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Korea's Regulatory Reform as a Strategy for Crisis Recovery

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This study was conducted for an OECD report on regulatory reform during crisis episodes, available as a Korea’s case at http://www.oecd.org/document/30/0,3343,en_2649_34141_44926558_1_1_1_1,00.html, and the views expressed in this document are those of the authors and should not be attributed to the OECD or to the government of Korea or to the KIET.

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Ⅰ. Introduction

The Republic of Korea seems to have rebounded successfully from the recent global economic crisis far earlier than expected.[1] It is doubly astonishing not only because it did so in the late 1990s as well, but, more importantly, because the quick recovery runs counter to the widely-shared predictions that an economy which is so dependent on exports, would not be able to be so resilient. It is only natural to ask what factors are contributing to the resilience of the Korean economy in the context of the global economic downturn and how these factors have contributed to such a swift rebound.

The pursuit of consistent macroeconomic policy tends to be singled out as the most important contributory factor: This involves little intervention in the foreign exchange and capital markets, leaving foreign exchange rates and interest rates largely to market forces, all of this combined with an expansionary budgetary policy, which was made possible due to the sound fiscal position. No doubt this sound macroeconomic policy management helped the economy to revive. But a more interesting and important question to ask is that what allows the Korean government to pursue such sound macroeconomic policies and make them stick in the first place.

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1) "An astonishing rebound", and "Briefing: Emerging Asian economies", *The Economist*, August 15, 2009.

This paper takes the view that the key factor is the decisive executive leadership and the government's willingness to undertake structural reforms and thereby establish credibility with both domestic and foreign investors in the face of external shocks. It is beyond question, in turn, that the external shocks helped to lay bare the high vulnerability of the economy and that the resulting sense of national crisis has afforded the government a virtually unlimited room to maneuver to undertake a wide variety of reform measures, especially because most of them were, in fact, overdue. Contrary of expectations, those reforms undertaken during economic crisis tended to have enduring effects in two ways.

First, the Korean government has made it a basic principle that the burden resulting from restructuring and reform ought to be shared equitably in such a way that the big businesses including the *chaebol* bear the brunt of it. Second, as the fallout from this, big businesses tended to learn the lesson that the ability to rely upon government favors and privileges has been fading rapidly and there remains no other way than to strengthen their ability to stand alone and adapt fully to market fluctuations, global and domestic. In short, the reduction in political uncertainties was welcome as giving a clearer environment for businesses. Obviously, the change of attitude on the part of big business has left much larger room for the government to induce small and medium-sized enterprises to support with the fairly pro-competitive and pro-market reforms by tilting them slightly in their favor, while strengthening the social safety net for those who are to be left out in the cold.

In general, it is possible to say that Korea is in a constant process of reform. But there clearly exists a policy reform cycle. The progress of regulatory and competition policy reform, for instance, is a clear proof of that. If we can say that the peak of Korea's pro-competitive and pro-market reforms was reached in the earlier period of the first economic crisis in 1997~98, the low point was reached during the earlier period of President Roh's rule(2003~2004),[2] from which the current Lee Myung-bak government seems to have been reviving the reform momentum once again in the face of the global economic crisis.

Presidents, Kim Dae-jung and Lee Myung-bak, who found themselves charged with the duty of overcoming the national crises invariably asserted that it was time to push forward market-oriented reforms and converge toward global standards, not to go back and relapse into more government intervention and protection. 'We should and can turn the crisis into opportunity.' was the catchphrase. No doubt it is very difficult for them to hold up the cause before the people in dire economic and social situations, but the general public generally rallied behind. Incidentally, it seems that the Korean people have also become quite acquainted with making such a big policy turnaround. As the Korean economy depends heavily on foreign trade (and investment) and suffers not infrequently from its extreme vulnerability, they have come to learn to distinguish between the moments when they have to acquiesce and relent

2) *The OECD Review on Korea*(2006).

and those when they can afford to oppose the government's pro-market reform initiatives.

Ⅱ. Regulatory Reform in Times of Crisis: Two Episodes

It is no accident that the high tide of regulatory reform in Korea has coincided with the onset of economic crisis. Although the source, nature, and magnitude of each economic crisis are different, regulatory reform has been looked upon as a useful and effective means to overcome the crisis, regain international competitiveness, and strengthen resilience of the economy. The '50% reduction of existing regulations' drive in 1998~99 and the 'Temporary Regulatory Relief(TRR)' Program in 2009 would represent Korea's uniquely drastic approach to regulatory reform in this light.

1. The '50% Reduction of Existing Regulations' Drive: The First Episode

The first massive regulatory reform drive during 1998~99 was undertaken when the Korean economy plunged suddenly into the deepest recession in history. The crisis was triggered by the continued exhaustion of foreign exchange reserves.[3] It

3) While the crisis was dubbed as the 'economic' crisis outside, within Korea it was called 'foreign exchange' crisis or simply the 'IMF crisis', the latter of which is a misnomer.

not only reflected the loss of credibility of foreign lenders and investors in the Korea's short-term economic policy management, but more importantly, in the politico-economic system of Korea itself and the Korean economy's ability to recoup from the economic crisis in the foreseeable future.[4)]

With the Korean government's decision to ask the IMF to come to its rescue, a drastic macroeconomic policy change and massive structural reforms of unprecedented degree and magnitude was a fait accompli. While there were some last-minute wheeling and dealing between the Korean government and the IMF, the IMF Stand-by Arrangement was reached swiftly.[5)] As expected, the IMF's demands for structural reform were

4) While the Asian financial crisis became increasingly contagious in the region and the rumours were around that Korea might be the next victim, the Korean politics went on as usual as if no such thing would happen to Korea. In anticipation of upcoming presidential election a few months away, Korean political (and bureaucratic) leaders, whether in the ruling party or opposition party, hesitated and failed to let Kia Motors, which came to the brink of bankruptcy in June 1997, go its way. Instead, the government introduced a new system of delaying the liquidation of defaulted firms by the lending banks in the aftermath of default of Hanbo Iron and Steel in January, which was embroiled in political corruption scandal. This posture was hardly understandable from the viewpoint of foreign lenders, investors, and experts, indicating only that Korea had neither willingness nor commitment to undertake a fundamental change in the government-business relations or in its style of managing the economy, far outmoded in the era of the rapidly globalizing world.

5) See the "Memorandum on Economic Program", and the "Letter of Intent (attached to the IMF Stand-by Arrangement)". Dec. 3, 1997.

wide-ranging: from financial and corporate sector restructuring to labour sector reform and to reform of trade and foreign direct investment policies.

In this sense, it may be debated whether the direction of the Korean government's plan to overcome the economic crisis was dictated by the IMF. While the observation cannot be entirely dismissed, it would be unfair to fully describe the process in such a way. First, most of the "key reforms contained in the IMF agreement had been on the agenda of the Korean government for many years, notably cleaning up the financial system, slimming the *chaebol*, and introducing greater transparency in corporate governance"[6], although they were blocked by the unfavorable political conditions at the time. Second, there was a difference between the sorts of reform the IMF required and those that the Korean people thought were necessary. Whereas the IMF package was focused on making Korean economy solvent and converge to global trade and investment standards, the Korean people tended to think it was the time to end the illegitimate political intervention into the economy and business, re-establish the government-business relations, and to pursue regulatory reform much further and deeper than what the IMF

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6) Cited from Heather Smith, "Korea", in Ross H. McLeod and Ross Garnaut(eds.)(1998), *East Asia in Crisis: from being a miracle to needing one*? (London, Routledge), p.83; Kang, Mansoo, *An Insider's view on Korean Economy in Three Decades*, Samsung Economic Research Institute, 2005. (Incidentally, he was Vice-Minister of Ministry of Finance and Economy at the time of crisis coming in 1997.)

called for.

This requires further explanation. With a tradition of government-led development for decades, regulations have come to be intertwined with government planning indistinguishably. The government's plans tended to be translated directly into laws, and the laws, in turn, to be composed of regulations designed to put plans into actions. Given the necessary fact that the government's plans tend to be at odds with the ways in which the free markets would function, those regulations tend to restrict the economic freedom of actions and decisions of business and the people concerned. Moreover, this tendency grows stronger in the process of promulgating the implementing legislations such as presidential decrees and directives of all sorts, as the bureaucrats tended to put the concrete details in them over which the administration, in lieu of the legislature, has the full authority.

It is thus quite natural that considerations for bureaucratic expediency and administrative efficiency tended to take precedence over those for the easiness and convenience of the regulated. In addition, the need to respond to the opportunistic behaviors on the part of the regulated (i.e., regulatory avoidances and circumventions) more swiftly and flexibly has constituted another reason why the bureaucrats tended to favor to follow this avenue. The end result has been a tight web of regulations that tend to increase the regulatory compliance costs and burden more than need to be. (Incidentally, this nature of regulatory system in Korea tends to allow an ample space for effective regulatory reform by the RRC, a point to which we will return later.)

For these reasons, especially when the economy slowed down, complaints about this tight web of regulations mounted again and again. The case in point was the situation just before the onset of the first economic crisis of 1997~98. 'High cost, low efficiency' was a phrase used describing the nature of economic and business environments. It is needless to say that this characterization was pointed to the outmoded regulatory structure and practices. It is no wonder, therefore, that such complaints turned into revolts in 1997~98 in the face of economic crisis.

The Korean people were shocked and dismayed by the unbelievable fact that the erstwhile buoyant Korean economy required IMF rescue. With their self-respect being irreparably damaged, Korean people chose Kim Dae-jung, a long-time opposition leader, as its next President at the election held just a few days after the IMF's Stand-by Arrangement was signed.[7] With the first 'genuine' transfer of power in four decades, the pre-existing political and economic establishments fell into disgrace and the mode of governing the state was cast into doubt. In short, the stage was thus perfectly set for the new President

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7) The catchphrase he used from the beginning was 'democracy and market economy', the meaning of which is not necessarily clear. But what is clear is that he intended to end the authoritarian rule and open a new era in which the people, not the government, could enjoy the sovereignty.

to institute a new governance system in Korea. After all, the wide-ranging structural reform package demanded by the IMF was at hand, and Korea's commitment to the IMF package was crucial in restoring confidence from the outside world.

