mr. Joonmo Cho.

Professor Joon-mo Cho, Labour market restructure in Korea

I am going to present about the Korean labor market reforms during the financial crisis. The goal of Korean labor market reforms in the financial crisis is the labor market practically. So first let me introduce what is the corruptibility. The first one is the lowering in payment to the market entrance. The Korean labor market is known as a dual labor market. So the first labor market, which is the labor market for the large companies provides the good working conditions, high salaries. But the secondary labor market, mostly for the small- and medium-sized companies, provides low salaries and bad working conditions. If the labor market is efficient and competitive, and inflow-outflow is working well, then the labor resources are going to be allocated quite efficiently. But since the labor market is segmented between first and second, inflow and outflow is somewhat limited. So misallocation of labor resources sacrifices the efficiency of the labor market. So this is one aspect of the corruptibility of the labor market.

The second one is the accessibility of the labor market in convention. In time of crisis the Korean government built the employment center to provide job information for the unemployed. So this contributed to frictional unemployment.

And the third one is efficient education and training programs. So through improving the abilities of the unemployed, the Korean government put tons of money to have this kind of efficient education and training program. The last one last one is basic protection through social insurance or social savings plan. We do have unemployment insurance and national pension, medical insurance and a whole bunch of social safety nets that the developed countries have. So we worked a lot to build this kind of infrastructure during the financial crisis. So I think that the Koran labor market policies have been successful to a certain degree.

And what I am going to say is that there is a certain negative side we need to worry about. But it's going to be less for the Egyptians, for the developing countries for the government to think about setting the policy for the labor market. I call it institutional security or insecurity. "Institutional security" means the institutions are coherent and institutional transparencies. Instead of defining coherent or transparency, I am going to go through the example of institutional insecurity. If you have poor monitoring system, then the employer is going to evade the labor law. So they may unjustly dismiss their workers and dismiss their pension if suddenly you go out and I don't like you, and that may happen. And another one is that vaguely defined legal definitions may increase the employer's opportunity. And another one is if there is a loophole to evade the labor law, then the employer can evade it. So even if there is a huge size of positive effect of the Korean labor market, we have to watch this negative side too. So if institutional insecurity is prevailing in the market, opportunity is reduced, contracting cost is increasing, ad the long term contract is going to be fragile, and the workers are not going to be loyal enough. For example if you go outside and you find another job instead of contributing to your company. And it will all decrease the efficiency from corruptibility.

Two key policies of Korean government during the financial crisis; the first one is the regulation of Korean dismissive laws. Before 1996 employers could not dismiss their employees. We have to distinguish two concepts, dismiss means to layoff due to managerial reasons, distrust means you are fired -- layoff due to employees' negligence. But in 1996, the law started to get avoided -- employers can dismiss their employees under a certain limited condition. But in early 1997 there was a true protest by the labor union and also other politically opposing parties. So the activation of law has been called upon for 2 years. And at the end of 1997, the financial crisis exploded and the IMF demanded that we had to adopt this kind of revolution of the new labor market regime. So in 1997 the dismissive law is immediately revolutionized. So this repeats all the way through the regulation process. In the temporary inconsistent deregulation process the full market and the strictness of the labor laws has been weakened. So some sort of chaos is going on.

What I'm saying is that the labor market reforms highly managed to be successful but we have to worry about those kinds of societal effects. And the other law is that in 1996 we allowed these temporary health services, called the Temporary Health Law. So by this law, the irregular workers have been rocked. But nowadays in 2002, the proportion of irregular workers is higher than 50 percent in terms of their employment type. So, during the financial crisis, it hurt the labor market in terms of its instability.

The unemployment used to be less than 3 percent, which is pretty low. This is the standard of ILO. In 1998 the unemployment rate has been rocking. In one particular month the unemployment rate was 8 percent and social profits was going on. So nowadays the unemployment rate was reduced less than 3 percent, so we recovered. But we should be worried about the quality of the labor market. So change in the average tenure in 1994, all tenures for all workers was 7.08 and employees average tenure in a big enterprise (greater than 300 employees) 8.3. But less than 300 employees for every tenure is 3.6. That's the criteria of last year. We tend to be declining so the labor market is becoming correctible, at least from the quantitative standpoint. At the end of 1997 we had a financial crisis, declining tendency becoming more prominent. So tenures are getting shorter and shorter and even the business recovery is not catching up. And also the trends of the proportion of employment through tenure tend to be increasing, but it fell during the financial crisis. The short-term / long-term contract become fragile so there is in fact the effect of corruptibility in this scene.

