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Designing a New Economic Framework

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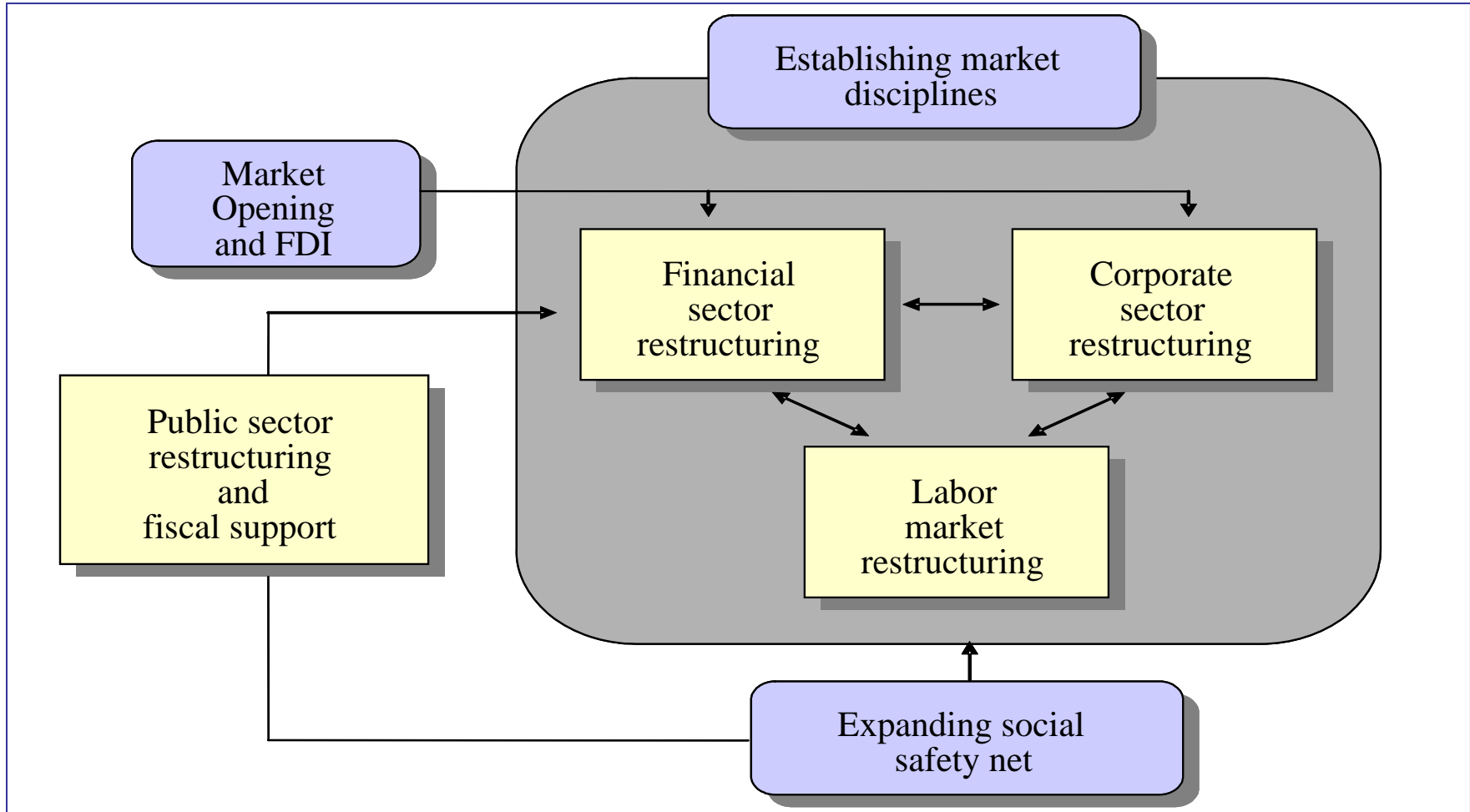
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- The miraculous growth based on mobilization of resources ran its course in the 1990s.
- The Korean government pursued continuous reforms for a more market-oriented economy.
- The 1997 financial crisis is a turning point.
- Structural reform since the crisis was extensive.
- Main objectives of the economic reform
 - (i) Encouraging a market-oriented economy
 - (ii) Improving the institutional regime, and
 - (iii) Constructing the knowledge-based economy

Scheme of Economic Reform after the Financial Crisis



Source: Government of the Republic of Korea 1999, p. 46.



