INSTITUTIONAL REFORM IN JAPAN AND KOREA: WHY THE DIFFERENCE?

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> The reality of a political-economic system is never known to anyone, but humans do construct elaborate beliefs about the nature of that reality—beliefs that are both a positive model of the way the system works and a normative model of how it should work.

Douglass C. North (1999, p.10)

> The theorists of "the end of ideology" and "the end of history" forget all this. For them, we have reached the point in time where no ideology is relevant and no utopia is pertinent. We have reached the final equilibrium of capitalist liberal democracy, and no learning or discovery [are] possible.

Geoffrey M. Hodgson (1999, p.9)

1. Introduction

Why has Japan been unable to carry out economic reforms—reforms that many astute observers of the Japanese political economy now think are needed? The answer commonly offered by many of those observers is that opposition by powerful interest groups has blocked reforms from taking place. For instance, according to Yamazawa (forthcoming), the farmers, construction companies, banks, and small and medium-sized enterprises and the LDP they support have formed an effective coalition against institutional reform. For Sato (2002) it is the "triad of elite bureaucracy, political parties, and big business" that has "been dragging their feet, [thus] stalling deregulation to protect their own interests"(p.234). While there may be disagreement as to exactly who these powerful groups are, there is no dispute over the reason why Japan has not been able to carry out economic reforms: That is, but for the opposition by powerful interest groups Japan would have carried out the necessary reforms and would have recovered from the economic malaise that has lasted since 1990.[1]

While agreeing with the view that Japan's powerful interest groups have blocked the necessary economic reforms from taking place, La Croix (2002) finds nothing extraordinary about its laggardly response to crisis, as rich countries such as Japan are typically slow in responding to crisis. Pointing out that it took ten years for New Zealand and two decades for Switzerland to carry out their respective reforms, he offers three reasons why such rich countries are slow in changing their institutions in response to a crisis: first, people in rich countries can afford to wait; second, institutions by their own nature cannot be too pliant; and third, policymakers in rich countries believe that they are already carrying out the right policies and are not, therefore, inclined to carry out extensive reforms.[2]

If La Croix is correct, Japan will eventually undertake economic restructuring such as corporate downsizing and solving the nonperforming loan problems. Indeed, since the 1970s Japan has been deregulating a number of industries such as domestic airlines, telecommunications, electricity, and retail business although deregulation has been limited by and large to reforming and liberalizing existing regulatory regimes (La Croix and Mak 2001). Such deregulation or restructuring may not be enough, however, to restore Japan's economic health, as it has been made in a piecemeal manner out of fear and necessity and not as part of "overall understanding of the causes of Japan's current difficulties and a uniquely Japanese solution" (Porter *et al*. 2000, p.187). Such a solution may require, as Lincoln (2001) has observed, a systemic change in Japanese society—a change in the "basic rules and practices that constitute the architecture for economic behavior" (pp.6-7). The prospects for such a change are not good, however, as long as there is a strong consensus among the Japanese that their current system conforms to what they believe to be "broader social norms and expectations, representing values that society is loath to lose" (p.8).[3]

South Korea (henceforth Korea), in contrast with Japan, undertook major economic reforms soon after the 1997-98 crisis. The speedy pace of the reforms may have been due to the fact that Korea is not a rich country and was suffering from a severe economic crisis rather than an economic malaise. This may suffice in explaining the difference in reform experience between the two countries. I, however, argue that there is an additional, rather critical, factor that accounts for the difference: that is, for a country to change its institutions it, at least those advocating the change, must have a model of institutions that they and the society at large can accept as superior to the extant institutions. I argue that Japan has yet to find such a model whereas Korea has had one since the early 1980s.

As is well known, Japan has gone through two major institutional reforms in its modern history—the Meiji Reform of 1868 and the post-WWII reform. The model for the first was many of the institutions in the West, as the term "westernization" then used to describe the reform clearly suggests (Fairbank, Reischauer and Craig 1965). The second was imposed by the Supreme Command for the Allied Powers (SCAP) and was patterned after many American institutions (Dower 1999). In those two earlier cases Japan was compelled to reform its institutions by outside forces and had definite models to follow. This time the situation is different: given that Japan has successfully caught up with the West with a political-economic system that is often claimed to be uniquely Japanese, many in Japan, even those who advocate a systemic reform, lack a clear vision or a model for institutional reform.[4]

Korea was in an economic crisis in 1997-98 and was forced to carry out major institutional reforms. But even before the crisis, there was a strong move to establish a liberal economic order, a move pushed and supported by many in academia and officialdom as well as by the *chaebols*, the large family-owned conglomerates in Korea. In fact, the only group opposed to reform was government bureaucrats who had much to lose with the establishment of a liberal market economy. Many of the reforms undertaken since the early 1980s—mostly deregulation—may have been done "incorrectly," thus planting the seeds for the 1997-98 crisis, but there was nevertheless no dispute over the reforms' ultimate goal—the establishment of a liberal market economy in Korea. That is, there was no ideological homage to the system of political economy introduced by the military government in 1961, and there rarely was, as far as I am aware of, the idea that the system was deeply rooted in Korean culture and tradition.[5] Rather, the change away from that system, which Amsden (1994) calls the Japanese-German late-industrialization model, was extensive enough to prompt her to say that Korea was becoming "Anglo-Saxonized"—a move, she claims, championed by "American-trained Korean economists." What the crisis of 1997-98 did was to provide an impetus for speeding up the pace of the reform that had been in progress in Korea since the early 1980s.

