A Korea-OECD Conference

Korea in the OECD Perspective:

Shaping up for Globalization

1-2 December 2000

Seoul, Korea

Ministry of Foreign Affairs and Trade
Korea Institute for International Economic Policy

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On the occasion of the fourth anniversary of Korea's accession to the OECD, the Ministry of Foreign Affairs and Trade has organized, in collaboration with the OECD, the *Conference on Korea in the OECD Perspective: Shaping up for Globalization*, which was held in Seoul on December 1-2, 2000.

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For the last four years, many Korea-OECD conferences had been held, touching upon various topics and issues. But it is the first time for OECD experts and Korean experts to convene together and examine the present situation and problems of the Korean economy from all-embracing perspectives. This conference encompasses three subjects – the New Economy and Korea, Korea's Reform: From Here to Where and Challenges of Globalization to Korea.

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This conference volume is published on the joint responsibility of the Ministry of Foreign Affairs and Trade (MOFAT) and the Korea Institute for International Economic Policy (KIEP).

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Opening Remarks

Duck-Soo Han
Minister for Trade
Ministry of Foreign Affairs and Trade

Good morning!

First of all I would like to welcome Deputy Secretary-General Schlögl and all the distinguished guests today. I'm also very happy to see Ambassador Young, who can actually relay the very solid foundation for making OECD recommendations and polices available to the government, not only economic but social and all polices related to the OECD.

This conference is actually one of the symbolic efforts by the Korean government showing that we would like to incorporate OECD recommendations and studies into Korean economic policies.

We joined the OECD in December 1996. And immediately after entering the OECD, we came into the very serious financial and economic crisis. And in the course of overcoming this economic crisis, there was consistently some criticism in Korea that the rather aggressive accession to the OECD might have caused some of the problems, especially in the capital liberalization policies taken by the Korean government at the recommendations of the OECD.

I think that that issue has been made clear by the Secretary-General and many statements by the Korean government. But I would like to emphasize once more that the crises did not come from Korea's accession to the OECD, rather Korea was helped very much by being a member of the OECD. The problem actually was caused by Korea's noncompliance with what the OECD recommended at the time of our accession – the strengthening of our financial supervision polices in Korea as well as sound macroeconomic polices for Korea.

Now after recovering from our very serious economic crises, I think we are confident that the OECD was a great help to us in overcoming our crisis. And we should work more closely with the OECD in modernizing our Korean economic policy as well as internationalizing codes and standards of our economic policies.

So, in the late half of last year at the recommendation of Ambassador Young, we would like to make some framework a rather institutional framework, to more automatically incorporate OECD works into Korea's economic policy.

We planned to set up 42 sectoral consultative groups for OECD studies. They include all the ministries of Korea as well as academia so that they will follow in accordance with their sectoral implications, the policies and recommendations and studies made by the OECD. At that sectoral forum they consistently follow up the studies at the OECD, and when there is a meeting, conference or discussions at the OECD that group will make some of their positions that will be presented at the OECD.

Now about 12 sectoral groups have been formed and for the first time we actually received some of financial assistance from our budget office next year in the amount of about $100,000, to support those sectoral group for financing some of our experts and academia present at the OECD meetings. And also helping to some extent the incorporating efforts at the level of the government, the OECD conducted analyses and works.

The Korean government approached the OECD and proposed this seminar. This is one of the more comprehensive seminars on the issues of interest to the OECD and Korea held at least once a year. On the other hand, we are conducting those sectoral group discussions concerning the OECD studies and analyses. So we proposed this seminar. The purpose was two-fold. First, we wanted to seek the advice and expertise of the OECD and advanced economies of the world on how Korea should prepare itself for the New Economy and globalization and how we can better manage and complete our economic restructuring efforts which began three years ago. Second, we wanted to increase the awareness of the Korean public about the economic cooperation and collective discourse taking place among the advanced economies under the auspices of the OECD.

This conference, I understand, will cover three broad issue areas. The first one is the New Economy and globalization and what they mean to Korea. The second is Korea's reforms and remaining tasks in the context of the globalization. The third and last issue is the challenges that globalization raises for Korea.

Considering the importance of these issues, it is easy to see how timely this conference is for Korea, the members of the OECD and the distinguished guests here at this event. With that in mind, I would like to briefly share with you my thoughts on globalization, an overarching theme for this conference. Globalization is indeed a very powerful phenomenon that best characterizes our world today. Despite its importance, its nature and implications are often misunderstood by the public.

Globalization, first and foremost, is a phenomenon led by technology and market forces. It is result of the technological progress and result of the desire of economic actors all over the world to seek bigger markets in which they can sell and buy more high quality products and better services. The critics of globalization often get this point wrong. They frequently aim their criticism of globalization at the governments and international organizations, as if globalization is entirely a result of public policies. That is a great misunderstanding.

In fact, globalization in large part progresses independently of public policies. Globalization is mostly the work of markets and technologies. Therefore, to be more accurate, public policies should be understood as responses to globalization rather than is direct cause. A question then arises. What kinds of policies should we come up with to properly respond to globalization? The answer is clear. Globalization offers a wide variety of benefits for us. And at the same time it has its downsides. So we should design and implement policies that help us maximize the benefits and minimize the negative effects of globalization. What are the benefits of globalization? In essence, globalization dismantles national barriers, promotes economic freedom of individuals, increases competition and efficiency, and reduces waste and unfair influence of vested interests.

Let me explain what I mean about economic freedom. Globalization brings down national barriers that limit our freedom to choose. Beyond the interests of the controlling political elite, beyond the interests of the privileged class and the protected economic groups, globalization offers individuals more choices; a choice to produce what they want to produce, buy what they want to buy and work where they want to work. Throughout history, human freedom has been greatly advanced thanks to the spread of democracy and market economy. Now globalization is expected to greatly boost the speed of this advancement.

Globalization is opening global markets, and open markets drive economic actors to become more competitive and more efficient. Through the process of competition, economic systems become more transparent, more fair, more efficient and more productive. In short, globalization offers us freedom, and long term prosperity.

How then do we maximize these benefits of globalization? The answer is that we should work to reduce the barriers that keep us from achieving more freedom, more competition and higher efficiency. To do that, different national economies have to work together to continue liberalizing domestic markets, and reducing and harmonizing regulatory hurdles.

Also more importantly, each country should continue to streamline and reform their domestic economies, so that they are in a line with international liberalization and harmonization efforts. Despite the great benefits, however, globalization has certain undesirable side effects. The most serious one is that those without proper skills in the knowledge and information-based economy can fall behind. This is true for both individuals and countries. The gap between those who move a hare and those who fall behind can grow as fast as the rate at which technology changes today. Then, what should be the policy response? To minimize this problem, one clear answer is that we should focus on human resources development through education and training. Another one is the building of information structure, and it is critical in this global age that we carry out these efforts at both the domestic and global levels. The great benefits of globalization can not be guaranteed in the long run unless the entire global community enjoys and shares them together.

Now let me briefly touch upon the ways Korea has responded to globalization. In essence, we have been working hard to make our economy more open, more flexible and more efficient, particularly since 1997. In fact, since the 1960s Korea has been one of the best examples of how an economy can enjoy the benefits of the globalizing world market.

However, our quantitative success in the world market eventually led us to overlook the continuous qualitative exchanges occurring in the world economy. As a result, we had let the financial and corporate sectors and other segments of our economic system become outdated. And in the end, we paid a price for our complacency when the economic crisis hit in 1997. Since then we have carried out reform measures in the financial, corporate, labor and public sectors. The goal for these reforms was clear. We want to enhance transparency, accountability and efficiency according to internationally accepted standards in order to get us back on track with the globalization process in the world market. While we implemented the four-sector reform on the domestic side, we have on the international side engaged in active efforts on three fronts. First, we have been working very hard to further open our economy to the world. Second, we have been actively embracing advanced international practices and norms in order to upgrade our economic system. And third, we have been participating actively in international cooperation mechanisms to further promote global openness and collectively formulate new international standards for the changing global economy.

Now, by no means is our structural reform and liberalization complete, and the remaining tasks may be the most challenging ones left to tackle. Nevertheless the Korean people are fully committed to accomplishing and completing the remaining tasks.

Let me remind you that in all these efforts to reform open of our economy and increase international cooperation, the OECD has continued to support us making significant contributions to our efforts. In fact, the OECD has offered Korea guidance and advice through its economic analysis, independent assessments and case studies of best practices. The OECD has also helped to raise the international market's confidence in the Korean economy.

As we face challenges before us, we would like to continue relying on the support of the OECD and its members. At this event, we hope to generate a better understanding of the challenges and opportunities Korea faces in this age of globalization and New Economy.

We hope to share that understanding with OECD experts and member countries. At the same time, we expect to gain valuable insights and supports from the OECD, particularly regarding what Korea should do to maximize the opportunities ahead of us.

Thank you.

Keynote Speech

H.E. ***Soogil Young***
Ambassador
Permanent Representative of Korea to the OECD

Minister Duck-soo Han, Dr. Herwig Schlögl, Ladies and Gentlemen:

The purpose of this seminar is to undertake a comprehensive review of the present state of the Korean economy as well as of the main challenges it faces. This seminar is unique in that it proposes to do so by listening to the views held by the OECD experts and comparing them with those of Korean experts and sectoral representatives.

As Korea's Ambassador and Permanent Representative to the OECD, I am very pleased to see this seminar held, and honored to co-chair it with Dr. Schlögl, Deputy Secretary-General of the OECD.

This seminar came to be held today as a result of a recommendation I made to the Ministry of Foreign Affairs and Trade one year ago. I would like to express my gratitude to Minister Han who has acted upon my recommendation.

I also would like to take this opportunity to express my gratitude to Dr. Schlögl, as well as Messrs. Yutaka Imai, Randall Jones and Dirk Pilat, three of the OECD's experts on Korea, who have accepted the invitation of the Korean government to be here today and make this important event possible. It goes without saying that I am grateful to Mr. Donald Johnston, the Secretary-General, who has agreed to co-sponsor this seminar.

Korea will mark the 4th anniversary of its accession to the OECD as the 29th Member on December 12, several days from now. The present seminar has been intended to mark this anniversary. The Korean government and the OECD have already held a number of joint seminars and conferences on a range of issues since even before Korea's accession to the OECD four years ago. But the present seminar is their first attempt to jointly undertake a comprehensive brainstorming on the state of the Korean economy in Seoul.

It is no secret that ever since Korea's accession to the OECD there has been controversy in Korea as to whether this was a good decision or not. My thinking on this issue has been that the issue itself is a false issue to Korea, considering the country's current level of development. Furthermore, the controversy stems from the failure to have a correct understanding of the value of membership in the OECD.

By my own analysis, there are at least ten values that membership of the OECD offers Korea and the success of our efforts to join the ranks of the advanced countries will depend critically on how well and evenly we realize those values. The OECD is a very unique international organization and functions like a school for national economic advancement to its members. Korea, in particular, has been struggling on the path toward becoming a fully developed country. In my opinion, had we not chosen to accede to the OECD, the prospect of completing this path would have been beyond our horizon. Considering that joining the ranks of the advanced countries has been among our ultimate national goals and that we now have developed to be a major member of the most advanced developing countries, the accession to the OECD seems to have been a historic choice of inevitability.

I will now list those ten values of the OECD, beginning with the benefit of the so-called peer pressure process of the OECD. As I do so, however, I should also add a few explanatory words about the program of the present seminar because the seminar itself is an exercise in this process.

In this respect, the OECD may be likened to a student seminar course at universities and graduate schools in which students rotate in making presentations, exchanging constructive criticisms and mutually offering recommendations for improvement on those presentations. The OECD is in fact an inter-governmental school offering seminar courses for the mutual and voluntary learning of the member government officials in essentially all fields of economic policies. Such exercises and such learning process are referred to as the peer pressure process. The most important objective of Korea's accession to the OECD was to benefit from this process, to learn from the peers, especially those who are ahead of us, how to improve the management of our economy and society and how to undertake the requisite reforms successfully and effectively.

I hope that, at the present seminar today and tomorrow, we, Koreans, will be able to confirm the value of the peer pressure process by interacting with the OECD experts through presentations and exchange of comments and criticisms.

This interaction will evolve around three topics. We will first discuss the challenges of the so-called "new economy" to Korea, focusing on the telecommunications revolution that seems to be the ultimate driving force behind it. We will then have a critical review of the present state of the comprehensive economic reform that was triggered by the financial crisis of three years ago. Finally, we will address the challenges of globalization, specifically asking how well we are responding to them. The significance of those topics taken together, summed up under the broad theme of "shaping up for globalization," should be self-explanatory.

We are in transition from one paradigm of development to another. For a long time we relied on labor force and borrowed capital, as well as on national firms, especially those in the form of chaebol, for continued economic growth. We pursued a resource-based economy, a government-led economy and a national enterprise economy. Such a paradigm has become obsolete. This was the principal message of the financial crisis. Acceleration of globalization, as well as the accelerated evolution of telecommunications technology, has come to dictate a new paradigm of development which consists of a knowledge-based economy, a market-based economy, and a multinational enterprise economy. The reforms that have followed the financial crisis in effect amount to an effort to shift to this new paradigm of development. In this seminar, we want to evaluate the progress Korea has made in this regard.

It so happens that on December 4, just a few days from now, we will also mark the 3rd anniversary of the Korean government's agreement with the IMF on a bailout program for Korea. Since then the foreign exchange crisis has been overcome and Korea has even graduated from the bailout program. Nevertheless, the structural problems of the Korean economy still persist and, as a result, in the recent past there has occasionally been talk of a possible second financial crisis. This demonstrates how time-consuming, as well as how difficult, it is to complete the requisite economic restructuring. The same facts underscore the significance of the discussions we will have today and tomorrow.

I believe that the present sense of crisis is a blessing in disguise, for it will compel us to continue to try to do better. But trying is not enough. We also need wisdom. I hope that the present seminar will help us enrich our wisdom in this regard.

It is important not to miss a good opportunity. Some people believe that since our financial crisis followed our accession to the OECD within a year, the causation must have run the same way. This is of course a wrong analysis. Would any Korean believe that the crisis would not have occurred if Korea had not acceded to the OECD?

It is on the record that the OECD offered the Korean government a number of good policy recommendations during the examination period which preceded the accession, including the recommendation that, in sequencing the liberalization of the inward international movement of capital, Korea should first liberalize long-term capital rather than short-term capital and before liberalizing the latter, and as a matter of priority, Korea should strengthen the prudential regulation of the domestic financial sector. What I regret very much is the fact that this advice was largely ignored and the movement of short-term capital was liberalized rather rapidly even before Korea's accession to the OECD, whereas the liberalization of long-term capital was postponed to beyond 2000. If these recommendations had been effectively implemented, we might have been able to avoid the financial crisis.

My point is that we should make sure we take full advantage of all the values the OECD offers us. I have covered the first of these 10 values and I will now turn to the other nine;

Second, we can be kept well-informed of the latest economic trends worldwide as well as their implications by participating actively in the discussions at the OECD;

Third, we can enhance the relevance of domestic studies and discussions of policy challenges by coordinating them with the studies and discussions which take place at the OECD;

Fourth, we will be able to make an objective assessment of where we are in terms of development by benchmarking ourselves against other members and by utilizing various developmental indicators produced by the OECD;

Fifth, we are able to make our economy far more transparent by participating in the OECD discussions with presentations and statistics about our economy and through various OECD reports on Korea;

Sixth, we can contribute to the development of the evolving international economic order by participating in the OECD work on international economic issues such as environment, trade, investment, taxation, competition policy, anti-corruption measures, regulation of bio-technologies, and so on;

Seventh, our participation in the discussions on the development of the OECD, itself one of the key players in international governance, will enhance our own international influence;

Eighth, we will enhance our diplomatic influence vis-à-vis the transition economies and the developing countries by taking an active role in the OECD's various programs of cooperation with non-members, in the management and activities of the OECD Development Centre, and by joining the Development Assistance Committee, thereby contributing to the improvement of the development assistance policies for developing countries;

Ninth, our participation in the OECD activities enables Korean government officials to build and utilize an international network with their counterparts in other member governments;

Tenth, there are on the average 800 meetings a year held at the OECD and the participation in these meetings significantly helps to internationalize Korean officials in regard to their professional expertise and diplomatic manners, as well as command of international languages such as English.

The fact that we may derive so many benefits from our membership of the OECD does not necessarily mean that we will in fact do so. A student may enter a good school but, if he does not work hard, he will not gain the benefit of being in a good school. Efforts should be made to derive those benefits to the maximum possible levels. Thus, we should always try to do better. Let me indicate a few directions for those efforts.

To begin with, I would like to report my feeling that, while our efforts to make use of the peer pressure process were very strong during the first two years after the onset of the financial crisis, those efforts seem to have slackened rather considerably during the last year or so. If I am right, I believe that the rapid recovery from the foreign exchange crisis has given rise to complacency, weakening those efforts.

We continue to derive many benefits in the areas of raising the transparency of the Korean economy, benchmarking our developmental progress and internationalization of officials. In the areas of making use of participation in international trends analysis and contributing to the development of the international economic order, I am afraid that our efforts have been rather passive and lukewarm all along. The same assessment seems to apply to our efforts in all other areas as well. The benefit of international networking has been rather weak, I believe, because of rapid rotation of Korean government officials at all levels.

I have shown that the benefits which can be derived from our membership in the OECD are rather diverse. I have also argued that many of those benefits remain to be exploited by us to a much fuller extent. I believe that these two facts together constitute a blessing to us in the sense that, by trying harder, we can make our participation in the OECD activities even more beneficial for the purpose of advancing our national development. What good news! And how nice it will be if the seminar today and tomorrow will help us see those opportunities and strengthen our will to seize them!

I am now ready to close my keynote speech and invite to this podium Mr. Schlögl, Deputy Secretary-General and my Co-chair for this seminar. Mr. Schlögl is an eminent German economist with a Ph.D. and has had many years of experience with the making and implementation of policies as a senior official in the German Ministry of Economics. At the OECD, he is responsible for preparing the annual Ministerial Council Meeting as well as for coordinating and directing the work on trade, investment, e-commerce, and bio-technology, among others. With these introductory words on Mr. Schlögl, I conclude my speech.

Thank you very much for your attention.

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Keynote Speech

Herwig Schlögl
Deputy Secretary-General
OECD

Good morning Ladies and Gentlemen!

Let me say again it's a great pleasure for me to join you here for a very interesting conference. First of all, I would like to thank the Minister for Trade, Dr. Han Duck-Soo and KIEP to organize this conference together with the OECD. Especially, I would like to thank Ambassador Soogil Young for taking the initiative for this conference, which of course, was very gladly taken up by the Secretary-General, myself and my colleagues.

Ambassador Young said so much positive things about the OECD. Let me say a few things about the role of Korea in the OECD. You may be familiar with the basic criteria to be part of the OECD: development, market economy and you have to have sufficient level of economic development. These are the criteria, which are fully met by Korea. Nevertheless, Korea is still an economy and country which is in a reform period from a government-directed economy to a market driven economy. But what really counted was the overwhelming role and commitment to reform by the representatives of the Korean government, parliament and by the Korean society as a whole.

Ambassador Young represented Korea in Paris in very difficult times including 1997 and 1998, the time of the so-called Asian crisis. Ambassador Young is a most able spokesman and interpreter of the issues and problems of his own country and at the same time, most able in interpreting best practices, policies and in bringing them back to Korea to help the Korean government overcome the difficult times. So, let me again thank especially Ambassador Young for playing this role and for contributing to our work in a sense that goes beyond the traditional OECD countries which used be the old industrialized countries, starting in Europe, including the US, Canada and Japan. Now the number of OECD members reached 30 countries that have diverse levels of development and of policy approaches.

Let me say a few words about the way Korea developed after the WWII and the Korean War, and then a very few words to the actual situation and the perspectives. My colleagues will take up more specific issues. I think, in spite of the serious crisis in 1997 and 1998, we must not forget where Korea has come from. After the WWII and the terrible Korean War, Korea was one of the poorest countries in the world. Over four decades, Korea became not only an industrialized but also a country which manages to take the lead in certain hi-tech industrialized areas. I think this is very important in the increasingly globalizing areas where the new-technology plays a key role. Let me mention a few areas in which Korea became the world leader. Korea is not just leading in the industries like shipbuilding and steel but now also leading increasingly in the ICT (information and communication technology) sector.

With this background, we have to look at the crisis in 1997 and 1998. I will not repeat the explanation of the Asian crisis, for it was made clear by the Trade Minister and by Ambassador Young that the OECD was not the cause of the crisis. But certainly one main set of causes was a very fast expansion in the corporate sector financed by relatively cheap credits and not looking carefully at profit. It was an expansion which not only covered the internal market but also had global markets in perspective.

So I think the Korean situation in the Asian crisis taught us a very important lesson. It is that even if you have good macroeconomic conditions, not huge budget deficit, not huge inflation, not even huge unemployment, even if you have a quite positive overall macroeconomic situation, the economy can fail. The economy can fail because of the structural side and institution of the corporate sector and the financial sector, maybe even such areas as industrial relations and the labor market. If these structures and institutions are not meeting the modern standards, the economy can fail although you have a very positive macroeconomic environment. However, this is at the same time a great opportunity for a country to reform and quickly get out from the crisis. The Korean macroeconomic environment is still relatively good, Korea has hard working people and they increasingly have very good education. What you have to do is to reform the structural impediment and to establish functioning and transparent institutions.

I think Korea and the Korean government is performing very well. I was personally even impressed by the determination of reform not only by governments like the Korean government but the Mexican government who by the way joined the OECD around the same time as Korea. To some extent, Mexico has the same problems as Korea. But again, you can also find that countries like Mexico have determination to reform. Sometimes I can say the rich European countries like Germany sometimes missed it.

However, I'm not saying Korea is on the same level as the rich countries in Europe or in North America. But the policies are going in the right direction. This does not mean that all the problems are solved. I have to be very clear and we'll address them in this seminar. The colleagues from the OECD and the colleagues of the Korean side will address issues like further reform in the corporate sector, labor market, social safety net and reform in the financial sector. All these sectors, we'll have time to touch on.

Again, thank you very much!

SESSION I

THE NEW ECONOMY AND KOREA

The New Economy: Prospects and Challenges

Dirk Pilat
Principal Administrator, STI/EAS
OECD

1. This presentation provides an overview of OECD work on the new economy and the challenges and prospects that the emergence of such an economy – if it exists – may pose to Korea. This presentation draws on three recent OECD studies, notably a July 2000 report "A New Economy: The Changing Role of Innovation and Information Technology in Growth"; the September 2000 Economic Survey of Korea; and a forthcoming OECD/Worldbank publication on "Korea and the Knowledge-Based Economy". Executive summaries of the first and the third publication have been made available to you and my colleagues from the OECD Economics Department will be able to provide more information on the Economic Survey.

2. Let me first say a little about the OECD work on growth and the new economy. This work is driven by a demand of OECD Ministers in 1999. Growth rates have diverged in OECD countries in the 1990s. At the same time, the United States experienced very strong growth. The OECD Ministerial Communiqué of May 1999 requested the OECD to address these variations in growth performance:

> "Growth performance varies considerably across and within OECD countries. Ministers asked the OECD to study the causes of growth disparities, and identify factors and policies (such as rapid technological innovation and the growing impact of the knowledge society and its demand on human capital, the arrival of new service industries, the best framework conditions for fostering the start-up and growth of new enterprises including SMEs ..) which could strengthen long-term growth performance."

3. Over the past year, the OECD has engaged in a range of studies to follow up on this mandate. An interim report was delivered to the June 2000 meeting at Ministerial level, and several other studies were published or released as working papers. Much of this work is available at a special website of the OECD, linked to this project. The work completed thus far has been partly of a fact-finding nature, *e.g.* analysis of trends and patterns in recent economic growth. In the coming year, OECD will further deepen its analysis of growth, with the aim to deliver a policy report to the OECD Ministerial meeting in May 2001.

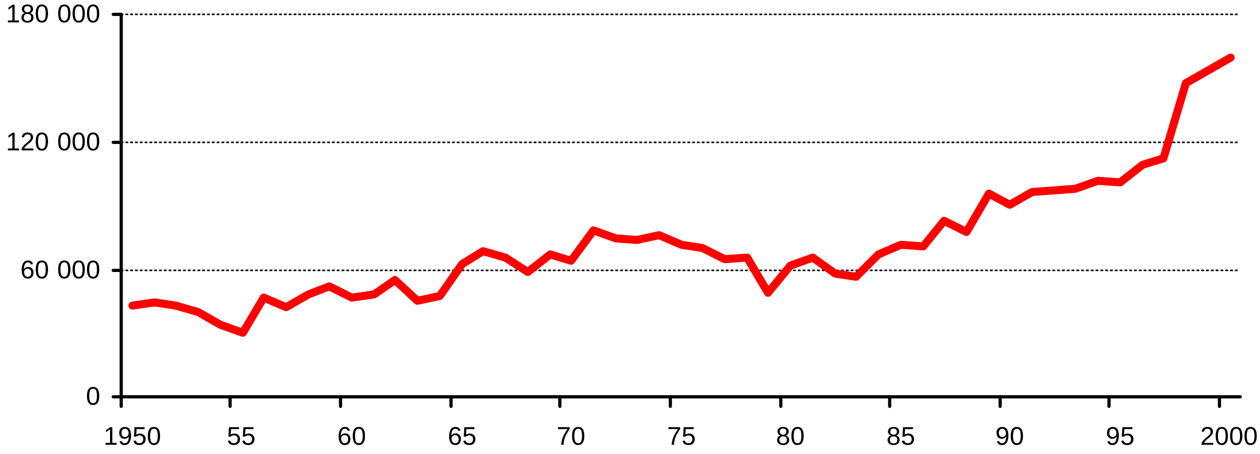
4. Let me first look briefly at growth patterns. Four patterns emerge. First, GDP per capita did diverge in the 1990s and picked in only a few. Growth was higher in a few high-income countries, such as Australia, the Netherlands and the United States. But growth in Japan, and in much of continental Europe, slowed down, in some cases linked to macroeconomic shocks. Korea, of course, also experienced a major shock, which implied slower average growth in the 1990s. Second, growth in some countries was supported by improved labour market performance. Third, capital deepening, in particular in information and communications technologies, supported growth. And finally, more rapid growth of multi-factor productivity in some countries may point to more rapid technological progress.

5. What drives these patterns? First, macro-economic policy continues to matter. Recently, inflation has been low, public deficits in better shape and cyclical conditions strong. Second, evidence for countries such as Australia, Denmark and the Netherlands attributes their strong economic performance primarily to a long process of structural reform. All of these countries have followed many of the recommendations of the OECD Jobs Strategy and have strengthened competition. But some factors also seem more important than in the past, notably a more rapid pace of innovation, the strong impact of information and communications technology, a growing importance of the right skills and of human capital more broadly, and a growing role for new firms and entrepreneurship.

6. Let' s briefly look at these four new factors in more detail. First, innovation is more central to economic growth. Innovation has become more market-driven, more rapid and intense, and more widely spread throughout the economy. Innovation is also closer linked to scientific progress, in particular in key fields such as ICT and biotechnology. Innovation now draws on a wide range of scientific and commercial knowledge, so that there is a need for co-operation to reduce uncertainty, share costs and knowledge. Start-up firms are important sources of new ideas and innovation. They often have an advantage over larger firms in new areas where demand is unclear, risks are large, and the technology has yet to be worked out. Finally, spending on innovation is on the rise in many countries, in both the public and the private sector.

7. Several indicators illustrate these developments. First, patenting is increasingly rapidly, particularly in ICT and biotechnology, ...

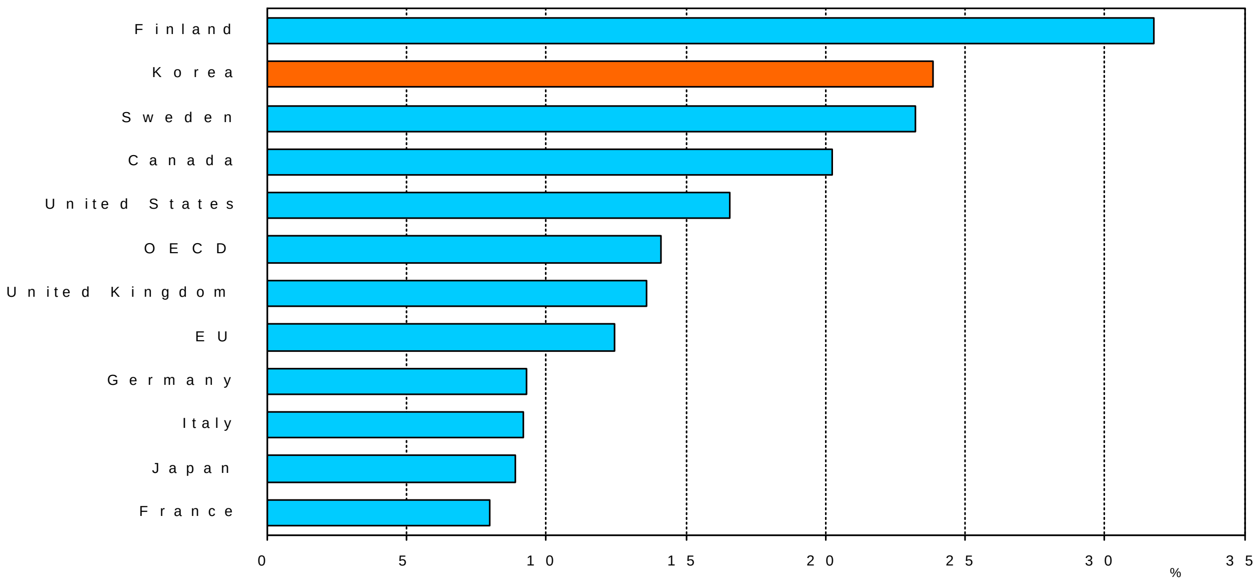
<Figure 1> Number of patents granted in the United States



Note: Patents granted in the US originate from all countries, with around 45% being of non-US origin**.**

8. ..with Finland, Korea, Sweden, Canada and the United States accounting for the most rapid growth in patenting in the ICT area in the United States over the 1990s. OECD analysis also suggests a strong link between R&D and the growth of MFP in the 1990s, with private investment as the key driver.

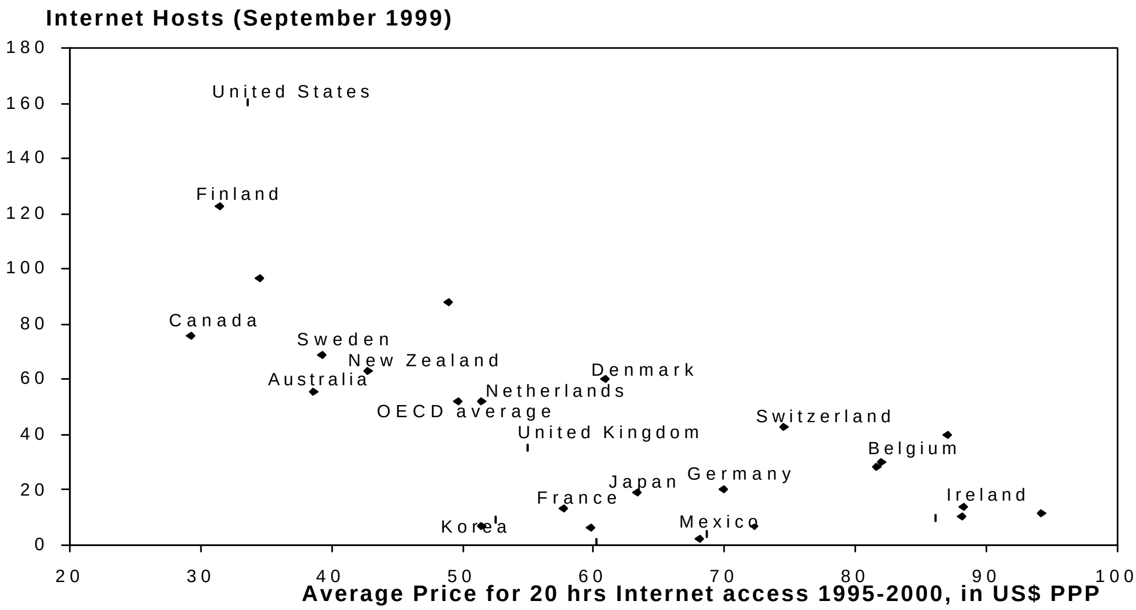
<Figure 2> Growth in ICT patenting at USPTO, 1992-99



9. The second new factor is ICT. Over the past 40 years, computer prices have dropped sharply, while their capacity has increased tremendously, which has contributed to the substitution of ICT for other capital goods and for other factor inputs. The diffusion of ICT accelerated after 1995 as a new wave of ICT spread rapidly throughout the economy. These new technologies link the existing capital stock of computers and communications systems in a network that significantly increases their utility. Services sectors such as finance and business services lead in investment in ICT. Many services have become more productive, more innovative, more tradable, and more exposed to competition. ICT has other effects. It is a key technology to speed up the innovation process, it has fostered greater networking in the economy, it enables faster diffusion of codified knowledge and it has helped to make science more efficient and linking it more closely to business. The ICT sector, itself, of course, is a key driver of growth and productivity in many OECD economies. And the Internet, as one of the latest applications of ICT, may offer a whole new range of options for new products, services and innovation.

10. OECD analysis confirms these trends. The contribution of ICT capital to output and labour productivity growth has been significant and rising in relative terms. In Canada, the United Kingdom and the United States, ICT equipment contributed about half of fixed capital's contribution to output growth. About half of the uptick in US MFP growth over the period 1996-99 occured in industries other than ICT, perhaps indicating that there are some spill-overs of ICT on the economy.

<Figure 3> Internet penetration and average costs of access

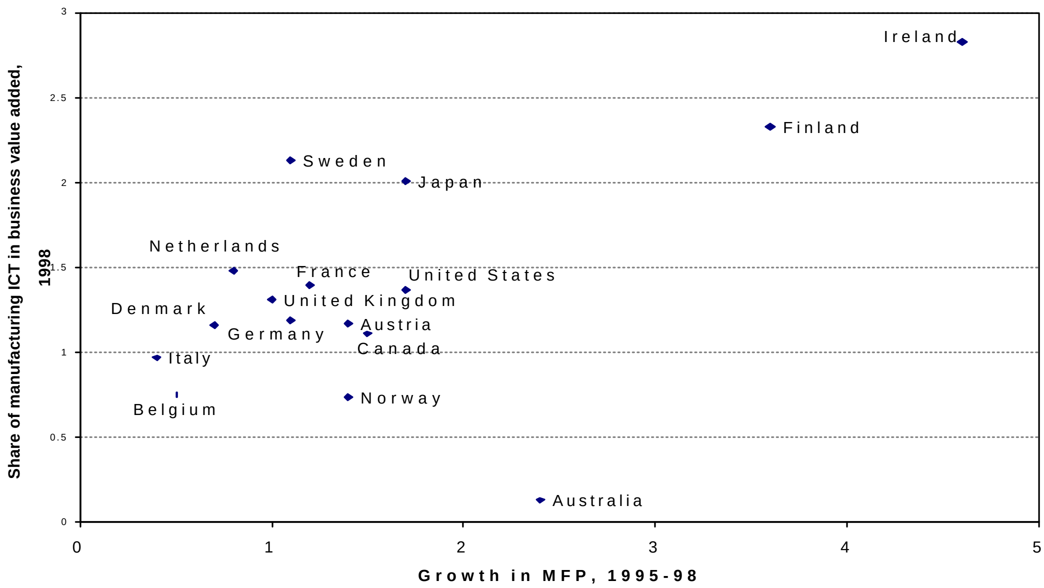


11. OECD countries differ in their take-up of ICT, however, partly due to the varying pace of telecommunications market liberalisation. Where it is slow, this has limited investment in the necessary infrastructure and raised costs. Many successful OECD countries moved early to liberalise the telecommunications and information technology industries. The Nordic countries, the United States and Canada are the leading nations in terms of Internet host density. Regulatory frameworks, the pricing of local calls – including the taxes imposed – and a low critical mass of ICT users in some countries are among the important factors that contribute to cross-country differences in the diffusion of the Internet.

12. The ICT sector itself also plays an important role in productivity growth in several OECD countries, as it is characterised by high rates of technological progress. A recent OECD study measures the size of this sector, which includes ICT manufacturing but also ICT services. This study suggests that Korea currently has the largest ICT sector, measured as a percentage of total employment in the business sector.

