On the Origins of the Korean Financial Crisis:  
An Institutional Approach*

Chuk Kyo Kim  
Hanyang University

Abstract:

Since the early 1990s, the Korean economy has undergone a transition from the state-led toward the market-led development. Structural reforms were required to make the transition smooth and successful. The government has, however, failed to accomplish much, due partly to the policy-makers’ insufficient understanding with regard to the functioning of a market economy and partly to the inherent weakness of Korea’s political system. This paper tries to explain the reasons why the government has failed to carry out the structural reforms and what are the underlying institutional deficiencies which are indeed the root causes of the Korean financial crisis.

Keywords: Korea, economy, financial crisis, institutions

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1. Introduction

There are a number of papers which deal with the causes of the Korean financial crisis that erupted in late November 1997. Broadly speaking, there are two different views on interpreting the causes of the crisis. One view is that Korea’s macroeconomic fundamentals were relatively sound and the crisis itself was essentially a consequence of the short-term liquidity shortages brought about by external shock. The crisis, in other words, was mainly caused by the instability within the international financial market, which had originated from the impact of the Southeast Asian financial crises. The so-called ‘contagion theory’ of this view was strongly supported by Jeffrey Sachs. This theory seems to be correct insofar as the crisis was triggered by the foreign banks’ denial of the rollover of Korea’s short-term debt. Again, this theory and the view are supported by the fact that Korea had high economic growth, high savings and low inflation rates prior to the crisis. Another view is that the crisis was caused by the inherent structural weaknesses of the Korean economy combined with some policy mistakes. This view argues that the Korean economy had structural weaknesses and hence the possibility of crisis was already there, even if there were no currency crises in Southeast Asia. According to this view as shared by Paul Krugman, the fundamental cause was not the liquidity shortage as such, but the structural weaknesses from which the Korean economy had been suffering for a long time.

The financial crisis in 1997 was certainly not due to such a single factor as external shock or internal weakness; instead, it should be attributed to a confluence of both internal and external factors. Although both factors have contributed to the crisis, the structural weakness should be regarded as the more dominant cause of the crisis, because the Korean economy could hardly be attacked by the speculative international capital unless it had such structural weaknesses as a fragile financial system, excessive debt of the corporate sector, and high external debt.

Since these structural problems were not new and had existed in Korea for a long time, the question arises as to why it was not possible for the government to remedy the problems earlier and what are the reasons for that. If we really want to understand the origins of the crisis, we have to answer these questions. Unfortunately, most of the papers dealing with the Korean financial crisis concentrate on the analysis of structural weaknesses without paying enough attention to the underlying institutional problems which are indeed the root causes of the crisis. Based on this reasoning, this paper tries to

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1 See Radelet and Sachs (1998).
explain the causes of the Korean financial crisis from the institutional aspect. We will first describe briefly the nature of major structural problems and discuss why the government has failed to carry out the structural reforms. We will then address the origins of the crisis some of which may go far beyond the economic dimension.

2. Structural Weakness

2.1 Macroeconomic Imbalance and Excessive External Debt

The Korean economy had been enjoying a rapid economic growth until the onset of the financial crisis in late 1997. The GDP growth rate averaged 7.4 percent between 1993 and 1996, and the annual inflation rate, measured by consumer price index, remained at a relatively low level of 5.1 percent during the same period. Meanwhile, the monetary and fiscal policies largely remained conservative. The annual M2 growth rate had been around 15 to 16 percent and the fiscal deficit had turned into surplus since 1993. Signs of disequilibrium could only be seen in the external sector. The current account deficit has been growing since 1994, amounting to 4.4 percent of GDP (see Table 1).

Table 1: Macroeconomic Fundamentals (%)