In the following section I argue that although there are signs of change the view that Japan's political economy is unique, deeply rooted in its culture and tradition and whatever may replace it will also have to be compatible with the cultural heritage is still widely held. It would not be surprising if finding such a system took longer, there being no model to follow, than adopting a ready-made system from abroad even if there were no opposition to reform by powerful interest groups.[6] To put it differently, Japan is now in a *paradigmatic crisis*, a crisis in the beliefs held by many Japanese about their own political-economic system, and is in need of finding an alternative paradigm that the people can accept—a process that inevitably takes a long time.[7] We should note that this is not the first time Japan has encountered such a crisis and it was at times of such crises that major systemic institutional reforms took place in Japan.

According to Harumi Befu (1993), Japan's national policies and institutions are predicated upon its national identity that is encapsulated in *Nihonjinron*—a "broadly based ideological stance for Japan's nationalism." He divides Japan's modern history into the following five distinct periods of *Nihonjinron*, which has alternated between "unqualified ethnocentrism, extolling Japan's cultural genius" and "depressed soul-searching." The first half of the 19^{th} century was a period of strong positive *Nihonjinron* with China as the inferior reference group; the second half of the 19^{th} century through the 1920s a period of strong negative *Nihonjinron* with the West as the superior reference group; the 1930s to 1945 a period of strong positive *Nihonjinron* with the admiration of the West suppressed; 1945 through the 1960s a period of strong negative *Nihonjinron* with admiration and envy of the West; and the 1970s to the time of the publication of Befu's book (circa 1993) a period of strong positive *Nihonjinron* with admiration and envy of the West giving way to disrespect. Looking at these five periods, we see, not surprisingly, that systemic institutional reforms took place in Japan only during the periods of strong negative *Nihonjinron.* Those are the periods when the institutions once held up by the Japanese as the "epitome of virtue and goodness" became to be regarded as the "curse of the nation."

If institutional reforms in Japan take place only during a period of strong negative *Nihonjinron,* there will have to be a change from positive *Nihonjinron* to a negative one before they are undertaken. If this is correct, the current paradigmatic crisis will have to lead to a change in national identity before reforms can take place. The economic malaise that seems to defy all attempts at cure and China's emergence as a major economic power may prompt this change, but when and how soon that will happen remain an open question.[8]

In sections 3 and 4, I discuss the reform experience of Korea where, unlike in Japan, the idea that its political economy is unique and deeply rooted in its culture and tradition is not widely shared. Very few have argued that the political-economic system that was established by the military government in the 1960s is based on its culture and tradition, and when changes took place in that system there were few ideological oppositions voiced against adopting institutions from abroad. In other words, in 1997-98 Korea was in an economic, not a paradigmatic, crisis and, consequently, its institutional reforms did not require a change in the paradigm that people in Korea held about their political-economic system. Thus, reforms came about more rapidly in Korea than in Japan. The paper ends with some concluding remarks.

2. After Catch-Up, What Now?

> Unless material wealth can successfully be turned into a sense of national identity and mental well-being, the Japanese will find themselves in a perpetual catch-up syndrome, always in a state of restlessness and mental hunger. It is about time that we take stock of our situation, live our lives at our own pace, and form our policies accordingly.
>
> Sakakibara (1993, p.11)

> Second, the difficulty in achieving reform is not limited to resistance grounded in distributional conflict. The difficulty in changing enduring expectations brought about by cognitive and ideological factors exacerbates the problems of social reform.
>
> Knight (1992, p. 213)

Ideologies are, to quote Denzau and North (1994, p. 4), "the shared framework of mental models that groups of individuals possess that provide both an interpretation of the environment and a prescription as to how that environment should be structured." As such, ideologies have a powerful influence on the institutional reform a country may choose to carry out.[9] In this section I argue that many in Japan share the ideology that Japan's political-economic system is unique, based on their culture and tradition, and that that ideology constrains the prospective institutional reform in Japan. To put it differently, Japan will be following a course of reform different from that of other reforming countries, such as the former republics of the Soviet Union, where reforms are based on the ideas of *technopols*—the highly trained social scientists brought into a position of political influence by a crisis—that are "usually based on the Anglo-Saxon economic tradition and consistent with the views of the multilateral institutions" (Edwards 2001, p.16).

The conventional wisdom that Japan has not been able to carry out institutional reforms because of the opposition by powerful interest groups is based on the assumption that although a majority of people in Japan realize that they will benefit from institutional reforms they are unable to organize and overcome the opposition due to the collective action problem à la Olson (1971). I argue here that this is a flawed assumption based on the notion that those who are not members of powerful interest groups believe that the extant system only serve the interest groups and a reformed system—one similar to the Anglo-American system—will provide them with greater benefits. The fact of the matter is that although doubts about it appear to be growing in recent years, a view still widely held among government officials, businessmen, and Japanese academics is that the nation's political economic system is a successful institution, superior to those of western nations, as it has helped their country to catch up with the West with material benefits shared widely and equitably within the nation (Lincoln 2001, p.202). This view may be only an illusion but then, as North (1999) points out, the reality of a political-economic system is never known to anyone and it is the beliefs, whether correct or not, about the nature of that reality that guide people in their action.

In their summary of reform histories of 13 countries, ranging from Australia to Turkey, Williamson and Haggard (1994) argue that during the 1980s there occurred a profound change in the intellectual climate in the West toward what is now commonly called neoliberalism and that its spread to those countries had a powerful influence in their reform of economic policies. This observation has two points relevant to our discussion here. One is that reforming a political economic system is not simply a matter of overcoming opposition by powerful interest groups; it also requires a change in the intellectual climate or paradigm of the system.[10] The other is that in Japan, a country that regards its political economic system as unique, a change in intellectual climate has yet to take place.