13. The ICT producing sector provides a considerable contribution to productivity growth in several OECD countries, and explains a considerable part of the pick-up in productivity growth in the United States in the second half of the 1990s. Some countries with a large ICT sector (Finland, Ireland) have experienced above-average MFP growth in the second half of the 1990s. But some countries with a small ICT sector, such as Australia, have also observed rapid MFP growth,

<Figure 4> The size of the ICT manufacturing sector and MFP growth



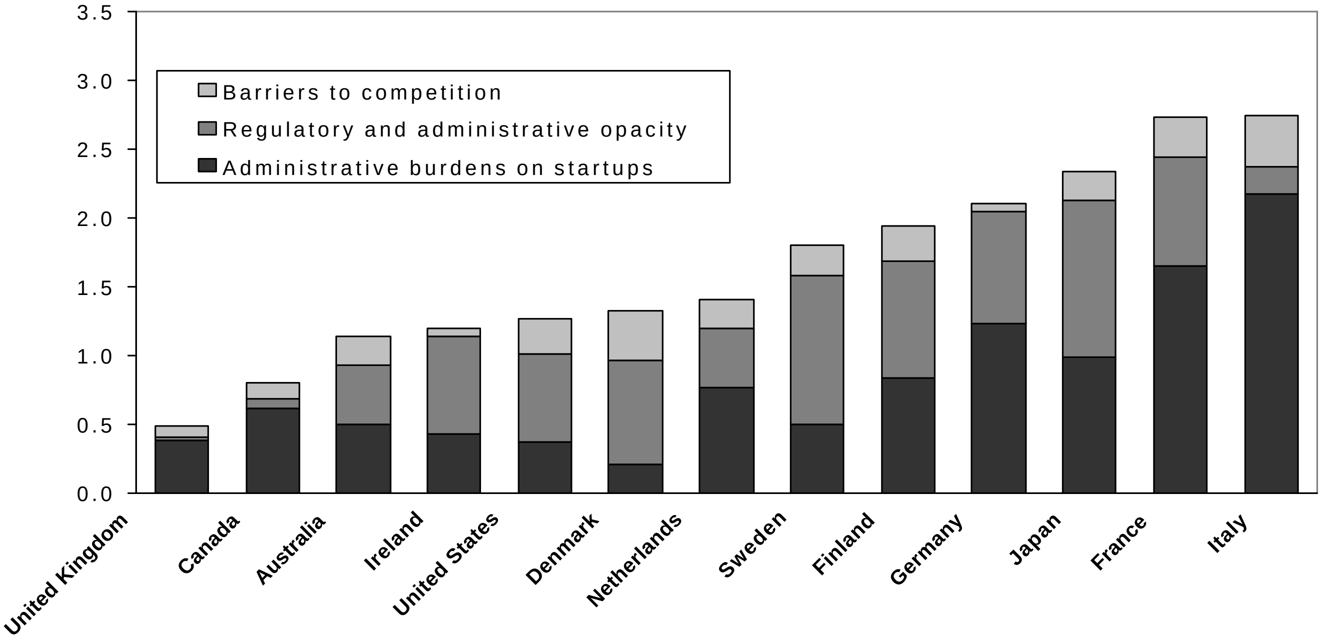
suggesting that a large ICT sector is no necessary condition for higher MFP growth.

14. Third, while ICT has allowed increased codification of knowledge, large amounts of knowledge remain embodied in people's skills, experience and education. Human capital is crucial to the new economy and surveys point to a lack of skilled personnel as one of the greatest barriers to innovation and the application of ICT. Recent OECD analysis shows clearly that the accumulation of human capital is an important pillar of growth and innovation. Some aspects have become more evident in the 1990s. First, initial levels of education are no longer sufficient in an economy which demands change continuously. Lifelong learning is increasingly important. Second, the skills required by an economy more based on innovation and technological change – creativity, working in teams and cognitive skills – were less needed in the past. Third, in some countries, shortages of specific categories of highly skilled personnel, such as ICT workers and scientists and engineers, have emerged in recent years, a potential sign of specific rigidities in these areas. In recent years, some countries have relied on immigration to fill these needs. Fourth, owing to the growing importance of personnel mobility for innovation, barriers to mobility and rigidities in education and training systems may inadvertently reduce knowledge flows within an economy.

15. And finally, start-up firms have gained prominence in the innovation process, as they are important sources of new ideas and innovations. In emerging areas, where demand patterns are unclear, risks are large, and the technology has not been worked out, small firms have an advantage over large established firms. They can be more flexible, are more specialised and may also be better at channelling creativity and providing the right incentives than large firms. New mechanisms, such as venture capital and the associated entrepreneurial expertise, have allowed these firms to grow rapidly. The changing innovation process has brought small start-up firms to the fore, as they are exploring new frontiers (electronic commerce, genetic engineering) and developing specialised niche markets. While data are limited, there are indications that the United States has experienced the strongest growth in such firms, which may be linked to low barriers to entry, high personal returns to entrepreneurship and low penalties on bankruptcy.

16. OECD data suggest that barriers to enterpreneurship, related to competition, regulations and administrative burdens differ substantially across the OECD. Korea is not included in the data shown here, due to incomplete data for certain variables, but the available numbers for 1998 suggest that Korea would most likely be in heavily regulated part of the graph.

<Figure 5> Barriers to entrepreneurship, 1998



17. What are the broad policy lessons that can be drawn from this work? First, countries with strong economic performance have been persistent reformers of product and labour markets, have strengthened competition and moved to a more market-based economy. Second, openness to trade, investment, knowledge and people is of growing importance in a global economy, where the required knowledge may be found across the world. Third, improving the conditions for start-up firms and entrepreneurship is of great importance for the emergence of new industries, such as ICT and biotechnology. And fourthly, sufficient public and private investment in capabilities is important to benefit from global knowledge; investment in science, education and infrastructure are important. But old factors still matter and the economic principles and rules that underpin OECD economies have not fundamentally changed.

18. How is Korea doing in this new economy, if it exists at all? Very good on some accounts. Education is at a high level, private expenditure on R&D is high, innovation in key areas, such as ICT and biotechnology, is strong, and Korea is well placed in the ICT sector.

19. But there are also important concerns. First, the innovation system requires reform. Universities provide only a small contribution to innovation, links between science and industry are weak, basic research is underdeveloped and links with the global economy need to be strengthened. An important element is the reform of universities, e.g. by the creation of centers of excellence, and by reforming regulations that govern the interaction between scientists and industry. Basic research will also require greater emphasis, in both the private and public sector. Funding will also need to be made more efficient, by the introduction of greater competition for public funding and by regular

evaluation and monitoring of policies in this area. And finally, stronger networks will need to be built within the Korean innovation system and between the Korean innovation system and the international community.

20. Second, the take-up of ICT remains limited, at least in certain areas. PC use is quite limited compared to international standards, and the spread of Internet hosts and secure servers for electronic commerce is low compared with leading OECD countries. Further regulatory reform of the telecommunications sector can help to further reduce costs and enhance diffusion. Unbundling of the local loop is of particular importance, and is a key policy issue in most OECD economies. The absence of competition in the local loop enables dominant operators to disregard the changing needs of businesses and users in relation to electronic commerce. The structure of pricing is at least as important as its absolute level, however. Policies encouraging the deployment of high-speed Internet access options also hold tremendous promise for improving Internet access, although these should also provide for competition. In the Korean case, too much emphasis may also have been placed on the ICT sector itself, potentially at the cost of the development of ICT services and the diffusion of ICT across the economy. Efforts to move to electronic government are also an important priority, both to improve the efficiency of government itself, but also to help create a critical mass for electronic commerce and ICT.

21. Third, the education system requires reform. While the overall level of educational achievement is high, the system does not meet new demands for creativity, flexibility and entrepreneurship. A greater focus on outcomes, rather than inputs in the system, may also be needed. New skills, such as communication, ICT, working in teams, will need to become a core part of the curriculum. To do this, educational institutions, and universities in particular, will need to establish closer links to the business sector, to better understand emerging needs and involve business in programme development. Informal education and life-long learning, in particular, will require greater emphasis as opposed to formal education. The evidence also suggests that a firm's effective use of ICT typically requires organisational change, restructuring and investment in human capital. While some of these are beyond the scope of government policy, governments can create an environment that is supportive of such change. It would entail the ability of firms to restructure without undue restrictions, flexible labour markets, ease of entry and exit in particular markets and measures that facilitate the mobility of personnel. Korea's existing system of industrial relations may not yet be well suited to these conditions.

22. And fourthly, the creation of new firms can be stepped up. While much progress has been made since 1998, barriers to the creation of new firms remain in place. Government policy may have focused too much in the past on the protection of SMEs, sheltering them from competition. Greater competition, and the related changes to corporate governance that will be discussed by my colleagues, will help to establish a more market-driven economy. Values such as

risk taking and entrepreneurship may also require greater emphasis to establish a more friendly business climate for new firm creation.

23. Much progress in several of these areas has been made in recent years and much reform is underway or in the process of being implemented, e.g. ongoing reform of the education sector, ambitious plans to improve the diffusion of ICT across the economy, a new science and technology strategy and ongoing efforts to establish a more market-based economy. The experience of other OECD countries suggests that the implementation of these reforms, their critical evaluation and monitoring are of great importance to success. In addition, efforts to build consensus for reform and involve stakeholders in the reform effort are often key to long-lasting change. Korea seems on a good track. Thank you.

The Korean Perspective on the New Economy

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Director General of Economic Policy Bureau
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I. New economy and recent trend of the Korean economy

Recent economic performances of low inflation and high economic growth in the US and European countries such as Sweden and Finland are well beyond the expectations based on their past performances.

This sparks debate as to whether these performances are sustainable, resulting from fundamental changes or just a temporary phenomena. The debate still seems far from conclusion. According to advocates, the concepts of New Economy are a little different. But they seem to share the following elements: IT revolution boosts productivity growth and globalization facilitates competition, which make higher economic growth with reduced price pressure possible.

As the Korean economy recently posted good economic performance of high growth and low inflation, some observers raised the possibility that Korean economy might be entering into a New Economy era.

In the following sections, recent performance of Korean economy will be evaluated from the perspective of the New Economy, and then, key issues regarding what needs to be tackled in order for Korean economy to reborn as a New Economy or to keep a good record of recent economic performance will be addressed.

II. Possibility of New Economy in Korea

1. Recent performance of Korean economy

After a severe recession in 1998 caused by the 1997 economic crisis, the Korean economy has posted high growth and low inflation since 1999.

Economic growth rate of 10.7% in 1999, 11.1% in the first half of this year respectively are well beyond the average growth rate of 5.9% or estimated potential growth rate of 5~6% in the 1990s.

And also inflation rate of 0.8% in 1999, 1.5% in the first half of this year are remarkable, compared with the average inflation rate of 5.4% in the 1990s.

Driving force behind this performance is the rapid development in ICT(information and communication technology) industry since the mid-1990s. During the 1990s, the annual average value-added increase rate in ICT industry reached 23.9%, highly exceeding the annual average growth rate of 5.9% in the same period.

Futhermore, value-added increase rate accelerated to 41.2% in the first half of this year. This outstanding performance in ICT industry lead to a great contribution rate of 45.9% to the economic growth in the first half of this year. Reflecting the brisk pace of growth of ICT industry, the share of ICT industry in nominal GDP jumped up from 3.7% in 1991 to 7.6% in 1999.

<Table 1> Growth rate trend of ICT industry

(unit: %)

	1991	1994	1997	1998	1999	2000 1st half	91 99 avg.
real GDP growth rate	9.2	8.3	5.0	-6.7	10.7	11.1	5.9
growth rate of ICT industry	10.7	26.4	30.5	20.7	41.1	41.2	23.9
Contribution rate of ICT industry to real GDP growth	3.6	12.1	37.6	-23.8[1)]	38.3	45.9	
share of ICT industry in nominal GDP	3.7	4.7	5.6	6.3	7.6	··	

Note: 1) Since real GDP decreased, negative(-) contribution of ICT industry to the growth of GDP means that positive contribution to the GDP itself(1.6%p growth rate).

In terms of prices, ICT industry has also played a important role by contributing to the stabilization of the price level. While producer price index increased by 4.4% on average during 1995~99, prices of ICT products decreased by 2.9% on average in the same period. Particularly in 1999, prices of ICT products decreased by 5.4% and contribute to changes in producer price index by minus 0.8%point.

<Table 2> Trend of prices changes of ICT products

(unit: %, %p)

	1995	1996	1997	1998	1999	1995~99
Changes in producer prices index	4.7	3.2	3.9	12.2	-2.1	4.4
changes in prices of IT products	-2.6	-1.8	-2.6	6.7	-5.4	-2.9
contribution of IT products prices changes to changes in producer prices index (%p)	-0.4	-0.3	-0.4	1.0	-0.8	-

Progress in infomatization in Korea is as follows. As of the end of 1999, PC supply estimated as the number of PCs per 100 persons reached 18.8%, far behind advanced countries levels of 40~50%.

<Table 3> PC supply

Country	Number of PCs per 100 persons			Country	Number of PCs per 100 persons		
	1997	1998	1999		1997	1998	1999
Singapore	40.0	45.8	52.7	Finland	31.1	34.9	36.0
US	40.7	45.6	51.1	Netherland	28.1	32.4	36.0
Sweden	33.9	39.5	45.1	Japan	20.2	23.7	28.7
Denmark	36.0	37.7	41.4	Italy	11.3	17.4	19.2
Luxemburg	38.3	38.9	39.6	Korea	15.1	16.9	18.2

Note: PC supply in Korea is estimated as new supply fore recent 4 years.
Sources: Electronic industries Association of Korea (2000. 4)
ITU. "World Telecommunication Indicators." 2000. 7.

However, in terms of internet usage, Korea is keeping up with advanced countries with over 16 million internet users. Subscribers to high speed internet service reached 3 million, which is the highest in the world. And mobile telephone penetration rate is over 50%, which is among the highest in the world. E-commerce in Korea is still in the initial stage, but increasing rapidly. B2C e-commerce in August of this year posted 11.45 billion won, accounting for 1.1% of total retail sale, which surpassed 0.68%(2000.1/4) of US and 0.1%(99) of Japan. B2B e-commerce size is estimated to be than B2C and has also being growing rapidly.

<Table 4> E-commerce in Korea

(unit: 100 million won)

	1996	1997	1998	1999	2000
B2C	14	63	150	2,464	11,389
B2B	140	216	590	98,617	175,208

Note: Numbers for 1999, 2000 are estimations by KISDI.
Source: KISDI(2000)

2. Evaluating the Prospects for Korea in the New Economy

The issue of whether recent performance of the Korean economy could be seen as a sign of New Economy will be addressed in the following.

1) Productivity aspect

Recently, the Bank of Korea analyzed productivity increase of overall industries, categorizing industries into three groups: ICT industry, highly ICT-used industry such as machinery, transport and finance, and ICT under-used industry such as construction, chemicals and distribution services.

According to that study(2000.11), productivity change is noticeable only in the ICT industry while insignificant or unclear in other industries. Total factor productivity(TFP) in ICT industry increased by 14.3% on average in 1994~97, exceeding the annual average increase rate of 9.8% in 1990~93. Particularly, the increase rate of TFP in ICT industry in the severe recession of 1998 reached as high as 14.6%. Even with business cycle factors eliminated, TFP in the ICT industry increased by 9.2% during 1990~93, 11.5% during 1994~97, 14.5% in 1998, 21.3% in 1999.

On the contrary, increase in TFP has yet to be clearly shown in industries other than ICT industry. TFP in highly ICT-used industry increased only by 1.4% on average during 1994~97, below the average increase rate of 2.3% during 1990~93. The increase rate picked up in 1999, after sharply decreasing in 1998, which was analysed to be caused by the business cycle factor.

TFP in ICT under-used industries increased by 2.2% on average during 1990~93, exceeding 1.5% during 1994~1997. However, with business cycle factors eliminated, the economic trend reversed to a downturn.

<Table 5> Trend of changes in TFP

(unit: %)

	1976 99	1990 93	1994 97	1998	1999
ICT industry	10.5	9.8(9.2)	14.3(11.5)	14.6(14.5)	32.2(21.3)
ICT highly used industries	0.0	2.3(3.4)	1.4(3.0)	-15.0(1.1)	8.6(1.6)
ICT under-used industries	0.1	1.5(2.4)	2.2(1.3)	-18.1(-2.9)	4.9(-1.6)

Note: Numbers in ( ) are growth rates without business cycle factors.

2) Others

While productivity increase of the overall economy has yet to be shown, we should be cautious in concluding that there are no New Economy factors. For example, as with the cases in other countries, statistics on productivity in Korean economy does not fully cover productivity changes in the services sector, such as quality improvement caused by the growing use of ICT technology.

Globalization, in particular, market opening in distribution service sector contributed to structural reform and reduced price pressure, resulting from fierce competition brought on by large-scale foreign distribution service suppliers.

However, it is likely that recent economic performances are not in relevance to New Economy phenomena.

First of all, technical rebound from the severe recession caused by economic crisis is clearly reflected in recent high growth rate.

Second, appreciation of the Korean won since 1999 contributed to the stabilization of prices by reducing the prices of imports.

<Table 6> Trends of changes in Won/Dollar Exchange

(unit: %)

Year	1996	1997	1998	1999	2000.1~10
₩/$ (yoy, average)	803.6 (4.2%)	951.1 (18.4%)	1,398.9 (47.1%)	1,189.5 (-15.0%)	1,119.9 (-5.9%)
changes in prices in imports	0.7	9.5	28.2	-12.1	9.1

Third, it seems premature to conclude that investment in ICT capital lead to productivity increases in the overall economy, taking into account that ICT capital stock still accounts for a small share of total capital stock. (Estimated share of ICT capital stock in 1999 is 5.2%)

Furthermore, against the US economy which has shown a long 10-year boom, the recent Korean economic boom period is too short to be regarded as sustainable or a trend.

Many domestic research institutions and international institutions seem to share the view that recent economic performances can be attributed to the business cyclical factors. Their economic forecast of the next year are relatively gloomy, although not entirely bad.

<Table 7> forecast on Korean Economy in 2001

WEFA(00.8)		IMF(00.9)		KDI(00.10)	
Growth	consumer price	growth	consumer price	Growth	Consumer price
6.0%	4.9%	6.5%	3.0%	5.4%	3.7%

It would be fair to say that the Korean economy is very unstable at the moment, considering the various uncertain domestic and foreign factors. And, it would be more relevant to address the issues of what should be done in order to stabilize the Korean economy and of conditions needed for the recent performance to be sustainable, rather than the issue of whether Korean economy is approching the New Economy era.

III. Policy tasks ahead for a New Economy era

There are many tasks ahead that need to be addressed before we can talk about a New

Economy era or improvements in efficiency of economic system: improvement in flexibility in labor market, efficient R&D system, accelerated deregulation and so on. Among these, only a couple of key tasks will be addressed here.

1. Round-up of economic structure reform and set-up of the market economic system

Among the most serious challenges the Korean economy faces are completion of the second round of economic structure reform and set-up of the market economic system. Without strengthening economic fundamentals and normalization and facilitation of market functions through the structure reform, steady and stable economic growth is difficult to achieve. (* Details on economic reform are left for the second session) With regard to facilitation of market function, setting up institutional framework for rapid exit and entry of firms is one of the key tasks.

Considering that the number of unemployment inevitably increases in the process of structure reform, job creation to deal with the unemployment issues must be addressed. Thus, favorable environments for the rapid establishment of start-ups are essential.

As is the case in Sweden where administrative procedures for the creation of a new company can be completed within 5 weeks, administrative huddles should be made lowest for start-ups.

2. Informatiztaion

Given the facts that ICT industry has played a leading role in economic growth and that greater portion of the world economy is turning digital , efforts to reinforce the social and economic foundation fitting for a knowledge-based society should be reinforced.

In regard to informatization, while rapid construction of information infrastructure is underway, there is a growing concern that shortage of IT experts will work as a bottleneck in informatization.

According to the Ministry of Information and Communication, the demand for IT experts is forecasted to reach 1.5 million by the year 2004 recording an increase from 1.07 million as of the end of 1999. This can be translated into a shortage of 210,000 personnel by 2004.

<Table 8> estimated shortage of IT personnel by sector and academic degree (2000~2004)

	Master, doctorate	bachelor	junior college graduates, etc.
software	12,032	65,467	-
communications	1,295	1,633	13,122
web services, contents	10,502	56,766	-
hardware, components	1,052	7,477	41,771

Taking into consideration that most countries suffer shortage of IT personnel and that worldwide competition in recruiting IT personnel is getting tougher, attracting foreign IT personnel may be limited.

Even though the Korean government introduced 'Gold Card' system to ease the conditions of obtaining the permission visas, basic social and economic environments in Korea are inferior to those in other advanced countries. In addition to foreign IT personnel recruiting efforts, it is imperative that we train our own IT personnel.

The Korean government has implemented various program to nurture IT personnel, including greater financial support to IT-related graduate schools and private academies, so that they may be equipped with the state of the art computer facilities in the course of training students.

In light of the importance of IT personnel, the private sector must redouble their efforts to nurture IT personnel through methods including cooperation with foreign education and training centers.

For the Korean economy to transform into a Digital Economy or New Economy, informatization of traditional industries and expansion of B2B e-commerce are prerequisite. Given the dominant share of traditional industries, it is hard to expect the Korean economy to leap into an advanced economy without their improvement in efficiency through informatization.

The Korean government is making its best effort to foster favorable environments for informatization and B2B e-commerce. Such efforts include a certain degree of tax exemption for e-commerce related investments and financial assistance for B2B e-commerce model development.

However, without active and voluntary participation of traditional companies, effects of such programs are limited. Recognizing the advantage of efficient management, cut in stock and procurement cost through informatization, companies should invest in ICT capitals in a more forward looking manner.

Comment

Seoghoon Kang
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Sungshin Women's University.

I have some comments on the "New Economy" in terms of its applicability to a small open economy like Korea. The main features of the New Economy can be characterized by high economic growth and low inflation rate. It appears that most of these new phenomena can be explained by the rapid technological innovation especially in the information and communication technology (ICT) industry and the worldwide trend of globalization. In Korea's case, however, economic growth heavily depends on the amount of export, which again highly depends on international business cycles, and the inflation rate is also determined by the import price, especially the international oil price and the Korean Won's exchange rate. Korea has enjoyed high economic growth and low inflation rate during the last two years. The apparent "Korean version of the New Economy" may not be the result of technological progress nor globalization. Most of it can be explained by the favorable external environment and the devaluation of the Korean Won. We need further research regarding the applicability of US-experienced New Economy to small open economies including Korea.

In view of national strategies, we need to further study how to balance the new economy-oriented industries mostly in the service sector, and the old economy-oriented ones mostly in the manufacturing sector. It should be noted that Korea's rapid economic growth during the last three or four decades is the result of the Korean government's industrial policy emphasizing on manufacturing. With the current level of Korean industries' technologies and innovation capabilities, Korea seems to have no other choice but to depend on the standard technology and low cost based manufacturing industries at least for a while. The name of the game in the New Economy for Korea is not whether the Korean economy can be regarded as a new economy or not, but how much emphasis should be put on the traditional manufacturing industries and the new service industries. For this matter, I have to mention that the New Economy that the United States enjoyed in the 1990s is based on the strengthened competitiveness of its manufacturing industries in the 1980s.

Now I have some comment on the role of education and human resources management (HRM). When we say the New Economy, the human resource management and reform of the educational system are always amongst top ranked topics. For the reform of educational system and human resource management, the role of government or generally speaking of public sector has been emphasized. My point is that we should rather put more emphasis on the "human resource management industry". I intentionally use the word "industry". Educational and HRM reforms should all be more based on the incentive mechanisms of the private sector. The government's role should be restricted to helping the people who need social protection and public education system. It is desirable that private HRM firms carry out such functions as employment projection, technological training and development of innovation system.

Another point that I want to make is that the role of female work forces in the era of the New Economy. It is generally agreed that female work forces may be relatively more suitable to new industries that do not require physical strength. We need further study how to break down barriers to the greater participation of female work forces in the economy and to fully utilize these valuable human resources.

Comment

Dong-Pyo Hong
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Korea Information Society Development Institute

The digital revolution, as a foremost subject of the world economy in the new millenium, has brought about fundamental changes in the economic, social and cultural structures across the world. In the digital economy based on the development of information technology (IT), it is possible to transfer massive information without limitation of time, space and cost. Consumers, firms and the government are now reaping lots of benefits through more efficient transaction. First, consumers are now able to purchase diverse goods more conveniently at lower prices. The advances in technology have increased the efficiency of firms' activity, reducing costs in the field of procurement, inventories, sales and distribution. From the perspective of national economy, the digital economy is expected to lead to higher production levels and to create more jobs through market expansion and new industry creation. The New Economy theory explains the current high growth, low unemployment and inflation rate of US economy as traits of the digital economy.

Yet, not every firm or country is able to enjoy the benefits of the digital economy. As we have discovered through the analysis of various cases, maximizing the benefits from IT investment requires the establishment of a new economic structure, one that is completely different from the conventional one. There are many differences between the law of digital economy and that of the existing economy.

Korea's recent growth in the IT industry is significant. Despite the foreign currency crisis in 1997, the growth rate of IT industry is over twice that of other industries and its portion in total GDP in 1999 is a significantly high 10.7%. As seen in the high rate of mobile communication and Internet users out of the total population, Korea is running fast in the informatization race. This growth, however, simply means that Korea has the prerequisite for realizing the digital economy. It does not mean that Korea is already a fully digital economy. The true meaning of digital economy depends on the balanced growth of quantitative expansion and qualitative growth. The current Korean economy requires improvement in from the perspective of software, which enables the full application of hardware. The digital economy has a very close relationship with the workout program in four sectors, which is implemented to reform the “high-cost and low-efficiency” economic structure. The core of this workout program relies on the investment in IT and its use in the private, government and industrial sectors in order to obtain a more efficient economic structure. It is necessary to realize and accept that digital economy in Korea is not an option.

We have to realize that the investment in IT is not a panacea for every problem caused by existing inefficiency and irrationality. Rather, the inefficiency and irrationality in the existing economy is working as an impediment to IT investment. It is said that the investment in IT contributes to enhanced transparency. However, IT investment is fostered in more transparent companies, industries and nations.

Without a structure that enables access to transparent information of firms, financial institutes and government, it is meaningless to invest in IT. The investment in IT is also believed to promote competition. But as seen in financial and communication markets in the US since the 1990s, IT investment is being made more actively in the existing competitive fields. In addition, the digital economy is expected to promote competition and lower entry barriers but this expectation is almost impossible in a vertically integrated industrial structure. Competition is the best incentive to induce many economic agents to invest in IT to enhance their competitiveness.

In the economics point of view, the digital revolution is a shock which must be absorbed by the market. That is to say, emphasis is being placed on the market’s role of resource allocation in the new environment. Most of all, capital and labor must be allocated to more productive sectors through the market mechanism. The financial sector has managed more conservatively since the workout program began and there are concerns that capital supply to venture companies is tightened.

Comment

Sung Won Hong
President
Cisco Systems Korea

These days, we talk much about the restructuring process. There are two kinds of restructuring. The first kind is restructuring on a large scale, such as the transition into an information society and finding out ways to make use of the overall technology. The second kind is restructuring on a small scale. This includes the restructuring of a small sized company and change of management system. Given that, it is essential for us to link two phenomena: the information and communication technology and restructuring.

The level of information technology in Korea is higher than we think. The rate of diffusion of telephone, mobile phone and the Internet access service shows it well. The Korean government is informatizing its database at a remarkable rate. Informatization works of the general public, land, real estate, finance, cash flow, tax and administration are well done. Korea started its industrialization process late, but owing to liberalization, it entered the road toward the information society almost at the same time as other developed countries. With a ready environment, more focused efforts by both public and private sectors should be now put into the systemization of resources and information.

And, I would like to present a word of advice to the government which has the perfect database to promote the creation of e-government in the comprehensive context of restructuring. I would conclude my comment by wishing Korea a successful restructuring by linking the ICT and restructuring in this transition period.

Comment

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Korea Economic Daily

As a globalist who supports the globalization process, I'm worried about the developing countries' lack of will toward globalization. In my view, the biggest reason is that developed countries have lost the status as their role model. By the end of the Cold War, the aim of countries around the world shifted from realization of ideologies to economic prosperity. The two axes of economic prosperity are globalization and the New Economy. However, the misgivings of developing countries is growing bigger and bigger.

First, the United States is the leading country of these two phenomena, but its foothold is now shaking. The turmoil of US presidential election raises doubts whether the international norms deserve to exist as the base for globalization. Furthermore, the US is the only country belonging to the New Economy. There are continuing bankruptcies of ICT enterprises, which are the leading players in the New Economy. So many scholars and journalists are arguing that economic development is resulted from not a New Economy but a bubble economy brought by the low oil prices.

Developing countries are also disappointed with European countries. At the Convention on Climate Change in The Hague this year, Europe saw itself as one and tried to apply the new system in full scale, however, at the same time barring others from doing so. Other countries are blaming Europe. European countries are giving direct subsidies to their companies more than 5.5 times of the United States. So, the US is arguing that it is unreasonable for European countries to call the indirect subsidy of the US to account. The Third World countries are agreeing on the US stance.

When developed countries give out prescription, developing countries think it is totally right but don' t fully agree at heart. For example, City Bank is charged with laundering black money of Russians and a French enterprise, Carrefour, in Korea, is suspected of tax evasion and illegal repatriation of foreign currency. The slogan of transparent management, fair competition and balanced corporation management structure rings hollow. The animosity of Japan against developed countries is more serious. Many Japanese think of globalization as the economic hegemony of US borrowing in the name of globalized market.

In conclusion, the self-restructuring effort of developing countries is important but at the same time the self-examination effort of developed countries is also important.

Response

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The first issue that was raised is about the electronic government. This is not the area what I am specialized in but I think what people are usually thinking about here is government procurement which should be handled electronically by electronic commerce and tax-collection. Recently, for instance, the French government started to do this and they really improved their tax collection quite substantially and actually made more money in terms of taxes than they would have received by traditional ways. This may be one of the situations but it is probably which is interesting to many governments. In social security, for instance, there are many applications when the government is going to extend into business and if e-commerce can be applied to business, it also has application for the government.

Benefits of technology such as ICT increases with the number of people and market. So, if you have a large market, the government is a large player. In the ICT area, if you basically increase the whole market for IT, you will possibly have a large benefit for the economy as a whole. There are some more specific issues on IT, raised by Dr. Hong. I think it is very important to not see the ICT in isolation. I mean we should really look at the condition under which the US is the main exemple of the New Economy has been able to move to that. First is regulatory reform, which was already implemented in the early 1980 to increase competition, especially in the telecommunications market. To improve its innovation system to really make the whole economy more efficient and more flexible, the labor market has been very important there. So, it is very important to not see the ICT from isolation from under factors like labor market that are really important in getting benefits.

I think another issue is whether the New Economy is only applicable to the US or also applicable to Korea. We do not just look at the US only as the possible example of the New Economy. One country which is very interesting as well is Finland. She is even smaller than Korea and has only about five million people. However, she has a very large ICT sector, very open to export and import and has accomplished a lot of reforms to innovate systems and human capital and to enlarge competition in the ICT sector. Experts are trying to consider every factor to answer the New Economy to be exactly applicable to each country, but problems still exist, for every country has its own institutions and policy backgrounds. But there are still lessons which can be learned from the US, for example, or other countries which are doing well.

Another point is that if we speak of the New Economy, we seem to talk about the sector of economy such as the new startup firms in ICT sectors. We are not trying to focus very much on drives of growth in an economy where ICT is playing an important role. If you focus just on the ICT sector, a lot of OECD countries do not find it relevant. Many OECD member countries do not have large ICT sectors. Countries like Australia and France have an ICT sector which makes up about 2% of GDP, whereas in Korea it amounts to 10%. Still Australia is the country that is doing well at the moment probably by using ICT. And probably those are some other things which are more relevant to a lot of countries in the world that just look at the production side.

SESSION II

KOREA' S REFORM: FROM HERE TO WHERE

Corporate Restructuring, Corporate Governance and Labour Market: Problems and Policies

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I. Introduction

Until the eruption of the recent financial crisis Korea's corporate sector had prospered following the strategy of aggressive expansion financed through borrowing. The expansion through borrowing strategy became even more aggressive as firms entered capital-intensive industries like cars and steel, as well as semiconductors. By the end of the 1980s such a strategy was reaching its limit. To an extent the sustainability of such a strategy depended also on the protection of domestic markets through regulation and trade barriers. As the degree of protection declined from the beginning of the 1990s so did company profitability. This left the Korean firms financially weak and prepared the ground for the financial crisis. Strong economic growth, nevertheless, kept the labour market tight and reduced industrial unrest. The number of days lost due to strikes per 1,000 workers did fall since the late 1980s, and by 1996 was close to the OECD average. During this period, however, arms-length (non-confrontational) industrial relations were not nurtured. The combination of full employment and the traditional family safety net reduced the urgency of developing a formal social safety net. Corporate restructuring since the crisis has been hindered by the slowness in improving corporate governance, industrial relations, job training and social safety net. This is despite the government's effort to put in place the legal and institutional framework that would facilitate the desired changes in all these domains as well as a large amount of expenditures where necessary. In what follows I discuss the nature of the problems and the reform efforts of the government in each of the three areas covered here. I then conclude with the assessment of what policy challenges are there to restore a dynamic corporate sector that is both resilient and competitive in a global market.

II. Corporate restructuring

It seems always useful to start with a basic question: what is corporate restructuring? At the level of an individual enterprise it means changing the structure of business activity by reallocating resources within the enterprise so as to maintain its value as a going-concern. It often carries a negative connotation as it is usually triggered by financial difficulties and involves disposing of workforce and assets. In the extreme case a company is liquidated. What we are witnessing in Korea is such a business response on a wide scale. Seen from another angle, however, restructuring is a necessary and positive move which prepares a springboard for future prosperity.

At the aggregate level the problem of the Korean corporate sector has been the combination of high indebtedness and declining profitability. To be sure there is nothing inherently wrong about borrowing as long as high profits are assured. But this is usually difficult to do, and a high debt expansion strategy entails a large financial risk. In the case of Korea there are reasons to think that financial leveraging was excessive. First, the domestic business environment was protected from foreign competition until the beginning of the 1990s since when a gradual market opening has taken place. Protective environment helped to support profitability. Second, lending institutions lacked proper credit risk analysis, and mutual credit-guarantees among companies belonging to a same business group raised the degree of debt financing to an artificially high level. Finally, the widespread perception that the government would always bail out troubled financial institutions and companies created moral hazard.

After the crisis the government has taken various initiatives to advance corporate restructuring. It set a guideline for the debt-to-equity ratio of 200 per cent, pushed for consolidation of main business activities among the largest groups (the so-called Big Deal), and prodded banks to engage in workout programmes. As a result, and helped by a strong economic recovery, corporate profitability improved and the debt-to-equity ratio declined, to below 200 per cent in mid-2000 for the average of manufacturing companies listed in the stock exchange. As well, the government let several small chaebols to go under and did not bail out Daewoo Motors, thus helping to dispel the “too big to fail” myth, although the government’s efforts to organise a rescue of HEC may indicate that it may still be more than a myth.

But, many companies still do not fully honour interest payments (one quarter of manufacturing firms), and the pace of restructuring has slowed as it is faced with increasing resistance from trade unions. Following the failure to sell Daewoo Motors and Hanbo Steel to foreign investors and the problems of Hyundai Engineering and Construction, the government has renewed its efforts to accelerate restructuring. The Financial Supervisory Service has instructed creditor financial institutions to carry out “credit risk assessments” of all firms with loans classified as “precautionary” or lower or with the interest coverage ratio of below one for three years in a row. The government has also introduced a new “pre-packaged bankruptcy” procedure that provides legal support to workouts as well as corporate restructuring vehicles (CRVs) which facilitates restructuring through the help of investment and managerial advise from the outside.

III. Corporate governance

The main problem with corporate governance in Korea has been the prevalence of insider monitoring, the problem often referred to as "grading one's own term paper". This is a common problem of corporate governance in all countries though with different degrees of seriousness. In the United States, for example, many companies protect their executives from hostile take-over bids through poison pills, and in Japan monitoring by main banks was effective only in the event of financial distress. In Korea corporate directors were promoted from the inside, and the role of outside directors was virtually non-existent. Transparency was lacking, minority shareholder rights were difficult to exercise, and the lenders did not exercise monitoring. M&A were heavily regulated. One can say that the Korea Fair Trade Commission exercised monitoring of large conglomerates, but the concern of KFTC has mainly been to check an excessive concentration of economic power, and not to improve large companies' performance.

Much has changed since the crisis in terms of the legal framework, though the change in actual practice has been lagging. First, transparency of company operations and financial results has improved substantially following the adoption of accounting rules that are of international standards and a tightening of auditors' accountability (as a result many accounting firms have been closed). The requirement that conglomerates prepare combined financial statements made capital transactions between the companies within the same group to be netted out so that conglomerates' financial structure is now clearer. Second, the number of outside directors was legally increased to 50 per cent of the size of the board, though it seems difficult in practice to ensure a large supply of outside directors. Cumulative voting was made possible, and a quarter of the companies on the stock exchange adopt this as a way of electing directors. And controlling shareholders were made legally accountable for mismanagement as de-facto directors. Third, the ownership threshold for exercising shareholder rights was significantly reduced. This gave rise to shareholder activism led by civil movements and set the stage for involvement by certain institutional investors known for their approach to investment enhancement through active use of corporate governance arrangements. Fourth, the market for corporate control has been liberalised with the elimination of the mandatory tender offer requirement and the bans on hostile as well as foreign M&As. Finally, the Korea Stock Exchange made it a listing requirement to disclose the degree of compliance with best governance practices recommended by the Corporate Governance Commission.

IV. Labour market

The labour market in Korea is characterised by the combination of job precariousness and strict protection of regular employees. The OECD has ranked Korea as the second strictest country out of the 27 member countries for which a review was carried out in terms of protection of regular employment contracts. This has no doubt encouraged job precariousness and contributed to a dualistic employment structure with stable, life-long employment in large companies with generous severance pay, on the one hand, and less stable employment in small companies, many of which cater for large companies through sub-contracting relations. Social safety nets have been weak, and occupational education and job training facilities inadequate. In these circumstances arms-length industrial relations have been difficult to develop.

Much progress has been made since the crisis in changing the labour code to conform to international norms and in recognising union rights. In addition, social safety nets have been reinforced and expanded, and some efforts have been made to build capacities to administer active labour market policies and deliver job training. But, partly because of lack of experience and time, these efforts have not resulted in social policy orientation that would facilitate work force reallocation towards higher value-added jobs. As well, confrontational attitudes of social partners have made the necessary corporate restructuring difficult to achieve.

V. Remaining challenges

Having briefly reviewed the problems, reform efforts and progress made so far in dealing with these problems, I now turn to the remaining challenges:

- *Backward-looking adjustment in the corporate sector should be finished quickly and more energy should be redirected towards forward-looking restructuring.* Corporate restructuring so far has focused on the financial problems that are the legacy of the past. Much progress was made in reducing the reliance on debt and improving the internally generated cash flows, but even after two years of economic recovery there still remain weak companies that cannot meet payment obligations. The opportunity cost of letting weak and non-viable firms absorb resources is very high since it hinders the development of the dynamic sector. Non-viable firms have to be liquidated as quickly as possible. In order to facilitate the forward-looking reorientation of restructuring restrictions on the formation of a holding company should be eased substantially.

