THE POLITICAL ECONOMY OF SOUTH KOREA: ECONOMIC GROWTH, DEMOCRATIZATION, AND FINANCIAL CRISIS

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I. INTRODUCTION

South Korea's economic development since the 1960s has been phenomenal. Devastated by the Korean War (1950-1953), South Korea was one of the poorest countries in the world in the 1950s. Its Gross Domestic Product (GDP) was a mere $1.5 billion and per capita GDP was only $70 in 1954. Starting in 1962 with a five-year economic plan, however, South Korea initiated industrialization to develop the economy. Through the implementation of several more five-year economic plans, South Korea now has the 13th largest economy in the world. Its national GDP in 2007 was $949.7 billion and GDP per capita reached $19,624. This rapid development is unprecedented in world history.

Although South Korea enjoyed the miraculous economic development in the past several decades, it also went through political and economic upheavals during the same time period. After the assassination of President PARK Chung-hee in 1979, a military dictator who orchestrated South Korea's rapid economic development, the Korean people were expecting a democratic government. However, that expectation was completely destroyed by another military dictatorship under CHUN Doo-hwan. To make matters worse, the Korean economy faced its first potential crisis in 1980 during the second global oil shock. Although the Chun administration overcame these difficulties, anti-government and political activist moves for democratization escalated.

In 1987, South Korea held its first direct presidential election in nearly 30 years. Despite the fact that President ROH Tae-woo, a hand-picked successor of previous dictator CHUN Doo-whan, was elected, the event symbolized the transition to democracy. Since then, civilian leaders have been elected as president and two power transitions have occurred. The first occurred when the conservative party lost to the liberal party in two recent presidential terms and the presidency has since gone back to the conservative party in the recent election last year.

This democratization has had many positive effects on Korean politics and society, such as human rights improvement, a better reflection of public opinion in policymaking, fair elections, as well as freedom of speech. Yet, it also had some potentially negative effects as well. For example, the legalization of labor unions enhanced labor rights but also led to wage hikes, which resulted in decreased exports. Moreover, frequent labor-management disputes led to a drastic increase in lost workdays, which contributed to the outbreak of the financial crisis.

In 1997, South Korea experienced a foreign exchange crisis and had to be bailed out by the International Money Fund (IMF). Although South Korea graduated from the IMF bailout program faster than expected, the Korean economy has not been able to get back to the pace it used to enjoy prior to the crisis. For example, the South Korean economy is expected to grow in 2008 by 4.9 percent.[1] While this expected growth rate is not bad compared to other countries, the Korean people are used to double-digit growth. Thus the focus of last presidential election was on getting the economy back on track.

In this paper, we examine the political economy of South Korea to explain the factors that contributed to the miraculous economic development as well as the cause of the financial crisis in 1997 which occurred during the period of transition to democracy. When South Korea enjoyed high rates of growth, political freedom was constrained and human rights were abused. However, after the transition to democracy, the Korean economy struggled and eventually experienced a financial crisis. Thus, we discuss the process of political and economic development in South Korea to draw lessons for other countries.

II. ECONOMIC DEVELOPMENT UNDER THE AUTHORITARIAN GOVERNMENT: THE PARK CHUNG-HEE ADMINISTRATION

A. The Statist Approach

Previous studies on South Korea's economic development have provided a number of theoretical explanations, but one of the most dominant theoretical frameworks is the government-led development paradigm, so called the statist approach.[2] According to this

1. Moreover, 17 percent of labor population between the age of 15 and 29 is unemployed (OECD, 2007). "Jobs for Youth: Korea," Organization for Economic Cooperation and Development (OECD). 2007. http://www.oecd.org/dataoecd/19/28/39797189.pdf (viewed on April 23, 2008).

2. Alice H. Amsden, *Asia's Next Giant: South Korea and Late Industrialization*, New York, NW: Oxford University Press, 1992, p.79. Peter Evans, Dietrich Rues-

approach, state (government) autonomy is a crucial factor in successful economic performance because government is the entity that designs and implements economic policies.[3] State autonomy is particularly important when policy shifts occur because new incentives that drive the policy shifts may lead to a new growth coalition and different winners and losers.[4]

Although state autonomy is important, cooperation between government and dominant social forces, such as *chaebol* in South Korea, is also crucial.[5] The reason is that dominant social forces often seek to affect economic policy-making to have their own interests reflected while the state seeks to reinforce its autonomy to implement effective industrialization policies.[6] The collaborative relationship between the government and the private sector, complete with its economic growth, was also needed to offset the lack of

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chemeyer, and Theda Skocpol, *Bringing the State Back In*, New York, NW: Cambridge University Press, 1985, pp. 44-72. Heo, Uk and Sunwoong Kim, "Financial Crisis in South Korea: Failure of the Government-led Development Paradigm," *Asian Survey*, Vol. 40 (2000), pp. 492-507. Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*, Princeton, NJ: Princeton University Press, 1990, p. 24.

3. According to Caporaso and Levine (1992), state autonomy denotes "the ability of the state to define and pursue an agenda not defined for it solely by private social interests." J.A. Caporaso and David P. Levine, *Theories of Political Economy*, New York, NY: Cambridge University Press, 1992, p. 181.

4. Stephan Haggard, "Review: The Newly Industrializing Countries in the International System," *World Politics*, Vol. 38 (1986), pp. 343-370.

5. *Chaebol* refer to gigantic business conglomerates in South Korea. With the government-led development approach, the Seoul government gave a preferential treatment to export-oriented corporations with respect to credit allocation. As a result, some family owned companies grew to become huge business corporations dealing with various industries. The close working relationship between the government and the business community played a significant role in developing the Korean economy. See Yeon-Ho Lee, *The State, Society, and Big Business in South Korea*, London: Routledge Advances in Asia-Pacific Business, 1997, pp. 18-28. However, the close relationship between the government and private sector is often regarded as a source of corruption and one of the causes of the 1997 Asian financial crisis. See Uk Heo. "South Korea: Democratization, Financial Crisis, and the Decline of the Developmental State" In Shale Horowitz and Uk Heo, eds., *The political Economy of International Financial Crisis: Interest Groups, Ideologies, and Institutions*, Lanham, MA: Rowman and Littlefield, 2001, pp. 151-164; and Uk Heo and Alexander C. Tan, "Democracy and Economic Growth in Developing Countries: A Causal Analysis." *Comparative Politics*, Vol. 33, No. 4 (July 2002), pp.463-473. Neal Jesse, Uk Heo, and Karl DeRouen Jr., "A Nested Game Approach to Political and Economic Liberalization in Democratizing States: The Case of South Korea" *International Studies Quarterly*, Vol. 46, No. 3 (September 200), pp. 401-422.