And then the gender distribution. Some scholars point out female empowerment. The financial crisis cost the female workers more. The proportion of female workers with true tenure tends to be increasing, but for male workers is relatively stable. So negative shock is more prevalent and hurt female workers more. And the young workers, as they are becoming older, the proportion of short tenure is reduced. If you want to computational evidence, every tenure of the U.S., which is known as the most practical labor market, is longer than Japan, which is known as long-term lifetime employment. So, what an irony. In the U.S. labor market, once matching of the employer ad employee took place, you can enjoy the longevity of a longer relation, so what an irony. And this happened as we're getting older and was steadily declining. This was 1994. This is 1999. So youngsters are producing more and the youngsters' unemployment rate is twice as high as the average unemployment rate. And these are irregular workers, this is the proportional or irregular workers with short tenures who tend to be increasing. So in sum, the young female workers, young workers, irregular workers, all of the workers who are working in our predatory labor market were affected more by the financial crisis.

I collected a total population of unjust detrimental court cases of 850 that happened between 1987 to 1990 to measure the employers' opportunism, an unjust system. This reveals two kinds of proxy variables, the first one is winning rate on the court. The percent when worker wins has an average of 33, and this is the tenure of workers on a winning case when injustice takes place is 8.6 years. So these two proxy variables are initialized. We can see that the winning rate tends to be stable after the 1990s, but during the financial crisis, it fell. If we had had secure institutions, we would not have these kinds of problems.

Another one is winning rates by period. In this economic dismissal case you have the rocket fall. This is presented to be caused by globalization and disorderly regulation of dismissal law. And this one is a weak tenure by period, and employer opportunity is prominent and statistically it was significant. And I also compared some means for the large and small firms, but due to time constraints, let me skip this transparency.

And also there are some official loopholes. If your business is less than five years, legally you are exempt from the retirement grant. According to Korean labor law, if you stay for one year, then one-month wage are accumulated. So if you retire, then one- month wages should be paid. But the less than five years employers are exempt from that labor law. And also if you have less than 10 employees, you don't have to have any contract documentation. So if you hire workers and you fire them the very next morning, this is legal. So this kind of incompleteness of labor law can boost up the informal sector growth.

And this is temporary health laws, this is employee and major company. And usually this worker is hired by the company, so a regular employment relationship is existing. But there are workers called temporary workers. They hire these and snap some fees for any training, any competition, and overt employers obligations. So as I said, this kind of phenomenon is also happening in the U.S.A.

This is about the social safety net. We prepared the social safety net, so that's a good thing. But I mean this year we have to be concerned about raising up this index. What I mean is that we have to have a national pension plan to save the poor or enhance the equity. And the other one is that we should have medical insurance working well. And the other one is unemployment insurance. This is working well. Every financial enterprise is applied to this kind of unemployment insurance and the retirement grant and overtime payment. The legal working hour limit is 44 hours and the new president is supposed to reduce that working hour limit. So probably we are highly likely to have a 40-hour working hour limit in a week. So if you work more than that, it is 1.5 times the wages you are paid. And we do have monthly, yearly leave. If you work one year, you can have 12 paid vacation plus one. So you can have 13 days off. And also we do have maternity leave. If you are having children, you can have maternity leave for 6 months. So this manual is well developed. But the question is for the maternity leave for the employers which suffer but have few liabilities. Only 21.2 percent of employers forfeit this duty. So monitoring systems and institutional security lower to enjoy the efficiency from the “practicability” (sic).

O.K., final one. This is correlation coefficient. The message -- if you cheat on legal welfare you are more likely to cheat on other welfare. The second thing, unemployment, irregular employment is likely to be associated with the illegal motif. So the message is - practicability, many scholars point out, practicability alone. But I am emphasizing institutional security, embracing this element of practicability should be emphasized. Coherent and transparent otherwise opportunism and informal factors may be growing. With this institutional security, we will get efficient in the labor market.