What this paper discusses

- 1. What were problems to the economy?**
- 2. What have been done?**
- 3. What are the results?**

Important but not included in this paper

- 1. Policy for R&D**
- 2. Education reform, etc.**

1. Introduction



Period (E.D. Plan)	President	State Leadership and Economic Regime
1962-1979 (1,2,3,4)	Park, C.H.	Authoritarian and strong leadership State-guided market economy
1981-1988 (4,5)	Chun, D.W.	Authoritarian and strong leadership Large corporation centered economy
1988-1993 (5,6)	Roh, T.W.	Authoritarian but weak leadership Large corporation centered economy
1993-1998 (6,7)	Kim, Y.S.	Democratic but weak leadership Reform oriented economy
1998-2002	Kim, D.J.	Democratic leadership Reform and globalization oriented economy

Economic Crisis: 1997



Principles of financial sector reform

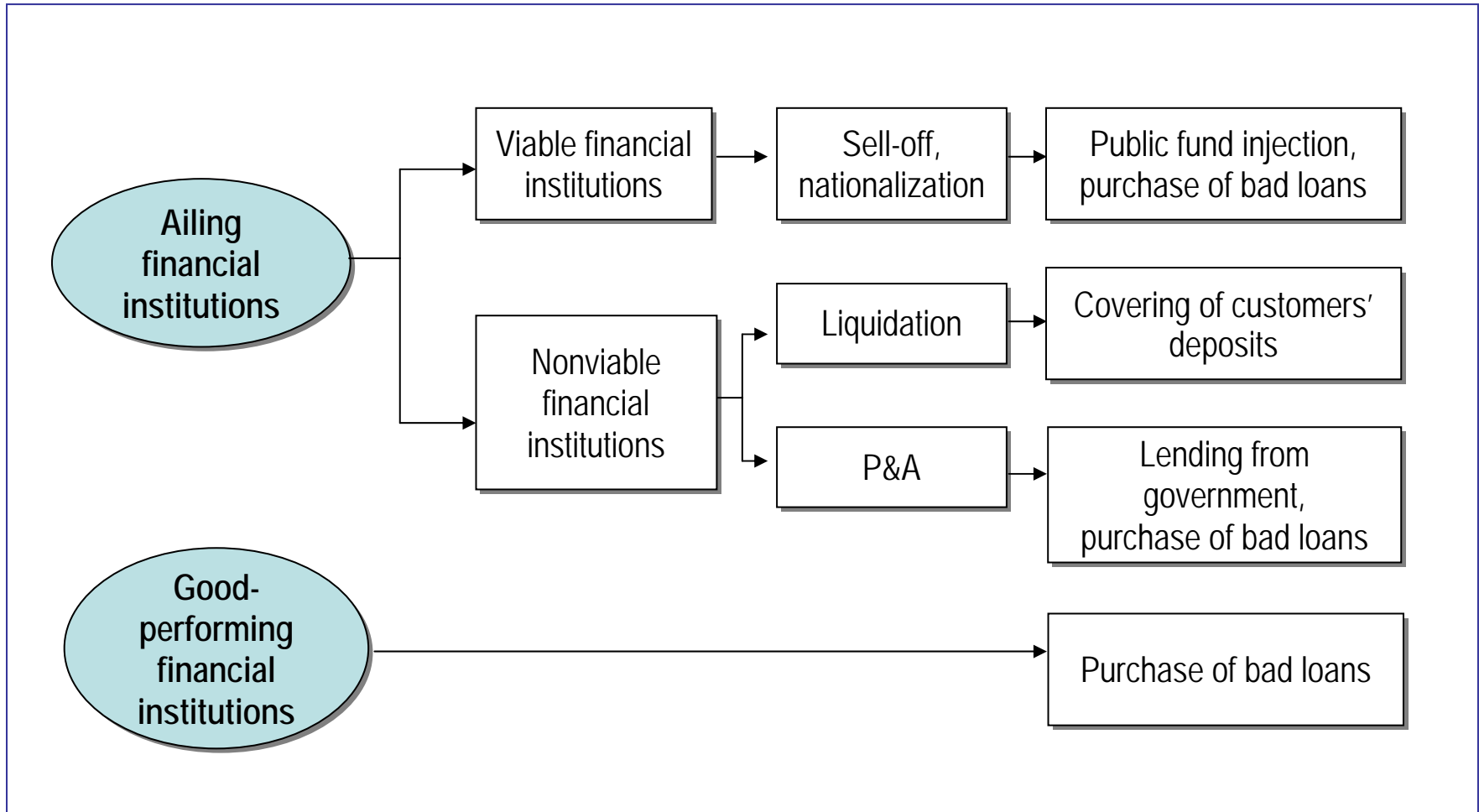
- (i) Restoration of financial intermediary functions through the elimination of uncertainties
- (ii) Exit of nonviable financial institutions and early normalization of viable institutions – settlement of NPL and injection of public funds
- (iii) Strict application of loss-sharing principles to the beneficiaries of the public funds

