Section 2 Structural reforms in the Republic of Korea after the Asian financial crisis

Below, we look at the reforms implemented in the Republic of Korea(ROK) after the Asian financial crisis as an example of an initiative to strengthen the fundamentals for growth through economic structural reforms.

1. Improvements in macro-economic conditions

After the outbreak of the Asian financial crisis, at the macro-economic level, the Republic of Korea recovered from its economic slump earlier compared with other crisis-hit countries such as Thailand and Indonesia. Around the middle of 1998, the ROK shifted from the austerity conditionalities (Table II-2-2-1) imposed by the IMF to expansionary fiscal and monetary policies, and the macro-economic policy measures and structural reform program implemented as a result of this shift made significant contributions to the economic recovery. In addition, due to currency depreciation, exports recovered quickly after falling in 1998, producing positive effects. Figure II-2-2-2, which shows trends in the growth rate of exports of goods and services (real growth rates based on 2005 prices), indicates that exports from the ROK grew more than those from Thailand, which was also hit by the Asian financial crisis, as well as those from Japan over the same period.

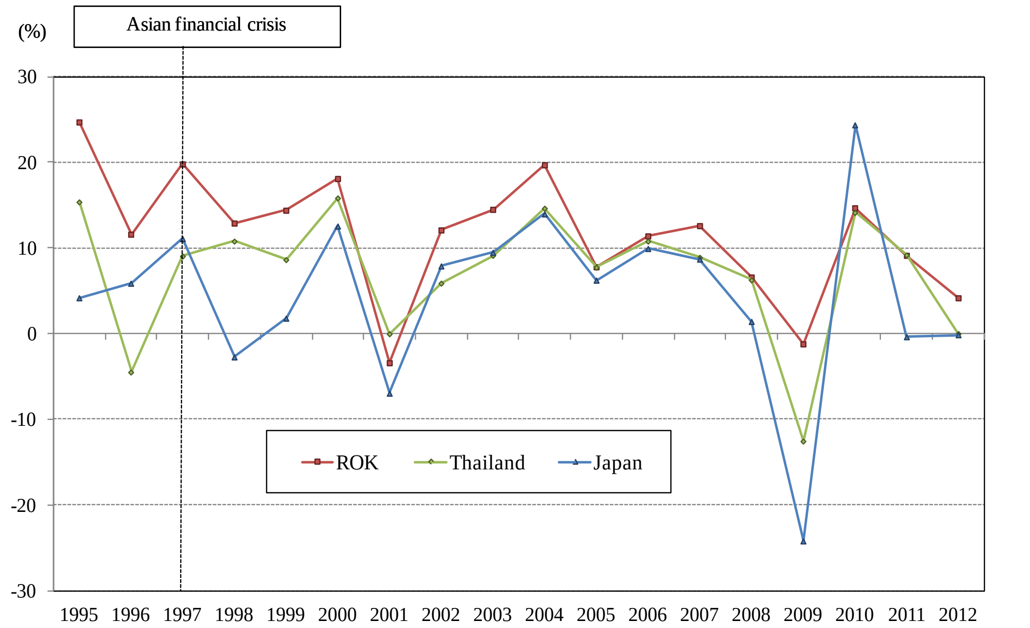
Figure II-2-2-3 shows trends in the unemployment rate in the ROK. The unemployment rate, which was 2.0% in 1996, the year before the outbreak of the Asian financial crisis, reached 7.0% in 1998, immediately after the crisis, rising as much as 5.0 percentage points over a period of only two years. However, in 1999, the unemployment rate started falling and plunged to 4% in 2000. After falling further in 2002, the unemployment rate has stayed almost flat. Although it was still higher than the level before the Asian financial crisis, the unemployment rate was 3.2% in 2012.

Table II-2-2-1 IMF conditionality

Category	Details
Macroeconomic goals	
	Narrow the current account deficit to below 1% of GDP in 1998 and 1999
	Contain inflation at or below 5%
	Limit the deceleration in the GDP growth to about 3% in 1998, followed by a recovery toward potential growth in 1999
Monetary policy and interest rates	
	Shift to a tighter monetary policy
	Approve rising market interest rates depending on market conditions
Fiscal Policy	
	Increase tax rates and broaden VAT coverage
	Reduce current expenditure and low priority capital expenditure
Financial sector restructuring	
	Close troubled financial institutions that have no prospect of recovery
	Strengthen requirement for auditing by internationally recognized accounting firms
	Allow foreigners to establish bank subsidiaries and brokerage houses by mid-1998
	Revise soundness supervisory standards upward in line with the BIS core principles for effective banking supervision
	Replace blanket guarantee scheme to a limited deposit insurance
Corporate restructuring	
	Improve transparency of financial statements through the adoption of international accounting principles
	Prohibit government intervention in bank management and lending decisions
	Reduce the debt ratio
	Remedy the practice of arranging debt gurantee between companies within the same group
	Improve the flexibility of the labor market and strengthen the functions of the employment insurance system
Capital and trade liberalization	
	Eliminate trade-related subsidies, restrictive import licensing, and the import diversification program
	Increase the investment ceiling on foreign ownership of shares to 50% by the end of 1997 and 55% by the end of 1998
	Allow foreign banks to purchase more than 4% of equity of Korean domestic banks
	Eliminate restrictions on foreign borrowing by corporations