6. Stephan Haggard and Chung-In Moon, "Institutions and Economic Policy: Theory and A Korean Case," *World Politics*, Vol. 42 (1990): pp. 210-237.

political legitimacy of the authoritarian regimes. The Government maintained stability through its economic success and by sharing the benefits of their newfound economic success with the dominant social and economic forces.[7] Thus, Peter Evans asserts that government had to be "embedded in a concrete set of social ties that binds the state to society and provides institutionalized channels for the continual negotiation and re-negotiation of goals and policies."[8]

B. Export-Oriented Industrialization

Although the South Korean government actively intervened in the economy to protect domestic industries, their intervention was also designed to lead the economy to be competitive in international markets.[9] Thus, White and Wade argue that the ultimate objective of the Korean government was liberalizing the economy to be able to compete in international markets.[10] This direction was manifested in the export-oriented industrialization strategy pursued by the government.

In 1962, the Korean government launched the first five-year economic plan. As U.S. aid was declining, the plan focused on transforming the economy from being foreign aid dependent to becoming independent. To this end, the government provided assistance to basic industries and invested in the improvement of social and economic infrastructure, which was critical for economic development. In other words, with the first five-year economic plan, the government aimed to improve the foundation of the economy before the initiation of export-oriented industrialization policy.

After the first economic development plan was completed in 1967, increasing exports became the keynote of the second five-year development plan.[11] The government planned on fostering industries for both export promotion and import-substitution, although

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7. Danny M.Leipziger, *Lessons from East Asia*, Ann Arbor, MI: University of Michigan Press, 1997, p. 235.

8. Peter B. Evans, *Embedded Autonomy,* Princeton, NJ: Princeton University Press, 1995, p. 12.

9. According to Lee (1985), the open economy system took root through the second development plan structurally. Jung-Bock Lee, "Industrialization and the Changes of Political System," Han-gook-jung-chi-hock-hoi (The Korean Political Science Association), Vol. 19 (1985), pp. 61-75.

10. Gorden White and Robert Wade, "Development; States and Markets in East Asia: An Introduction," in Gorden White, ed., *Developmental States in East Asia*, New York, NY: St. Martin's Press, 1988, p. 182.

11. Ho-Jin Kim, *Han-gook-jung-chi Che-ju-ron* (The Theory of Korean Politics), Seoul: Park-Young Sa, 1990, p. 135.

import-substitution was designed mainly to support the material supply required for manufacturing exporting goods. Due to the lack of capital and advanced technology, the government initially promoted labor-intensive light industries for export. As the economy grew with the increase in exports, the government gradually moved its focus from light industries to heavy-chemical industries.

The export-oriented industrialization policy had two meaningful effects. First, import substitution of light industrial goods was almost completed by the end of the 1960s, and the quality of the products had reached international standards.[12] Second, export-oriented industrialization had a significant impact on the industrial structure. Prior to the policy, primary industry, especially agriculture, was the major industry in Korea. For example, the agriculture industry accounted for between 40-50 percent of the total industrial structure in Korea until the early 1960's. The second industry, such as manufacturing, made up mere 10-20 percent. However, by the late 1960's, both types of industries had balanced out, and each of them accounted for approximately 30 percent of the industrial structure.

Starting in the early 1970's, the government started pushing for Heavy Chemical Industrialization (HCI). With the 3rd five-year economic development plan (1972-1976), the government appointed nonferrous metals, petrochemicals, general-type machinery, shipbuilding, and electronics as five strategic fields. Since HCI was expensive and risky, the dependency of business on the government for credit allocation increased. As a result, the government-business ties deepened.

C. Control of the Financial Sector and the Government-Business Ties

To implement the export-oriented growth policy, the Korean government made two policy moves: 1) control the financial sector to provide preferential treatment of export-oriented industries and to increase domestic savings; and 2) manage the exchange rate to stabilize exports. To this end, the Korean government purchased bank stocks and publicly owned the main banks, which provided two benefits: 1) it buttressed the state autonomy; and 2) gave it power over credit allocation. To fully exercise its power of credit allocation, in September 1965, the government announced a law

12. Bohn-Ho Koo, *Han-gook-gyung-je-ui Yeok-sa-jeok Jo-Myung* (The Historical Approach on Korean Economy), Seoul: Korea Development Institute, 1991, p. 188.

that limited interest rates. According to Haggard, Kim, and Moon, this reform policy was one of the locomotives that contributed to South Korea's economic growth.[13] With this policy, the Korean government aimed to move a significant amount of capital from the private money market to banks by controlling the unrealistic interest rates of the private money market and then raising the interest rates of savings account. In addition, the government intended to increase domestic savings to create an important source of domestic investment. The policy worked and savings rates consistently increased over time. For instance, in the 1960s the average personal savings share of GDP was only 1 to 2 percent, but by the 1970's it had increased to 7 percent.[14]

In addition, the Korean government aggressively managed the exchange rate to maintain the value of the Korean currency, *won*, without much fluctuation. The *won* was kept devaluated to promote exports. Some scholars point out that the effect of exchange rate management was limited due to the large proportion of imports of raw materials or was irrelevant because of heavy subsidies and coerciveness on exports.[15] However, a deliberately maintained realistic exchange rate "provided an incentive to export and sustained the price stability of imported materials."[16]

III. ANOTHER AUTHORITARIAN GOVERNMENT: THE CHUN DOO-WHAN ADMINISTRATION

On October 26, 1979, President PARK Chung-hee was assassinated by the Korean Central Intelligence Agency (KCIA) director, KIM Jae-kyu. The death of President Park brought about confusion and instability due to the power vacuum caused by the elimination of an absolute ruler that had governed the country for nearly two decades. Against the Korean people's hope to have a democratic government, Major General CHUN Doo-whan came to power. Thousands of people went out to the streets to protest against the Chun government. On May 18, 1980 in Kwangju, there was a massive demonstration by college students and private citi-

13. Stephan Haggard, Byung-Kook Kim, and Chung-In Moon, "The Transition to Export-led Growth in South Korea: 1954-1966," *Journal of Asian Studies*, Vol. 50 (1991), pp. 850-873.