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<tr>
<td>Fiscal Surplus/GDP(^1)</td>
<td>-1.9</td>
<td>-0.7</td>
<td>0.3</td>
<td>0.5</td>
<td>0.4</td>
<td>0.3</td>
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<tr>
<td>Current Account/GDP</td>
<td>-2.82</td>
<td>-1.25</td>
<td>0.29</td>
<td>-0.96</td>
<td>-1.74</td>
<td>-4.42</td>
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<tr>
<td>Real Effective Exchange Rate(^2)</td>
<td>93.5</td>
<td>98.8</td>
<td>100.9</td>
<td>98.3</td>
<td>98.0</td>
<td>96.0</td>
</tr>
<tr>
<td>CPI Inflation</td>
<td>9.3</td>
<td>6.3</td>
<td>4.8</td>
<td>6.2</td>
<td>4.5</td>
<td>4.9</td>
</tr>
<tr>
<td>Real GDP Growth</td>
<td>9.2</td>
<td>5.4</td>
<td>5.5</td>
<td>8.3</td>
<td>8.9</td>
<td>6.8</td>
</tr>
<tr>
<td>Gross Savings Ratio</td>
<td>37.3</td>
<td>36.4</td>
<td>36.2</td>
<td>35.5</td>
<td>35.5</td>
<td>33.8</td>
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Note: 1) Consolidated public sector.
       2) Trade volume weighted, numbers below 100 mean overvaluation.

Despite the current account deficit, steady inflows of foreign capital boosted by the financial market liberalization kept the overall balance in surplus. Except for the external sector, the Korean economy has a sound macroeconomic performance. Based upon this macroeconomic performance, some argue that the Korean crisis is attributable to the
instability of the international capital market, which had originated from the countries in Southeast Asia. A further argument is that Korea’s current account deficit was relatively small compared to those of the other crisis-hit countries, such as Mexico and Thailand, so that the current account deficit cannot be blamed for the crisis.

This argument is not very convincing. When we look at Korea's external liabilities, we observe that they have rapidly increased due to the continued current account deficits. The total external debts, which amounted to USD 88.74 billion in 1994, went up to USD 164.34 billion in 1996, doubling within a two-year period. The maturity structure had also been deteriorating since the early 1990s with the short-term debt accounting for 56.6 percent of the total external debt in 1996. As a result, the short-term liabilities far exceeded Korea’s foreign exchange reserves (see Table 2). These figures were certainly high enough to signal a potential foreign exchange crisis. Therefore, the assertion that Korea’s macroeconomic fundamentals were sound before the crisis is exaggerated.

Table 2: External Liabilities (USD 100 million, %)

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<tbody>
<tr>
<td>Gross External Liabilities</td>
<td>629.0</td>
<td>670.0</td>
<td>887.0</td>
<td>1197.0</td>
<td>1643.4</td>
</tr>
<tr>
<td>External Liabilities/GDP</td>
<td>19.99</td>
<td>19.38</td>
<td>22.04</td>
<td>24.46</td>
<td>31.60</td>
</tr>
<tr>
<td>Short-term External Liabilities/Total External Liabilities</td>
<td>58.82</td>
<td>60.15</td>
<td>65.84</td>
<td>65.75</td>
<td>56.58</td>
</tr>
<tr>
<td>Short-term External Liabilities/Foreign Exchange Reserves</td>
<td>215.69</td>
<td>198.89</td>
<td>227.48</td>
<td>240.58</td>
<td>279.75</td>
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Note: 1) External liabilities include external debts as defined by the IBRD, plus offshore borrowings of Korean banks and overseas borrowings of Korean banks’ overseas branches.

2.2 Excessive Debt Financing of the Corporate Sector

As mentioned earlier, the Korean government has pursued high growth policy since the early 1960s. This policy objective has never changed except for the period of the Chun Doo Hwan administration from 1981 to 1987. The Roh Tae Woo administration tried to implement stabilization policy but could not succeed due to the pressures from the large business conglomerates. The Kim Young Sam administration had also tried to control the chaebols but again failed because of its potential negative impact upon the economy.
Instead of controlling them, the Kim administration began to support the chaebols to stimulate the economy.

Since the early 1970s, the Korean government started to promote the heavy and chemical industries which required large capital and involved significant risks. In promoting heavy and chemical industries, the government favored the large firms because they were in a better position to finance the large scale investment in terms of capital, manpower, and technology. The government supported them with all kinds of incentives in order to facilitate their investment in heavy and chemical industries. The government relied very much on banking institutions to support the big firms as they were under government control. This policy contributed to the rapid growth of large business groups known as chaebols.