Within months after his inauguration, President Kim directed the cabinet to cut down the existing regulations by half. The initiative had been taken by the newly-created Regulatory Reform Committee(RRC), co-chaired by the Prime Minister and a civilian. According to the *Basic Law of Administrative Regulations*, which came into full force in February 1998,[8] and bolstered by the President's order to push strongly ahead the regulatory reform, the RRC asked each of 35 ministries and agencies to submit 'Plan to Streamline Existing Regulations' under its jurisdiction. Upon the RRC's report at the Blue House Meeting, in which all the cabinet members participated, finding that the plans submitted by the ministries and agencies proved far from adequate, the President ordered each ministry and agency to resubmit the plans so that the existing regulations could be cut by more than 50% by the end of the year.[9]

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8) The *Basic Law of Administrative Regulations*, on which the President's directive is based, was enacted August 22, 1997, months before the onset of economic crisis, by the previous government, while its implementation regulation (that is, the Presidential Decree) come into force February 24, 1998, the day before the President's inauguration day.

9) The rationale behind setting the target of 50% was notoriously simple. Since there were so many and duplicative regulations, the President thought that it would be the good first step to make the mess cleaned up and then waiting for the all the dust coming

A presidential directive with specific targets was simply unprecedented. It startled the entire bureaucracy, while giving large powers to the RRC. In these extraordinary circumstances, each ministry and agency had no choice but to prepare a revised plan in an effort to ensure that it could reach the target while minimizing the risks of being subjected to the oversight by the RRC. On its part, however, the RRC selected and classified those regulations, the jurisdiction of which was overlapped across ministries and had thus proved extremely difficult to make progress, into the so-called 'specific (sectoral or thematic) tasks'[10] and subjected them to its intensive review.[11]

As of the end of 1998, the number of existing regulations was, indeed, cut almost by half from 11,125 to 5,695.[12] The kind of regulations hit hardest was those that had resided mainly in

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down, proceed with the next step in a more schematic fashion. Interview with a former official who served as a junior advisor in the Blue House.

10) See Appendix 1 for the list of 'specific (sectoral or thematic) tasks', usually dealt with by 'bundles'.

11) Through this avenue, the RRC could exert its influence and authority to the fullest extent and put at work the same guiding principle as manifested in the IMF's structural reform package.

12) Of course, this number can hardly be accepted at face value, since apples (major and important regulations) and oranges (minor ones) cannot be compared. Furthermore, this figure was somewhat beguiling, for among other reasons, some ministries apparently played with numbers. They tended to group the regulations that they considered to be essential and thus must remain, while dividing those that they considered less important and thus could be dispensed with.

implementing legislations subordinate to laws, lacking clear legal base or mandate. About one third of those regulations that were eliminated outright (namely 1,840 out of 5,430 regulations) belonged to this category. Given their presumed arbitrariness, the beneficial effect would be immeasurable. Moreover, this outcome sent a strong and clear message to the bureaucracy that such regulations would have no place in the new system of regulatory oversight, reinforced by the 'regulations registration' system, also provided for in the *Basic Law*.

Together with the structural reforms in the financial and corporate sectors, as called for by the IMF, this massive regulatory reform in 1998 and thereafter must have greatly contributed to the quick recovery from the economic crisis, although it is very difficult to provide quantitative evidence. According to a benefit analysis, projected for the span of five years(1999~2003), of the major regulatory reform measures in 1998 alone, the impact was substantial indeed.[13] It was estimated that it would generate at

13) See Ha, Byungki, *Cost Benefit Analysis on Korea's Regulatory Reform in 1998*, Korea Institute for Industrial Economic and Trade(KIET), October 1999. This report calculated three types of costs and benefits on the reform measures; effects on employment, private burden ease and government saving. The measures were chosen for analysis among all the measures to be taken considering importance and calculability and categorized into four groups as foreign investment, job creation, business burden easing, citizen convenience and anti-corruption based upon characteristics. The calculations were initially done by government officials according to the manual and summarized with some amendments by the author of the report.

least 680 thousand new jobs, about half of which can be attributed to the increased inflow of FDI, which amounted to USD 27 billion at the minimum.[14] Also, it was estimated to reduce regulatory compliance costs by KRW 18,690 billion (USD 15 billion), which amounted to 4.4% of GDP in 1997, in addition to the government's administrative cost savings of KRW 590 billion.

2. Temporary Regulatory Relief(TRR) Program: The Second Episode

As such, Korea's unique new system of regulatory reform has since been well established and maintained at least before the Roh Moo-hyun's 'Participatory Government' came to power in February 2003. By then the economy fully recovered from the economic crisis to the extent that the painful memory of adjustment to the crisis sank into oblivion in the minds of people, and the claim that Korea had not needed to undergo such a painful and disgraceful period gained some audience. Accordingly, the impetus for regulatory reform waned rapidly and even receded, as the course of the national policy was set in the almost opposite direction. The Roh government explicitly gave policy preference to equality over freedom and redistribution over

14) The same investigator recently conducted the same analysis again by putting real, rather than projected, parameters. It shows that these figures were overestimated. The FDI inflow amounted only to USD 21 billion, and it helped create (or keep) 113 thousand new jobs at the minimum.

growth.

As the economy began to show clear signs of deteriorating and the unusually high youth unemployment increasingly became a major political concern around 2005, however, the government began to look back to regulatory reform as an effective vehicle to reinvigorate the slackening economy. But the main vehicle it decided to rely on was different. It added a new system, namely the so-called 'ministerial meeting of major regulatory ministries,' to be supported by the 'regulatory reform task force,' established alongside the Office of Regulatory Reform in the Prime Minister's Office.

With a strong initiative by the Prime Minister (co-chairman of the RRC), the new body was charged to select the so-called 'regulation bundles' and prepare proposals to reform them in a package. The 'regulation bundles' were of such nature that they were so highly interrelated and the legal authority was dispersed among related ministries, and that the business found most cumbersome but proved resistant to reform efforts in the past. Moreover, to speed up the reform process, these proposals were submitted to the 'ministerial meeting of major regulatory ministries,' chaired by the Prime Minister.

Of course, the final reform proposals were also presented to the RRC for a formal review. In this sense, the RRC was also involved in the process. But it was inevitable that the RRC's role was largely circumscribed to review regulations to be introduced anew or strengthened through its RIA review process, although the legal authority to reform existing regulations, including the 'regulation bundles', still rested in the RRC. Despite such renewed reform efforts, however, the number of regulations registered rose from 7,724 at the end of 2002 to 8,084 at the end of 2006.

It was against this background that President Lee Myung-bak was elected in 2008 with a philosophy of 'practical centrism'. He was elected on a campaign pledge that he would turn Korea into a first-rate advanced country by making laws, institutions, policies, and practices of Korea converge fully to the global standards. As soon as he took office, he declared that his government would be a business-friendly government.

Although President Lee has given top priority to regulatory reform with a view to reinforcing a free market economy, the RRC's relative status remains pretty much the same as before. While the 'ministerial meeting of major regulatory ministries' is no longer in existence, the 'regulatory reform task force' has been moved to the newly created Presidential Commission on National Competitiveness(PCNC), as its arm to monitor the business grievances and complaints about regulations and suggest remedial actions. On the other hand, the PCNC has been charged with some responsibility to undertake reform of 'regulation bundles'.

Of course, regulatory reform is not the sole responsibility that the PCNC has been charged to take. Given the wide-ranging mission of the PCNC, however, it has come to play a significant role in regulatory reform process in the current government, because, among other reasons, most of the PCNC's reform agenda tended to belong to this category, directly or indirectly. For example, the issues that the PCNC has dealt with include a further freeing of foreign direct investment measures especially for free economic zones, deregulation of various kinds of restrictions applied to Seoul metropolitan areas, and improving procedures related to employment of foreign labor.

In view of this, one may say that the institutional structure for regulatory reform of Korea has been reshuffled again. But it would be fair to say that a new division of labor has emerged, because the PCNC, a temporary institution whose mandate is merely based on the Presidential decree, tends to take up regulatory reform issues that have been politically contentious and thus tended to provoke a higher level of bureaucratic resistance to reform efforts, while the RRC, the legally formal institution for regulatory reform, tends to resume, over time, its previous role and status to the fullest extent. It seems that there are dark sides and bright sides to this new division of labor, though.

On the dark side, one may argue that there tends to arise some confusion among the public and the business as to which institution holds the main key. However, it is obvious that the RRC does, since what the PCNC has decided has to be subject to the RRC review process nonetheless. On the bright side, it should be noted that, as the PCNC tends to take up regulatory reform issues that have been politically contentious, it tends to help strengthen the image of the RRC as the gate-keeper ensuring and upgrading the quality of regulations, making possible the full use of reform mechanisms such as RIA, registration of regulations, and sunset review, among others. In this sense, the new division of labor would be a welcome development.

Indeed, the recently instituted 'Temporary Regulatory Relief (TRR)' program represents a prime example of the RRC's accomplishments in its effort toward reforming *existing* regulations as well as the regulations being newly introduced or strengthened. In the midst of deepening global financial crisis, the Korean government, along with the majority of OECD countries, has actively undertaken a series of counter-measures. Treading on the heels of USD 28 billion fiscal package, on May 27, 2009, the Korean government (and the RRC) released a list of 280 regulations, the application of (or part thereof) which will be suspended or delayed for two years, when the stagnant economy is supposed to bounce back.