14. Leipziger, *Lessons from East Asia*, supra note 4, p. 169.

15. Amsden. *Asia's Next Giant*, supra note 3, pp. 65-67.

16. Sung Deuk Hahm and Uk Heo, "The Economic Effects of US and Japanese Foreign Direct Investment in East Asia: A Comparative Analysis," *Policy Studies Journal*, Vol.36 (2008):

zens asking for democracy. The government sent troops and suppressed the protest by force, which resulted in approximately 200 deaths and 800 injuries. As a result, the CHUN Doo-whan government constantly faced anti-government protests despite the fact that he was elected president by the electoral college in 1981. Before the election, a constitutional amendment passed which limited the presidential term as a non-renewable, single term of 7 years.

As soon as President Chun took office, his administration faced a number of serious economic problems. Due to the second oil shock in 1979, inflation was high and was threatening the economy. The policy efforts by the previous government to reduce inflation were not successful due to the intense investment in the heavy chemical industry (HCI). The economic structure was based on big business conglomerates (*chaebol*), which was causing problems in the economic structural as well as an unequal distribution of wealth. To make matters worse, the international economic environment was not friendly to Korean exports either. The second oil shock brought on an international recession, which gave rise to protectionism in many countries. To confront with these problems, the Chun administration adopted aggressive policy measures to continue to develop the economy in order to compensate for the lack of political legitimacy. We explain each of them next.

A. Inflation Control

Since the PARK Chung-hee administration mainly focused on growth, there were inflation pressures. In the late 1970s, inflation reached a dangerous level due to the second oil shock and the heavy and chemical industrial drive. Although the Park Administration recognized the seriousness of inflation, their policy response, such as the 4.17 Policies for Stability,[17] was not limited because Park did not want to slow down growth or the HCI drive.

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17. The Policies for Economic Stability, also called the 4. 17 Policies, which were announced on April 17, were first implemented in 1979 under the Park Administration. These policies mainly consist of seven parts: first, currency management; second, reducing the fiscal deficit; third, liberalizing imports; fourth, reforming the price system according to market economy; fifth, stabilizing wages; sixth, controlling investments in HCI; seventh, stabilizing the price of real estate (Lee 2003). Hyung-Goo Lee, Jo-se Jejung-jung-check O-sheep-nyun Jeung-un mit Jung-check Pyung-ga (The Record and Analysis of Fiscal and Monetary Policies for 50 years), Seoul: Korean Institute of Public Finance, 2003, p. 52.

The Chun Administration, however, was different. The government placed emphasis on reducing inflation to acquire socio-economic stability. In addition, the Chun government realized that continued inflation might reduce South Korea's international competitiveness, which would slow down exports and, eventually, growth. Thus, controlling inflation became one of the main policy objectives of the Chun Administration.[18] To combat it, the government adopted a tight fiscal policy, such as a government expenditure freeze in 1984, raising interest rates, and reducing credit.[19] The budget deficit was also reduced by 39 percent by 1985.[20] A report by the Bank of Korea describes the period of the Chun administration as "a period of stability of prices."

B. Economic Restructuring

In addition to inflation control efforts, the Chun administration attempted to overhaul the economic structure to enhance stability. To this end, the Chun government tried to reduce the dependence of the economy on big business conglomerates (*chaebol*) and heavy chemical industries with the Policies for Restraining Economic Centralization in 1980. This policy was meaningful because its approach was to restructure the existing Korean economy. After this policy was adopted, the government stepped up its efforts to distribute more resources to medium and small size enterprises.

Another policy effort by the Chun administration was "rearranging businesses" to improve the overall effectiveness of the national economy. Due to the government-led development approach, some industries, such as shipping and construction heavily relied on the government in the 1970s.[21] Although these businesses were supported by the government through investment and favorable tax policies, they failed to overcome the hurdles presented to them by the new international economic environments in the 1980s. These included a global recession, increased protectionism in developed countries, and international pressures for Ko-

18. Jung-Gil Chung, *Dae-Tong-Ryung-ui Kyung-je Leadership* (President's Economic Leadership), Seoul: The Korea Economic Daily, 1994, p. 146.

19. Staphan Haggard and Chung-In Moon, "Institutions and Economic Policy: Theory and A Korean Case," *World Politics*, Vol. 42 (1990), pp. 210-237.

20. *Ibid.*, Haggard and Moon (1990) also pointed out that the effort for fiscal restraint was particularly impressive, since the average annual growth rates of government spending between 1962 and 1979 had been 28 percent. p. 222.

21. Korean Economic Research Institute. Han-guk-ui Gee-eup-jeep-dan (*Korean Kombinat*), Korean Economic Research Institute, 2005, p. 212.

rea to revalue their currency. The government, therefore, selected unprofitable businesses and liquidated them through acquisition (50 companies), merger (17 companies), and legal management (1 company). Until 1988, the number of those reorganized businesses had reached 70.[22]

In addition, the Chun Administration avoided direct government intervention in the economy by cutting down or removing tax policies designed to support specific export-oriented industries. Instead, the government put more emphasis on improving business environment and economic infrastructures.

