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POST-CRISIS FINANCIAL REFORMS IN THE REPUBLIC OF KOREA: PROBLEMS AND PROPOSED REMEDIES

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I. INTRODUCTION

This paper considers changes in economic policy measures undertaken over time by the Government of the Republic of Korea to conform with global standards. It draws a few lessons from the Korean experience that warn against an excessively rigid application of such standards, as discussed in the literature on sequencing of economic liberalization. The paper deals with the question of the optimal order of financial transformation, of particular relevance to the discussions about the Asian financial crisis. It suggests alternative policy options for structural adjustment by the Korean Government that have been presented in a number of academic and journalistic circles.

It is now evident that the Republic of Korea recovered from the crisis better than the other crisis-hit Asian economies: its growth rate was 10.9 per cent in 1999 and was estimated to be 8.8 per cent in 2000; its inflation rate was about 3 per cent and its foreign exchange reserves stood at more than US$ 96.2 billion at the end of 2000 – the largest in its history. Its present rate of economic growth resembles its remarkable pre-crisis performance

– for more than 35 years the country had experienced rapid growth with an average growth rate of 8 per cent.

Many observers have sought to determine whether the crisis was caused by some fundamental factors inherent in the Korean economy or by unfavourable consequences of changes, especially financial ones, in the international economic system. Earlier, the Republic of Korea had been performing well in terms of traditional fundamentals such as growth rates, inflation rates and balance of payments. However, its economic system, involving excessive investments by its *chaebol* and the latent sociocultural institutions associated with them, was considered unsound. In addition, it suffered from the contagion effects of the South-East Asian financial crisis.

Some observers may attribute the Republic of Korea's recent strong recovery and the return to its previous high growth performance to its various adjustment efforts. In fact, however, there have been serious indications of some undesirable side effects of its recovery efforts, which have prompted suggestions that there might be better alternatives. This paper discusses possible lessons from the Republic of Korea's reform process. It argues that some aspects of the global standards as norms for reform are insufficiently defined to be operational, while others are too rigid and lead to a credit crunch and a vicious circle. It points out pitfalls in the rigid application of global standards arising from the dynamics of the reform process. Although the reform programmes have comprised multidimensional changes, this paper focuses on only one dimension, namely that of financial reform, which is a central element in the overall reforms.

Two building blocks of the financial structure of society are direct financing based on the capital market, and indirect financing based on banking. An economy may lean, in relative terms, towards either direct or indirect financing. For example, the United States economy, with a well-developed capital market, is primarily based on direct financing, while most other economies are mainly dependent on indirect financing. Each has its advantages and disadvantages. Since no economy can drastically change its financial structure within a short period of time, it is best to proceed incrementally whenever there is a shift of emphasis between the

two. It can be observed that many late-starters among developing economies relied heavily on indirect financing.

Alan Greenspan, Chairman of the United States Federal Reserve, in his speech at the annual meeting in 1999 of the International Monetary Fund (IMF) and World Bank, stressed the importance of a well-developed capital market. He observed that almost all economies which had recently experienced a financial crisis had an underdeveloped capital market and a financial structure that depended heavily on banking. He stressed the importance of capital markets, particularly when the banking sector underperformed.

We concur with Greenspan that an economy, particularly a developing one, should have a balanced mix of direct and indirect financing, so that a situation of non-performing loans may be improved by funds from the capital market. It would do better to change from a structure of dominantly indirect financing to one of diversified financing from both the capital and the banking market. Indeed, a report issued in December 1999 by the Korean Institute of Finance on financial restructuring agreed on the need for more direct financing with the aim of increasing the relative share of the capital market to 60 per cent from its current level of 30 per cent (Korea Institute of Finance, 1999).[1]

However, such a balanced mix of direct and indirect financing cannot easily be achieved. Especially for late-starters of economic development, it is hard to build the infrastructure necessary for supporting a balanced financial structure, as many institutional factors cannot be put in place over a short period of time. Within a limited period of time, what can be done is to make the best use of the resources mobilized to expand the relatively smaller area of direct financing. Hence the short-term outcome would at best be more direct financing schemes on the way to a more balanced financial structure.

The effort towards more direct financing does not necessarily imply that the banking system, thus far extensively utilized, should be suppressed and a capital market artificially created. Social custom, which cannot be changed rapidly, would tend to deter a drastic overhaul of the existing

system, if not preventing it altogether. Society needs time to accept a new system, however desirable it may be. Hence, in conceptualizing the mix of the two financing mechanisms, there should be some optimal sequence and speed in transforming the existing financial structure. Moreover, the schedule of the transformation process should be realistic, bearing in mind the internally available resources and the conditions of the external environment. Otherwise the transitory period would involve considerable welfare losses that would harm many creditors and debtors, both internal and external.

Immediately after the outbreak of the Asian financial crisis in 1997 the Government of the Republic of Korea tried to restructure its economy on all fronts. Its main thrust was to rapidly secure a balanced financial reform – the very point made by Greenspan – but it did not give due attention to its various inherent limitations in the transformation process.

The Government has so far placed considerable emphasis on global standards. The major causes of the crisis were said to be so-called crony capitalism involving the *chaebol*, and non-transparent corporate governance in the Korean economy, along with many other features associated with moral hazard. The business practices through crony capitalism were seen as deviating from the global standards. Consequently, it was proposed that the undesirable practices be reduced by adopting these standards. However, what constitutes global standards was not made explicit. More fundamentally, insufficient attention was given to the question of whether global standards exist for every economic aspect, and whether the Korean economy had the ability to conform with the global standards and correct the supposedly undesirable elements within a specified short adjustment period.