Steps of the reform

- (i) The gov't liquidated troubled institutions, removed NPL and recapitalized promising FIs by injecting public funds
- (ii) FIs adopted strict standards
- (iii) Various institutional reforms were implemented.



Method of Financial Sector Restructuring



Source: Kim, 2003, p.238

2. Financial Sector Reform



Sources and Uses of Public Funds, 1997–2004

(trillion won)

	Purchase of NPLs	Settlement of insured deposits	Contribution	Recapitalization	Purchase of assets	Total
Bond issues	20.5	20.0	15.2	42.2	4.2	102.1
Fiscal funds	-	-	-	14.0	6.3	20.3
Recycled funds	17.4	7.4	2.2	6.0	5.1	38.1
Others funds	1.1	2.9	0.2	0.03	0.1	4.3
Total	39.0	30.3	17.6	62.2	15.7	164.8

Source: Public Fund Oversight Committee



Results of financial sector reform

- The total amount of bad loans decreased (66.7 t.won in 1999 to 31.8 t.won in 2002).
 - The share of bad loans out of total loans decreased (11.3% in 1999 to 3.9% in 2002).
 - The financial health and profitability of FI increased and M&A became activated.
 - Infrastructure was improved.
 - development of capital market
 - consolidation of financial regulations
 - market-oriented financial supervision
 - privatization of government-owned FIs
- > The financial crisis was a blessing!



- Many large firms had unpayably large amounts of debts (due to expansion strategy) -> Triggered the financial crisis.
- Vicious circle of insolvency existed.

Objectives of the corporate reform

- (i) To eliminate overcapacity
- (ii) To encourage firms to be more competitive by concentrating on their core competencies