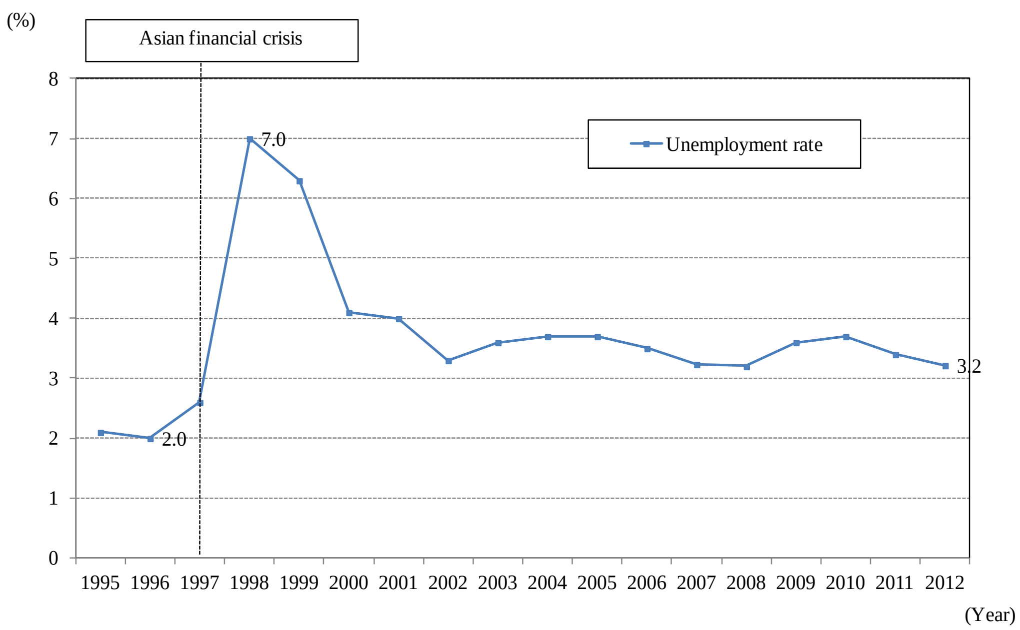
Source: Kim, B. (2010).

Figure II-2-2-2 Trends in growth rate of ROK's exports of goods and services (comparison with Thailand and Japan)



Notes: Real growth rate using 2005 prices as the benchmark.
Source: *Key Indicators for Asia and the Pacific 2013* (ADB).

Figure II-2-2-3 Unemployment rate in ROK



Source: *Key Indicators for Asia and the Pacific 2013* (ADB).

2. Promotion of structural reforms

Immediately after the outbreak of the Asian financial crisis, the government of the ROK dealt with such problems as non-performing loans, excess supply capacity and conglomerate groups' over-leveraging, and this effort contributed to resolving various problems faced by financial institutions and companies[194]. The government of President Kim Dae-jung, which was inaugurated in the midst of the Asian financial crisis, promoted four major domestic economic reforms in parallel with the IMF conditionalities. The four major reforms were reforms of the financial sector, the corporate (conglomerate) sector, the labor market and the public sector. Below, we take a look at the reforms of the financial sector, the corporate (conglomerate) sector and the labor market.

(Financial sector)

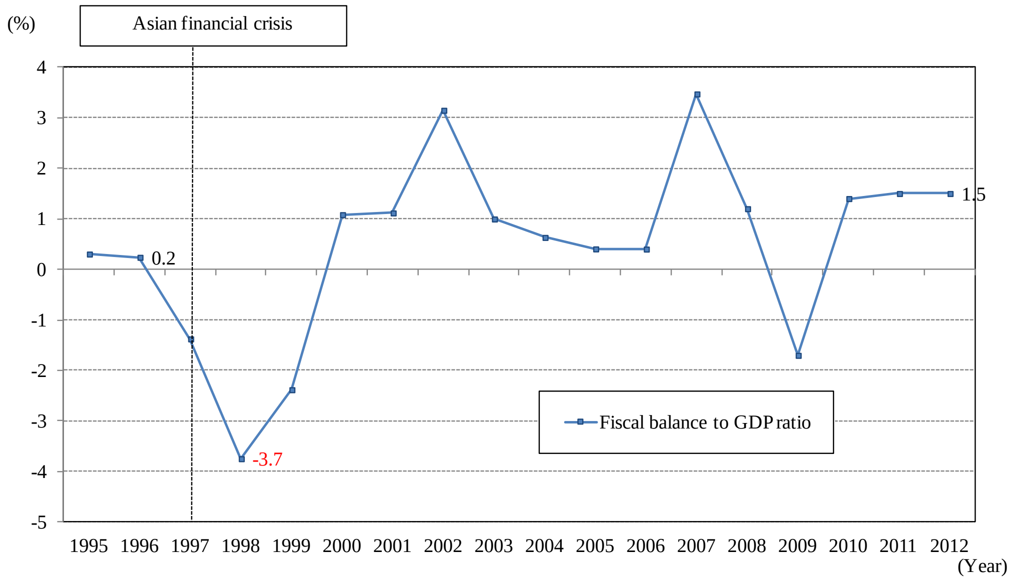
In the financial sector, reforms to restore the soundness of the business foundation and carry out an industry realignment were implemented with regard to the entire financial system, with an emphasis on banks saddled with massive non-performing loans. Among the reforms' notable features were (1) consolidation through large-scale realignment, (2) a rise in the ratio of foreign ownership of shares, and (3) adoption of a form of U.S.-style corporate governance[195].