- *Focus of corporate governance reform should now be shifted towards nurturing the business culture which views the adoption of good governance practices as beneficial to companies.* The legal framework for corporate governance has been in place. Much of the fine-tuning in terms of improving actual practice should now be left to markets, and the government's role should be limited to advocacy and enforcement of legal rights. Cumulative voting should be included among the good governance practices that the listed companies are required to disclose whether they follow or not. There is some empirical evidence that the stock market views positively the improved corporate governance among the 6-25th largest chaebols. The government should encourage further empirical research on the extent to which the stock market value good governance practices. Similarly, independent influence of outside directors has sometimes been questioned. But given that they have the same fiduciary responsibility as executive directors they are liable to the damage given to the company. With an increasing number of derivative suits against company directors their behaviour is bound to change. On a broader scale, increased competitive pressure provides discipline to corporate executives. In this respect continuing liberalisation of imports and regulatory reform are of crucial importance, and so is a further shift of focus of KFTC away from chaebol monitoring towards protecting healthy competition.

- *The government should step up efforts to create conditions conducive to less conflicting industrial relations, to reduce rigidities in the labour market and to strengthen the growth process by ensuring a more productive use of human resources.* Industrial relations are in principle the matter between the social partners. However, a case can be made for an active government role where arms-length relations have not developed for historical reasons. Costs of confrontational industrial relations can be expected to increase further with the introduction of union pluralism at the enterprise level from 2002. In these circumstances government measures to facilitate less conflicting industrial relations can be considered as providing public goods. The government should take a strong initiative to reactivate the Tripartite Commission and play a role of an honest broker between the social partners. While the recognition of union rights has advanced, the protection of regular employment contract remains excessive and should be eased to reduce precariousness of employment. In addition, both the coverage and effectiveness of labour market and social safety net programmes should be improved further. In view of continuing precariousness of jobs and the need to enhance capacity for application of new technology both quality and relevance of education and training need to be improved.

Financial Sector Restructuring and Regulatory Reform: Progress and Remaining Challenges

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I. Restructuring the Financial Sector

It seems that the phrase that one hears most often in Korea these days is "second-stage restructuring". The key question is whether a "third-stage restructuring" programme will be necessary. To consider that question, this section will briefly describe the "first-stage financial-sector reform" – in other words, the reforms introduced from the time of the 1997 crisis until August 2000 – and evaluate its major accomplishments and shortcomings. It will then offer some preliminary comments on the "second-stage restructuring plan" that is currently being launched.

1. The first-stage financial-sector restructuring programme

The first-stage restructuring programme had two main objectives.[1] The *immediate* goal was to respond to the systemic crisis in the financial system triggered by the 1997 foreign-exchange crisis. A sharp deterioration in balance-sheet quality resulted in insolvency for a large number of financial institutions. The *second* challenge, which was more long-term in nature, was to move from a financial system characterised by an extremely high level of government intervention and direction to a market-based system. Prior to the crisis, the financial system, particularly the banking sector, was used by the government to channel resources to targeted activities, while profitability and prudential soundness were secondary considerations. Consequently, financial institutions had little incentive to cut costs, develop new products or improve credit-risk analysis. The dual nature of this challenge – accomplishing a regime change while facing a crisis – has made financial-sector restructuring in Korea exceptionally complex.

1) Maintaining a functioning financial systems

To achieve the first goal – that of maintaining a functioning financial system – a total of

[1] The first-stage restructuring programme was discussed in the 1998 and 1999 *OECD Economic Surveys of Korea.*

109.6 trillion won, which is equivalent to almost one-fourth of GDP, had been spent as of August 2000 <Table 1>. Almost two-thirds of this amount was used to rehabilitate the banking system, with the remainder spent in the non-bank financial sector. Given the criticisms about the lack of transparency regarding the restructuring programme, it is perhaps worthwhile to provide an overview of these expenditures. The programme was originally financed by 64 trillion won of government-guaranteed borrowing that was authorised in June 1998 <Table 2>:

- 43.5 trillion won of this borrowing was used by the Korea Deposit Insurance Corporation (KDIC) to re-capitalise weak financial institutions and to pay insurance claims. Including the use of re-cycled funds (shown in Panel B), spending by the KDIC exceeded 50 trillion won as of August 2000.

- 20.5 trillion won of this borrowing was used by the Korea Asset Management Corporation (KAMCO) to purchase non-performing loans, primarily from banks. KAMCO generated a significant amount of recycled funds by selling these assets, enabling it to purchase more non-performing loans. In total, KAMCO has spent about 30 trillion won for this purpose <Table 3>. Since impaired assets were bought at a discount – 45 per cent of face value for secured loans and 3 per cent for unsecured loans – KAMCO was able to purchase loans with a face value of more than 75 trillion won by August 2000.

In addition to the 64 trillion won of government-guaranteed borrowing and 18.6 trillion of re-cycled money, another 27 trillion won of public funds was spent for financial-sector restructuring <Table 4>. A significant portion – more than 10 trillion won – was spent on the state-run specialised banks, such as the Korea Development Bank and Export-Import Bank. In addition, these outlays include expenditures related to Daewoo.

2) Establishing a market-oriented financial system

The establishment of a market-oriented financial system required the closure of nonviable institutions. This was a major event in Korea, which had never experienced the failure of a financial institution prior to the crisis. Since the crisis, though, the number of commercial banks has fallen from 27 to 17, with a further decline likely, while the number of merchant banks dropped from 30 to nine <Table 5>. Overall, the number of financial institutions fell by almost a quarter.

To achieve the second goal – a market-oriented financial system – it is necessary to replace the heavy hand of government intervention with the invisible hand of market forces. The essential requirement was to upgrade prudential standards in line with international norms. The most important steps thus far have been:

- A unified supervisory body, the Financial Supervisory Commission, was created in April 1998.
- KAMCO was re-organised to handle a non-performing asset management fund.
- Accounting and disclosure standards for financial institutions were brought closer into line with International Accounting Standards.
- A “Prompt Corrective Action” framework has been introduced.
- A “forward-looking loan classification” standard has been implemented.
- The corporate governance framework for financial institutions has been improved.
- To supervise banks, the so-called “CAMELS” system, which follows the practices of leading bank supervisory bodies around the world, has been put in place
- The calculation of BIS capital adequacy standards has been improved.
- Exposure limits on banks’ lending to individual companies and to chaebols were tightened.
- In the insurance sector, a solvency standard based on that used by the European Union was introduced.
- Mark-to-market valuation has been introduced for ITC funds.

2. Results of the first-stage financial sector restructuring programme

There have been positive results from the first-stage restructuring programme. Most importantly, a functioning banking system has been maintained, with loans by deposit money banks increasing 25 per cent in 1999 and 30 per cent (year-on-year) in the first half of 2000. This has allowed a recovery led by a strong rebound in consumption and investment. The banking sector now includes five privately-owned banks with BIS capital ratios of over 10 per cent and investment-grade ratings from international rating agencies. These banks had combined profits, after provisioning and taxes of 173 billion won in 1999 <Table 6>. However, their return on equity, at 8 per cent, was well below the FSC’s standard of 15 per cent. More broadly, there are a number of fundamental problems remaining in the financial sector.

1) Vulnerability to on-going corporate-sector restructuring

First, the financial sector remains exceptionally vulnerable to recurring shocks from corporate bankruptcies. Despite extremely favourable conditions – buoyant output growth, low interest rates and an exchange rate well below pre-crisis levels – a significant number of the major business groups have serious balance-sheet problems. According to a study by one securities firm, 9 of the top 25 chaebols had an interest coverage ratio of less than one in 1999.[2] The dichotomy between the strong macroeconomic performance and the large number of companies in distress is remarkable. With economic growth now slowing, there is a strong likelihood that non-performing loans will increase, thus posing a threat to the weak commercial banks. Excluding the five strong banks noted above, the other six nationwide banks recorded a combined loss amounting to 2.5 trillion won in 1999, mainly due to provisioning of their high level of NPLs <Table 6>.

2) Problems in the non-bank financial sector

Second, there are serious problems in the non-bank financial sector, particularly investment trust companies (ITCs) and insurance companies. It is clear that Korea's fragile capital market was not capable of absorbing the failure of Daewoo. Consequently, the failure of the second-largest chaebol, which was supposed to dispel the "too big to fail myth", may have ironically re-enforced it. Indeed, the recent efforts by the authorities to avoid a collapse of Hyundai Engineering & Construction suggest that "too big to fail" is still relevant. Following the failure of Daewoo, there was a "flight-to-safety" with money flowing from the ITCs and bank trust accounts to bank deposits, whose share of total deposits in financial institutions increased from 33 per cent in 1998 to 44 per cent in the first eight months of this year <Table 7>. Meanwhile, the combined share of ITCs and bank trust accounts fell by the same amount. This has important implications for the capital market since bank trusts and ITCs have been major purchasers of equities and bonds issued by the corporate sector. With money flowing away from these institutions, new stock issuance fell by 57 per cent during the first eight months of 2000, while bond issuance dropped by 52 per cent for large companies and 77 per cent for small companies. While bank lending has increased, it has been concentrated in the household sector. Consequently, the rise in bank lending has not been enough to compensate for the decline in direct financing, thus leading to concerns about a credit crunch.

Concerns of a credit crunch, though, appear exaggerated at this point. Moreover, one of the main objectives of the restructuring programme has been to encourage banks and the capital market to become more selective in deciding which companies to provide financing to and to avoid funding non-viable companies. To the extent that recent trends reflect such enhanced attention to credit risks, it is a positive step. At the same time, though, the development of a vibrant capital market is a key part of financial-sector reform. In this light, the recent contraction of direct financing, and the return to primarily bank-based financing, is an unwelcome development.

3. The second-stage financial restructuring programme

[2] Indosuez W.I. Carr Securities, *Korean Banks*, September 20, 2000.

The second-stage restructuring programme, which was announced in September 2000, established three main goals.

a) To enhance asset quality through prompt elimination of factors that may cause potential loss.
b) Establish the basic framework for market-oriented restructuring of the corporate sector by improving the financial system.
c) To strengthen further the competitiveness of the financial industry.

The second-stage plan envisages outlays of 50 trillion won, of which 10 trillion won is recycled money and 40 trillion won is additional public money. The largest share of the money – 20 trillion won – is intended to restructure ailing ITCs <Table 8>. Significant amounts are also to be allocated to banks with BIS ratios under 10 per cent, insurance companies, state-run development banks and Seoul Guarantee Insurance Company, which had guaranteed Daewoo bonds. There has been some debate as to whether this amount is sufficient, with some arguing that another 10 to 20 trillion will be necessary. Whatever the final amount, it is essential to address existing problems promptly and with sufficient resources and in a way that limits moral hazard problems. The second-stage restructuring plan is to be completed by the end of this year.

One important part of the reform in the banking sector was the approval of legislation to allow financial holding companies in September 2000. Six weak banks had to submit restructuring plans to the FSC at the end of August. Based on these, the Management Evaluation Committee decided that two banks, which did not request additional public funds, should be permitted to pursue their plans. However, four other banks, which did request public money, are to be placed in a financial holding company after the injection of additional public funds to raise their BIS capital ratios to over 10 per cent. It remains unclear, though, whether any other financial institutions will be included in this holding company.

Financial holding companies, however, may not be a panacea for resolving remaining problems. Putting weak banks together does not automatically guarantee better performance. Given the excess capacity in the banking sector, the closure of weak banks – as was done in 1998 through so-called "Purchase and Assumption" agreements – appears to be preferable. In any case, it is important that the holding company structure be used effectively to reduce excess capacity. In addition to holding companies, the authorities have been arguing for the creation of "mega-banks" through the merger of healthy banks. However, the advantages of creating larger banks need to be weighed against the impact on competition. A continued decline in the number of banks could lead to an unacceptably high degree of concentration in this sector.

In the non-bank financial sector, the goal is to eliminate insolvency as soon as possible. Three merchant banks received public funds and were placed under the responsibility of the KDIC in October. Prompt corrective action is to be applied to securities companies with low capital ratios. In addition, insurance companies with low solvency ratios will be examined and consolidation measures, including P&A, will be implemented. Finally, the FSC will encourage weak ITCs to implement self-rehabilitation plans to increase their capitalisation. In general, there has been a lack of transparency in dealing with the ITCs. The government has introduced a number of new products – such as collateralised bond funds, high-yield bond funds and tax-free bond funds – to provide liquidity relief for ITCs, as well as weak companies. While these new products have eased the problems of ITCs, it is unclear whether the underlying solvency problem in the ITC sector has been resolved.

4. Outlook regarding the remaining problems in the financial sector

This is an ambitious plan, particularly the target date of finishing by the end of 2000. There are, however, remaining concerns about the outlook for financial-sector restructuring. *First*, one central issue is the tendency to put the market mechanism on hold while using *ad hoc* policies to deal with emerging problems in the financial system. One example is the policies used to protect some investors from losses associated with Daewoo. Individual investors and non-financial corporations were allowed to redeem 95 per cent of the value of Daewoo securities while other investors were not protected from losses. Such an approach is inconsistent with the principal that investors bear the ultimate responsibility for the risks associated with their investments. A second example is the government's decision to call on banks and insurance companies to create funds for purchasing bonds. Such an approach appears to undermine the principle of autonomy for financial institutions regarding their own solvency and profitability. To give an idea of how the market perceives such policies, a leading securities firm recently recommended against investing in Korean banks because, "The recent 10 trillion won bond fund is an example of the fact that the banks will increasingly use their surplus liquidity to bail out other parts of the financial system".[3]

To be fair, policymakers are sometimes faced with difficult tradeoffs between maintaining stability and allowing market forces to improve efficiency. Given the imperfections of the Korean financial system, government intervention to some extent is inevitable. However, continued intervention by the authorities risks making market players dependent on government policies, requiring repeated government interventions. The reliance on measures that are not based on market principles to maintain stability risks increasing the degree of vulnerability in the financial system.

A s*econd* fundamental problem has been the continued flow of credit to non-viable companies, resulting in ever increasing non-performing loans. Including bad loans purchased by KAMCO, total non-performing assets have risen to 139 trillion won in March 2000 before declining somewhat <Figure 1>. Some of the increase reflects the introduction of tighter classification standards – specifically the forward-looking criteria at the end of 1999. However, the steady upward trend since the start of the expansion in the fall of 1998 also reflects a continued flow of credit to weak companies. Such an increase is somewhat surprising in the context of strong economic growth of 11 per cent last year and 9 per cent this year and the fall in long-term interest rates to well below pre-crisis levels. The risk is that if the financial system continues to generate a high level of non-performing loans, even during periods of robust output growth, a series of financial-sector restructuring programmes to clean up the resulting problems may be necessary.

There are several possible explanations for continued lending to non-viable firms. It may reflect government pressure to lend to weak firms in order to avoid the negative effects of bankruptcy on employment and economic growth. One aspect of this may be the reliance on workout programmes to rehabilitate weak firms. In some cases, this may have led to continued support to firms with little chance of successful restructuring. Many of the 46 companies still in work-out programmes may eventually fail, resulting in more NPLs. One solution is greater reliance on formal, court-based restructuring, included the planned "pre-packaged bankruptcy" procedure. More generally, it is important to limit government influence on banks in order to achieve market-based restructuring of the corporate sector. This would include privatising the re-capitalised banks. Admittedly, this may not be feasible at present but should be an important objective and should begin as soon as the market permits. To establish a market-based financial system, banks need to be responsible to their principal owners. When that owner is the government, there will be either an undue government influence on private-sector decisions or a corporate governance failure.

Continued lending to non-viable firms may also reflect weak credit analysis skills in financial institutions. An improvement in such skills cannot be mandated and it is clear that structural change requires time. But a few elements that would encourage such change include:

- As noted above, there needs to be an efficient exit mechanism in order to stop the flow of capital to non-viable companies.
- Further increasing foreign participation will bring new management and risk analysis skills into the financial sector. However, such investment will tend to be limited by *ad hoc* government interventions in the financial market.
- It is essential to implement effectively the forward-looking loan classification system, which provides proper incentives for banks to stop lending to non-viable companies. Under the old classification system, based on delinquency in making payments, financial institutions had an incentive to grant additional loans to troubled firms and thereby limit the deterioration in asset quality. Under the forward-looking system, loans to a weak firm, as judged by interest coverage ratios, are immediately classified as non-

[3] Indosuez W.I. Carr Securities, *Korean Banks*, September 20, 2000.

performing. However, the effective implementation of the new system is a challenge for both supervisors and financial institutions.

Third, developments in the capital market appear worrisome. In particular, the bond market has changed fundamentally from the pre-crisis period, when more than 90 per cent of bonds were guaranteed. Moreover, the ITCs, which were often linked to the issuer, were major purchasers of bonds. With the credit crunch in 1998, firms turned to the bond market for financing, resulting in a 63 per cent rise in total issues. Following the Daewoo crisis, however, issuance has slowed sharply. In 1999, it fell below the 1997 level and the bond market now appears paralysed. Given the surge of bond issuance in the wake of the crisis, the amount of bond redemption is set to rise progressively until a peak at the end of 2001. In this context, it is crucial to take measures to strengthen the capital market, including:

- Improving corporate governance practices to ensure that firms focus on shareholder value.
- Greater transparency, combined with proper disclosure procedures to allow investors to accurately assess risks.
- Assuring the independence of bank and non-bank financial institutions from the chaebols to prevent them from being used as piggybanks by the industrial sector.
- The development of credit-rating agencies to allow investors to monitor their investments.
- A clear recognition of the principle that the investor assumes the investment risk.

Fourth, the outlook for securities companies, which recorded strong profits in 1999, appears to be dimming. One factor, of course, is the decline in the volume of equities traded this year. This has been exacerbated by the surge in online trading, which accounted for only 1 per cent of trading in January 1998. By March 2000, its share had surpassed one-half and has continued to increase to 63 per cent in August 2000, making Korea the world leader in this regard. The popularity of online trading reflects the spread of the Internet and computers, which bodes well for the development of the new economy in Korea. In addition, it is due to the important role of individual investors, who account for 95 per cent of trading on KOSDAQ and 71 per cent on the Korea Stock Exchange. Given the small commissions attached to such trading, this has negative consequences for securities companies' earnings. Although the commissions for online trading were originally set at 0.5 per cent, the same as for traditional transactions, intense competition has reduced them to 0.025 per cent – one-twentieth of the commission on traditional transactions. The increased competition may force some securities firms to close, merge or specialise in certain areas.

5. Conclusion on financial-sector restructuring

There are great incentives to successfully conclude the restructuring of the financial sector and similarly great risks attached to failure. *First*, the amount of money involved is so large that it will have an important impact on Korea's future. Total borrowing following the first and second restructuring programmes is projected to total 104 trillion won – about a fifth of GDP. This amount, which is guaranteed by the government, exceeds the total accumulated debt of the central government – estimated at 90 trillion won at the end of 1999 by MOFE <Figure 2>. Successfully completing the financial restructuring programme will allow the final cost to be substantially lowered by:

- Continuing KAMCO's sales of the non-performing assets that it purchased. KAMCO has been successful in this regard, having earned 18.3 trillion won from the resolution of 34.8 trillion won in non-performing loans <Table 9>. In addition to the rapid resolution, the amount recovered by KAMCO exceeded the purchase price of 16.4 trillion won. Indeed, KAMCO is ahead of its goal of resolving 32.9 trillion won of NPLs by the end of 2000. It is essential that KAMCO continue its progress toward achieving its goal of resolving 65.9 trillion won by 2003, though this may become more difficult in the context of slower growth. Moreover, the most attractive assets were likely to have been sold first.
- Successful restructuring would boost the stock prices of re-capitalised institutions, allowing the government to realise capital gains as they are privatised.

While the government estimates that 60 trillion won of the debt is non-recoverable, obtaining the other 44 trillion should be a key objective for Korea, where limiting government debt has long been an important objective. This should remain a priority, given the prospective costs of population ageing and uncertainty about North Korea.

Second, with the enactment of the second-stage foreign-exchange liberalisation programme next year, Korea will rank as one of the most open OECD countries in this regard. The effect of liberalisation will be to facilitate capital outflows by removing ceilings on resident's overseas deposits and facilitating purchases of securities. In this context, it will be essential to advance restructuring and maintain the confidence of domestic investors and avoid de-stabilising capital outflows. In short, the slowdown in economic growth will provide a major test of whether Korea's restructuring efforts have reduced its vulnerability to crisis.

II. Regulatory Reform in Korea

The fundamental goal of the reforms introduced in the financial sector, as well as in other areas of the economy, is to establish a more market-oriented economy. This requires changing the role of the state in the economy and in society by reforming regulations that govern firms and individuals. Since the 1960s, the government has actively intervened in the market to channel the nation's limited resources to favoured sectors. The government has acknowledged that today "numerous and unnecessary administrative regulations have undermined national competitiveness and become the cause of corruption and misconduct" (Office of the Prime Minister). Such regulations have stifled the initiative and creativity of the private sector, thus slowing economic growth.

1. The regulatory reform process

Regulatory reform in Korea is guided by five principles established in the 1997 Basic Act on Administrative Regulation (BAAR):

- Eliminate, in principle, all anti-competitive economic regulations;
- Improve the efficiency of social regulations in areas such as the environment, health and safety;
- Shift from *ex ante* control to *ex post* regulation;
- Base all regulations on adequate legal authority;
- Benchmark global standards.

The Regulatory Reform Committee (RRC), located in the Prime Minister's office, was given the difficult task of eliminating half of the 11, 095 existing regulations in the year beginning in April 1998. This goal was practically achieved, with 49 per cent of regulations abolished <Table 10>, while 43 per cent of the remaining regulations were improved. One particular concern was the widespread use of "administrative guidance" – informal instructions from civil servants to the private sector that are a major source of bureaucratic power. The RRC identified 1 849 "informal regulations" that had no legal basis. Of these, 162 were formalised, while the remainder was abolished. Finally, to improve transparency, the RRC has compiled a list of all regulations currently in force.

It is difficult, though, to determine the precise benefits of this item-by-item approach. To achieve numerical targets, however, there is clearly an incentive to begin with those regulations that are easy to change and redundant measures, rather than to focus on the most difficult items. Moreover, implementing reforms will not be a simple process, as it will require changing the mindset of lower-level civil servants who have been responsible for interventionist policies.

Nevertheless, it is clear that eliminating half of existing regulations in such a short time frame could not help but have a real impact on the role of government in the economy. Two recent developments suggest that an improvement in the regulatory environment did, in fact, take place. *First*, inflows of foreign direct investment increased by 74 per cent in 1999 to a record high of $15.5 billion, and further to $12.2 billion in the first ten months of 2000, up 19 per cent year-on-year. *Second*, there has been a surge in the number of firms created, including venture companies, in 1999.

In addition to reviewing existing regulation, the RRC is trying to ensure that new regulations are necessary and transparent. Ministries proposing regulations must report views received during the mandatory 20-day public consultation period and complete a "Regulatory Impact Analysis" (RIA), which explains the need for the new regulation and provides a cost-benefit study of its expected impact. Of the 884 regulations reviewed in the first year of this procedure, 241 were rejected and 81 were voluntarily withdrawn by the ministry concerned. This procedure also makes ministries more selective in proposing new regulations and encourages them to consider other policy options. Moreover, proposed legislation must be reviewed by the RRC. Finally, there is a sunset provision that requires a review of all regulations after five years to determine if they are still necessary.

Following its success in reducing the number of regulations, the focus of the RRC should move away from a quantitative approach and towards a focus on improving the quality of the remaining regulations. The objective should be to establish comprehensive, results-oriented reform plans in key sectors, particularly electricity and telecommunications.

2. Introducing competition in the electricity industry

Korea announced a ten-year plan in 1999 to introduce market forces into its electricity sector,[4] which is dominated by the Korea Electric Power Corporation (KEPCO), a 57.6 per cent state-owned company. The key elements of the plan include the division of KEPCO's generation and distribution assets, their further privatisation, the introduction of competition in generation and retail supply and the creation of an independent regulator. KEPCO's non-nuclear generating assets are to be divided into five wholly-owned subsidiaries – a number thought to be large enough to discourage collusion and allow effective competition, while permitting each subsidiary to reach the minimum efficient scale of production. In addition, legal requirements for entry into power generation will be eased. These steps would allow the gradual introduction of consumer choice; beginning in 2001, large customers are to be allowed to purchase either directly from an independent power producer or a KEPCO subsidiary at an agreed price or from a cost-based pool. KEPCO's distribution assets would be divided into a number of wholly-owned subsidiaries by 2001, and privatised beginning in 2003. Choice of supplier would not be allowed for ordinary customers until some time after 2009. An Electricity Supervisory Board would eventually be established to supervise the market. The obligations of supplying below-cost electricity to farmers and remote areas would be covered by the government and a mechanism to support domestic coal production and LNG are to be devised.

The introduction of competition should significantly reduce costs: according to an estimate by KIET, electricity prices could decline by 9 per cent. With residential consumption in Korea still only a third of the OECD average, this represents large potential benefits as the demand for electricity continues to expand. Implementation of the first steps of the reform programme, however, has fallen behind schedule, reflecting significant opposition to the privatisation programme. The opposition is strongest from KEPCO's labour union, which is concerned about possible job losses. However, given the rapid projected growth in electricity demand, the restructuring plan would not result in job losses, but rather a slower rate of employment creation in the power sector. Moreover, lower electricity prices would promote job creation in other sectors.

It is important, therefore, to introduce competition into electricity. The key elements are:

- Carry out the privatisation of KEPCO as planned.
- Effectively separate the generation, transmission and distribution of power to promote competition. As KEPCO will remain the sole provider of transmission services, it is important that it sell its shares in its five generating subsidiaries as well as in its distribution facilities, to remove incentives to cross-subsidise affiliates and to discriminate against independent suppliers.
- Create an independent regulatory authority – separate from MOCIE – to ensure non-discriminatory access to transmission and distribution, as well as to prevent other anti-competitive behaviour.
- Split KEPCO's nuclear power business, which generates 42 per cent of electricity, into at least two companies.
- Phase out the large subsidies granted to agriculture and industry through below-cost sale of electricity, at the expense of residential and commercial users.
- Accelerate the timetable of the plan, which will not allow most consumers to benefit from competition for a full decade.

[4] This electricity industry was analysed in the OECD's report on *Regulatory Reform in Korea* (OECD, 2000).

1) Promoting competition in the telecommunications sector

Telecommunications has been a dynamic sector of the Korean economy.[5] The number of telephones per 100 inhabitants increased from 7 in 1980 to 52 in 1997, surpassing the OECD average of 49, making Korea the 10th-largest telecommunications market in the OECD. Growth in recent years has been led by the mobile telephone market, which reached over 50 subscribers per 100 inhabitants by the end of 1999, the fifth-highest in the OECD area. Indeed, the number of mobile subscribers overtook the number of fixed network subscribers in mid-1999. With the entry of a second firm in the local market in 1998, all parts of the telecommunication service market are, in principle, open to competition. A private company, DACOM, has been allowed to compete with Korea Telecom (KT)[6] in international calls since 1990 and in national long-distance calls since 1995. The number of facility-based suppliers has increased from five in 1995 to eight, including one in the national long-distance market <Table 11>. Increased competition contributed to a 22 per cent fall in the price of long-distance calls between 1996 and 1999. In the area of mobile service, Korea is one of only five OECD countries that have licensed at least five service providers, allowing for the development of vibrant competition in this area.

2) Remaining challenges in the telecommunications sector

However, there are a number of weaknesses in the Korean telecommunications sector. *First*, the number of new facility-based entrants has been rather low. Ireland, for example, had 29 compared to three in Korea. *Second*, while prices have fallen as noted above, the extent of the decline in the national long-distance market is substantially less than the declines in some other countries, such as Japan (50 per cent) and France (46 per cent). *Third*, the former monopoly, KT, remains the dominant firm with a market share of 88 per cent in the long-distance market, as well as 99 per cent in local calls and 60 per cent in international calls. *Fourth*, there is a considerable amount of cross-shareholding, including between companies that compete against each other, raising possibilities of collusion and conflicts of interest.

In addition, the government continues to play a major role in guiding the development of the telecommunications sector, including the use of public funds to develop infrastructure. The Basic Telecommunications Act of 1997 gives the Ministry of Information and Communication (MIC) the power to “advise” facility-based carriers in which areas to invest. Until recently, MIC controlled investment by KT and is also involved in other aspects of firms’ activities. The high level of

[5] The telecommunications sector was analysed in the OECD’s report on *Regulatory Reform in Korea* (OECD, 2000).

involvement stems, in part, from MIC's goal of promoting domestic manufacturers of telecommunication equipment. To some extent, the service sector has been used as a tool for industrial development. For example, service providers are required to contribute 1.8 to 3 per cent of their revenues to a fund to support domestic producers.

Another major concern is a lack of consistency in promoting competition. In the local market, for example, the loop network may not be unbundled, thus requiring Hanaro to replicate the existing infrastructure. The prohibitive cost of such investment makes it unlikely that there will be effective competition as long as unbundling is prohibited. An opportunity to enhance competition was missed when two broadband wireless local loop (B-WLL) licenses were awarded in 1999 to the two existing local loop operators with no charge, rather than to two new entrants.

The pricing of local services is another important factor in promoting competition. The approval system for telecommunication tariffs was abolished in 1995, except for local services provided by KT and SK Telecom, the leader in cellular services. KT increased local call charges by 50 per cent between 1993 and 1997 in order to bring its tariff structure more into line with costs. However, the price of a three-minute local call, currently set at 45 won, is well below its cost of 59 won. The failure to rebalance fully the price structure has negative implications for competition and market entry in the local loop and for KT's ability to upgrade its network. However, further price increases should not be approved until an appropriate cost methodology is applied to KT, which only began to restructure and reduce its labour force in 1998. The present tariff approval system has not provided KT with sufficient incentives to reduce costs and improve efficiency.

3) Policies to encourage a dynamic telecommunications sector

To promote the continued development of the telecommunications sector, a key element of the new economy, the authorities should focus on increasing competition. Streamlining licensing procedures would help promote competition, particularly for local telephone service. Authorisation by MIC is still required for potential suppliers of facility-based services.[7] The relatively small number of new facility-based entrants may be due to the difficulties created by the licensing requirements. Prospective firms are only allowed to apply during one-week periods in March and September and must provide MIC with detailed information concerning, for example, strategies for marketing and sales, investment financing, human resources and R&D. This allows MIC to discriminate between applicants based on whether it agrees with their business plans. The licensing system also differentiates by the type of service (local, long distance or international) that is offered.

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[6] Korea Telecom was established as a 100 per cent government-owned public corporation in 1982, thus separating the supply of commercial services from policy. It is the only integrated operator in Korea, offering services in the local, long distance, international and leased line markets.

Introducing a class license system would promote competition. Moreover, the licensing system could be simplified by establishing the minimum criteria that must be met by prospective entrants. This approach, which has been adopted in some other OECD countries, would ease the regulatory burden, while ensuring transparency and eliminating the possibility of discriminatory treatment. In addition, introducing competition in the cable television industry, a potential supplier of local telephony services, would also be beneficial.

In addition, the privatisation of KT and the entry of foreign companies are essential to a competitive and dynamic telecommunications sector. The government, which announced a plan in 1987 to reduce its stake in KT to 51 per cent over ten years, still owned 59 per cent at the end of 1999. Korea implemented its WTO commitments on foreign ownership ahead of schedule. Foreign equity ownership of up to 20 per cent of KT was allowed in 1998, rising to 33 per cent in 2001. The recent sale of a 13 per cent stake in KT raised foreign ownership to 19 per cent and MIC has raised the possibility of finding a foreign strategic partner for KT. For other fixed-wire and wireless service providers, the commitment to raise the limit on foreign ownership to 49 per cent in 2001 was achieved two years early. However, the barriers to foreign ownership in the telecommunications sector are still high compared to other OECD countries. Removing these restrictions would help achieve the ambitious investment plans needed to fulfil the government's goal of constructing a "Korean Information Infrastructure".

It is also important that MIC avoid micro-managing the telecommunications sector. The emphasis on promoting a domestic manufacturing industry has hindered the development of an efficient and technologically-advanced telecommunication service industry. Direct participation of the government in infrastructure projects can be inefficient and such investment should be left to private companies, who respond more effectively to the demands of users. Moreover, the tendency of MIC to make decisions with the aim of developing the equipment manufacturing industry should be replaced by focusing more on the interests of the users of telecommunication services. Finally, the rule mandating that telecommunication operators devote a certain percentage of their revenues for R&D of domestic producers should be abolished.

It will also be necessary to establish the regulatory framework for the transition from a monopoly to a competitive market. The establishment of an independent regulator, with powers over licensing, pricing and other regulatory safeguards, is essential to promote competition. Korea is one of only two OECD countries without an independent regulatory agency in this sector. An independent regulator, in consultation with the KFTC, which retains responsibility for competition policy, should also prevent collusion between firms in the telecommunications sector, where cross-shareholding is extensive, and competition should be introduced in the cable television sector. Strengthening competition will require stimulating new entry and preventing unfair practices by

[7] For all other categories of service, only registration or notification is required.

existing suppliers, while protecting other public interests, including universal service. In particular, MIC should allow unbundling of the local loop network and award spectrum licenses on the basis of open, non-discriminatory tendering procedures.

Competition would also be enhanced by imposing price caps in markets where KT remains dominant (local, leased line and long distance), while refraining from interfering in pricing in all other markets. A price cap method would provide a transparent approach that would lead to automatic adjustment of prices, thus preventing political interference. It is important, though, that the price caps be administered by a regulator independent of MIC. The Korea Communications Commission (KCC), which was created as an independent consultative body within MIC in 1997, has the potential to become such a regulator. Finally, given KT's dominance of the leased lines and national long-distance markets, price gap regulation would appear to be appropriate in those markets as well.

Finally, a number of other elements are needed to establish fair competition in the telecommunications market. *First*, the interconnection framework for other service providers wishing to link to the network should be improved. At present, the right of interconnection to KT is guaranteed, with terms determined by negotiation between the two parties, subject to review by KCC and approval by MIC, which has established criteria for such agreements. If no agreement is reached within 90 days, either party can request arbitration by the KCC. In an international perspective, interconnection charges in Korea are high relative to prices and revenues; a long-distance service provider pays 28 to 37 per cent of its revenue as interconnection charges. Interconnection charges account for a quarter of KT's revenues. The methodology for setting these charges should be changed.[8] *Second*, number portability, which allows users to change their service provider without changing their telephone number, is not allowed in Korea. The lack of portability imposes relatively high transaction costs, especially for small businesses, thus helping the incumbent firms. *Third*, a transparent mechanism for allocating spectrum has been lacking. MIC has announced that it is considering the possibility of using auctions to allocate licenses for third-generation mobile telephones. Such auctions should exclude dominant carriers in order to encourage competition. *Fourth*, Korea does not have a framework for providing universal service in a competitive environment. At present, KT is responsible for universal service.

3. Conclusion on regulatory reform

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[8] Korea uses the *fully distributed cost* approach, which tends to overestimate interconnection costs, thus helping the incumbent firm. This approach is not sufficiently rigorous in distributing common costs across different services and does not discount inefficiencies of the former monopoly carrier. Most OECD countries are adopting *the long-run incremental cost* methodology, which is forward looking and allows for the profit margin of the incumbent.

Greater economic efficiency should be promoted by accelerating the implementation of a wide range of structural reforms. While the restructuring of the financial system along market-oriented lines is essential, it needs to be complemented by measures to enhance competition and to accelerate the restructuring of the corporate sector. The rapid pace of the economic expansion in 1999 and 2000 should not lead to complacency about moving ahead with the objective established in the wake of the crisis of building a more market-oriented economy. Progress on this front would have two important benefits. *First*, it would sustain the growth potential, thus promoting the convergence of income levels in Korea, which are currently about 60 per cent of the OECD average, to the norms of Member countries. *Second*, it would make Korea less vulnerable to future crises in a world of increasing global competition.

Regulatory reform is an important aspect of increasing both flexibility and competition. The government has made rapid progress in this area by reducing the number of regulations by half during a one-year period and attempting to eliminate the use of administrative guidance that is not based on laws. While the quantitative progress is indeed impressive, it is important to focus now on qualitative improvements, focusing on changes that will enhance competition in key sectors, particularly electricity and telecommunications.

<Table 1> The first-stage financial sector restructuring programme

(Trillions of won as of August 2000)

A. Expenditures by type of institution	
Banking sector	70.3
Investment trusts	12.2
Merchant banks	11.9
Insurance companies	10.5
Other[1]	4.7
Total	109.6
B. Sources of financing	
Government-guaranteed borrowing	64.0
Recycled funds	18.6
Other public funds	27.0
Total	109.6
Per cent of GDP in 1999	22.7

Note: 1) Mutual savings and loans and credit co-operatives.
Source: Ministry of Finance and Economy

<Table 2> Expenditures financed by government-guaranteed borrowing

(Trillions of won as of August 2000)

	Korea Deposit Insurance Corporation					Korea Asset Management Corporation	Total
	Equity Participation	Contribu-Tions and Insurance Claim payments	Asset Purchases	Other	Sub-total	Purchase of non-performing loans	
A. Original 64 trillion won[1)]	20.5	21.0	1.8	0.2	43.5	20.5	64.0
Type of institution							
- Banks	16.5	9.6	1.8	0.0	27.9	17.3	45.2
Five merged banks	1.2	9.6	0.2	0.0	11.0	1.1	12.0
Korea First and Seoul Bank	9.0	0.0	1.6	0.0	10.6	4.2	14.8
Other banks	6.3	0.0	0.0	0.0	6.3	12.2	18.5
- Other financial Institutions	4.0	11.4	0.0	0.2	15.6	3.2	18.8
Life insurance	3.9	1.4	0.0	0.0	5.3	0.0	5.3
Guaranty insurance	0.1	0.0	0.0	0.0	0.1	1.4	1.5
Merchant banks	0.0	5.8	0.0	0.0	5.8	1.5	7.3
Credit co-operatives	0.0	2.9	0.0	0.0	3.1	0.1	3.2
Mutual savings	0.0	1.3	0.0	0.0	1.3	0.0	1.3
B. Recycled funds	..	..	..	..	7.5	17.9	25.3
Used	3.0	4.2	1.9	0.0	9.1	9.5	18.6
Remaining	..	..	..	..	0.4	6.3[2)]	6.7
C. Total Expenditures[3)]	**23.5**	**25.2**	**3.7**	**0.2**	**52.6**	**30.0**	**82.6**

Note: 1) Authorised in June 1998.
2) KAMCO transferred 2 trillion won to KDIC.
3) Original 64 trillion won of borrowing plus recycled funds.