This bold initiative, called 'Temporary Regulatory Relief (TRR)' program, aims at overcoming economic crisis and protecting (and increasing) jobs, among others, by bolstering private sector investment and consumption, and taking regulatory burden off the shoulders of small and medium-sized enterprises, self-employed businesses, and the citizens. Korea's TRR represents an unprecedented experiment in the history of regulatory reform both within and out the country. Bearing some semblance with the regulatory moratorium undertaken by the Task Force on Regulatory Relief in early Reagan years, though, this program is distinct in that it applies to existing regulations, not to new regulations in the pipeline.

Judging that fiscal package alone would not be sufficient to boost private sector investment and consumption, the RRC, on its part, devised TRR as an institutional supplement to it. Without aligning it with extraordinary regulatory reform measures of commensurate proportion, its influence would be short-lived. Thus the RRC has turned its eyes to reforming those regulations that look more egregious at the time of extreme economic difficulties, given their presumed inhibiting effects on doing business, consumption and investment.

In fact, the PCNC adopted a plan early this year to subject more than 1,000 existing regulations to a sunset review. But the RRC has found this measure needed further action in the short term, as the sunset review could bear fruit only after the deadline reaches, which generally means 3 to 5 years from the time of imposition. Against this background, The RRC and the Office of Regulatory Reform under Prime Minister, a standing unit for the RRC, embarked upon a search for a breakthrough, and reached to a conclusion that more urgent measures were needed to adopt a more flexible approach to the application or enforcement of regulations and to turn the regular sunset review into a new mechanism more suitable to the current economic situation.

In a nutshell, TRR amounts to a mirror image of sunset review mechanism. Put differently, TRR is a different form of sunset review turned upside down. While sunset review generally applies prospectively, under TRR, the regulations would lose the whole or part of their legal force before the sunset review is undertaken to determine their fate. Under the TRR program, the Korean government suspended or delayed the application or enforcement of those regulations that look most inappropriate especially in the light of dire economic situations facing the country. Given the difficulties of and political resistance to outright deregulation, the Prime Minister's Office has come to the judgment that it would constitute a workable surrogate mechanism for regulatory reform. Representative examples are provided in the Appendix.

The TRR's impact on the economy has not been collected widely. Yet there is some evidence that indicates its beneficial impact may be huge. For example, affirmative rating ('highly satisfied' plus 'satisfied') for the government's regulatory reform efforts has gone up by 20% from 29.1% in the first quarter of 2009, namely before TRR, to 49.0% in the second quarter.[15)16)]

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15) Federation of Korean Industries(FKI), "A Survey on the Satisfaction with the Regulatory Reform", in April and August 2009. It should be mentioned, however, the subject for the survey and the survey method are different. In the first survey, 355 business firms answered, whereas in the second, the opinions of 51 experts from the big businesses, research institutes, and academia were solicited for the survey.

16) Such a positive evaluation is corroborated by a few of the international institutions. See IMD's World Competitiveness Report, and the World Bank's "Doing Business" Report.

Especially noteworthy is the fact that the people surveyed specifically expressed their high satisfaction with the TRR Program. The internal report prepared by the Provincial Government of Gyeonggi-do, for example, the economic impact of TRR is estimated to be substantial. In that Province alone, more than 20 investment projects, that would otherwise have been abdicated due to prohibitive regulations imposed, for example, on the expansion of existing plant facilities, or postponed due to overly burdensome regulations, have come to be embarked upon by virtue of TRR. In a couple of months the total new investment would amount to at least KRW 150 billion (USD 120 million).[17]

Although the number of regulations registered tends to stabilize at the level of around 5,100, the RRC's efforts and contribution in preventing bad or low quality regulations from being instituted must not be downplayed.[18] The RRC is now doing best to prevent the ungrounded and low-quality regulations from being instituted in the aftermath of the huge and prolonged 2008 protests against the decision to reopen beef imports from the U.S. This was falsely charged as being likely

17) The Provincial Government Office of Gyeonggido, "Report on the Beneficial Effect of Deregulation on Firms in the Region", August 2009.

18) The number of regulations registered dropped precipitously from 8,084 at the end of 2006 to 5,114 at the end of 2007. This sudden drop owed to the big change in the regulations classification and registration system itself in February 2007. The current government has started with 5,247 regulations and, as of the end of July, it went down to 5,088.

to put the public health in jeopardy. It is our belief that there can virtually be no other institution that would stand up boldly against the attempt to institute such bad regulations in Korea.

In 2008, for instance, 228 out of 974(23.4%) new regulations proposed by the ministries was selected as ‘major’ regulations to be subjected to the RRC’s review process, and among them, 17(7.5%) new regulations were withdrawn, whereas 108(47.4%) regulations were required to be improved on.[19] By contrast, in 2007, under the previous government, 397 out of 1,259(31%) new regulations were classified as ‘major’ regulations, and among them, 25(6.3%) were withdrawn, while 218(55%) were required to be improved on. It is noticeable that the number of new regulations proposed declined sharply in the meantime, although the decision rule of the RRC appears highly consistent, despite the changes made in the composition of members of the RRC.

3. Implications

It is no doubt very difficult to measure the impacts of the massive regulatory reform drive on the recovery from economic

19) From January to August 2009, 110 out of 600 new regulations proposed by the ministries have been selected as ‘major’ regulations to be subjected to the RRC’s review process, and 13 out of 110(12%) new regulations were withdrawn, 52(47.2%) regulations were required to be improved on. For the review, the RRC met 13 times, whereas its two subcommittees (dealing with economic regulations and social regulations respectively) 10 and 8 times each.

crisis. More difficult is the measurement of economic benefits resulting from the ordinary process of regulatory reform conducted constantly. From the institutional perspective, however, we can offer some important and interesting lessons. After all, we believe, the true intention behind regulatory reform is not so much in reducing the number of the existing regulations as in changing the attitude of government officials toward regulations and their tendency to rely on regulations excessively in the name of administrative efficiency in particular.

First, it was the economy in deep trouble that provided such a strong impetus for massive regulatory reform. Generally speaking, a crisis offers a window of opportunity for such reform. It necessitates and justifies a comprehensive reform. What counts, however, is getting timing right, as the process of setting up a new institution responsible to undertake a comprehensive reform takes much time. In this regard, it was really a boon to the Kim Dae-jung government that an institutional apparatus like the RRC, fully equipped with a full array of advanced reform tools and procedures such as the mandatory review process for new regulations in the form of a regulatory impact analysis(RIA), regulatory sunset review, and mechanisms to streamline existing regulations, had already been put in place.[20]

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20) In retrospect, the IMF reform package turned out to be a bitter medicine for the good and long-term health and competitiveness of the Korean economy. But without the RRC apparatus being in place, the course of reform would have been far different, reducing the effectiveness of the medicine.

More important is the legitimacy and reputation of the newly created reform institution, given that it is impossible to carry through reform packages without such institutional assets. In the case of Korea, with most of the important and powerful stakeholders, such as big business and the political parties, being discredited as the direct parties that caused the economic disaster, it was only natural that new institution like the RRC could gain the legitimacy and reputation as a reform institution. In addition, happily or not, as the faithful implementation of the IMF package became an imperative to regain credibility in Korean economy from the outside world, the RRC's guiding principles of pro-market, pro-competitive reform could be hardly challenged.

With the successful accomplishment of the first mission, namely the '50% reduction of existing regulations', the status of the newly-created RRC has since been established. It was remarkable and even legendary, indeed, given the fact that the RRC, a legally formal administrative body but designed to be operated foremost at the private sector's initiatives. It demonstrated that as long as sufficient political backing is guaranteed, the RRC, albeit being instituted in such a peculiar form, can serve as an effective vehicle for regulatory reform.[21)]

Second, the strong commitment by the political leaders plays

21) From our perspective, this was a proven fact. Unfortunately, however, this fact has been defied from time to time afterwards, as will be explained below.

a decisive role. In the case of Korea, the directive of the '50% reduction of existing regulations' was not the sole case that showed the President's personal commitment to reform. He reiterated the importance of swift and continuous regulatory reform on innumerable occasions such as the National Council meeting and the ministerial report conferences to the President of the Ministerial Annual Operating Plans. In addition, he regularly asked for monthly progress report at the weekly meetings with the Prime Minister. Of particular importance was the President's special directive issued October 1998, which called for the reform efforts to be stepped up in light of the fact that the 50% target was still afar.

All of his words and actions as such caught the attention of the press, reinvigorating the participation in the reform process by the private sector such as economic associations. It not only put the bureaucracy generally on the defensive, but made the National Assembly go along with the reform. For instance, finding that the National Assembly showed signs of taking a back step in the process of deliberating on reform legislations submitted by the administration partly on the pressure by the private interest groups, the President declared that he would veto the laws tapered as such.

Third, the successful experience of massive reform of existing regulations contributed to the successful institution of the RRC's another powerful weapon in its arsenal, namely the mechanism of reviewing ex ante new regulations or regulations. In 1998, even in the midst of economic crisis, 573 new regulations went through this review process. Among them, the RRC determined 51 new regulations to be withdrawn, and 112 to be improved upon by adopting alternative approaches to regulation. With this result, the RRC not only demonstrated that it could serve afterwards as a bulwark against the bureaucracy's habitual dependence on command and control-type regulations and regulatory enforcement styles,[22] but made the principles of regulatory reform applied to as consistently as they could be.