Chairperson

Many thanks, Mr. Cho. The labor market aims to achieve with its four elements. But again institutional insecurity is involved in the four elements in order to achieve sufficiency in the labor market. This is the essence of the labor market. We now turn to Dr. Ahmed Galal to comment.

Dr. Ahmed Galal

Thank you, Mr. Chairman. First I have to apologize to Mr. Cho for not being able to read it extensively because I received the paper yesterday. It was wise to prove that the term you coined as "institutional security" is a major loophole in the labor market regulations. And therefore from the beginning I felt that despite the fact that you had evidence, and I will argue with you about the evidence now, the hypothesis that you tried to prove -- whether it was right or wrong for Korea -- you were always trying to move with one direction. And I'll show you afterwards how you did this. Secondly, it's the first time for me to hear this term "institutional insecurity". I went more in depth in institutional economics, but I did not go in depth in labor economics. So I know institutional instability, I know the terms “coherence” and “transparence,” which are institutional aspects. But to have this term “institutional insecurity” without, as you did in the presentation now, saying explicitly what you mean from the beginning -- it is not a normal or conventional term used in this literature. The same goes for other things like when you said, "the benefits are depreciated". Again, we say that the benefits are lessened, not depreciated.

Third point, one of the major issues you have tackled is how the flexibility of the market had negative effects on the labor market. And without this flexibility or the institutional aspects that you included, this dismissive law and whatnot had a negative impact. I have a different view. I remember one of the greatest economist problems is that countries do not reform unless they are subject to a crisis. And having a look on the labor markets and labor courts even in Egypt -- there is a problem in reforming the labor markets of the nation. Why? Because it is too sensitive an issue. It has to go to social contract agreement and the labor in general population. And therefore governments are always reluctant to touch the sensitive issues unless there is a crisis. And as Dr. … pointed out, you make good use of the crisis by figuring out responsible action. And I believe the faults of Africa required flexibility. You said that the right to dismiss employees under certain conditions -- so what is the vagueness there? It must be left to sway unless you provide a very long detailed co-angle description of how you can dismiss labor and work, and under which circumstances you can dismiss labor. Which is a matter of industry specific or sector specific, which is difficult to provide in the long-life sense. In Egypt I will tell you the experience we had in order to overcome this problem.

You mentioned as one of the major loopholes that the law did not touch upon the small- and medium-sized enterprises. The enterprises with less than five laborers were allowed to exclude the regulation. But I see this as a positive aspect because those kind of enterprises are subject to shock and vulnerable to shock in a more extensive way than the big ones. So it is better to leave them and allow them to act as a safety net or as a cushion for whatever happens due to the regulations. So I would argue the other way around that the flexibility provided in the labor market was prime for the crisis that was able to be introduced in the Korean market. But without it you could not have it and this was explained by that it was supposed to be implemented or enacted after two years. And due to the IMF you had to enact it before. That was a good thing for the flexibility of the market. I don't agree with evidence you provided at all, even the win- win rates because you showed that the win rates were exalted in figure 9 where you showed that the win rates have sky-rocketed in 1999 because of the opportunism of the employer. But actually we should consider here how many years any case stayed in the courts -- it might take two years -- and this is an effect of the crisis success. So employers had to get rid of laborers during the crisis. So it is because of the crisis that the people were getting rid of laborers and that is normal I think. So really I don't believe in this vagueness or the negative loopholes in the labor code that you had in Korea. On the contrary, I see it as a good thing.

Another thing I will briefly mention, if you want to achieve high growth rates, then you have to distort the market. And you say that provided opportunism for the employers, well again that's the same thing. If you want to have high growth rates then you should distort the market by providing more incentives for entrepreneurs. And this kind of incentive is why it takes more flexibility to get rid of labor when there is a recession or a slowdown. So in this aspect I won't agree with the evidence or the argument you provided. Just to give you a reflection for the Egyptian case. The labor costs involved cannot be bad because of the sensitive issues involved. It introduced elements of flexibility, and one of them is this ability to dismiss laborers in situations of facing economic destitute. However that's subject to a number of procedures and explanations -- what kind of dismissal can be allowed. But on the other hand, what I found that the entrepreneurs really don't have a problem with Egyptian labor market because they have the weight to provide the stability to introduce an element of flexibility. They are able to dismiss people whenever they want by providing them with short-term contracts instead of long-term contracts. So I don't think that we are institutionalizing this stability is the same in Egypt compared to any other countries because the matter of having this instability is needed and you can legalize it instead of illegalizing (sic) it or doing it in another way. Thank you.

