KOREA'S FINANCIAL CRISIS OF 1997

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&
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Foreword

I am happy to present here the lecture on "Korea's Financial Crisis of 1997" by Dr. Seung-soo Han, former Deputy Prime Minister and Finance Minister of Korea. The lecture was delivered on February 15 at a Seminar jointly organized by ICRIER and CII, and was chaired by Dr. Manmohan Singh, former Finance Minister, Government of India. Dr. Han's impeccable professional background and active involvement with public policy making in Korea provides him with a unique perspective with which to view the contemporary global economic situation and analyze the Korean financial crisis within this overall perspective.

Dr Han offers us a panoramic view of the financial crisis and Korea's response to it. He draws our attention to the fact that Korea's crisis was different from that of other Latin American and South-East Asian economies in as much as there was no evidence of "mismanagement of monetary and fiscal policy." Dr Han analyses the handling of the Korean crisis against the backdrop of the political transition following a historic election in which a long-standing opposition party came to power in Seoul. He believes the government's decision to guarantee all foreign liabilities of Korean financial institutions was a crucial mistake that "paved the way" for the private banking crisis to develop into a sovereign debt crisis. The bailout offered to the Kia Group was also a mistake, which compounded the crisis. This along with the crash in Hong Kong resulted in a massive outflow of foreign capital.

What is instructive about the Korean crisis is the fact that the situation was turned around fairly quickly. Dr Han's objective assessment of his political successor's efforts is extremely interesting and educative, especially for an Indian audience. Dr Han's discussion of the reform in the financial and corporate sectors, in the labour market, the restructuring of public enterprises and of the liberalisation of foreign trade and investment regulations should all be highly instructive for Indian policymakers, researchers and the general public.

Dr Han ends on a cautious note, stating that Korea has only seen the "end of the beginning" rather than the "beginning of the end" of the economic problems it faces. It is only when the current reform programme succeeds in rejuvenating growth can Korea safely assume that it is out of the woods. Dr. Han concludes with the hope that other countries will not only learn from Korea's successes but will also avoid the mistakes made by Korea in not adapting smoothly to changing conditions at home and abroad.

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About The Author

DR. SEUNG-SOO HAN

DR. SEUNG-SOO HAN is a Member of National Assembly, Seoul, Korea; he is a distinguished Korean economist and has held several positions in Government of Korea including those of Finance Minister and Deputy Prime Minister of Korea, Chief of Staff to the President, Minister of Trade and Industry, Member of the 13th National Assembly and Professor of Economics, Seoul National University. He was Korean Ambassador to the United States during April 1993-December 1994. He was also a Visiting Professor at the Universities of Harvard (USA), Cambridge (UK) and Tokyo, and President, Korean International Economic Association (1984-85). His publications include *The Health of Nations* (Seoul Computer Press, Seoul, 1985)

Minister Singh, Mr. Shah, Dr. Ahluwalia, Ladies and Gentlemen,

I am very pleased to address this distinguished audience, and I especially want to thank the Confederation of Indian Industry as well as the Indian Council for Research on International Economic Relations for their kind invitation.

As you know, this month marks a symbolic high point in the Indian-Korean relationship. Korea was deeply honored to be invited to participate in the 13th Indian Engineering Trade Fair as a "Partner Country" and to have last Friday designated as "Korea Day." Although I am visiting India in a private capacity, I would like to join my government in expressing our gratitude for the dual honor accorded Korea by India in connection with the 13th Indian Engineering Trade Fair.

These symbolic acts are important because they reflect the reality of an increasingly close economic partnership between our two countries. In the past five years, bilateral trade volume has more than doubled, while Korean investment in India has increased some 60 fold. These trends will, I am confident, continue and deepen, particularly once Korea emerges from its current recession.

This brings me directly to the subject of my remarks this afternoon. Nineteen-ninety-eight was a very difficult year for many Koreans but it was also a year of drastic reform and dramatic change. As a consequence of these reforms and change, Korea is beginning to see, as the Washington Post commented a few weeks ago, "a light at the end of the economic tunnel." The Asian Wall Street Journal ran a similar article in the front page a few days ago.

International credit rating agencies are again bolstering Korea's credibility as a place to invest in. Standard & Poor's restored Korea's sovereign credit rating to investment grade from the "junk" status to which it was lowered a year ago. Fitch IBCA, the British credit rating agency also upgraded Korea. A few days ago Moody's followed suit.