Source: Ministry of Finance and Economy

<Table 3> Purchases of impaired assets by the Korea Asset Management Corporation
Trillions of won, between November 1997 and August 2000

Type	Purchase price	Face value
Ordinary loans[1]		
Secured	7.3	11.7
Unsecured	2.0	14.6
Sub-total	9.3	26.3
Restructured corporate loans[2]		
Secured	10.0	18.7
Unsecured	3.8	12.3
Sub-total	13.8	31.0
Assets acquired from investment trust companies[3]	6.4	18.5
Total	**29.5**	**75.7**

Note: 1) Ordinary loans are those acquired directly from the financial institution. Initially, KAMCO purchased assets for a tentative price. Since September 1998, purchases have been at 45 per cent of face value for collateralised loans and 3 per cent for loans without collateral.
2) Restructured corporate loans (special assets) are acquired through court-approved re-organisation or composition proceedings. The price is determined by a court-approved estimate of present value of projected cash flows.
3) Related to the Daewoo crisis.
Source: KAMCO.

<Table 4> Other public funds used for financial-sector restructuring
(Trillions of won as of August 2000)

Source of funds	End-1997 through 1999 first half	Since 1999 first half	Daewoo-related	Total
National Property Management Special Account	3.1	5.6	1.5	10.2
Public Management Fund	4.4	2.0	0.0	6.4
Borrowing from financial institutions	0.5	1.0	2.8	4.3
Government budget	0.3	2.7	0.0	3.0
Loans from World Bank and ADB	0.0	1.4	0.0	1.4
Other	0.6	1.1	0.0	1.7
Total	**8.9**	**13.8**	**4.3**	**27.0**

Source: Ministry of Finance and Economy

<Table 5> The number of financial institutions

	End of 1997	August 2000	Change
Commercial banks	27	17	-10
Merchant banks	30	9	-21
Securities companies	36	30	-6
Insurance companies	50	37	-13
Investment trust companies[1]	31	21	-10
Mutual savings	231	153	-78
Credit co-operatives	1,666	1,326	-340
Leasing companies	25	16	-9
Specialised and development banks	7	7	0
Total	**2,102**	**1,615**	**-487**

Note: 1) Includes investment trust management companies.
Source: Ministry of Finance and Economy

<Table 6> Indicators of bank profitability for nation-wide banks

(billion won, per cent)

	Banks with high capital ratios[1)]	Banks with lower capital ratios[2)]	Seoul Bank and Korea First Bank
1998			
Before-tax profits[3)]	203.12	-585.25	-2 148.45
After-tax profits	1.05	-1 230.78	-2 428.68
Return on equity (per cent)	3.08	-87.42	-129.66
Return on assets (per cent)	0.17	-4.87	-9.36
Total loans	21,302.14	22,381.43	17,723.70
NPL	1,124.22	1,217.19	3,409.75
NPL ratio (per cent)	4.69	6.83	19.16
Loan loss reserves	836.52	753.24	1 780.90
Reserves/NPLs (per cent)	91.38	61.12	52.48
Capital adequacy ratio (per cent)	12.78	3.31	-1.18
Number of branches	309	322	315
Operating expenses/operating Reserves (per cent)	95.02	113.67	157.17
1999			
Before-tax profits[3)]	214.30	-943.10	580.80
After-tax profits	173.38	-895.73	-1 618.85
Return on equity (per cent)	8.23	-35.48	-310.26
Return on assets (per cent)	0.47	-2.05	-7.48
Total loans	30,589.30	31,143.98	14,001.25
NPL	1,694.22	3,335.63	1,977.80
NPL ratio (per cent)	5.65	11.07	13.67
Loan loss reserves	1 469.38	2 674.20	859.25
Reserves/NPLs (per cent)	87.40	77.44	62.81
Capital adequacy ratio (per cent)	12.29	8.35	10.93
Number of branches	374	386	314
Operating expenses/operating Reserves (per cent)	96.04	135.34	83.85

Note: 1) BIS capital adequacy ratio of more than 10 per cent. This group includes Shinhan Bank, Hana Bank, KorAm Bank, Kookmin Bank and Korea Housing and Commercial Bank (since 1997).

2) BIS capital adequacy ratio of less than 10 per cent. This group includes Chohung Bank, Hanvit Bank, Korea Exchange Bank and Peace Bank.

3) Operating profits after provisioning. A simple sum method is used in this table.

Source: Financial Supervisory Commission

<Table 7> Deposits at financial institutions

(Per cent of total, trillions of won)

	1998	1999	2000 June	Change[1)]	Outstanding amount
Bank deposits	32.9	39.3	44.2	11.3	388.8
Investment trust companies	17.1	14.5	10.7	-6.4	94.5
Bank trusts	14.7	11.2	9.4	-5.3	82.8
Insurance companies	11.8	12.2	12.3	0.5	108.2
National Post Office	1.6	1.8	2.2	0.6	19.2
Merchant banks	1.9	1.1	0.6	-1.3	5.4
Other[2)]	20.0	19.9	20.6	0.6	180.7
Total	**100.0**	**100.0**	**100.0**	**0.0**	**879.6**

Note: 1) Percentage point change between 1998 and June 2000.
2) Includes the National Agricultural Co-operative Federation, mutual saving and finance companies and credit co-operatives.

Source: Bank of Korea

<Table 8> The second-stage financial-sector restructuring programme

(Trillions of won)

Investment trust companies	20.1
Re-capitalisation of Seoul Guarantee Insurance Company	8.3
Insurance companies and credit co-operatives	6.9
Banks with BIS ratio under 10 per cent	6.1
Specialised and development banks	4.4
National agricultural and fisheries co-operatives	1.7
Support for bank provisioning	1.0
Other	1.5
Total	**50.0**

Source: Ministry of Finance and Economy

<Table 9> Asset resolution by KAMCO

(Trillions of won as of end-September)

	Face Amount	Purchase price	Amount retrieved
International bidding	4.9	1.2	1.5
ABS issuance	6.2	3.3	3.3
Foreclosure auction	2.9	1.8	2.4
Public auction	0.5	0.3	0.3
Voluntary payment	4.5	1.2	2.1
Rescheduling	1.1	0.8	1.0
Sub-total	20.1	8.6	10.6
Recourse and cancellation	14.3	7.7	7.7
Total recovery	**34.4**	**16.4**	**18.3**

Source: KAMCO

<Table 10> Progress in regulatory reform

	Total Number of Regulations	Regulations examined in 1998				
		Total	Eliminated	Per cent of total	Improved	Per cent of remaining regulations
Health & welfare	2014	1326	1015	50.4	311	31.1
Financial market	1453	1079	734	50.5	345	48.0
Agriculture & forestry	991	760	507	51.2	253	52.3
Construction & transport	974	739	496	50.9	243	50.8
Maritime & fishing	902	690	485	53.8	205	49.2
Industrial resources	831	634	433	52.1	201	50.5
Environment	643	394	224	34.8	170	40.6
Culture & tourism	540	370	270	50.0	100	37.0
General administration	484	332	214	44.2	118	43.7
Science & technology	454	287	230	50.7	57	25.4
Labour affairs	420	307	211	50.2	96	45.9
Police administration	382	239	150	39.3	89	38.4
Information & communications	342	252	182	53.2	70	43.8
Education	272	197	142	52.2	55	42.3
Legal administration	88	43	11	12.5	32	41.6
Veterans affairs	87	57	45	51.7	12	28.6
Fair trade	75	31	16	21.3	15	25.4
Unification	57	35	20	35.1	15	40.5
National defence & military	46	39	34	73.9	5	41.7
Diplomatic relations	40	21	6	15.0	15	44.1
Total	**11095**	**7832**	**5425**	**48.9**	**2407**	**42.5**

Source: Prime Minister's Office

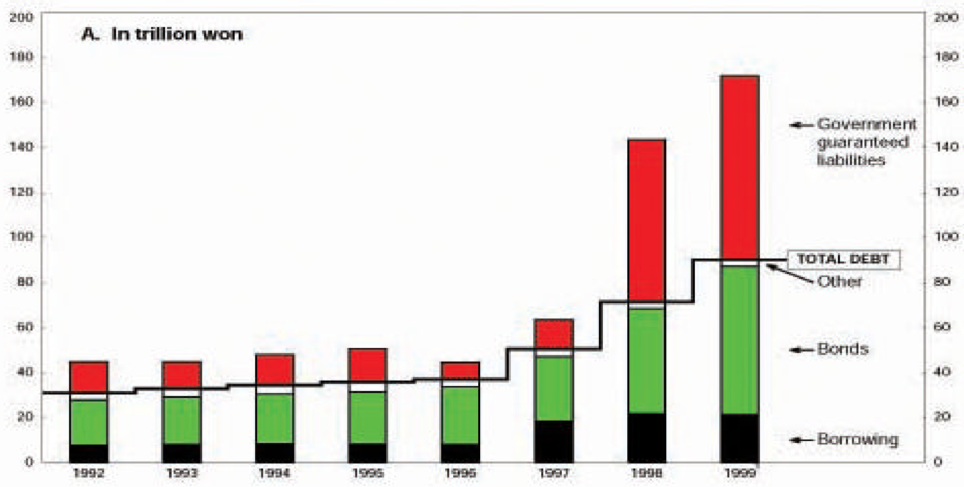
<Table 11> Number of carriers participating in each market[1)]

	Local	Long Distance	Inter-National	Leased Line	Cellular	Portable communication services	Radio paging	Cable television[2)]
1991	1	1	2	-	1	-	1	-
1991-95	1	2	2	-	2	-	11	29
1995-98	2	3	3	3	2	3	13	29

Note: 1) The table indicates the number of carriers in each market segment. Thus, Korea Telecom is counted in local, long distance, international and leased lines.
2) Programme providers.

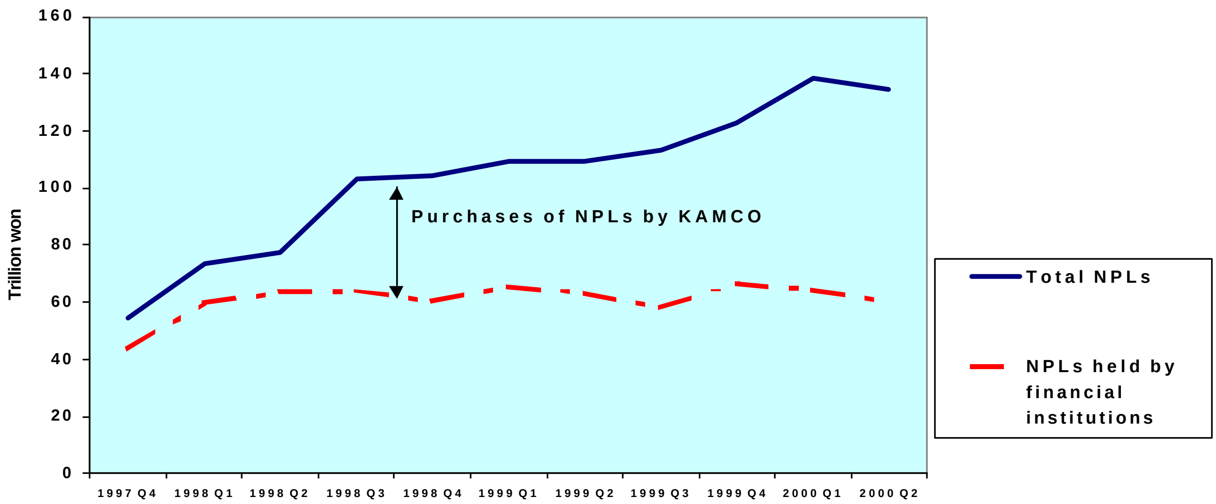
Source: Ministry of Information and Communication

Figure 1. Central government gross debt and guaranteed liabilities



1. Estimate by the Ministry of Finance and Economy.
Source: Ministry of Finance and Economy.

Figure 2. Non-performing loans



Note: Forward-looking loan classification system introduced.
Source: Financial Supervisory Commision.

Korea's Financial and Corporate Sector Reforms

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I. Financial Sector Reform

1. Goals and Principles

1) Restructuring-Related Governmental Institutions

On April 1, 1998 the Financial Supervisory Commission (FSC) was established in order to strengthen the supervision of financial institutions. The supervisory authorities for banks, security houses, insurance companies, and other financial institutions were placed under the FSC – the FSC has played a crucial role in the restructuring of financial sector. On January 1, 1999, the new Financial Supervisory Service (FSS) was established. FSS integrated the existing supervisory authorities, leaving policy making to the FSC. Together with the Ministry of Finance and Economy (MOFE), the FSC set the principles and developed the resolution plans for nonviable financial institutions in accordance with international standards and procedures, as well as a full supporting scheme for other financial institutions that had a chance to return to normal operations.

Compared to the FSC and the MOFE, the Bank of Korea did not play a crucial role during the restructuring process, because the central bank's role was limited to curbing down inflation after the amendment of the Bank of Korea Act. While the Bank of Korea has become free from the responsibility of prudential regulation of the commercial banks, the independency of the currency and credit policy of the central bank has been more clearly stipulated by the revised Bank of Korea Act.

2) Principles of Financial Sector Restructuring

(1) First Stage Financial Restructuring

Until now, the financial sector restructuring process could be divided into two stages. The first stage of the financial sector restructuring was intended to recover the stability of the financial system in the short-run. The two pillars of the first stage financial sector reform were the closing of troubled financial institutions and the disposal of the financial institutions' non-performing loans (NPL).

Many reports suggest that the recent financial crisis in Korea was caused mainly by structural problems that increased balance sheet risks at financial institutions, which eventually exposed the country's vulnerabilities to external shocks. Financial fragility deserves special emphasis, since Korea justified its lax supervisory monitoring by a high growth strategy. Looking back, capital account liberalization should have been pursued in an orderly fashion so as to enhance financial development, not to stifle it. In the course of pursuing rapid financial liberalization since the 1980s, however, Korea did not pay enough attention to the importance of the market mechanism in a capitalist society and was, instead, engrossed in a high-growth strategy. A highly leveraged, unhedged financing strategy allowed Korean firms to expand without due consideration of overall risks. Korea became a textbook case of how financial repression and lack of reform combined with speedy capital account liberalization results in poor supervision and monitoring and a lack of market discipline.

Considering the background, the FSC and the MOFE set implementation of financial sector restructuring in this direction: ① quick recovery of the financial system through a wide-ranged, fast restructuring, ② application of international best practices and standards, ③ establishment of the loss-sharing principles, ④ sufficient support to enhance capital adequacy, and ⑤ minimization of the taxpayers' burden.

The FSC and the MOFE also set the following procedural principles:

① The capital adequacy standards is the basis for identifying troubled financial institutions.

② If financial institutions fail to satisfy the capital adequacy standards, they are required to submit rehabilitation plans.

③ An appropriate appraisal committee of experts should evaluate the rehabilitation plans.

④ Upon reviewing the appraisal committee's evaluation, the FSC determines the policies which must be implemented. If the rehabilitation plan is not approved, resolution will be pursued. If the plan is approved conditionally, the FSC requires the submission of forceful self-rescue and implementation plans. If the plan is approved unconditionally, the FSC provides support through the disposal of non-performing loans (NPLs) as well as other measures.

⑤ The FSC and the MOFE formulate policy schemes for the facilitation of the normalization of financial institutions.

⑥ Transferring business for nonviable financial institutions, purchase and assumption (P&A), merger between nonviable banks, and merger between a sound bank and a nonviable bank will be considered. In cases of P&A, a focus is put on providing financial support at a level sufficient to prevent the deterioration of the asset quality of acquiring financial institutions. In cases of a merger between nonviable banks, the focus is placed on the swift creation of competitive and efficient, leading banks. In cases of merger between a sound bank and a nonviable bank, which will be utilized as a means to resolve nonviable banks, sufficient financial support will be provided to the merged bank so as to prevent the deterioration of the asset quality of the sound bank.

(2) Second Stage Financial Restructuring

The first stage of the financial sector reform based on the above principles was proceeded under the leadership of the government, focusing on the closing of troubled financial institutions and the disposal of the financial institutions' non-performing loans (NPL). Compared to the first stage of restructuring, the second stage of financial restructuring aims at cleaning up the unrealized NPLs and enhancing the competitive power of the domestic financial industry through restructuring that is future-oriented. More specifically, the second-stage financial restructuring focuses on: ① completion of hardware restructuring by the end of the year 2000, ② removal of potentially harmful factors of the banking system through the closing of insolvent enterprises and disposing the NPLs of non-bank financial institutions, ③ support of software restructuring which includes improving the corporate ownership structure and the management reform of financial institutions.

The second stage of financial restructuring thus requires all market participants to exert various restructuring efforts based on spontaneous motivation. That is to say, the role of the government is to be limited just in helping to form the institutional environment which induces such restructuring efforts by the market participants and allows them to receive their deserving rewards.

<Table 1> The First and Second Stage Financial Restructuring

	First Stage	Second Stage
Goal	Recovery of Economic Crises	Strengthening Competitive Power (Creation of a Matured Financial Culture, Establishment of a Market Order)
Focus	Individual Institutions (or Firms) (Troubled Financial Institutions, Insolvent Enterprises)	Market (Financial System, Market Participants' Way of Thinking)
Form	Government-led	Market-led
Contents	Hardware Reform	Software Reform

2. The First Stage Restructuring Program

1) Improvement in Institutional Setting

Various financial systems have been improved. These include the deposit insurance system, credit criteria, and other regulations related to the financial sector. Loan Classification Standards, provision requirements, and prompt corrective action (PCA) have also been established. In addition, loan customs and procedures and the risk management system have been improved.

(1) Reform of Prudential Regulation and Supervision

Prompt Corrective Action System

For almost all financial institutions, the prompt corrective actions (PCA) system was either fully implemented and strengthened or newly established by June 1998. The most important indicator in the PCA system is now the BIS capital adequacy ratio for banks, the operational net capital ratio for securities companies, and the solvency margin ratio for insurance companies.

The assessment accuracy of capital adequacy was improved by upgrading asset classification standards to international standards, provision requirement standards, and accounting principles. In addition, significant efforts have been made to improve evaluation of financial institutions. Especially for the commercial banks' CAMEL system (Capital Adequacy; Asset Quality; Management; Earnings; Liquidity), "Sensitivity to market risks" has been added to the existing list to make it CAMELS.

<Table 2> Indicators in the PCA System

	Indicator
Bank, Merchant Bank	BIS Capital Adequacy Ratio
Securities Company	Operational Net Capital Ratio
Insurance Company	Solvency Margin Ratio
Mutual Savings and Finance Company	BIS Capital Adequacy Ratio

Source: Financial Supervisory Commission

<Table 3> Classification in the PCA System

	First Step	Second Step	Third Step
Bank	Less than 8% Greater than 6%	less than 6% greater than 2%	less than 2%
Merchant Bank	Less than 8% Greater than 6%	less than 6% greater than 2%	less than 2%
Securities Company	Lessthan150% Greater than 120%	less than 120% greater than 100%	lessthan 100%
Insurance Company	Lessthan100% Greater than 50%	less than 50% greaterthan0%	lessthan0%
Mutual Savings and Finance Company	Less than 4% Greater than 2%	less than 2% greater than 1%	less than 1%

Source: Financial Supervisory Commission

Bank Disclosure System

In October 1998, unified disclosure standards for financial institutions were introduced. As a result, all financial institutions, including banks, merchant banks, securities companies, insurance companies, credit unions, mutual savings and finance companies, and lending-specialized financial institutions, are now subject to the new disclosure system. This new system stipulates that a regular disclosure is to be made twice a year and strengthens the penalty for false or dishonest disclosures.

Also, in April 1998, the FSC introduced new disclosure items necessary for judging management conditions. These include the size of non-performing loans and credit and risk management systems. In particular, the first half-year preliminary audit results have become one of the mandatory disclosure items.

Prudential Regulation of Foreign Exchange Businesses

In July 1998, regulations were changed to improve risk management for short-term foreign exchange risk. Accordingly, each financial institution was required to report maturity mismatches in the categories of 1 to 7 days, 7 days to 1 month, 1 to 3 months, 3 to 6 months, 6 months to 1 year, and over 1 year. The new regulations also have made financial institutions subject to the overall exposure limit for each country based on international credit ratings. Furthermore, the new regulations required that the provisions would be accumulated to maintain the ratio for current assets (90 days to maturity) to current liabilities (90 days to maturity) of at least 70%. After June 2000 financial institutions have to maintain this foreign exchange liquidity ratio above 80%.

Accounting Practices

After January 1, 1999, the provision for loans classified as substandard or below has been excluded from Tier 2 capital in calculating the BIS capital adequacy ratio. In the past, securities were treated similarly to loans in that they were valued at purchase price. After November 1998, mark-to-market valuation for securities was introduced to evaluate securities at their current market prices. It was applied to all the new funds created after November 15, 1998, while the existing funds continued to be evaluated at their purchase prices. From July 2000 the funds made up before November 15, 1998, have been prohibited from receiving additional deposits.

(2) Deposit Insurance System

The deposit insurance system was amended in a way so that the amount of guaranteed principal was reduced to prevent moral hazard of depositors and financial institutions. The new deposit insurance system, which has three categories: always protected, temporarily protected until the year 2000, and not protected, has been applied to all deposits except the performance-based investment and trust accounts.

From January 2001, the existing full-protection system will be abandoned and the limited-protection system will be adopted. The coverage limit will be increased from the current 20 million won to 50 million won per person for each financial institution. The goals of introducing limited-coverage are three-folds: ① establishment of market principles; ② enhancing confidence in the government policy and sovereign credit rating; ③ expediting the restructuring process with the help of market forces.

<Table 4> Deposit Protection System

Financial Institution	Always Protected	Temporarily Protected until the End of 2000	Not Protected
Commercial Banks	Deposits, Installment Savings, Retirement Funds, Principal-protected Trusts	Foreign Deposits, Certificate of Deposits (CD), Development Trusts, Bonds issued by Banks, Repurchase Agreements (RP) issued before July 24, 1998.	Merit-basedBonds, RP purchased after July 25, 1998
Merchant Banks	Receipt Notes, CollateralizedNotes, Cash Management Account(CMA)		Non-collateralized Notes, RP, Bonds issued by Merchant Banks
Insurance Companies	Corporate Insurance in the form of Retirement Funds, Individual Insurance Contracts	Corporate Insurance except Retirement Funds, GuaranteedInsurance contracted before July 31, 1998	Guaranteed Insurance contracted after August 1, 1998, Re-insurance Contracts
Securities Companies	Deposits, Futures Deposits, Option Deposits	Repurchase Agreements (RP) purchased after July 24, 1998	Accounts used for Tax Deferral Purposes, Bonds issued by Securities Companies
Mutual Savings and Finance Companies	Deposits, Installment Savings, Receipt Notes		
Credit Unions	Deposits and Investments approved by the Credit Unions		

(3) Loan Classification Standards and Provision Requirements

In July 1998 there was a major revision of the loan classification standards and provision requirements. In accordance with international practices, loans in arrears of 3 months or more are now classified as substandard or below, and loans in arrears of 1 to 3 months are considered precautionary loans. As a consequence, most of the emergency loans made to the "technically" bankrupt companies were reclassified as substandard loans instead of precautionary loans. In addition, the provision requirement for precautionary loans have been raised from 1% to 2%. Provision requirements were newly introduced for commercial papers (CP), guaranteed bills, and privately placed bonds belonging to trust accounts.

<Table 5> Changes in the Loan Classification Standards

Period of Overdue Payment	Old	New
1 month to 3 months	Normal	Precautionary
3 months to 6 months	Precautionary	Substandard or Doubtful
Longer than 6 months	Substandard or Doubtful	Substandard or Doubtful

<Table 6> Provision Requirements Based on the Loan Classification Standards

	Old	New
Normal	0.5%	0.5%
Precautionary	1%	2%
Substandard	20%	20%
Doubtful	75%	75%
Loss	100%	100%

By the end of 1999, the asset quality classification standards based on a forward-looking approach, which takes expected future performance into account as a criterion, was introduced. According to the forward looking criteria (FLC), financial institutions have accumulated an additional large sum of provisions. While the imposition of the strengthened criteria reduced financial institutions' short-term profitability, it has contributed to enhancing the soundness of their financial structure.

(4) Financial Holding Company

On October 2000, the bill introducing a financial holding company system was passed. Accordingly, various financial institutions, such as banks, securities companies, and insurance companies, will be located under financial holding companies with the expectation that comprehensive financial products will be created to meet customers' needs. The biggest advantage of the financial holding company system is the synergy effects it can create, such as reduction of management costs through common ownership of infrastructure, joint investment in information technology, and efficient management of organizations and human resources.

2) Contents for Restructuring of Financial Institutions

By August 2000, a total of 487 financial institutions were closed. In the banking sector, 5 banks were closed through P&A, and 5 other banks had merged with other banks. As for the non-bank financial institutions, 21 merchant banks, 6 security companies, 13 insurance companies, 10 investment and trust companies, 78 mutual savings and finance companies, 340 credit unions, and 9 leasing companies were closed.

<Table 7> Restructuring of Financial Institutions

	Number of Institutions (end of 1997) (A)	Restructuring				
		Revoking Licenses	Merger	Dissolution	Total (B)	Ratio(%) (B/A)
Bank	**33**	**5**	**5**	**-**	**10**	**30.3**
Non-bank	**2069**	**87**	**131**	**259**	**477**	**23.1**
Merchant Bank	30	18	3	-	21	70.0
Securities Companies	36	5	-	1	6	16.7
Insurance Companies	50	5	6	2	13	26.0
Investment and Trust Companies[1)]	31	6	1	3	10	32.3
Mutual Saving and Finance Companies	231	43	19	16[2)]	78	33.8
Credit Unions	1666	2	101	237[3)]	340	20.4
Leasing Companies	25	8	1	0	9	36.0
Total	**2102**	**92**	**136**	**259**	**487**	**23.2**

Note: 1) Including Investment Management Companies (IMC).
2) Transfer of Contracts.
3) Including bankruptcies.
Source: Ministry of Finance and Economy

(1) Banking Industry

The profitability of Korean banks had been quite low even before the crisis because of poor asset quality, regulated interest rates, excessive competition for deposits, and poor asset-liability management. Since the crisis, Korean banks have been facing the "twin" banking problem: worsening asset quality and under-capitalization. The bankruptcies of large business corporations triggered by over-investment and highly-leveraged financial operations have resulted in the deterioration of loan portfolios of the Korean banks. Consequently, the large amounts of NPLs have caused widespread fears of bank failures, thereby making depositors search for better-quality banks.

<Table 8> Bank Performance during the Pre-Crisis Period

(unit: millionwon, %)

	1995		1996		1997	
	city	local	city	Local	city[1)]	local
ROA	0.28	0.56	0.23	0.47	-0.69	-0.94
ROE	3.91	5.63	3.49	5.41	-22.4	-18.1
BIS Capital Adequacy Ratio	8.97	11.44	8.97	10.15	6.66[2)]	9.60[2)]
Bad Loan Ratio[3)]	0.95	0.96	0.83	0.91	2.30	5.82
NEBTR[4)]	35,621 (-20.5)	6,260 (9.1)	37,265 (4.4)	6,697 (7.0)	28,864 (-24.2)	5,143 (-23.2)
Net Income	6,784 (-22.5)	1,892 (9.4)	6,535 (-3.7)	1,933 (2.2)	-33,603	-5,595

Note: 1) Housing & Commercial Bank is included.
2)100% loan loss provisions and securities valuation losses are applied.
3) Bad Loan Ratio= (doubtful loans + estimated losses)/total loans.
4) Net Earnings before Taxes and Reserves.

The banking industry in Korea consists of commercial banks and specialized banks. As of the end of February 1998, there were 16 nationwide commercial banks, including Seoul Bank and Korea First Bank, and 10 regional banks. Nationwide banks are termed "city banks", while regional banks are called "local banks." The 26 commercial banks together with the Korea Long Term Credit Bank (KLTCB) are now classified into five groups: (1) 5 closed banks; (2) 7 conditionally approved banks; (3) 13 viable banks; and (4) Korea First Bank and Seoul Bank, which were nationalized before the banking sector restructuring framework was put in place.

Among the twelve banks whose BIS capital adequacy ratio as of the end of 1997 were below 8%: Daedong Bank, Dongnam Bank, Dongwha Bank, Choongchung Bank, and Kyunggi Bank were acquired by Kookmin Bank, Housing Bank, Shinhan Bank, Hana Bank, and KORAM Bank, respectively. The process was done through purchase and assumption (P&A).

The rehabilitation plans of seven banks: Cho Hung, Hanil, Commercial Bank of Korea (CBK), Korea Exchange Bank (KEB), Peace, Kangwon, and Chungbuk, were conditionally approved. Among the seven, CBK and Hanil Bank merged and have become Hanvit Bank. Also Cho Hung Bank merged with Kangwon Bank and Hyundai Merchant Bank and has become CHB.

The FSC approved the rehabilitation plans of 13 banks (6 nationwide banks, 6 regional banks, and 1 specialized bank) whose BIS capital ratio exceeded 8% at the end of 1997. Among these, Boram Bank merged with Hana Bank. It was the first merger between the two viable banking institutions. Also, Kookmin Bank merged with Korea Long-Term Credit Bank (KLTCB).

Korea First Bank and Seoul Bank experienced financial trouble and were nationalized even before the financial crisis. Korea First Bank was sold to the New Bridge Capital consortium at the end of 1998.

As of November 2000, the banks with a high level of government equity are scheduled to be merged through the bank holding company. Alternatively, the banks with sound capital structures are encouraged to agree on merger without government intervention. However, these banks are to be provided with incentives, including subscribing subordinated bonds and NPLs and tax benefits.

(2) Non-Bank Financial Institutions

① Merchant Banks

Since the Hanbo group declared bankruptcy in March 1997, merchant banks which were engaged in a wide range of business activities, including limited deposit and credit, trusts, securities, international financing, and leasing, suddenly found themselves with the crushing burdens of NPLs. Each major bankruptcy further eroded international financial institutions' confidence in merchant banks, exacerbating the merchant banks' borrowing difficulties at home and abroad. The government finally suspended 14 insolvent merchant banks on December 1997, and it was the first financial sector restructuring effort ever pursued in Korea. Later, the licenses of 18 merchant banks were revoked and the assets and liabilities of all closed merchant banks were transferred to a bridge bank. Also, three merchant banks were merged to others, and four became subsidiaries of the KDIC.

② Securities Companies

Securities companies recorded net losses for the three fiscal years before the crisis, mainly due to the lackluster stock market and rising operating expenses and financial expenses. Upon the deregulation of the law concerning the opening of branch offices in 1996, and most brokers increased their branches. These new investments resulted in higher operating costs and decreased net profits. Moreover, during the past two years, many securities companies experienced a sharp increase in the cost of funding due to increased short-term borrowing and a drop in customer deposits.

Until August 2000, five companies had their licenses revoked and one was dissolved. On the other hand, from April 1, 1998, domestic and foreign securities companies were allowed to set up new securities firms. During the second half of 1998, capital adequacy regulation, conceptually similar to that recommended by the BIS, was put into operation. The regulation not only forces some inefficient and incompetent securities firms to exit, but also prevents investors from being too exposed to the risks of bankruptcy or the insolvency of securities companies, and improves the safety and stability of the securities industry.

③ Insurance Companies

The polarization of the life insurance industry, in particular, has deepened since November 1997. The troubled small- and medium-sized life insurers have been experiencing the difficulty of managing liquidity as the new business ratio decreased while the number of paid claims was on the rise. This was largely due to the loss in confidence on their credit-worthiness and their insufficient solvency margins. The loss of small- and medium-sized life insurance was due to excess management expenses, since the distribution system of the life insurance industry is out-of-date and relies too much on solicitors. Due to the accumulation of net loss the earnings of life insurance companies were, on average, negative. By August 2000, five life and non-life insurance companies had their licenses revoked, six were merged, and two were sold.

④ Investment Trust Companies

The investment trust companies (ITCs) serves as a fund manager, beneficiary certificate seller (distributor), and investment advisor. There are also investment management companies (IMCs) specializing only in fund management and investment advisory services. The ITCs are institutional investors while IMCs are not.

ITCs have been suffering from a bearish stock and bond market, causing unrealized capital losses on the ITCs' securities accounts. The high bond yields also encouraged many investors to redeem their beneficiary certificates, seeking higher interest rates for their money. In response, the ITCs had to borrow a lot of money to redeem the bonds, as they were unable to sell them in the market. A large debt in turn led to huge interest payments, which made things even worse. The ITCs continued to guarantee a return that they are unable to realize on their own investments. By August 2000 six ITCs and IMCs had their licenses revoked, one was merged, and three were dissolved and have transferred their business to a bigger investment trust.

⑤ Mutual Savings and Finance Companies

Out of 231 mutual savings and finance companies, the licenses of 43 companies were revoked. Also 19 companies were merged and 16 companies were either sold or dissolved. FSC imposed management control measures and management guidance measures on many companies with the goal of inducing rehabilitation. A bridge company specifically for mutual savings and finance companies was established in September 1998 to manage the closure process.

⑥ Credit Unions

340 credit unions that were deemed incapable of recovery were closed (2 revoked licenses, 101 mergers, 237 dissolution or sold-off). Troubled unions will be required to pursue individual efforts or undergo mergers to induce rehabilitation.

⑦ Leasing Companies

Since the mid 1990s, keener competition among leasing companies and a continuing economic recession decreased leasing companies' profit figures during last couple of years before the crisis. As a result, many of the 25 leasing companies had substantial non-performing lease assets and sizable losses in security investments. Consequently, in June 1998, ten leasing companies were ordered to be either liquidated or acquired according to decisions made by their major shareholders. So far, eight companies had their licenses revoked and one company was merged.

3) Fiscal Support Scheme

The government's basic position regarding fiscal support has been that financial restructuring is to be funded by the financial institutions themselves, and that there should not be official financial support unless financial institutions undertake individual efforts to reduce costs and recapitalize through foreign investment. In cases where financial support is offered, it ought to be sufficient enough to return solvency to the troubled financial institutions, which are required to writedown the capitals of existing shareholders.

The government initially planned to spend a total of 64 trillion won in order to facilitate financial sector restructuring. The 64 trillion won has been raised and injected into troubled financial institutions for deposit payment, recapitalization of banks and purchase of NPLs by Korea Deposit Insurance Corporation (KDIC) and Korea Asset Management Corporation (KAMCO). As of the end of 1999, of the 64 trillion won in public funds, 20.5 trillion won were allocated for recapitalization, 21 trillion for deposit payment, 20.5 trillion for disposal of NPLs, and the remaining 2 trillion for other uses. By sector, 45.2 trillion won were injected into the banking sector, and the 18.8 trillion won to the non-banking sector. As of August 2000, KAMCO and KDIC have retrieved 17.9 trillion won and 7.5 trillion won respectively, by reselling their NPLs and acquiring equities from banks.