Although the commercial banks were officially privatized in the 1980s, they continued to remain under governmental influence. Therefore, the chaebols had easy access to bank loans, which resulted in over-borrowing. Under these circumstances, banks’ liabilities were perceived as though they had an implicit guarantee from the government. Thus, the banks extended credits to the chaebols, believing that the government would bail them out in case the chaebols fail to service their debt. On the other hand, the chaebols also believed that the government would not allow them to go bankrupt. This created the moral hazard problem for both the banks and the chaebols.

As a result, the chaebols and financial institutions did not bear the risks associated with large debts. The implicit guarantee by the government encouraged the overly-leveraged business expansion in a riskier manner than was economically sound. This further led to a rapid increase in debt-equity ratios of firms, particularly those of the chaebols. Debt to equity ratios of the Korean manufacturing firms had increased from 286.8 percent in 1995 to 396.5 percent in 1997. The ratios of the top 30 chaebols soared from 347.5 percent to 519 percent during the same period (see Table 3). Some of the chaebols showed their debt-equity ratios to be higher than 1000 percent. This suggests that the financial institutions either did not engage in basic risk and credit analysis or their decisions were overruled by the government.
Table 3: Top 30 Chaebols’ Debt-Equity Ratio (%)

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<td></td>
<td>Chaebol</td>
<td>D/E</td>
<td>Chaebol</td>
<td>D/E</td>
<td>Chaebol</td>
<td>D/E</td>
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<tr>
<td>1</td>
<td>Hyundai</td>
<td>376.4</td>
<td>Hyundai</td>
<td>436.7</td>
<td>Hyundai</td>
<td>578.7</td>
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<tr>
<td>2</td>
<td>Samsung</td>
<td>205.8</td>
<td>Samsung</td>
<td>267.2</td>
<td>Samsung</td>
<td>370.9</td>
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<tr>
<td>3</td>
<td>LG</td>
<td>312.8</td>
<td>LG</td>
<td>346.5</td>
<td>Daewoo</td>
<td>472.0</td>
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<tr>
<td>4</td>
<td>Daewoo</td>
<td>336.5</td>
<td>Daewoo</td>
<td>337.5</td>
<td>LG</td>
<td>505.8</td>
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<tr>
<td>5</td>
<td>Sunkyung</td>
<td>343.3</td>
<td>Sunkyung</td>
<td>383.6</td>
<td>SK</td>
<td>468.0</td>
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<td>6</td>
<td>Ssangyong</td>
<td>297.7</td>
<td>Ssangyong</td>
<td>409.4</td>
<td>Hanjin</td>
<td>907.8</td>
</tr>
<tr>
<td>7</td>
<td>Hanjin</td>
<td>621.7</td>
<td>Hanjin</td>
<td>556.6</td>
<td>Ssangyong</td>
<td>399.7</td>
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<tr>
<td>8</td>
<td>Kia</td>
<td>416.7</td>
<td>Kia</td>
<td>516.9</td>
<td>Hanwha</td>
<td>1214.7</td>
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<tr>
<td>9</td>
<td>Hanwha</td>
<td>620.4</td>
<td>Hanwha</td>
<td>751.4</td>
<td>Kumho</td>
<td>944.1</td>
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<tr>
<td>10</td>
<td>Lotte</td>
<td>175.5</td>
<td>Lotte</td>
<td>192.1</td>
<td>DongAh</td>
<td>359.9</td>
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<tr>
<td></td>
<td>total</td>
<td>347.5</td>
<td></td>
<td>386.5</td>
<td></td>
<td>519.0</td>
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The extremely high level of debt increased the financial burden of Korean firms which had traditionally maintained low levels of profitability. For almost a decade before the crisis, the average return on equity of chaebols had been lower than the prevailing interest rate. This suggests that despite the preferential financial treatment by the government and the banks the chaebols performed worse than the independent firms. The terms of trade shock in 1996 and 1997 following drastic falls in the prices of the major Korean export products also contributed to a further deterioration of the profitability of the Korean firms. Consequently, the number of defaulting firms had sharply increased even before the financial crisis in late 1997.

2.3 Weak Financial Sector

Problems in the corporate sector spilled over to the financial sector. As noted earlier, the implicit government guarantee for banks’ liabilities created the moral hazard problem. Korean banks thought that the chaebols were “too big to fail”. Naturally, they continued to

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extend credits to them despite their huge leverage. Since the banks were risk-free, they had no motivations to develop management skills and techniques for credit analysis and evaluation. The long and extensive intervention by the government had undermined autonomy and accountability of the banking sector. The high entry barrier and strict business segmentation had also contributed to the deepening inefficiency of financial institutions. Since the early 1990s, the government has tried to improve efficiency of the financial sector through deregulation and market liberalization. As will be discussed in the following, this government policy was not successful; rather, it worsened the balance sheet of the financial sector.