The Japanese political economy, especially the one introduced after WWII, has been given such names as "nonliberal capitalism," "developmentalism," "non-capitalistic market economy," "mixed economy à la Japonaise," "Japanese capitalism," and "Japanese-style capitalism" to differentiate it from the Anglo-

American capitalism. Nonliberal capitalism, which Streeck and Yamamura (2001, p.6) argue characterizes the German and Japanese economies, is a system of political economy where "various forms of hierarchical and organizational coordination that sometimes require heavy injections of public authority" are used with "vertical control or horizontal collective bargaining often overriding contractual exchanges as entered into by private agents on their own volition, discretion, and calculation." Developmentalism is, as defined by Murakami (1996, pp.145-6), an "economic system that takes a system of private property rights and a market economy (or in other words, capitalism) as its basic framework, but that makes its main objective the achievement of industrialization (or a continuing growth in per capita product), and, insofar as it is useful in achieving this objective, approves government intervention in the market from a long-term perspective."[11]

The fact that the Japanese economic system is given various names to differentiate it from the Anglo-American system does not necessarily mean that it is truly different.[12] Likewise, the fact that Japan used industrial policy to hasten economic growth in the post-WWII era and has in fact succeeded in catching up with the advanced industrial countries of the West does not prove that it was effective.[13] These issues, however important they may be, are of no concern here. What we are interested in is rather the reasons for the labels given to differentiate the Japanese political economy from the Anglo-American system and the reasons why industrial policy is said to have been effective in Japan, as they provide us with an insight into why reforms have been slow in taking place in Japan.

According to Okimoto (1989), the main contribution that industrial policy made to Japan's economic success was the promotion of communication and consensual policy making between government and business and the strengthening of public-private policy networks.[14] These networks are based, he argues, on long-term obligatory and affective ties and have given Japan's political economy extraordinary flexibility, which contributed to its catching up with the more advanced industrialized countries of the West in a short span of time.

Japan's policy networks are based, according to Okimoto, on ascriptive relations such as marital and kinship relations (*keibatsu*), the common place of origin, contact through mutual friends, school ties (*gakubatsu*), and on functional ties that emerge from friendships developed in the course of government-industry contact, participation in informal study groups, and *amakudari* networks. As he put it, these public-private policy networks are an exemplary case of the "fusion" of what is normally regarded as mutually exclusive opposites in the West—market and organization, public and private, and formal and informal. And, this fusion is a notable characteristic of government-business relations in Japan and a by-product of Japan's deep-rooted socio-cultural values, which give "distinctive shape and life to the institutions of Japanese capitalism" (Okimoto 1989, p.237).[15]

It is clear that by "Japanese capitalism" Okimoto means that because of its unique socio-cultural values Japan's political economy is different from that of the West. Morishima (1982) is more specific about the reasons for the difference: the "Western-style" capitalism is based on a "rational religion aimed at emancipating the individual" whereas the "Japanese-style" capitalism is rooted in a "religion aimed at justifying the status quo" (p.197).

Murakami and Rohlen (1992) also argue that Japan's political economy is different from that of the West. They point out that policy networks, which were critical for the effectiveness of Japan's industrial policy in promoting economic growth, are based on social exchange between government and business—a mode of exchange that entails long-term unspecified obligations on the part of participants.[16] This social exchange is, they argue, what has made Japanese businesses comply with the government's administrative guidance even when there are no statutes compelling them to do so. There is the "implicit give-and-take operating in a long-term framework in which both government and private firms get what they want—that is, a social exchange framework." Such a framework is necessarily exclusive in nature with benefits and obligations of social exchange (and security thus provided) limited to the select participants.

Cognizant of the changes in Japan's political economy in the late 1980s, Murakami (1987) pointed out that the catch-up model that Japan had used in the post-WWII era was no longer appropriate for the new society. He argued that Japan should "…prepare sufficient room for creative adventures, technological as well as social, without being afraid of the possible risks involved. This is liberal in a wide sense and is contrary in many ways to the Japanese approach in the catch-up phase."[17] Japan, he predicted, is likely to fail to maintain its level of prosperity unless it overrides the institutional inertia from the past, but he does not foresee Japan adopting the Western-type individualism. As he sees it, the Japanese political economy such as its mode of decision-making ("long-term, multi-issued, often implicit agreements"), which accounted for the success of the Japanese economy in the post-WWII era, is based on Japan's deep-rooted socio-cultural values that will remain more or less unchanged.

The Japanese system of political economy, which, according to Hayami (2001, p.328), is a product of an evolutionary process involving "conflicts, compromises and synthesis between the traditional value system and the imitated Western institutions and organizations," is a "nexus of pseudo-community organizations." That is, in Japan, a firm simulates a community while several firms are grouped together under a "community spirit." They in turn establish a community relationship with government agencies. This "multi-stranded nexus of communities" has served Japan well, according to Hayami, by reducing moral hazards and transactions costs.

But, Hayami (1998) has also argued that this catch-up model of Japan is no longer effective in sustaining economic growth and will have to be replaced with a new model of society that promotes innovative ideas and concepts. In that society, free competitive markets will have replaced the community or social exchange relationship both within and between corporations, and entrepreneurs will be encouraged to innovate with proper rewards. What is needed for such a society to be established in Japan is, according to Hayami, the removal of government controls and regulations that were put in place during the catch-up period of Japan's economic development. He is, however, silent about how the controls and regulations can be removed when they are a part and parcel of the "multi-stranded nexus of communities" that, as some have argued, are rooted in Japanese culture and tradition.