<Table 9> Fiscal Support (as of August 2000)

(unit: trillion won)

		Deposit Insurance Fund					Bad Asset Value Fund	Total
Bond Issue	Assigned	**43.5**					**20.5**	**64.0**
	Fiscal Support (A)	Recapital-ization	Deposit Payment	Buying Assets	Others	**Total**	**20.5**	**64.0**
		20.5	21.0	1.8	0.2	**43.5**		
	Bank	16.5	9.6	1.8	0.0	27.9	17.3	45.2
	Non-bank Financial Institution	4.0	11.4	0.0	0.2	15.6	3.2	18.8
Re-use of the Recovered Portion		**7.5**					**17.9**	**25.3**
		3.0	**4.2**	**1.9**	**-**	**9.5**	**9.5**	**18.6**

Source: Ministry of Finance and Economy

<Table 10> Trend of Non-Performing Loans

(unit: trillion won, %, %p)

	December 1999 (A)	March 2000 (B)	June 2000 (C)	Change	
				C - A	C - B
Total Loans (A)	590.9	592.6	607.5	16.6	14.9
Below-Substandard (B)	88.0	90.4	82.5	-5.5	-7.9
Ratio (B/A)	14.9	15.3	13.6	-1.3	-1.7
Net Below-Substandard[1)](C)	49.6	49.0	44.0	-5.6	-5.0
Ratio[2)](C/A)	9.0	8.9	7.7	-1.3	-1.2
NPL (D)	66.7	64.1	60.9	-5.8	-3.2
Ratio (D/A)	11.3	10.8	10.0	-1.3	-0.8

Note: 1) Below-Substandard Loans - Provisions
2) (Below-Substandard Loans - Provisions) / (Total Loans - Provisions)
Source: Financial Supervisory Service

<Table 11> Non-Performing Loans of Financial Institutions

(End of June 2000)

(unit: trillion won, %, %p)

	Bank	Non-bank	Insurance company	Securities Company	Total
Total Loans (A)	502.5	49.6	46.1	9.3	607.5
Below-Substandard (B)	56.5 (68.5)	16.5 (20.0)	5.4 (6.5)	4.1 (5.0)	82.5 (100.0)
Ratio (B/A)	11.2	33.3	11.7	44.1	13.6
Net Below-Substandard[1)] (C)	31.4	9.5	1.5	1.6	44.0
Ratio[2)] (C/A)	6.6	22.3	3.6	23.5	7.7
NPL (D)	35.2	16.2	5.4	4.1	60.9
Ratio (D/A)	7.0	32.7	11.7	44.1	10.0

Note: 1) Below-Substandard Loans - Provisions
2) (Below-Substandard Loans - Provisions) / (Total Loans - Provisions)
Source: Financial Supervisory Service

<Table 12> Non-Performing Loans of Banks

(End of June 2000)

(unit: trillion won, %, %p)

	Commercial Banks (17)			Specialized Banks (6)			Total		
	March2000	June 2000	+/-	March 2000	June 2000	+/-	March2000	June 2000	+/-
Tatal Loans (A)	339.3	348.1	8.8	146.1	154.4	8.3	485.4	502.5	17.1
Below-Substandard (B)	47.4	43.3	-4.1	16.7	13.2	-3.5	64.1	56.5	-7.6
Ratio (B/A)	14.0	12.4	-1.6	11.4	8.5	-2.9	13.2	11.2	-2.0
Net Below-Substandard[1)] (C)	26.1	23.7	-2.4	9.7	7.7	-2.0	35.8	31.4	-4.4
Ratio[2)](C/A)	8.2	7.2	-1.0	7.0	5.2	-1.8	7.8	6.6	-1.2
NPL (D)	27.2	26.7	-0.5	10.6	8.5	-2.1	37.8	35.2	-2.6
Ratio (D/A)	8.0	7.7	-0.3	7.3	5.5	-1.8	7.8	7.0	-0.8

Note: 1) Below-Substandard Loans - Provisions
2) (Below-Substandard Loans - Provisions)/(Total Loans - Provisions)
Source: Financial Supervisory Service

<Table 13> Non-Performing Loans of Non-Bank Financial Institutions

(End of June 2000)

(unit: trillion won, %, %p)

	Mutual Savings and Finance Companies (166)			Merchant Banks (7)			Leasing Companies (18)		
	March 2000	June 2000	+/-	March 2000	June 2000	+/-	March 2000	June 2000	+/-
Total Loans (A)	17.4	17.6	0.2	9.1	6.7	-2.4	16.2	15.1	-1.1
Below-Substandard (B)	6.0 (6.0)	5.5 (5.5)	-0.5 (-0.5)	1.6 (1.6)	2.2 (1.9)	0.6 (0.3)	6.7 (6.7)	6.5 (6.5)	-0.2 (-0.2)
Ratio (B/A)	34.5 (34.5)	31.3 (31.3)	-3.2 (-3.2)	17.6 (17.6)	32.8 (28.4)	15.2 (10.8)	41.4 (41.4)	43.0 (43.0)	1.6 (1.6)
Net-Below-Substandard[1)](C)	4.7	3.7	-1.0	0.5	1.0	0.5	2.8	2.8	-
Ratio[2)](C/A)	29.2	23.4	-5.8	6.3	18.2	11.9	22.8	24.6	1.8

	Credit Unions (1,336)			Total		
	March2000	June 2000	+/-	March2000	June 2000	+/-
Total Loans (A)	10.1	10.2	0.1	52.8	49.6	-3.2
Below-Substandard (B)	2.5 (2.5)	2.3 (2.3)	-0.2 (-0.2)	16.8 (16.8)	16.5 (16.2)	-0.3 (-0.6)
Ratio (B/A)	24.8 (24.8)	22.5 (22.5)	-2.3 (-2.3)	31.8 (31.8)	33.3 (32.7)	1.5 (-0.9)
Net-Below-Substandard1) (C)	2.2	2.0	-0.2	10.2	9.5	-0.7
Ratio2) (C/A)	22.4	20.2	-2.2	22.1	22.3	0.2

Note: 1) Below-Substandard Loans - Provisions

2) (Below-Substandard Loans - Provisions) / (Total Loans - Provisions)

Source: Financial Supervisory Service

II. Corporate Sector Reform

1. Goals and Strategies

1) Goals

The goal of the corporate sector reform is the elimination of corporate weaknesses which has been accumulating from the past. During Korea's high growth period, the private sector focused on quantitative expansion rather than efficiency in investment. It lacked efforts to enhance productivity, improve the financial structure, and enhance technical innovation. As a result, over-investment and over-capitalization has contributed to weakening the private sector's productivity and competitiveness. Thus, the recent Korean financial crisis was fundamentally brought about by the limitation of the development pattern and the weakness of the overall economic system. Therefore, corporate restructuring is a procedure to seek a new development path of the corporate sector, meeting the challenges of the rapidly changing world economic environment.

2) The 5+3 Principles

Current corporate restructuring has its roots in the five key principles agreed on January 1998 between the, then, president-elect Kim Dae-Jung and the representatives of the biggest 5 Chaebols. The principles include the steps to: ① enhance management transparency, ② eliminate cross guarantees, ③ improve capital structure, ④ establish core competence, and ⑤ strengthen accountability of the major shareholders and management.

Enhancing management transparency is essential to assessing the exact corporate values in the market through disclosing actual management performance and decision-making processes. Eliminating cross guarantees is also important because massive cross guarantees among affiliated companies, which has been intensively used as a tool for external expansion of companies, actually brought about the very weakness of the private sector. Improving capital structure is necessary to remove the associated risks of over-indebted management. Establishing core competence is indispensible to solve the problems arising from over-investment and marginal business. Finally, strengthening accountability of major shareholders and management is introduced to improve corporate governance, establishing the responsibilities of owners and protecting the rights of minority share-holders. In short, the objectives of corporate restructuring is to enhance transparency, independence, and soundness of management; thus, to achieve a competent buildup and a responsible management system.

Three additional principles were added to the list later on August 1999: ① improving governance of non-bank financial institutions, ② preventing circulation loans and illegal insider trading, and ③ preventing improper inheritance and donation.

3) Principles of Corporate Restructuring Implementation

Corporate restructuring was to be implemented based on voluntary negotiation between companies and creditor financial institutions, not by direct intervention of the government. This principle of voluntary restructuring can reduce the side-effects of direct government intervention, and furthermore evade the criticism of improper intervention on individual property rights.

For voluntary restructuring of corporations, the following three procedural principles were set. First, restructuring implementation should be mostly led by financial institutions through fully carrying out the rights and duties as a creditor. Second, a fair loss sharing principle should be applied to the interested parties. This indicates that it is desirable for corporations and creditors to share restructuring costs based on the relative responsibilities for the losses. Third, 'workout,' which rehabilitates companies that undergo temporary managerial difficulties or are expected to have weak competence in the future, should be used as the main method in implementing corporate restructuring.

Workout plans have proceeded under the following principles: ① minimization of losses, ② fairness, ③ swiftness, and minimization of costs. If companies which are on the verge of insolvency are selected as workout targets, the losses of creditor financial institutions will be over-extended.

2. Corporate Restructuring Implementation System

1) Corporate Restructuring Agreement (CRA)

Corporate restructuring has had two basic implementation systems: Corporate Restructuring Agreement (CRA) and Corporate Restructuring Coordination Committee (CRCC). Workout being a process in making road for improvement through negotiation among the interested parties, CRA was created June 1998 to mediate conflicting interests among creditor financial institutions. CRA formally defines workout as a means for corporate restructuring and provides the overall implementation procedures. A total of 210 financial institutions, including banks, security houses, insurance companies, merchant banks, investment and trust companies, signed the agreement.

While workout based on CRA was the basic framework for corporate restructuring, two different sub-systems were established in order to implement the restructuring of the five biggest chaebols and small- and medium-sized enterprises (SMEs) separately. As a result, ‘Steering

Committee Agreement of Major Creditor Banks for the Restructuring of the Five Biggest Chaebols (SCA)' based on CRA, and the 'Implementation Model for the Workout of SMEs (IMW)' were established respectively.

Thus, for the five biggest Chaebols the coordination among creditor financial institutions was implemented by SCA, and the restructuring of their affiliates was implemented by 'Capital Structure Improvement Plan (CSIP)' which was agreed between the five biggest chaebols and their lead banks. The CSIP stipulates streamlining the affiliates to concentrate on core business, improvement of financial structure through selling-off the side business, recapitalization, elimination of cross guarantees, and the big-deal plan for eight major businesses such as the petro-chemical industry. For the 6th-to-64th chaebols and other large/medium standalone companies, workout based on CRA was pursued. For SMEs, additional supportive plans were provided for solving SMEs' financial difficulties and preventing a chain of bankruptcies. The borderline of these two sub-systems, however, became vague after the 12 affiliates of the Daewoo group were included in the workout list at the end of 1999.

2) Corporate Restructuring Coordination Committee (CRCC)

The Corporate Restructuring Coordination Committee (CRCC) was launched as a mediation system by the CRA. This private organization has played a role of mediator in relation with the application of CRA. The main activities of CRCC are to make an adjusted proposal in case voluntary negotiations fail among creditor financial institutions, and to levy a penalty for violations of CRA. The CRCC is to be dissolved when the IMF program ends.

3. Contents of Corporate Restructuring

1) Corporate Structure

(1) Transparency of Corporate Accounting

By inducing proper decisions by investors and financial institutions, credible information of corporate accounting enhances the efficiency of allocating resources. It enhances national credit rating as well, thus attracts foreign capital. To this end, the government revised corporate accounting standards based on international best practices and introduced consolidated financial statements on December 1998. The consolidated financial statements were applied to the 1999 fiscal year. Distortions from illegal insider trading can now be prevented and the actual financial status of corporations can be detected transparently.

(2) External Audit

The role of external auditors who confirm the credibility of information disclosed by corporations is important because corporations can distort their results by exaggerating the performance or hiding the loss. In order to strengthen the auditing of the corporate account, the independence of the accounting supervisor should be guaranteed. To this end, listed corporations are now required to have an external auditor appointment committee. In addition, a sanction on the false audit has been strengthened.

(3) Disclosure System

Improvement has been made in the official disclosure system to enhance the transparency of management and to provide investors with reliable information swiftly. The penalty on false and unfaithful disclosure was introduced, too. In addition, an electronic disclosure system, which enables the disclosure of business reports of listed corporations to the public through internet, was introduced in March 1999. A more objective accounting standard and an improved disclosure system help the public understand the actual management and the related information based on transparent accounting.

2) Corporate Governance

Advanced-level corporate governance enhances the transparency of corporate management. Corporate governance is the upper management system for decision making, performance, and supervision to maximize profits of the interested parties such as the management, shareholders, employee, creditors, etc. Efficient corporate governance can supervise arbitrary management, too. In Korea an owner's dogmatic management and related negative effects have been a chronic problem. In particular, by complicated investments and cross transactions, heads have been able to manage all the affiliates even though they own a small portion of total shares. Hence, the essential part of corporate governance reform is to establish responsible management and to protect the rights of minority shareholders.

(1) External Director System

An independent external director system was systemized, so the board of directors could better function. After April 1998, one forth of the directors(minimum one) of a listed corporation should be external directors. Also, after January 2000, one half of all directors(minimum three) of a listed corporation whose total capital asset is over two trillion won should be external directors. When an external director resigns, a new member should be appointed in the first general shareholder's meeting. The new law also stipulates that an external director recommendation committee should be established, and one half of the committee members should be external directors.

(2) Internal Auditor and Audit Committee

An internal auditor and an audit committee were introduced to strengthen the audit inside of corporations. A listed corporation whose total capital asset is over one hundred billion won should appoint at least one internal auditor. Also, a listed corporation whose total capital asset is over two trillion won should establish a audit committee. In establishing an audit committee, a corporation is exempt from appointing internal auditors. An audit committee is required to consist of at least three directors, and two thirds of the committee members be external directors.

(3) Rights of Minority Shareholders.

The rights of minority shareholders were strengthened to enhance the direct management supervision function of shareholders. A shareholder's proposal rights was introduced and the requisites to exercise the rights of minority shareholder, such as the right for shareholder derivative suit and the right to inspect the corporate ledger, were significantly eased. The activation of the rights of minority shareholders in fact have caused the private minority shareholders' movement and contributed to facilitate the transparent management of Chaebols. In addition, institutional investors' voting right was liberalized to strengthen the supervision by institutional investors and to prevent the owner's dogmatic management. The cumulative voting system was also introduced, although it was not an obligatory item, to check the power of owners in the appointment of directors. In addition, an actual director system was introduced, in which the one who influences the directors' decision is regarded as a director, thus should take the corresponding responsibilities.

(4) The Model of Corporate Governance Structure

The model of the corporate governance structure, which is based on OECD corporate governance principles, was made by the Corporate Governance Improvement Committee, and the listed corporations were advised to follow the model and had to announce officially whether they actually did it. The disclosure document form of corporations were revised to include the items related with corporate governance and the audit system on April 2000.

3) Corporate Restructuring Assistance System

(1) Corporate Restructuring Funds (CRF)

Corporate Restructuring Funds (CRF) of 1.6 trillion won has been raised by financial institutions to improve the financial structure of SMEs which experience temporary financing difficulties. The management of CRF, including the selection of target corporations and setting the conditions for assistance, was entrusted to renowned foreign fund managers in order to secure transparency, fairness, and expertise. CRF are divided into the security investment fund and the debt restructuring fund, where the former is used for the investment of newly issued SMEs stocks for the purpose of recapitalization, and the latter assists the conversion of SMEs' short-term debts to long-term debts. Accordingly, one debt adjustment fund (Seoul) and three CRFs (Hangang, Mugunghwa, Arirang) were established on Setember 24, 1998. CRF have also performed ex-ante and ex-post normalization management of target corporations.

(2) Corporate Restructuring Company (CRC) and Corporate Restructuring Vulture Fund (CRVF)

Corporate Restructuring Company (CRC) and Corporate Restructuring Vulture Fund (CRVF) were introduced to facilitate the liquidation of ailing corporations. A CRC is a corporation under the commercial law which focuses on restructuring works, such as take-over, normalization, sell-off, purchasing bonds, M&A, agent business for corporate liquidation procedure, etc. A CRVF, which is an association under the civil law, creates funds from investors, makes investments by lending to or purchasing assets from target corporations, and distributes profits to investors. As of October 2000, a total of 51 CRCs and 11 CRVFs are registered. The CRCs have invested 1.2634 trillion won in 538 ailing target corporations by September 2000. In particular, direct take-over of the right of management sums up to 25 corporations (157.7 billion won).

(3) Corporate Restructuring Vehicle (CRV)

Because of the financial institutions' strengthened asset evaluation system, creditor financial institutions have incentives to separate debt-swapped equities and related loans arising from the workout of the corporations from their accounts. Corporate Restructuring Vehicle (CRV) manages debt-swapped equities.

Although CRCs can also manage target corporations in the workout list as they take over debt-swapped equities and ownership of loans, their management is limited in that CRCs are not financial institutions essentially, and that their capital assets are relatively small to take over large enterprises. CRVFs invested by CRCs can solve such financing problems partly, but they may result in operational inefficiency especially when when the size of assets is large. Therefore, CRV was introduced in order to supplement the limitations of CRC and CRVF and implement corporate restructuring smoothly. A CRV can borrow funds up to 200% of its equity capital, and creditor financial institutions' holding of CRVs' stocks is allowed to exceed the limit which are specified by individual law.

(4) Legal System

The laws related to the liquidation of ailing corporations, such as the corporate reorganization act, the composition act, the bankruptcy law, were revised. The corporate reorganization act was revised to improve the expertise of courts and shorten the procedure of liquidation. The composition is a procedure to derive a collective agreement among creditors and debtors to prevent bankruptcy when debtors bear a certain cause to the bankruptcy. Composition can only be applied when there is a reliable relationship between creditors and debtors. Despite the original objectives, there have been a tendency to prefer composition to liquidation even in situations in which applying composition was inadequate. The composition act was revised to strengthen the right and role of creditors by expanding the necessary conditions to dismiss the composition and authorizing the right of composition cancelation. The bankruptcy law was also revised for cases related with bankruptcy to be treated smoothly and reasonably.

(5) Tax System

By June 1998, the tax system was considerably revised to support corporate restructuring. Revisions were made in the areas of organizational changes(e.g., merger and division) and business restructuring (e.g., transferring corporation or business, exchanging property etc.). Tax on dividends of mutual funds and securities transaction tax in stock transfers have become exempt. For private investors, tax on gains on the disposition of securities was exempt, and separate taxation on dividend income was introduced. Various kinds of tax exemption for CRVF were introduced as well, which include tax exemption on stock transfers, exemption of the investment income tax, dividend income tax, and securities transaction tax, and exemption of local tax including acquisition tax, and registration tax, when taking over assets.

4. Results of Corporate Restructuring

1) Four Biggest Chaebols

(1) Overall Evaluation

The four biggest chaebols (Hyundai, Samsung, LG, SK) participated in the Capital Structure Improvement Plan (CSIP) and exerted self-rescue efforts. Resultingly, their financial structures have been significantly improved. Overall, they have fulfilled the restructuring plans so that the average debt ratio of the four chaebols have fallen to 173.9% at the end of 1999 from 352% at the end of 1998.

The four biggest chaebols have exerted self-rescue efforts such as selling assets, inducing foreign funds, separating and disposing affiliates, and improving governance structure. During, 1999 they procured 12.2 trillion won by selling assets and 22.7 trillion won by issuing new equities. Therefore, the total sum amounted to 37.7 trillion won by self-rescue efforts which exceeded the target (33 trillion won) by 14.4%. In addition, they attracted foreign capital amounting to 84.3 billion dollars which again exceeded the target (71.9 billion dollars).

<Table 14> Improvement in Financial Structure of the Four Biggest Chaebols

(unit: trillion won, %, %p)

	End of 1998 (A)	End of June 1999 (B)	Result			
			End of 1999		+/-	
			Planned (C)	Actual (D)	(D-A)	(D-B)
Debt Ratio	352.0	254.6	197.7	173.9	-178.1	-80.7
(including Asset Revaluation)	286.8	207.8	171.8	147.4	-139.4	-60.4
Debt	165.1	160.9	128.3	139.6	-25.5	-21.3
Equity Capital	46.9	63.2	64.9	80.3	33.4	17.1

<Table 15> Restructuring of the Four Biggest Chaebols

	Planned	Actual	Ratio (B/A, %)
	1999 (A)	1999 (B)	
Self-Rescue Efforts Total (trillion won)	33.0	37.7	114.4
·Selling Assets	13.7	15.0	109.6
·Recapitalization	19.3	22.7	117.8
Foreign Capital Inducement (million dollars)	71.9	84.3	117.2
Elimination of Cross Guarantees (trillion won)	2.7	3.1	116.7
Number of Separation of Affiliates	173	442	255.5
Change in Corporate Governance[1)]	136	143	105.1
Number of Disposal of Affiliates	84	94	111.9

Note: 1) Appointment of directors, external directors, and external auditors in affiliates.

(2) Affiliates of the Four Biggest Chaebols

The Hyundai group announced that it would designate its manufacturing (heavy industry, construction, automobile, and electronics) and financial sector as its core competent businesses, and reduced its affiliates to 26 by the end of 1999 from 57 at the end of 1998. Hyundai disposed of affiliates in such areas as petrochemicals, aircraft, railroad vehicles, and power generation facilities. Hyundai's debt ratio was also reduced to 181% at the end of 1999.

The Samsung group designated electronics, financial services, and trade/service as its core competent sectors. As a result, it disposed of affiliates in such businesses as petrochemicals, power generation facilities, ship engines, and automobile. Reducing its total debt to 6.3 trillion while increasing equity capital to 6.9 trillion, Samsung reduced its debt ratio to 166.3%.

The LG group's core competent businesses were energy, chemical, telecommunications, construction/distribution, and financial services. Its debt ratio was reduced to 184.2% at the end of 1999.

The SK group announced that it would promote energy chemical, telecommunications, construction/distribution, and financial services as its core competent business. Consequently, the number of affiliates was reduced to 38 by the end of 1999 through the disposal of subsidiaries and merger between affiliates. SK reduced its total debt by 200 billion won and increased equity capital by 7.5 trillion won. Thus its debt ratio went down to 161.0% at the end of 1999.

2) Daewoo, Affiliates of the 6th-to-64th Chaebols, and Other Large/Medium Standalone Corporations

A total of 104 corporations have been appointed for workout, including 12 affiliates of Daewoo group. Among them, 58 corporations completed the program early, dropped out, or merged, and 46 corporations have remained in the workout list as of August 2000. The workout program started when eight major banks established workout strategies for swift restructuring of the affiliates of the 6th-to-64th chaebols and large/medium standalone corporations. The banks received applications from the troubled corporations, or directly appointed the target corporations. For selected corporations, workout programs were set and implemented on the basis of the agreement between the main creditor bank and other creditor banks.

<Table 16> Number of Workout Corporations

(As of August 2000)

	Selected (A)	Change				Current	
		Drop-out	Early Graduation	Merger	Total (B)	(A-B)	Exchange of MOU
Majorly Indebted Corporations	61	5	15	12	32	29	27
Large/Medium Standalone Corporations	43	3	20	3	26	17	17
Total	104	8	35	15	58	46	44

Note: Including two affiliates of Saehan Group

Daewoo group was late in starting their restructuring compared to the other four biggest chaebols, hence, their outcome was not satisfactory. The group's financing difficulties inflamed as its credit rating continued to fall. Although Daewoo announced an additional restructuring plan to solve their problems on April, 1999, the unsatisfactory results of restructuring made matters worse. Daewoo announced 'The Acceleration of Restructuring and a Concrete Practice Plan' in June, and creditors also renewed Daewoo's debt on the assumption that Daewoo would implement the plan reliably. As a result, a special agreement for implementing restructuring was made between creditor financial institutions and Daewoo in August, which specified concretely detailed restructuring plans and postulated the right to dispose of security if Daewoo fails to fulfill it. Such methods, however, turned out to be insufficient in solving Daewoo's short-term liquidity crisis. Consequently, Daewoo was appointed for a workout program on August 26, 1999. On November 3, 2000 creditor financial institutions concluded that ten of Daewoo's affiliates should be sold.

<Table 17> Results of Workout (as of August 2000)

(Unit: 10 million won, %)

		Debt Restructuring					New Loans[1]
		Grace on Debt Repayment		Debt/Equity Swap[1]	Others[2]	Total	
		Reduction of Interest Payment	Normal Interest Rate				
Non-Daewoo (56)	Planned	189,277	47,950	72,401	10,347	319,975	10,982
	Actual (Ratio)	171,696 (90.7)	34,627 (72.2)	28,572 (39.5)	37,591 (363.3)	272,486 (85.2)	11,313 (103.0)
Affiliates of Daewoo (12)	Planned	533,641	11,888	85,849	34,389	665,767	56,110
	Actual (Ratio)	530,744 (99.5)	11,888 (100.0)	5,666 (6.6)	35,257 (102.5)	583,555 (87.7)	37,209 (66.3)
Total (68)	Planned	722,918	59,838	158,250	44,736	985,742	67,092
	Actual (Ratio)	702,440 (97.2)	46,515 (77.7)	34,238 (21.6)	72,848 (162.8)	856,041 (86.8)	48,522 (72.3)

Note: 1) Debt/equity swap and purchase of convertible bonds
2) Including cancelling out of Deposits and Loans, repayment, and normal transactions
Source: Financial supervisory Commission

(1) Corporations in Workout

The total debt of all the corporations in the workout program, including 12 of Daewoo's affiliates amounted to 98.5742 trillion won as of June 2000. The total portion of 12 of Daewoo's affiliates was 66.5767 trillion won (67.5%). Of the total debt by the 12 Daewoo affiliates, grace was granted on 53.744 trillion won with interest-exemption (99.5% of the planned amount), and the debt amounting to 0.5666 trillion won was converted to equities (6.6% of the planned amount). In addition, new credits up to 3.7209 trillion won (66.3% of planned amount) were supplied to them. Of the debt of the 6th-to-64th conglomerates (31.9975 trillion won), grace was granted on 17.1696 trillion won (90.7% of planned amount) with interest-exemption, and 2.8572 trillion (39.5% of planned amount) won was converted to equities. Also, new credits of 1.1313 trillion won (103.3% of planned amount) were provided.

The 68 corporations in the workout program exerted self-help efforts of 5.4295 trillion won (100.2% of the planned amount) at the end of June 2000. It was 38.1% of the original target for the whole workout term (generally 3-5 years). The self-rescue efforts included selling properties (3.5081 trillion won: 117.2% of the planned amount), inducing foreign capital (0.57 trillion won: 163.3% of the planned amount), disposing of affiliates (0.1764 trillion won: 14.1% of the planned amount), and issuing new shares (0.5616 trillion won: 137.5%of the planned amount). But, the self-rescue efforts of 12 Daewoo affiliates were only 0.4074 trillion won, which was 46.0% of the self-rescue efforts plan (0.8858 trillion won).

<Table 18> Self-Rescue Efforts of Workout Corporations

(Unit: 10 million won, %)

		Selling Assets		Foreign Capital Inducement	Disposing Affiliates	Issuing New Shares	Others	Total
		Properties	Real Estates					
Non-Daewoo (56)	Planned	27,740	23,002	3,490	7,108	4,085	3,013	4,5437
	Actual (Ratio)	33,032 (119.1)	28,621 (124.4)	5,700 (163.3)	1,010 (14.2)	5,616 (137.5)	4,969 (164.9)	50,327 (110.8)
Affiliates of Daewoo (12)	Planned	2,204	1,223	-	5,383	-	1,271	8,858
	Actual (Ratio)	2,049 (93.0)	1,294 (105.8)	- (-)	754 (14.0)	- (-)	1,271 (100.0)	4,074 (46.0)
Total (68)	Planned	29,944	24,225	3,490	12,491	4,085	4,284	54,295
	Actual (Ratio)	35,081 (117.2)	29,915 (123.5)	5,700 (163.3)	1,764 (14.1)	5,616 (137.5)	6,239 (145.6)	54,401 (100.2)

Source: Financial Supervisory Commission

(2) Disposal of Affiliates

The 17 majorly indebted chaebols which started workout as of the end of 1999, have disposed 237 affiliates out of their 303 affiliates, of which 128 affiliates have already completed the disposal process. The 237 affiliates include 112 affiliates sold, 52 liquidated, 51 merged, and 22 for court receivership or composition. The other 6th-to-64th conglomerates in the workout program carried out disposed 52 affiliates(27 sold, 19 disposed, 2 merged, and 4 for court receivership) out of 109 affiliates.

<Table 19> Disposing of Affiliates of Workout Corporations

	Affiliates (A)	Workout (B)	Conti-nuation (C)	Disposing				
				Selling	Liquidation	Merger	Court Receivership	Total (A-B-C)
Majorly Indebted Chaebols	303	54	12	112(68) <47.3>	52(28) <21.9>	51(32) <21.5>	22 (-) <9.3>	237(128) <100.0>
6^{th}-to-64^{th} Conglomerates	109	39	18	27(14) <51.9>	19(9) <36.5>	2 (-) <3.9>	4 (-) <7.7>	52 (23) <100.0>

Note: 1) ( ) denotes the number of affiliates for which disposing is completed.
2) < > denotes ratio in percentages.
3) Selling includes separation from the group.
4) Court receivership includes composition.

3) Small- and Medium-Size Enterprises (SMEs)

The restructuring of SMEs proceeded in the direction of strengthening financial institutions' support, since SMEs in general do not possess much ability for self-restructuring and have a relatively small number of creditor financial institutions. To this end, 'the Implementation Model for the Workout of SMEs (IMW)' was separately made, which is based on the Corporate Restructuring Agreement (CRA). In particular, a special policy for strengthening financial support was made for healthy SMEs. On May 1998 the task force for SMEs was established under the direct control of the presidents of each bank. All 36,823 SMEs were classified into three categories: primary assistance, conditional assistance, and others as of November 1998. Consequently, various financial assistance schemes were devised and carried out for the corporations in the first category, such as providing new loans, renewing the existing loans, converting debts to medium- or long-term credits. At present, restructuring for the corporations in the second category is implemented through providing new funds on the condition that they should exert intensive self-rescue efforts, such as reducing the debt ratio, selling properties, and issuing new equities.

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OECD Recommendations on Labor Issues and Korea's Compliance with Evaluations
- Labor Law, Relations, Market, and Social Security -

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I. Introduction

(1) There are two sources of recommendation by the OECD toward Korea; The first recommendations are from the ELSA committee. The second are "Korean Economic Surveys" which are published by the OECD annually.
(2) In April of 1996, the ELSA committee proposed some important recommendations regarding the discussion for Korean OECD membership.
(3) The representatives of the ELSA committee at the discussion made the following 3 recommendations to the Korean government ; first, the Korean government should make its best effort to arrange Korean labor law to meet ILO standards; second, minimize arrests and imprisonment of union officials and members; third, create less hostile labor relations in Korea.
(4) The Korean government responded to these recommendations with a new proposal stating that it would make efforts to revise labor law and improve labor relations. The ELSA committee decided to continuously monitor Korean labor to inspect the process of the new proposal.
(5) The most recent monitoring results were reviewed at the 96th regular ELSA meeting in April of 2000. The recommendations at this meeting were on labor law, labor relations, labor market policies and, most importantly, on economic and sociological change in the environment.
(6) The recommendations for the Korean labor market and social securities are in "the Korean Economic Survey." This survey, which was published in 1997/1998, has six main suggestions.[9]

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[9] the 6 main recommendations are as follows; First: The Korean government should make efforts to have more flexible employment, Second: enlarge social welfare, Third: have more active labor market, Fourth: have a more competitive product market, Fifth: have a more trained workers, and Sixth: have more innovative technologies.

<Table 1> Recommendations by OECD and their Process and Achievements

Issues	Period	Recommendations by OECD	Korean Compliance
Labor law	New member (1996)	① multiple trade unions	· introduction of multiple unions · delay enterprise level until 2002
		② right of public servants to organize trade unions	· permission for teachers' union · public workers' workplace organization
		③ third party intervention	· abolition of provision banning third party intervention
		④ political activity of trade union	· abolition of provision banning political activity of trade union
	1999 and after	⑤ earlier than scheduled introduction of multiple unions at enterprise level	· establish ways of unifying the bargaining channel(the system will start Jan. 1, 2002)
		⑥ expand the number of public officials joining the workplace associations	· this issue will be discussed in the Tripartite Commission
		⑦ abolition of notification of third party intervention	· the provision on notification regards government help to third parties
		⑧ wage payment to full time union officials	· discussion is under way by the Tripartite Commission
		⑨ narrow the scope of essential public services	· from 2001, inner-city bus services and banking services will be excluded from scope, and other services are currently discussed in Tripartite Commission
		⑩ union membership of unemployed workers	· this issue is under discussion by the government
Labor relations	New member	① Arrests of union officials and members	· strict application of law · minimize number of arrests
	1999 and after	② Delay in implementation of agreement made at Tripartite Commission	· launch of the 3rd Tripartite Commission
Labor market	New member	① flexible labor market	· new legislation of lay-off, and employment leasing(Feb. 14, 1998)
		② protection for the weak group	· special unemployment schemes for youth, female, and non-standard workers
	1999 and after	③ expansion of active labor market	· intensifying job search network and job training system
		④ mid and long term unemployment policy	· more investment of HR development in youth and long term unemployed
Social security	1999 and after	① social security net expansion with minimum cost	· establish productive social workfare network

(7) In chapter 2, this paper reviews what the OECD recommendations are, Korean compliance toward the recommendations, and their evaluations. In chapter3, this paper

reviews future policy implications.

(8) The recommendations by the OECD on Korean labor issues and social securities are better reviewed during two periods. The 1st is between 1996-1999 regarding the recommendations for Korea's new membership in the OECD. Another is after "the Meeting of the Extended Bureau of the ELSA Committee" in June of 1999, which proposed new recommendations in lieu of the changed Korean environments after their financial crisis.

II. Korean Compliance with Evaluations toward OECD Recommendations

1. Labor Law Issues

1) Abolition of the Provision Against Multiple Trade Unions.

(1) The Korean Government revised " The Trade Union and Labor Relations Adjustment Act (TULRAA)" abolishing the prohibition of multiple trade unions on March 13, 1997.
(2) At the enterprise level, the effective date will begin Jan.1, 2002, to establish a bargaining channel.
(3) As a result, the Korean Confederation of Trade Union (KCTU), 18 quasi-industrial organizations, and the trade unions at the enterprise level, which join KCTU, are legalized in their activities.

2) The Right of Public Servants and Teachers to Organize Trade Unions

(1) The Korean government enacted " The Teachers' Trade Union Establishments and Their Management Act", in December of 1998 to implement the former agreement made at the Tripartite Commission regarding teachers' rights to organize trade unions.
(2) As a result, the Federation of Teachers' Union(FTU) which joins KCTU, was legalized.
(3) The subjects for negotiations are limited with respect to the issues, work standards, and welfare. In Jun of 2000, the collective agreement between the FTU and Minister of Education was signed.
(4) The "Establishment and Operation of The Public Officials' Workplace Associations Act" was enacted on Feb.20, 1998 and has been effective since Jan.1, 1999.
(5) On Feb. 6, 1998, the first Tripartite Commission decided to grant public servants the

right to organize in two stages as follows;

Step 1: Grant establishment of “public servants’ workplace associations” as a prior step to trade unions.

Step 2: Allow the organization of trade unions while taking into account public opinion and the revision of related laws.

(6) Public officials of grade 6 or lower are now eligible to join the association, where a range of issues will be discussed, such as handling grievances in the workplace, improving the work environment, enhancing job efficiency etc.

(7) The actual number of public officials eligible to join the association stands at 338,000(64%) and the rate of organization is 9.2% (32,000).

3) Abolition of the Provision Banning Third Party Intervention

(1) The Korean Government abolished a legal provision which prevented third party intervention, in March of 1997, to bring the labor legislation in line with internationally recognized standards.

(2) Under the new law, both trade unions and employers are entitled to receive support when engaging in collective bargaining and industrial action from 4 groups:

industry level unions or national federations, to which the trade unions belong;

employer’s associations to which the employers belong;

persons who are authorized by other relevant laws and regulations;

these notified to the authorities 3 days in advance by trade unions or concerned employers from whom they wish to receive support (Article 40(1) of the act).

4) Authorizing the Political Activity of Trade Unions

(1) The 1st Tripartite Commission decided to abolish the provision banning the political activity of trade unions and guaranteed authorization of trade union political activity.

(2) Trade Unions were exceptionally authorized to have free political activity among groups of associations by adding a provision in “the Election for Public Office and Election Malpractice Prevention Act” in April of 1998.

(3) The political activity of trade unions was substantially opened by the revision of labor law (TURRAA) in December of 1998.

(4) The Korean Federation of Trade Union (KFTU) and The Korean Confederation of Trade Union (KCTU) nominated and supported their own candidates for the National Assembly election in April 2000.

5) Earlier than Scheduled Introduction of Multiple Unions at the Enterprise level.

(1) The reason for the delay in the introduction of multiple unions at the enterprise level was to have sufficient time to work out ways to unify the bargaining channel.
(2) Most trade unions in Korea are enterprise based. Therefore multiple collective bargaining agreements need to be signed depending on the number of unions in the work place. It would lead to business interruptions if an employer needed to engage in bargaining with every union in the firm.
(3) The revision of labor related acts in March of 1997, granted a multiple trade union system in principle. However, the implementation of the multiple union system at the enterprise level has been delayed for five years, amidst worries of possible disorder and confusion in the collective bargaining process. (Article 5(1) of Agenda of The Trade Union and Labor Relations Adjustment Act)
(4) Regarding the delay, both the labor and management sides have not taken any objection.
(5) In addition, the bill containing the bargaining channel unification options is pending at the National Assembly. This bill was enacted on suggestions by The Tripartite Committee.[10]

6) Expand both the Number of Public Officials Joining the Workplace Association and the Right of Public Servants to Organize Trade Unions.

(1) The Korean government tries to extend association membership to public officials by prudently reviewing the operation of the Workplace Association.
(2) The Korean government expanded its scope[11] of membership to officials whose jobs are in guidance or intermission in: the Cultural Property Bureau, Environment Agency, and the Transportation Office.
(3) Lee (1997) has an opinion for the gradual establishment of trade unions in the Korean

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[10] The contents are as follows: First, Trade unions at the enterprise level will create an exclusive unified bargaining channel. Second, if unification is not made, a trade union fitting the requirements of a representative union – having more than 50% of union members among the total union members at the enterprise level – will have the right to bargain with the employer. Third, if there is no representative, a trade union can be organized according to stipulations of presidential decree.

[11] The reasons for limiting this scope of membership are as follows: First, officials of grade 5 or less are managers or supervisors in government. They act as the heads of organizations with whom the workplace associations are to have consultations. Second, those who deal with confidential information such as personnel, budget, and jobs in security, etc, need to be excluded from joining the workplace associations to ensure autonomy in workplace association operation. Simply, those who act for management and those who represent the interests of management should be excluded from joining trade unions.

government.

(4) The ILO committee on freedom of association recommends that the right of organization should be allowed for public officials as well, and that the scope of public officials limited in their right to strike should be minimized.
(5) Advanced countries usually limit the right to strike for trade unions of public officials, but guarantee their right of organization.
(6) The Federal Court of the United States decided in 1969 that a state act limiting trade union membership for public officials was in breach of the constitution. Yet this limitation of the right to strike has different features from state to state.
(7) Public officials in Japan are allowed to have trade unions, except for those in fire fighting, police, and prison.
(8) The issue allowing trade unions for public officials will proceed following discussions at the Tripartite Commission, taking into account public opinion while simultaneously collecting information on workplace association operations.