Prudential regulation was also very weak. For instance, basic regulations, such as the capital adequacy ratio, did not exist in the case of merchant banks. Regulatory control of commercial banks was also almost ineffective given the loose accounting rules, inadequate loss provision, partial recognition of stock revaluation loss and others. In other words, the financial liberalization which was not accompanied by the commensurate prudential regulation could not improve the management efficiency of the financial institutions.

Table 4: Indicators of Bank Management Performance (Year-end value, %, KRW million)
(Average of 20 domestic commercial banks, including trust accounts)

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<tr>
<td>Return on Assets</td>
<td>0.45</td>
<td>0.42</td>
<td>0.32</td>
<td>0.26</td>
<td>-0.93</td>
</tr>
<tr>
<td>(Foreign banks)</td>
<td>(1.32)</td>
<td>(1.17)</td>
<td>(1.53)</td>
<td>(3.89)</td>
<td></td>
</tr>
<tr>
<td>Return on Equity</td>
<td>5.90</td>
<td>6.09</td>
<td>4.19</td>
<td>3.80</td>
<td>-14.18</td>
</tr>
<tr>
<td>(Foreign banks)</td>
<td>(10.96)</td>
<td>(10.28)</td>
<td>(12.51)</td>
<td>(34.79)</td>
<td></td>
</tr>
<tr>
<td>Operating Income</td>
<td>31.7</td>
<td>52.1</td>
<td>39.1</td>
<td>40.2</td>
<td>26.8</td>
</tr>
<tr>
<td>Employee (Foreign banks)</td>
<td></td>
<td>(138.0)</td>
<td>(146.0)</td>
<td>(231.0)</td>
<td>(819)</td>
</tr>
<tr>
<td>Non-performing Loan Ratio</td>
<td>7.4</td>
<td>5.8</td>
<td>5.2</td>
<td>4.1</td>
<td>6.0</td>
</tr>
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</table>

Note: 1) Foreign bank branches operating in Korea.
2) The ratio of sum of estimated loss, doubtful, and substandard loans to total loans.

The results were high levels of non-performing loans, or the NPLs. As Table 4 shows, NPLs as percentage of the total loans have been very high, ranging between 4 and 7 percent. The ratio went up from 4.1 percent in 1996 to 6.0 percent in 1997, indicating a rising trend prior to the currency crisis. Consequently, the returns on assets and equity have been declining from the early 1990s, implying that the banking institutions faced decrease
in their profitability. In contrast to the falling profitability of the Korean banks, returns on both the assets and equity of foreign banks operating in Korea have increased since the early 1990s.

3. Failure of the Structural Reform

Korea had several financial crises in the past due to the similar structural problems as experienced in 1997. In 1972, Korea had serious foreign exchange shortages, high debt burden in the corporate sector, and a fragile banking sector. In the early 1980s, Korea had also experienced a crisis due to the serious excess capacity caused by the over-investment in heavy and chemical industries, which put many big firms almost on the brink of bankruptcy.

Korea could successfully overcome the crises largely due to the government’s strong control over banks and big firms. Since the banks were under strong government control, liquidity problems were easily resolved by government intervention. The government could also effectively carry out such reform programs as investment realignment, limiting new entries and others because businesses complied well with government policy. In the 1970s and 1980s, the government guided and supported the chaebols while monitoring and controlling their investment activities through both discretionary power and incentives. For the chaebols, compliance with the government directives was the only means to survive. Therefore, the government could effectively carry out reform policy.