The Chun government also changed the credit allocation policies by introducing a cap on credit that can be assigned to one *chaebol*. The new policy also required a government's approval before a *chaebol* invested in a new business. This measure was to help correct the unfair relationship between big firms and small businesses.[23]

C. Effects of New Economic Policies

Policies adopted by the Chun administration to control inflation worked. Moreover, with the changed role of the government in credit allocation and the economy in general, the Korean economy got back on the track and resumed its rapid growth. The average growth rate during the Chun Administration (1981-1987) was 8.7 percent and the national GDP reached $100 billion. Considering that the growth rate of 1980 was -1.5 percent, the new policies to deal with economic problems worked effectively. As Evans, Rueschemeyer, and Skocpol pointed out, some economic policy measures adopted by the Chun administration were only possible because of its strong autonomy of the state.[24] Also, it should be noted that the "three lows" in economic conditions—low oil prices, low interest rates, and low exchange rates—provided a friendly environment for economic recovery and growth. In summary, the

22. Hun-Joo Park, "The Perspective of Small Business in South Korea." Korean Development Institute (KDI) School Working Paper Series 06 (13). 2006, p. 25.

23. Yeon-Ho Lee, *The State, Society, and Big Business in South Korea*, London: Routledge Advances in Asia-Pacific Business, 1997, pp. 46-53.

24. Peter Evans, Dietrich Rueschemeyer, and Theda Skocpol, *Bringing the State Back In*, New York, NW: Cambridge University Press, 1985. p.175.

Chun government's new economic policies gave way to other economic take-offs in the 1980s and a more liberalized economy.[25]

IV. DEMOCRATIZATION AND ECONOMIC DEVELOPMENT

A. The Transition to Democracy

Although the Chun administration was successful in bringing the economy back around, protests for democracy increased due to the administration's human rights abuse and authoritarian rule. The movement peaked at the accidental death of a college student, PARK Jong-chul, which was caused by a police beating. Thousands of people came out to the street to protest against the Chun government and to request a direct election for the next president. On June 29, 1987, the government made an announcement to give way to the transition to democracy, which included: 1) a direct election of the president; 2) a guarantee of human rights; 3) guarantees of freedom of speech; 4) local autonomy; and 5) securing freedom of political parties.[26] With 93 percent support for the direct presidential election in a referendum, the constitutional amendment to change the presidential election process was promulgated on October 29, 1987.[27]

The June 29 announcement also included the pardon of KIM Dae-Jung, a life-long opposition leader, which enabled him to join the presidential race in 1987. KIM Young-Sam, a political rival of KIM Dae-Jung, was also determined to run for presidency.[28] Since the running of both candidates would split the votes and reduce the chance for electing a civilian president, the two Kims—KIM Dae-jung and KIM Young-sam—attempted to have a single candidate, but failed. As a result, the direct presidential election resulted in the victory by the governing party's candidate, ROH Tae-woo with

25. Dahl-Joong Chang, "Kyung-je-sung-jang-gwa jung-chi-byun-dong (Economic Growth and Political Transition)." In *Korean Politics-Issues and Tasks,* ed. The Korean Political Science Association, Seoul: Bobmunsa, 1993, p. 80.

26. Hyun-Sheup Kim, Witaehan chokuk Kŏnsŏlae pijanghan kakoh (The grim promise to build the great father land), *Kyunghyang sinmun*, June 29, 1987, p. 3.

27. Larry Diamond and Doh-chull Shin, "Institutional Reform and Democratic Consolidation in Korea," Larry Diamond and Doh-chull Shin ed., *Institutional Reform and Democratic Consolidation in Korea*, Stanford, California, Hoover Institution Press, 2000, p.6.

28. John Kie-chiang Oh, *Korean Politics*, New York: Cornell University Press, 1999, pp. 98-101.

36.6 percent of votes while KIM Young-Sam and KIM Dae-Jung received 28 and 27.1 percent respectively.[29]

Despite the fact that President ROH Tae-woo was elected through the popular election, his administration's legitimacy was still questioned because of his military background and the support provided by the previous authoritarian leader, CHUN Doo-whan. Moreover, the National Assembly's audit found serious evidence of corruption by President CHUN Doo-whan and the opposition party pressured to indict him. Thus, the Roh administration attempted to separate itself from the legacy of Chun's authoritarian regime, however it was without much success.

Due to President Roh's unpopularity, the opposition party enjoyed the majority in the National Assembly, which caused difficulties for the new administration to pass policy resolutions. To correct the situation, President Roh approached the two opposition leaders, KIM Young-sam, and KIM Jong-pil, which resulted in a three party merger on Jan 22, 1990. The party merger helped not only the ROH Tae-woo administration to pass policy resolutions in the National Assembly but it also helped KIM Young-sam to become the governing party's candidate in the next presidential election.

On December 18, 1992, KIM Young-sam was elected to become the first civilian president selected through a direct election. To have complete control over the military, President KIM Young-sam purged the members of the Hanahoe, an inner circle organization with specific political orientation which was secretly organized by CHUN Doo-hwan in 1963. The Hanahoe members enjoyed domination in key military positions and entered into politics once General CHUN became president. To politically neutralize the military, President Kim retired all the Hanahoe members from the military.

President KIM Young-sam also reopened the corruption case of Presidents CHUN Doo-whan and ROH Tae-woo by declaring the "judgment of history" on June 3, 1993. CHUN Doo-whan was sentenced to life in prison and ROH Tae-woo was sentenced seventeen years in prison for the military coup on December 12, 1979, the brutal suppression of the Kwangju uprising on May 18, 1980, and embezzlement.

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29. Stephan Haggard and Robert R. Kaufman, *The political economy of democratic transitions*, Princeton, NJ: Princeton University Press, 1995, p95.

The KIM Young-sam administration also adopted local autonomy to further democratize the political system. With the adoption of local autonomy, the KIM Young-sam administration reduced the central government's involvement in local policy making. This change made significant contributions to democracy in South Korea.