7) Abolition of Notification of Third Party Intervention

(1) The original reason for the notification procedure was to promote the autonomous resolution of problems between parties concerned. This was accomplished by the prevention of unnecessary conflict between providers of support for trade unions and employers, as well as between employers and trade unions by clearly defining those supporters.
(2) This procedure does not entail permission or approval from authorities. Therefore, trade unions and employers are able to receive necessary support during collective bargaining and industrial action from persons of their own choosing.
(3) The act stipulates that any unauthorized third person who intervenes in collective bargaining or industrial action without being notified to the competent authority is subject to punishment. (Article 89 of TURLAA). The purpose of this provision is to discourage those who intentionally manipulate, incite illegal strikes, or act in a way to disturb legal exercises of labor rights by workers.

8) Wage Payment to Full Time Union Officials

(1) Article 24 of the TULRAA stipulates that wage payment to full time officials by employers is prohibited in line with the “Principle of Unions’ Independence” starting Jan. 1, 2002.

(2) The third Tripartite Commission attempted to develop a concentrated opinion on the issue based on the consultation between the Korean government and the KFTU, but the Commission failed to come to an agreement on the issue even though they debated for one month in September of 1999.

(3) In December of 1999, the members of the public sector of the Tripartite Commission suggested this arbitration, therefore the Korean government proposed legislation based on this suggestion to the National Assembly.

(4) The contents of the proposed legislation by the Korean government are as follows: First, there is no obligation for the employers to pay wages to full time union officials. But, there is an exception made if there is an agreement between employers on the issue. The employers would then be allowed to pay wages on the condition that the number of the full time union officials is less than or equal to the number stipulated by presidential decree. Second, the article stating that wage payments to full time union officials be included in unfair labor practice should be cancelled. Third, the articles on Prohibition and dealing with punishment for strikes for the purpose of obtaining wage payment to full time union officials will be established.

(5) Most OECD countries leave the issue of wage payment to full time union officials to personal decisions between the employers and trade unions.

(6) In the U.S, traditionally employers have paid wages to full time union officials,[12] but the number of paid trade union officials and the supported activity of trade unions by employers are limited and clearly stipulated.

(7) In EU countries, such as the United Kingdom, Germany and France, the issue of wage payment to trade union officials is left to both the employer and employee exclusively.[13]

9) Narrow the Scope of Essential Public Services

(1) The ILO considers that right to organize is completed by the right to strike and recommends that the scope of essential public services be minimized. The ILO also indicates that limiting the scope of the right to strike will be flexibly applied to each country's circumstance.[14]

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[12] "The Labor Management Relations Act or Taft – Hartley Act" prohibits an employer's payment to trade unions intending to control trade unions. This payment is regarded as unfair labor practice (Section 8<a> 2.). Still this provision does imply that prohibition of wage payment to trade union officials and precedents for the issue should be approved. The precedent for the issue was set in the case of Caterpillar Inc. vs. United Auto Workers, CA3, NO. 96-7012, 3/3/97. d.(Ministry of labor, Republic of Korea, April 2000)

[13] Park (1999)

[14] Taken from the "ILO, Freedom of Association" : Digest of Decisions and Principle of Association Committee of the Governing body of the ILO, fourth edition, Geneva, 1996.

(2) The ILO Committee on Freedom of Association has limited the scope of essential public services to those “sectors which threaten people’s life, safety and health if their operations are stopped,” thus excluding the banking, transportation, and oil refinery sectors.

(3) The scope of essential public services in Korea has been defined as follows: (Article 71 (2) of the TULRAA) : 1) railroad and inner-city bus services, 2) water, electricity, gas, and oil refining and supply, 3) hospitals, 4) banking and 5) communications services.

(4) Banking and inner-city bus services will be excluded from the scope of essential public services in 2001.

(5) The scope of essential public services in Korea has been substantially reduced in enactment of the related law in March 1997, after considering their weight in the national economy and the availability of workers to be replaced in those services.

(6) Most of the countries of the world, with some degree of difference, limit labor disputes in essential public services compared to other businesses.[15]

(7) Through discussion by the Tripartite Commission, measures of narrowing the scope of essential public services in stages will be reviewed.

<Table 2> Comparison of essential services of Korea and ILO

Korea	ILO standards
Water supply & electricity Hospital services Telecommunications services ※ Under the Public Officials Act, air traffic controllers are restricted in their rights to collective action.	Water supply & electricity Hospital services Telephone services Air traffic controllers
Gas, oil refining, and oil supply services Railroad (including urban railway)	Not included in essential public services

[15] Examples of other countries defining essential public services ; USA: If an industrial action threatens public health and safety, the action is barred for 80 days by presidential decree declaring an emergency state.; U.K.: When the required services for the national economy are suspended, the government has the authority to utilize available means, including mobilization of the army, under laws related to national emergency.; Japan: Administrative authorities and labor relations commissions can refer industrial disputes in essential public services to compulsory mediation and, when a strike breaks out, order emergency mediation which automatically imposes a no-strike period of 50 days. Workers in the electricity and coal mining businesses are forbidden to strike under a strike–regulation law.
Compulsory arbitration applies to workers(public employees) at state–run corporations, such as postal services, forestry management, minting, printing, etc., and to local public workers at local public corporations, such as railroads, public transportation, gas and water sully corporations, etc.; Singapore: Strikes are forbidden in water supply, electricity, gas and power supply services. A no–strike period applies to transportation, banking, broadcasting, postal and hospital services for a certain period of time, and industrial action in these sectors may be referred to as compulsory arbitration.

(8) Railroad service in Korea is a monopolistic business run by the state or local governments. The dependence of the public on the national railroad and the subway in major cities (ex: Seoul, Busan) is too heavy to exclude them from the list of essential public services because the strikes will bring severe losses and impediment to the national economy.[16]

(9) Excluding petroleum refinery and supply businesses from the scope of essential service sectors is not quite feasible in Korea because of the importance of these businesses to national security and the economy.

(10) Oil is the key energy source in Korea, accounting for more than 60% of domestic energy consumption. Thus, an undisturbed oil supply remains a critical underpinning for the national economy. If the oil supply is cut off due to industrial actions or other reasons, strategic industries will possibly be brought to a halt, inevitably jeopardizing national security and inflicting a significant loss on people's lives, society and economy

10) Union Membership of Unemployed Workers

(1) Article 2 of the "Trade Union and Labor Relations Adjustment Act" defines workers as those who live on wages, salary or other equivalent forms of income. The Act also prescribes that if a non-worker is allowed to join a trade union, the trade union is disqualified.

(2) However, if a dismissed worker has made an application for the remedy of unfair labor practices to the Labor Relations Commission, he/she will hold union membership until a review of the decision is made by the Central Labor Relations Commission. (Paragraph 4 of Article 2 of the TULRAA) Therefore, in reality, the unemployed (dismissed) are denied membership to a trade union.

(3) In Korea, most of the trade unions are enterprise-based. A trade union is an organization that exists to maintain and improve the working conditions of laborers and to enhance workers' economic and social status.

(4) Since non-workers, i.e. the unemployed (the dismissed, or people who leave jobs voluntarily), do not belong to the workplace, the purpose of regulating the eligibility requirement is by law to make clear the above fact. Expected problems which arise when people who lose their jobs are allowed to join trade unions are as follows:

(5) If a third party member without employment relations to an enterprise (a dismissed

[16] There is a Supreme Court precedent for the subway service in the scope of essential public services. (The Supreme Court Precedent, May 15, 1990, on the "Restriction and Prohibition Dispute Act")

worker or a displaced worker) joins a union and works as a union member, he/she does not need to engage in collective bargaining with the enterprise, yet he/she will also be participating in collective bargaining. Employers may face a contradictory situation where they have to engage in collective bargaining at the request of someone who has no employment relationship after he/she is appointed as union official.

(6) The Korean government attempted to legislate a bill granting the unemployed (the dismissed) union membership only at non-enterprise level unions.

(7) Unit trade unions can be largely divided into enterprise level unions which are organized at each enterprise, and non-enterprise level unions which are organized by units of occupation and industry.

(8) In case of an enterprise level union, union membership is granted only to those employed in the firm concerned due to organizational characteristics of the union. Accordingly, there is no room for the unemployed (the dismissed) to be granted union membership at enterprise level unions.

(9) An effort is being is being made to earnestly implement agreements reached at the Tripartite Commission on 6 Feb. 1998 and 28 Sept. 1998.

(10) There were 2 revision bill submissions for the TULRAA to the National Assembly and rejections of the bill by the National Assembly for the reason that more in depth studies have to be conducted in scope of the dismissed or the unemployed.

(11) The Subcommittee on Labor- Management Relations of the 3rd Tripartite

(12) Commission decided to present 3 alternative options[17] on the

(13) issue to the Standing Committee. (on Nov. 11, 1999)

2. Labor Relations Issues

1) Arrests of Union Officials and Members

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[17] 1st opinion – Remove sub-paragraph d. of paragraph 4 of Article 2 of TULRAA which prescribes that those who are not workers "should be allowed to join the organization, provided that a dismissed person shall not be regarded as a person who is not a worker, until a review decision is made by the National Labor Relations Commission, when he/she has made an application to the Labor Relations Commission for remedies for unfair labor practices". Insert in its place a provision stating that in case of enterprise level unions, workers who are not employed by a firm or workplace concerned are not allowed to be members of the union of the firm.
2nd opinion – As agreed in the 2nd Tripartite Commission, grant the displaced workers union membership to non – enterprise level unions.
3rd opinion – Through revision of Article 23(1) of the TULRAA, relax the qualification requirements of unions to have as officials those ineligible to be union members. In this option, the unemployed are not granted union membership. On Nov. 12, 1999, the Standing Committee of the Tripartite Commission decided to have the Ministry of Labor and the Ministry of Justice report the results of consultation on this issue, and prepare alternative options in cooperation with the "Implementation Monitoring Team" at the Subcommittee on Labor- Management Relations. They re-submitted the

(1) Arrests of union officials and members are mostly due to violations of other laws rather than labor related laws. The majority of illegal strike acts in Korea, unlike in other countries are criminal violations, such as violence during strikes, unlawful occupation of premises, damage to facilities, etc.

(2) As of Feb. 23, 2000, the number of imprisoned workers and those wanted by the police are 4 and 1, respectively. Out of the 131 imprisoned, 123 were released before 1999, and coming into the year 2000, 4 more were released, leaving only 4 in prison. Five workers imprisoned in 2000 were released.

<Table 3> Number of Arrests

(As of 23 Feb., 2000)

	Total	Arrested						Wanted (An arrest warrant has been issued)
		Released					In prison	
		Sub-Total	Arrest cancelled	Review of legality for confine-ment	On bail	On probation		
Total	14	13	-	2	7	-	4	1
Violation of the Law	3	3	-	-	-	-	3	-
Illegal strike	11	10	-	2	7	-	1	1

(3) There is a reason why there are many arrests of union members. The law on assembly and demonstration, etc. could be resolved using the following two solutions: one, a trade union system at the enterprise level and another, the existence of pre-modern labor management or labor relations at the enterprise level.

(4) The Tripartite commission has developed better labor relations and has made less arrests of union members.

2) Activate th Korea Deposit Insurance Corporation e Tripartite Commission and the Implementation of the Agreement Made at the Commission.

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alternatives to the Standing Committee. With the declaration of non- participation in the Tripartite Commission by the FKTU on Nov. 15, 1999, the discussion was suspended.

(1) The Tripartite Commission was established to have more effective structural reform in financial crisis. The Commission's goal is to have a policy agreement among the tripartite – the employee side, the employer side, and government.
(2) The procedures of the Commission are as follows: First, in the beginning of 1998, the president elect proposed an establishment of the Tripartite Commission. Second, in January of 1998, the Commission was established and there was social agreement on 90 issues at the Tripartite Commission. Third, the Korean government enacted "The Establishment and Management of the Tripartite Commission Act" (May 24, 1999) to have more institutional policy agreements among the Tripartite.
(3) Fifty nine agreements are fulfilled out of seventy one government duties, most notably, budget expansion against unemployment, the legalization of teachers trade unions, political activities of trade unions, and the appliance of employment insurance to all establishments.
(4) The third Tripartite Commission is currently in discussion on the reduction of working hours, employment patterns etc. to have more stable labor relations and better policies dealing with global competitiveness.

3. Labor Market Issues

1) Flexible Labor Market

(1) The Korean government recognized that the stiffness of the labor market has resulted in high costs and low efficiency and that the government has continuously made efforts to have a flexible labor market.
(2) To have a flexible labor market the Korean government has tried to introduce the flexible working hour system, the new lay-off legislation, and the employee leasing system of 1993.
(3) In 1997, the flexible working hour system was started by revising "The Labor Standard Act." The new layoff system and the employee leasing system have begun due to an agreement by the Tripartite Commission in February of 1998.
(4) The Korean labor market has changed rapidly, while the Korean economy has suffered from financial crisis. After this financial crisis, the life-long employment style had diminished and diversified employment patterns had been rapidly introduced.
(5) Increasing the rate of regular workers has decreased and the rate of daily or temporary workers has increased. The rate of daily or temporary workers was 53% in 1999 (Figure 1) and in 2000.

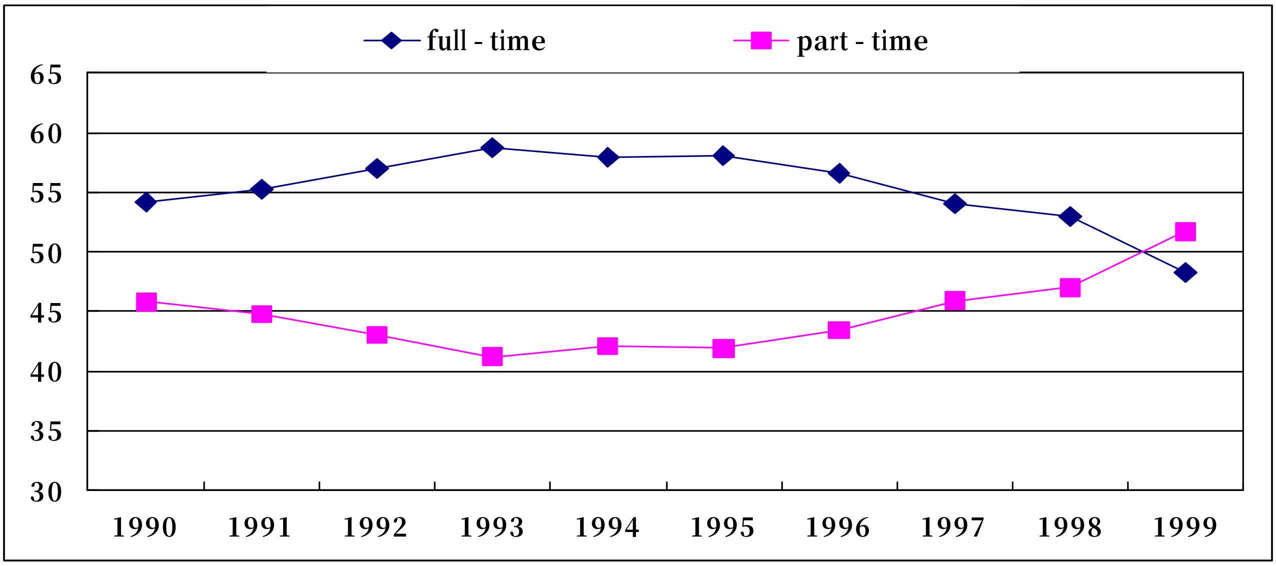
(6) The change in wage systems has spread in the Korean labor market. In big firms and in the banking industry, the seniority wage system has been reduced and the annual salary system, incentive wage system and stock option systems have expanded.(Park and Lee, 2000)

(7) Reform of the labor market structure in Korea has been an important factor to overcome financial crisis.

(8) Labor market flexibility has been accompanied by some undesirable phenomenon as well. First, rapid changes of employment pattern have resulted in the resistance of trade unions to adjust. Second, labor market flexibility without social security network growth has resulted in an unstable society with higher proportions of non-regular employment than normal, worsening the quality of life in the socially weak group.

<Figure 1> The rate of non-regular (Daily, Temporary) workers

(unit: %)



Source: Song (2000)

2) Protection for the Weak Group : Female-Primary Provider, Youth and Non-Regular Workers.

(1) The Korean government has strengthened support to the weak group dealing with work conditions and secure living.

(2) From Oct. of 1998, employment insurance has expanded its coverage to less than 5 establishments and the unemployment benefits receiving period has increased by 60 days resulting in receiving dates in the range of 90 - 240 days.

<Table 4> Expansion of the Coverage of EIS

(unit: 10 thousand persons)

	1995. 7	1998. 1	1998. 3	1998. 10	1999	2000
Establishments	30 more	10 more	5 more	all	all	all
Covered persons(A)	431	567	611	850	860	870
Number of joined(B)	430	430	469	490	600	646
B/A(%)	99.8	75.8	76.8	57.6	69.8	74.2

Sources : Ministry of Labor(2000a)

(3) The number of poor people who are covered by the National Assistance Act has been expanded from 310,000 in 1998 to 570,000 in 1999.

(4) The Korean government has established a data base for the poor group and strengthened the support of job training, job searches and so forth for them. The loan schemes for the poor and unemployed have also begun in April of 1998, dealing with living costs, educational fees, and small business starter.

(5) The National Basic Livelihood Security Act (NBLSA) was enacted in Aug. of 1999 and enforced from October 1,2000. This system will contribute to the protection of low income group living institutionally.

(6) The Korean government announced a guide principle on the application of labor standards dealing with short term contract workers in Jan. of 2000. Coverage of the major 4 social insurance (Employment Insurance, Medical Insurance, Work Accident Insurance and the Pension Scheme) has been applied to daily or temporary workers and the coverage of Work Accident Insurance has been expanded to less than 5 establishments from July of 2000.

(7) To promote women's job opportunities, the "Female Job Quota System" and the "Fair Employment between Women and Men System" has been introduced. Also, to support primary providing women, special training systems for employment or starting a business are being introduced.

(8) The intern system, public works, and training for youth have been introduced and strengthened to promote youth employment. Around 45% of youth interns were hired at their work place as regular workers. (Jeong, 2000)

<Table 5> Youth Unemployment

(unit: %)

		Korea	U.S.A.	UK	France	Germany	OECD average
Unemployment rate(total)		6.8	4.5	6.3	11.7	9.4	7.0
Youth		11.7	10.4	12.3	25.4	9.4	12.8
Youth/total		172.1	231.1	195.2	217.1	100.0	182.9
Education	Less middle	5.7	10.9	10.9	14.8	14.2	11.1
	Less high	8.2	5.1	7.1	9.7	8.9	6.5
	Less tech college	5.7	2.4	3.5	6.7	5.2	4.0
Higher tech college/total		83.8	53.3	55.6	57.3	55.3	57.1

Note: the rate for Korea is the average of Jan. - September, 1999, and the rate of youth for other countries are in 1998. The rate by education for other countries is in 1996.

Source: Korean National Statistics Office, *Economically Active Labor Force Survey*; OECD, *Employment Outlook*, 1999.

(9) Even though the Korean youth unemployment rate shows similar percentages as OECD countries in Table 5, there are more levels and therefore the youth exit rate into the non labor force is also high in Korea.

(10) To promote the youth employment rate, more fundamental and institutional approaches to the “school to work” transition would be required, especially job training in high school, and school to work cooperation networks. Also, a hiring system would be reviewed and changed to meet the industrial and employment structural change.

(11) Non-standard employment needs more opportunity and job security for social insurance. Fast growth of the non-standard employment pattern has contributed to more flexibility in the Korean labor market but has resulted in widening the income disparity between groups and worsening employment security to the weak group.

3) Expansion of Active Labor Market Policies

(1) Strengthening executions for job matches in public and in private sectors has been carried out during the financial crisis. The Work-Net has been introduced and expanded nation-wide to have better job information for workers and businesses.

(2) The Daily Worker Employment Center was established nation-wide to improve job opportunities for the “Daily Workers” and to have better consultation and job training systems for them.

(3) Training for the unemployed, youth, and poor groups has been strengthened by introduction of the industry demand based training system, training benefits which cover 50% of the minimum wage, the incentive system toward better qualified training institutions, and the training voucher system.

(4) Some unfairness and ineffectiveness appeared dealing with public support for private training, such as training cost calculations according to the number of trainees. The job acquisition rate also should be reformed in order to be more competitive and stimulating.

(5) Occupations in public job training institutions should be changed to more advanced technological industries from the declining labor intensive industry that now exist.

<Table 6> Training for the unemployed in Korea

	1998		1999	
	Persons	%	Persons	%
Total	331	100.0	331	100.0
Re-employment training				
Sub-total	301	90.9	280	84.6
Re-employment training for the unemployed	170	51.4	200	60.4
Employment promotion training	106	32.0	55	16.6
Training for high school graduates and the newly unemployed	11	3.3	7	2.1
Training for over junior college graduates in the promising jobs	-	-	10	3.0
Training for starting a business	14	4.2	8	2.4
Manpower development training				
Sub-total	30	9.1	51	15.4
Training for skilled workers	15	4.5	15	4.5
Training in priority jobs	11	3.3	16	4.8
Paid leave training	4	1.2	20	6.0

Note: See Kang, Soon-Hie, Jaeho Keum, Dong-Heon Kim(1999) about training category in details.
Source: Ministry of Labor

4) Mid and Long Term Unemployment Policies

(1) Mid and long term unemployment policies are need to replace temporary programs. The unemployment rate decreased to the level of 4% (970,000 unemployed) in the beginning of 2000 from the peak value of 8.6% (1.78 million unemployed) in February of 1999.

(2) Starting in March of 2000, the unemployment rate has decreased steadily to 3.7% in May of 2000, due to current economic recovery.

(3) Annual comparisons of budgets for unemployment counter-measures since the year 1988, is as follows: The Korean government established the first comprehensive unemployment counter measures in March of 1988 in the wake of the economic crisis

at the end of 1997. It continued to formulate “the Comprehensive Unemployment Counter-Measures” in 1999.

(4) The Korean government set aside a total of 9.24 trillion Won as the budget for unemployment counter-measures in 1999.

(5) In 2000, the Korean government reduced the budget for unemployment counter-measures by 35.9% compared to the 1999 budget due to expected economic recovery. The reduction was made mainly in short-term jobs such as public works <Table 8>. But, the Korean government wants to place or maintain more focus on job training and job searches for youth, female primary providers, and the poor group. Support for livelihood stabilization for the unemployed would be continued even if the unemployment rate has sharply decreased.

(6) The Korean government has made efforts to expand the “Employment Insurance System” (EIS) and to establish more solidly the “National Basic Livelihood Security System” (NBLSS).

(7) Expansion of the EIS, establishment of the nation wide Work-Net, and the Profiling System for the unemployed will be of greater focus in order to became the skeleton of long term unemployment counter measures.

<Table 8> Unemployment Budget

(unit: 100 million won)

	Budget		
	1998	1999	2000
Total amount (% change)	42,807	92,400 (86.3)	59,220 (△35.9)
·Provision of short-term jobs	10,444	25,218	11,000
·Vocational training and job placement services	9,011	6,868	4,305
·Employment stabilization support	1,224	4,832	3,663
·Support for Livelihood stabilization for the unemployed	22,128	55,482	40,252
Unemployment rate (E%)	6.8	6.3	4.5 (estimate)

3. Social Security Net Issues

1) Social Security Net Expansion and Cost Minimization

(1) The EIS and the livelihood protection programs are implemented as primary safety nets, while public works, vocational training, loans to jobless people, school expenses and

lunch support for children of the unemployed are offered as supplementary safety nets.

(2) Korea lags behind other advanced OECD countries in terms of types of social safety net programs, scope of application, level of benefits, and lack of connection between social safety net programs.

(3) Expansion of the EIS and the NBLSS would take on the most important roles for the future Korean social safety net, especially for the unemployed and people in low income brackets.

<Figure 2> Principle of Social Security Net Expansion

Expansion of the EIS
▼ non-covered, non-protected unemployed ▲
Expansion of the NBLSS

(4) The EIS will be expanded so that it can cope flexibly with recent employment status change such as the increase in daily workers and long-term unemployment problems.

(5) The NBLSS has been designed to guarantee minimum living conditions, and medical and school expenses for people in low income brackets by the government, while assisting those in the program to escape from poverty and unemployment.

(6) By establishing the link between each social safety net program, a continuous service will be provided for a certain period of time until jobless people get re-employed.

(7) Since the level of the social safety net for people in low income brackets is low compared to that of advanced OECD countries, it will be continuously expanded.

(8) To prevent welfare recipients from falling into welfare traps which has been experienced by some advanced countries, the government will establish the safety net so that welfare receipt is linked to corresponding work requirements for people capable of work (called the future oriented productive welfare system).

III. Conclusion and Policy Implications

1) The ELSAC(Employment, Labor and Social Affairs Committee) found the Korean labor law reform to be highly improved at the 96th meeting in April of 2000.

2) The ELSAC reviewed the monitored results on Korean labor issues and decided that the special monitoring on labor reform should be stopped and that monitoring would be included in the

issues of the labor market and social security net. These issues would be reviewed approximately 18 – 24 months later.

3) The Korean government and society have enacted a better labor environment for themselves to escape from financial crisis and to fulfill the OECD recommendations on Korean labor issues.
4) We will have some policy implications in future reviewing Korean compliance and evaluations toward the OECD recommendations.
5) First, Korea needs more advanced systems in labor law, relations and labor market sectors to be adaptive to the global economy and to be an advanced society.
6) Second, the influence of the Tripartite Commission is essential for Korea to instill harmonious actions between employers and trade unions. This would provide socially agreeable structural change.
7) Continuous investments in job search systems in public as well as in private sectors would be carried out and job training systems would need to be adaptive to industrial demands and to be changed more effectively.
8) The Social Security Net should expand toward a future oriented productive welfare system which meets the needs of the Korean model of development based on comparative country studies.

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Regulatory Reform in Korea: At Crossroads?

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I. Introduction

After the Asian Financial Crisis hit, Korea embarked on an unprecedented regulatory reform[18] program in order to combat the long-term structural problems which had made Korea especially vulnerable to the adverse effects of the financial crisis, as well as the recession brought about by the financial crisis. In 1998, regulations dealing with foreign investment were eliminated or modified. Furthermore, nearly fifty percent of all the existing regulations were eliminated, and further twenty percent were modified. More importantly, a permanent mechanism was established for examining new regulations, to make sure that the benefits of the regulations would outweigh the costs. In addition, existing regulatory institutions were overhauled, so that a more efficient system of regulation and prudent supervision would be installed. In 1999, the OECD undertook a comprehensive review of Korea's regulatory reform program, and the final report, published in 2000, concluded that:

> "The success of the Korean government in managing a difficult and risky transition process since the 1997 crisis is impressive. Though many reforms are still planned or just launched, the package of reforms as a whole, combined with the credibility of government commitment, is invigorating. …With the crisis passing, the Korean government can now focus on the multi-year programme of regulatory and structural reforms need to create the foundations for sustainable long term growth."[19]

Mere few months after the publication of the report, some aspects of the regulatory reform seems to be in jeopardy, as some unfortunate events have reduced some of the momentum behind regulatory reform, and in some cases, have created a popular resistance against further reform. Also,

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[18] The OECD takes a somewhat more comprehensive view of regulatory reform than the Korean government. The OECD's view of regulatory reform includes reforms in administrative regulations, competition policy, market openness, and sectoral regulatory systems, while the Korean view of regulatory reform tends to be limited to reforms in administrative regulation. In general, this paper will use the OECD's view of regulatory reform.
[19] OECD (2000), p. 99

the quick recovery in late 1999 and early 2000 had created some sense of complacency. Thus, even though everyone agreed that further reforms were necessary, the recovery allowed delays of needed reforms. Finally, there seems to be some problem in addressing what is the appropriate tool to deal with particular problems.

This paper will examine various aspects of Korea's regulatory reform since the financial crisis, focusing particularly on the period after the OECD review. In the second part of the paper, the Korean reforms and the major conclusions and recommendations of the OECD reviews will be presented. The third part of the paper shall describe the adversities that are faced by Korea in furthering its regulatory reform. Some of these problems have been mentioned in the OECD report, and some have only emerged in the last few months. The fourth part of the paper makes a recommendation to combat these problems. The paper ends with a short conclusion.

II. The Review of Korea's Regulatory Reform

1. Reform of Foreign Investment Regime

When the Asian Financial Crisis hit Korea in November of 1997, many of the chronic problems of Korea's financial and corporate sectors were brought to light. A history of close ties between the financial, corporate sectors and the government encouraged over-reliance on debt financing. The implicit guarantee by the government on loans made by the corporate sector, as well as the implicit guarantee that the government will not let banks go under, encouraged reckless debt-financed expansion by the corporate sector, and reckless lending by the financial sector to finance these expansions. Such behavior remained unchecked in large part due to the opaque nature of Korean business practices and government administrative practices. Also, the government maintained a wide array of explicit and implicit sets of regulations and guidelines which distorted and placed various burdens on business activities, but there was insufficient infrastructure and resources devoted to prudential oversight, supervision, and implementation of these regulations. In short, the number of rules was excessive, many regulations were unnecessary, and there was no structure in place to make sure that the rules were being carried out properly.

The results of such overburdened and inefficient regulatory structure contributed to low productivity and competitiveness of the Korean economy, as well as a wide-spread disrespect for laws and regulations, as private agents scrambled to bypass or get around the regulations, sometimes using illegitimate means.

As the Asian financial flu hit Korea and foreign investors refused to rollover short-term loans made to Korean financial and corporate sectors, Korea experienced an extreme capital outflow. The foreign reserves of the Korean government fell to a mere $3.9 billion in December 1997, and Korea was faced with the possibility of declaring a moratorium on its foreign obligations. While emergency loans from international organizations such as the IMF, World Bank and the Asian Development Bank, as well as guarantees of support from thirteen industrialized countries forestalled the moratorium, Korea still had to deal with the problems of low foreign reserves, a general recession brought about by the policies designed to combat the capital outflow, and the distressed finances of many financial and corporate institutions whose financial capital had dried up.

An ideal solution to solve all these problems, which could also increase the productivity of the Korean financial and corporate sectors, was foreign direct investment. Traditionally, Korea had discouraged foreign direct investment in Korean companies, and maintained several regulations against foreigners, such as prohibitions on hostile takeovers, individual and collective ownership ceilings, and complex requirements for approvals which raised the costs of foreigners seeking to buy Korean companies and operate in Korea. Furthermore, Koreans generally had a somewhat negative view of foreign control over Korean businesses, believing that these foreign owners would not have “the welfare of Korea” as a goal in their business practices. As a result, in 1996, Korea had the lowest level of foreign investment in the OECD, as the in-bound FDI was less than 0.5% of the GDP.

However, as the financial crisis and recession proceeded, the government initiated massive legal and regulatory reforms to facilitate inward foreign direct investment. Sectors formerly closed to foreign investment were opened, the amount of required paperwork was cut, and discriminatory regulations, such as ownership ceilings were removed or lowered. Korea Investment Service Center (KISC) was established under Korea Trade-Investment Promotion Agency (KOTRA) to act as a “one-stop.” KISC would help foreign investors could find appropriate Korean companies to invest in, then help take care of all the regulatory paperwork that the foreigners had to go through. To facilitate foreign firms’ operations in Korea, restrictions on foreign land ownership were virtually eliminated. Restrictions on takeovers, including hostile takeovers by foreigners were virtually eliminated.

<Table 1> Korea’s FDI Liberalization, 1993-2000

(As of May 2000)

Classification	Total	Liberalized								Remaining Restricted
		1993	1994	1995	1996	1997	1998	1999	2000	
Manufacturing	585	2	1	-	6	1	2	2	-	0
Services	495	9	23	42	39	16	20	3	2	2 (22)
Others	68	5	6	2	4	10	-	-	1	2 (2)
Total	1148	16	30	44	49	27	22	5	3	4 (24)

Note: The number of business categories are based on the five digit Korean Standard Industrial Classification level.
“Others” category includes agriculture, fisheries and mining.
“Liberalized” include both complete and partial liberalization
The number of remaining partially restricted business categories are in parentheses.
Business categories, including government services and non-profit organizations where FDI is prohibited by domestic laws, are not included.

Source: Kim and Kim (2000)

<Table 2> Investment Flows

(in millions of US dollars)

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Inward FDI	1,179.8	728.3	588.1	809.0	1,775.8	2,325.4	2,844.2	5,412.3	9,333.4
Net Portfolio Investment	3,054.8	5,802.5	10,014.4	6,120.1	11,590.7	15,184.6	14,295.3	-1,878.2	8,676.4
Overseas Investment	1,488.6	1,161.5	1,340.0	2,461.1	3,552.0	4,670.1	4,449.4	4,739.5	4,197.8

Note: The figures given are based on national accounts data, and differs from notification figures, or "total invested" figures used by MOCIE.

Source: Bank of Korea, Economic Statistics Yearbook (2000), Bank of Korea website

<Table 3> Inward Investment Flows by Selected Industries on Notification Basis

(in millions of US dollars)

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total Notified	1,396	864	1,044	1,317	1,941	3,203	6,971	8,852	15,541
Manufacturing	1,069	648	527	402	884	1,930	2,348	5,735	7,130
Services	326	244	517	915	1,057	1,254	4,568	2,938	8,358
Financing, Insurance & Real Estate	153	43	66	302	434	267	336	582	2,823
Others	1	2	0	0	0	18	55	179	54
Actually Invested	1,177	803	728	991	1,357	2,308	3,087	5,213	10,336

Note: Notification figures and actual figures by MOCIE differ because some investments notified are not carried through; actual figures reported by MOCIE and national payment based figures by Bank of Korea differ because of different methods of measuring and different definitions.

Source: Trends in Foreign Direct Investment, Ministry of Commerce, Industry and Energy, 2000. 1.

Foreigners commented that doing business in Korea had gotten substantially easier due to the reforms.[20] As a result, FDI rose markedly, from 0.48% of the GDP in 1996 to 1.73% of GDP in 1998. The rise was especially acute in the financial sector, where regulatory restrictions had been especially high before the crisis. Such successes in inducing foreign investment, as well as the mounting evidence that the Korean economy had lost its competitiveness, in large part due to the inefficient regulatory structure, prompted President Kim Dae Jung to initiate a massive regulatory reform program, encompassing all areas of the economy.

<Table 4> Global Competitiveness Ranking

		1996	1997	1998	1999	2000
IMD	Overall Ranking	27	30	35	38	28
	Transparency	36	38	43	42	41
	Bureaucracy	33	37	42	40	35
	Bribery and Corruption	26	36	33	36	34
	Total Number of Countries Surveyed	46	46	46	47	47
WEF	Overall Ranking	20	21	19	22	n.a.
	Government Bureaucracy	32	35	50	49	n.a.
	Administrative Regulations	37	48	43	53	n.a.
	Total Number of Countries Surveyed	49	53	53	59	n.a

Note: n.a. – not available
Source: IMD (various issues) The World Competitive Yearbook
World Economic Forum (various issues) The Global Competitiveness Report

Korea's Regulatory Reform

Korea's regulatory reform took place under the following principles:

- Eliminate, in principle, all anti-competitive economic regulations;
- Improve the efficiency of social regulations in areas such as environment, health, and safety;
- Shift from ex-ante control to ex-post management;
- Base regulation on adequate legal authority; and
- Benchmark global standards

The reform took place on two fronts: under the first, which has gotten the most attention, all ministries were forced, by the order of the President, to take stock of all existing regulations under their control, register them, and reduce their number by one-half by the end of 1998. All regulations which had no basis in existing laws were to be eliminated. If a ministry felt that existing regulations, which had no basis in law, should yet be maintained for valid reasons, it had to introduce bills to the National Assembly so that a legal basis for the regulations could be established. Table 5 shows the

[20] Jones (2000), pp. 173-179, American Chamber of Commerce in Korea (1999)

results of the initiative. By the end of the process, 48.8% of existing regulations had been eliminated, and of those remaining, 2,411 regulations (21.7%) had been modified. In all, 70.5% of existing regulations had been eliminated or revised.[21] The Korean government maintains an internet-based database of registered regulations at http://www.rrc.go.kr.

<Table 5> Numbers of Regulations Eliminated or Modified in 1998 and 1999

1998 Regulatory Reform

Existing Regulations	Eliminated	Remaining Regulations (A)
11125	5430 (48.8%)	5695

Post-Reform Adjustments

Modified by National Assembly	Re-examined	Newly Established	Previously Overlooked Regulations	Remaining Regulations (B)
140	94	608	274	1116

Regulatory Reviews in 1999

Total in beginning of year (A+B)	Eliminated	Modified	Remaining
6820	-503 (-7.4%)	570 (8.4%)	6308

Source: Regulatory Reform White Paper (2000)

A second, and arguably more important part of the regulatory reform was the establishment of a regulatory review mechanism. The Regulatory Reform Commission (RRC) was established as a body directly answerable to the President. Chaired jointly by the Prime Minister and a civilian representative, the RRC consists of the two chairmen, six ministers representing the government, and twelve civilian members, from business, academia and NGOs.[22] The RRC is responsible for reviewing all new regulations and all regulations which are to be strengthened. Under the Commission, there are three sub-committees which perform preliminary examinations of regulations under consideration. Two sub-committees concentrate on economic regulations and one concentrates on administrative regulations. Each sub-committee has access to pools of specialists.

As a part of the review process, ministries are obligated to submit Regulatory Impact Analyses (RIAs), which contain cost-benefit analyses for the new regulations under consideration, as well as an examination of alternative means to carry out the policy goal, to make sure that there are no alternative means which could achieve policy goals more effectively. A five-year sunset

[21] Though some measures had been overturned or delayed in 1999. See Table 5 "Post-Reform Adjustments."
[22] NGO representatives were recently allowed to participate following OECD recommendations.

provision for regulations was also instituted, so that existing regulations would be reviewed every five years, and eliminated if deemed no longer necessary.