Chairperson

And we go for questions and comments.

Question

I am a lecture assistant. The first thing I would like to tell you from my experience in this lecture and I'm not sure if you'd like to know. My experience here is that it is completely wrong to repeat the statement that although the fact that North Korea and South Korea are authoritarian countries, but managed to overcome their crisis. I do believe that yes, maybe they are authoritarian countries but by that evidence has been laid down by the model. But despite the fact that they did manage to give players of the game some flexibility to play the game. We are told that in the 1996, it was initiated -- a low -- but this low was not acted on. Korea managed to play a role and push this low to an active position in 1997. If what I got from you is right, that means that we cannot actually watch Asia for development. This is one thing.

The second thing is, I want to ask you about privatization during your economic crisis. I would like to ask you, have your companies in Korea been declaring the dismissals? And if so, how did you manage to covert with those people, laborers being dismissed from those companies. And you mentioned something about the dismissal law and the limitations under it, could you briefly elaborate on what are these limitations? Generally what are the contracts given to these laborers after being dismissed from their companies?

Second question, I did not understand enough about your discussion about market information for unemployment. I mean what kind of information, did you talk for example that these sector are blank or are empty ... what kind of information did you give them in order to cope with these problems? Also insurance programs you have related to unemployment. How did you manage to shoulder this process? Did you ask for example, the IMF to give you some assistance? Thanks.

Chairperson

Thank you. Would you like to have more questions before answering?

Answer:

No. Thank you for your opinions -- I'll think about them. Economically most people are suspicious about economics. I am pro-market. Pro-market means freedom and the more important point is discipline. So illegality and social chaos in the market - I have a question - what is the role of labor laws? From the standpoint of an institution, labor laws should reduce the transition part and increase efficiency. That is the role of the labor law. Also, you can help the poor people or the irregular worker or the employers. So that is efficiency. But I don't want to go into the details of this. And also I appreciate his point that the labor market is the derived market, and once this commodity market or capital market goes up, then the debt is retracted into the labor market. So you see that even if the commodity or capital market is recovered from the crisis in a relatively short time, the labor market can't be as efficient as normal.

I'm not saying that the correctibility (sic) is good or bad. The goal of correctibility was to recover from the financial crisis. I am more supportive of the Korean government policy. To have more complete policies I have to point out -- and this one is long -- what if it changes? I'm not saying what the market policy is -- I evaluate honestly Korean labor markets.

And also the informal sector. The informal sector is good. It is like a lubricant. It cushions. It's good. But the informal sector tends to be expended if getting into the debt track. Compared to the pain of economic development, that informal sector will kill you. So you see that this lubricant is good for a short time. A certain degree of informal sectors is inadequate, but if you allow them to kill your labor market economics, then it's going to be a big problem in the future in the long-term crisis. And the other one is that if you are becoming poor or unemployed or are an irregular worker, you tend to be molded. Whatever you off -- I'll work for you. Then your life is screwed up. You fall in the trap of a bad job. So especially for the youngsters, government policy is to help them get a job. Union between the businesses and the government -- they meet and discuss this kind of labor reform. But the difference is that the labor union is strong in the large companies like the chaebol. Small- and medium-sized companies did not have good representatives, so the labor law is more modulated for the representatives of our companies.

Three important things. One, we have to solidify the necessity of dismissal. Two, we have to screen the workers who are laid off in a logical and objective fashion. You cannot fire workers on a random basis. And the third one is that you have to notify in and advance and should negotiate with the union leaders. So these kinds of provisions should be solidified. Still, laying off the regular workers is pretty hard. That is the one main reason to have the irregular workers before -- no doubt about that. But also, the other side is that irregular job laws should be evaluated to have sustainable economic development. Thank you.

Chairperson

Any more questions or comments?