V. ECONOMIC POLICIES AND ECONOMIC PERFORMANCE UNDER DEMOCRATIC GOVERNMENT

A. The ROH Tae-woo Administration

The ROH Tae-woo administration's emphasis on equity and balance enhanced the social welfare system through housing policies and a national health care plan.[30] To supply more homes, the government adopted a policy to construct two million new housing units. To this end, an annual average of two hundred thousand homes were built. The national health plan adopted by the PARK Chung-hee administration was also expanded to include people in the lower income brackets and the minimum wage law was adopted to assist in the redistribution of wealth.

However, the public investment to improve social welfare aggravated the balance of payments. To make matters worse, the trade deficit caused by a surge in imports led to an economic decline. In addition, the number of labor unions and labor-management disputes increased significantly. For example, the number of labor unions rose by 19.5 percent in 1988 followed by 19.8 percent in 1989.[31] Labor unions organized strikes to raise wages when labor-management disputes occurred. The ROH Tae-woo administration, however, decided not to intervene, which led to the increases in lost worker productivity especially in the early period of the Roh administration (1987-1989).

The frequent strikes eventually led to wage increases for labor workers. The average income of labor workers grew by 10 percent in 1987, 15.5 percent in 1988, and 21.1 percent in 1989. The rapid income growth resulted in higher rates of inflation, a loss of interna-

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30. Seong-Ryeul Cho, "Economic Reform and National Strategic Change of the Roh Tae-woo administration," *Hankuk jungchi hakhaebo* (*Korea Political Science Association Review*), Vol. 30, No. 2 (1996), p 196.

31. Seong-Jae Cho and Jung-Woo Kim, *Hankukŭi nosakwan'gye byŏnhwa ch'uyi bunsŏk mit saeroun nosachŏngch'aek panghyang* (The analysis of the relation between labor and manager and new direction of labor and manager policy), Gwach'on: Ministry of Labor, 2007, p. 33.

tional competitiveness, and slower economic growth. For example, between 1987 and 1989, the average wage of labor workers in South Korea went up by 46.6 percent whereas it increased by only 0.1 percent and 9.8 percent in the U.S. and Japan respectively. This difference in wage increases significantly reduced South Korea's international competitiveness.[32] As a result, Korea's economic growth rate dropped to 6.4 percent in 1989 from 11.5 percent in the previous year. Given that the average growth rate for 1985-1990 was 14.4 percent, this was a significant decline in economic growth. Thus, President Roh vetoed a labor reform bill in 1989 that favored labor unions. However, the labor sector continued to put pressure on the Roh government especially after South Korea joined the United Nations on September 19, 1991 and the International Labor organization on December 9, 1991.[33]

Table 1. Labor-management Dispute Status

Years	1987	1988	1989	1990	1991	1992	1993
Labor Dispute Figures (cases)	3,749	1,873	1,616	322	234	235	144
Days not worked by economic activity	6946935	5400836	6351400	4487200	3257600	1527600	1308300

Source: International Labour Organization (ILO), LABORSTA - database of labour statistics (http://laborsta.ilo.org/).
Ministry of labor of South Korea, *Hankukŭi nosakwan'gye byŏnhwa ch'uyi bunsŏk mit saeroun nosachŏngch'aek panghyang* (The analysis of the relation between labor and manager and new direction of labor and manager policy), Gwach'on: Ministry of Labor, 2007, pp. 18-19.

Table 2. Income Growth Rates

Years	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Wage Growth (%)	9.2	8.2	10.1	15.5	21.1	18.8	17.5	15.2	12.2	12.7

Source: Ministry of Labor, Maewŏl nodong t'onggye chosa bogosŏ (labor statistics monthly report), from 1985 to 1994.

32. Won-dok Lee,*1987nyŏn ihu hankukui nodong undong* (Labor Movement in Korea after 1987), Seoul: Korea Labor Institute, 2000, p. 15.

33. Young-ki Choi, Gwang-seuk Jeon, and Cheul-su Lee, Bum-sang Ryu, *87nyŏn ihu nodongbŏpjeŭi byŏnch'ŏnyŏn: bŏpchejŏng mit chŏngch'aek byŏnhwaŭi yŏksa* (The changes of labor law after'87: the history of law establishment and policy change), Gwacheon: Ministry of Labor, 1999, pp. 79-132.

Table 3. Inflation

Years	1987	1988	1989	1990	1991	1992	1993
Inflation (%)	3.07	7.14	5.68	8.56	9.34	6.23	4.79

Source: International Monetary Fund (IMF), the world Economic Outlook(WEO) Database April 1999, Inflation
(http://www.imf.org/external/pubs/ft/weo/1999/01/data/index.htm)

B. The KIM Young-sam Administration

The KIM Young-sam administration began liberalizing the economy through deregulation and a decrease in government intervention. The Kim administration decided not to investigate rampant corruption coming from the financial institution's lending practice. Traditionally, there was a close tie between politicians, government officials, and businessman. Politicians/government officials pressured banks to give loans to export oriented businesses, especially *chaebol*, and *chaebol* made illegal campaign contributions to politicians in return.

To cut the politics-business ties and make financial transactions transparent, the KIM Young-sam administration adopted the real-name financial transaction policy. Prior to the adoption of the policy, the South Korean government implicitly admitted false name financial transactions to increase savings and money circulation. However, false name accounts were commonly used to avoid capital gain taxes as well as in money laundering schemes.

Another policy adopted by the Kim administration related to the real-name financial transaction system was the real-name property ownership. The implementation of the policy started with the financial disclosure of high-ranking public officials. This initial step was meaningful because the use of false names for real estate ownership was common. This alias or borrowing of another person's name was commonly used to avoid capital gain taxes for sales or inheritance of real estate properties.

In addition, to join the Organization for Economic Cooperation and Development (OECD), the KIM Young-sam administration pushed economic policies, which included the liberalization of the foreign exchange rate, foreign direct investment, and insurance. These policies led to an increase in foreign capital flow, which was followed by the rise of mercantile banks or quasi-financial companies to handle the foreign capital. However, these new financial institutions lacked experience in dealing with foreign capital which was partially to blame for the cause of the financial crisis in 1997.[34]

The Kim administration also introduced a labor reform bill to change the labor-management relationship. The bill included three important changes: 1) legalization of layoffs by the management; 2) flexible work hours; and 3) laborer reform to improve the efficiency of the labor structure.[35] The bill faced strong opposition and stalled in the National Assembly.