The RRC has actively sought out the opinions of businesses, both domestic and foreign. Government representatives visited foreign chambers of commerce in Korea, and met with several business leaders to gather opinions on which areas of regulations needed reform. Their opinions have been reflected in several of the decisions taken by the Regulatory Reform Commission.

A government-commissioned report by the Korea Institute for Industrial Economics and Trade (KIET)[23] estimated the potential gains from the modification or elimination of 324 economic regulations which had been carried out in 1998. The reform of these regulations had eliminated barriers for foreign investment, facilitated the establishment of new businesses, and reduced regulatory burdens. The total potential reduction of regulatory burden on the private sector between 1999 and 2003 was estimated at 18.7 trillion won, and the potential growth in employment due to these reforms was estimated to be around 1.06 million jobs. The report also estimated that these reforms would bring in additional $36 billion in foreign investment between 1999 and 2003. The report further estimated that should regulatory reforms succeed in five key industries (electricity, construction, distribution, road transportation and telecommunications), Korea's real GDP growth would rise by 8.57% over the baseline estimates after ten years.

Reforms also took place in other areas. Though not a part of the Korean government's formal regulatory reform program, these areas of reforms are nevertheless encompassed by the OECD's definition of regulatory reform. These reforms involve prudent supervision, corporate governance, and competition policy. As part of the financial sector restructuring process, the supervisory agencies for the financial sector were consolidated into the Financial Supervisory Commission (FSC) and its subordinate agency, the Financial Supervisory Service (FSS) which implements the regulations and carries out the actual day-to-day supervisory and regulatory activities. The standards for the evaluation of bad debt, as well as the standards for financial statements were strengthened. Restrictions against the establishment of foreign bank branches, as well as restrictions against foreigners serving as board members in financial institutions were eliminated.

As a part of corporate restructuring, the standards for transparency and financial standards were raised. Also, for the giant conglomerates ("chaebols"), the cross-subsidiary debt guarantees were prohibited. The chaebols were obligated to reduce their debt-equity ratios below 200%, and reduce the numbers of subsidiaries. The subsidiaries of these companies were obligated to enlist outside directors in their boards, and the rights of minority shareholders were strengthened. More controversially, the government encouraged the chaebols' initiatives to swap and merge subsidiaries

[23] Ha et al. (1999). The study was also cited in OECD (2000), p. 40 and p. 46.

in some business areas such as semi-conductors, automobiles, and airplane parts manufacturing.[24]

In order to make the public utility sector more efficient, the privatization process was accelerated. In the electricity sector, plans were drawn to privatize the generation and distribution of electricity over a period of ten years, leaving only the transmission network under the direct control of a public enterprise. To regulate the liberalized electricity sector, an enhanced regulatory mechanism would be established under the Ministry of Commerce, Industry and Energy.

2. OECD Regulatory Review

As Korea carried out its regulatory reform program in 1998, Korea asked the OECD to evaluate its regulatory regime and the ongoing reforms as part of the OECD regulatory reform country review program. Korea's purpose in asking for the review was threefold: First, Korea needed to bring attention to the reforms it had made, to emphasize that foreign investment and the general business environment in Korea was improving, and Korea was serious about carrying out its reform process, thus raising foreign investor confidence in Korea. Second, Korea needed an unbiased review from an outsider to point out the deficiencies in its regulatory structure, to find out which areas needed further reforms. Finally, Korea needed assurance that the reforms were headed in the right direction.

Representatives from OECD reviewed various aspects of the Korean economy and the regulatory system between late 1998 and 1999. Preliminary reports were issued and review meetings were held in late 1999 and early 2000, and the final report was issued in June 2000. The review concentrated on the following areas: The macroeconomic effects of regulatory reform, the government capacity to assure high quality regulations, regulatory reform and competition policy, regulatory reform and market openness, regulatory reform in the electricity sector, and regulatory reform in the telecommunications sector. In each of these areas, the OECD evaluated the state of Korea's regulatory system as well as the ongoing reforms, and offered several recommendations and suggestions.

For macroeconomic effects of regulatory reform, the OECD pointed out that many of the factors leading up to the Asian financial crisis, including Korea's interventionist government policies, formation of chaebols, the close ties between government, corporate and financial sectors, the moral hazard of the private sector leading to risky behavior, had their bases in the Korean development process. However, looking back on Korea's development experience, the OECD placed more emphasis on Korea's ability to invest in human capital and engage in high levels of investment, and Korea's outward-oriented development strategy as key factors behind Korea's successes rather than government intervention. The report pointed out that, since the crisis, the

[24] Often referred to as "Big Deals."

regulatory reform became a key element in Korea's effort to shift to a more market-oriented economic system; and the regulatory reform, as well as the structural reforms contributed substantially to Korea's recovery process. This section of the report also warned that, while much has been done, there are still much more that needs to be done. The report stated that "future growth will come from gains in productivity driven by competition and innovation. Regulatory reform will be important in establishing the conditions for such growth," and "In the longer-term, Korea's potential growth rate depends on its success in implementing a market-oriented framework, which will drive productivity growth." The dangers which could arise from slowing, or even reversing the current reforms, as well as the danger from the government retaining its interventionist strategy was especially emphasized.

In the section on government administrative reforms, the report noted the very strong political leadership for reforms by the President, and rated highly the enactment of the Basic Act on Administrative Regulations (1997); the establishment of the Regulatory Reform Commission; the establishment of a registry for regulations which would greatly enhance transparency; and the establishment of the Financial Supervisory Commission, the first "truly independent regulatory body able to create and maintain the conditions for effective competition." The OECD reflected positively on the 50% reduction in the number of regulations, but worried that such number-oriented reforms may not have addressed the true underlying problems in Korea's regulatory system. Thus, the report pointed out the need to concentrate more on the quality of reforms rather than the quantity in further reforms. Similarly, the report praised the adoption of RIAs by the Korean regulatory authorities, but worried that the quality of the RIAs are not yet satisfactory, in large part because the bureaucrats are not familiar with RIAs. The report also questioned the need for five-year sunset reviews. While sunset provisions are desirable, member country experience has shown that five years may be too short a time for periodic reviews. Finally, the report pointed out the weak implementation of regulations as a critical problem in Korea.

In the area of competition policy, the OECD acknowledged that Korea has established a solid legal foundation for enforcing competition policy. The Korean competition authorities are doing more to deal with serious horizontal arrangement, moving away from a purely structural approach of competition policy to an approach based on abuse of dominance. However, there were some differences of opinion between the OECD and the Korean authorities on Korea's chaebol policy. The OECD report questioned the need for the competition authorities to engage in chaebol policy, since many chaebol policies deal with corporate governance and financial prudence issues rather than competition issues. The OECD expressed the opinion that the chaebol-related competition problems can be dealt with by consistently applying economy-wide competition principles rather than by enforcing special rules for chaebols. Thus, the OECD felt that the Korean Fair Trade Commission (KFTC) should re-examine their policy responsibilities as the Korean government has adopted other reforms concerning corporate governance and finance, and the regulatory duties dealing with chaebols can divert resources from the tasks of competition law enforcement which could be a more powerful mean of encouraging market adjustment and market discipline on chaebols. In the same vein, the OECD questioned the Korean practice of restricting the chaebols from entering certain industries reserved for small and medium sized enterprises (SMEs). Also, the OECD commented on the lack of effective judicial sanctions for the KFTC, especially the lack of powers to obtain evidence. The lack of a private means of address against anti-competitive practices was also noted.

In the area of market openness, the OECD noted that while Korea has made substantial progress to reduce barriers to trade and investment for foreigners, increase transparency, and using international technical standards, more efforts are needed on all fronts. Also, the Korean practice of letting some producers' associations or producers' groups formulate industry technical standards was pointed out as an implicit market barrier.

In the electricity sector, the OECD viewed favorably the industry reform bill, especially its plan to privatize the generation and distribution sectors, and recommended its implementation. However, because the regulatory agency for electricity would be placed under the Ministry of Commerce, Industry and Energy, the lack of independent sectoral regulatory agency was considered as a shortcoming in the plan. In the telecommunications sector, the OECD report stated that, while much progress had been made, the competitive environment for much of the telecommunication sector is still weak, and the regulatory role of the Korea Communications Commission, as well as its independence, needs to be strengthened.

The OECD made several general and specific recommendations for further reforms in its report. The general recommendations are as follows:

- Sustained strong political support will be needed at the highest levels to continue reform in the next several years;
- To create a policy environment supportive of market competition, regulatory reform should be based on comprehensive reform plans, …containing the full set of steps needed for effective competition, followed by rapid implementation and periodic, public evaluation;
- Continue to strengthen market disciplines as the most effective mans to address the "chaebol problem," and in the near term, withdraw explicitly from more interventionist approaches;
- Strengthen the role and effect of competion policy and the [Korean] Fair Trade Commission in ensuring that liberalizing markets benefit consumers;
- More effort is needed to prevent regulatory problems before they occur by strengthening quality control mechanisms for regulatory development inside the administration;

- Institutionalize transparency and consultation mechanisms between government and business, labor and civil society, and continue to work to eliminate the use of administrative guidance;
- Further attention to development of implementation capacities in a range of areas would accelerate reform results;
- Improve the policy foundation for the efficiency, independence, and accountability of new independent regulators by developing guidelines for their systems of governance, policy coherence, working methods, and relations with the competition authority;
- Take further steps to integrate market openness principles into national regulatory regimes;
- A vigorous public debate will be needed if regulatory reform is to be seen as a strategy for achieving domestic social and economic objectives, rather than as painful crisis management that can be abandoned once recovery is underway.

Some of the specific recommendations are listed in Table 6, along with the government' s position.

<Table 6> Specific OECD Recommendations and Korean Government Position

OECD Recommendations	Korean Government Position
• Broaden the responsibilities of the Regulatory Reform Commission to include issues of direct relevance to establishing and protecting market oriented economic policies, such as taxation and subsidies, industrial policies, and regional development policies.	• Recommendation nder long-term consideration, as the recommendation requires revisions in the Basic Act on Administrative Regulations
• Competition policy attention and resources should be increasingly concentrated on measures that are more clearly related to "efficiency" goals.	• Recommendation adopted. KFTC agrees that efficiency should be the overriding goal of competition policy, and more attention is being paid to efficiency issues.
• The KFTC's powers to obtain information in investigations may need to be strengthened	• Proposal submitted to National Assembly.
• Eliminate protectionist measures that prevent potentially efficient competitors from entry into sectors reserved for "small" business, that apply stricter structural tests to discourage large firms from acquisitions in the protected "small business" sectors, and that reserve aspects of government procurement to cartels of "small" businesses.	• Recommendation adopted. Sectors reserved for small businesses will be eliminated in stages.
• Consider strengthening rights of private action, which might require changes to aspects of the legal system	• Recommendation under long term consideration.
• Ensure that RIA disciplines are systematically applied to the review of existing regulations in regulatory reform programs, and improve the quality of RIAs for all regulations by adopting a mandatory review by an expert and independent body, by rigorously training ministry staff, and by including market openness issues in the assessments.	• Releasing RIAs under long-term consideration. • Consultations with expert and independent bodies during the consideration of new regulations are currently required.
• Broaden the current membership of the Regulatory Reform Committee to include representatives from major Korean civil society groups.	• Recommendation adopted. The range of civilian RRC membership widened.
• Consider the development of an explicit public consultation strategy.	• Recommendation adopted. Procedures on public consultations are in place.
• Reform the Basic Act on Administrative Regulations to require that RIA be released to the public as part of the public consultation process.	• Recommendation under long-term consideration.
• Prepare and implement a program aimed at assuring high levels of compliance with regulatory requirements, including development of means of incorporating compliance-friendly design principles as part of regulatory development.	• Initial study on regulatory compliance has been undertaken.
• Reinforce the technical capabilities of standards-related bodies, such as standards institutions, laboratories and certification bodies.	• Technical reviews and relevant negotiations are underway.
• Engage more actively in the negotiations of Mutual Recognition Agreements (MRAs)	• Several MRAs are under negotiations.

III. Obstacles to Korea's Regulatory Reform

Compared to the rapid reforms of 1998, the speed of regulatory reform began to slow down somewhat in latter 1999. Some aspects of the slowdown were inevitable; it would have been impossible to continue reducing regulations by 50% forever. Furthermore, as seen in Table 5, some reversals in numbers of regulations took place due to the introduction of new regulations, as well as the rejection or delay of some parts of the reform in the National Assembly. For example, the ambitious plan to reorganize the electricity sector was delayed because the National Assembly ended its session without considering the electricity sector reform bill. Also, there were intensive lobbying efforts by some interest groups to keep some regulations in place. The RRC or the relevant government agencies plan to resubmit many of the bills which were rejected, or not considered.

However, there are more serious problems which have further slowed down the regulatory reform process. In some ways, these problems threaten to undermine future regulatory reforms. First, the problem of implementation remains, especially the problem of lax punishment. An example is the recent crackdown on illegal internal transactions between chaebols. In February 2000, the Korean Fair Trade Commission (KFTC) found that the top seven chaebols engaged in 1.079 trillion won's worth of illegal transactions, resulting in 12.4 billion won's worth of illegal subsidy between the subsidiaries. The penalty charged by the KFTC was only 7.51 billion won, less than the amount of the subsidy.[25]

As another example, in December 1999, the FSC found that some financial investment companies owned by a chaebol had, through illegal transactions and stock price manipulations, channeled 20 trillion won into its fellow chaebol subsidiaries. As a consequence, the FSC handed out penalties, which ranged from warnings to three month suspension of duties for certain individuals, and three month suspension of certain transactions involving stocks, bonds and securities of affiliated chaebol firms. However, while certain individuals were fired from their jobs and convicted for violating securities laws, all sentences were suspended, and most can still work in the financial sector, even in their old jobs. The relatively minor nature of these punishments are due, in part, to the fear that severe punishments may bring a contraction in economic activities, which may hinder the recovery process, since the Korean economy is still in a fragile state.

Even more serious is the beginning of some public backlash against further regulatory reforms as several shortcomings in implementation and supervisory system have been revealed. Recently, a large bribery scandal involving the Financial Supervisory Service (FSS) has revealed that many of the problems which had been inherent in the old regulatory and supervisory system still remain in the new system. While only two employees have actually been accused of accepting bribes, the investigation into this incident has revealed several problems. For example, the banks under supervision still engage in questionable personal lobbying activities, and the banks have

[25] The maximum amount of penalty is legally limited to 2% of the total sales of the company. The amount of penalty imposed here is the highest ever charged by the KFTC for a similar offense. However, chaebols often resist paying the full amount of the penalty. A 1999 KFTC report showed that the chaebols only paid 40% of penalties incurred in 1998 and 1999.

accused the FSS of still engaging in semi-official administrative guidance which are opaque in nature. Various commentators have pointed out the problems of FSS, which includes the following:

- Because the FSS was formed by consolidating four regulatory agencies, and because the FSS consists of both civilian and government workers, there is a clash of cultures which makes working together difficult.
- FSS consists of more than 1,000 workers, and the system is too unwieldy.
- There are no prudent check and balance on the FSC and FSS itself.
- Except for very high ranking officials, most people who work for FSS are not required to disclose their financial investments.
- The FSS personnel retain their old top-down, interventionist habits.

Due to these problems, some commentators have advocated reducing the size of the FSS, and even re-splitting the FSS into separate agencies, which will undo much of the effort in establishing the FSS and FSC in the first place. Yet, much of the criticism seems misdirected. Bribery or the old interventionist habits will still exist no matter what form the regulatory agency takes. Also, whether the organization is unwieldy depends not necessarily on the mere number of employees belonging to that organization, but rather how much manpower it takes to do their job properly. The lack of rules on reporting the investment of employees is a serious problem in transparency, but such lack of disclosure rules is evidence that the reforms have not proceeded far enough, rather than the reforms have headed in the wrong direction. While much of the criticism against the new supervisory agency is valid, some of the cures advocated by some commentators seem to be unrelated to the problem. The government has taken a more moderate approach to reforming the FSS. Rules on reporting private investment will be instituted, some downsizing may be considered, and sharing of responsibility between FSS and the central bank is also being considered. However, the bribery incident has considerably reduced the public confidence in the reform measures taken place in the last three years, and a thorough investigation, as well as harsh punishment, and a more complete auditing and supervisory mechanism on the activities of FSS will be necessary if the public is to regain confidence in the FSC and FSS, as well as the recent financial sector reforms.

Some further problems which have eroded the public support for more regulatory reforms include lax inspection system for imported seafood, and the issuing of licenses for “love hotels.” During the summer and fall of 2000, pieces of lead were being found in imported crabs sold in Korean markets. The initial investigation showed that the lead originated from crabs which had been exported by small number of exporters in China. The news reports of this incident increased the public demand for more regulation to make sure such problems do not occur again. The “love hotel” problem involves a recent deregulation measure which eliminated some restrictions on the building of hotels. After deregulation, there has been some increases in the number of small hotels in residential areas. The problem arises because many of these hotels are engaged in prostitution activities, and the public in these residential areas have demanded that the government institute more regulations restricting the establishment of such small hotels, especially around school zones.

In both of these examples, public have strongly demanded more regulations, believing that the current regulations are inadequate to protect public health or public mores. Further, they have looked unfavorably on recent deregulation measures which they believe caused or contributed to these problems. However, a closer look at these examples show that the problem lies not with the lack of regulation, but on the lax implementation of existing regulations. In the case of the imported crabs, regulations on inspections are in place, but the level of punishment for importers and distributors who distribute harmful foodstuffs is low. Thus, there seems to be little incentive for importers and distributors themselves to inspect the goods they import or distribute, leaving only the official government inspectors, whose time and resources are limited, to inspect the imported merchandise. In the case of hotels, while several regulations were indeed eliminated, several regulations are still in place. For example, regulations restricting the establishment of such hotels within a fixed distance from a school are in place, but they were not properly carried out. The parties responsible for checking the compliance did not perform their jobs. Thus, the problem was that of implementation, not lack of regulations. However, the first reaction of the public was to institute more regulations.[26] Thus, the political pressure to eliminate regulations were somewhat weakened by these experiences. The public should realize, though, that unless the system for enforcement and implementation of existing regulations improve, it is unlikely that imposing new regulations will do any better.

The weakening of political will for regulatory reform seems to have led to a reduction in the political call for reforms. Much of the momentum for regulatory reform during 1998 and 1999 were driven by a strong political will stemming from the desire to recover from the economic crisis. However, as the economy recovered, and as certain notorious examples brought out what was perceived to be negative effects from deregulation and regulatory reform, the political will seems to have been reduced. As a result, the speed and the degree of the reforms seem to have been slowed down. While there are still some important measures taking place through the RRC, the general momentum and demand for reforms seem to have been weakened.

Further reducing the public support for regulatory reform is that the result of the regulatory reforms has not lived up to expectations. As the OECD report has pointed out, the general regulatory reform has concentrated on quantity of reforms rather than quality. Thus, even though

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[26] Reportedly, some of the strongest supporters of new regulations to restrict the building of new hotels are the existing hotel owners, who can now exact premiums (excess profits) due to the artificially low supply of these hotels. These excess profits act as incentives for other builders to build more hotels, often by bypassing the existing regulations through illegal means. Thus, an undesirable cycle is set up, further weakening the existing regulatory structure.

nearly 50% of regulations had been eliminated numerically, from the public's point of view, little has changed. Such situation contrasts strongly with the more qualitative reforms which took place in the area of foreign investment, which resulted in an increased the level of foreign direct investment.

The OECD report, as well as various literature on regulation, place considerable emphasis and importance on effective implementation of existing regulations. However, implementation had always been pointed out as one of the biggest shortcomings in the Korean regulatory structure. Even if the regulations themselves are well thought out, it matters little if they are not carried out or enforced properly. In addition, Korean commentators often mention "moral hazard" as being a major contributor to the mismanagement of the Korean economy. Moral hazard arises because a lack of transparency mismatches the gains and losses to private individuals or firms involved in a risky venture, often due to government intervention. Thus, the way to reduce moral hazard, if government intervention cannot be eliminated, is to improve transparency so that the mismatch is highlighted, and in addition, set up a reward-punishment system so that the gains and losses are correctly matched. The diligent implementation and enforcement of well designed regulations, as well as appropriate punishment, which raises the private costs of engaging in moral hazard behavior, is crucial in order to root out moral hazard.

In addition, effective implementation of regulations, which includes not only negative incentives such as punishments, but also positive incentives such as more dialogue, cooperation, and more effective execution of existing regulations, is crucial if the government and regulatory reform is to gain public confidence. Such public confidence is crucial if the rule of law is to take firm root in the Korean economy. Lax enforcement and weak enforcements have led to a lack of credibility and public confidence in the regulatory and legal system, which in turn, acts as incentives for the public to ignore laws and regulations, or to engage in bribery or other illegal acts in order to bypass them. Korea must realize that prudent supervision and transparency must be coupled by strong enforcement and appropriate penalties if it is to avoid the problems of moral hazard, and maintain the foundation of the rule of law.

In this light, the recent decision to grant or extend limited additional powers to the Korean Fair Trade Commission (KFTC) can be seen as a somewhat positive development. However, the additional powers granted or extended fell short of what the KFTC had originally wanted, and this case illustrates the lingering fear over what may happen should penalties or enforcement be "too harsh." The KFTC had originally announced its intention to submit a bill to the National Assembly which included following elements: A three-year extension of the right to request information on private bank accounts so that it can investigate illegal transactions; the ability to impose fines of 2 million won per day or 200,000 won per day on any firms or individuals (respectively) who hinder KFTC investigations by refusing to hand over evidence requested by the

KFTC; and an increase in the ceiling for fines from current 10 million won to 100 million won. However, after consultations with the members of the National Assembly, the KFTC amended its bill in consideration of "burdens on businesses" and "equity with other ministries." Under the new bill, only a two-year extension for the right to request bank account information was requested, and this right would not be exercised for investigations of false corporate subsidiaries. The right to impose fine on firms or individuals who refuse to hand over evidences was excluded from the bill, and the ceiling for fines was raised only to 50 million won.

The National Assembly, in not fully granting all of KFTC's requests, appealed to the current weak economic environment, arguing that harsh implementation and punishments may further weaken the economic environment. While this argument may be valid in the short run, in the long run, it serves to weaken the economic environment, since it reduces the incentives for the economy to overhaul its management practices. Korea often states that it requires a regulatory system "appropriate" to Korea's unique circumstances. However, the "appropriate" system is not one which allows current problems to continue. In some areas, Korea may legitimately require standards which are even tougher than the international standards if past experience has shown that a problem is particularly worse in Korea than elsewhere.[27] The desire to weaken regulations because it may cause difficulties often act as incentives to not reform or overhaul existing practices.[28]

To its credit, the government is beginning to focus on the quality of regulations in its regulatory reform process, which includes implementation and enforcement issues. A reform in regulatory implementation may be as crucial as regulatory reform if Korea is to streamline its regulatory system. Korea must reduce regulatory burden on its citizens and businesses by eliminating unnecessary regulations, and make sure that those regulations which remain fulfill socially necessary goals and are formulated in the most efficient way possible. Then, there must be firm implementation of those regulations so that the social goals are fulfilled, and the confidence in the economy and the social structure are maintained. The above-mentioned desire for more regulation may be a distorted reflection of the poor state of regulatory implementation.

[27] For example, one can argue that Korea needs regulations on transparency which are tougher than those of other countries because the other countries have non-regulatory means in place to guarantee transparency, and Korea has already shown that it has serious problems in transparency.

[28] Similar arguments are made by business representatives who argue against allowing more private actions against firms. While they acknowledge that private actions can be useful, they argue that more private suits will cause difficulties for firms and destabilize the economy in these dangerous times.

A continuing problem in the Korean regulatory system is that there are often, strong political demand for more regulations, but there is little off-setting political demand for fewer regulations. This imbalance seems to arise from the traditional interventionist and paternalist view of the government held by many Koreans, that the government must intervene to maintain efficiency and order; as well as the state of poor implementation of existing regulations. Thus, every time there is a social or economic problem, there is increased demand for more regulations, without duly considering whether such regulations are necessary or efficient. Such social demand for more regulation, regardless of its need or efficiency, acts as a barrier for effective regulatory reform. It also points out a problem in public confidence – that the public does not trust the market mechanism or private incentives to fulfill social goals.

There are often valid cases where new regulations must be adopted, and costly distortions in the economy must be borne in order to fulfill social goals. However, there should be clear consensus that the goals of the regulations are valid, and the regulations are formulated in the most efficient way possible. Often market mechanism or the market-based incentives can carry out social goals as effectively, and more efficiently than government-imposed regulations. New regulations submitted to the RRC are often rejected on the grounds that the regulations are not formulated efficiently. However, the reasons for such rejections are often not widely publicized, leading to the misunderstanding by the public that the RRC has rejected the social objectives inherent in the regulations. Such public misperception has played some part in the weakening of political will for further regulatory reform, and it is a problem that needs to be solved quickly.

The Regulatory Impact Analyses (RIAs) are designed to examine the problems of efficiency and need for regulations objectively, and serve as one of the main evidences for the Commission in considering a regulation for approval. However, Korea does not make the RIAs public, in part because the RIAs are often written in a haphazard fashion. Yet, if the RIAs are publicized, it would have several beneficial effects: The public would realize that the effectiveness and the efficiency of regulations are important issues which have been considered by the RRC, thus the confidence in the regulatory reform process would rise; there would be strong incentives for the government ministries to increase the quality of their RIAs; transparency on regulatory reform and regulatory consideration process would increase; and reasoned public opinion would act as a check and balance to the RRC. At the very least, it would spark useful debate on the nature and need for regulations between the regulators, the regulated and the public. The RRC and the government should re-examine their position on making the RIAs available to the public.

V. Conclusion

In recent papers, some economists argued that the "miracle" growth of East Asian countries, including Korea, was due to growth in inputs such as labor and capital, rather than through growth in productivity or technology.[29] These papers implied that the era of input-oriented rapid growth for East Asian countries was coming to an end. The OECD report, citing a report by the Korea Development Institute (KDI), echoed such arguments when it stated:

> "..Korea's future growth will increasingly depend on new sources of total factor productivity gains. Consequently, establishing market principles and institutions will be essential to improving the allocation of resources and raising the gains in output per unit of input."[30]

Korea is rapidly approaching the barrier where economic growth can no longer depend on increasing the labor hours worked; and the Asian financial crisis has shown that rapid and arbitrary investment can lead to harmful overinvestment. In the end, Korea needs to "work smarter." Regulatory reform, along with structural adjustment, management reforms, and a shift to a knowledge-based economy, which depends on the quality of labor and not the quantity, is necessary to maintain Korea's growth in the future, and make the quantum jump to a fully developed, mature economy. Again, as the OECD report emphasized:

> "Together with other structural reforms, regulatory reform, if accelerated and broadened, should be able to raise potential and actual Korean growth rates in the long-term by stimulating supply-side gains in efficiency and technology, and at the same time, increasing consumer demand."[31]

Along with regulatory reform, a reform in regulatory implementation is also critical. If implementation, including the ease of compliance, the levels of punishment, and the levels of enforcement are inadequate, the public is likely to lose confidence in regulations as well as the reform process, and any reforms are not likely to succeed. Given that Korea has had a long tradition of problems in regulatory implementation, more attention on implementation issues are critical if Korea is to succeed in reforming and overhauling its economy.

Finally, a fuller dialogue needs to take place between the regulatory authorities and the

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[29] For example, Krugman (1994) and Young (1995).
[30] OECD (2000) p. 48.
[31] OECD (2000) p. 48

public, especially on the logic of individual regulations and the reform process. Public release of RIAs can serve as ideal tools to educate the public and spark discussions. The government should seriously consider the release of RIAs in the near future.

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Comment

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Three years ago, after the Korean economy was put under IMF conditionality due to shortage in foreign exchange reserves, Korea's big businesses underwent unprecedented Copernican changes. For businesses, the experience was more significant both in content and in future implications than anything that they had ever undergone in the last 30 years of rapid growth. During the upheaval, some conglomerates have already disappeared into history, while others took the opportunity to prepare for greater growth in the future. But most companies realized that the only way to survive would be to adapt themselves to the extreme changes. In short, from the viewpoint of Korea's big businesses, this process can only be seen as one of "challenges and opportunities".

Restructuring as Challenge

- Improving management and accounting transparency

The present and proposed policy system regarding transparency is one of the most advanced in the world. The issue is whether or not the system itself works as originally intended. While important parts are being neglected, too much attention is being given to minor aspects. For example, promoting small shareholders rights is very important to guarantee managerial or accounting transparency. However, in some cases, they were promoted a little too much, so that top management, with its goodwill and best knowledge, may lose chances for bigger success in the future.

- Delayed restructuring in the labor market and public sector

We are experiencing a rapid pace of restructuring in both financial and corporate sectors, but progress in the labor market and public sector are stalling. It is not just a matter of equality between social sectors, but is important to restructuring itself: because of delay in the labor market and public sector, restructuring is being hindered in other sectors. From the case of Daewoo Motors and other public enterprises, the labor unions had false expectations, such that sit-ins or strikes could guarantee at least some of their jobs. The labor unions are generally quite slow to realize that the year 2000 is different from the early 1990s with its wave of democratization and labor movements. One has to realize the so-called "layoff paradox", which is that when a firm survives the hard times by laying off workers, it can lead to a larger employment in better days ahead.

- The financial market crunch

The current credit crunch situation is a natural consequence of the not-so-clever policy stance that tries to complete restructuring in corporate and financial sectors at the same time within the period of several months. Furthermore, a vicious circle has been formed in the midst of the hectic process of restructuring. Without putting priorities or preconditions on the restructuring effort, the requirement of financial institutions' asset soundness may easily end up with tight money supply in the various sectors of financial market. But this credit crunch situation may lead to worsened asset structure of financial institutions in the end.

Restructuring as Opportunity

- Sound financial structure imposed by external parties

Corporate restructuring is in many senses a "forced reform" rather than a voluntary one. Being "forced" by others, restructuring has brought some casualties. Survivors of this immunization, however, are starting to build a sound structure and working system that will enable the survivors to withstand future shocks.

- Changing attitude toward foreign capital and foreign management

Ever since the outbreak of the foreign exchange crisis, one of the most frequently heard worries was that "this may cause the outflow of national wealth". Also, many Korean workers used to have the preconception that foreign management tends to cut the workforce or jeopardize jobs. Fortunately, however, these preconceptions, especially the misunderstanding of "national wealth," have been fixed mainly with the help of policymakers. Notwithstanding the mere recovery of economic indicators, this kind of changing attitude seems to be an important reason why Korea is considered a model case in economic recovery from the viewpoint of foreign observers.

- Renovation of corporate culture

All economic players, not just the restructuring corporations but also consumers, workers, and investors learned that nothing is immortal and that everything changes. The corporate sector is the place where such a renovated mindset has massively occurred. Workers no longer regard their workplace as a lifetime employer, but are starting to realize the importance of fostering one's own ability. Top management has learned that changes in internal organization, core competence, and key technology occur continually, and more importantly that at times these should be changed intentionally. In sum, Korean big businesses are learning the true meaning of creative destruction.

Getting Closer to the Market

Recovery of Korea's big businesses from the IMF crisis was a switchover process from government-led growth to market-oriented growth. It has been rare for a country to successfully pass through such challenge and become an advanced economy. People in Korea, including yourselves, are participating in such a rare process.

The Biggest Challenge: Seeking the Engine for Sustained Growth

Many of the country's conglomerates are undergoing an identity crisis. These giants, which had achieved enormous growth over several decades, have suddenly found themselves unable to act on even the most basic questions, such as what business they should be in. The Korean economy is basically in a similar situation; it needs to find a new engine for growth that will work in the long run. Even after the companies choose their business fields, many issues will remain. How do they run their business? What are the best ways to manage employment and capital? On thing is for certain, the answers should not be those of the past. Academics are touting knowledge-based management as the answer. While this seems promising, it will be hard to implement practically.

The top management of Korea's conglomerates is faced with critical problems. They may feel that someone who was teaching restructuring methods until recently may turn out to be a competitor tomorrow. Conglomerates must not only adjust to the new rules of the game for themselves, but must also struggle with competitors who are experienced in those rules. For Korean big businesses, the ordeals of last three years were only a beginning; the biggest challenges are still ahead.

Comment

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Korea has accomplished a great deal over the past three years. Bold policies and a commitment to reform have addressed many of the weaknesses that contributed to the crisis in 1997 and transformed the landscape for economic decision making. But much remains to be done to ensure that the gains endure and that the Korean economy is sufficiently sound and flexible to adapt and prosper as conditions change. Indeed, the sharp deterioration in market sentiment in recent months despite excellent macroeconomic performance is largely related to poor microeconomic performance, especially worries about a highly leveraged corporate sector with poor profitability, and to perceptions that the reform process has stalled. The basic framework for restructuring, the corporate and financial sectors, is in place and, looking ahead, the key issue will be implementation and ensuring a stronger role for markets – especially creditors and investors – to drive the process.

To strengthen performance and boost investor confidence, corporations need to further reduce debt. Improvements in corporate financial structure will need to be buttressed by deeper operational restructuring and improved disclosure. A large number of companies are still saddled with weak cash flow and poor profitability. Devoting greater attention to strengthening the bottom line will require cost cutting, the sale of non-core assets, and strategic alliances. In some respects, the difficult part of corporate restructuring still lies ahead – nonviable firms need to be closed down, and viable but distressed companies should be subject to rigorous workouts involving debt write-downs as opposed to rescheduling. The recently announced list of nonviable companies is a step in the right direction, but this will now need to be translated into action and banks will need to continue to scrutinize other weak companies. So that more value is not destroyed, a quick resolution in the highly visible case of Daewoo, whose affiliates have been in workout for a year without any significant asset sales, is also critical. Finally, the campaign to discourage Korea's largest chaebol from ill-advised and excessive investments financed by debt will require longer-term efforts. Success will require progress on a number of fronts – strict oversight by investors and creditors, enhanced risk management practices, elimination of anti-competitive practices, stronger and more efficient insolvency procedures, and improved corporate governance.

Much has been done to stabilize the financial system, but more needs to be done before the system's soundness is firmly established. Deeper corporate restructuring will likely entail additional losses for the financial system. It is now up to the banks, under the supervision of the authorities, to take an aggressive attitude in accounting for asset quality. Only by doing so will banks convince markets that known credit losses have been met and that they are now making operating profits sufficient to meet new credit losses in the future. For balance sheet improvements to be sustained, banks will need to strengthen business practices, especially with regard to risk analysis and lending practices. The privatization of Korea First Bank was a landmark step, and priority will need to be given to privatizing the other nationalized banks and divesting government stakes in recently acquired banks. The costs involved in the government continuing to own these banks for several years outweigh the benefits from waiting in the hope that share prices will rise.

Efforts are also needed to develop a vibrant capital market to reduce reliance on bank debt as the main source of financing for investment. Experience elsewhere suggests that it will take time to develop a genuine long-term corporate bond market. The recent trend toward securitization in

Korea is a positive development. Reform and restructuring of insurance companies, which should offer longer-term products invested in longer-term traded securities, would also contribute to capital market development, as would reform of the investment trust industry to create a genuine fund management business. Pension reform, which is under consideration by the government, should also be designed with a view to fostering the growth of capital markets.

Most of the needed improvements in the regulatory framework, or what might be called the "hardware," have now largely been completed. However, important steps remain to be completed to the "software" of the supervisory system. In particular, it will be important to move from a process that emphasizes formal compliance with regulations, which was the tradition of the predecessor organizations of the FSS, to one that concerns itself mainly with assessing risk and promoting better risk management.

Although there is still a long way to go to complete the restructuring and reform process, this is largely a reflection of the magnitude of the necessary changes and should not detract from the major achievements of the last three years. Restructuring needs to be seen as an ongoing market-driven process, to be pursued not just in response to crises but also in good times. Indeed, although the government clearly has a critical role to play in monitoring and enforcing regulations, Korea is a maturing economy and it will now be important for the government to step back from intervening in the operation of markets and economic decision making. In the future, it should be creditors and investors, rather than the government, who take the lead in imposing discipline on market participants.

Comment

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As the result of reform, the Korean economy is showing quite favorable macroeconomic indexes. However, in contrast to the indexes, the Korean economy is in reality in a very difficult situation. Recently, the indexes have begun to deteriorate.

In the case of the financial sector, in spite of the injection of public funds which amount to 109 billion won, the normalization of market function was not achieved. The delay in closing down the insolvent companies, such as Daewoo Motors, and in the workout program resulted in an insolvent financial sector which amplified the worrying sentiment. The financial institutions are reluctant to give out further loans because they were facing the second-step financial sector restructuring. In particular, the difficulty in lending for small and medium-sized enterprises (SMEs) grew worse. In this situation, the Korean government is trying to process the second-step restructuring by creating more public funds.

In the corporate sector, the debt-equity ratio was lowered to the government-designated 200% and the reform to eliminate mutual debt guarantees between sister companies in the same business groups was somewhat successful. However, in other sectors, nothing was changed from the pre-crisis period. The most serious problem is the delay in processing the shutdown of insolvent companies. Recently, there has been some effort in closing the insolvent companies, however too late. Furthermore, the regular mechanism for closing is not working until now. In the public sector, the reform is still not done and the labor market reform is in slump.