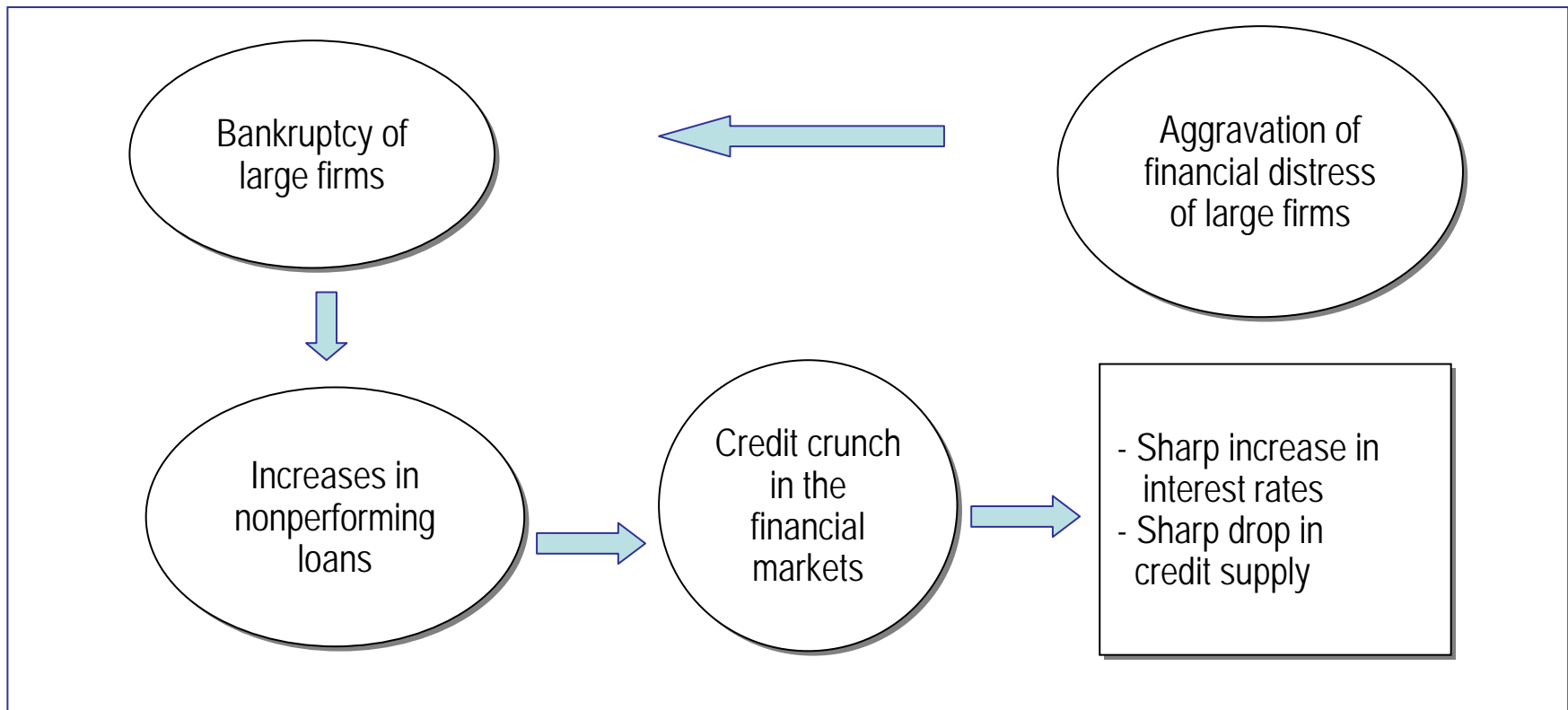
Major reform measures related to the corporate governance system

- improve transparency, enhance the accountability and independence of the Board of Directors, protect the property rights of minority shareholders, liberalize M&A, strengthen the role of creditors, improve the financial soundness, etc.

Also improved bankruptcy procedures and removed anticompetitive regulations



The Vicious Circle of Insolvency



Source: Nam, 2004, p. 344

3. Corporate Sector Reforms

Major Reform Measures Related to Corporate Governance in Korea in the Postcrisis Period