Gyohten (2000) is another astute observer of the Japanese political economy who has argued that Japan needs to adopt new principles such as "competition, transparency, accountability and self-responsibility" if it is to pull itself out of the current economic malaise. But he also points out that adopting those principles would mean an almost complete turnaround or almost complete denial of the traditional Japanese principles that had served the nation well in the past. In other words, it would mean doing away with traditional practices such as "corporate social responsibility, stable employment and human orientation, the maintenance of social order." These are social exchange relations between big businesses and their employees and between them and society at large that have been a part of social fabric in Japan for many years, and terminating those relations will not be an easy matter for anyone on either side of the relationship. The government will, for example, have to let the insolvent firms that have been its partners in social exchange go bankrupt, but doing so will be violating a relationship of trust and cooperation between members of that social exchange. The same reluctance is exemplified in the government's attempt to carry out regulatory reform, as economic regulation has been used as a means for achieving social policy goals such as sustaining the viability of small producers in declining industries and as doing away with it would be an abrogation of a "social contract" with those small producers (Carlile and Tilton 1998). In other words, institutional reform in Japan is not simply a matter of getting rid of certain government regulations by overcoming the opposition by special interest groups but is more involved in that it would require changing a fundamental relationship between government and society that had underlain such regulations.

This brief review of writings by some of the highly knowledgeable observers of the Japanese political economy is obviously not exhaustive but nevertheless captures, I believe, the dominant view held by Japan's opinion-makers and policymakers about the Japanese economy and what the new model for Japan is to be. That is, it points out that, in the eyes of many of the influential Japanese thinkers and opinion makers, Japan's political economy is different from those in the West and whatever may replace it will have to be compatible with its deep-rooted culture and tradition.

The idea or belief that institutional reform in Japan has to be compatible with its culture and tradition has a long history in Japan. When Shōtoku Taishi (574-622 AD) set out to modernize the structure of Japan's imperial government in the early part of the 7th century it was the Chinese system of administration that presented a model for reform. The borrowing from China was, however, carefully circumscribed such that there would be only "graft[ing] Chinese ability onto the stock of Japanese spirit" (Morishima 1982, p.23). At the time of the Meiji Restoration in 1868 Japan learned a list of things to borrow from the "senior" nations of the West, but again its "westernisation" was guided by the principle of *wa-kon yō-sai* (Japanese spirit with Western ability) (Morishima 1999, 44). In those two historical cases Japan clearly had a model or "navigational chart" to follow although the reform was to be in conformity with the "Japanese spirit." What distinguishes the present situation from those two earlier cases is that, having caught up with the West, Japan has "no similar navigational chart" to guide its reform (Morishima 1999, 44).

Rightly or wrongly, Japan is groping for a new system of political economy of its own creation and not following or emulating a model that is well established in other societies. This new system is not going to be patterned after the Western system, as with Japan's parity with the West now "…shame is displaced as motivating agent by the pride of honour, Westernisation by a resurgent nostalgia for the authentically indigenous patrimony of culture" (Dale 1986, p.176). The two reforms of the past, although patterned after models abroad, did not require a fundamental change in Japanese ethos, at least in the eyes of the Japanese. The system created after the Meiji Restoration was a capitalism that conformed to "Japanese spirit"—state capitalism that is "nationalistic, paternalistic and anti-individualistic" (Morishima 1982, p.18). The viability of that system is now being questioned, but in the eyes of many Japanese it cannot be replaced with the individualistic Anglo-American model because they regard it antithetical to the Japanese ethos of collectivism and the "Japanese spirit."[18] Worse, as they see it, the Anglo-American model might only bring in the "disadvantages of the capitalistic system, such as a wider gap in income distribution, rampant money worship, and the vulgarisation of culture, or superficial fashions"

(Sakakibara 1993, p.141). This time Japan has no model that it can emulate to its advantage and will have to create a system of its own—a process that will necessarily take a longer time than adopting an on-the-shelf model that has been used in other countries.[19] Sakakibara may have captured the mood of the nation when he said that "[i]t is about time that we take stock of our situation, live our lives at our own pace, and form our policies accordingly"(1993, p.11).

3. No "Korean Capitalism" in Korea

Until recently Korea also practiced industrial policy, which began with the establishment of a military government in 1961. The government set economic development as a top national priority and, as a means of achieving it, nationalized most of the commercial banks and assumed the power to appoint the heads of all the commercial banks. It also established several special purpose banks such as the Korea Development Bank (1961), Kukmin Bank (1963), and the Foreign Exchange Bank (1967), all engaged in administering "policy loans" on behalf of the government. The banks in Korea—commercial as well as special purpose—thus became merely an arm of the government for allocating credit for developmental objectives.

This system of political economy that put the Korean state in command of the key factor market closely resembled the system that Japan used successfully during its post-World War II recovery (e.g., Amsden 1994, Cho 1994, Pyung Joo Kim 1994).[20] This is as to be expected, as President Park was trained at a Japanese military academy during Japan's colonial occupation of Korea and looked at Japan as a model for economic development and, having little regard for academic economists, relied on economic experts who had been educated in Japanese schools and had worked in Japanese banks for economic management (Woo 1991).