Various kinds of global standards were suggested, but not all of them have been enforced with equal strength. Some of them have been strongly and consistently implemented, while others have been merely discussed. The two most distinctive global standards selected by the Government are the Bank of International Settlements (BIS) ratio and the leverage ratio. Both are intimately related to the financial structure. The Republic of Korea's financial firms were required to attain the BIS ratio of over 8 per

cent within a year following the outbreak of the financial crisis, and all conglomerate groups were to reduce their leverage ratio to below 200 per cent by the end of 1999. The aim of these measures was make the financial structure of the firms concerned consistent with the global standards. However, the announcement of these standards came as a shock to all the firms targeted for reform, as their attainment appeared to be extremely difficult – if not impossible – within the specified period imposed by the authorities. Moreover, there was no guarantee that governance and management would change in parallel with the changes in the financial structure. These standards also induced an economy-wide financial crunch: there was a drastic contraction in bank lending, and a significant number of bankruptcies of illiquid firms, with only a moderate increase in share issuing and trading.

At times of unfavourable external shocks, such as an oil price hike or a deterioration in the terms of trade, policy measures should be altered to mitigate their adverse effects. When new internal factors are identified as additional elements that exacerbate the effects of a crisis (such as huge non-performing loans to major companies belonging to the Daewoo group), the policy stance also needs to be modified. When the policy measures undertaken turn out to have unexpected effects, additional measures are needed to address these.

As with economic liberalization, financial transformation, to be successful, should be pursued progressively. In the light of the Korean experience with the recent crisis, this paper suggests some lessons that favour a gradual and sustainable transformation for a small economy, such as the Republic of Korea, with a large indirect financing scheme at the beginning of the transformation. Section II sketches the plans that aimed at resolving the crisis facing the Republic of Korea. Section III evaluates the global standards proposed as the norms and the adjustment efforts undertaken for the resolution of the crisis. Section IV discusses public funding and labour market reform. Section V examines the changes that took place till the end of 2000. And finally, section VI suggests overall lessons.

II. CRISIS RESOLUTION IN THE REPUBLIC OF KOREA: FOUR REFORMS

Numerous studies on the Korean financial crisis of 1997 have identified its principal causes: the increase in labour costs outpacing that of productivity; the appreciation of the Korean won, partly due to capital inflows resulting from capital account liberalization; the excessive build-up of short-term foreign currency liabilities on the balance sheets of companies; and the contagion effects from the crisis-ridden South-East Asian countries.

The causes of the crisis can be grouped into external and internal factors. The external factors included: massive and volatile capital movements in recent years; inadequacies in the global financial architecture for avoiding systemic risks; an inappropriate system for determining the exchange rate; and self-fulfilling expectations and the herding behaviour of international bankers and investors. The internal factors included structural ones such as insufficient transparency, endemic moral hazard, and lack of market discipline, reportedly prevalent in the non-financial sector of the Korean economy. Specifically, these were identified as excessive corporate leverage, poor corporate governance, an inadequate monitoring mechanism to impose accountability and transparency on management, improper practices associated with cross-holdings and cross-subsidization within the *chaebol*, and the misconceived notion that these companies were "too big to fail". All these were seen to result in encouraging high-risk businesses and excessive investments away from market-based logic. Other internal factors in the financial sector seen to have precipitated the crisis included commercial bank operations implicitly guided by the Government rather than by profit-oriented management principles, and lending practices based on collateral instead of strict project evaluation.

Korean corporate establishments, whether in the financial or non-financial sector, have lacked adequate governance and thus the transparency associated with a good accounting system. And they have not necessarily been oriented towards profit maximization. Prior to the crisis, the de facto public role of financial institutions in assisting the Government's com-

mercial policies, together with the latter's inappropriate macro management, resulted in an overvalued local currency. The existing supervisory system was improper: it allowed large short-term liabilities and caused massive maturity mismatching.

As a small country with little influence on its external environment, the Republic of Korea, particularly its financial sector, is vulnerable to the moods of international lenders. Since all possible remedies to rectify external factors were beyond its reach, its only option was to correct its internal weaknesses. The Government also decided to dispense with moral-hazard-driven lending that often led to excessive investments motivated by hidden subsidies.

In order to obtain immediate liquidity, the Korean Government extended the maturity of short-term external debts with de facto government guarantee of commercial bank debts, and then issued global bonds to ensure the country's access to international financial markets. Subsequently, the Government launched reform programmes for each of the financial, corporate, public and labour sectors (Ministry of Finance and Economy, 1999). The following sections describe these reform programmes in both the financial and non-financial corporate sectors.

A. Financial sector

For the financial sector, 15 legislative reform measures were introduced to make the Korean financial system conform to the norms set by the Organisation for Economic Co-operation and Development (OECD), supposedly for enhancing its efficiency, transparency and soundness.[2] A new Financial Supervisory Commission (FSC) was established for more effective financial supervision. Disclosure was strengthened by obliging financial firms to comply with the disclosure requirements of international accounting standards, especially those regarding off-balance-sheet transactions, asset classification and special disclosures such as those related to unusual losses and contingent liabilities. Governance-related corporate reforms for financial firms were also introduced.

For establishing a sound banking system, many critical measures were undertaken. Weak institutions were either closed or consolidated with stronger ones. The Basel Committee's Core Principles were adopted, with emphasis on the guidelines for transparency and disclosure. In addition, more stringent loan classification standards and provisioning requirements were adopted. Public funds were utilized to rehabilitate troubled institutions and to help them attain a capital adequacy ratio above the Basel norm of 8 per cent. Banks were advised to seek foreign investments. The private sector made serious attempts, with the Government's guidance, to find foreign strategic partners who could inject both new capital and management expertise.

