Policy Forum 98-03: Democracy and the Korean Economic Crisis

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NAPSNet Forum #15 -- Democracy and the Korean Economic Crisis

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Northeast Asia Peace and Security Network

DEMOCRACY AND THE KOREAN ECONOMIC CRISIS

#15 -- March 18, 1998

The is intended to provide expert analysis of contemporary peace and security issues in Northeast Asia, and an opportunity to participate in discussion of the analysis. The Forum is open to all participants of the Northeast Asia Peace and Security Network (NAPSNet) . As always, NAPSNet invites your responses to this report. Please see "NAPSNet Invites Your Responses," below, and send your responses to the NAPSNet Coordinator at: napsnet-reply@nautilus.org .

DEMOCRACY AND THE KOREAN ECONOMIC CRISIS

Essay by Jongryon Mo and Chung-in Moon

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I. Introduction

The following essay, "Democracy and the Origins of the 1997 Korean Economic Crisis," was written by Jongryon Mo, Assistant Professor of International Relations and Associate Director of the Center for International Studies, and Chung-in Moon, Professor of Political Science at the Graduate School of International Studies, at Yonsei University. The essay explores the relationship between democratic development and the Economic crisis in the ROK. This essay will be forthcoming as the Epilogue in "Democracy and the Korean Economy," eds. Chung-in Moon and Jongryn Mo, Hoover Institution Press.

II. Essay by Jongryon Mo and Chung-in Moon

DEMOCRACY AND THE ORIGINS OF THE 1997 KOREAN ECONOMIC CRISIS

1. Introduction

On November 21, 1997, the South Korean government formally asked the International Monetary Fund for stand-by loans. With this request, the Korean government admitted its inability to meet international debt payments with its own means. The hope was that the request for IMF aid would end the tumultuous Korean banking-currency crisis that had begun as early as June 1996.

Regardless of the success of the IMF program, Korea is bracing for a painful restructuring and stabilization process that fundamentally will change its economic system. Growth will slow: the Korean government agreed to a 3 percent economic growth rate for 1998 as a condition for accepting the IMF rescue plan; some research institutions have even forecast negative growth. The lowest rate of growth since 1981 has been 4.8 percent in 1992. Planned cutbacks in government spending and private sector investment will mean the loss of jobs for millions of workers. The government estimates that unemployment will rise from about 2.5 percent in 1997 to 3.9 percent in 1998, while some analysts predict the rise to be as high as 7 percent.1 With the Korean won at half of its previous value, the prices of imports will jump, unleashing an inflationary spiral.

As part of its agreement with the IMF, the Korean government pledged to take drastic reform measures to deregulate and liberalize its economy. Restrictions on capital movement and foreign ownership will be lifted to induce foreign investment in Korean assets. To ease corporate restructuring, the government has proposed to make it easier for firms to layoff workers. At the same time, the government will take measures to make the Korean economic system more transparent and accountable. Especially, the owner-managers of the chaebol will be forced to report consolidated financial statements and discontinue the practice of mutual-payment guarantees in which chaebol member companies promise to pay third party lenders if their sister firms default on loans.2

By any measure, the current crisis represents a major setback in economic performance. It will take many (at least 2-3) years before Korean per capita income in dollar terms will regain its 1996 level.3 What happened? "As is all too often the case, we find ourselves playing theoretical catch-up -trying, after the fact, to develop a framework for thinking about events that have already happened" (Krugman, 1998). Among the many empirical puzzles about the current crisis, this paper focuses on the democracy connection. That is, we ask whether or not democracy was a significant cause of the current crisis.

Throughout this volume, we observe various structural changes that democracy has brought about since 1987, such as the ascendance of labor unions, expansion of social welfare programs, the activation of distributive politics, and the erosion of government control of the economy. We have also seen fundamental changes in the relationships among state, capital, and labor and their relative influence on the policy-making process. Given the magnitude of the economic and political changes that Korea has experienced under democracy, it is natural to ask how they are related to its current economic crisis.

Our basic argument is that Korea's economic crisis was very much of endogenous origin, which was compounded by the immaturity of Korean-style democracy, or the failure to consolidate democratic reforms. Certainly, democratization has brought major procedural reforms at the national level, such as the direct election of the president and other electoral reforms. There are some signs of consolidation, such as the election of Kim Dae Jung in December 1997, marking the first victory of an opposition candidate in a presidential election.

In many ways, however, Korean democracy is still maturing. In the context of the economic crisis, it was particularly costly that the formal and informal rules required for or compatible with the effective functioning of democracy were not fully developed, especially, such behavioral requisites as tolerance, willingness to negotiate and compromise and respect for the rule of law.4

The immaturity of Korean democracy has produced many negative effects. The private sector did not use their new economic freedom in a responsible manner; fiscal discipline and prudence have been lost through the manner in which banks and corporations expanded their operations. The government also stands guilty of lax and unruly behavior as it failed to monitor and regulate certain economic activities, such as the accumulation of foreign debts by banks and corporations.