C. The 1997 Financial Crisis

Starting in the mid-1990s, South Korea showed signs of economic trouble. By June 1997, foreign debt by Korean banks had reached 24 percent of the gross national product. What made the debt even riskier was the amount of short-term debt, which was approximately 350 percent of their foreign exchange reserves. Moreover, the average debt-equity ratio of the thirty largest business conglomerates (*chaebol*) was almost 400 percent. Considering that the average debt-equity ratio of large U.S. firms is a mere 70 percent, the financial structure of the Korean *chaebol* was seriously problematic.[36]

What led to the rather sudden rise of international debt? According to Demetriades and Fattouh,[37] "[F]inancial liberalization and tight monetary policy, which kept domestic interest rates above world interest rates, encouraged commercial and merchant banks to rely heavily on cheaper foreign credit-perceived to be cheaper because of the pegged exchange rate." Since there was no prudential supervision system over international lending practices, short-term borrowing was enhanced.

The high rates of short-term loans and international debt along with the low level of political involvement and economic control did not allow the Kim administration to make proper adjustment before the financial problems became uncontrollable, which eventually led to a serious foreign exchange problem. Exchange rates

34. Jung Kim, "The political logic of economic crisis in South Korea," *Asian Survey*, Vol. 45, No. 3 (2005), pp. 468-469.

35. Sŏng-tŏkYŏm, Nosa daerip sae bulssi / chŏngni haeko dŭng 3jae nollan (the tinderbox of antagonism between labor and manager), *Kukmin Ilbo*, July 3, 1996, p. 3.

36. Henry Laurence, "Financial system reform and the currency crisis in East Asia," *Asian Survey,* Vol. 39, No. 2 (March-April 1999), p. 363.

37. Panicos O. Demetriades and Bassam A. Fattouh, "The South Korean financial crisis: Competing explanations and policy lessons for financial liberalization," *International Affairs*. Vol. 75, No. 4 (October 1999), p.788.

skyrocketed in the second half of the year, and the administration had to ask the International Monetary Fund (IMF) to bail it out from default. What caused the financial crisis in South Korea in 1997? There are many reasons, but one of them may be found in immature institutionalization of political and economic organizations which still had the legacy of the government-led development paradigm. During the authoritarian leadership under the statist approach, the government allocated credit to private business companies, which led to close ties between the government and private business companies. As a result, bribery and kickbacks were common between the government and private business companies, which made transparent lending practice virtually impossible. Although some improvements were made thanks to the transition to democracy, there still was corruption in lending practice.

Moreover, international competitiveness declined as the price of exporting Korean goods rose significantly. Since labor unions were legalized after the transition to democracy, the labor-management disputes often led to labor strikes, which reduced productivity and worsened the financial structure of the business companies. The management of private business companies, however, was not able to lay off labor workers due to labor unions. Thus, the Kim administration attempted to address these issues through a labor reform bill and a financial reform bill. However the bills stalled in the National Assembly due to the president's lame duck status and the incorporation of the opposition parties.

D. The KIM Dae-jung Administration: Post Crisis Reform Policies

Although President KIM Dae-jung won the presidential election by a 1.6 percent margin, the KIM Dae-Jung administration was in a better position to implement labor and financial reform than the KIM Young-sam administration. Moreover, the policy prescription by the IMF strongly recommended the Kim government restructure *chaebol* and ill-performing financial institutions.[38] Thus, the Kim government privatized most publicly owned banks. In addition, the government attracted foreign capital to save struggling companies.

The IMF recommended high rates of interest and tax increases along with cutbacks on government expenditures. Following the

38. Tong Whan Park, "South Korea in 1997: Clearing the last hurdle to political-economic maturation," *Asian Survey*, Vol. 38, No. 1 (January 1997), pp. 2-4.

IMF's policy prescription, the Kim government significantly raised interest rates, which made credit allocation extremely difficult for small and medium size enterprises. As a result, a number of companies went bankrupt and unemployment rates rose significantly. Thus, this policy recommendation by the IMF was severely criticized.[39]

Turning to the financial sector reforms, the IMF emphasized that reform policies must be based on economic logic and not political considerations. Moreover, the IMF strongly encouraged the Seoul government to further liberalize their markets.[40] To meet the IMF expectations, first the KIM Dae-jung administration attempted to improve the institutionalization of financial transactions. To this end, the Kim government created two financial supervisory authorities: the Financial Supervisory Commission and the Financial Supervisory Service.[41] These institutions monitored banks' BIS (Bank for International Settlements) ratio and their adherence to international standards. In addition, the Kim government abolished the cap of aggregate Foreign Direct Investment (FDI) of Korean equities to attract more foreign direct investment.[42]

Turning to corporate reform, the KIM Dae-jung government adopted the approach called "big deals."[43] Through this approach *chaebol* swapped weak businesses to merge into strong companies. When the big deal was not possible, a new company was created through combining the weakest businesses from *chaebol*. For in-

39. Panicos O. Demetriades and Bassam A. Fattouh, "The South Korean financial crisis: Competing explanations and policy lessons for financial liberalization," *International Affairs*. Vol. 75, No. 4 (October 1999), p.791; David A. Zalewski, "Brothers, Can you Spare $58 Billion? Regulatory Lessons from the South Korean Currency Crisis," *Journal of Economic Issues*, Vol.33, No. 2 (June 1999), p. 359.

40. Henry Laurence, "Financial system reform and the currency crisis in East Asia," *Asian Survey*, Vol. 39, No. 2 (March-April 1999), pp. 365-366.

41. Kyng Suh Park, "Bank-led Corporate Restructuring." In Stephen Haggard, Wonhyuk Lim, and Euysung Kim ed., *Economic Crisis and Corporate Restructuring in Korea*. New York: Cambridge University Press, 2003, p. 181; Jin-Wook Choi, "Regulatory forbearance and Financial Crisis in south Korea," *Asian Survey*, Vol. 42, No. 2 (March-April 2002), p. 270.