The reform drive was extended to the capital market, following the diagnosis that bank-dominated indirect financing had contributed to the crisis. The shallow investment base was seen as inhibiting structural improvements in corporate finance, and the weakness in the domestic bond market was considered an impediment to the improvement of corporate debt. High priority was therefore given to the advancement of the national capital market, and, in parallel, new financial commodities such as asset-based securities and mutual funds were introduced.

B. Corporate sector

High corporate debt and weak governance had resulted in excessive debt-financed expansion by Korea's conglomerates, and this had raised the country's vulnerability to a financial crisis. Implicit risk-sharing by the Government, together with inadequate corporate governance, had led bank borrowers to become overly dependent on debts (the mirror image of over-burdened lenders with non-recoverable loans) and to make excessive investments. The overall situation had made both the banks and businesses extremely vulnerable to bad shocks.

In order to overcome the syndrome of over-borrowing, the Government saw the need to conform to international standards. Specific provisions to this end included: (i) strengthening the accountability of controlling

shareholders and management to improve corporate governance; (ii) enhancing the transparency of management; (iii) eliminating cross-debt guarantee between firms affiliated with *chaebol*; (iv) improving the capital structure of firms, focusing on their core competences; (v) introducing outside directors to participate in important corporate decision-making to protect the interests of general shareholders against the controlling shareholders who monopolized decisions; (vi) recommending the utilization of economic value-added and cash flows in business operations; (vii) strengthening the legal rights of small shareholders to detailed information on corporate operations; and (viii) augmenting internal auditors' functions.

For carrying out the corporate restructuring, the creditor banks were assigned a catalytic role. Three different approaches were adopted corresponding to the restructuring requirements of three groups differentiated by size: the top five *chaebol* and their affiliates, other smaller conglomerates, and small and medium-sized enterprises (SMEs). The top five were allowed to pursue their self-designed restructuring, as they were believed to have the capacity to absorb any resulting losses. Other conglomerate groups, ranked from 6 to 65, were made to enter into "debt work-out" arrangements with financial institutions, based on the principle of burden-sharing. The SMEs were supported with restructuring funds by financial institutions.

To facilitate rehabilitation, additional measures were taken. All forms of mergers and acquisitions (M&As), including hostile takeovers, were liberalized, and the 25-per-cent ceiling on equity investments by *chaebol*-affiliated companies in other companies within the group were also lifted. It was recommended that private firms adopt the Code of Best Practices of Corporate Governance, established by the Committee on Improving Corporate Governance composed of private experts.

It is useful to remember that, as a byproduct of the indirect financing tradition, Korean firms, in general, had high debt leverage. To reduce their excessive leverage, thereby improving their balance sheets, a phased reduction of their debt-to-equity ratio was contemplated. Specifically, in December 1998 the top five *chaebol* reached an agreement that they would

reduce their debt-to-equity ratio from 400 per cent to 200 per cent on a consolidated basis by the end of 1999.

Another reform programme was business swaps, with the goal of enhancing core competence. The business swaps, commonly called “Big Deal”, were extended to semiconductors, oil refining, aircraft, railroad rolling stocks, power generation facilities and vessel engines, and petro-chemicals. The restructuring programmes also involved selling off sub-sidiaries to more competitive companies, or spinning off the subsidiaries to independent companies. It was hoped that these measures would con-tribute to enhancing international competitiveness in those sectors by not only eliminating overlapping and excessive capacities, but also achieving economies of scale.

III. GLOBAL STANDARDS AND EVALUATION OF THE POST-CRISIS ADJUSTMENTS

At the end of 1999 the Republic of Korea’s foreign exchange reserves amounted to more than US$ 73 billion, compared to less than US$ 9 billion at the end of 1997. With this remarkable improvement in exchange reserves, the country’s President proclaimed, “… in less than two years since the outbreak of the financial crisis, Korea has reemerged more quickly and strongly than anyone expected, demonstrating its resolve and resilience to overcome such a huge adverse shock ...”.

The Korean adjustment sketched above has been claimed to be a process of adapting previous practices to so-called “global standards”. However, the question is whether there are global standards for all aspects of economic life. Even where such standards exist, it is one thing to talk about them and another to adopt and implement them. As some global standards are foreign to Korean business tradition, they cannot be applied rapidly in the adjustment process without causing difficulties.

Some global standards are quantitative, but others are qualitative and not easily quantifiable. Quantitative standards, such as the BIS ratio and

the leverage ratio, are easily measured, and therefore can be objectively monitored. However, in the absence of a good yardstick for the qualitative or unquantifiable standards, monitoring and regulation concerning their implementation becomes difficult. Indeed, this distinction is very significant in the case of the Republic of Korea, since, in practice, the quantitative standards have been aggressively enforced.

A. Qualitative standards and their effects

Some qualitative standards do not have definite norms or criteria to adopt and follow, while others are in the process of revision and modification in the global community in the light of new developments made during last few years following the East Asian crisis. This implies that the mechanical enforcement of qualitative global standards, some of which are subject to somewhat arbitrary interpretation, cannot be implemented exactly and might not produce the intended results.

(i) Accounting standards

In the name of international accounting standards the Korean Government has demanded that all conglomerates present combined financial statements of all related firms. However, it is well known that there is no single international accounting standard; it is, at present, under discussion in the OECD. Moreover, its main contents seem somewhat different from those of the American Accounting Standard, and these differences need to be resolved, an exercise that is likely to take some time. Therefore, it sounds hollow to talk about a single global standard in accounting, not to mention the mechanical and stringent enforcement of its implementation.