Question:

In Egypt we always complain about this relation between education and the labor market. We always say that it has no relation with what's going on in the labor market. Education policy and employment policy -- I don't think that they go together -- they are unrelated. In the slides, the education policy is still in favor of quantity despite the fact that quantity has become fundamental in order to meet the latest development and labor market needs. What is the status in Korea? And what are their mechanisms used in order to make this relation and keep it sustainable? The other question is not for you but for our Egyptian economist. Are you serious in activating our financial market and are you serious about avoiding a financial crisis like what happened in Korea? What can prevent copying Korea? Thank you.

Answer:

Well you point out that the education policy should go with the labor policy. But many times they are taken separately. If the foreign office is not coordinated very well, then some kind of problem may happen. We try to minimize those kinds of poorly coordinated problems, but any country may have such problems so we have to watch out. Everybody knows that.

Germany has the most efficient system for forced work transitions. In Korea especially college students seem to have such problems. The college kids' unemployment rate is high and the college education forfeit is not to be lost. Especially for the large companies, they can't be downsizing. So they also require some kind of career. The youngsters that want careers find it pretty tough to get into the major league. So the labor market is getting tougher and tougher for college kids -- no doubt about that. But the government should work to connect the school to distribute the wages between college and university. For example, you can create certain courses to accumulate experience in the real field. But how can we count that as credit for college students? The companies can use it as a probational (sic) period. If you are industrious enough, then it won't cost any more than the irregular worker. So those kinds of links between the university and the company are necessary. So once you deliberate the educational costs, it's good for colleges, then it's not transferred. These do not provide good quality education. So I think we should try to improve those problems. Everybody knows the problem of Korean education. The same situation with Egypt and Korea.

Chairperson

The second question -- what is the main lesson from Korea concerning this financial restructuring to Korea?

Egyptian economist:

I think that at the time of crisis or even at the time of pre-crisis the role of the government should be intensified. And allocation of public money and public effort is a necessity. And from the previous experiences of Korea, the government must establish new institutions in order to combat debt as well as other important issues. So it is in market economy that the role of the government could be forgotten. This is a lesson to be learned. And first the government provided the constraints for how to behave. The government has to in order to secure the efficiency and the competitiveness of the market. And of course, as was mentioned, with high labor costs, distortion in the market may appear. If it reaches a certain limit it may turn into a crisis. It is the government's job to find out how to bring the economy back to a level of competitiveness and to eliminate all aspects of the distortion that exists in the market. This is the lesson. And I think this is the main basis of what is called the German model after the Second World War. And in this book by Earhart, called "Competition and Prosperity", the role of the government is to make sure that every factor within the economy is working within the framework of a practical decision. If there is distortion, monopoly, or any other disturbance then the government should bring the economy back without complication.

I think that I mentioned that Asia didn't really do reform. It was more like cosmetic reform. What I mean by “cosmetic reform” is reforms that might look nice but just on the surface of it. But the real reforms the country needs. It's hard to find the answer to that. For example, from 1991 when Egypt started, it was technological reforms, it was so happy that the exchange rate had been quite unstable and interest rate had been frozen. But all this is just like the top of the fence, administrative measures. And usually during the transitory period, things are quite calm -- so you might be happy as a country that things are going O.K. And the final test for the market? The market rates. That's what happens exactly. Why is it that we didn't tackle the painful reforms? We didn't start in the early ‘90s as things were going our way. We didn't start right away and better the financial reform with the corporate reform. It took us eight years to sign an agreement with foreign industrial organizations. If we were serious we would have though. Yes, they are the stronger side in the negotiations, we have to concede some things. These may be more to their favor in certain aspects in the beginning. But the time we lost has also a price. So it's a game -- to play it now or to play it later. Eventually we have again to concede to the terms and so on. But why? Where is the loss of time? We are going to pay back the people for this loss of time and loss of work.