Although the government could overcome the economic crises in the early 1970s and 1980s through direct government intervention, the fundamental structural problems of the Korean economy, such as a fragile financial sector, high leverage of chaebols and chronical balance of payments difficulties could not be resolved as the Roh Tae Woo and Kim Young Sam governments continued to pursue a high economic growth policy relying heavily on the chaebols. If the Kim Young Sam government had not pursued the high growth policy and placed more emphasis on stability, Korea’s external debt would not have been so serious at all, so that Korea could have been able to ward off the attack of speculative international capital in 1997. When the Kim Young Sam government took office in early 1993, Korea’s balance of payments was more or less in equilibrium and external debt was at a manageable level. Unfortunately, the Kim Young Sam government continued to adopt the high growth policy and relaxed the control over the chaebols and financial institutions under the name of globalization and liberalization, which created the serious balance of payments difficulties piling up the huge external debt.
The Kim Young Sam government announced globalization to be the national policy goal and has undertaken various reform measures toward globalization and liberalization since 1993. The first important policy action was the change in the government policy planning system. Until the early 1990s, the Korean government had the five-year development planning system which provided the over-arching policy coordination framework since its introduction in 1962. Thanks to the rise of pro-market ideology and the consequent loss of legitimacy of centralized coordination, the five-year development planning practice was abolished shortly after the Kim government took office in 1993. Accordingly, the Economic Planning Board which was responsible for planning and policy coordination was merged with the Ministry of Finance, forming the Ministry of Finance and Economy. This symbolized the demise of the planning system in Korea. Although the Ministry of Finance and Economy was a super ministry in terms of size, its function for financial affairs has been considerably weakened. Moreover, it has reduced its controls on foreign borrowing more than what it needed to and thus failed to supervise the financial institutions involved in foreign borrowing to the extent that the government was even not aware of the exact amount of foreign borrowing and the huge mismatch in its maturity structure.

The government further dismantled the selective industrial policy which among others monitored investment activities of chaebols. Thus, the investment decisions were largely left to private firms. There was no more effective control and coordination mechanism which could check the excessive competition among the chaebols. This led to overinvestment which was typically exemplified by Samsung’s entry into the already overcrowded auto industry in 1993. The lack of investment coordination resulted in overcapacity in many other industries too, such as semiconductors, petrochemicals, and shipbuilding.

This kind of market friendly policy change was originally conceived to promote competition so as to activate the self-regulating market mechanism. The policy has, however, failed to change the management behavior and pattern of the chaebols which became more and more independent of the government as they had direct and easy access to the international capital market. Especially following the financial liberalization, much of the power the government exercised over them has grown considerably weak whereas they became aggressive and active in pursuing their interest. As a matter of fact, the chaebols began their publicity campaign against government regulation and the campaign was successful as some of the leading newspapers were owned by the chaebols.
In this background, the chaebols were able to pursue their business expansionism. They diversified their businesses into non-banking financial institutions such as insurance, securities and short-term financing corporations. They expanded their investment through debt financing and cross-debt guarantee practices among their affiliate companies. The government implicitly supported them because of the fear that their bankruptcy may potentially bring about a serious economic recession, which was politically undesirable. The result was over-investment and over-diversification by the chaebols, which led to the strengthening of their economic power. For example, sales of the top 30 chaebols, which had occupied 35.0 percent of the total sales of the manufacturing industries in 1990, rose up to 40.7 percent in 1995. In the case of the top 10 chaebols, the situation was much worse in that their shares increased from 22.8 percent to 33.9 percent during the same period.4

The formerly closely tied relationship between the government and financial institutions also underwent a considerable change. The government actively promoted the financial liberalization from the early 1990s and significantly relaxed its control over the financial sector. The five-year financial liberalization plan was announced in 1993. The objective of the plan was to accomplish interest rate deregulation, abolition of policy loans, reduction of entry barriers, granting of more managerial autonomy, and capital account liberalization. As a consequence of the financial deregulation, financial institutions became considerably independent in their business operation. Their management practices and patterns, however, did not change much because they had little experience in commercially oriented lending practices. Although most financial institutions were officially privatized, moral hazard continued to play an important role in extending credits. Thus, credit lending continued to concentrate on the chaebols. The financial deregulation may have contributed to encouraging competition by reducing entry barriers, but it failed to resolve the moral hazard problem.