The Ministry of Finance and Economy predicts that after a negative growth of 5.8 % last year, the Korean economy would grow at 2% this year; the Bank of Korea prediction is at 3.2%. Morgan Stanley is even more optimistic predicting that the Korean economy would grow at 4% this year. It seems that the Korean economy is returning to the positive growth trajectory.

If accurate, this is certainly welcome news. But be that as it may, I think it is very important that both Koreans and foreign observers draw the appropriate lessons from Korea's, and East Asia's, economic travails of the past 15 to 18 months. By so doing, can we avoid repeating the mistakes of the past and gain some useful perspectives on economic and financial policy formulation in the 21st century?

I will begin by tracing the background to Korea's financial crisis of late 1997. I will then discuss the government's response to the crisis. I hope that this analysis will have some relevance for other countries whose economies may have certain points in common with Korea's. While its is certainly true that economic policy making can not operate on the premise that "one size fits all." it is no less true that individual countries have much to learn from each other's experiences in this regard.

The currency crisis that erupted in Thailand in July 1997 developed into a general financial collapse in Asia. By late 1997, its contagion spread to Indonesia, Malaysia, Philippines, Hong Kong and Korea. In the two-month period from October to December, 1997, the Korean won depreciated by 112% against the U.S. dollar, while the stock of foreign exchange reserves went down from 22.3 billion to a mere 3.8 billion U.S. dollars, bringing the country to the brink of sovereign default.

The nature of the financial crisis in Korea was quite different from that of traditional ones. Unlike Latin America's currency crises, Korea's crisis had little to do with the mismanagement of monetary and fiscal policy. Many believe that the currency crisis in Korea was only a symptom of structural problems. Excess debt financing, weak regulation of financial intermediaries, an inefficient corporate sector, inflexible labor market and ever expanding public sector are the often cited causes of the crisis.

However, even if we acknowledge that the root of the Korean crisis lies in structural weaknesses, there still remains an important question: Why did it happen in December 1997? Why not earlier or later? The much criticized background factors such as excess debt financing, crony capitalism, government controlled financial markets, a lifetime employment system, and inefficient public sector were not new. They have been around ever since Korea started to engineer the so-called "Asian Miracle" and they were sometimes even praised as the secret to Korea's success. Then what brought on the loss of foreign investors' confidence in Korea in 1997 so suddenly?

If it was hard to predict the crisis in the first half of 1997, then what unforeseen factor caused the loss of foreign investors' confidence thereafter? The best way to answer this question is to analyze the evolution of the Korean crisis from the perspective of foreign investors.

As the new year began in 1997, foreign investors started to look at Korea with care because of the unexpectedly long span of the recession that started during the third quarter of 1995 and the large current account deficit in 1996, which was 5 percent of GDP and the largest in 5 years. However, despite the worry, it is fair to say that foreign investors' long term view on Korea had as yet not changed much by that time. Moody's and S&P reaffirmed the foreign currency long-term credit rating of Korea at A1 and AA-, respectively.

On December 26, 1996, union workers began strikes in response to the labor legislation newly enacted. The new labor law centered on eliminating job security that had been taken for granted for many years in Korea. The strikes were suspended only after a month had passed, following the government's announced decision to revise the legislation. Furthermore, on January 23, the Hanbo Steel and Construction company declared bankruptcy, with a total debt estimated to be about 6 billion U.S. dollars, dispersed across 61 banks and other financial institutions. For foreign investors, Hanbo's bankruptcy focused a spotlight on the underlying weaknesses in the Korean banking system and the murky relationship between the government, banks and conglomerates.

However, it is important to note that the Hanbo rating itself did not imply deterioration of the sovereign credit rating of Korea. On the contrary, Moody's report seemed to support the Korean government policy in handling Hanbo's bankruptcy. In the past, bankruptcies of conglomerates have been dealt with by takeovers by larger groups with government subsidized loans. But in handling Hanbo, the government had insisted on a more rigorous treatment, and foreign investors regarded the government action as showing firm determination to carry out market reforms aimed at creating a more independent and accountable banking system. In other words, Moody's had clearly differentiated the sovereign credit rating of Korea from her private financial institutions' problems at that time.

If the Korean government were to be blamed for failing to prevent the crisis, the critical period would be July through September, 1997.

First, facing the string of corporate defaults and the worse-than-expected profits report of Korean banks in the first half of 1997, foreign investors started to see the strong likelihood that the Korean government would have to bail out troubled conglomerates and banks.