There are short-term and long-term needs. We need to have entrepreneurs -- people who think for the future and are insisting on achieving results, who are disciplined, who know exactly what they are doing, and who will not sway to the public opinion. Egypt missed that. It had some success, but only partial success. If we organize the Egyptian economy along those lines, if we address public opinion more clearly, if we are able to gather the efforts -- because every other policy has been done in Egypt -- we know exactly what we have done with the implementation problem. In the 1960s, Egypt was a totally different story from Korea. We had political problems and war and regional war and so on that was a setback for Egypt. But this is not enough of an excuse. The Koreans know exactly where to start their reforms from, even the fundamental for a viable corporate sector. It's not perfect of course, but they are working on it. And because they are starting from a good starting point it helped them overcome the crisis. It is very difficult to withstand real markets. And who knows when we are going to come out of this problem? Korea managed to do that in a few years’ time because of the infrastructure. Egypt didn't establish the rules for that. But we are given many details about the steps involved in government. So I think this is a brief outline of what happened in the case of Egypt -- a totally different story. But because they are open economies, they are open to crises. But one method is handling it in a more rigorous way, and another is handling it in a more cautious and hasty way that might go well or poorly. But in the case of Korea, they know exactly where they are, where they stand and so and so forth. In Egypt we have to do two things at the same time -- you have to establish what is your starting point for reform and then build on that. So in our case it is more difficult.

Comment

I just want to say two words. First of all I think that the Korean crisis should give signals that no one is immune from crisis. People say that there is no way we can face crisis -- that is silly -- we can face crisis. The second is to stop erasing the thought of social stability because from what was said previously, social stability is our main concern and we delay or take this piece -- like reforms instead of drastic reforms. It ends up that we have a social crisis if we do not take drastic reforms. So instead of treating cancer with aspirin, it is better to take drastic action in order to cure the real causes of the problem. Thank you.

Chairperson

Many thanks to our guests … and we appreciate all your comments and questions. I dismiss this session. There is an announcement that there will be a meeting after this section to summarize all the points of the discussion during this interesting seminar, and this will be so kindly shared by Dr. Keesung Roh.

Dr. Keesung Roh

It is a great honor and pleasure to be here at your university. And also I admire always the splendor of the past culture of Egypt. Well, I don't have to summarize all the papers here. There has been hot discussion between the participants and our speakers. So let me summarize in my way what was discussed today and then I will give a couple of minutes to each one of the speakers -- just one round. And then the other doctor will conclude what were the lessons derived from this seminar.

Take a look at how Korea's economy developed, how Korea faced the financial crisis in 1997. I think there are some key words that explain our economic development in that case. The first key words are selection and … I found these key terms invented in the research and science technology fields in our country. We have budget constraints. Especially, we have a lack of vocabulary regarding the technology development. The production is a function of economical and labor and technology, etc. Also the production is dependent upon the institutional setting.

So our government had to select some sectors and priorities then concentrate the resources on the selected ones. So our government put high priority on growth rather than equity, rather than stability. They also put weight on the manufacturing sector rather than the service sector. So we put weight on the exporting sector. By doing this we had to pay some costs. When risk is involved we have to pay some costs. The only difference is if we pay the cost today or pay the cost tomorrow. So during the economic development we paid a lot of costs. That is the high rate of inflation, unbalanced income distribution, and also the concentration of economic power -- that was already explained by pointing out chaebol. So we focused on the manufacturing sector and also we selected some specific products -- like Hyundai and Samsung. So we paid some cost for economic concentration. And in 1997 all of a sudden we had the financial crisis. So we paid the costs all at one time, which was larger than the sum of the cost we had paid for the four years before the crisis. A lot of firms went bankrupt and a lot of workers lost their jobs and many bankers had to leave their jobs. So in this sense, there was a very wide range of government intervention. At the beginning of the development, the leader might judge which is good or which is better, but our economy has been getting larger and larger.

In 1996 we had a chance to be a member, so economically we want the market. Market means being perfectly competitive. So instead of the government intervention, we need the market discipline and for this we need some information about reform. The consumer and the firms should know the full information and then they can discipline the firms or the economic entity. So as was said in the last section, to summarize and devise the lessons for ethics, that is the goal of the government.

So through these sessions we can derive the role of the government for the new environment of the economic world. So it will be good for the Egyptian government for formulating that policy from now on. Well let me stop here and I would like to invite the Korean speakers to comment or give some recommendations. You don't have to speak on the issues you have presented, this is an open discussion. So Dr. Moon-Soo Kang, why don't you open the topics of lessons to the Egyptian economy?

