

A Case for Macroeconomic Expansion with Structural Reform

Wonhyuk Lim

Director of Development Research, Korea Development Institute (KDI)



Dismissing Keynes Again

In his preface to *The General Theory of Employment, Interest and Money*, John Maynard Keynes wrote: “The ideas which are here expressed so laboriously are extremely simple and should be obvious. The difficulty lies, not in the new ideas, but in escaping from the old ones...”¹ Believing in the power of ideas, Keynes thought that rational policy discourse would follow once his new theory was understood. In “Political Aspects of Full Employment,” however, Michael Kalecki² pointed out that even if the new principles were understood, business leaders would be opposed to full employment achieved by government spending, for it would weaken their bargaining position by making the threat of an investment downturn or a layoff less credible than otherwise. Thus, adopting Keynesian policy would be a political as well as intellectual challenge.

The evolution of policy discourse since the onset of the 2008 global financial crisis has reaffirmed this dual concern. In the immediate wake of the crisis, what James K. Galbraith³ calls “False Keynesianism” prevailed and all major economies around the world instinctively adopted a stimulus. This bastardized version of Keynesianism treated the global financial crisis as if it were just a severe recession, to be cured in a couple of years through a large dose of easy money and “shovel-ready” projects. This was an intellectual failure for the Great Depression, and more recent financial crises in Japan and other countries suggested that it would take a long time for highly indebted economic agents on their own to repair their balance sheets after a deleveraging shock. Faced with the zero lower bound on the nominal interest rate, conventional monetary

policy would have a limited effect and fiscal policy would have to step in to facilitate debt restructuring and to reduce the risks of mass unemployment and deflation.

Furthermore, “False Keynesianism” paid no attention to the structural causes of financial fraud and instability that had precipitated the crisis. This stood in stark contrast to policy responses to previous financial crises and served as a testament to the political domination of the financial sector. As is well known, the Great Depression triggered off massive investigations into dealings in the financial industry and brought about dramatic institutional changes in financial disclosure, regulation and supervision. More recently, the savings and loans crisis of the 1980s led the U.S. government to allocate a budget of \$50 million to uncover any unlawful acts or practices that had contributed to the collapse of these financial institutions. The Justice Department sent 367 FBI agents to the Resolution Trust Corporation (RTC) to support its investigations and subsequently 2,168 persons were found guilty and ordered to pay damages in excess of \$600 million. Although the global financial crisis was far greater in magnitude than the savings and loans crisis, no comparable effort was made in terms of criminal investigations and institutional reforms. Clearly, bringing culpable parties to justice would make them consider the *personal* costs of malfeasance and enhance the credibility of institutional reforms.

As soon as the danger of systemic collapse had passed in 2009, even the bastardized version of Keynesianism came under attack. Intellectually, the old-fashioned notion of “sound finance” stormed back and called for fiscal consolidation,

even though the bond market was signaling with its extremely low interest rates that the U.S. and other major advanced economies undertake aggressive fiscal expansion. Despite its lack of empirical evidence, the idea of “expansionary contraction”—that is, gaining market confidence through fiscal consolidation to produce an expansionary effect on output—won policy support, especially among European countries. Politically, small government advocates saw a chance to “starve the beast” and dismantle what was left of the New Deal institutions. They could care less about high unemployment as long as social unrest was contained.

This intellectual and political shift away from Keynesianism is not only deflating the global economic recovery but also increasing the risk of another crisis down the road. Conspicuously missing from the current policy package is structural reform to reduce moral hazard and boost productivity. The eurozone is making matters worse by continuing to perpetuate uncertainty about the magnitude of potential investment losses instead of agreeing on a clear debt restructuring strategy with a credible stress test for residual risks. It is no surprise that popular frustration with the lack of accountability and high unemployment is beginning to boil over, as evidenced by the Occupy Wall Street movement.

Korea’s Experience with Macroeconomic Expansion and Structural Reform

Combining macroeconomic expansion with structural reform to reduce moral hazard and boost productivity is not an impossible proposition. Korea’s experience after the 1997 Asian financial crisis provides a clear example that it can be done, even though it involved some factors that might not be easily replicated in other countries. Due to some fortuitous timing with an election, the outbreak of the crisis was followed by a change of government within a month, allowing Korea to manage the crisis with a relatively clean slate. The severity of the crisis strengthened the position of entrepreneurial reformers, at least in the early post-crisis period,

and led the government to tackle the nonperforming loans problem head-on. Although Korea was forced to adopt a high interest rate policy under the terms of its agreement with the International Monetary Fund, its prior fiscal discipline provided space for deficit spending, which the government used not only to strengthen social safety nets but also to improve productivity-enhancing infrastructure, such as information technology networks. Also, Korea’s established industrial base could quickly generate a current account turnaround once the exchange rate was adjusted. In fact, Korea’s current account balance went from negative 5 percent of GDP in 1996 to positive 14 percent of GDP in 1998. Last but not least, small government advocates were a minority in Korea.

In the wake of the Asian financial crisis, Korea faced two major challenges. First, “legacy costs” or problems resulting from mistaken or unlawful decisions of the past had to be addressed. Foremost among these problems were massive nonperforming loans (NPLs) that had resulted from unprofitable investments. Public funds had to be injected to clean up NPLs and to rehabilitate the financial sector. Also, any unlawful acts or practices that had contributed to corporate failures had to be investigated and rectified. Second, to avoid a repeat of this kind of disaster, institutional reforms had to be implemented. The pre-crisis distortions in financial resource allocation and corporate governance had to be fixed. Reducing moral hazard, improving corporate governance, and promoting competition constituted the central pillars of Korea’s structural reform program.