But the greatest damage to the Korean economy came from ten years of policy gridlock under an immature Korean democracy.5 The Korean government under democracy made numerous attempts to reform the very features of the economic system that caused the economic crisis, such as rigid labor markets, unruly business practices of chaebol, and the backwards banking and financial sectors. But in almost every case, reform debate continued without a lasting resolution, which resulted in increased uncertainty and confusion. The government handling of the crisis itself has also been hampered by the inability to resolve policy conflicts.

The structure of this essay is as follows: We first describe a sequence of events leading up to the December outbreak, highlighting the policy mistakes that the government made along the way. We then explain the economic causes of the current crisis, focusing on the domestic economic institutions and practices. Once the causes of the economic crisis are identified, we show how policy gridlock under democracy prevented the government from taking corrective actions. In our conclusion, we emphasize the importance of the democracy connection in the emerging debates on the Asian financial crisis.

2. The Unfolding of the Economic Crisis

There are many accounts of how the crisis began. The origin of the crisis dates back to as early as 1995. At that time, the Korean government adhered to a strong won policy despite market pressures for currency devaluation amidst sluggish exports and surging imports. Three factors account for the choice. First, departing from the previous policy stance, the government tried to enhance its international competitiveness through corporate restructuring rather than currency devaluation. Policy makers believed that a devaluation would undermine their effort to force firms to restructure. Second, price stability mattered. Cost- push inflation followed by devaluation could undermine price stability. After having gone through inflation-generated social and political trauma in 1989-1990 as well as 1993-94, price stability has become a policy priority. Finally, politics factored in. The banking and financial sector, big business, and state enterprises all benefited from the strong won. They enjoyed windfall profits by borrowing foreign capital with low interest rates. Their vested interests and political lobbying delayed the timely devaluation of the Korean won, laying the foundation for the financial crisis in late 1997.6

But the macroeconomic parameter involving foreign exchange policy was only a necessary condition. The crisis was triggered by failures of the corporate sector and dismal microeconomic policy performance by the government. In fact, many attribute the immediate cause of the crisis to the bankruptcy of the Hanbo Group in January 1997. Hanbo, built around a construction company, invested heavily in its steel operations with borrowings from Korean banks. But cost overruns and mismanagement increased Hanbo's debt to 5 trillion won by the time it filed for bankruptcy. While Hanbo was making such a capital investment, the world steel industry went into a recession. A combination of massive debt and the recession drove Hanbo to the brink of bankruptcy as early as the second quarter of 1996. Despite a series of emergency loans provided by Hanbo's creditors, Hanbo defaulted.

If this had happened in any other country, it may have been a simple story of a firm who made a bad investment decision. But it sent a shock wave not only in Korea but also in the international financial community. In Korea, the Hanbo collapse quickly became a political scandal, eventually implicating a number of politicians, including a son of the incumbent president. Those politicians who accepted political contributions from Hanbo were charged with bribery and influence peddling. The international financial community, which lent heavily to Korean firms, reacted to the Hanbo incident with alarm not because they did not know Hanbo's troubles in advance, which they did, but because the Korean government let it collapse. Korean firms had always been heavily leveraged, but they had been able to borrow from foreign banks under the implicit understanding that the Korean government would stand behind them in times of trouble. When the international financial community realized that Korean firms and banks were no longer safe, they became reluctant to lend or roll-over existing debts; when they did lend, they asked for higher interest rates. Following the

Hanbo incident, for example, the interest rates above the London interbank offer rate (LIBO) that Korean banks and firms had to pay in the international money market rose to 0.20 percent, from an average of 0.15 to 0.18 percent in the previous December.

But Hanbo did not immediately result in a full-scale crisis. Hanbo was not well-known to international investors. More importantly, people expected the Korean economy to weather the Hanbo bankruptcy. After all, people thought, Korea had POSCO, the hugely profitable, second largest steel maker in the world, that could take over Hanbo without serious damage to the economy. This kind of optimism, however, gradually gave in to pessimism, as a number of other chaebol groups followed Hanbo into bankruptcy (Sammi in March, Jinro in April, and Daenong in May). Then came Kia in July.