Second, on July 2, faced with a ballooning current account deficit, the Thai government devalued the baht and within a month the Southeast Asian crisis started. Indonesia, Philippines and Malaysia were affected, and foreign investors became nervous about Korean conditions as well. To make matters worse, on July 15, Kia Motors, the nation's third largest carmaker, asked for emergency bank loans to avoid bankruptcy. And the credit agencies promptly began downgrading ratings for several major Korean banks. They estimated that the fiscal bailout for the banking system would ultimately cost as much as 20% of GDP. This made it increasingly difficult for Korea's private sector to obtain foreign funds.

Third, the government did not react effectively to the Southeast Asian crisis. As the foreign credit lines of Korean private banks and companies were terminated or reduced, the government pledged it would guarantee all foreign liabilities of Korean financial institutions. Despite its naïve intention, this was a crucial mistake that paved the way for the private banking crisis to develop into a sovereign debt crisis.

At this precarious moment, the government made a critical mistake that sent the wrong signal to nervous foreign investors. Exhausted by the three-month-long political battle, the government reluctantly decided to bail out the near-bankrupt Kia Group on October 22; this was the moment when Korea's private banking crisis officially turned into a sovereign debt crisis. By coincidence, on October 23, Hong Kong's stock and foreign exchange market crashed. On October 24, S&P promptly downgraded the credit rating of Korea from A+ to AA- with the rating outlook remaining negative. S&P lambasted the Korean government's decision to bail out Kia by saying that "the bailout might alleviate short-term pressures but the long run economic consequences are unambiguously negative." Korean bonds tumbled to junk levels and investors became nervous that the world's 11th largest economy was heading for a Mexican-style crisis.

Two events, the bailout of Kia and the crash in Hong Kong, triggered a massive outflow of foreign capital. Foreign banks refused to roll over loans, and as a result Korean banks and corporations had to buy dollars in the domestic exchange market to service their obligations. The Korean currency dropped sharply from 915 on October 21 to 965 won per dollar on October 31, and its slide accelerated. In November, the government made another fatal mistake by wasting a substantial part of its foreign reserves in its futile foreign exchange market intervention. In early November, the Bank of Korea announced that its reserves were around 30 U.S. billion dollars. But foreign investors estimated that the actual reserves could be as low as 15 billion dollars, which is about five weeks' worth of imports and only a fifth of Korea's short-term debt. They correctly understood that the announced numbers did not include dollars borrowed through forward market intervention. By misreading the situation, the government lost its credibility as well as foreign exchange reserves.

Korea signed a 55 billion U.S. dollar stand-by arrangement with the IMF on December 3. Despite the world's biggest emergency credit package, however, Korea's financial turmoil showed no sign of abating. By December 23, the yield spread of KDB's 10 year global bond widened to 693 basis points. At the beginning of 1997, it had been 57 basis points. The Korean won lost 60 percent of its value against the dollar and the Korean stock market dropped 50 percent in 1997. More than 17,000 companies went bankrupt including 8 conglomerates.

Let me now discuss the government's policy reforms during the last one year in response to the crisis in the four key areas; the financial sector, the corporate sector, the labor market, and the public sector. Structural problems inherent in these sectors are usually given as major causes of Korea's financial crisis.

Financial Sector Reform

In the financial sector, the entire industry is being restructured. The National Assembly passed last year necessary legislation to create an independent Financial Supervisory Commission and also to give the authority to the Bank of Korea to conduct monetary policy. Until then this authority resided with the Ministry of Finance and Economy.

Non-viable institutions have been—and will continue to be—shut down. In the first nine months of last year, 94 financial institutions were shut down or had their operations suspended. This included the closure or suspension of 5 out of 33 banks, 16 out of 30 merchant banks, 6 out of 34 securities firms, and 2 out of 8 investment trust companies.

At the same time, viable institutions have been merging, reorganizing, and recapitalizing. As of the end of last year, 6 major banks were undergoing voluntary mergers in order to achieve scale economies and efficiency, and non-bank financial institutions have been rehabilitated at the initiative of their major shareholders. In addition, non-performing loans are being dealt with. By the middle of this year, we will have eliminated as much as a half of the outstanding non-performing-loans at the end of last year.