(ii) Transparency

To serve the customers of global markets more successfully, suppliers need to be much more transparent than before. However, it is not clear

whether there is a yardstick to measure the degree of transparency of individual firms or that of a national economy consisting of numerous firms. As noted above, Korean firms, especially those belonging to *chaebol*, have been not very transparent, as they have been engaged in internal trading mingled with transfer pricing, cross-dealing, cross-subsidization and cross-holding of shares. While often criticized, the old practice of creating economic rents through interest-rate controls and allocating them to designated areas was accepted as normal. It is now generally agreed that more transparency is needed in the Republic of Korea. However, the patterns of corporate behaviour cannot be overhauled in one day; they can be improved, but only incrementally. How can firms be expected to attain a certain level of transparency within a certain period of time when the required level is not made clear to them or when they know they cannot attain it? In the United States, the failed Long Term Capital Management (LTCM) fund, which had two Nobel laureates as advisers and a successful Wall Street fund manager as its chairman, demonstrated a probable lack of transparency and adequate risk-prevention measures. The fact that achieving transparency still remains an enormous task in the Republic of Korea, after three years of vigorous adjustment efforts, implies that it cannot be attained within a short period of time.

(iii) Corporate governance

Corporate governance is an issue of considerable concern, particularly after witnessing the past behaviour of firms in terms of excessive investments. The factors generally identified as contributing to the failure of corporate governance include: (a) issues relating to control and ownership; (b) inadequate financial information; (c) no credible exit policy; (d) lack of monitoring of financial institutions; (e) few legal rights or protection for minority shareholders; and (f) no substantial role for directors. Moreover, until 1997 there were no well-recognized bankruptcy procedures, with few, if any, insolvency procedures for large firms.

Many measures have been taken to address these deficiencies. Information disclosure requirements have been made more extensive and frequent; firms now have to report on more items, and accountability is

being enforced with the requirement that independent accountants be responsible for the credibility and accuracy of their financial statements. To facilitate the exit of non-viable firms, the Company Reorganization Act was amended to add an economic test, a time test and a mandatory reduction of shares.[3] A cumulative voting system for boards of directors – together with more outside directors playing an enhanced role – in all listed firms was instituted, and the controlling shareholders were made de facto directors legally accountable in case of mismanagement. Consequently, many firms have installed outside directors who work for the shareholders, although their influence is not particularly satisfactory. As with transparency, it will take more time for this qualitative standard to become well established.

B. Quantitative standards and their effects

Many elements associated with the qualitative global standards are neither clearly defined nor expected to produce the desirable results rapidly if and when implemented. Requirements for such standards have been of a rhetorical nature, and their implementation has proved impractical. They have been neither strictly observed nor have they been able to substantially transform Korean business practices, even though they have been frequently and strongly stressed by the Government.

As for the quantitative standards, the Korean Government introduced the BIS capital adequacy ratio for financial firms and the debt-to-equity ratio for non-financial firms. As mentioned above, the Government demanded that banks raise the BIS ratio to over 8 per cent and that non-financial firms lower the debt-to-equity ratio below 200 per cent, and it has closely monitored the attainment of these targets.

(i) The BIS ratio

The BIS ratio was devised by the international community in 1988, originally as an operational yardstick in order to level the playing field for all internationally active banks from diverse traditions and customary

practices. Moreover, it was designed to take care of credit risk. It was not associated with market risk, let alone counter-party risk or systemic risk. In other words, it aims at preventing these banks from taking excessive risks in their lending activities. In a strict sense, this ratio does not have to be uniform for all banks; it can differ among institutions depending on their history, business strategy, line of business and size. Recently, various countries have begun to allow their banks to have their own risk-management models in place of the BIS ratio. This may be an indication that the BIS ratio has limitations in handling all kinds of risks faced by financial firms.[4, 5]

Yet in the Republic of Korea, the BIS ratio was enforced uniformly for all Korean banks, including those not involved in international business activities. In the implementation process the Korean banks were advised to raise their ratio above 8 per cent.[6] Those failing to meet this requirement were threatened with closure. It was believed that the higher the ratio of the bank, the better equipped it would be to allay foreigners' fears about the Korean economy. In any case, in order not to lose their licence, all Korean banks had to satisfy the ratio requirement at all costs.

The Korean financial situation turned worse with the surfacing of sudden and substantial increases in bad debts owing to the work-out decisions of firms belonging to the Daewoo conglomerate and by the adoption of more stringent guidelines for discerning bad debts through the introduction of so-called "forward looking criteria". These increased the number of non-performing loans and/or considerably worsened the credit-worthiness of many outstanding loans of banks and other institutions, thereby causing them additional hardship in meeting the required BIS ratio.

The 1997 IMF structural reform programme that prescribed, among others, high interest rates and strengthened prudential regulation, caused a credit crunch, made worse by the enforcement of the BIS ratio. Every bank, struggling to survive at the worst time during the crisis, was forced to reduce its lending at whatever cost. Furthermore, ill-timed work-out decisions and the sudden introduction of the "forward looking criteria" further intensified the credit crunch. In retrospect, insufficient consideration was given to the issue of timing in introducing reform measures.

Recently, some measures have been introduced to modify the mechanical application of the BIS ratio. These will be discussed later.