The problems during the reform process can be cited as follows. First, the market economy principle was not kept. During the reform process, there were many cases violating the market economy principle. For instance, the financial institutions could not play the leading role in the closing of insolvent companies while relying on the government's decision. And in the case of Daewoo Motors, the investors should have taken the responsibility, but rather it was relayed on to banks, which ultimately resulted in the deepening of unsoundness in the banking sector. The second problem was the failure of mediating different interest groups. For example, during the mediation process between the labor unions and the management, and during the public sector restructuring, the government should have carried out the mediation with a long-term vision and strict principles, regardless of how difficult it was. The third problem was who would execute the reform measures. In the process of reform, there were confusion and disagreement among government departments; however, the government's reconciliation function was weak. Furthermore, the government more often than not had missed the right moment to determine and implement certain policies, and could not distinguish between what was more urgent and what was less urgent. Moreover, the nonexistence of long-term master plan and vision became the limit to persuading the interest groups. The fourth problem was quantitative reform rather than qualitative reform. In implementing the reform program, the Korean government had a tendency to put more emphasis on quantitative reforms, which have more visible effects than qualitative reforms, since the latter are difficult to achieve and take a long time to be completed. The examples that show this tendency are the creation of venture business boom and the “big deal” program among the conglomerates.

The future reform policy must be processed in the following way. At fist, restructuring of the financial sector and normalization of capital supply by the banking sector must be completed quickly and thoroughly. For this, public funds should be injected as soon as possible. Of course, the public funds should be strictly managed, and the sacrifice and responsibility should be asked from the institutions where the public funds were put into.

At the same time, through the market mechanism for the closing of insolvent companies, the effective distribution of production elements should be achieved and the vicious cycle (insolvent companies→insolvent financial sector→another insolvent companies) must be stopped. And moral hazard that is prevailing in our society must be eradicated. For this purpose, all the economic agents should abide by rules and norms, and the economy must perform under the institute and system. The public sector reform should not be delayed any more, and the labor market needs to be more flexible soon.

Lastly, the government must try to support the SMEs. One of the reasons Korea faced the financial crisis is the excessive weakness of Korean SMEs compared to those in developed countries, in other words, the weakness of the sub-structure of industries that are vulnerable to outside shocks. Ironically, Korea was able to overcome the crisis in a rather short period of time is because of the SMEs. The restructuring of SMEs was achieved naturally by serious bankruptcies among the SMEs that could not get financed from banks. And the SMEs thoroughly restructured themselves during the last three years out of the experience that when a crisis comes, the banking sector turns away from them first. This contributed much to the rapid recovery. As the result, in the latter half of 2000, there are hardly any new bankruptcies, despite the tight money market.

The necessary financing should be made available to the SMEs only with credit regardless of the size and the mortgage of enterprise. For this, not only is the grandization of financial institution through restructuring needed, but also competition in the domestic financial market should be further encouraged by allowing various financial institutions free market access. Moreover, the rules of the game for fair competition among all kinds of companies should be laid out immediately. And the institutions supporting the SMEs should support the technological innovation, specialization, informatization and establishment of external and internal network systems of the SMEs.

Comment

Dong Won Kim
Editorial Writer
Maeil Business Newspaper

Korea met its financial crisis because she failed to deal with the globalization trend of the 1990s. So, how Korea overcame the crisis must be evaluated by internal and external efforts in coping with globalization. However, a large gap exists between Korean scholars and scholars from abroad in evaluating the Korean economy.

This divergence of opinion is caused by the unique characteristics of Korea's restructuring system. It first has the characteristic of regime change. It goes beyond the general meaning of restructuring, which aims to enhance the efficiency in the resource division. The regime change in Korea has the characteristic of abolishing the present development system, which helped Korea sustain its high-rate growth for 40 years. And, it is the transition process to go into a more open and market-based system. How one understands the characteristic of regime change makes difference in the point of view.

Recently, the Korean government has been criticized harshly from in and out of the country for lagging in restructuring process. What is the reason for blaming? The answer is the regime change characteristic in the Korean restructuring system. Foreign media are asserting that the main cause of the financial crisis in Korea is crony capitalism. Korea already knows that she cannot and should not maintain it.

However, there is not any unified idea upon whether the open system recommended by international organization such as the OECD can be applied to the Korean situation. We have to pay attention to this fact. Seen from the outside, the new economic system is in accordance with global standards. Koreans are ready to bear the pain in reform and restructuring. But is it worthy bearing? Koreans have no answer. This is why there is a growing sense of crisis in the Korean society again. The typical case is the recent announcement by the Korean government to put an end to the government-driven workout program, which lasted for two and a half years. The government announced that banks would be responsible for the disposition of insolvent enterprises. This brought unrest to domestic financial markets. In this respect, the Korean government is pointed out as the main reason behind the recent economic instability.

Korean restructuring has not been able to break the chain of vicious cycle; the withdraw of financial and corporate sectors which brings the rise of unemployment and which consequently leads to the fall in total consumption and a sense of crisis. So, what is mostly needed in the Korean society is market confidence in that the recent restructuring program is not only for the withdraw of insolvent companies; it will bring about a market-driven economy with the result of efficient resource allocation and investment movement and increase in employment.

In conclusion, whether the third stage of restructuring is necessary or not is being questioned these days. Whether it is necessary or not, what is clear is that the restructuring program will take much time and pain. All Koreans are aware of that fact. However, on account of the regime change, it became unpredictable about other actors' response. For example, Korean conglomerates, especially Hyundai and Daewoo, went into bankruptcy because they too relied on the government. Another possible crisis is the collapse of trust system. Nobody is sure whether his or her pain in the restructuring process is equally shared or not. When everybody has a firm belief in the fairness of pain, then Korea can step into the new regime. Koreans have successfully adjusted to the changing system with much effort and pain. I believe that like the past, Korea will successfully adjust to the changes through learning and mutual trust.

Comment

Won-Am Park
Professor
Hong-Ik University

During the past three years after the outbreak of the financial crisis, Korea made great efforts to overcome the crisis by implementing various structural adjustment and reform programs. The economy recovered very quickly to record a double-digit growth in 1999 and an over 9% growth up to the third quarter of 2000. However, the Korean economy began to decelerate rapidly in the fourth quarter. Korea's stock price slid to the level just before the crisis and the won/dollar exchange rate tumbled.

As the external conditions turn gloomy and the US seems to head for a hard landing, more clouds are gathering around the Korean economy. In order to restructure the crisis-hit financial sector, the government has spent 110 trillion won thus far and plans to allocate additional 40-50 trillion won, which amount in total to 30% of GDP. According to the World Bank study on the financial crises (Caprio and Klingebiel, 1996), the resolution cost is 10-20% of GDP in many cases and 40-55% in the cases of Argentina and Chile in the early 1980s. Korea's resolution cost is certainly above the average. Do we have to put more public money in the future?

It's possible. Our corporate restructuring is far form complete. As Dr. Imai and Dr. Jones point out, sales of Daewoo Motors and Hanbo Steel are not completed yet and Hyundai could be the stumbling block to full recovery. One quarter of manufacturing firms (nine of the top 25 business groups) do not cover interest payments by operation profits. With economic setback ahead, non-viable firms will suffer more, producing more non-performing loans. This is the situation we are facing now.

Then what should be done? The recent NBER paper by Caballero and Hammour (2000) stresses on "creative destruction" with the massive restructuring as a core mechanism of development, especially when investment is "sunk" with the crisis. The theories of experimentation and technology adoption call for a shift in the development paradigm from the "big shift" into a myriad of "little nudges." Developing countries typically suffer from severe deficiencies in their contractual environment and post-crisis financial problems. If the contracting ability is limited, the institutional environment should be arranged to stimulate creative destruction. Underdeveloped and politicized institutions are a major impediment to a well-functioning creative destruction process. Caballero and Hammour further pointed out that increased liquidations during crises did not result in increased restructuring.

I understand that all reform measures suggested by the OECD in the field of financial and corporate restructuring, labor market and regulatory reform are measures for setting up the institutional environment for creative destruction. How much to accept is our responsibility. The Korean economy should undergo the process of creative destruction. In particular, Hyundai should be creatively destructive, if entrepreneurs there are really different form the ones in Daewoo.

The sudden increase in the resolution cost and the delay in restructuring are mostly attributable to the Daewoo collapse. On this point, some argue that Korea's problems have been created after the crisis, in other words that our crisis was caused by the financial panic rather than Korea's fundamental weaknesses. This kind of argument does not help the prevention of another crisis. Whatever the reason for crisis, the collapse of Daewoo shattered the Korean economy and brought about the difficult situation we must overcome. If Hyundai collapses, our case would not be much different from the cases of Argentina and Chile. This should not imply that the government must prevent the collapse of Hyundai, but that Hyundai as well as other large business groups should undergo the process of creative destruction.

SESSION III

CHALLENGES OF GLOBALIZATION TO KOREA

Challenges of Globalization to Korea

Tae-Dong Kim
Chairman
Presidential Commission on Policy Planning

I. Globalization and Korea

1. Globalization: Progress to Date

During the past five decades, the world has seen a notable and incessant progress of economic globalization. For instance, the portion that trade takes in world GDP rose from 6% or so in 1950 to about 15% these days.

The border no longer exists in the area of finance as well as in services. As an example of how fast the globalization processes have been, it took only ten years for the daily turnover of foreign exchange market to grow from US$ 190 billion in 1985 to US$1.5 trillion. There is no hard distinction between the so-called multinational enterprises and local firms because so many enterprises are participating in the global market today, and almost all enterprises are in one way or the other involved in the global market. With the help of information technology advancement, these trends are likely to continue and further accelerate in the 21st century.

2. Globalization and Korea

National competitiveness in the 20th century was the ability to maximize usable resources at the state level. For the 21st century, it is the ability to create global players and the capability of establishing a network at the global level. This new paradigm created by globalization poses itself as both a threat and an opportunity to Korea. Korea can turn it into an opportunity if it quickly finds its identity in this new system and makes use of it. If not, however, it will obviously be a threat.

Nations have two choices in coping with globalization. One is to refuse the open market system and avoid global competition, while the other is to actively participate in global competition by market opening and liberalization. Korea has definitely taken the latter approach. Korea's export-driven development policy or acceptance into the OECD membership in 1996 clearly shows that Korea was willing to open and meet the challenges of global competition.

The Kim Dae Jung administration has been continuously extending the depth and scope of liberalization as a strategy to recover from the 1997 financial crisis. As a result, foreign direct investment and portfolio investment, including M&A works by foreigners, have been fully liberalized. Hosting of the 2000 ASEM Summit, active participation in APEC and promotion of an FTA with Chile are a few examples of how the role of the Korean government in promoting globalization is expanding. The Korean government will also engage itself actively in the New Round negotiations of the WTO.

While duly pursuing globalization and open competition, the Korean government recognizes the importance of preventing and responding to the backlashes of globalization. It will pay special attention to this in the hope of helping every country to benefit from globalization.

II. Globalization and Korea's Economic Reform

1. Economic Reform for Survival

For an economy which had a fair amount of autonomy and was somewhat isolated from other economies, stabilization policy was an effective measure to manage domestic business cycle.[32] However, under such changing circumstances as capital account liberalization, fiscal policy would lose its effectiveness. Expansive fiscal policy in times of flexible exchange rate regimes and free international capital mobility may cause exchange rates to surge and lead to current account deficits, jeopardizing income stabilization. Especially for countries whose financial system needs further development, including Korea, neither fiscal nor monetary policy would work so effectively.

Although the global economy is deeply integrating day after day, there is still no global government that can stabilize the global economy. While the business cycle in emerging markets has become increasingly volatile, international financial institutions such as the IMF do not seem to have the capability nor will to bring stability to the global business cycle.

The vulnerability of domestic economy to external shocks is more alarming now than in the past and it is especially true for such a small open economy as Korea. In that the robustness and the soundness of the economic system are crucial in the era of globalization, economic reform has become "a matter of survival," rather than "a matter of choice," for Korea.

2. Economic Reforms in Korea

[32] Even in this case, monetary policy can be truly meaningful in a soundly operating market economy, where increase in the quantity of liquidity can lead to decrease in interest rate and increase in private investment. The private sector's credibility of the government is crucial for the successful implementation of monetary policy.

Korea should have had a sound economic system prior to joining the OECD. Government-led bank lending or crony capitalism was often found in the Korean business system. A proper auditing system was not available to supervise the Chaebol of their management practices.

In late 1997, the time has come for Korea to pay the price for impatiently joining the ranks of advanced countries. It will take a year or two from now for Korea to return to the pre-crisis level of GDP per capita, US$10,000. It is apparent that Korea has wasted five years already, and it will take a much longer time to adjust income disparity and unemployment rate, an outcome of the Asian crisis. To prevent another crisis in the future and to recover as fast as possible, the Korean government is focusing on four areas of economic reforms. The four areas subject to reform are financial, corporate and public sectors, and the labor market.

Korea maintains a high level of savings rate, which is one of the top five rates in the world. Financial sector reform is crucial to turning the high savings rate into efficient investment. The essentials of financial reform will include enhancing the structure of financial institutions and streamlining the regulatory (monitoring) system. As for yet, even though public fund of KRW 108 trillion plus additional KRW 40 trillion this year will be injected into the financial sector restructuring, it leaves much more room to be filled.

Corporate reform follows the so-called '5+3' principles. The eight principles are as follows: (1) enhancing corporate transparency; (2) eliminating cross guarantees within the same business group; (3) improving the capital structure; (4) focusing on the core competences; and (5) increasing the accountability of large shareholders, plus (6) forbidding the Chaebol to own financial institutions; (7) curbing indirect cross-ownership; and (8) preventing the evasion of inheritance tax and gift tax. These principles are similar to those of OECD recommendations. So far, with the exception of the principle of eliminating cross guarantees, other areas have shown little improvement.

Public sector reform has particular importance in Korea not only because it leads other sectors' reform but also because the public sector has the lowest competitiveness in Korea. The government will gain high credibility for its reform efforts once reform work is done in the public sector. Nevertheless, it will take a while before the results of downsizing and regulatory reforms become visible.

The fact that countries with flexible labor markets, such as the U.S., the U.K. and the Netherlands, show lower unemployment rates provides meaningful implications to Korea. Although there are views against flexible labor market, especially from the labor side, the Korean government is making persistent efforts to create a more flexible labor market through the Tripartite Commission.

The economic reforms of the four areas have been promoted in the last three years at the strong will of President Kim. These reforms, if successful, will significantly improve Korea's business environment and help Korea enjoy benefits of globalization.

However, there are two risk factors that could lead to failure. First is the lack of human resources capable of promoting reforms. From government officials to executive managers, bankers and labor leaders, Korea is in need of experts in many areas undergoing reform. Second, there are anti-reform or anti-globalization movements in Korea. For example, during the general election season early this year, some politicians have exaggerated the sales figure of Korean firms to foreign businesses as outflow of national wealth and used this case to serve their political purposes.

Despite these restraints, the Kim Dae Jung administration is promoting "Djnomics," which aims at parallel development of democracy and market economy, pursuing liberalization and reforms concurrently.

III. Policy Objectives in the Era of Globalization and Korea's Response

1. Social Integration

With market integration, the scope of competition has expanded from the national level to the global level. The WTO regime does not allow any less competitive industry to be subsidized by the government. However, this does not implicate that there should be no social policy for those lagging behind.

OECD member countries' experience of welfare policy is an important lesson to Korea. Many of OECD member countries have been transformed into the "enabling state" from the "welfare state". This means that the government's role has changed from that of merely providing social welfare to support less privileged groups of people to that of giving them more self-reliance.

Following this trend, the Korean government is treating the "productive welfare" system as one of its top policy objectives. Productive welfare is a preventive, ex ante measure that provides a minimum level of welfare while focusing on education, re-training to enhance potentials of the vulnerable groups and make them self-reliant.

Since October 2000, the Korean government is applying The Basic Law of Social Security and designing various development programs.

2. NGO Activities and Conflict Resolving Mechanism

All the same, globalization is creating conflicts in many areas. NGOs of different ideas and objectives are now aggressively presenting their views on globalization. The 1999 WTO Ministerial Conference in Seattle and the 2000 IMF/World Bank Meeting in Prague are such examples.

Dialogues between the NGOs and the government are important to minimize the side effects or conflicts of globalization.

During the last decade of movements toward a mature democracy, the number of NGOs in Korea has increased dramatically to some 4,000. The Korean government is supporting NGOs by enacting the Civil Organization Support Act. It is important to invite NGOs to official-level talks so they can have opportunities to offer constructive ideas of various groups, instead of complaining without alternatives.

3. Korea's Efforts for Resolving Conflicts at the Global Level

Globalization has caused problems or conflicts that can only be resolved at the global level. Here are some cases in which Korea has made contribution as a member of the global community.

First, Korea is working on reducing the problem of "Digital Divide". As globalization and digitization are concurrently progressing, the information disparity became a major source of growth disparity between countries. President Kim Dae Jung, at the APEC meeting in November this year, suggested five areas of cooperation to resolve this problem.

Second, to forestall future financial crises with international repercussions, Korea will actively participate in sharing information on speculative capitals. More specifically, the establishment of hedge fund monitoring facility has been put forth by President Kim and was agreed by the APEC members.

Third, to eradicate corruption and bribery, Korea abides by the OECD Anti-Corruption Agreement. Korea has already legislated the Anti-Corruption Act. A more comprehensive law is expected to be legislated in the near future.

Fourth, Korea will play a major role in mitigating the income disparity between countries. The globalization will inevitably produce countries that fall behind but no global government to adjust this problem exists. This problem should be addressed by the voluntary efforts of developed countries because hindered process of globalization will also prove costly to them. Developed countries, for their own interest, should share the burden. Korea as member of the OECD will extend its role in supporting under-developed countries.

Comment

Whan-bok Cho
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Introduction

Not long ago, the topic in the international economic field changed from interdependence to integration by the effect of globalization. The collapse of Cold War and the progress in technology opened the era of globalization, which resulted in the borderless economic activity and endless competition. In an international sense, the end of Cold War became an international opportunity for globalization; in the case of Korea, ironically, the financial crisis at the end of 1997 became a chance of accelerating its globalization process.

Korea's economic stance has been elevated: Korea ranks in the 13th place and 12th place for GDP and the size of trade, respectively. The experience of a financial crisis at the end of 1997 formed a new paradigm in its external economic relationship. Without market opening, there will be no fair competition, and globalization of economic practices cannot be expected. In other words, without opening there is no reform and without reform there is no guarantee for the viability of the Korean economy in the future. The continuing opening has become the key to our survival.

Korea is going to take up a more active role in the international economic order as a rule maker rather than a rule abider. In this respect, Korea is newly recognizing the role and function of the OECD, and is going to further strengthen the cooperative relationship with the OECD in the future. I am going to look into the economic and diplomatic tasks of Korea in keeping up with the globalization trend.

Cooperation in Development

The international society agreed that the benefits of globalization have been divided unevenly between developed and developing countries. The gap between rich and poor and the eradication of poverty are worldwide problems that should be resolved together.

The change in recognition, especially of developed countries, seems to be wrought by the recent anti-globalization protests in Seattle, Bangkok and Prague led by many NGOs. The recent strengthening in the support program for developing countries by the World Bank and the IMF is in the same context.

Now is high time for the international society to take into deep consideration the claim of developing countries that the gap between developed and developing countries is growing bigger and bigger and it is caused by the fundamental limit of existing world economic system. The international society should also consider the claim that the economic globalization only guarantees the flow of capital in a limited situation for free flow of labor, which only protects capital profit.

In spite of the financial crisis, Korea as a leading developing country thinks of cooperation for development as the integral part of its external economic policy and is going to strengthening cooperative efforts in the future. Korea's ODA in 1999 amounted to 0.08% of the whole GNP which equals to $200-300 million and has been increasing, when compared to the rates from 1996 to 1998, 0.03%, 0.042% and 0.058% respectively. Regionally, Korea supported 81% of the international ODA to the Asian region in 1999, where Korea has a close economic and historical relationship. Furthermore, for the poorest countries, Korea is allowing no tax market access with special grant for them. To narrow the gap in the filed of ICT, in other words the Digital Divide, there will be further international cooperation in the coming year.

Conversation with Civil Society

In Korea, voices that are critical of globalization are getting louder and a resistance movement against the globalization trend is likely to grow bigger. The sovereign creditworthiness has become a very important element in managing the national economy for the stable inducement of foreign capital. The excessive anti-movement against globalization did more harm than good to creditworthiness of the Korean economy, which has just started to recover from the financial crisis, so it must be examined in the aspects of economy and security.

Globalization is an unavoidable trend, so the Korean government should have more conversation with the civil society to maximize the profits from globalization. In other words, complementary mechanism to eliminate the negative elements brought by the rapid globalization, such as financial crises, collapse of cultural identity and unstableness in the labor market, must be discussed along the cooperative process so that the profits of globalization can be shared by more people.

The Field of International Finance

The East Asian region felt direct impact by the financial crisis in 1997. The vulnerability in the East Asian region to financial crises and the possibility of direct and indirect impacts of financial crises in the future is very high. Through the experience from the 1997 crisis, Korea already knows the damage caused by the absence of management system. As the result, Koreans have a consensus on the necessity of restructuring the international financial system.

Korea is taking a series of initiatives in the East Asian region, participating in international conferences such as the G-20. And the currency swap agreement was made among three East Asian countries, Korea, China and Japan, and among the ASEAN countries. In June 2000, Korea agreed on the currency swap agreement with Japan. Moreover, to supervise the speculative short-term capital, a scheme to operate the monitoring channel of short-term capital movements is under way. Between Korea and Japan, this scheme is already at work and it is expected to be expanded to Thailand and Hong Kong in the first half of 2001 as the first step, and to the ASEAN + 3 countries (Korea, China and Japan) as the second step. With this, an early-warning system for financial crises will be created within this year and is going to be used next year by the decision among the ASEAN+3 countries.

Our Trade Policy

The globalization trend calls for a new way of thinking. Korea until recently did not support the idea of bilateral and regional FTAs. In other words, multilateral issues were the foremost concern of its trade policy and the Korean government was against such policies. This was caused by the Korean government's change of perception that the coexistence of FTAs and the WTO can be possible and that the opening and harmonization of the international economy can be gradually achieved through regional and multilateral cooperation. Second, Korea began to realize that as for Korea, being largely dependent on international trade, isolation from FTAs would not be any good for its national interest. So the government's new economic policy includes the immediate market access and the opening and reform through FTAs.

Under these circumstances, Korea is moving toward the FTA negotiation with Chile from November 1998. Based on the experience with Chile, Korea is going to expand FTA ties with many other trade partners, especially the countries that have industry and trade structures supplementary to our own and many FTA ties, although the profit of trade and investment is small in the short run.

In conclusion, in a globalizing trade system, multilateralism is the proper means to make a more open world economy. But at the same time, the Korea government will make use of the FTA as a means to open markets both at home and abroad.

Comment

Yoo Soo Hong
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The most important point in the relationship between globalization and the domestic economy is whether the opening of domestic economy is a precondition to the development or the development of domestic economy is a precondition to the opening.

Of course, the two are complementary but in the long run, a time gap between the two is formed. There is a tendency among developing countries to give priority to development rather than opening in the first-stage economic policy. In the case of Korea, after the accession to the OECD in 1996 when the national per capita income reached ten thousand dollars, market opening and liberalization took place. At that time, there was an idea of cautiousness that it was too early for these measures to be adopted, but the more prevalent idea at that time was that opening the domestic economy will advance the Korean economy.

After four years since entry into the OECD, it is still difficult to decide which idea was right. However, the fact was proven that although the market opening is inevitable in the era of globalization, it does not automatically bring about the development of the domestic market. On the contrary, the weakness of the domestic economy must be reinforced by our own strength for the successful opening.

For a small open economy like Korea to join in the globalization trend, its domestic economic system should be reformed such that it would ease the difficulties in processing macro economic policy and security policy caused by the rapid market opening and liberalization. There are many challenges Korea is facing in the globalization process. The main economic issues are as follows: ① the problem concerning the economic actors (especially multinational corporations); ② the improvement in economic norms and standards by benchmarking the best practice and the participation in multilateral organizations and agreements; ③ the contribution to reducing both internal and external gap between rich and poor; ④ the pursuit of sustainable development toward a positive sum; and ⑤ the balance among nationalism, regionalism and globalism in political and economic spheres.

Chairman Kim's presentation shows the stance and effort of Korean government toward each issue. For the first and second issues, the Korean government has pursued market opening and domestic reform simultaneously under the philosophy of DJnomics. For the third issue, there were growing efforts for the social integrity and NGOs. Finally, to resolve the international gap regarding the fourth issue, the Korean government tried to cooperate in monitoring short-term capital, anti-corruption and the information gap problem.

I support the Korean government' s efforts and I wish it would continue with more results. Among many tasks, I think the most urgent one is the internal reform and anti-corruption drive. Kim Dae Jung administration successfully overcame the financial crisis in the first stage, but the present economic situation of Korea shows us that there has not been significant achievements in resolving these two tasks.

I do not want to repeat the corruption matter here, for there are many discussions about it with a series of banking accidents. I would just like to speak out my opinion that without the fundamental reform of inefficient official system and the administration of justice, it is impossible to cut the corruption ring in Korea.

The driving force toward reform is diminishing significantly in Korea. The leading force comes from internal integrity and powerful leadership. So, if internal conflict and the gap between rich and poor persist, the contribution to lessening the worldwide gap will not be an easy task.

The sustainable development is not only a global problem but also a very serious domestic economic problem. The worldwide problem of the waste of resources and the environmental pollution can be solved only when domestic efforts accompany.

My conclusion is that globalization and the development of domestic economy are both sides of the coin, but at the same time, the latter should be a precondition. I want to stress again the significance of problems related to reforming the domestic economy, which are discussed throughout this conference.

Comment

Byong-Sun Kwak
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Globalization poses itself as both a threat and an opportunity to Korea. In choosing between acceptance and refusal of globalization, Korea took the first course. The world economy is integrating, but there is no world government that would stabilize it. So small open economies like Korea should cultivate the power to meet this new trend. The domestic economic system must be strengthened to be more sound. This is not a matter of choice but a matter of survival.

Korea had not established a market economy, which is enough for the accession to the OECD. In this situation, the opening of the capital market brought the financial crisis in 1997. If the financial crisis occurs again, Korea would become a weak country. So Korea is now restructuring four sectors, i.e. banking, corporate and public sectors and the labor market, to reach global standards. However, there are risks that hinder the restructuring efforts. They are the lack of human resources and the exaggerated propaganda of the side effects of globalization. The counterplan to this is Djnomics that pursues democracy and market economy at the same time. As to facing the challenges in the globalization era, efforts have been made to incorporate the social agents.

Throughout the history, the hegemonic powers forcefully opened the weak countries. Globalization in these days can also be seen as a way to open world markets by Western states with strong capital markets to maximize their profit. Why does one state have leadership and another state is controlled by that state? This is a most fundamental and serious question, which must be considered in terms of national policy. Generally, the difference of global view by each state is the answer to that question. A state which reads the world with progressive thoughts, makes creative ideas, raises important problems and reaches integration in a diverse society can become a leading state. This is the matter of people and the quality of human resources.

However, if we look at the Korean society, rather than uniting our energy to strengthen our competitiveness in the globalized world, Koreans are wasting energy by distrust, enmity and jealousy. A more serious problem is that the discontent does not only belong to the have-nots in the distribution process but also it has penetrated to all the classes.

Our competitiveness in the face of the challenges of globalization lies in the hands of the quality of human resources. There is no other way to improve the quality of human resources than to create the basis. In this point, encouragement and support should be given to teachers. Furthermore the guideline of human resource quality must be established.

There are so many tasks for the educational sector, but one task is the change of the criteria of competent persons. To achieve this, the higher civil service examinations must be rescinded immediately because this kind of examination hinders the creativity of competent persons and results in their waste.

On the other hand, the sense of integration uniting the people together and inducing their cooperation is required for national competitiveness. Ensuring a common identity is the way to survive in the era of globalization. As the base for the social unity, the building of trust, cooperation and the democratic process are part of social capital, which is important to the formation of elements of competent persons. Formation of social capital is a prerequisite for productive welfare. It is worthwhile to pay attention to the recent OECD introduction of the concept, the social capital, with the same importance as the human capital.

I want to stress that the success and failure of keeping up with globalization for the Kim Dae Jung government is in the hands of administers and people who are affected by them. In this respect, the British Prime Minister Tony Blair's statement that the first, second and third importance in the state affairs is the education sets a right path to follow for national management in the era of globalization. It is difficult to cope with the new global trend without changing our unique ideas and attitude.

Leaders of each sector can attribute greatly to the formation of social capital by education because of their power of influence. We should remember that the world norms in the globalization era are not generated by themselves but by the leaders of each state.

Comment

Yoon-ja Kim
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It used to be said that a cough in Wall Street causes a bad cold in the whole Asian economy. Like this saying, today's world economy has become so harmonized that a butterfly's flutter in Bangkok could bring a big storm to Wall Street.

Harmonization of the world economy is proof of the new era of globalization. And in the process, the two-sided financial accumulation has accelerated the development of productive forces and has altered the unstable business cycle. The autonomy of policy making for a country has weakened significantly. In spite of that, the possibility of stable long-term economic growth depends on the economic system. This is the point in small countries like Korea because they are always susceptible to changes in overseas economies.

Korea has very little natural resources and relies on exports of numbered kinds of goods, such as steel, semiconductors and automobile. We are subject to impact of every session of depression. Therefore, I think the autonomy of policy making and the increasing domestic demand have to be stressed as important preconditions for our structural readjustment. Opening the domestic market and inducing foreign investment must go hand in hand with securing the control of foreign capital.

Both domestic and foreign scholars worry about the weakness of Korea's social welfare networks. If we admit that some labor market readjustment is needed, first of all, we have to consider re-education programs and a certain amount of social subsidies during unemployment. And this must be considered as a certain kind of social investment to increase social productivity.

Moreover, as seen form the expression 'Too big to kill,’ we have already seen a high level of socialization of productive forces. And now it is impossible for us to regulate our economy by market mechanism alone. Therefore, new social consensus mechanism is being called to manage this huge economic power.

To this end, participation of all interest groups, especially workers and labor unions, should be guaranteed in the social decision making process. Planning this kind of participation is the most important task in the economic reform, and, at the same time, the key to successful economic recovery.

Comment

Young Ha Kim
Editorial Writer
The Chosun Ilbo

Now Korea is facing multilateral challenges. The challenges come from globalization, the knowledge-based society with informatization and lastly restructuring.

The challenge from globalization directly affected the labor market and the employment system. The knowledge-based system challenges many labor problems and forces the establishment of a new social security system. The various impacts of restructuring on the labor market and the necessity of changing the existing system are intertwined, making the situation very difficult for Koreans to handle. So, this is high time for us to establish the social security system, which fits our current situation. The most important task is the development of a new social security system and means for social integration. What deserves our attention is the fast reform in the social security system by the Korean government, spearheaded by unemployment insurance and Basic Social Livelihood Law. The structural change is occurring in social integration and the social safety net.

However, each problem has its own problems. What is most important is the structural adjustment to the knowledge-based society, driven by informatization. So, there must be changes in the traditional labor market system. The task Korea is facing is the establishment of a new labor market structure and the change in the educational and job training systems. We can learn lessons from the OECD member states.

The current system – employment insurance and Basic Social Livelihood Law – has reached a quite high level. However, there are many hardships like the lack of budget and the restructuring process. So, in this transitional period, the implementation of balanced social security policy is the most urgent and difficult problem. The mutual effort of the private economic agents and the government is essential. The social consensus is also needed.

Lastly, the establishment of a social safety net suitable in the knowledge-based society is necessary. Three preconditions should be considered. First, the high-rate growth era has come to an end. Second, the maturity rate in the New Economy for Korea will be slower than developed countries, so excessive expectations can be dangerous. Third, as costs of restructuring and reform will be large, the soundness of finance structure and the reform of tax system must accompany each other. Reform of the job training system, high education system and job education system to be suitable for the New Economy must be carried out simultaneously with these preconditions.

Open Discussion

Minister Han: I just would like to ask one question. In the course of comments and discussion, Professor Kim actually gave a wonderful speech. In terms of policy makers, concerning this globalization and complementary measures, the most important thing that we should do is to respond to globalization through lessening the speed and to establish more protectionist walls so that the Korean economy can be insulated from this globalization process. Will that process be plausible and acceptable in terms of Korea's future growth? I think Professor Kim meant exactly that the Korean economy had been very intense in introducing foreign investment during the last two years and half. She suggested looking at Mexico and Latin America. How was FDI introduced? What impact did FDI have on Latin America? Can we say that Mexico's active participation in globalization through NAFTA, possibly by voluntarily reduction of tariff, was successful, or as some claim was it a total disaster? Some say it was totally dominated by the US economy so that the welfare of domestic people had not improved. If some members of the OECD can give a wider view, looking at particular cases in this globalized world, it will be very helpful for us to understand whether really globalization and positive response to globalization is inevitable, acceptable and desirable. If I condense my question in one: "Is there any country that was successful by responding in a negative way to globalization?"

Ambassador Young: What was requested by the OECD was the early liberalization of the movement of long-term capital. And this is probably what the Korean government should have accommodated. But on the other hand, in other areas there were some things that the OECD wanted us to do, which I think we should have not done but have done. One of them is accepting the request of the OECD countries for us to commit ourselves to reforming the labor norms up to global standards very soon, which the advanced countries of OECD have had the experience of more than a century. But this is something that we need at least a certain minimum amount of time. Nevertheless, we have committed ourselves and agreed that we would fully respect the rights of the workers by standards that prevail in the advanced countries. And subsequently, until this time we are critically evaluated by the OECD countries and this I think is sort of major embarrassment to us as far as our membership to the OECD is concerned. And even in the near future, if the prospect is not so good, we will be judged lest we show satisfactory results in terms of accommodating the request by the OECD countries. This is a challenge to the Korean government that requires very serious consideration.

Professor Kim said that the OECD gave out a verdict that Korea's regulatory reform has been satisfactory. But if you read carefully, that is not what the text really says. As far as the quantitative approach is concerned, the regulatory reform so far has been very good. But that is not enough. What is really important, what should be focused upon from now on is to look at the quality of the regulation. The OECD report lists a number of areas such as the telecommunications sector and the power sector where the government's role is substantial, therefore are in need of further regulatory reform. So, the real meaning of the OECD recommendation in these areas has been that we should move on to the second stage of regulatory reform. Professor Kim cited a movement opposing the reform launched and led by the government. This shows that we have a need to create social consensus supporting the reform measures. So, once again, this highlights the important role the civil society has to play. But more importantly, I think the role of the political system is crucial in the reform process.

Dr. Schlögl (on FDI): First of all, you have to realize that to my knowledge and to OECD knowledge, there is no country which suffers from the FDI influence. On the contrary, they benefit from it. That is the empirical evidence we have. But, let me put it in a little bit broader context; if Korea and other countries decided to be reluctant to attract FDI, it will only damage Korea and those countries who do that. No one will complain. There is huge competition for funds globally. In Europe and in the US, they even have a government agency to attract and convince foreign investors. Let me just mention, in the last couple of years, the most successful capital importers, the US and China, huge countries with so different society and economic system, have both at the same time allured investors.

I think if FDI does not come in, the reform in corporate sector will not succeed in a reasonable period of time. This does not mean that Korea has to liberalize all sectors for FDI. There are sectors where a social and political environment is skeptical to get investment. It is understandable. The FDI is not the WTO issue. It is basically in the hands of each country to define a number of sectors where FDI is not needed in the near future. But when you see the reform requirement in your industry, for example the massive unemployment which is strategically important for the survival of a democratic society, FDI can really help to smooth this reform process. So again, no one could complain about Korea's decision that foreign investment is not good.

Dr. Imai: Japan is the least successful capital importer and the Japanese are actually suffering from it because foreign investment really influences foreign management and participation of banking industries. Mexico, as far as I can judge, benefited enormously from its association with NAFTA and investment from the US. Mexico had long ago liberalized its capital market to have a fully integrated financial market, but there was at the same time sheer policy mistake, which was macro policy fixing to defend its fixed exchange rate. However, the Mexican crisis had nothing to do with accession to the OECD, although the two incidents coincided.

SUMMING-UP

Summing-Up

Herwig Schlögl
Deputy Secretary-General
OECD

I would really like to make two points, which look the most important to me. First of all, my colleagues and myself found out that whenever the educational process began to discusse in the country, the concrete policy issues get the broad spectrum. However, we are not looking for consensus here, because we want to find the best solution for the problems. I think we are all agreeing on more or less. So, I would like to say that Korea is going through a very important transitional period. Some even talked about the change of economic paradigm or economic regime change, but we would say the transition from a government-directed economy and society to a market-driven one.

I think, we the OECD respect Korea's determination of reform, and we also think Korea already has gone quite a long way. Although it has indeed been interrupted by the financial crisis which in a way had not only a negative effect but also in a way contributed to accelerating necessary reforms in the Korean economy. And that especially relates to the restructuring of the corporate sector. Because the overall structure of the Korean economy has not been a healthy one, it was dominated by a few numbers of big conglomerates with an underdeveloped area sector of small and medium sized enterprises.

So, our experience is that if you have this imbalance in the structure, the economy is much more open to the crisis, and cannot so quickly respond to the crisis. Especially, the huge block of the economy has many problems, which requires huge efforts and is a burden for reformers. We also discussed that having more or less necessary funds in place to restore the financial sector and to restructure the corporate sector hopefully helped, from our perspective, the restructuring process by further inflow of the long-term private capital. So, I think the perspectives are not as gloomy as Koreans think. We do not see the repetition of a financial crisis. Although it is true that we now have indications of the global economy slowing down, I hope our experts already calculated that when they checked the growth rate of Korea for the next two years from 2001 to 2002 between 5.5-6%. In the range in OECD terms, that is not bad. However, to Koreans, I learned that it is not so impressive.

Let me finally thank Trade Minister Dr. Han Duck-soo and Ambassador Young for giving the OECD the opportunity to have an open exchange of ideas and issues. And I think Korea and the

OECD both profited from this seminar. That is how the OECD works; there are always two railroads. It is not only Korea learning from the OECD, but the OECD already has learned much from Korea.

I hope to be back in not so soon but in some time. Thanks!

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