Policy challenges	Specific measures adopted
Improve transparency	Mandated combined financial statements for top 30 business groups (Jan. 1998, starting with business year 1999) Adopted international accounting and auditing standards (GAAP and GAAS; Dec. 1998) Mandated board resolution and disclosure for large-scale intersubsidiary transactions (Dec. 1998) Strengthened law enforcement against window dressing and poor auditing Mandated establishment of a committee for appointing independent auditors (Jan. 2000)
Enhance the accountability and independence of the Board of Directors	Made it possible to hold de facto directors (chongsu) accountable for their decisions, and introduced fiduciary duty and cumulative voting (Dec. 1998) Mandated appointment of outside directors: no less than 1 person (1998); no less than one-fourth of the board (1999); no less than one-half of the board (2000, for financial institutions and large listed companies) Mandated establishment of an auditing committee (Dec. 1999)
Protect the property rights of minority shareholders	Lowered filing requirements for motion to dismiss directors and auditors (Feb. 1998) Lowered filing requirements for derivative action suits (May 1998) Lowered filing requirements for inspection of accounting books (Feb. 2001) Lowered requirements for recommending outside directors (Feb. 2001)
Liberalize mergers and acquisitions	Abolished mandatory tender offer (Feb. 1998) Abolished ceiling on equity investment by foreigners (May 1998)
Strengthen the role of creditors in corporate governance	Allowed banks to exercise voting rights on stocks in their trust accounts (Sept. 1998) Mandated periodic assessment of corporate credit risks (Mar. 2001) Gave the Korea Deposit Insurance Corporation the right to investigate unlawful activities on the part of financially distressed firms (Mar. 2001)
Improve the financial soundness of firms	Induced reduction of debt-to-equity ratio through Capital Structure Improvement Plans (1998–99) Prohibited intersubsidiary loan guarantees (Feb. 1998)



- Korea is a medium open economy.
- Korea recognized the importance of opening up the nation.
- It accelerated its globalization trend by participating in multilateral and bilateral free trade negotiations.
- Korea completed FTA talks with Chile, EFTA, Singapore, and ASEAN, and is now holding the first round of talks with the USA.
- It aims to be a Northeast Asian Hub.



Aims of the government:

- 1) To minimize the social costs caused by the L-M conflicts
- 2) To build a flexible and stable labor market
- 3) To reduce economic and social disparities

To achieve these objectives, **the government initiated**

- 1) To create quality jobs
- 2) To secure flexibility and stability in the labor SUPPLY
- 3) To improve the market efficiency through job-matching
- 4) To reform the education sector to meet demand
- 5) To improve L-M relations



Real Wages, Labor Productivity, and Employment



Source: Yoo 2004.



Why Important?

1. Government sector takes a significant portion.
2. Government provides economic environment.

What is the role?

1. Encouraging a market-oriented economy
2. Improving the institutional regime
3. Constructing the knowledge-based economy

How to achieve?

- Leveling playgrounds, providing economic environment, reforming institutional regime, as well as providing public goods etc.



What kind of reforms?

1. Government sector reform
2. Restructuring institutional regime
3. Maintaining fiscal soundness and privatization
4. Building-up information society
 - Building up the e-government
 - Effective management of knowledge and information resources
5. Improving the social welfare system

6. Public Sector Reforms

Privatization Plan for Public Corporations

Timetable	Enterprise	Employees	Sales (billion won)	Number of subsidiaries	Government Share (%)	Profit (billion won)	Results
Immediate (by end- 1999)	Pohang Steel and Iron Corporation	19,294	9,718	16	26.7	729	Privatized in Oct. 2002
	Korea Heavy Industries and Construction Corporation	7,851	3,008	3	84.3	45	Privatized in Dec. 2000
	Korea General Chemical	263	15	1	98.8	(57)	Liquidated in Nov. 2000
	Korea Technology and Banking	163	438	1	10.2	2	Privatized in Jan. 1999
	National Textbook Corporation	739	52	0	40.0	4	Privatized in Nov. 1998
Step-by-step	Korea Telecom Corporation	58,556	7,784	13	71.2	80	Privatized in May 2002
	Korea Tobacco and Ginseng Corporation	7,573	4,243	1	35.3	226	Privatized in Oct. 2002
	Korea Electric Power Corporation	33,036	13,116	7	58.2	561	Government share reduced to 54 percent
	Korea Gas Corporation	2,891	2926	5	85.7	(336)	Government share reduced to 51 percent
	Daehan Oil Pipeline Co.	385	34	2	48.8	(44)	Privatized in Nov. 2000
	Korea District Heating Co.	1,044	203	3	72.2	1	Government share remains at 72 percent