Kia is a major automobile producer with an international reputation. Kia as a group was the seventh largest chaebol in Korea. When Kia declared bankruptcy in July 1997, the crisis was in full swing. If Kia could go under, nobody seemed safe. The problem was compounded by the indecisiveness of the Korean government. In public, the government under the leadership of deputy prime minister Kang Kyungsik maintained that it would rely on the market mechanism to solve the Kia problem. But many suspected that the government wanted to turn Kia over to another Korean group, Samsung being a likely candidate. The management and unions of Kia fiercely fought to keep their company independent by striking a deal with creditor banks. The banks were willing to reschedule Kia's debts because they wanted to avoid Kia's bankruptcy, in which case they would have to write off their loans to Kia. The government, however, opposed Kia's request for rescheduling while demanding the resignation of Kia's top management. Three months went by before the government finally put Kia on court receivership and turned it into a state- owned enterprise by converting government loans into equity. But the damage had been done. By October, the floodgate had opened. Foreign banks began to call in loans and stop rolling them over. As a result, Korea faced a situation in which its banks and companies could not secure new funds at any price.

As foreign banks and investors pulled out of Korea, the Korean won begin to feel the pressure. Korean banks and companies needed dollars to pay back their foreign debts. The demand for dollars also came from foreign investors who dumped their Korean assets. The supply of dollars was limited. Korea was running a current account deficit and Korean banks and companies could not borrow from abroad. With foreign banks refusing to inject new capital into Korea, the Korean government was left only with the dollar reserves of its central bank, the Bank of Korea, to defend the won. In a way, the Korean government was in a no-win situation. If they defended the won, it would risk the depletion of its dollar reserves, in which case no one in Korea would be able to meet their foreign debt payment. If the Korean government did not defend the won, it would place enormous pressure on Korean banks and firms by increasing their debt service costs.7

In retrospect, it would have been better if the Korean government had decided to float the won, which it did not. For two months in October and November, the Korean government spent close to $15.1 billion to prop up the won in foreign exchange markets. By the time Korea asked for the IMF bailout, its liquid foreign reserve, which had been $22.4 billion as late as September or early October, fell to a paltry $7.3 billion. With its dollar reserves depleted and no prospects for new private borrowings, the Korean government had no choice but to turn to the IMF. To the last minute, the Korean government tried to avoid an IMF bailout by appealing to the international financial community with promises of financial reforms. On November 21, the Korean government finally made a formal request for IMF standby loans.

3. Structural Causes of the Crisis

It may be a while before we see solid academic analysis of the causes of the Korean financial troubles. The Korean crisis caught us by surprise. For those of us living in Korea, it was only in November that we learned of the severity of our foreign exchange situation. At the time of this writing, the situation in Korea is still unstable and is projected to remain so for the foreseeable future. Korean newspapers and magazines are busy keeping up with the breathtaking pace of daily financial market activities. When the dust settles, we will have a clearer picture of what happened in Korea.

This does not mean that we are short of explanations. In the beginning, explanations tended to focus on problems in Korea - mismanaged banks, highly leveraged chaebol, government allocation of credit, and corruption. As time went by, we learned that the Korean crisis is a symptom of a larger international problem, be it an oversupply of Japanese yen or the instability of the current flexible exchange rate system. Thus, the first point of departure in future debate on the issue will be which factor was more important in Korea, internal or external.

If we look at the situation from the outside, the story of the Korean problem is rather simple. There was plenty of capital in international financial markets in 1995 and 1996. In East Asia, cheap capital was available from Japan, which kept its interest rates very low--less than 1 percent--to stimulate its sagging economy. The demand for foreign capital in Korea, on the other hand, was strong. Korea had to finance its massive current account deficit which swelled to the largest ever level of $23.7 billion in 1996. Moreover, Korean firms and banks sought foreign capital to take advantage of large interest rate differentials between Korean and foreign credit markets. The following hypothetical story illustrates the way in which the favorable conditions in the international money market led to massive borrowing by Korean firms:

The borrower in this case may have been a Korean industrialist seeking to build a factory. He went to a Korean bank and learned that the cheapest loan originated in yen. The industrialist borrowed in the Korean currency, the won, and agreed to make payment in won. Say he borrowed $10 million worth of won. His bank then financed the loan by borrowing an equal amount in yen from a Japanese, European or American bank. These foreign bankers borrowed the yen at less than 1 percent, re-lent it at 2.5 to 3 percent to the Korean banker, who charged the industrialist a higher rate, say 8 or 9 percent - all nice markups for the banks. Sometimes the industrialist went directly to the foreign lender, bypassing his local banker and borrowing for less than 8 or 9 percent. And sometimes the loans were not in yen, but in dollars. After all, dollar loans were available for as little as 5 percent and, re-lent in Korea, can still produce a nice markup. There was, of course, a gamble. This lending worked only if the won kept its value against the yen and the dollar. The industrialist made his monthly loan payment of, say, $150,000 in won and his Korean banker converted these won into an equal sum in yen or dollars to repay the overseas lender.8

This worked for a while. But a recession hit the Korean economy in the second quarter of 1996. Korean firms suffered from an overvalued currency and downturns in its key export industries such as semiconductor, steel and shipbuilding. It is no coincidence that many of the bankrupt firms has a major presence in the steel industry, including Hanbo, Sammi, and Kia. In fact, because of the depressed export prices of key export items, Korea's terms of trade, the ratio of export to import prices, became the lowest in 1996 since the second oil shock of 1979. Domestic industries such as construction and retail had gone into a recession even before export industries and were not in a position to take up the slack. As a result of the recession, Korean firms became largely unprofitable and found it difficult to service their debts. By 1996, corporate profits, as measured by the ratio of ordinary income to sales, fell to 1 percent, the lowest since 1987.