In 1965 the Korean government carried out its first financial reform with the advice of American academic economists. Although the reform—allowing the interest rates paid by government-owned commercial banks to match the market rates—has often been cited as an exemplary case of a successful financial liberalization, in reality it only expanded the financial resources available for policy loans by diverting funds from unregulated informal markets to the government-owned commercial banks with virtually no effect on the basic direction of the government policy. The following quote from Kim (1994, p.278) is quite revelatory of what the reform actually accomplished:

> During this period a host of U.S. advisors (E.S. Shaw, John Gurley, Hugh Patrick, and others) visited Korea frequently under the auspices of USAID and international organizations. Their recommendations were put into practice with much fanfare and had an apparently dramatic effect for a while. These experiments, imbued with American ideas and implemented by officials more susceptible to U.S. influence, made ripples on the surface of Korea's financial structure. *In most cases, these experiments were short-lived, distorted, ignored, and eventually overwhelmed by the main currents flowing steadily under the surface.* [Italics added]

In 1980, when General Chun Doo Hwan took over the government in a military coup following the assassination of President Park, the Korean economy was in severe crisis—a high rate of inflation, a terms-of-trade deterioration resulting from the second oil crisis, and excess capacity and low profitability in some of the government-promoted heavy and chemical industries (OECD 2000). The very survival of the new government was at stake especially since it lacked political legitimacy, and restoring the economic health became an imperative for its own survival. Continuing with the policies of the previous regime was not an option open to the government since they were regarded as responsible for the crisis. The course of action that the government opted instead was to radically change the policy regime by bringing in a number of reform-minded liberal economists (Moon 1994).

One such individual, brought in as the chief economic advisor to President Chun to help manage the crisis and carry out an economic reform, was a Stanford University trained economist named Kim Jae Ik. He and his like-minded colleagues prepared a major reform agenda for the new government, basing it on the lessons they had learned at major American universities. As to be expected, the agenda they presented consisted of a reduction in government deficit, a tight monetary policy, a restraint on the growth of wages, trade-account liberalization, relaxing control over foreign investment, privatization of major commercial banks, and phasing out the subsidies to heavy and chemical industries (Kim 1991). These are exactly the set of policies that subsequently became to be known as the Washington consensus—fiscal discipline, appropriate public expenditure priorities, tax reform, financial liberalization, appropriate exchange rate policy, trade liberalization, abolishment of barriers to foreign direct investment, privatization, deregulation, and property rights (Williamson 1994).[21]

This congruence between Korea's reform agenda and the Washington consensus is no surprise, given that Kim and most, if not all, of his colleagues were trained in economics at major American universities where neoclassical economics has been dominant. With the support of a president who admittedly was a *tabula rasa* in economics and, unlike his predecessor in office, had no vision of his own for steering the economy, the newly empowered reform-minded economists were able to translate policy prescriptions based on the neoclassical economics they had learned into a concrete reform agenda in Korea (Woo 1991).

As part of this reform agenda the government launched a new round of financial liberalization, far more substantial than the one in 1965. It sold off government-held shares in commercial banks while imposing an eight-percent limit on the number of shares of a bank that an individual person or a *chaebol* firm could own. It also removed a number of entry restrictions, thus making possible the establishment of foreign joint-venture banks, non-bank financial institutions (NBFIs), insurance companies, regional banks, and security companies. The commercial banks were also given the freedom to set interest rates on regular deposits and loans and on corporate bonds, commercial papers, and transferable certificates of deposit. NBFIs were also given more freedom in setting interest rates.

But again, as in the case of the 1965 reform, the financial liberalization of the 1980s was more about interest rate deregulation and less about credit allocation. Although the share of policy loans in total domestic credit was reduced from 50.4 percent in 1970-74 to 28.1 percent in 1990-94, a consequence of the growth of NBFIs, their share of bank loans remained more or less the same—47.8 percent in 1972 to 47.5 percent in 1990 although it reached as low as 39.3 percent in 1985 (Kong 2000, Table 3.1). Such a large share of policy loans is a clear indication that in spite of financial liberalization the government retained a powerful influence over bank credit allocation through various administrative measures that were not apparent to outside observers.

As in the case of Japan, there is much controversy over the effectiveness and efficiency of industrial policy in Korea. Among the defenders of the system are Amsden (1989) and Wade (1990), who argue that the Korean government successfully used industrial policy—a non-Anglo-American system of political economy—to bring about rapid economic growth. They do not, however, attribute the success of industrial policy in Korea to its culture and tradition.

This author (1992) also argues that industrial policy was efficient in promoting economic growth during the early phase of Korea's industrialization. His rationale of the success of industrial policy is that close relations between the government and the *chaebol* in Korea resembled those in a hierarchical, internal organization and that the government and the *chaebol* in Korea should thus be viewed as constituting a "quasi-internal organization" and state intervention with private firms as an equivalent to internal directives of the corporate head office to its subunits in a multi-divisional corporation. It then follows that intervention by the state *can* be effective and efficient in achieving its developmental objectives, as directives of corporate headquarters *can* be effective and efficient in achieving corporate objectives. It is, however, important to note that, in the author's argument, the quasi-internal organization did not derive its efficiency from Korea's culture and tradition but from its ability to economize the transactions cost à la Williamson (1975). That is, there is no "Korean capitalism" in Korea.

4. Interest Politics and Financial Reform in Korea in the 1990s[22]

The fact that in Korea there is no "Korean capitalism" and no equivalent to Japan's *wa-kon yō-sai* does not mean that financial reform in Korea was carried out strictly in accordance with the principles of financial liberalization. Korea also has powerful interest groups and their parochial interests influenced the way in which financial reforms were carried out. This section discusses various financial reforms in Korea in the 1990s and the influence of various interest groups on their outcome.

(1). Domestic Liberalization: Entry and Interest Rate Deregulation

In the early 1990s, the government deregulated the entry and business scope of financial institutions in order to promote competition in financial markets and thus increase their efficiency. In 1994 nine such merchant banks were established with the addition of sixteen in 1996. Many of these merchant banks were formerly investment finance companies owned and controlled by the *chaebol,* which remained as the owners of the newly created merchant banks.