The government had to step in with public funds and urge financial institutions to take proactive measures against insolvent firms. Although the injection of public funds was likely to generate political controversy, the Korean government decided to bite the bullet and stabilize the financial system. Estimated to be around 28 percent of the country’s GDP in March 1998, the magnitude of NPLs was too large for financial institutions to resolve the problem on their own. Executives and shareholders did not have the political clout to block

financial sector restructuring, which basically involved the injection of public funds in return for equity write-downs and managerial changes. The government injected public funds to recapitalize financial institutions, to settle deposit insurance obligations, and to purchase NPLs and other assets. Overall, 787 insolvent financial institutions (or 37.5 percent) had been either closed or merged by June 2003.

Korea also made concerted efforts to investigate malfeasance on the part of managers whose firms or financial institutions had become insolvent. In 2001, an amendment to the Depositor Protection Act made it possible for the Korea Deposit Insurance Corporation (KDIC) to investigate managers of failed firms for malfeasance. Public prosecutors also launched major investigations in 2001 and arrested more than 100 executives.

In addition to resolving “legacy costs,” the government had to terminate implicit guarantees against bankruptcy, improve corporate governance, and strengthen competitive pressure so that firms and financial institutions would make their investment decisions under the discipline of market forces. Massive corporate failures served as credible signals that the government’s implicit guarantee regime had indeed changed. Through both court-led corporate reorganizations and out-of-court workouts, the management of many leading *chaebol* was displaced and controlling shareholders saw their holdings either written down or altogether wiped out. In fact, of the 30 largest business groups in 1996, 14 had gone bankrupt or entered workout programs by the end of 1999. The government from very early on focused its corporate restructuring efforts on improving the governance of the *chaebol*. In January 1998, then-President-elect Kim Dae-jung announced the five principles of corporate restructuring: (1) enhancing the transparency of corporate management; (2) eliminating in-group inter-subsidary loan guarantees; (3) improving capital structure; (4) focusing on core competence; and (5) enhancing the accountability of controlling shareholders and managers.

Starting in 1998, a number of measures were introduced to improve financial disclosure and accounting standards, including a requirement for consolidated financial statements covering all companies under the effective control of the same business group regardless of the level of shareholdings. To strengthen minority shareholder rights, the government lowered shareholding requirements for bringing derivative actions, requesting termination of directors and auditors, and convening a special shareholders’ meeting. To enhance the independence of corporate boards, listed companies were required to include at least one outside director in the board membership. The National Assembly also passed a securities class action bill. In addition, amendments to the Monopoly Regulation and Fair Trade Act (MRFTA) sought to regulate inter-subsidary transactions that controlling families had frequently used to advance their interests at the expense of other shareholders. The principal means of preventing “tunneling” and facilitating corporate restructuring was to impose controls on various in-group inter-subsidary transactions, particularly loan guarantees and share and bond purchases at above-market prices. In a landmark case at the end of 2001, a district court in Suwon ruled in favor of shareholder activists and ordered the chairman and nine past and present executives of Samsung Electronics to pay compensation of nearly 100 billion Korean won for misuse of company funds and undue resource transfers to other subsidiaries.

In addition to addressing the problems of moral hazard and corporate governance, the Korean government made efforts to strengthen market competition. The most important and extensive policy reforms in this area occurred in the rules governing foreign investment. In the wake of the crisis, the government completely eliminated the ceiling on foreign equity ownership in the stock market. A new Foreign Investment Promotion Act enacted in November 1998 streamlined investment procedures, strengthened incentives, and created innovative new mechanisms for regional governments to play a role in attracting foreign investment. In addition to encouraging new entry by domestic

and foreign firms alike, the government also made efforts to remove exit barriers that had impeded corporate restructuring. Bankruptcy reforms in the post-crisis period expedited the bankruptcy procedure and introduced a major change in principle: to qualify for court-led bankruptcy procedures required an assessment of whether the value of the firm as a going-concern did in fact exceed its liquidation value. The courts were required to rule in favor of liquidation when the returns from doing so exceeded the firm's value as a going-concern. This principle was actually tested when Dong-Ah Construction was liquidated in 2001.

Attacking moral hazard in the middle of a crisis, as Korea did, was a difficult proposition, but it had to be done to prevent recurring crises. By comparison, enhancing productivity through infrastructure investment and structural reform was relatively straightforward, but here too care had to be taken in order to make the best use of fiscal resources and to overcome resistance from vested interests. The combined policy package of macroeconomic expansion and structural reform made Korea a more resilient and efficient economy today.

From Contractionary Contraction to Expansion and Reform

Although conventional wisdom holds that macroeconomic expansion in the U.S. and other advanced industrial nations is unlikely due to domestic politics, both the bond market and protesters

on the street are increasingly demanding a decisive shift away from contractionary contraction. While small government advocates and moralizers may continue to prescribe pain for the masses, their intellectual case is weak and their political position is fundamentally shaky in a democracy. While business leaders may value the disciplinary effect of unemployment on workers to a certain extent, they also know that persistently high unemployment can create serious social unrest. As a result, macroeconomic expansion is not a lost cause. To be effective both economically and politically, it should be combined with structural reform to reduce moral hazard and boost productivity. Such reform would not only help to mitigate financial instability but also enhance growth prospects to prevent recurring crises.

References

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Endnotes

- ¹ Keynes (1936).
² Kalecki (1943).
³ Galbraith (2011).