Dr. Moon-Soo Kang: It is difficult to know about other countries' experiences. I might make a recommendation that may be wrong. But hopefully we can provide some lessons from Korea's experiences. After we suffered from the crisis we had many visitors from China and from other soviet countries who asked - why did you fall victim to this type of thing? So let me briefly mention a couple of topics. One is the importance of the role of the government. … problems that may require massive layoffs or may require the use of public funds, which based on tax money. And this urgency provides political support for the leaders of the Korean people because they felt it was a great crisis. They knew that we would fall to the income level of $2,000 from $10,000. That was the basis of the government’s revision of bills for corporate restructuring and all those reforms required laws at the National Assembly.

Secondly, there was some discussion about an early warning system. We worked with the World Bank on how to develop this early warning system, but we were wrong. Why couldn’t we detect that this kind of crisis was coming from somewhere like Thailand or Indonesia? So we studied countries that had economic crises prior such as Norway, Finland and Sweden. So we studied what kind of policies they had taken to successfully solve their problems. After financial analysis, we found that we had a high external debt ratio. When Korea entered the OECD, Korea was required to liberalize petrol control. However, the government could not devise and strengthen preventative measures to lower this risk element that may complicate the regulation liberalization of capital control. So when we had the crisis, the government had no figures to tell them how much debt Korean firms and banks had standing abroad. So developing economies should closely monitor what is proportional to their short-term debt, and how to appropriate some of that. So, for example after Korea recovered from the crisis, foreign companies were willing to provide new loans to Korean banks. So again, the proportion of short-term debts, out of proper debts is now increasing.

Another thing that was mentioned was that a more open economy could easily be a victim when the economy opens the capital market because foreign traders can change their mind and foreign can capital can easily change its direction. Before the crisis, foreign capital entered Korea, Thailand and Indonesia, and lent money to Korean firms and Indonesian firms with very high interest-rate margins. But after the crisis struck, they quickly changed their minds and began to withdraw their money and ask for payment of the money. This put economies at risk of being in default. So open economies have to keep reserves to safeguard against the whims of foreign investors and lenders. It is up to the policymakers and academics in Egypt and Korea to study experiences of other countries. That will prepare policymakers and politicians when there is a crisis or even a small crisis, in which they can easily adopt a new foundation from which they can stop the businesses. If they do not prepare, and the economy experiences a crisis, then they have to start from the beginning, which requires quite a long time.

In the case of Korea, we studied outside economies but the government was not dedicated to the kind of reform necessary because it may require political cost. They wanted to win the next election, so they didn’t want to pay for all the reform measures. So we paid a high price for that. Lastly, in Korea policymakers feel we can avoid problems by growing fast, so they used public money to solve the problems. But they would not disappear. Thank you

Chairman.

Thank you Dr. Kang.

Question:

When the financial crisis broke out, I was a student in Chicago, and I felt I was a victim of the crisis, because the won was heavily depreciated. But after five years, I have traveled to foreign countries to study financial restructuring and corporate restructuring, and I have been involved in many research projects. So maybe the crisis gave me a job. What I have learned from the five years of experience is that I am quite proud of the Korean performance. The Korean crisis, in terms of the depth of the crisis, was quite severe and difficult to overcome in a short period, but we had success in comparison with other countries. If you look at the example, there is no one cure-all prescription for national restructuring, it all depends on history and legal systems and so on. So you have to provide your own prescription. Thank you very much.

(from the Egyptian side)

I am not really prepared to comment on the Korean experience. I only got the chance today. But what is clear is that growth has a price and growth requires caution and prudence to be able to foresee different distortions that may occur during the process. Also a point that has to be emphasized is when the government is looking for reform, social consideration in reform is very important. The question of political power is relevant in this situation as well. You need to have a government capable of facing a crisis and its consequences, one that is able to say to the people that in order to overcome a crisis everyone has to pay something. Social consideration is important but you have to have a balance between different considerations. Of this depends on the many different aspects of the political and social life of the society. The role of the government. The government, in a market economy, has to create a role that enhances efficiency. This is very important because of the possibilities of distortion and the possibilities of corruption. A great part of the crisis was due to the tolerance of the banks in borrowing and granting money to the large corporations. This will always lead to mismanagement. These are problems we are facing now in Egypt. The lessons to be learned from exchanging experiences, is very useful and to read the two papers of Dr. Kang and Dr. Cho and to listen to the presentations and they have been very helpful. Thank you.