42. Jae S. Mah, "Regulatory Lessons from the South Korean Currency Crisis: Comment on Zalewski." *Journal of Economic Issues*, Vol. 36, No. 3 (September 2002), p. 797; Uk Heo and Jung Yeop Woo, "South Korea's Experience with structural Reform: Lessons for other countries," *Korean Social Science Journal*, Vol. 33, No. 1 (June 2006), p.11.

43. Kyng Suh Park, "Bank-led Corporate Restructuring." In Stephen Haggard, Wonhyuk Lim, and Euysung Kim ed., *Economic Crisis and Corporate Restructuring in Korea*. New York: Cambridge University Press, 2003, pp. 181-206.

stance, Kia Motors was bought out by Hyundai Motors and Samsung Motors was sold to Renault. Hyundai took over Semiconductor part of LG, and power components of Samsung Heavy Industries and Hyundai Industries were annexed by the Korea Heavy Industries and Construction (Hanjung).[44]

To enhance the transparency of the accounting practices of *chaebol,* the government passed the Act on External Audit of Stock Companies that mandated them to submit annual financial reports.[45] Moreover, the government required that *chaebol* be subject to audits by a credible international accounting firm twice a year.[46]

Finally, to make the labor market more flexible, as the IMF suggested, the KIM Dae-Jung administration legalized layoffs for necessary management. Yet, the law led to increases in the high rates of unemployment and brought forth the specter of more labor-management dispute. Therefore, the government launched the Tripartite Commission of Labor, Business and Government in 1999 to deal with the layoff related problems.[47]

Another issue with the labor reform was increasing irregular (non-union) workers. Since the irregular workers could not join a labor union and did not have a guarantee of working hours nor benefits, the business management preferred increasing the number of irregular workers than regular employees. The high portion of irregular workers continues to be a social issue and often used as an excuse for labor strikes.

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44. Yoo, Seong Min, *Chaebol, gwayeon wigiŭ jubŏminga?* (Are the Chaebol in the Real Culprits of the Economic Crisis?) Seoul: Korea Development Institute, Bibong Press, 2000, pp.1-182; Uk Heo and Jung Yeop Woo, "South Korea's Experience with structural Reform: Lessons for other countries," *Korean Social Science Journal*, Vol. 33, No. 1 (June 2006), p.12.

45. Jongryn Moand Chung-In Moon, "Business-Government Relations under Kim Dae-jung." In Stephen Haggard, Wonhyuk Lim, and Euysung Kim ed., *Economic Crisis and Corporate Restructuring in Korea,* New York: Cambridge University Press, 2003, p. 129; Uk Heo and Jung Yeop Woo, "South Korea's Experience with structural Reform: Lessons for other countries," *Korean Social Science Journal*, Vol. 33, No. 1 (June 2006), p.12.

46. Henry Laurence, "Financial system reform and the currency crisis in East Asia," *Asian Survey,* Vol. 39, No. 2 (March-April 1999), p. 365.

47. Florence Lowe-Lee, "Labor flexibility, a key to economic success," *Korea Insight,* DC: Korea Economic Institute, 2006 (http://www.keia.com/Publications/Insight/2006/september%2006.pdf)

E. The ROH Moo-hyun Administration

ROH Moo-hyun was the fourth civilian president since South Korea's transition to democracy. He was unexpectedly elected and thereby a different kind of president. The two previous civilian presents—KIM Young-sam and KIM Dae-jung—had been life-long opposition leaders with strong support from specific regions. They both had been democracy activists. However, President ROH Moo-hyun had none of these qualifications. Thus, President Roh was constrained only by the boundary of constitutional rights and did not try to control other political institutions.[48]

In terms of economic performance, the South Korean economy recovered from the 1997 financial crisis and graduated from the IMF bailout program earlier than expected. Learning from the experience, the Korean government significantly increased its foreign exchange reserve from $20.4 billion in 1997 to $206.1 billion in 2006, the fifth highest in the world.[49]

Despite the quick recovery from the crisis, the economy also revealed potential problems due to the policies adopted to stimulate the economy during the KIM Dae-jung administration. One of the main problems was credit card debt. To enhance private consumption to bolster the economy, the KIM Dae-jung administration strongly encouraged credit card usage. This policy helped the economy grow in the short-term, but the consequences came later because the much of the growth was largely based on debt. The over usage of credit cards resulted in more than 3.2 million Koreans with bad credit ratings, which in turn led to a decrease in private consumption in 2003 and 2004.[50] In other words, the KIM Dae-jung administration's campaign to increase private consumption based on credit card was myopic. The reason for the adoption of this kind of short-sighted policy may be found in South Korea's presidential

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48. Sung Deuk Hahm and Dong Seong Lee, "Consolidation of Democracy in South Korea: Evaluation of the Roh Moo Hyun Administration, 2003-2008." Presented at the Annual Meeting of the American Political Science Association 2007, Chicago, Aug 30 – Sep 2, pp. 7-10.

49. Mun-il Bak, "Jipyoro bon Oehanwigi 10nyŏn" (Economic indexes of 10 years after foreign exchange crisis), *Seoul Sinmun*, November 21, 2007, p.18.

50. Sung Deuk Hahm and Dong Seong Lee, "Consolidation of Democracy in South Korea: Evaluation of the Roh Moo Hyun Administration, 2003-2008." Presented at the Annual Meeting of the American Political Science Association 2007, Chicago, Aug 30 – Sep 2, p. 17; Byoung-Jik Kim, "Roh moo hyun jŏngbu ch'orahan kyŏngje sŏngjŏkpyo" (Roh moo hyun administration's poor economic records), *Munhwa Ilbo*, January 29, 2007, p.5.

system with its non-renewable, single-term for five years. Since the president cannot run for another term, political accountability becomes insignificant. Thus, presidents tend to adopt policies good for the short-term, leaving the following president to pay the price.