But the external factors alone cannot explain why Korea fell in 1997. Other countries in East Asia, especially Taiwan, have been able to escape the financial crisis so far. So we have to look for internal factors. In terms of economic factors, it took a congruence of three forces to create a banking and currency crisis in Korea: deterioration of bank balance sheets, mounting foreign debts, and declining corporate profits. Korea could have survived the adverse international conditions if one of the three factors had been absent. For example, Korea could have prevented a banking crisis from spilling over to the currency market if it had not had such high exposure to international debts (McKinnon, 1998).

The current economic crisis in Korea began essentially as a banking crisis. The kind of corporate bankruptcies that Korea experienced in 1997 would shake any banking system. But the Korean banking sector was particularly vulnerable. If the banks had been stronger, they may have been able to withstand the initial crisis without undermining their credit ratings in the international financial markets.

Korean banks have long been loaded with significant amounts of non-performing loans even though there are no reliable data.9 Banks have also suffered from the slumps in the asset markets such as real estate and stocks that lowered the value of their assets. When the IMF bailout came, few banks were healthy enough to meet the BIS requirements for self-owned capital.10 Korean banks are also notoriously inefficient with an excess number of workers and branches. They also lag behind in modern financial techniques. When lending to businesses, banks base their lending decisions mainly on the size of collateral, not on the merit of investment proposals. Backward banking practices of Korean banks have been a source of much ridicule; some have dismissed them as little more than "pawn shops."11

The present state of the banking sector resulted from the long period of government intervention and dominance. For a long time, the government allocated credit to favored sectors through policy loans and administrative guidance (Cho and Kim, 1995). Credit control and allocation were the key instruments of the government's industrial policy. Since it was the government who decided where money went, the banks did not really have an incentive to develop capacity for project evaluation. Moreover, the risk for the banks was minimal. The government provided explicit guarantees for depositors while it bailed out the companies that they supported. The government acted as "an effective risk partner of private industry." The implicit co- insurance scheme among government, banks, and industry worked well for a long time, fueling the industrialization of the Korean economy. But it left the banking sector inefficient, backward, and dependent. The state-dependent banking sector was also a breeding ground for corruption. Since capital was in short supply and the government regulated interest rates, banks could and did allocate credit, under government direction, to those who can deliver favors to them, such as friends of powerful politicians or to the highest bidder of bribery.

The question remains of why weak banks became such a problem in 1997, and not before. The banking sector has always been weak. Ironically, the banking problem was exasperated by the very measures to make the banking sector more competitive. Under foreign and domestic pressures for liberalization and deregulation, the government has over the years relaxed or removed many financial regulations. The old model of the co- insurance mechanism began to unravel. Freed from government interference, the banks expanded and entered new businesses, some of which carried high risks. Many of them went on a borrowing binge and made risky investments at home and abroad. In retrospect, it is clear that the Korean banks were not ready to compete under the newly deregulated environment. In the name of globalization and democratization, however, the government failed to supervise and monitor their activities to the point of negligence. There were disturbing parallels between Korean banking problems and the savings and loan crisis of the early 1980s in the United States. In both cases, deregulation led to "a flood of new money, reckless lending and inadequate government supervision - a clear recipe for a costly disaster."12 Like the

United States government during the savings and loan crisis, the Korean government confused deregulation with supervision.

The second culprit for the economic crisis was the size of Korea's external borrowing. If Korean banks and firms had not borrowed so much abroad, a series of bankruptcies in 1997 would not have triggered a currency crisis. Korea has always relied on external borrowing to finance its investment.13 As a result, Korea has always had substantial foreign debt which, in some years, amounted to as high as 50 percent of GNP. As of the end of 1996, total external debt reached $109.8 billion, representing 22.6 percent of GDP. In November of 1997, right before the IMF bailout, Korea's external debt stood at $116.1 billion, about 23 percent of 1996 GDP. After much controversy over the calculation of foreign debt, the IMF and the Korean government came up with a new way of tabulating foreign debt, called external liabilities (Chosun Ilbo, December 31, 1997). According to this new formula, Korea's official foreign debt as of November 1997 came to $156.9 billion. Unlike external debt, external liabilities include liabilities of overseas branches and offshore affiliates of Korean banks. Even this size of external liabilities is not so high by historical standards. But the problem was not the absolute size of foreign debt, but its structure. Short-term debt (loans with maturity of less than 1 year) accounted for 58.8 percent while long-term debt represented 41.2 percent of the total. This type of the loan composition was unusual by historical standards. The last time Korea had to grapple with the problem of foreign debt was the early 1980s, particularly 1982, when the ratio of external debt to GNP was around 50 percent. Even then, however, the share of short-term debt did not exceed 30 percent.