Another important deregulation in domestic financial markets was a significant loosening of restrictions on the *chaebol*'s ownership of other NBFIs such as life insurance companies and investment trust companies. Before the deregulation, the top 15 *chaebol* firms were not allowed to own and control life insurance companies while the next top 15 *chaebol* firms were allowed to have only up to a 50 percent ownership of life insurance companies. But, in May 1996, all *chaebol* firms but the top 5 were allowed to own and control life insurance companies. Also, before the deregulation, only the commercial banks could own investment trust companies, but in 1996 that restriction was abolished, resulting in the *chaebol*'s control of many of the investment trust companies.

In the 1980s the government was not successful in deregulating interest rates because the *chaebol* were opposed to it in fear of a heavier interest burden that higher market-determined interest rates would impose on them (Choi 1993). In the 1990s, however, much progress was made in interest-rate deregulation because the *chaebol* saw an advantage in having free NBFIs and thus freer access to credit, albeit at higher interest rates than charged by the still regulated commercial banks. Thus, in 1993 the government was able to declare the deregulation of all lending interest rates (except for policy loans) and many deposit interest rates, including long-term savings, corporate bonds, certificate of deposits, and checking account. The actual implementation of this deregulation policy took, however, a bizarre course.

As originally planned, long-term interest rates were to be deregulated before short-term interest rates. In the event, however, short-term interest rates such as the rates on the certificates of deposits and commercial papers of NBFIs were deregulated first in a speedy manner while time deposit rates of commercial banks were still under *de facto* government control. In loans, too, commercial bank lending rates and corporate bond interest rates remained subject to administrative guidance when all restrictions were removed from interest rates on NBFIs' commercial papers and from the amount that they could issue.

A consequence of this "short term commodities first, long term commodities later" deregulation was a rapid increase of the share of commercial papers in firms' external financing from 7.6 percent in 1992 to 16.1 percent in 1995 (Cho 1999). High-yield commercial papers and other short-term instruments became an important part of financial transactions with NBFIs being a major player in that business. As a result, the Korean financial market came to be dominated by short-term financial activities with a concomitant rise in overall financial risk. It also became a dualistic structure consisting of tightly controlled commercial banks still lending at low controlled interest rates and rapidly growing and relatively free NBFIs headed by merchant banks, many of which were owned by the *chaebol*, lending at higher market-determined interest rates.

(2). External Liberalization

Given that the top 30 *chaebol* firms were subject to an aggregate ceiling in the amount of bank credit they could obtain, they naturally turned to NBFIs for financing. They also sought financing from offshore banking and began demanding the liberalization of international financial transactions. This demand coincided with the pressure from international financial capital for access to the Korean market. The Korean government itself had good reason for accommodating this demand since it was keenly interested in joining the OECD, which required Korea's capital-account opening as a condition for its membership. This conjunction of forces made the post-1993 financial opening of Korea one of the most rapid and comprehensive ones in the developing world.

The measures taken to open the capital account included removing regulations on the issuance of foreign-currency denominated bonds by domestic firms and financial institutions, export-related foreign borrowing and general commercial borrowing, and abolishing the annual ceiling on foreign-currency loans by financial institutions. These measures did not, however, apply equally to both long-term and short-term transactions: short-term transactions were fully deregulated while long-term transactions were either partially deregulated or not at all.

Why did the government carry out such unbalanced financial opening? The idea of financial liberalization was not something to which the Korean government was then fully committed. It still regarded it necessary to use the commercial banks as a vehicle for achieving policy objectives such as promoting small and medium-sized enterprises and establishing strategic industries.[23] The pressure for financial liberalization was increasing, however, from both the *chaebol* that saw the advantage of having easy access to the global capital market through their NBFIs and the foreign financial interests that saw profitable opportunities in investing in the booming Korean economy. Under such unyielding pressures the government undertook financial reform, giving in where pressure was strong and holding back where it was not (Cho 2002). Given that NBFIs' activities were mainly in short-term transactions whereas those of the commercial banks were in longer-term maturities, the unbalanced financial opening was an inevitable outcome of the interest politics playing on financial reform.

(3). *Chaebol* Reaping the Benefits from Liberalization

While financial liberalization—both external and internal—gave more freedom to the *chaebol* in their search for financing, the government's ability to control them and curb their highly concentrated economic power was substantially reduced since 1993. For instance, in 1993 the credit-ceiling scheme—the last stick that the government had over the *chaebol*—was modified, exempting from the ceiling the affiliated companies that were in the *chaebol*'s chosen areas of specialization. Furthermore, the number of the *chaebol* to which the ceiling applied was reduced from the top 50 to the top 30 in 1993 and was further reduced to the top 10 in 1996. Restrictions on the holdings of non-business related land and the debt structure were also abolished. The ceiling on the ownership of bank shares was also raised in 1994, allowing more shares to be purchased by the *chaebol*, and in 1996 they were given more freedom with respect to the ownership of NBFIs. Although the government also made effort to introduce stricter rules regarding cross debt guarantees, cross shareholdings, insider trading, the role of the board of directors, and the rights of minority shareholders it failed to translate its effort into laws.

One of the consequences of the financial reforms undertaken during the 1990s was the increasing autonomy of the *chaebol* from the state as they became less dependent on the government-controlled commercial banks. This autonomy was further strengthened by the *chaebol*'s ownership of NBFIs and their freer access to international capital, as discussed above.