Between the outbreak of the Asian financial crisis and the end of 2001, the government of the ROK injected public funds totaling 155.3 trillion won, equivalent to as much as 30% of GDP, into banks in order to dispose of non-performing loans held by them and restore their fundamentals by increasing their capital. The ROK was able to implement such a massive fiscal measure because it had maintained a sound fiscal position prior to the Asian financial crisis (Figure II-2-2-4). When injecting public funds into banks, the Financial Supervisory Service checked whether proposed recipients met the BIS (Bank for International Settlements) capital adequacy ratio requirement of at least 8%, and banks which did not meet this requirement were merged with other banks. As a result of the injection of public funds, banks' non-performing loan ratio (the ratio of non-performing loans to outstanding commercial loans) declined steeply, as shown in Figure II-2-1-20 that was presented earlier. In addition, regarding the disposal of non-performing loans, Korea Asset Management Corporation (KAMCO), which was established after the Asian financial crisis in order to finance government funds, gradually proceeded with the purchase of non-performing loans. As described above, the government-initiated quick restructuring and reorganization made significant contributions to restoration of the soundness of the financial sector in the ROK after the Asian financial crisis, and consolidation of the banking sector proceeded.

Meanwhile, as a result of expanded moves into the ROK's market by U.S. and European financial institutions after the Asian financial crisis, the ratio of foreign investment of the ROK's financial institutions increased. Moreover, because of the adoption of a U.S.-style corporate governance, large companies and financial institutions were obligated to establish various committees comprised mainly of outside directors[196].

[194] Lee and Rhee (2007)
[195] Ko (2008)
[196] Ko (2008)

Figure II-2-2-4 Trends in fiscal balances to GDP ratio in ROK



Source: *Key Indicators for Asia and the Pacific 2013* (ADB).

(Corporate (conglomerate) sector)

In the ROK, a structural reform program intended for conglomerate group companies, known as the "Big Deal," was carried out. Viewing conglomerate groups as the main cause of the Asian financial crisis, then President Kim Dae-jung called on conglomerate group companies to (1) eliminate excess debts (financial restructuring), (2) select and concentrate business operations by resolving excess diversification (business restructuring; "Big Deal") and (3) strengthen corporate governance[197].

Regarding (1), the elimination of excess debts, the debt ratio of the 30 major conglomerate groups stood at approximately 519% in the fourth quarter of 1998[198], immediately after the outbreak of the Asian financial crisis (Figure II-2-2-5). The Kim Dae-jung Administration requested the 30 major conglomerate groups to reduce the debt ratio to 200% or less by the end of 1999. When taking out loans from banks, conglomerate group companies made debt guarantee arrangements with each other. The administration called for resolution of all debt guarantee arrangements between companies within the same group by March 2000[199] (Figure II-2-2-5).

As for (2), the selection and concentration of business operations through the resolution of excess diversification, the Kim Dae-jung Administration carried out large-scale business consolidation of conglomerate group companies (the "Big Deal,") through government-initiated policy measures. Eventually, business consolidation was implemented in nine business sectors – semiconductors, rolling stock, oil refining, power generation facilities, marine engines, aircraft, petrochemicals,

197 Ko (2002), Ko (2008)
198 Generally, it is said that the soundness of management will be undermined if the debt ratio surpasses 50%.
199 Ko (2002)

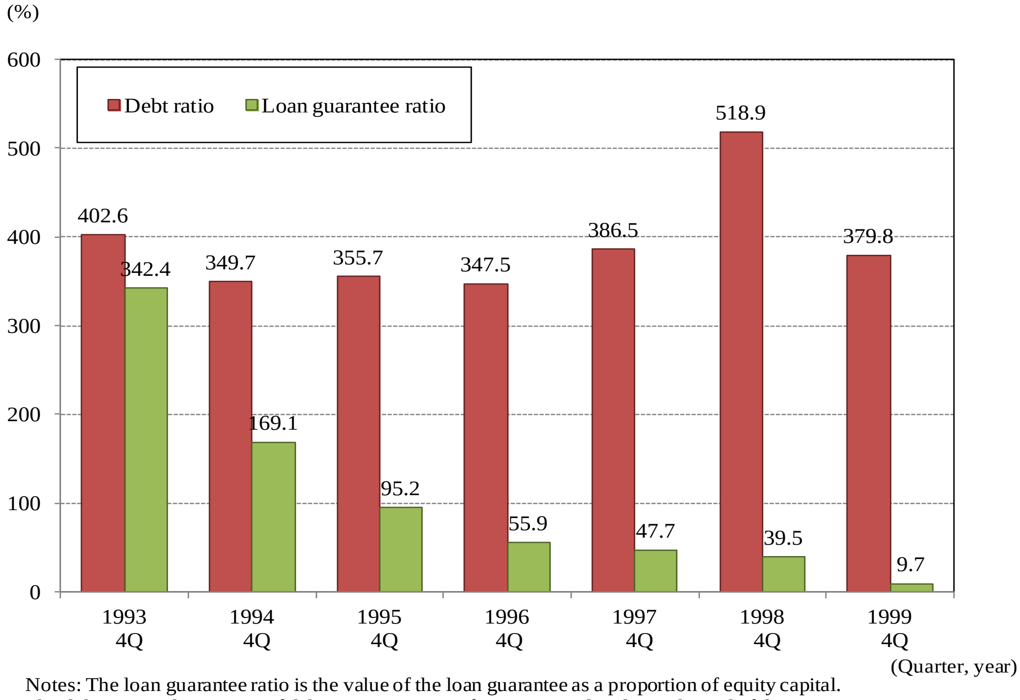
automobiles and electronics. In the rolling stock, oil refining, power generation facilities, marine engines and aircraft sectors and consolidation was completed by 1999[200]. Through this consolidation, the number of companies in each market was reduced to one or two. As a result, the market size per company in the ROK became 1.5 times that of their equivalents in Japan in the case of passenger cars and steel and 2.2 times that in the case of mobile phones (the figure for mobile phones is an estimate for 2009 and the figures for the other items are actual results for 2008)[201]. As described above, the business and financial conditions of conglomerate group companies have improved due to the "Big Deal," and this forms part of the foundation of the ROK's subsequent competitiveness[202].