We have to look at both supply and demand sides to understand why Korean banks and institutions accumulated such massive debts. As discussed before, foreign banks were happy to lend to Korean banks and firms in 1995 and 1996. After Korean joined the OECD in February 1996, Korean banks were able to borrow at even cheaper rates; the spread over LIBO was an average of 0.43 percent for Korean commercial banks in 1995, but fell to 0.26 percent by February 1996. OECD membership is largely symbolic, but it significantly increases a new member's credit rating in international financial markets. Between 1994, when Korea's entry passed its first test, and 1996, when it officially joined, foreign banks more than doubled their lending to South Korea, from $52 billion to $108 billion.

Demand side factors were also at play. Domestic savings fell to the lowest level in 1996 since 1987. Korean firms turned to foreign sources to finance their investment. Given that Korean firms increased their investment in 1996, i.e., domestic investment as a share of GDP rose in that year, their demand for foreign borrowing was even greater. Financing of domestic investment was not the only source of demand. With lifting of capital controls, Korean firms and banks expanded their operations abroad. According to one estimate, about $60 billion of total foreign debt outstanding as of November 1997 were used to finance the chaebol's direct investments abroad. Korean banks also invested in foreign assets with funds borrowed from foreign banks in the range of $23 billion. Korean banks were major investors in the bond markets in Southeast Asia, Russia, and Latin America (Chosun Ilbo, January 8, 1998).

As we can see from these statistics, a number of factors were involved in the accumulation process. Among them, two factors seem most important: unwise business decisions by banks and firms, and the breakdown of the government's supervisory and monitoring functions. Failed decisions look unwise after the fact, and we cannot say for certain that those decisions could not be justified at the time they were made. Thus, the problem seems to lie more with the government's failure to monitor the situation.

The third contributing factor was declining profitability of Korean firms, especially in foreign markets. Corporate profits have always been low in Korea, but they fell to the lowest level ever in 1996. Korean exporters have also been losing market shares in key export markets, such as the

United States. This trend began in the early 1990s. For a couple of years in the mid-1990s, Korean firms were able to stumble forward with cheap debts and favorable market conditions in some industries, such as in the semiconductor industry. But these favorable conditions did not last long, and certainly could not reverse the continuous decline of their competitiveness.

Korean businesses have long blamed "3 highs" for their troubles - high costs of labor, capital, and distribution. The cost of doing business is also raised by lack of transparency and accountability on the part of the government. In particular, wages have risen at an average rate of (7.8%) in real terms, often exceeding productivity gains during the 1987-1996 period. Much of the increase in wage level came from the unions' political power, which was strengthened after the democratic reforms of 1987 (Mo, 1998a).

While costs have risen significantly since the late 1980s, productivity or efficiency gains have lagged. As a result, Korean companies have been squeezed between late developers with low cost, such as China and Southeast Asian countries, and countries with better technology and greater economies of scale, such as the United States and Japan. One reason why Korean firms made so many risky investments may be their desire to break out of this squeeze.

Critics of chaebol, however, point to corporate mismanagement. They argue that Chaebol companies turned a blind eye to productivity and research and development because of their obsession with expansion and market share. Chaebol could expand because they basically faced a risk-free environment. As discussed above, the co-insurance scheme among banks, government, and chaebol allowed the latter to borrow without fear of bankruptcy.

The chaebol have also suffered from their own structural and organization limitations. Their organization is highly centralized; owner-managers with shares far fewer than 50 percent control every one of the member companies. This skewed governance structure has raised concerns about fairness and the concentration of economic power. More importantly, there is growing recognition that the corporate governance structure of the chaebol has undermined their competitiveness. Decisions by owner-managers go unchallenged and no effective internal and external monitoring mechanism for investment decisions exists. Critics argue that owner-managers of Samsung and Ssangyong put their groups at risk by entering the automobile industry as their pet projects.

The chaebol are also criticized for their expansion into businesses outside of their core competencies. A typical group has an affiliate in almost every industry, and its organizational chart resembles an armada, with one or two flagship companies escorted by a whole range of member companies. Expansionary behavior is motivated in part by jealous competition for prestige and for a position in the pecking order, defined in terms of size. The main instrument of expansion has been mutual-payment guarantees among member companies of chaebol.

4. Democracy as a Causal Factor

The central link between democracy and the economic crisis is the government and its policies. The question is whether different government responses could have prevented or alleviated the severity of the crisis, and if so, why the right policies were not chosen and whether democratization was a factor in the government failure to take appropriate actions.