Chairman

Dr. Salim, please.

Dr. Salim

We have here a visiting Prof. Hussein from Singapore National University. I am interested because Singapore was one of the East Asian Tigers that was not hit by the financial crisis. Why? I asked the question to many Singapore scholars and I found that the key factor was that we were able to accumulate enough reserves, almost $80 billion. We had enough to defend our currency, to defend our stock market. Prof. Hussein?

Prof. Hussein, Singapore National University

I think the point you mentioned is valid. Singapore’s reserves are among the highest in the world, now over $100 billion. But there are other things as well, good government, and maybe even luck. But there are three main points. I think that one main lesson that can be learned is that when economies accelerating very fast, 4 percent growth, 6 percent, 10 percent in so short a period, be very careful. This is also a question in China. The bubble may burst in China. The growth is unbelievable. A crisis is coming, it is just a question of when, but hopefully China will learn.

The second thing is running an economy in a globalized world, a world where the market looms large. The economists know, but the problem in many countries is that economists do not govern. But in a globalized world it is necessary to have more technocrats in government, people who know the market, who know that if you don't take certain radical actions you are going down the drain. Technocrats with sufficient economic background and mobilization of political skills need to be installed in the government and need to be in positions of influence.

The final lesson to be learned is something a little more philosophical. If you asked me, high quality of life is not really necessary, why should a country be so obsessed with growth or higher growth. Japan had high growth but has the highest rate of suicide in the world. But growth is not everything, a society has to decide on its own values, and think, "at the end of the day, what do I want to achieve?" Thank you.

Dr. Salim

Thank you very much Prof. Hussein for your wonderful comments, especially the last one. It is true growth is not everything, and one has only to look at the United States, where homicide and suicide are higher than in any other Western country. And in conclusion, I have visited Korea many times and in conversations with my Korean friends, and learned that the secret of Korean success is ability of Korea to devise its own model of development. It is neither a Soviet model, nor an American one. It is a model that suits it, one in which the state plays a certain role. The state does not own the means of production, but it has a role. This is not the American model, which dictates that the smaller the role of the state, the better the shape of the economy. … It did not allow the private sector to work as an agent for multinational corporations, as is the case in many developing countries. They buy regulated goods from abroad to sell them at a profit at home with no capital accumulation in the country. But this was not the case in Korea. This vicious link between domestic capitalism and international capitalism was not there. During the Cold War, Korea closed its market, but today the name of the game is opening the market. "Open your market. If you open your market, then you will be all right." But you need infrastructure first, then an open market, as is the case in Korea.

Now, as for the causes of the Asian financial crisis, it is still a matter of debate. The former deputy finance minister of Japan said that the cause of the crisis was globalization. But the conventional view in Korea is that the Asian crisis was because of deformities in the domestic economies and in handling corporate structure. I agree with that. There is a lot to be learned from the Korean model of development and there is a lot to be learned from the way Korea dealt with the financial crisis. I would like to thank our Korean friends for their interest in us, and coming all the way to Egypt. I hope this kind of joint venture will continue in the future between the Center for Asian Studies and the KDI. I would like also to thank my fullest thanks to all of my colleagues to participate in this seminar. I would first like to give you copies of our publications on Korea. Also, Dr. Kamal El-Menoufi has something to declare.

Dr. Kamal El-Menoufi

I am very glad to have this stimulating seminar. We have learned a lot about Korean development. I hope our Korean friends now have more knowledge about the Arab and Egyptian development models. I like to thank them and look forward to widen cooperation between our institutions. Thank you.

Dr. Keesung Roh

I would like to comment on the lessons from the Korean experience. We have a few unsolved issues today, for example the origins of the financial crisis in Asia and in Korea, and also the link between labor market and education in our country. But we reorganized the Ministry of Education to the Ministry of Human Resources. I would also like to comment on the development model. There is no universal model. Which model we have to select depends on the country. We have a saying that reform is more difficult than revolution. We tried before and failed. Just look at Japan, they needed to reform, but it is very difficult to do that. Lastly, I would like to thank all the participants, Korean and Egyptian for today's hot debate on various issues. Thank you very much.