In addition to this industry-wide reform, the newly-created Financial Supervisory Commission is continuing to tighten prudential regulations and supervision of individual financial firms. Last May, the so-called "prompt corrective action" system was implemented. Under this system, any financial institution exhibiting signs of weakness is immediately "recommended", "requested", or "ordered" by the Financial Supervisory Commission to take certain corrective actions, depending on the seriousness of the problem. The institution may be recommended to reduce manpower, capital, and/or dividend payments. Extreme cases may call for an order to consolidate shares, put board members on probation, or merge with another body. This "prompt corrective action" mechanism enables regulatory bodies to respond quickly to the slightest signs of trouble in the financial sector.

Corporate Sector Reform

Let me now turn to corporate sector reform, which focuses on three objectives: letting weak companies exit the market, improving capital structures of viable companies, and improving corporate governance.

In February last year, the bankruptcy-related laws (Company Reorganization Act, Composition Act, Bankruptcy Law) were revised to ease the exit of insolvent firms. In May, the continued viability of 313 financially troubled large firms was evaluated by their creditors. The 55 that were found non-viable were denied loan extensions. Of these 52 were affiliates of Korea's top business conglomerates, known as chaebols. The 258 firms that were deemed viable are undergoing "corporate workout programs" with their creditor financial institutions. The scope of corporate financial restructuring is not limited to large corporations. The viability of about 22,000 small and mid-sized corporations with large debts have also been examined. Among them, 13,000 were found still viable and subsequently classified as candidates for workout programs.

In order to improve capital structure and reduce over-capacity, Korean businesses are selling assets and rationalizing their businesses through business swaps with other chaebols. Through these swaps, business groups are exchanging their non-core units for companies that are closer to each group's core competence. For example, Samsung is giving up its automobile unit to Daewoo and taking over Daewoo's consumer electronics unit. The LG Group is giving up its semiconductor unit to Hyundai. Significant results are expected in reducing over-capacity in the areas of petrochemicals, power plant equipment, ship engine production, oil refining, rolling stock manufacturing, aerospace, semiconductors and the auto industry. Eventually these efforts are hoped to result in greater specialization and enhanced competitiveness of Korean businesses. In addition, in order to improve the capital structure and to prevent unwarranted chaebol expansion in the future, cross-debt guarantees totaling 10 trillion won -- or about 30% of all such guarantees among the top 30 chaebols -- were terminated by the end of March 1998. As of April 1, 1998, new cross-debt guarantees are prohibited. Existing guarantees will be completely eliminated by the end of March 2000.

In order to improve corporate governance and enhance management transparency and accountability, Korean firms have been required—since February last year—to appoint outside directors and retain external auditing committees. The required portion of outside directors has been expanded to a quarter of the entire board. The definition of "outside director" has been further clarified in order to prevent any abuse. In May, minority shareholders' voting rights were strengthened, and the representation requirements for class action suits was substantially relaxed from 1% to 0.01%. Also, restrictions on institutional investors' voting rights were removed and the legal liabilities of controlling owners were strengthened in June. In October, a cumulative voting system was introduced.

In December, Korean accounting standards were revised, bringing the rules in line with international standards. Starting from this year, the chaebols are required to produce combined financial statements covering all of their affiliated subsidiaries. These changes are designed to enhance business valuation and to increase transparency. Undoubtedly, these changes will contribute to improving business management and corporate governance in Korea.

Labor Market Reform

The labor market reform is centered on enhancing flexibility. Since the crisis, Korean workers no longer expect guaranteed lifetime employment. Early last year, the Tripartite Commission composed of labor, management and political leaders was created. The three sides have cooperated to chart a path towards new labor relations. Through their collaborative efforts, the Labor law was revised in February 1998 to allow managers to make layoffs based on managerial need, including but not limited to, business transfers or M&As.

The Korean government is doing its part to ease the workers' burden in this nationwide reform process. As widespread rationalization in public and private sectors inevitably means higher unemployment, the share of funding allocated to social welfare has been expanded within the reduced government budget. This includes US$7.3 billion for more job training and more unemployment benefits.

Public Sector Reform

The Korean government has been pursuing three goals in public sector reform. The first is downsizing. In the central government, the workforce will be reduced by 11% by the end of next year. A 5% cut was already implemented last year. In local governments, employment will be reduced by one-third by the year 2002. About 11% of local officials left their job last year. Furthermore, the total number of government officials is fixed by law, preventing the possibility of government expansion in the future. All government ministries and agencies are under management review by civilian consultants this year. Based on the result of this evaluation further government reorganization will be carried out. In conjunction with this effort, all government-affiliated institutions including various publicly funded organizations and research institutions are being streamlined.