We evaluate the government performance in terms of reforming the economic system and managing the financial crisis. Granted, it is all too easy, after the fact, to blame the government or politicians for policy failures. A combination of three economic forces interacted to create a crisis environment. In view of their strength, it is fair to say that it would have been difficult to prevent a crisis solely with government actions. But the Korean government cannot escape responsibility for the current crisis because it had, for a long time, recognized but failed to solve the economic problems that caused the crisis; financial, chaebol, and labor reforms had been high on national economic agenda (Cho and Kim, 1995; Jeong and Mo, 1997; Kim and Mo, 1998; Yoo and Lim, 1998; Mo, 1998a; Moon 1998a; Judd and Lee, 1998). Across the reform areas, we can discern common patterns. First, no fundamental reforms have been achieved. The government has made progress in some areas, especially labor reform in 1997, but even here some key issues, including the laws regulating layoffs, were left unresolved. Under international pressure, the government undertook several financial liberalization and deregulation measures, but the Korean financial markets remained insulated and restricted by international standards. Chaebol reforms were probably the least effective. Instead of reform using market principles, the government turned to command-and- control type of regulations to contain the expansion of the chaebol; e.g., forced dispersion of ownership and specialization of business lines (Moon, 1998b).

Second, government policies has been characterized by inconsistency and incoherence (Mo, 1998a). In almost every area of reform, the government has oscillated between reform and the status quo. The fluctuation of reform efforts have followed administrative and electoral cycles. New governments began with ambitious reform projects, but ended up backsliding toward the end of their administration. Labor policy was typical. Both Presidents Roh Tae Woo and Kim Young Sam espoused or tolerated reformist labor policies in the beginning, but soon reverted to pro-business positions. The policy toward the chaebol has exhibited a more complicated pattern. The governments of Roh Tae Woo and Kim Young Sam have exerted continuous pressure on the chaebol, experimenting with various measures designed to moderate their market power and enhance their competitiveness. But the intensity of their reform efforts has not been uniform; it tended to rise after an election, but receded as another election approached (Moon, 1996).

Third, the reform process has been top-down. Major reform acts by Kim Young Sam, such as the real name financial transaction system, were proclaimed typically with executive order without much deliberation and debate. Many attribute this pattern to Kim Young Sam's personal style. But the top-down approach reflects more troubling aspects of the political process under democracy. That is, top-down reforms may have been the only alternative when groups with stakes in the outcome of reform cannot negotiate an agreement on their own. Since democratization began in 1987, the government experimented with various mechanisms to foster dialogue and cooperation between labor and management; but labor and management could not come to an agreement on their own (Mo, 1998b). We see the same pattern with the reform of the chaebol. Even after ten years of debate, the government is still searching for a viable chaebol policy (Jeong and Mo, 1997; Lee and Lim, 1998). Financial market reforms have not been much different; the commissions set up to facilitate compromise and agreement did not produce lasting reforms. A typical example is the rivalry between the Ministry of Finance and Economy and the Bank of Korea over primacy in monetary and banking policy. This conflict first came to the fore in 1989, and flared up even in the middle of the economic crisis in November 1997.

The picture that we have depicted thus far of the Korean political process is one of paralysis and gridlock. This is particularly true if the interests of powerful groups are threatened. In their effort to maximize their private interests, they play a game of attrition against their opponents instead of trying to find a negotiated settlement. This failure of dispute resolution has been the most salient feature of the Korean democratic experience and explains why Korea has failed to reform its economic system.

Government paralysis and gridlock also played an important role in the government handling of the economic crisis. As discussed above, policy makers made several mistakes. Some of them were a matter of judgment and not a symptom of gridlock. For example, the decision to defend the won throughout 1997 had its own justifications and could not be dismissed based only on ex post evidence. But the Kia debacle was a typical case of gridlock. Kia (its unions and management), creditor banks, and the government were all powerful actors and the stakes were high for all. In pursuit of narrow self-interest, they entrenched themselves in their positions and failed to make concessions.14

In the critical month of November, the government was paralyzed for two weeks by bureaucratic infighting over control over monetary policy and the supervision of financial institutions. The main antagonists were the Ministry of Finance and Economy and the Bank of Korea. Regardless of the merit of each side, what was remarkable about the whole episode was that the dispute in question had gone on for almost ten years and had come back to haunt the government at a time of crisis.

To summarize, the current crisis reflects the failure of the political system as much as of the economic system. It is the job of the former to correct the problems of the latter. But the Korean political system failed to carry out long overdue reforms and to contain the unfolding financial crisis. Why did the Korean political system fail? We argue in this paper that the most significant cause of the government failures was the immature nature of Korean democracy.