The *chaebol*, perhaps the most powerful interest group in Korea, certainly played a role in getting rid of regulations such as the ceiling on their ownership of bank shares, the limit on foreign borrowing, and the ceiling on aggregate credit as they saw their own advantage in removing such regulations. But it also needs to be pointed out that when deregulation served their own material interests the *chaebol* could appeal to the neoclassical free-market paradigm that had become dominant in Korea's political economy since the early 1980s (Kong 2000, KDI 2001).

5. Concluding Remarks

There is no question at all that the economic crisis of 1997-98 provided the impetus necessary for the Korean government to restructure the economy. It has undertaken various measures to achieve macroeconomic stability, introduce transparency and accountability in corporate governance, liberalize further the trade and capital accounts, and reform the financial sector. To improve corporate governance, for instance, measures were introduced to place outside directors on the board, strengthen the position of small shareholders, require *chaebol* affiliates to combine their financial statements and stop credit guarantees among them (Jung 2002). Although the restructuring was done under pressure from the IMF and caused a severe economic hardship and popular resentment, it was not like being forced to establish alien institutions in Korea as the IMF programme that Korea had to follow was not fundamentally different from the government's policy stance of the preceding two decades (Jwa 2001, ch.9; Kong 2000, ch.6).

The crisis put most of the financial institutions in a desperate situation and led to a reduction in the number of banks from 33 to 23 by the end of 1999. It also forced the government to establish two state-owned corporations, the Korea Asset Management Corporation (KAMCO) and the Korea Deposit Insurance Corporation (KDIC), to clean up the nonperforming loans and strengthen the capital base of the banks. The funds spent by those corporations reached about $128 billion (at the exchange rate of 1200 Korean Won to one U.S. dollar), 29 percent of Korea's GDP in 2000, as of September 2001. Although this injection of public funds into the banking system resulted in *de facto* nationalization of the banking system, that did not mean that the Korean financial system had reverted to the system established by the military government in 1961. It was only an exigent measure with no far-reaching consequence on the fundamental course that Korea charted out for its political economy in the early 1980s—the establishment of a liberal market economy.

The nation's commitment to that goal was reaffirmed soon after the crisis by President Kim Dae-jung, who took the post-crisis financial reforms as an instrument to "put an end to the previous system of governmental control and to guarantee the greatest possible degree of autonomy for the management of financial institutions" (Kim 1999, p.50). As he saw it, Korea's future lay in the establishment of a genuine and open market economy and there was no going back to the state-led growth model of the earlier years whatever its merits might have been then.

Korea's post-crisis financial restructuring is the culmination of a long drawn-out reform process that started in 1980 when there was a paradigm shift in political economy in Korea. In the course of that process, powerful interest groups tried to and did in fact influence the outcome of reforms for the benefit of their own parochial interests; however, there appears to have been no dispute over the end state of that process—the establishment of a liberal economic order (Choi 1987). Even those who criticize the post-crisis reforms as a failure say that the reason for the failure is a premature dismantling of the state-led growth model and not the final goal of the reforms, which is to establish a liberal market economy (Crotty and Lee 2001).

Korea has now fully recovered from the crisis of 1997-98 and its economy has grown much more rapidly since 1999 than Japan's economy. Thus the short-term prospects for the Korean economy look better than those for the Japanese economy. But there still remains the question of whether the ready adoption of a liberal economic order will in the long run turn out to have been the right choice for Korea.[24] As Lin and Nugent (1995, p.2362) pointed out after an extensive review of the literature on institutions and economic development, formal institutions imported from abroad may not function effectively or, worse, may even be a source of social conflict, if they are not compatible with the country's indigenous institutions. It may turn out that the imported institutions are not effective in Korea due to their incompatibility with Korean culture and tradition, whereas Japan may eventually find its own system of political economy rooted in its culture and tradition although it pays a cost in the short run while searching for it.

According to North (1998), "…most societies throughout history got 'stuck' in an institutional matrix that did not evolve into the impersonal exchange essential to capturing the productivity gains that came from the specialization and division of labor that have produced the Wealth of Nation." If this observation of North is correct, Japan's search for a new political economy compatible with its culture and tradition but also suited to a global world economy will be a difficult one as such a system requires a harmonious merging of what appears to be two incompatible opposites—social exchange (a mode of exchange based on long-term unspecified obligations on the part of participants) and impersonal exchange on a global scale.[25] Some societies, as pointed out by Platteau (2000), do undertake profound changes in institutions when faced with new economic opportunities and constraints imposed by economic and political forces. Given what Japan has done in importing and adopting alien institutions to its advantage in its modern history we should feel confident that Japan is one of such societies.[26] The question nevertheless remains as to whether endogenous changes in institutions will take place in Japan before it slides into a deeper economic crisis.