Fourth, it is generally said that especially in crisis situations, the focus of regulatory reform tends to be more on alleviating regulatory costs and burden immediately to help the business stay alive than on introducing the market forces in an effort to revive and strengthen international competitiveness of industries and businesses, since these reform attempts tend to exacerbate the difficulties facing them. This has not been case for Korea. While having much in common, the problems with economic regulations in Korea, especially from the perspective of the business and the people, differ much from those with social regulations. Not unlike in other (advanced) countries, the key problem with social regulations is an unnecessarily high compliance costs and burden resulting from the regulatory standards set so uniformly and enforced so rigidly. As for economic regulations, however, the problems

22) For this phenomenon the bureaucracy is not solely responsible, since what justifies their approach is the tendency of the people to attribute all the responsibility of social and economic ills to the government.

with them in Korea may well be said to consist in the intrusive nature of some government intervention and interference into the decision-making of business, which accompanies high degree of uncertainty and lack of predictability.

In this respect, there seems to be little benefit in distinguishing between the reform of economic and social regulations. As far as the nature of the problems of economic regulations belongs to such variety, it would entail as its integral part the strengthening of economic regulations to prevent the rent-seeking activities and moral hazard problems. The case in point may be the prudential regulations. It is exactly this course that the Korean government took in reforming financial and corporate sector regulations, which we now turn to.

Ⅲ. Competition Policy

1. Restructuring of the Corporate Sector

As briefly mentioned above, the most direct cause of the economic crisis in 1997 was the precipitous fall of foreign exchange reserves, which, in turn, was triggered by the failure of merchant banks and commercials banks to roll-over their huge short-term loans borrowed from foreign financial institutions and lent to equally heavily indebted firms, and conglomerates, in particular. It is a matter of course that this precarious financial sector needed a major surgery. What was more evident was the fact that the excessively leveraged corporate sector could not withstand the ordeal in the face of unprecedented financial crisis.

The source of the problem was that the combination of easy access to capital and implicit government guarantees of conglomerates' investments encouraged the Korean corporate to borrow heavily, leading to high debt-to-equity ratios.[23] In 1997, the average debt-to-equity ratio for corporate in manufacturing sector were 396%, compared with 154% in the U.S., and 194% in Japan. Operating in a slowing economy and unable to generate sufficient cash flow to service their short-term debts,

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23) Joh, Sung Wook(1999), *The Korean Corporate Sector: Crisis and Reform,* Korea Development Institute.

eight of the top 30 *chaebols* had effectively become insolvent by July 1997.[24]

Reflecting the debt servicing difficulties of the corporate sector, ten of Korea's 26 commercial banks posted losses in the first half of 1997. The crisis continued to snowball. By the end of October 1997, the total amount of bad loans held by suspended merchant banks amounted to 51% of their total loans. Evidently corporate failures prompted the banks to begin redeeming commercial paper discounted by merchant banks, which in turn called in their short-term loans to companies.[25]

In response, the government prepared a reform package for the financial sector, focused mainly on strengthening prudential regulation, in July and sent it to the National Assembly for the revision of the *Bank of Korea Law* and other 13 financial reform-related laws. The laws were only passed on December 29, 1997, when the Korean economy had already been hit by the crisis contagion in the region. The bureaucratic conflict between the Bank of Korea and the Ministry of Finance and Economy also delayed the process.

If belated, it was nonetheless an imperative to restructure the corporate sector, *inter alia,* conglomerates, *chaebol* in Korean, above all else. The focus was placed on converging corporate

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24) Net earnings of those companies fell 28%. Following the collapse of Hanbo Iron and Steel in January, the interest rates over the LIBOR that banks and firms had to pay in the international money market rose, albeit slightly. See Smith, op. cit., p. 77.

25) *Ibid.*

governance system to the global standard, which included auditing procedures, shareholder rights, the composition of boards of directors, access to corporate control (*e.g.*, hostile takeovers) and insolvency procedures. Debt guarantees between *chaebol* affiliates was prohibited, while encouraging companies to improve their financial structure by reducing debt. The government required the top five *chaebols* to submit their capital structure improvement plans with a threat of applying sanctions to noncompliance. As for other 58 *chaebols,* debt was restructured in the framework of workout.

In response, the top five *chaebols* and their creditor banks formulated capital structure improvement plans with a focus on reducing debt-to-equity ratios. Meanwhile the government prepared a swap of affiliates between *chaebols*, covering eight major industries, including semiconductors, aircraft, railroad vehicle, vessel engine, power generation facilities, petrochemical and oil refining industries. The so-called 'Big Deal,' a sort of forced M&A, was meant to streamline overlapping investments made by *chaebols* in those sectors, since they were met with severer trouble. After all, M&A was not yet active in Korea by that time in Korea.

Of course, concerns were raised about on the consequences of the Big Deal, undertaken by government fiat. Leaving the issue of the legitimacy and the propriety of the government's attempt at the Big Deal, given the fact that the better course to take was to let the market decide, their potential anti-competitive effects was hotly debated. In addition, there were other issues concerned with the government's liability in the future when its decisions would be found faulty, and excess capacity problem that would not go away instantly with the Big Deal.[26)] M&A of Hyundai Motors and Kia Motors is the case in point. To this controversy and the implications of this attempt we will return below.

The most significant event was the dissolution of Daewoo Group, the fourth largest *chaebol* in Korea. The bankruptcy of Daewoo Group in 1999 and its subsequent liquidation process, which was quite harsh, served as a landmark showing that no company in Korea was 'too big to fail.' Whatever the true reasons behind this decision, it is safe to say that such myth has since drifted away with the Daewoo Group.[27)]

Moreover, it was a foregone conclusion that other *chaebols* had no choice but to go along with the restructuring exercises. In 1998 alone, 17 out of the top 30 *chaebols* either went bankrupt or were forced into workout programs, and the remainder had their major subsidiaries spun off. As a result, the average debt-to-equity ratio of the survivors among the top 30 *chaebols*, which had risen sharply to 519% in 1997 from 348% in 1995, dropped precipitously to 116% in 2003. It was a remarkable achievement, indeed. As a matter of course, both the shareholders' equity ratio and the debt-to-equity ratio of corporate sector improved significantly, too. The shareholders' equity ratio in its manufacturing sector, which continued to fall

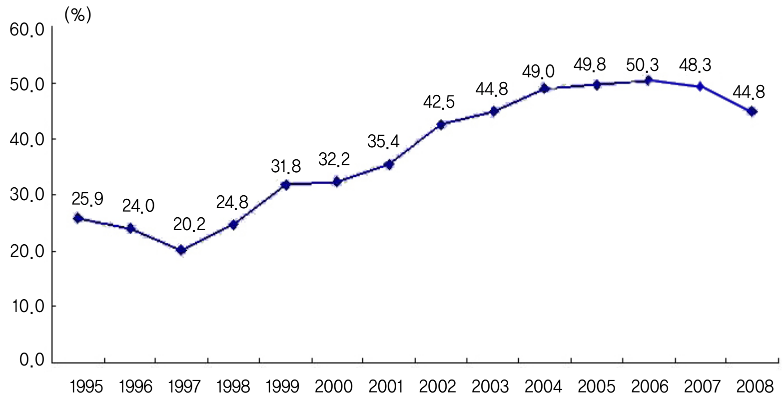
26) OECD(2009), DAF/COMP/WD15/ADD1.

27) Incidentally, the economic term 'moral hazard problem' has since become a familiar term used by the general public.

down to 20.2% in 1997, soared significantly to reach 44.8% in 2008 (see Figure 1). At the same time, the debt-to-equity ratio of the same sector fell continuously from 396% in 1997 to 215% of 1999 and then to 123% in 2008. The 181 percentage points drop made during 1997~99 was impressive (see Figure 2).

The improved financial position had strong beneficial effects. It not only helped to overcome the crisis sooner, but strengthened their international competitiveness greatly. In addition, the favorable changes in the shareholders' equity ratio and the debt-to-equity ratio were found to have increased total factor productivity in those business lines in which they were key players.[28] It can be debated whether the reduction in the

Figure 1. Shareholder's Equity Ratio, Manufacturing Sector



Source : Bank of Korea, Financial Statement Analysis, various issues.

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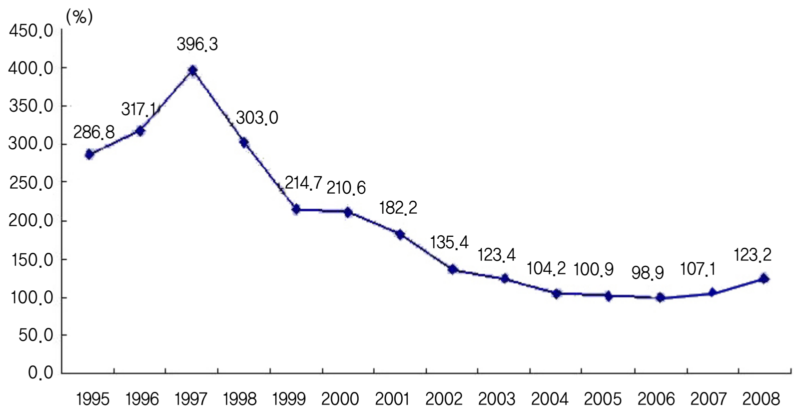
28) Kim, Won Kyu(2007), "The Effect of Industrial Restructuring Policy: Post-Financial Crisis", *KIET Industrial Economic Review,* Korea Institute for Industrial Economics & Trade, Vol. 12, No. 5.

Figure 2. Debt-to-Equity Ratio, Manufacturing Sector



Source : Bank of Korea, Financial Statement Analysis, various issues.

debt-to-equity ratio went too far so that long-term investment growth and the growth potential may have suffered from it.[29] This remains fairly uncertain. But given the fact that Korean firms, and *chaebols* in particular, had long relied more heavily on debt financing than on internal and external capital, such concern may have some ground, since the ratio of the manufacturing sector in Korea recorded 123.2% as of the end of 2008, whereas it stood at 128.2% in Japan, and 146.6% in the U.S. (see Table 1). After the dust settled, the government enacted the *Corporate Restructuring Promotion Law* in 2001, and the business restructuring gear has since been changed into a normal mode.