(ii) Debt-to-equity ratio

A similar inadequacy was observed with respect to the debt-to-equity ratio requirement for business firms. As noted above, all conglomerate firms were required to reduce their leverage ratio to below 200 per cent by the end of 1999. However, the reasons for this numerical target were unclear. Firms that could not meet the target were under threat of work-out or closure.[7] Consequently, in view of the difficulties in raising new money in the crisis situation, they were forced to reduce their liabilities, and, correspondingly, to rearrange their asset items.

In general, firms can reduce their debt-to-equity ratio by selling off subsidiaries or assets (e.g. closing failing businesses) or by issuing new stocks. Of these options, the most natural reaction is to eliminate various assets, preferably with the less indispensable items being removed first. But if these cannot be sold, the more valuable assets have to go. Sometimes highly liquid assets must be abandoned, resulting in a shortage of cash, despite the fact that they might have been maintained at their minimum levels. As a result, the lack of liquid assets can interrupt normal business operations. The credit crunch and interruptions in business operations can considerably intensify the liquidity squeeze. Consequently, many firms, faced with difficulties in securing working capital, are forced to sell their most valuable assets, thereby reducing their prices and values of collateral. Such a situation is likely to result in a further increase in bad loans.

Indeed, in the Republic of Korea, not all bad loans encountered *ex post* were bad loans *ex ante*; most were merely outcomes of the crisis, associated with the currency depreciation and liquidity squeeze. A number of projects could not be completed due to falling investments as a result of the recession, currency depreciation and interest-rate hikes. A number of financial intermediaries liquidated their instruments prematurely, affected as they were by a self-fulfilling loss of confidence. This caused a further fall in investments and worsened the liquidity squeeze, thereby intensifying

the recession and leading to a further currency depreciation and another increase in interest rates. An attempt to limit real currency depreciation caused a decline in output, which only served to validate the collapse of confidence, thereby accelerating the vicious circle.

Along with the pressure to meet the BIS and leverage ratios, the sale of shares or firms to foreigners was emphasized as a top priority. However, the possibility of “fire sales” caused considerable anxiety among many Koreans, as such sales would have caused welfare losses. As it turned out, no substantial fire sales took place owing to a boom in the stock market in 1999 which provided an easier way out through the issue of stocks. Thus the *chaebol* managed to meet the debt-to-equity ratio requirement by the end of 1999, not through a major reduction of debts, but rather through new issues of equities. The stock market boom contributed to increasing direct financing, but did not significantly lower the level of debts or alter the business practices of indirect financing institutions to make them more prudent than before. As a result, the subsequent burst of the stock market bubble and the decline in equity prices throughout 2000 caused the firms with large debts to once again experience difficulties in satisfying the required ratio.

IV. PUBLIC FUNDS AND OTHER ADJUSTMENT EFFORTS

In addition to the application of global standards to two carriers of production – firms and financial institutions – other reforms were introduced in the form of “Big Deal” and work-out measures related to the factors of production (i.e. labour and capital) and direct intervention, although emphasis on them was weak.

A. Labour

The Republic of Korea has achieved some progress in labour market reform by revising the Labour Standards Act, which legalized layoffs by

management. In January 1998 the Tripartite Commission was established to enhance labour market flexibility, and cooperation between labour, management and the Government. Intended to resolve difficult problems through consensus, it resulted in employment reduction immediately after the crisis. But its long-term usefulness remains to be seen, as the mere existence of the institution does not necessarily ensure cooperation between labour and management. In addition, manpower-leasing businesses were introduced in July 1998 to provide workers with a broader range of jobs through the "worker dispatch scheme".[8]

B. Capital: foreign capital

New resources (external and internal) needed to be injected into the troubled banks and firms for meeting the targets of the BIS ratio and the debt-to-equity ratio respectively. The Korean Government initially intended to rely mainly on external resources. The principal strategy was to be the sale of companies, particularly good ones, despite complaints over possible "fire sales". The Government argued that this was because bad companies could not be sold. Confronted with unfavorable comments by foreigners on the credibility of Korean firms, sometimes related to the very sale of the companies, and, without any objective criterion, the sale price of firms was decided almost entirely by foreigners. Thus a buyers' market for Korean firms was created as a result of the Korean Government's desperate need for foreign capital.

This need prompted the Government to allow hostile takeovers, for the first time in the country's history, as part of the terms of the standby agreement reached in 1997 with the IMF. Prior to that, hostile M&As were considered a taboo; they were seen as being harmful to the entrepreneurs who had nurtured companies in a difficult environment. However, foreign investment banks advised that hostile M&As were indispensable for obtaining the needed foreign capital.

Some of the M&As were initiated not by demand in the market place, but as a result of pressure from the Regulatory Commission, with what

appears to have been government guidance reminiscent of its industrial restructuring attempts of the 1970s and 1980s. However, not much attention was paid to the diversity of the different *chaebol* groups and to the differences among industries. The restructuring policies seem to have been superficial, lacking in detail and inconsistent, with an emphasis on market mechanisms, particularly evidenced in the many M&As that took place. Table 1 shows the recent trends in capital inflows. The absolute magnitudes increased over the three years immediately following the crisis, but their ratios to GDP were still smaller than those of such economies as the United Sates, the United Kingdom, China and some South-East Asian countries. The shares of the foreign capital inflows (FDI and portfolio investments) in gross investments in the Republic of Korea were 9.6 per cent in 1997, 4.9 per cent in 1998, 16.2 per cent in 1999 and 17 per cent in 2000.