Industrial realignment also proceeded among companies outside conglomerate groups. In particular, inefficient companies were shaken out of the market in such business sectors as textiles/apparel, financial services and construction. The number of listed companies decreased by around 30% each in the textiles/apparel sector and the financial sector and by around 20% in the construction sector[203].

Regarding (3), strengthening of corporate governance, the Kim Dae-jung Administration permitted hostile takeovers upon the IMF's recommendation[204]. Consequently, regarding the internal ownership ratio of shares in the 30 major conglomerate groups after the Asian financial crisis, the ratio of shares owned by founding families declined while the ratio of shares owned by group companies rose (Figure II-2-2-6). Moreover, in order to enhance transparency over corporate management, various reforms related to corporate governance were implemented, including easing of the requirements for the exercise of the rights of minority shareholders and introduction and expansion of the outside director system[205].

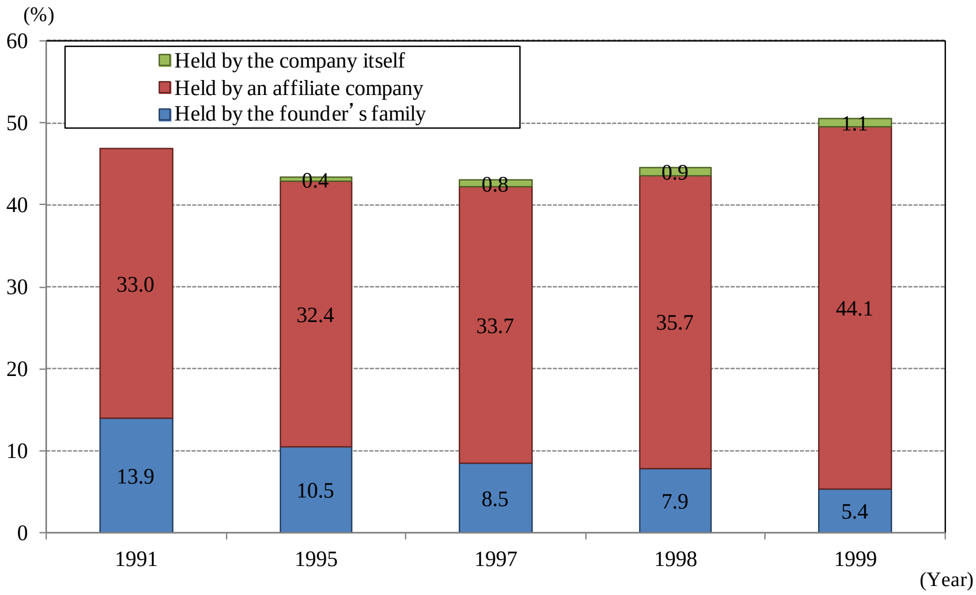
200 Ko (2002)
201 Sano (2011) and the Ministry of Economy, Trade and Industry (2010)
202 The "Big Deal" led to the creation of monopolistic and oligopolistic markets, and distortions caused by monopolies, such as restriction on free market competition, overly high domestic prices and unfair practices employed against subcontractors, have been pointed out (Sano (2011)).
203 Sakuma (2002).
204 Ko (2002).
205 According to Ko (2008), a series of violations of laws and regulations concerning corporate governance have been committed mainly by major conglomerates, so there still remains challenges that should be resolved through corporate governance reform.

Figure II-2-2-5 Major management Indicators for ROK's 30 major *Chaebol* conglomerate groups



Notes: The loan guarantee ratio is the value of the loan guarantee as a proportion of equity capital. The debt ratio is the amount of debt as a proportion of equity capital and uses the end of the previous year as the benchmark (excluding the finance and insurance sector).
Source: Kou, Y. (2002).

Figure II-2-2-6 Internal ownership ratio of Shares in ROK's 30 major *Chaebol* conglomerates



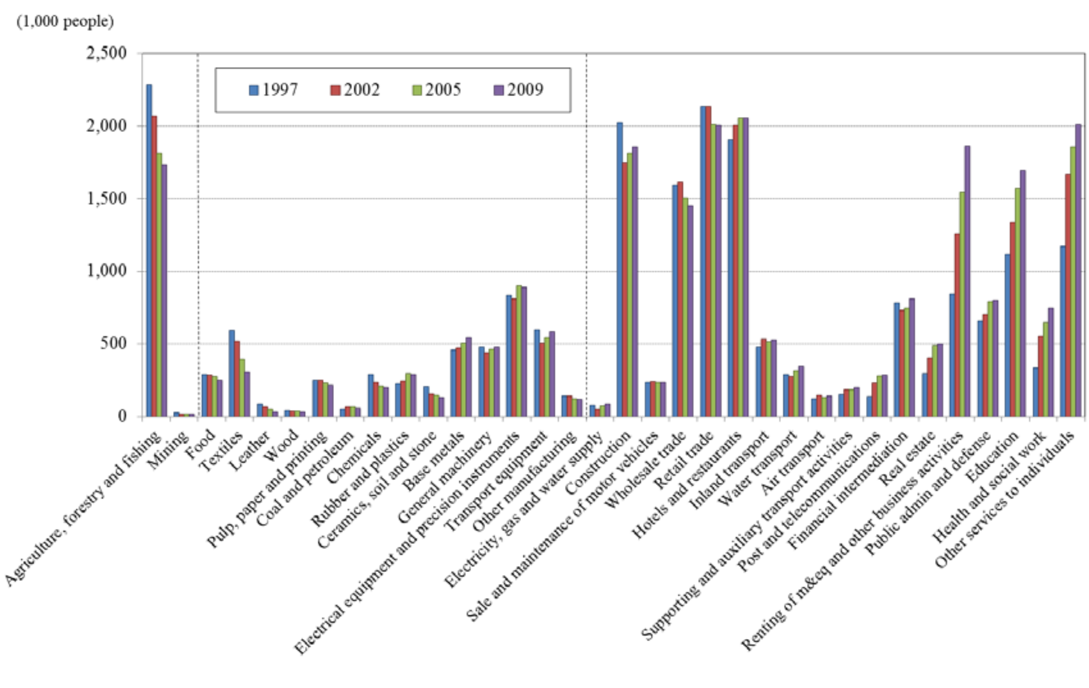
Notes: Internal ownership ratio of shares is the total value of shares held by the founder's family, affiliate companies and the company itself as a proportion of the company's stated capital (as of April each year). No data for shares held by the company itself is available for 1991.
Source: Kou, Y. (2002).