29) *Ibid.*

Table 1. Financial Soundness Indicators of Corporate Sector

Shareholder's Equity Ratio(%)									
	1995	1997	1998	1999	2000	2005	2008	Japan* (2008)	U.S. (2008)
All-industry	24.7	19.1	22.9	29.8	31.1	47.4	43.5	33.5	-
Manufacturing Sector	25.9	20.2	24.8	31.8	32.2	49.7	44.8	43.8	40.6
Debt-to-equity Ratio(%)									
	1995	1997	1998	1999	2000	2005	2008	Japan* (2008)	U.S. (2008)
All-industry	305.6	424.6	336.4	235.1	221.1	110.9	129.8	198.2	-
Manufacturing Sector	286.8	396.3	303.0	214.7	210.6	100.9	123.2	128.2	146.6

Source : Bank of Korea, *Financial Statement Analysis*, various issues.
Note : * End-March 2008.

Along with restructuring the corporate sector, the government embarked on privatizing public enterprises in the same spirit from July 1998, *inter alia,* in the utilities sector such as electricity, gas and telecommunications. By the end of 1999, all or part of state-owned stakes in 13 public enterprises or their subsidiaries were sold off. Compared to the previous attempt in the Kim Young-sam government, pursued mainly to replenish government revenues, it was focused more on improving the level of efficiency by making them more fully incorporated into the market system, and thereby strengthening their accountability. To ensure that privatization would not end up merely changing public monopolies into private monopolies, the Korea Fair Trade Commission (KFTC), Korea's antitrust watchdog, was called in to oversee the process.

2. Competition Policy Reform and the 'Big Deal' as an Abnormality

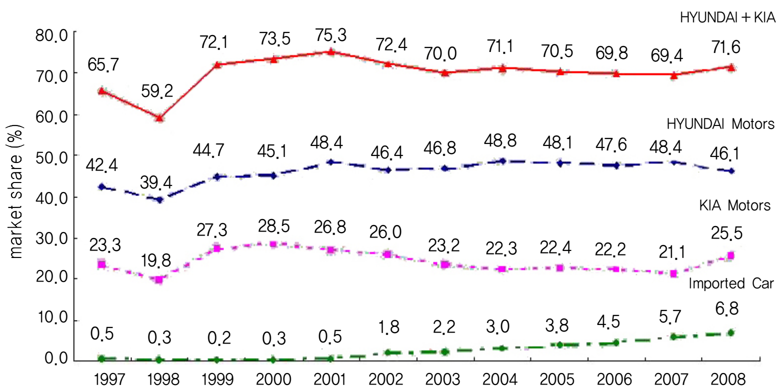
In the face of the economic crisis, the Korean government enacted the *Monopoly Regulation and Fair Trade Act (MRFTA)* in February 1999 with a view to facilitating M&As of non-viable firms. Pursuant to Article 12-4 of the Enforcement Decree of the amended *MRFTA,* mergers of failing firms could be treated exceptionally in the review process by KFTC. To this category belong the cases where the firm's production facilities are too difficult to utilize in the relevant market but for the concerned merger and/or where there is no other possibility to exist that would have less anti-competitive effects than the merger in question.

According these stipulations, the KFTC approved Hyundai Motor's acquisition in shares of Kia Motors in April 1999, because it determined the latter company as a non-viable firm. As Hyundai Motor's market share being 44.7%, while Kia Motor's 27.3%, it might as well to be assumed that some possibility of monopolization in the relevant market was open. In fact, their combined market share continued to rise from 72.1% in 1999 to 75.3% in 2001, when M&A came in vogue, reflecting the buoyant business climate at that time and the vaults of big business that had been enriched in the post-crisis period.

While this figure has since continued to fluctuate, it tended to be stabilized at the lower level, however. It stood at 72.4% in

2002, and 71.6% in 2008 (see Figure 3). It seems difficult to argue that the M&A of Hyundai Motors and Kia Motors approved in the wake of the crisis, played havoc with market competition in the short term. However, there are dissenting views that this might result in a near monopolization of the domestic auto market in the long run if changes in market share are insignificant.[30] This could lead to price increases especially in the small-size segment of the market, which is less exposed to competition from imported cars, with potential negative implications for consumer welfare.

Figure 3. Trend of the Market Share in the Korean Automobile Market



Source : Korea Automobile Manufacturers Association, *Monthly Automobile Statistics*, various issues.

30) Park, Byung Hyung & HoYoung Lee(2007), *Case Studies on the Effects of Merger Remedies.*

Of particular importance was the radical change in the KFTC's policy stance toward cartel. In fact, controversies arose around the possible justification of exempting cartel activities from competition law application in times of severe economic distress, let alone the economic crisis. Whatever the truth may be, the KFTC chose to strengthen its competition policy. It is remarkable, indeed. According to the *Package Clearing Act of Cartels,* enacted in February 1999, the KFTC outlawed (or required some supplementary actions toward) 20 cartels, which had been at work under 18 other laws, and eliminated 17 other collusive fee-setting arrangements in 9 professional services. Along with these efforts, with the intention of a clearer *per se* rule approach against horizontal price fixing, the relevant language in Article 19 of the *MRFTA* amended in February 1999 was changed from whether a restriction is 'substantial' to whether it restricts competition 'unfairly'. As cartels were thought to reduce competition inherently with in this context, since then there has been no need to carry out the market analysis of effect in particular cartel cases.[31] As such, the prohibition of horizontal cartels has been on top of the reform list in terms of competition policy.

3. Recent Developments

Since President Lee Myung-bak, once a top CEO at Hyundai, took office in February 2008, significant changes have been

31) See OECD(2007), "Korea : Progress in Implementing Regulatory Reform", *OECD Reviews of Regulatory Reform*, p.77.

made. Most prominent of them are the passage of two amendments of concerned laws in the face of opposition.

One is the elimination of the ceilings imposed on equity investments in domestic firms by big businesses including conglomerates in pre-circumscribed lines of business in March 2009. Subject to this peculiar regulation had been 31 in total. Some of them were affiliates of conglomerates with over KRW 2 trillion in terms of total asset, and others were big business group with KRW 10 trillion or more. The regulation, first introduced in 1986, had been abolished in 1998, but was reintroduced in 2001, albeit with small changes in its content. Whether the ceiling of 40% had been indeed inhibiting new investments by big businesses is not clear. Nonetheless, the big business groups accused the system on the grounds that there is no such thing in advanced countries, and that it acts in the direction of discriminating the domestic business against foreign firms. On the other hand, critics argued that it would promote economic concentration, making Korea's financial structure more vulnerable to external shocks.

Whatever the merits of each side, it is fair to say that this reform, representing the most hotly debated regulatory reform issue in Korea for a long period of time, has been made possible owing mainly to the onset of global economic crisis. How much it would contribute to bringing forth new investments, alleged to have been pent up due to the regulation, remains to be seen. Also in question is the effect of the abolition of ban on cross-affiliate investments among big business groups, given that it has been argued that it would serve as a vent for the conglomerates' renewed entrepreneurship.

The next step is the deregulation of the rules, finalized in July this year, which had prohibited outright major businesses' holding of ownership in commercial banks in Korea. This rule had been put in place in fear of concentrating economic power in the hands of a few businesses and the possibility of monopolizing bank credits.

The line distinguishing conglomerates between regulated and unregulated has been redrawn in the way to subject fewer of them to the first category by increasing the threshold from KRW 2 trillion to KRW 5 trillion in terms of their assets. It has resulted in the big drop from 79 to 41.

Pro-competitive steps have also been taken especially in such industries thus far heavily regulated as finance, broadcasting & communication, tourism, and medical care, among others. Regulations that had discriminated service industries in favor of manufacturing industries have been relaxed, too, in an effort to prevent the distortion in the investment market, among others.

4. Implications

Competition policy in Korea can now keep abreast with that of advanced countries more fully, mainly due to the current government's abolition of some of peculiar business regulations, such as the investment ceiling system, thus far imposed on big business group in the name of preventing economic concentration. As pointed out above, with the elimination of the most controversial stipulations, Korea's competition law could be enforced with far greater consistency.

In times of distress, business managers facing intense pressure to keep their business afloat tend to be more susceptible to the temptation to engage in unfair, anti-competitive, and restrictive practices or conducts. Nonetheless, the Korean government seems to succeed in disseminating the notion that, without competition, there cannot be competitiveness at all. The need for greater discipline by market forces has been understood better and more widely shared than it had been before the first economic crisis. Thanks to this change in mood, the regulatory framework to cope with economic crisis has continued to be ungraded to keep pace with new developments in OECD countries.

We believe that Korea deserves credit in this respect. We are inclined to regard the 'Big Deal' as not being commendable, since it not only took as much time as it might when it was left to market, but left legacies that were politically thorny. Leaving this episode aside, the application of competition law has been nearly impeccable. By and large, the Korean government has been successful in putting market discipline at work, and we believe, this is what has made the Korean economy more resilient and thus able to overcome the ongoing crisis earlier than expected and faster than other OECD member countries.

Recent success business stories in the midst of global economic crisis about the brilliant performance of Korea's leading companies such as Samsung(semi-conductors), Hyundai (automobiles), and LG(home appliances), among others, help boost the Korean people's self-confidence. The corollary is that they would support market-driven reforms more fully.

Finally, it should be noted that in Korea all regulatory proposals have to be reviewed or examined by the RRC, and in its review process the examination of their potential and real anti-competitive effects has been received attention. From the beginning of this year, however, the RRC has strengthened this procedure by seeking *ex ante* review by the KFTC and giving the highest preference. It means that all government regulations have come to be subject to scrutiny based on the principles of market competition. After all, the KFTC and the RRC have much in common in trying to make market more competitive and conducive to increasing efficiency in the market mechanism.