It seems optimistic to have expected the Republic of Korea to attract even the same amount of foreign capital as the Nordic countries managed

Table 1

FOREIGN CAPITAL INFLOWS AND GROSS INVESTMENTS

	1997	*1998*	*1999*	*2000*
Foreign direct investment:				
Reported	69.7	88.5	155.4	156.9
Arrivals	30.9	52.2	106.1	102.6
Foreign indirect investment	122.9	-2.9	69.9	119.6
Foreign capital inflows	153.8	49.3	176.0	222.2
Gross investments *(Billion won)*	15 177.3	94 054.8	128 771.2	148 202.5
Year-average exchange rate	951.1	1 398.9	1 189.5	1 130.6
Gross investments *(US$100 million)*	1 595.7	672.4	1 082.6	1 330.8
Foreign capital inflows/ gross investments *(Per cent)*	9.6	4.9	16.2	17.0

Source: Ministry of Industry and Resources for FDI; Bank of Korea for indirect investments.

during their crises in the early 1990s (the proportion of foreign capital in these countries was estimated to be about 20 per cent),[9] given that the latter are regarded as very transparent, while the Republic of Korea has been criticized for its lack of transparency. At best, foreign capital might have amounted to about 20 per cent of the total new resources needed. Assuming that all gross investments made at that time were utilized exclusively for purposes of structural adjustment, the calculated ratios above suggest that the extent of contributions of foreign capital for Korean restructuring did not deviate from what could be expected based on the experience of the Nordic economies. There is an obvious limit to the amount of foreign resources that can be attracted for restructuring, especially by developing economies, and therefore, new and effective ways of mobilizing underemployed internal resources need to be developed.

C. Public funds

In the Republic of Korea, given the difficulty in mobilizing under-utilized internal private resources, the easier option was to use public resources. Thanks to fiscal soundness inherited from the pre-crisis era, the Korean Government was able to mobilize sizeable public resources to shore up the capital adequacy position of major financial institutions. The injection of public funds was carried out in a front-loaded manner in the hope of quickly restoring confidence in the market, thereby raising most banks' BIS ratio well above 10 per cent. This also provided the Government with room to lower the interest rate and thus mitigate a credit crunch.

The main vehicles for the injection of public funds for restructuring are the Korea Asset Management Corporation (KAMCO) and the Korea Deposit Insurance Corporation (KDIC). The KAMCO purchased and disposed of impaired assets from financial institutions, while the KDIC's function was to create a system of deposit insurance based on limited guarantees for depositors, with the premium linked to prudential soundness of each insured institution. But it also participated in the restructuring process by providing recapitalization funds to targeted banks and reim-bursing depositors in other institutions.[10]

With the help of public funds, banks were transformed into a vehicle used extensively as the main corporate creditor for corporate sector reform. However, the injection of public funds created new problems. First of all, it changed the former private banks into de facto public entities. When the liabilities of banks were guaranteed in 1997 for maturity extension, this resulted in the "socialization of private debts". Many banks were in a sense nationalized, despite outside pressure to rely on the market mechanism and private initiative. Thus with the injection of public funds, the trend towards nationalization of private enterprises was further intensified.

These public funds were expected to be paid back. The shares purchased in exchange for the KDIC debt certificate to raise the capital adequacy ratio were required to be sold, and the money from the sale used to pay for liquidating the debt certificate. However, in reality it is not clear when the money will be repaid. In the meantime, the financial injection implies an increase in public expenditure to finance the interest payments on the debt certificates, possibly risking inflation. Moreover, the debt certificates exchanged for banks' shares are valuable assets for the banks to further utilize, as they can issue new liabilities based on those certificates. However, their utilization may amplify the inflationary potential. So far this kind of potential danger has been averted.

The Government initially projected that the total amount of public funds to be injected would be 64 trillion won,[11] for recapitalizing financial firms and paying the banks' depositors on their behalf. However, after the injection of the public funds, there appeared to be a further financial need for recapitalizing financial firms whose non-performing loans had increased due either to bankruptcies of their borrowers, or to a deterioration of the quality of the loans. In October 2000, the Ministry of Finance and Economics requested the National Assembly to authorize an additional 40 trillion won. The planned use of this new money was not very different from that of previous funds: investments into banks to strengthen their capital base and the BIS ratio, and investments into the Seoul Guarantee Company, several credit unions and credit cooperatives to augment their respective loss provisions. Moreover, many feared that the 40 trillion won would not be the final injection of this kind. Indeed, by the end of 2001, the total amount of public funds injected was reportedly 156 trillion won. This

included not only the original funds of 64 trillion won and the additional 40 trillion won, but also other special purpose public funds and the reused funds from the repayment by the institutions that had used the original public funds for restructuring purpose.

At around the same time, it was revealed that 45 trillion won of the initial 64 trillion won was unlikely to be recovered, and the net interest payments accumulated during the past four years on the total public funds was estimated to be 44 trillion won. As a result, the congressional hearing on this matter disclosed that the total national burden from the operation of the public funds amounted to 89 trillion won. In order to avoid the problems associated with such use of public funds, it is obvious that there needs to be a more active utilization of private money.

D. "Big Deal" and work-out programmes

A "Big Deal" was introduced through which production facilities of big firms were supposed to be swapped and their overcapacity curtailed. However, the Government determined which businesses would have to be swapped without any consultation with the firms involved, and it offered no room for compromise. But the swaps required many conditions and compromises on the part of the c*haebol* groups concerned. The conditions were hard to meet and compromises even harder, in spite of pressure from the Government. Hence, the "Big Deal" turned out to be a failure in the sense that the initial plan was not implemented as intended, and the problem of overcapacity resulting from the past excessive investments has never been resolved.