(Labor market)

The ROK's labor market was already flexible with regard to non-permanent employment. With regard to permanent employees, in February 1998, the government, companies and labor unions, under a trilateral cooperative policy, reached an agreement to the effect that the dismissal of permanent employees should be permitted when it is inevitable for the sake of the survival of the employer company, and this agreement increased the flexibility of the labor market. The business consolidation initiatives mentioned earlier, including the "Big Deal", produced adverse side effects such as growth in unemployment, but an increase in non-permanent employment is presumed to have partially absorbed job losses. In addition, the government implemented reemployment training programs as a policy measure to help unemployed people find new jobs. The total amount of fiscal expenditures on employment support measures reached to 7% of GDP[206].

Figure II-2-2-7 shows trends in the number of employees by industry in four selected years, 1997, 2002, 2005 and 2009. From 1997 to 2002, a period when structural reforms were carried out, the number of employees decreased in agriculture, forestry and fisheries and construction as well as many manufacturing industries, including textiles. Instead, the number of employees increased sharply in service industries, such as rental/business services, education, healthcare/social welfare and personal services. Presumably, these industries partially absorbed an increase in workers who had lost jobs due to the structural reforms. In 2002 and thereafter, jobs were maintained in manufacturing industries to some degree, while the number of employees increased in such industries as electric and precision equipment, transport equipment, base metals, rubber and plastics.

Figure II-2-2-7 Trends in number of employees by industry in ROK



Source: February 2012 edition of *Socio Economic Accounts* (World Input-Output Database).

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206 Sakuma (2002).

(Opening up strategy)

As described above, since the Asian financial crisis. The ROK has carried out various structural reforms in major sectors of the domestic economy, including the financial sector, the corporate (conglomerate) sector and the labor market. While those reforms related to the domestic economy, what is notable about the ROK's policies since the Asian financial crisis is its aggressive strategy of opening up to the outside world. As the ROK's domestic market is relatively small, the country has pursued the policy of opening up and has actively promoted the conclusions of free trade agreements (FTAs) since the Asian financial crisis. Table II-2-2-8 shows the status of the conclusions of FTAs by the ROK.

Table II-2-2-8 ROK's FTAs

Stage	Partner	Date of entry into force	Share of ROK's exports in 2012
Already in force	Chile	April 2004	0.4
	Singapore	March 2006	4.1
	EFTA (European Free Trade Association)	September 2006	0.3
	ASEAN	June 2007 (products) May 2009 (services) September 2009 (investment)	14.3
	India	January 2010	2.2
	EU	July 2011	9.0
	Peru	August 2011	0.3
	the U.S.	March 2011	10.7
	Turkey	May 2011	0.8
Signed	Colombia		0.3
Under negotiation	Canada; Mexico; GCC (Gulf Cooperation Council); Australia; New Zealand; China; Viet Nam; Indonesia; Japan, China, and ROK; Japan		Canada (0.9) Mexico (1.6) GCC (3.5) Australia (1.7) New Zealand (0.3) China (24.3) Viet Nam (2.9) Indonesia (2.5) Japan, China, and ROK (31.4) Japan (7.0)
Preparations for negotiation or joint research underway	MERCOSUR (Southern Common Market of South America), Israel, Central America, Malaysia, and others		-

Source: Development Bank of Japan (2013), materials from METI.

(Promoting deregulation)

After the Asian financial crisis, the Kim Dae-Jung Administration actively implemented deregulation measures, including abolition of barriers to market entry and easing regulations on foreign investment entry into the ROK. Figure II-2-2-9 shows the FDI regulatory restrictiveness index[207] for the ROK by industry. Between 1997 and 2013, the FDI regulatory restrictiveness index

[207] An index of the strength of various restrictions and regulations concerning inward foreign direct investments that is calculated and published by the OECD. The closer the value of the index is to zero, the more open to foreign investment, the economy is. As for the calculation method of the FDI regulatory

significantly declined in most industries in the ROK, indicating that the country's strategy of opening up involved drastic deregulation. The overall FDI regulatory restrictiveness index (the bar graph in the far right of Figure II-2-2-9), which covers all industries, declined from 0.54 in 1997 by 0.39 points to 0.14 in 2013. This is a fairly sharp decline compared with declines in the indexes for other countries, including advanced and emerging economies[208].