Ⅳ. Market Openness

From the macroeconomic point of view, it is certain that the prompt correction of misaligned foreign exchange rates at the incipient stage of economic crisis both in late 1997 and 2008 contributed greatly to bolstering exports, stabilizing the foreign exchange position, and restoring the credibility toward the economy's external sector's balance and stability. One may say that it was simply an imperative in view of the economy's extremely high dependence of foreign trade. It is true. But what has to be recognized is the fact that the Korean government has since the first economic crisis put significant and continuous efforts to reform the foreign trade and investment regime with a view to making the economy capable of adjusting to the global market forces more easily.

Korea's trade liberalisation process that started in the mid 1980s was slow and lagged much behind high expectations of major trading partner countries. Liberalization of foreign direct investment was weaker still, even though some liberalization measures had been taken in the process of Korea's joining the OECD in 1996. The level of market openness and institutional transparency had been relatively low compared to other developed countries, as evidenced by many complaints made by foreign governments and businesses.

In this sense, it is no surprise that the financial crisis in 1997 became a watershed in the history of Korea's trade and foreign investment policies. Although it is true that the IMF, the U.S., Japan, and other major countries brought enormous pressure to bear on Korea to move quickly in the direction of liberalizing trade and foreign direct investment, which was also the course that the Korean government should take on its own in an all-out effort to overcome the crisis and to make Korean industries sustain its competitiveness in the rapidly globalizing world market.

1. Trade and Transparency

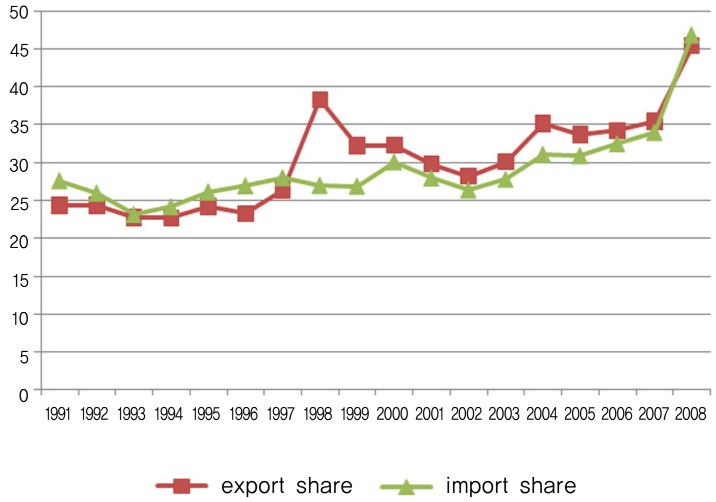
The reforms that the IMF Stand-by Agreement of 1997 required the Korean government to undertake in accordance with its commitment to the WTO were four-fold: the abolition of export-related subsidies, import licensing system, and the import diversification program, along with the increased transparency in import certification procedures. For all of these, the government implemented the requirements faithfully. After all, they were demanded due mainly to their disbelief in or dissatisfaction with the dubious intention behind those systems and the way they were operated, whether this disbelief or dissatisfaction had any real base or factual evidence, and therefore, it was understood that the faithful implementation was all the more important.

As demanded, the government abolished three export-related subsidies earlier than committed to the WTO, phased out the import diversification program swiftly in June 1999 to alleviate special concerns of Japan, also earlier than scheduled.[32] In addition, Korea Customs Service(KCS) streamlined and modernized its customs procedures to such an extent that it has later come to be praised for standing at the cutting edge of international best practice. Thanks to these efforts made over time, foreign businesses can enter the Korean market far more easily, to the benefit of enhancing consumer welfare and competition in the Korean market.

Given the fact that the steep increase in exports contributed greatly in the process of recouping from the crisis in 1998~99, it seems necessary to look at the movements of trade and export dependence. As shown in Figure 4, the share of export in GDP increased to 38.3% in 1998 from 26.4% in 1997. Evidently, the shocking rise of foreign exchange rate helped the exports greatly, indeed. It is vindicated again in the current crisis. The share of export and import reached to a historic level, 45.4%

32) In passing, it is interesting to note whether the abolition of the import diversification program, which had been accused because it was instituted to protect local electronics companies from Japan, helped Korean electronics companies such as Samsung Electronics and LG Electronics to have led the electronics market in the world in such products as LCD TV and mobile phone. In the midst of current global financial crisis, these companies gained their market shares and surprised economists by recording huge operation surplus, while Japanese rivals showing deficits. Business Week, "Why Korean Tech Firms Make Money but Japanese Tech Firms Don't", July 31, 2009.

Figure 4. Trend of Trade Dependence of Korea



Source: www.kita.org.

and 46.8% in 2008, respectively.

It is also noteworthy that Korea-Chile FTA negotiations started in December 1999, two years after the financial crisis. It was initiated by President Kim Dae-jung, who argued that era of economic diplomacy had come, and Korea should not be left outside alone in the rapidly growing web of FTA's. The reason for selecting Chile as its first FTA partner country was the judgment that it would not present as many difficulties as it would with other countries that are geographically close to Korea, or with major trading partners. If expected to proceed smoothly, though, the negotiation took a long time until it was ratified in February 2004.

It was mainly due to strong opposition and resistance of farmers, as it was seen that major imports from Chile would apparently be agricultural products. According to the bilateral commitment to concessions, Korea was to eliminate tariffs on 96.3% of its tariff lines(HS 86) within ten years. Special features included were liberalization of investments, the expansion of trade in services, and a special safeguard mechanism in anticipation of the possibility of surge in agricultural products.

The effects of the Korea-Chile FTA turned out to be much more profound that initially anticipated.[33] The most conspicuous effect has been the extremely high level of consumers' satisfaction with Chilean wine. It was significantly low-priced. As a result, its import surged by 174.2% in 2005, one year after the FTA came into force.[34] Although not as much recognized by the public as for the case of wine, imports of several agricultural products such as grape and pork jumped, too. On the other hand, Korean companies' exports also soared in a variety product lines, and mobile phone and TV, in particular. Total export to Chile has since increased at the rate of 42.4% annually on average. This favorable result helped turn the public opinion in support of FTA's decisively, clearing the way forward to negotiate more FTAs.

33) It is to be noted that the tariff rates for 391 agricultural product items were left to what would obtain through the outcome of the Doha Development Agenda.

34) Jung, Jaehwa (2006), "Analysis on Export and Import Two Years after Korea-Chile FTA", March, Symposium Memo.

Bolstered by this successful experience, the Korean government adopted a goal to become 'FTA hub' as its major trade strategy. By August 2009, effective FTAs are with Chile, Singapore and ASEAN. FTAs with U.S., EU and India are ready for National Assembly's ratification. FTAs with Canada, Mexico, New Zealand, Australia, Peru and GCC are under negotiation, while joint studies are going on with other countries such as China and Japan. The share of Korea's trade with the FTA partner countries in Korea's total trade in 2008 has risen to 12.1%, next to the U.S.(34.0%) and China(19.7%). When the FTA's with the U.S., EU, and India come into force, the trade share will increase sharply to 35.3%.[35)]

In addition, due to diverse commitments made in relation to FTAs, the Korean market will become more open and transparent. It is noteworthy that even tariff and non-tariff barriers to sensitive products are committed to be reduced or phased out. Openness of Korean Market, in fact, goes beyond what can be observed in the WTO MFN tariff rate or those bounded in the GATS.[36)]

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35) Ministry of Strategy and Finance, Press Releases, 22 July 2009.

36) The simple average MFN rate of Korea was 12.8% in 2008 with 91.5% tariff lines bounded. Average tariff varies significantly across and with sectors, especially high tariff in agriculture products. In regard to market openness, it is not the average tariff rate, not that high compared with other countries though, that matters but severe protection by tariff peaks mainly in agriculture products, which is not easy to be reduced on the political grounds, as easily observed in other countries. This difficulty is one reason, among others, why Korea government has

Presently, the ratification of Korea-U.S. FTA is pending, while negotiations with China and Japan are at the incipient stage. The impact of FTA with Korea's neighbor countries is estimated to be profound. Currently, they are in delay for political reasons. If successfully concluded, they would place Korea as the front runner in the rush toward FTA's these days.

With respect to transparency, Korean government achieved significant outcome, in addition to what has been mentioned above. It has implemented polices to enhance transparency actively by streamlining and improving the standardization and certification system. Korea's system of standards and conformity certification procedures has once cumbersome, generating many complaints from many of its trading partners. The foundation has been set since the *Basic Act on National Standardization* was enacted in 1999. It shows that Korea is fully committed to bring the procedures related to the conformity with international standards. For this purpose, Korean government has been encouraging negotiations to reach mutual recognition agreements (MRA's) with trading partners. The Korean Agency for Technology and Standards, a national standardization agency affiliated to Ministry of Knowledge Economy, now has approved MRAs with 44 accredited bodies of 35 countries.

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vehemently pursued FTA strategy as a way for further market openness. Currently, Korea maintains import of only one product, rice, to quantitative restrictions, while tariff quotas for beef were replaced by a tariff from January 2001. See WTO, *Trade Policy Review-Republic of Korea*, WT/TPR/S204, September 2008.

2. Capital Flow

Despite ample evidence on the benefits of integration of local financial markets into international markets, Korea had maintained extensive controls on international capital flows until it joined the OECD. Korea's plan to liberalize capital flows failed to go a long way toward it until the onset of the 1997 financial crisis.[37] It was only after the crisis that Korean government accelerated the reform of foreign direct investment regime, with a view to rebuilding the foreign exchange in shortage and securing the fund needed for economic reforms.