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Endnotes

[1] Implicit in this argument is the assumption that the markets will work themselves once the government is taken out of them. But, as remarked by North (2001, p.408), that assumption is a "lot of nonsense" since the removal of government does not guarantee that market competition will take place in a socially desirable way.
[2] These three reasons imply that Japan will not undertake institutional reforms until it ceases to be a "rich" country, which may take a long time. But, according to Olson (1982), it will take more than a country's ceasing to be rich for it to undertake such reforms, as it needs to have an educated public who will see the necessity to "repeal all special-interest legislation or regulation and at the same time apply rigorous anti-trust laws" (p.236).
[3] Other reasons offered by Lincoln are, to quote, belief in the value of the existing system, interconnected nature of the distinctive features of the existing system, and a weak process of deregulation and administrative reforms.
[4] Sato (1999) also notes that the current situation in Japan calls for a systemic change as fundamental and momentous as the 1868 Meiji Restoration and the 1945 postwar reform but unlike the two historical cases the current change will have to be driven by internal forces and thus will be very difficult to achieve.
[5] Kim (1994) used the term the *Korean model* of political economy and predicts that Korea's new political economy will be in conformity with its *cultural values*. Italics added
[6] North (1999) points out that Marx and Engels provided the ideological foundation, a "belief system," for Lenin's revolution in the war-torn Russia of 1917. We might speculate whether the Russian revolution would have taken place if there had not been the belief system created by Marx and Engels. We should note that one reason why institutional changes took place rapidly in Eastern and Central Europe after the collapse of the Soviet Union is that the transition economies were modeling their reforms after the western capitalistic system and not searching for a "third model."
[7] Kuhn (1962) defines paradigms as "universally recognized scientific achievements that for a time provide model problems and solutions to a community of practitioners" (p.x). Here I use the term as a conception of the economy held by a majority of the people in that economy. In that sense it is close to "weltanschauung."
[8] McCormack (1996) depicts the Japan of the early 1960s as a nation in search of its own identity as in the following quote: "In Japan, the quest for wealth and power, and for equality of status with the West, launched in the late nineteenth century, has clearly been accomplished. But what has the century of striving meant? And what is there now to take its place as a focus for national endeavor? Both the historical and the political questions are bound to exercise many minds in the years ahead" (p.153).
[9]Clague (2002) notes that the timing of the reforms undertaken in less-developed countries of the world between the early 1960s and the late 1990s coincided with a change in the ideological climate in those countries. In her detailed study of the evolution of property rights in Kenya, Ensminger (1992) points out that the notions that people held about fairness and justice as well as purely economic

considerations influenced the change from common to more restrictive property rights among the Orma in the 1980s.

[10] Ensminger (1992) also reaches a similar conclusion in her study of institutional changes among the Orma. To quote (p.180), "[t]he speed and success of their economic transition are controlled not just by technological innovation, the adoption of new governmental institutions, and entrepreneurial ingenuity, but also by the *process by which new institutions are legitimized*" (italics added).

[11] This system, in which the state uses industrial policy to achieve its developmental objectives, also goes by the name of Japanese capitalism, a mixed economy à la Japonaise, or Japan-style capitalism.

[12] Lincoln (2001) argues that the Japanese economic system is, in fact, different from the American economic system, a difference due to differences in their social norms and behavior.

[13] Flath (2000, ch. 9), for example, argues that the reputation of Japan's industrial policy owes to the mere fact that the post-war period of Japanese economic success happened to coincide with the years when the MITI was a powerful government ministry!

[14] Another term for such networks is social capital. Putnam (1993) identifies social capital as involving networks, norms, and social beliefs that evolve out of processes that are not overtly investment activities. Investments made in building trust and reciprocity are investments in building social capital.

[15] Hayami (1998) described the Japanese system as a nexus of pseudo-community organizations, which has evolved through serious conflicts, compromises and syntheses between the traditional value system and the imitated Western institutions and organizations.

[16] In social exchange, unlike in economic exchange, the obligations incurred in exchange are not clearly specified in advance. Social exchange requires trusting others (and in turn creates trust), and benefits from social exchange are less detachable from the source that supplies them than are economic commodities (Blau 1968).

[17] It should be noted here that by liberalism Murakami (1996) meant a variant of liberalism unique to Japan and not the "classical economic liberalism."

[18] Obviously the meaning of the "Japanese spirit" is neither immutable nor wholly agreed on even by the Japanese. According to Westney (1987, p. 24), Meiji reformers redefined Japanese "tradition" to find a fit between the imported new institutions and their social environment. The same process of redefinition will probably take place with respect to the "Japanese spirit" if the current economic crisis continues, making the exigencies of institutional reform more manifest.

[19] Patrick (1999, 69) finds no surprise in Japan's not having a navigational chart for its future since it has caught up with the leading nations of the West and since none of them has a "clear vision of its desired future 50 years hence" either. But it should be pointed out that an important difference between Japan and those nations is that in the case of Japan the prolonged economic malaise has prompted many to question the viability of what they regard to be a unique political economy based on their deep-rooted culture and tradition whereas in the other nations any change in the system is viewed as a minor doctoring within the existing paradigm.

[20] According to Cho (1994, p.29), the Japan that President Park Chung Hee took as a model for economic development was the Meiji Japan of the late 19th century. For example, Park followed the Meiji slogan for promoting a strong economy and a strong military, encouraging the rapid development of big corporations as a means for achieving a strong economy.

[21] Williamson and Haggard (1994) point out that during the 1980s there occurred a profound change in the intellectual climate in the West toward what is now commonly called neoliberalism and it had a powerful influence in policy reform in many developing countries.

[22] This section draws heavily on Lee, Lee and Lee (2002).

[23] The Ministry of Finance and Economy supervised long-term foreign capital transactions while the Bank of Korea had jurisdiction over short-term foreign capital inflows, and the latter was reportedly a greater predilection toward financial liberalization than the former.

[24] Jung (2002) questions whether the new system of political economy will be successful in Korea. As he sees it, Korea has the cultural heritage of a centralized state system and an egalitarian value system, and that heritage is incompatible with a "neo-liberal governance model."

[25] Hayami (2001) argues that although Japan is a society of "limited-group morality" it has been able to enforce informal contracts beyond a single community, a limited group, and thus extend economic exchange to other communities through its "multi-stranded nexus of communities." It is through this mechanism, according to Hayami, that Japan has been able to reap the benefit of extended market exchange, which is attributed in the West to its "generalized morality."

[26] According to Lincoln (2001), the new system that will emerge in Japan will be different from that of the past fifty years but will be still more “constrained” than that in the United States or Europe.