There have also been work-out programmes for several firms, with somewhat favourable aid packages offered to them. The rationale for these programmes was to provide liquidity to those firms deemed solvent but experiencing temporary liquidity problems. In other words, if short-term liquidity was provided, the firms under the work-out programmes were expected to become normal. Even with the good intention of the work-out programmes not many firms returned to normal even with the rescue

financing, and some of them had to be either liquidated or financed further. The work-out programmes therefore have been criticized as having been too lenient in the sense that they included too many firms (including non-viable ones) and that the aid packages discriminated against other good firms that were not part of the work-out programmes.

V. AN ASSESSMENT OF THREE YEARS OF RESTRUCTURING EFFORTS

Upon entering 2001, three years after the Republic of Korea initiated its restructuring efforts, the evaluation by foreigners of the outlook of the Korean economy differs from that of many Koreans. According to a survey of 2000 foreign firms running businesses in Korea, conducted by the Korea Trade and Investment Corporation in the first half of December 2000, 53 per cent of foreign firms were optimistic about the Korean economy and intended to increase their investments in the country. In contrast, Koreans were less optimistic, according to other surveys done by various newspapers; Koreans expected a further deterioration not only because of worsening external conditions, but also because of the discrepancies between the restructuring plan and its actual implementation.

In this context, we examine a few new developments since the end of 2000. First, many quarters of the economy, including the Korean Chamber of Commerce and Industry, have severely criticized the Government's obsession with the BIS ratio. Even the Bank of Korea has argued that the BIS ratio should be applied differently to different banks (especially depending on whether they are from an advanced economy or not). In addition, the Financial Supervisory Commission (FSC) revealed that it might not be preoccupied with the BIS ratio per se, and would be more concerned with other yardsticks, including profitability indicators such as the rates of return on assets and on equities. These changing views, that banks should not be too tightly constrained in lending so as to mitigate the prevailing financial crunch and serious financial dis-intermediation, seem quite different from three years earlier when the authorities were preoccupied with the BIS ratio.

As explained earlier, the task of reducing the debt-to-equity ratio for the c*haebol* to below 200 per cent by the end of 1999 was met, not by reducing debts but by increasing equities, helped by the stock market boom in 1999. However, with the decline in stock prices during the second half of 2000, firms with a satisfactory debt-to-equity ratio began to suffer due to the remaining obligation of interest payments. Indeed, the absolute size of debts on which the interest was paid had not been reduced even with the improvement of the ratio in 1999. This suggests an urgent need to find more direct ways of lowering cash outflows and debt liabilities rather than using indirect ways of lowering the debt-to-equity ratio (and thereupon the debt burden).

The experience with the work-out programmes indicates that simple channelling of liquidity to loosely selected firms does not always transform them for the better. The point is that firms' debts should be dealt with by reducing their interest payment obligations in addition to the removal of moral-hazard-inducing misdemeanors. Thus before the injection of liquidity, there should be an assurance that their debts will be cleaned before their resumption of normal operation. The cleaning would better precede any injection of funds, irrespective of whether these are provided by work-out programmes or public funds. Hence, a debt-equity swap, which compels the reduction of debts, could be an effective solution.

As a response to the criticism that even insolvent firms were kept alive because of the lenient criteria in the loose work-out programmes, the creditor institutions have, since November 2000, applied more stringent criteria for discerning firms for credit supply, especially those firms regarded by the earlier lenient criteria as normal or "too big to fail". They have been pressured to identify as candidates for exit the firms that have had interest compensation ratios of under one for the last three consecutive years and the firms that are unable to pay the normal operating bills in their main trading areas. This surely has served to distinguish viable firms from the others and to facilitate a few experiments in debt-equity swaps. However, such experiments cannot be sufficient unless debts are substantially decreased or the swaps are extended to a wide range of firms, with each undergoing a market test for determining the swap rate.

Since the strengthening of the criteria, however, a few firms have been forced out of the work-out programmes, and many others have managed to receive liquidity by remaining in the work-out programmes, even against the will of creditor banks. Actually these banks have often been forced to finance aid packages. In such cases, the Government's involvement in and domination over the banks' decision-making have not been consistent with its proclamation of encouraging private initiative. The Government has justified its intervention on the grounds that this prevents market disruptions. Some officials have argued that the intervention has been indispensable since some markets would have collapsed without it. Recently, such cases have increased substantially. In the corporate bond market, the FSC has forced banks, even against their will, to underwrite the corporate bonds of liquidity-short companies. In the market of investment trusts, the Government has allocated to banks, irrespective of their preferences in portfolio selection and management, bonds issued by corporations that are of virtual junk bond status. The Government has also strongly encouraged bank mergers on the grounds that the enlarged banks would be able to handle the existing non-performing loans more effectively. Indeed, the bank mergers had become a symbol of financial restructuring even before the public could clearly understand and accept the rationale behind this approach. For the first bank merger, the Government selected two banks engaged mainly in retail banking and with relatively negligible non-performing loans, as they had not been involved in wholesale financing in the past. This initiative prompted a strike by bank employees. Since then, forced mergers have been severely criticized, especially in the academic community, as an improper way of restructuring.

All these cases of government intervention have deviated from the principle of market mechanism and global standards. Apart from the mergers, the privatization of banks, as the fundamental task for financial stabilization and restructuring, has been set aside. Critics have strongly upheld the idea of removing undue government influence with the aim of improved corporate governance. In fact, such interference renders the previous insistence on global standards rather weak.