In fact, the liberalisation of international capital flow constituted one of the key elements in the IMF reform package. It forced the Korean government to expand the ceiling imposed on equity investment by foreigners, to allow foreigners to buy shares of Korean banks, to remove the restrictions on short-term financial products and investment in the domestic bond market, to streamline the procedures to be applied to FDI, and to allow borrowing of domestic firms from abroad.

In response, the Korean government promulgated the *Foreign Investment Promotion Act* (effective as of November 1998). It represented the Korean government's resolute policy turnaround—from control and regulation to promotion and

37) Noland, Marcus(2005), *South Korea's Experience with International Capital Flows*, 21 January 2005, p.17.

support.[38] Foreign participation in hostile M&A and land acquisition by foreigners, among others, were of the highest symbolic value, since both measures had been considered to be the last measures that Korea would take. It is needless to say that more industry lines have been open to foreign investment. With 24 industries being partially liberalized and 4 industries being wholly shut out of 1,058 industries, the liberalization rate of FDI soared to 99.6% as of April 2000 from 90.7% in 1995. As of 2008, only three sectors — television and radio broadcasting, and nuclear power generation — are fully closed to foreign investors and 26 sectors are partially restricted out of 1,083 business lines.

It is no wonder that this policy turnaround greatly stimulated the inflow of FDI. It jumped to USD 5.3 billion in 1998 and USD 10.0 billion in 1999, which amounted to 1.54% and 2.25% of GDP, respectively. The sharp increase in FDI inflow also contributed greatly to rebuilding foreign exchange reserve, supporting Korean companies' restructuring process.

Of particular importance was another turnaround in the public's attitude toward foreign capital. The experience of job saving and/or income increase in the companies acquired by foreign investors played an instrumental role in bringing about

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38) This can be clearly seen in the name of the new law of FDI. It was the first time that the word 'promotion' replaced the term 'introduction', used in the old FDI law, *Foreign Capital Introduction Act*.

this change. Little did they think that foreign investors would provide them with jobs that the local companies could not. Even those who first accepted FDI policy perforce eventually came to believe in the benefits of FDI.

Other related changes include the establishment of the 'ombudsman office' in October 1999 to address the grievance of foreign investors, designation of Free Economic Zones (3 zones in 2003, and additional 3 zones in 2008), the continued improvement of business environment and living conditions for foreign investors in residence, and the continuous expansion of a variety of incentives to foreign investors including cash grants.

As such, Korea has come a long way toward full liberalization of capital flows. In the face of the current crisis, which once again led Korea to face disturbances in external sector, Korean government has stepped up the ongoing liberalization process. A greater emphasis has been put on expanding incentives, and on improving business environments and living conditions for foreign investors and their families. The PCNC,[39] for example, has decided in May 2009 to ease eligibility restrictions further and increase the amount of cash grants, and to establish the semi-cabinet-level FDI Promotion Committee, in which representatives of foreign investors and investor groups participate.

39) Among the PCNC's members, there are four foreigners, most of them have direct or indirect relations with their countries' Chamber of Commerce and Industry in Korea.

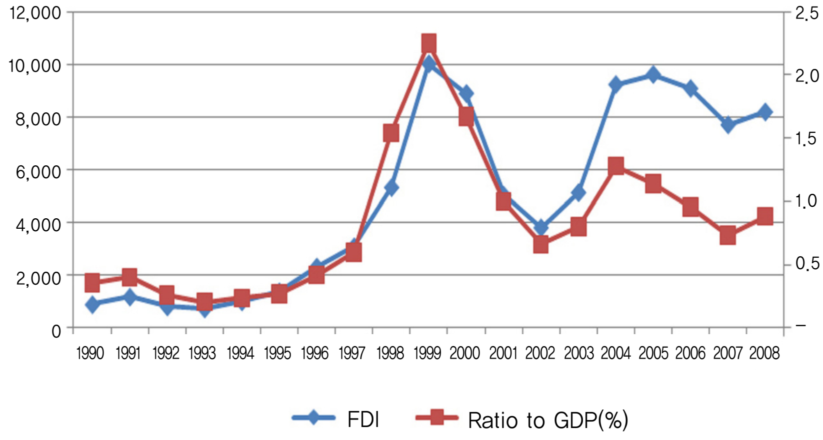
Owing to these continued efforts and eagerness to improve Korean FDI environment, the FDI inflows have shown a sign of stabilizing at the level of around USD 10 billion annually. In addition, it is notable that while the increase of capital inflow in 1999 and 2000 was caused by foreign minority partners' buying binge of Korean companies, thus its nature being 'temporary',[40] the recent inflow of FDI tends to partake of the longer-term nature.[41] This stability owes partly to the government efforts keenly interested in maintaining credibility of foreign direct investors.

If we turn to portfolio investment, the picture is quite different. It has proved that there are two aspects. In one aspect, it constitutes a significant source of crisis, in the other, a contributing factor speeding up the recovery from the crisis. The financial crisis in 1997 led initially to a sharp depreciation of Korea's currency(Won), triggered by massive foreign capital outflows. In response to deprecation, started from 16 December 1997, Korea shifted from a managed to a free floating exchange

40) Noland, Marcus(2005), "South Korea's Experience with International Capital Flows", 21 January 2005

41) The statistics for FDI, quoted in this paper and reported by MKE, is expressed by the amount on the arrival basis, which thus exclude retreats. On the other hand, Bank of Korea reports FDI statistics including retreats which appear on the balance of payments. The gaps between the two have been large in 2006, 2007 and 2008. Most of recent retreats are related with foreign investors' selling of foreign invested companies mainly to realize investment profits, one example of which being Phillip's sell of LG Display co. Ltd. shares in the stock market.

Figure 5. Trend of FDI in Korea



Note : The statistics of FDI is on the arrival basis.

rate system, allowing the exchange rate of the won to be determined by changes in supply and demand in the market. As restrictions on foreign investment on Korean equities had been lifted,[42] and domestic bond and money markets were opened to foreigners through a series of liberalization measures during 1997~98, Korea's equity market has become more fully integrated to all kinds of markets abroad.[43] Furthermore, with the enforcement of *Foreign Exchange Transaction Act(FETA)*, enacted in April 1999, the movement of capital across borders has been facilitated. Korea pursued liberalization of all foreign exchange transactions partly to be in line with a new free floating system and market openness in the real sectors.

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42) Ceilings on purchases of Korean stocks remain for some companies, such as KT telecom and KEPCO.

43) Noland, Marcus(2005), "South Korea's Experience with International Capital Flows", 21 January 2005

Pursuant to this new Law, adhered to the negative list system, virtually all the current account transactions have been liberalized. In addition, since 2001, all foreign exchange transactions except those related to international peace and public safety have been liberalized. This gradual approach has been evaluated as helpful in enhancing the efficiency of foreign exchange market, while transactions attracted by those measures tending to cause fluctuations in foreign exchange rate.[44] Now the Korean government is planning to liberalize the capital account completely by the end of 2009.[45]

As such, liberalized markets arguably helped foreign portfolio investors return, albeit slowly, thereby contributed to stabilizing the financial markets in the process of recovery. It has been true for both crises. The foreign portfolio investment recorded a net outflow of USD 1.7 billion for the fourth quarter of 1997 and USD 35.3 billion for the second half of 2008, but they returned, if slowly. What matters is the pace of moving in and out.

As it did before, in this crisis, the massive outflow of portfolio investors provoked sharp depreciation of Korea's currency(Won), in stark contrast to the situations in neighboring countries, shaking the crisis mentality further. Of course, this massive outflow was provoked due mainly to doubts about the stability

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44) KIEP(2001), *Foreign Exchange Market Liberalization; The case of Korea.*

45) WTO(2008), WT/TPR/S204

of financial institutions, in particular, the banks, as it had been the case before. Whether the doubt is well-founded or not, it only reiterates the absolute importance of transparency and the level of trust in the supervisory system.[46]

3. Implications

Admittedly, market openness has two sides. On the one side, market openness is the powerful source of growth. It is conducive to increasing efficiency in resource allocation, raising productivity,[47] and enhancing consumer welfare. On the other side, it exposes the economy to all kinds of political and market vagaries, disturbances, and fluctuations. Which way to go is always a really difficult choice to make. Curiously enough, Korea's choice has tended to be made belatedly, despite the fact that it has had no other viable option than to make the best use of the open world market.

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46) Currently Korea government, by forming a committee, has been working on the improvement of financial supervision system.

47) It is estimated that 1% increase in trade dependence rate raised total factor productivity by 0.3% during 1970-2005 in Korea. See Kim, Won kyu(2006), "Market Openness and Productivity", *e-KIET Industrial Economic Information*, September 2006. Another study showed that the increase in import and FDI in Korea contributed to enhancing total factor productivity with larger effects in manufacturing sector than in service sector, and the enhancing effect in the group of industries with more import and FDI is larger than the one in the other group of industries. See Lee and Kim (2003), "The effects of Opening Market on Productivity", *The Bank of Korea Monthly Bulletin*, March 2003.

Fortunately, however, the opening of the economy, whether forced or voluntarily pursued, has invariably brought large benefits with it, surpassing its expectations. Both crises are no exception to this rule. The crisis has come from outside, and the crisis in turn has provided the strongest impetus for the reform of trade and investment regimes, which would not have been made available, and with successful reforms the economy has revived fast once and again.

Given the fact that especially in times of distress, these regimes tend to be regressing, it is remarkable that Korea has invariably embraced the free trade and investment regime wholeheartedly. In the first economic crisis in 1997, there was no other viable option than to be faithful to the demands of the IMF and major players in the world market. The case with the current crisis is different. As mentioned above, it was the Korean President who warned against the temptation to rely easily on protectionist policy at the G20 summit.