The market opening policy did not contribute to improving efficiency of the financial sector either while increasing its exposure to the foreign exchange risk. Since 1994, the government has accelerated the capital market liberalization to prepare for joining the OECD. Since the decision to join the OECD was highly politically motivated, the capital market liberalization was not accompanied by a strong regulatory framework. This policy change has stimulated the Korean private sector to rely on the cheaper foreign borrowing. The merchant banks which could engage in most financial transactions borrowed and lent recklessly. This led to a rapid increase in foreign liabilities of merchant banks. The

government’s loose restrictions on private firms were also harmful. The Korean business firms became free to take out loans from foreign banks and many of them overindulged. On the other hand, the foreign banks were no longer barred from buying and selling large amounts of foreign currency which enabled them to speculate against the Korean won. Thus, the rapid pace of liberalization and the market opening measures raised the vulnerability of the Korean financial institutions that were not equipped with proper credit assessment and risk management tools.

The exchange rate policy has also contributed to encouraging excessive foreign borrowing. The Korean currency was effectively tied to the US dollar with very little variation, resulting in its overvaluation. This led to the excessive foreign borrowing by the Korean financial institutions, particularly the merchant banks as the domestic interest rate was much higher than the international rate. Moreover, the government intervened in the foreign exchange market in order to maintain the overvalued currency as it believed that devaluation might trigger inflation and increase the debt service burden of the private sector. The intervention was further intensified as the Southeast Asian crises started to press upon the Korean won. The intervention resulted in the rapid depletion of foreign exchange reserves causing a vicious circle of impairing foreign investors’ confidence in Korea and accelerating capital outflows. Along with the premature capital market liberalization, the exchange rate policy was the substantial policy mistake which precipitated the financial crisis.

As discussed above, the Kim Young Sam government’s liberalization and deregulation policy turned out to aggravate the structural problems of the Korean economy. From the late 1996, there were a number of signs indicating this: a series of corporate bankruptcies, a rising current account deficit, and increasingly serious non-performing loans at commercial and merchant banks. In response to the deepening crisis, the Kim Young Sam government attempted a few important reform measures, beginning in December 1996. The problem was that the government failed spectacularly with all these attempts. These demonstrated failures led to a further and serious weakening of the international confidence in the Korean economy.

The first one of the failed attempts was to reform labor laws so as to facilitate worker lay-offs for a speedier structural adjustment of the economy. The reform bills passed the National Assembly in December 1996, but they had to be revised in March 1997 in order to delay the implementation of key reforms. The second important failure was to dismiss the responsible management promptly. This failure was dramatically demonstrated by the case of the Kia Group. It took more than three months from its bankruptcy before the
incumbent chairman could be dismissed. Furthermore, the Kia Automobile was eventually placed under the protection of the Korea Development Bank, creating the semblance of a temporary nationalization of a major bankrupt firm in effect. The third one in this series was the failure to consummate the eleven-month work of the Presidential Commission for Financial Reforms by passing the resultant financial reform bills through the National Assembly. These bills aimed at strengthening the prudential regulation of financial institutions, among others. The government, however, failed to persuade the National Assembly to enact these bills. This failure was largely due to a confrontation between the Ministry of Finance and the Bank of Korea over the supervision of financial institutions.

4. Origins of Crisis

Why did Kim Young Sam fail to persuade the politicians to enact the reform bills and to carry out the other related reform policy? It is often argued that the failed attempts were largely due to his weak political leadership. His political leadership certainly played a role. But should it solely be blamed for the failed reform attempts? In this connection, it is worthwhile to look at Korea’s constitutional order.

According to Korea’s constitution, the incumbent president is not allowed to run for a second term. The single presidential term has certainly merits in the sense that the system eliminates any kind of longer rule of one president, which could lead to dictatorship. The system has, however, a kind of political built-in instability with negative impact on the economy, particularly in a country where power is concentrated on the president with the political party playing an insignificant role in the policy-making process. Since the president has a relatively short five-year fixed term, he is tempted to do “too many things in too short period”, leaving many reform programs unfinished. Furthermore, he also wants to do something grand which is often economically not justifiable. One good example was the Kim Young Sam government’s decision to join the prestigious OECD which led to the premature liberalization of capital account. The two million housing construction plan of the Roh Tae Woo government was another good example which caused a serious inflationary pressure, undermining the economic stability accomplished under the Chun Doo Hwan administration.