There was a mismatch of domain between democratic outfit and authoritarian ethos, which is not unusual in transitional democracies such as South Korea. Democratic transition has not only altered the political landscape by expanding space for pluralistic maneuver by social forces, but also fostered democratic reforms and institutional changes. But major political actors, including executive leadership, bureaucracy, the ruling New Korea Party, and even peak political organizations, have not completely shed their authoritarian behavior. Authoritarian inertia, deeply embedded in people and institutions, has persisted, undermining the very process of democratic consolidation, the rule of law, and respect for negotiated outcomes. Failure of ensuring fine-tuning between democratic outfit and authoritarian ethos has deepened political and policy gridlock without producing any meaningful compromises.

Korea's traditional political culture and practices have also proven detrimental. Negotiation, an essential component of democratic governance, has not taken root in Korean political culture, explaining why groups have had difficulties reconciling their differences and negotiating an agreement. Emphasis on consensus-building has also undermined the functioning of majority rule in the National Assembly. The Korean National Assembly has not been able to tackle those issues that pit strong interests against each other.

Some attribute such government failures as political gridlock, bureaucratic politics, and ineffectual monitoring to incompetent executive leadership (Moon and Kim, forthcoming). South Korea has adopted a presidential system. Thus, despite democratic institutional constraints, the president in South Korea is expected to play an important role in formulating, monitoring, and implementing public policies. It is more so because of the historical legacy of an imperial presidency in which power is extremely concentrated in the hands of president and his staff. Presidents Roh Tae Woo and Kim Young Sam were not known to have any political and economic convictions or commitment, and became indecisive when faced with difficult policy choices. In particular, President Kim Young Sam has been widely criticized for lack of expertise, knowledge, and competence, especially on economic issues. Thus, he delegated his power and authority to his staff, but failed to monitor the formulation and implementation of economic policies. As past history illustrates, lack of executive leadership commitment and monitoring has always ended in fierce bureaucratic fighting and policy gridlock. In view of this, Kim's dismal leadership performance can be seen as a critical catalyst aggravating government failures.

Others point to the government-business nexus as the root cause of policy stalemate. Even though

Korean society has made much progress in procedural democracy since 1987, the government-big business coalition has not changed, and may even have become stronger under democracy. According to this view, it was the unwillingness of the government and business elite to sacrifice their private interests or give up some of their privileges that defeated most reform initiatives.15

By large measure, the preceding three views represent differences of opinion on how widely the blame for policy gridlock should be shared in the Korean society. We are most sympathetic to the first view because problems of unruly and irresponsible behavior were more pervasive throughout the society than the second and third views seem to imply. It was not just the president or the ruling elite that failed to show tolerance, the willingness to compromise or respect for the rule of law. Thus, the causes of policy gridlock must be a problem or problems shared society-wide and we see one in the incompatibility between inherited political culture and the requisites for the effective functioning of democracy.

Finally, it should be noted that the Korean political system may still have performed reasonably well if its electoral system had succeeded in resolving policy conflicts. Since 1987, however, national elections have been dominated by regionalism without producing any policy mandates. Economic issues have been marginal campaign issues, so no political party could obtain an electoral mandate to carry out its reform program. The problem lies with the deeply conservative and homogenous Korean voters who vote according to their regional loyalty.

5. Conclusion

The Asian financial crisis of 1997-1998 will mark a turning point in Asian history. Although it is too early to assess the full economic and political consequences of the crisis, they will, no doubt, shape the political and economic development of Asian countries in many years to come. In view of the significance of the events that have transpired, they are likely to spawn many analyses of their causes and consequences. Already, debates have emerged on the following questions:

Which was the more significant cause of the crisis, external or internal forces? Who was more responsible for the crisis: politicians, bureaucrats, bankers, businessmen, or workers? Is the Asian model of economic development dead?16 Can theories of currency crisis explain the pattern of the Asian crisis? (Krugman, 1998) Should Asian countries have delayed the lifting of capital controls? (McKinnon, 1998) Does the Asian crisis call for a regional stabilization fund? (McKinnon, 1998) Should the IMF impose the traditional program of stabilization, i.e., high interest rates and fiscal austerity, on Korea?17

This essay emphasizes one important factor in the Korean case that has been ignored by journalists and scholars--the role of democracy. As we argued in the introduction to this volume, we do not intend to make a general statement on the relationship between regime type and economic outcome. That remains valid in this essay. We are interested in explaining how the process of democratization has shaped the political environment in which the economic crisis arose and unfolded.18

The ultimate cause of the economic crisis in Korea can be found in the failure of the political system that has undergone the process of democratization. While Korea has struggled to adjust itself to the new democratic environment, the forces of globalization have shaken its "fragile" economic system. The rapid pace of technological innovation and the emergence of low- cost competitors made obsolete the model of Korean development that had served so well in the past. Korea might have needed more time to learn to work with democracy, but the forces of globalization did not wait for Koreans to sort out their differences under democracy.