- The Korean gov't acknowledged the importance of venture businesses.
- **Restructuring** since the crisis has proceeded favorably to venture businesses.
 - to nurture cutting-edge technology
 - to advance the industry structure
 - to increase employment
- **Environments** after the crisis also favorable
 - many large firms went bankrupt or restructured businesses
 - niche markets emerged and IT grew fast, with low entry barriers; not inferior to developed countries (start-up stage)
 - favorable labor market: retirees with know-how

7. Venture Business Policy



Number of Registered Venture Firms by Industry, 1999–2004

	1999	2000	2001	2002	2003	2004
Manufacturing	3,478	5,363	6,889	5,679	5,234	6,023
	(70.49)	(60.96)	(60.47)	(64.70)	(67.96)	(68.63)
Data Processing, Software	1,248	2,925	3,715	2,390	1,832	1,997
	(25.29)	(33.25)	(32.61)	(27.23)	(23.79)	(22.76)
R&D, Services	69	213	333	286	278	351
	(1.40)	(2.42)	(2.92)	(3.26)	(3.61)	(4.00)
Construction, Transportation	65	144	206	172	117	147
	(1.32)	(1.64)	(1.81)	(1.96)	(1.52)	(1.68)
Retail	26	74	116	119	144	158
	(0.53)	(0.84)	(1.02)	(1.36)	(1.87)	(1.80)
Others	48	79	133	132	97	100
	(0.98)	(0.90)	(1.17)	(1.50)	(1.25)	(1.14)
Total	4,934	8,798	11,392	8,778	7,702	8,776
	(100.00)	(100.00)	(100.00)	(100.00)	(100.00)	(100.00)

Source: Small and Medium Business Administration (www.smba.go.kr)



The Korean government's policy for venture capital

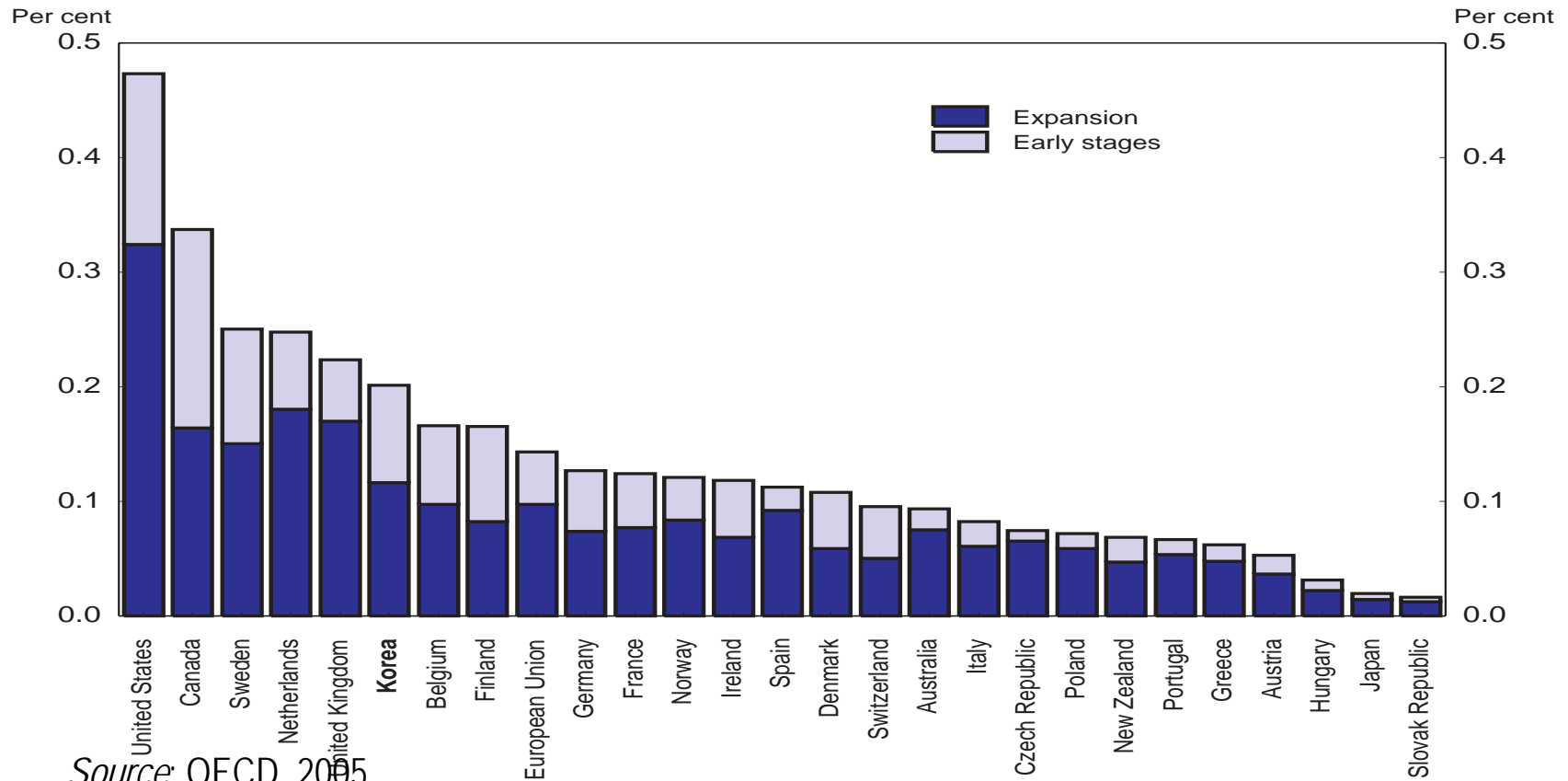
- To promote formation of venture capital markets
 - to open the KOSDAQ: more relaxed requirements than KSE
 - > venture industry boom
 - > became significant for the growth of the Korean economy
 - > The venture investment (as a share of GDP) since the crisis was one of the highest.