The second goal is privatization. The government is selling its shares in large enterprises. Eleven out of 24 government-invested enterprises will be fully privatized, along with 67 of their 82 subsidiaries. POSCO, world's largest and the most efficient steel maker, Korea Heavy Industries Corporation, and Korea Technology Banking Corporation will be privatized by the end of this year. Two of Korea's largest corporations—Korea Telecom and Korea Electric Power Co.—and Korea Tobacco & Ginseng Corporation will be gradually privatized in two years.

The third objective is deregulation. A new Basic Law on Administrative Regulations was enacted and the Regulatory Reform Committee was created in April last year. The Regulatory Reform Committee was assigned the task of eliminating nearly half of the total 11,125 administrative regulations within 6 months, 2,407 remaining regulations were amended.

Polices for Globalization

Until the outbreak of the financial crisis in 1997, public policy and popular attitudes toward foreign capital tended to be both conservative and nationalistic. Beginning in the early 1960s when Korea embarked on the first five-year development plan, the government policy toward foreign capital was basically one of ”borrow, build factories and pay back with export earnings” rather than “encourage foreigners to invest directly in Korea”. This wariness toward foreign direct investment had historical roots. Korea, being a small country surrounded by major powers, had constantly to be on guard lest its sovereignty be violated. Many Koreans believed that foreign ownership of national assets meant economic domination, which could lead to political domination and occupation. Thus the defensive mentality of the Koreans led the government to adopt a policy in favor of borrowing rather than foreign direct investment.

However, with rapid economic growth and accumulation of national wealth, Korea became a middle-ranking economic power and the Korean people became more self-confident. In addition, foreign technology, particularly high-technology, was not a free good any more as in the 1960s. In order to meet the demand of the sophisticated industrial structure for advanced technology, it was recognized that high-technology embodied in foreign direct investment was necessary. At about this time, the economic crisis erupted. The Korean people were psychologically ready to accept foreign direct investment and had become more positive toward globalization. Against this background, let me now briefly explain what Korea is doing to open up its market for foreign investors. Korea is committed to opening the economy fully and making it attractive to foreign investors. Virtually all Korean business lines are now open to foreign investment. The only exceptions out of 1,148 industries are 31 businesses related to national security. The number will be further reduced to 20.

The capital market has also been opened fully. There is no longer any limit on foreign equity ownership, and no more restrictions on foreign ownership of local bonds or short-term money market instruments. Foreign exchange transactions were also considerably liberalized last year.

In June 1998, the government removed a key barrier to foreign investors’ entry into the Korean market by allowing foreign ownership of Korean real estate. In addition, foreign investors can take advantage of reduced or even free rentals of government properties, including purpose-built industrial parks.

Numerous other changes of benefit to foreign investors are incorporated in the massive revision of the Foreign Investment Law passed by the National Assembly last September.

Of course, it will be years before the full impact of these reforms can be felt. But already they've helped to boost international confidence in the Korean economy and generate renewed optimism among the Korean people.

Following the traumas of 1997 and 1998, we began the new year amid growing signs of economic recovery, usable foreign exchange reserves are up almost sixfold since year-end 1997. The rate of corporate bankruptcies is steadily declining, and the stock market index has doubled since hitting the bottom in June of last year. The dollar/won exchange rate has stabilized, and interest rates have fallen to below their immediate pre-crisis level. Unemployment remains a nagging concern, but the jobless rate may finally have peaked.

I do not, however, want to paint too rosy a picture. The recovery, if we can call it that, is very precarious. It could be slowed or even reversed depending on a number of circumstances both at home and abroad. This is probably not the beginning of the end of our economic woes, but it may be the end of the beginning.

The beginning of the end will come when the current reforms are seen as irreversible by Koreans and the international community. That is why it is so important that the reform effort continues to be supported by a broad political consensus. This is, I think, likely, but by no means certain. If, for example, unemployment were to seriously worsen, the consensus could break down. As is generally the case -- but nowhere more so than in Korea -- politics and economics go had-in-hand.

It is said that "nothing succeeds like success." But, as we have seen in Korea's case, a truly successful economy must be able to adapt smoothly to changing conditions at home and abroad. The Korean economy failed to pass this test in 1997, and we learned a painful lesson as a result. I hope that our experience will prove to be a salutary one not just for ourselves but for other countries as well.

Thank you.