The single term also impairs the constancy of economic and social policy because a five-year period is often too short for implementing many reform programs which require a longer period. The unfinished reforms are not usually carried out by the next president because he wants his own reforms to be implemented, creating uncertainties in policy
implementation. What is more important is the lame duck phenomena for the president as he comes to the end of his term, which makes it extremely difficult for him to carry out reforms. This is one of the reasons why Kim Young Sam failed to persuade the politicians to enact the reform bills in 1997. The vested interest groups, such as labor unions and even bureaucrats, did not support him because they knew that he was going to lose his political power very soon. Therefore, it seems fair to say that the failed reform attempts by the Kim Young Sam government should be in part attributed to this inherent weakness of Korea’s political system.

Apart from the political system mentioned above, there are many other institutional deficiencies which prevented the smooth transition toward a market economy. Although the government-led high growth strategy of the last three decades brought about a significant improvement in the standard of living, it entailed some serious adverse side effects. Korea’s corporate management and financial system lacked transparency; moral hazard was endemic; and, overall, the economy was suffering from the absence of market discipline as a result of the collusive relationship built-up between businessmen and politicians. Korea’s commercial banks served as the main conduit of resource distribution in line with the governments policy direction. This de facto public role of commercial banks acted as a serious impediment to the development of a genuine banking industry based on profit-oriented, accountable, and transparent management principles. Over several decades, Korea’s major business groups (chaebols) undertook a debt-financed expansion strategy via a very aggressive use of leveraging. There was no adequate monitoring mechanism to impose management accountability and transparency, and the lack of an effective governance structure allowed a continuation of the high-risk business strategy. These are all institutional problems which were a deterrent to the efficient working of a market economy.

Since the early 1990s, the Korean economy has undergone a transition from the state-led toward the market-led development. The institutional changes were required to make the transition process successful and less costly. The Kim Young Sam government attempted to carry out some reform measures to this end, but it failed to do so for the reasons mentioned above. Many government policy-makers believed that the liberalization and deregulation would bring about an efficient market order. The actual outcome was disappointing for them. They did not realize that the efficient functioning of a market economy requires far more than just dismantling regulations, cutting subsidies, and reducing protection. In other words, the Korean policy-makers did not pay enough attention to the institutional aspect of the market economy. This was certainly a big mistake they made in their efforts toward a market-friendly policy formulation.
Korea’s rapid development in the past owed much to the authoritarian rule of a strong political leadership. Since the early 1990s, the state has retreated from directing the economy without preparing the institutional framework needed for the efficient functioning of a market economy. In other words, the old disciplining mechanism has gone without being replaced by a new one conducive to the efficient working of market economy.\(^5\) Therefore, it would be appropriate to say that the root of the crisis lies in the institutional vacuum which occurred in the process of transition from state-led toward market-led development.

5. Concluding Remarks

This paper has tried to look at the crisis from the institutional aspect and has demonstrated that the crisis was deeply rooted in the institutional deficiencies. To remedy the institutional deficiencies, fundamental changes were required involving many political, social, and economic reforms which were hardly possible under the Kim Young Sam government. This implies that even under the Kim Dae Jung administration the wide-ranging institutional reforms would have been extremely difficult to implement, unless Korea had an external shock, such as IMF intervention. Korea’s structural problems were so interwoven with politics and chaebols that the internal reform attempts alone could hardly be successful. Therefore, one could argue that the external shock treatment was a necessary evil for the successful implementation of structural reforms.

Sweeping reforms are going on in the government, finance, business, labor, and social affairs. Banks have recapitalized with public funds. The regulatory oversight has been considerably strengthened following the establishment of the independent Financial Supervisory Commission. Considerable progress has been made in restructuring the chaebols by letting the Daewoo Group go bankrupt, thereby reducing moral hazard associated with their over-investment and over-diversification. Corporate governance is also being reformed with a view to enhance transparency and accountability. Flexibility of the labor market has also been increased by allowing layoffs for managerial reasons. The social safety net was also augmented to cope with the unemployment and urban poverty problems. Bureaucracy has been streamlined.

\(^5\) For papers stressing the importance of institutional changes, see Chang et al. (1998), Lee (1998), Lee (1999) and Mathews (1998).
These reforms are largely concerned with changes in the formal institutions such as rules and regulations. The efficient working of a market economy, however, requires not only the changes in the formal institutions, but also changes in the informal institutions, such as values, attitudes, and tradition, which are far more difficult to implement. Therefore, one can conclude that the ultimate success of Korea’s structural reform will very much hinge upon the informal institutional reforms.
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