In 1998, the ceiling on the value of shares acquired by foreigners was abolished, and the regulation of investments by foreign investors was also significantly eased as a result of the enforcement of the Foreign Investment Promotion Act. Among other measures was the introduction of special tax programs to revitalize small and medium-size enterprises and promote development of technologies and human resources (Table II-2-2-10).

These various deregulation and incentive policy measures promoted the establishment of venture companies, leading to a steep increase in the number of companies listed on the KOSDAQ market (Figure II-2-2-11). In 2001, the number of companies listed on the KOSDAQ market was higher than the number companies listed on the KOSPI market, and this trend remained unchanged in 2013. The ratio of KOSDAQ's total market capitalization to KOSPI's total market capitalization declined after peaking at 13.2% in 2004 and has stayed stable at around 10% since 2005.

The aggressive opening up policy has encouraged the ROK's companies to compete globally and has led to a rise in the foreign investment ratio in the ROK[209]. Figure II-2-2-12 shows trends in the shares of the total market value of all listed the ROK's companies by shareholder. During the 10 years from 1998 to 2007, share ownership by government and public organizations, which are included in the "others" category, and individuals declined, while the ratio of share ownership by foreign shareholders increased. Since the collapse of Lehman Brothers in 2008, the ratio of share ownership by government and public organizations has been increasing again and the ratio of ownership by foreign shareholders has stayed at around 35%. However, the ratios of ownership by individuals and institutional investors have been declining.

Pressure from the entry of foreign shareholders is expected to contribute to the enhancement of corporate competitiveness by increasing the incentives for managers to improve business efficiency and fulfill accountability to shareholders.

Since the global financial crisis triggered by the collapse of Lehman Brothers in September 2008, the ROK government has been striving to enhance corporate competitiveness through various policy initiatives. For example, the government has implemented deregulation measures targeted mainly at small and medium-size enterprises, including improving the business environment through corporate tax reduction and introduction of electronic tax filing to ease the tax payment burden; promoting

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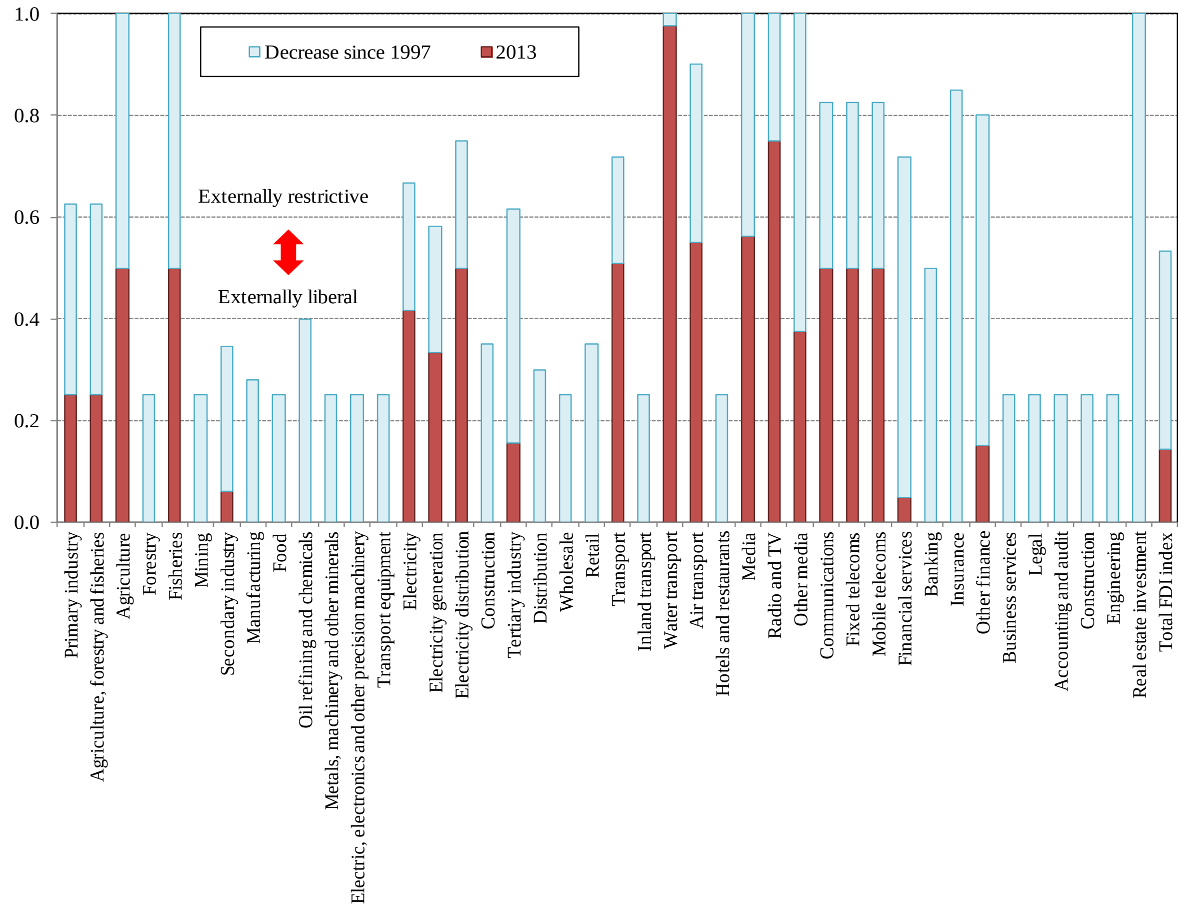
restrictiveness index, explanations are available from Golub (2003), Kalinova, Palerm, and Thomsen (2010) and Koyama and Golub (2006).