- To establish the Act on Special Measures for the Promotion of the Venture Business
 - to relax regulations
 - to issue official certification to technology-intensive SMEs.

7. Venture Business Policy



Venture Capital Investment by Stages, 1999–2002



Source: OECD, 2005



Adjustment of the venture boom

- Possibility of bubbles in KOSDAQ was raised.
- A dark outlook about the profits of venture business began to be proposed.
- NASDAQ crashed
- Illegal activities of some venture businesses made the KOSDAQ index dropped.
- Too much investment into the KOSDAQ.
 - > Bubbles burst in 2000.
 - > Since 2001, the number of firms stabilized, operating income stagnated.
 - > Since 2003, the venture businesses markets became more optimistic.



Performance Trend of Venture Firms Listed in KOSDAQ

	1998	1999	2000	2001	2002	2003
Number of firms	171	234	244	379	340	373
Total assets (A)	6,296,057	12,484,547	19,318,401	28,718,219	24,245,793	26,678,148
Operating income (B)	516,997	972,341	1,211,966	1,048,571	1,052,473	1,302,817
B/A*100	8.21	7.79	6.27	3.65	4.34	4.88
Total liabilities (C)	4,273,547	5,806,513	7,091,118	11,184,646	9,550,174	9,933,722
Cash in end of year (D)	361,081	681,707	1,217,975	1,561,178	1,188,488	1,351,337
Risk (C/D)	11.84	8.52	5.82	7.16	8.04	7.35

Source: KOSDAQ (<http://km.krx.co.kr>)



- The Korean government attempted to establish **the market discipline** and reduce government intervention: The structural reform was extensive, **covering most areas of the economy**.

More specifically,

1. **The financial sector reform** was mostly about hardware, such as cleaning up of NPL or ailing FIs.

2. **The corporate sector reform** improved the corporate governance system, revised bankruptcy procedures, and removed anticompetitive regulations.

3. **Labor sector reform** aimed to make the market principles work properly.

4. **The government** provided a level playing field and sound macroeconomic environments through institutional reforms and the provision of public goods.

5. The government made effort to find, nurture and develop **venture businesses**.