Another economic issue that the Roh administration faced was reduced corporate investment. With the raised labor cost and the aggressive strikes by labor unions, business corporations increased foreign investment at the expense of declined domestic investment. According to Samsung Economic research Institute, the average annual growth rate of corporate investment for equipment was 7.8 percent for 1990-1997, but it declined to 1.15 percent for 2000-2005.[51]

These issues resulted in sluggish economic performance. The average annual economic growth rate during the CHUN Doo-whan administration was 8.7 percent. During the ROH Tae-woo administration, it was 8.4 percent, and it was 7.1 percent during the KIM Young-sam administration. However, the average annual economic growth rate for the KIM Dae-jung and ROH Moo-hyun administrations was only 4.4 percent and 4.2 percent respectively.[52] Moreover, between 2002 and 2006, the portion of the population living in poverty increased by 12 percent.[53] Despite that, the Roh administration significantly increased social welfare expenditures. For example, only 17.9 percent of government expenditures were allocated for social welfare in 1997, but that was increased to 25.3 percent in 2006.[54]

In summary, the Roh administration had to deal with the results of the myopic policies adopted by the KIM Dae-jung administration to quickly recover from the financial crisis. To make matters worse, the Roh administration increased social welfare expenditures by increasing taxes to improve social wealth redistribution. As a result, corporate capital moved to foreign countries looking for better business environments, which in turn slowed the

51. Yoo-young Kim, "Oehanwigi 10nyŏn, Kumnyung- kiŏp, ŏdŭnkŏtgwa Irŭnkŏt" (10 years after foreign exchange crisis, what we lost and got in finance and businesses), *Donga Ilbo*, November 15, p.10.

52. Byoung-Jik Kim, "Roh moo hyun jŏngbu ch'orahan kyŏngje sŏngjŏkpyo" (Roh moo hyun administration's poor economic records), *Munhwa Ilbo*, January 29, 2007, p.5.

53. Sung Deuk Hahm and Dong Seong Lee, "Consolidation of Democracy in South Korea: Evaluation of the Roh Moo Hyun Administration, 2003-2008." Presented at the Annual Meeting of the American Political Science Association 2007, Chicago, Aug 30 – Sep 2, p. 17

54. Ibid., footnote 26, p. 17.

economy. Aggressive labor unions further aggravated economic performance.

VI. CONCLUSION AND DISCUSSION

South Korea's miraculous economic development along with that of a few other East Asian countries generated theoretical debates in the political science and economics communities. The debate largely focused on the government-led development paradigm vs. market-oriented paradigm. The debate generally concluded that the role of government in South Korea was critical along with the value of human capital. To describe the role of government in South Korea's economic development, we revisited the development process and described economic policies adopted by the government.

In addition, we also analyzed how the transition to democracy in South Korea occurred and why democratization may affect economic performance. As Huntington noted,[55] South Korea experienced two power transitions and a deepening of democracy. Unlike the expectation of scholars who argue that democracy helps economic growth,[56]the initial economic performance of democratic governments in South Korea was rather poor.

There could be three reasons for economic success by the authoritarian regime and the rather poor performance by the democratic government. First, the authoritarian government was able to keep labor costs low to make Korean products competitive in international markets. Moreover, former military leaders (e.g. PARK Chung-hee, CHUN Doo-whan, and ROH Tae-woo) employed technocrats to develop the economy. With the strong support of the leaders, technocrats designed policies to develop the economy. However, civilian leaders (e.g KIM Young-sam, KIM Dae-jung, and ROH Moo-hyun) largely appointed their political allies and supporters to government posts. They used authorities to appoint cabinet posts to payback their political debt. Thus, political

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55. Samuel S. Huntington, *The Third wave: Democratization in the Late Twentieth Century*. Norman, OK: University of Oklahoma Press, 1991, p. 267.

56. Ross E. Burkhart and Michael S. Lewis-Beck, "Comparative Democracy: The Economic Development Thesis," *American Political Science Review*, Vol.88 (1994), pp. 903-910; Yi Feng, "Democracy, Political Stability and Economic Growth," *British Journal of Political Science*, Vol. 27 (1997), pp. 391-418; Mancur Olson, "Dictatorship, Democracy, and Development," *American Political Science Review*, Vol. 87 (1993), pp. 567-576.

connections played a key role in their cabinet appointment, which often led to a problematic policy making.

A second reason can be found in the presidential system installed after the transition to democracy, which does not allow the president to rerun for another term. Since the president does not have to worry about the next term, shortsighted policies tend to be adopted as long as they are good for the short-term. A great example of this practice is the KIM Dae-jung administration's campaign to increase credit card usage to promote private consumption to stimulate the economy. It helped the Korean economy to recover from the 1997 financial crisis, but credit card debt became a serious social problem during the ROH Moo-hyun administration period. This problem tends to appear in every presidential system regardless of term limits.

Third and finally, civilian presidents, particularly Presidents KIM Dae-jung and ROH Moo-hyun adopted pro-labor policies and increased social welfare expenditures through tax increase. The objective of these policies were to reduce the gap between the rich and the poor, but the outcome of the policies was the departure of corporate capital to foreign countries and an aggravation of the wealth gap due to increased unemployment. In other words, the redistribution-oriented policies not only hindered growth, but also aggravated the wealth inequity between classes.

The experience of South Korea's political and economic development summarized above, has important policy implications and provides lessons for other developing countries. It is common in newly democratized countries for the government to adopt policies emphasizing wealth redistribution in attempts to attract more support from the poorer classes. As in the South Korean case, however, redistribution-oriented economic policies tend to yield economic struggles, at least in the short-term. Thus, newly elected democratic leaders need to be cautious in their policy decisions.

Another lesson drawn from the South Korean example is that the transition to democracy does not result in immediate economic growth. Instead, democratization requires consolidation, which involves institutionalization of the political and economic systems. In the process, previously dispersed interest groups as well as organized groups begin to aggregate and articulate their interest, which sometimes creates political instability. Thus, the rate at which democratic and economic systems institutionalize is of critical importance for economic performance after democratization because the maturity of institutions will play a critical role in policy making and implementation.