[208] For example, during the same period, the index declined by 0.03 point for Japan, by 0.00 point for the United States, by 0.09 point for Mexico, by 0.02 point for Brazil, by 0.17 point for Indonesia and by 0.30 point for Malaysia. Refer to the OECD (2011) as well.

209 Ko (2008).

business rehabilitation and continuation through the revision of the bankruptcy law; and encouraging business startups through the abolition of the minimum capital requirement[210]. Figures II-2-2-13 and II-2-2-14 show trends in the number of venture companies and "Inno-biz" companies[211] and in the business opening/closure rates. The figures indicate that because of the deregulation measures, new business startup activity has become very brisk in the ROK. As for the business opening/closure rates, although simple comparison may not be appropriate, the ROK's rates are around three times as high as those of Japan, indicating that the revival of the economy is more active in the ROK than in Japan[212].

Figure II-2-2-9 ROK's FDI regulatory restrictiveness index by industry (comparison between 1997 and 2013)



Notes: In the FDI regulatory restrictiveness index, 0 signifies that the country is completely open to external investment, while 1 signifies that it is completely closed to external investment.
Source: *FDI Regulatory Restrictiveness Index* (OECD).

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210 Doing Business (2012).

211 Inno-biz companies are cmpanies which have more innovative technologies than venture companies.

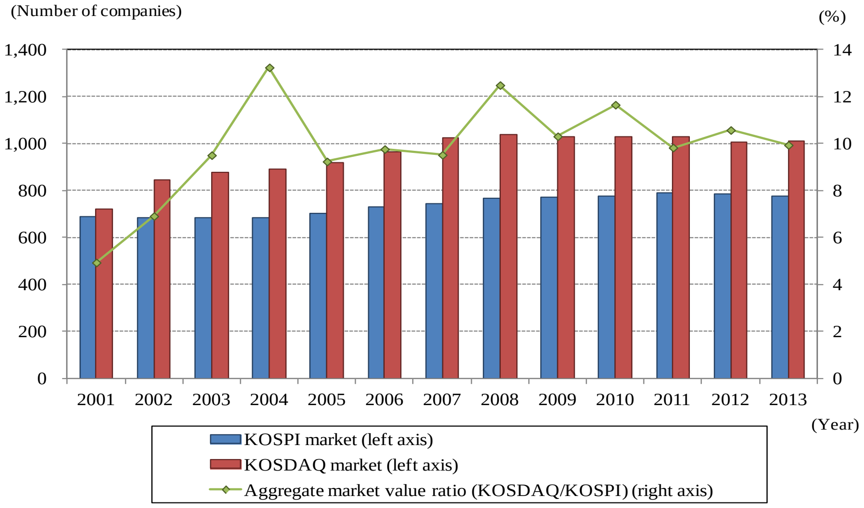
212 According to the Small and Medium Enterprise Agency (2014), the business opening and closure rates were 9.3% and 10.3%, respectively, in the United States in 2010 and 11.4% and 10.7% in 2012 in the United Kingdom in 2012.

Table II-2-2-10 Measures introduced under the special tax system (May 1999)

Incentives for SMEs	
	・For newly-established SMEs: 50% reduction in corporation tax and fixed asset tax for the first five years after establishment. Exemption from acquisition tax and registration tax for the first two years after establishment.
	・20% reduction in corporation tax for SMEs in the manufacturing sector.
Incentives for technology development and human resource development	
	・50% deduction for income arising from the transfer of patent rights.
	・Capital gains tax exemption for venture capital investment
	・Income deduction for individual investors who invest in SMEs or startup companies
	・Tax exemption for foreign engineers

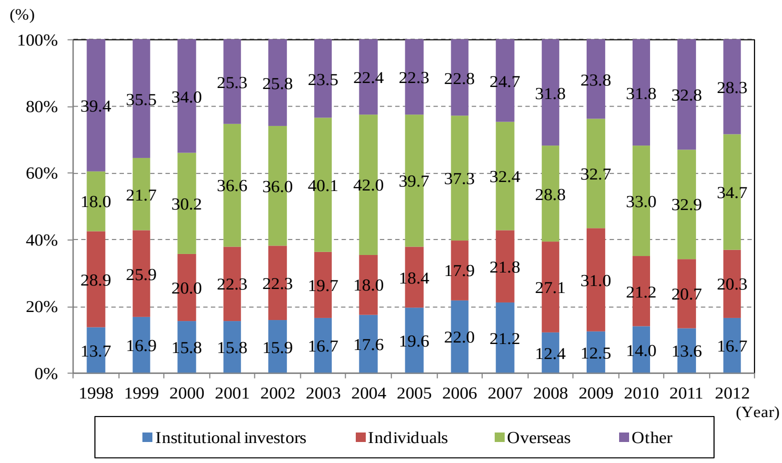
Source: Sakuma (2002).