We do not suggest that the process of democratic transition and consolidation is inherently less favorable to economic performance. The problem in Korea was not democracy, but the way in which it was practiced. Ironically, one can say that the failure to socialize and institutionalize democratic reforms precipitated and escalated the economic crisis. If the Kim Young Sam government could have succeeded in ensuring transparency, openness, fair competition, and the rule of law as dictated by democratic reform mandates, unruly corporate expansion, corruption of banking practices, and some of the government failures such as ineffective monitoring, might well have been prevented.

What impact the current crisis will have on Korean democracy is unclear. If Korea experiences a long period of economic hardship as a result of the crisis, we cannot entirely rule out the possibility of democratic breakdown. The public may blame democracy for their economic troubles; even before the crisis, the movement to reevaluate and restore President Park Chung Hee was gaining strength.

On the other hand, the current economic crisis may be a powerful lesson for Korean society. Democracy requires responsible behavior and respect for the rule of law. That may sometime involve compromise and the sacrifice of short-term for long-term gains. This simple truth has been lost largely in the first ten years of democracy, and Korea is now paying the high price.

III. Notes

1. Endnotes

1 "Koreans Worry about Increasing Layoffs," New York Times, December 17, 1998.

2 Consolidated accounts are supposed to increase transparency in financial accounting. According to The Economist (December 13, 1997), the consolidated accounts would have shown that in 1996 chaebols' debts were 37 percent higher and their profits 37 percent lower than what the unconsolidated accounts showed.

3 Weekly Chosun, 1997/01/22.

4 We owe Ramon Myers for elaboration of this point.

5 Policy gridlock is also a feature of many mature democracies, including the United States. We argue that policy gridlock took a particularly perverse form in Korea and that the immaturity of democracy was largely responsible. In a later section, we examine some other causes of gridlock.

6 The decision to defend the won during this period turned out to be costly as the Bank of Korea depleted $16 billion from its reserve to support the Korean won in June 1996.

7 This concern about debt servicing cost also explains why the Korean government did not devalue its currency earlier (Joongang Ilbo, December 11, 1997).

8 Borrowing Asia is Troubles," New York Times, December 28, 1997.

9 The proportion of non-performing loans in the banking system at the height of the crisis, December 1997, was estimated to be 15 to 18 percent (see Financial Times, December 16 and The Economist, December 29, 1997). The size of non-performing loans amounted to 7.5 percent of GDP (IMF Press Release, December 4, 1997).

10 Some of the healthy banks are Kukmin Bank, Shinhan Bank, and Jutaek Bank.

11 "Asia Needs a New Model," Wall Street Journal Interactive Edition, December 9, 1997.

12 "Inadequate Regulation Seen in Asia's Banking Crisis," New York Times, December 22, 1997.

13 The preferred method of inducing foreign capital has been borrowing rather than direct investment. Korean firms, in general, favor borrowings to finance their investment because it is easier to maintain control with borrowings than with equity financing. Bureaucrats who wanted control of the economy also favored borrowings because multinational firms would be less subject to government intervention than domestic firms.

14 Deputy Prime Minister Kang Kyung-shik was mainly responsible for resolving the Kia issue, but lacked credibility. His political opponents questioned his motivation. Minister Kang had been chairman of the local committee to attract Samsung's auto plant to Pusan while he was a national assemblyman from that city.

15 We thank Wonhyuk Lim for bringing up this point.

16 In a crisis environment, nothing looks to be working and everything seems to be wrong. That seems to be the case in Korea. It is no exaggeration that the current crisis has been linked to almost every feature of the Korean model of economic development. The characteristics of the model are: government industrial policy, strong bureaucracy, the corporate finance system, the corporate governance system (the chaebol), the rigid labor markets, and protection of domestic industry. For the recent views of its weaknesses, see "New Economic Models Are Failing while America Inc. Keeps Rolling," Wall Street Journal Interactive Edition, December 8, 1997, and "Asian Models Trip Up," Financial Times, December 6, 1997.

17 The main critic of the IMF approach is Jeffrey Sachs (New York Times, December 18, 1997).

18 In theory, it is impossible to investigate the effects of regime change on macroeconomic performance, especially the economic crisis of 1997, because we do not know what might have happened in the absence of the regime change, that is, if the pre-1987 authoritarian regime had remained in power. So we can only, as we do in this paper, evaluate the performance of the democratic regime as it has evolved in Korea in terms of some objective (and subjective) criteria such as its role in causing the current crisis. We can only speculate on what might have happened under alternative regimes, e.g., an authoritarian regime or a mature and consolidated democracy. In this paper, we speculate that had Korean democracy been consolidated or matured sooner, it would not have produced such disastrous policy outcomes.

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