What has made him outspoken was the Korean people's support in his initiative. It represents a sea of change in the context of Korean trade politics. What he counted on was probably this change in the political landscape. Apart from big business that fared best in the post-crisis periods, most of the Korean people have now come to understand and realize the real benefits of market openness. From their point of view, it not only helped to restore economic stability, growth, and the international competitiveness of Korean firms, but also made available for them all sorts of favored consumer products represented best by Chilean wine. It has not been conceivable to see the market share of imported cars reach as high as 6.04% in 2008, a big leap from 0.42% in 2000.[48)]

This remarkable change in attitude guarantees that their political support would not go away or backward easily.[49)] Rather, it would serve as a strong political force requiring and making the fuller integration of Korean economy to the global economy possible.

The best lesson that Korea has learned from the crisis seems to be the respect for credibility. They now understand its importance well. Moreover, they have learned what makes the credibility go up or down. For example, they understand that in the globalized world, transparency, abstention from discriminatory impulse, and credit rating, among others, are all increasingly important elements. Korean people have begun to join the global economy wholeheartedly. And this change owes greatly to

48) Sales of foreign invested companies, such as GM Daewoo, Samsung Renault and Ssangyong motor companies are not included in the imported cars.
49) Since Sovereign Asset Management threatened to take-over SK in 2003, the negative perception of foreign capital arose again. High yields have also led to a widespread concern over the nature of speculative foreign capital. Companies invested by foreign investment banks and private equity funds such as New Bridge Capital, Lone Star Funds, Sovereign Asset Management are prime examples of high return. Criticism on the speculative foreign capital was highlighted by disputes on the legality of Lone Star Funds' acquisition of Korea Foreign Exchange Bank.

the self-confidence restored and earned from fairly successful experiences of overcoming the crisis, whether it was its own creation or forced from outside.

Ⅴ. Conclusion

In hindsight, the first economic crisis, in which the Korean economy was driven to a corner and left with no other viable option than to call the IMF in, was indeed a blessing in disguise. Of course, the business and the people had to suffer much pain and hardship that the extraordinarily radical and harsh structural restructuring and adjustment accompanied in the short run. However, the painful experience helped the Korean government, business, and the people alike to face and respond to the current global economic crisis with composure and a certain level of confidence in its ability to overcome it. Underlying this confidence and ability is, no doubt, the fairly successful structural reforms pursued continually since the first economic crisis, although the impetus for reform was at times slowed down.

As analyzed by The Economist so pointedly, the Korean economy's "astonishing rebound" would not have been made possible if its financial and corporate sectors had remained in such a weak and precarious situation as it did in 1997.[50] In

50) The Economist pointed out that relatively low private-sector debt made firms (as well as households) more likely to spend government handouts under the expansionary fiscal policy framework to cope with the crisis. See "An astonishing rebound," and "Briefing: Emerging Asian economies". *The Economist*, August 15, 2009.

other words, if Korea somehow had managed to get away with such reforms then and, as a result, the financial and corporate sector had remained fraught with all kinds of fragility and vulnerability, it is certain that the Korean government, in the face of the current global economic crisis, would have been pressed hard to a far greater extent than it has been to put them in order before and above all else.

Indeed, in the face of the current economic crisis, however, the Korean government has instead taken expansionary countermeasures both in terms of fiscal and monetary policy, along with reinforced social safety nets. It is remarkable that, in light of the global nature of the current crisis, President Lee Myung-bak pressed hard at the G20 summit conference, for example, that all the advanced countries go hand in hand to undertake such economic policy direction and keep away from protectionist impulse at least however severe it may become. This is a clear evidence for Korean government's confidence in its ability to recover from the economic crisis only if the global economy would not be plunged into deep recession by the short-sightedness of major countries as it had been widely manifested in the 1930s. Needless to say, what has made President Lee stand up squarely before the unprecedented global financial crisis and speak up is the state of health and resilience of Korean economy laid down fairly firmly through the painful process of structural restructuring and reform undertaken in the midst and aftermath of the crisis.

It is certain that Korea learned an invaluable lesson from the first economic crisis, and rightly. What had led Korea to pursue earnestly and painstakingly such a harsh and radical reform package was the strict but priceless lesson that the era of the government-led economic development and growth had come to a close. The time had come to let the market forces put to work as fully as possible, while having the private sector bear full responsibility for their decisions and outcomes. In the minds of most of Korean people, competition, market openness, and innovation rather than government's direction and interference, protection, and assistance were upheld as the right solution for continued and stable economic growth and the effective antidote to political-economic rent-seeking activities and corruption, pervasive moral hazards problems, and illegitimate redistribution of social costs and burdens resulting from faulty meddling by the government with the business.

As illustrated in this case study, most of the reform and restructuring attempts in Korea thus far have been made generally in accordance with market principles. Of course, although there have been some exceptions here and there, the fact that Korea really learned the important lesson from the economic crisis remains unmistakable, however. In the current crisis, the Korean government has abstained itself from any kind of political and bureaucratic intervention.

Warren Buffet is quoted to have said that "It's only when the tide goes out that you learn who's been swimming naked." The current crisis once again exposed what there remained still as weak points in the Korean economy despite the structural reforms undertaken continually thus far. Some parts of the financial sector and the capital market have earlier been left adrift for a while at the mercy of foreign lenders and credit-rating companies, whose judgment was proved faulty. Certainly the government mentioned and reiterated the need for and the importance of a further restructuring of financial and corporate sector as to, for example, the shipbuilding, sea freight, and construction industries. But the government has issued no specific plan or directives, leaving the problems to be solved by the private hands.

It represents nothing but a warning and a strong signal that the government would not intervene as it did over decades. What is left moot is that it is a matter for the private business and the financial institutions concerned to solve for themselves. The government's stance not to intervene in the recent Ssangyong Motor Co.'s plant takeover is a case in point, which stands in stark contrast to the case of Kia Motors Co. in 1997.

This remarkable change of attitude of the government, we believe, would serve as a living lesson for the public that the market-driven reform is indeed legitimate in the sense that it leaves no space for political or bureaucratic favoritism whatsoever. Regulatory reform, competition policy, or market openness reforms have been undertaken basically in accordance with market principles, ruling out the possibility to favor big business at the cost of small and medium-sized business sector or the public at large, contributing greatly to upholding the legitimacy of such reforms.

It is no surprise, therefore, that the level of consciousness of the general public has been changing quite speedily in the direction of favoring and supporting the market-driven or market-oriented reforms. The fact that the government has faced no or little significant protest or opposition to the conclusion or negotiation of FTA's appears to attest this. Now, in Korea, expensive foreign imported cars are not hard to see around on the streets, drivers of which seem to feel no threat from doing so as before.

It is not a small achievement, given Korea's economic history. What has made this remarkable change possible in a short span of time? This study concludes that this is the result of a virtuous circle of legitimate reform. As stressed in the section on regulatory reform, the existence and the performance of the RRC should be noted again here. There has never been a time when the business — either big or small — has praised the achievement of the RRC and the government ministries at large. They have continued to mount complaints and grievances that the progress that has been made is far from satisfactory.

Often the strength of complaints tends to be understood as indicating the failure of the regulatory reform process. By contrast, we claim that this is the prime motor of reform in Korea, because it is such complaint that serves as the most important and powerful political base from which the RRC could step up its reform efforts, generating the next round of complaints of higher degree necessitating the upgraded answers. A virtuous circle is at work, indeed, quite nicely in the political economy and the continuously democratizing governance system in Korea. “What are the best practices?” or “What is the global standard?” is the question most people in business as well as the government are asking and looking for.[51)]

51) Incidentally, the local autonomy system reestablished since 1993 appears to have contributed considerably to this change in attitude, which is another matter we have no space here to touch upon.

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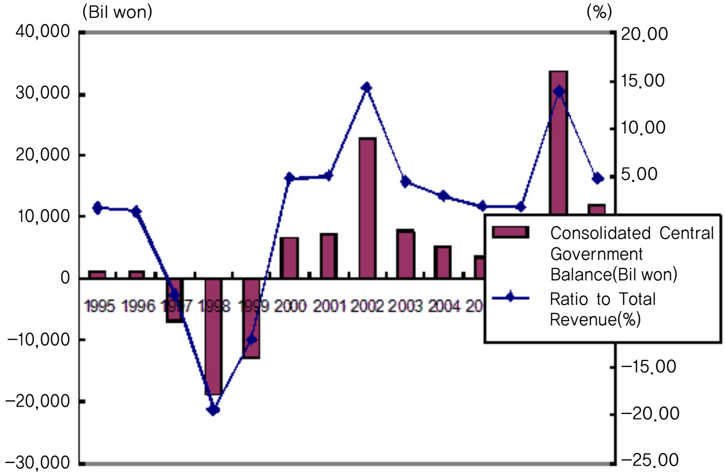
Appendix

Figure A1.1. The Korean Government's Balance



Representative Examples of Regulations Reformed by "Bundles"
(Regulations related to …)

2004

Constructing Productions Facilities
Constructing Golf Courses
Large Scale Distribution Stores
Traditional Market Modernization

2005

University Administration
Airline Industries
Creativity in Culture and Arts
Private SOC Investments
Surface Freight Transportation

On-the-Job Training
e-Commerce
Tourism and Leisure Industries
Software Industries

2006
Small and Medium-Sized Companies in the Industrial Complexes
Higher Education Institutions
Taxation Procedures
Supervision of Financial Institutions
Use and Reuse of Industrial Wastes

2007
Improving the Competitiveness of Financial Industries
Food Safety
Assistance to Small Merchants
Discrimination against Foreign Business and People

2008~09(by the PCNC)
Operation of Industrial Complexes
Investigation of Cultural Treasures
Administrative Penalties
Utilization of Lands
Competitiveness of Tourist Industries
Upgrading of Construction Industries
Upgrading of Traffic Signal System
Various Charges and Levies for Regulatory Purposes
Traditional Liquor Industries