Figure II-2-2-11 Number of companies listed on ROK's stock markets and aggregate market value ratio



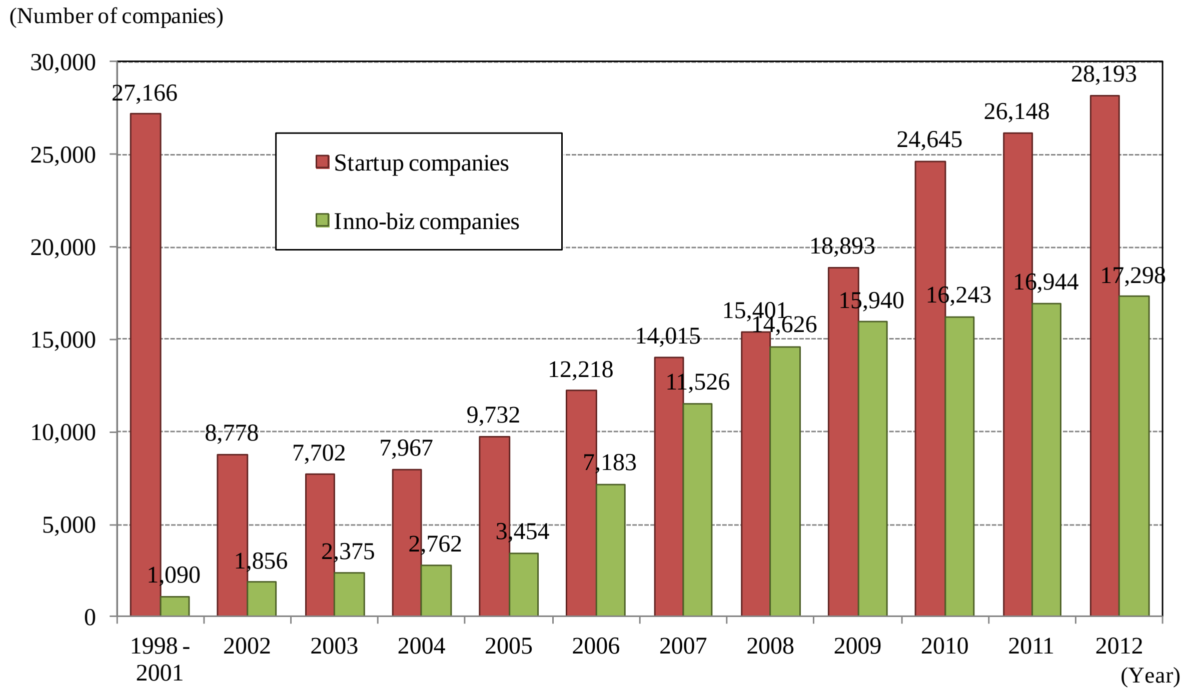
Notes: The aggregate market value ratio is calculated by dividing the aggregate KOSDAQ market value by the aggregate KOSPI market value.
Source: Korea Exchange.

Figure II-2-2-12 Proportion of shares of ROK's listed companies by shareholder type (aggregate market value basis)



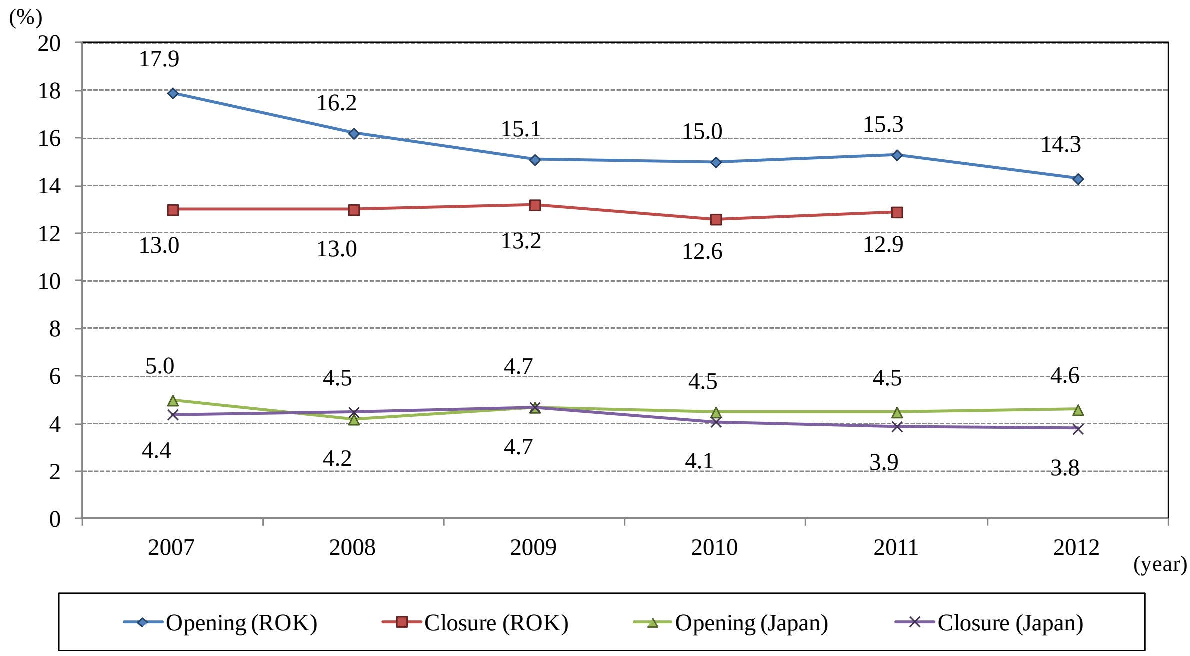
Notes: Proportion of the aggregate market value of shares by shareholder type
Source: Figures up to 2006 are based on Kou, Y. (2008), while those for 2007 and beyond are compiled from data published by Korea Exchange.

Figure II-2-2-13　Trends in number of venture companies and Inno-biz companies in ROK



Source: Small & Medium Business Administration.

Figure II-2-2-14　Trends in business opening /closure rates in ROK (comparison with Japan)



Notes: The nature of the statistics and definitions in the two countries differ, so a straightforward comparison is not possible. Figures for Japan are on a fiscal year basis.
Source: Small and Medium Enterprise Agency (2014), *Business demography statistics in 2012 (2012)* (Statistics Korea).