VI. LESSONS FOR BETTER RESTRUCTURING

The attention to qualitative standards and the rather rigid enforcement of two quantitative standards have contributed remarkably to economic recovery in the Republic of Korea, as mentioned in the introductory section. However, the strict adherence to the quantitative standards has also brought about undesirable side effects, including a credit crunch, resulting in an economy-wide vicious circle. Consequently, the Korean business community has complained that governmental involvement has created unnecessary hardship as well as being largely inconsistent with the proclaimed market principles and global standards. The misgivings about financial restructuring could have been avoided if the rigid enforcement of a few ratios had been a little flexible. In this context, the following section discusses a few lessons learned from the restructuring.

(i) The dynamics of transformation should to be taken into account in securing qualitative and quantitative objectives of restructuring.

The qualitative objective can be attained over time only when there is an appropriate infrastructure, while the attainment of the quantitative objectives can better be managed flexibly according to developments in the market and other relevant measures. It should be remembered that an adequate balance should be maintained between the formal legal structure and the realities of governance and management.

For nurturing a deficient, if not a missing, capital market in emerging economies, the Government should, in addition to various qualitative factors associated with it, encourage the participation of well-developed institutional investors, such as mutual funds, pension funds, insurance companies, and, most importantly, investment banks. These institutions should form a system enabling reliable credit evaluation and reasonable portfolio allocation. Securing an exchange rate system with due regard to capital flows suited to such emerging economies should also be a prerequisite.

But all these elements require an ability for constant adjustment. Indeed, the underlying dynamics of financial transformation are very

complex; they are affected by such factors as the changes in external conditions, government policies, the conduct of numerous private entities and expectations. The injection of public funds, for example, is just one government policy along with all these elements. Even if they are disbursed as scheduled, the dynamics could shift in unexpected directions as a result of variations in the other factors. In other words, the dynamics cannot be fully controlled. In the Republic of Korea, besides the sudden liquidation of loans due to the abrupt imposition of the BIS ratio, the collapse of confidence, continuous currency depreciations and interest rate alterations invoking balance sheet difficulties all contributed to the vicious circle discussed above. And once the vicious circle appears, it is not easy to overcome due to the difficulty in forecasting all elements affecting it. Hence, in order to adequately respond to these uncertain dynamics, government responses need to be flexible. One or a few drastic measures that could partially and temporarily break the inherent dynamics cannot be relied upon completely in an uncertain dynamic environment, even if the measures, for all their good intentions, retain the convenience of easy and objective monitoring, such as the application of the BIS ratio or the injection of public funds.

(ii) New resources need to be injected along with the cleaning up of bad assets and liabilities in the balance sheet.

The Korean Government pursued, as a practical approach, the option of injecting public funds rather than mobilizing private funds. However, this prompted the criticism that the Government preferred a simple but ineffective solution that failed to achieve its intended goal.[12] The failed outcome suggests that simply injecting public funds into banks without cleaning up the sources of their loan portfolio and without considering the possibility of newly-arising bad assets in corporations that are confronted with a worsening economic situation, cannot normalize the financial sector.

In the Republic of Korea, the initial injection of 64 trillion won was determined on the assumption that this would take care of 50 per cent of the then existing bad assets on the balance sheets of firms, provided that the remaining 50 per cent would be absorbed by the firms themselves from other external resources. However, as noted above, the actual funds injected

turned out to be 156 trillion won, including the addition of 40 trillion won to take care of the new criteria for non-performing loans and the unexpected bankruptcy of Daewoo. This demonstrates that even the injection of huge amounts of public funds failed to control the uncertain dynamics of the Korean financial reform process.

In order to halt the dynamics associated with bad assets in firms and financial institutions, such assets have to be written off, with a corresponding reduction of their capital base. Thereafter, in order to restore a good portfolio balance, the liabilities should also be reduced, and at the same time the capital base should be strengthened. The most appropriate and direct means of accomplishing this is through debt-equity swaps, as explained below. Indeed, the best short cut to breaking the vicious circle is by cleaning the balance sheets of the widest range of firms and financial companies to the maximum extent possible. The restructuring of firms in the financial sector should be accompanied by the restructuring of firms in the real sector.

In passing, it should be pointed out that the implementation of debt-equity swaps is more difficult when the stock market is booming than when it is depressed. Also, it is important to avoid too much reliance on foreign capital. Foreign capital is an attractive new financial source for development and/or restructuring, but it has its own logic in international movements. As the Feldstein-Horioka puzzle explains, there need to be limits to the contribution of foreign capital to domestic capital formation, say up to 20 per cent, although the limit would differ depending on the stage of development and restructuring.

(iii) Debt-equity swaps need to be tried in parallel with the establishment of a junk bond market.

As mentioned above, in 1998 the Korean Government, in addition to the policy of attracting foreign capital, introduced measures to mobilize internal resources especially by activating direct financing channels. Mutual funds are now allowed to mobilize savings withdrawn from bank deposits due to their low interest compensation or to investors' lack of confidence in directly investing on their own in the securities market. Mutual funds

are, indeed, a new financial product in the Korean economy. However, they have been limited to the closed-end type, which puts a limit on their growth. Also, pension funds have been encouraged to invest in the securities market, which is less conservative than mutual funds. Vulture funds were discussed, but so far there do not seem to have been any noticeable activities by such funds.

None of these means have been sufficient to mobilize capital and channel it to capital-strapped companies. Hence new ways must be devised for mobilizing those internal resources that are regarded as underutilized. Owing to the inadequacy of public funds, underutilized private domestic resources need to be mobilized for corporate restructuring of both the financial and real sectors. For achieving this objective, first of all underutilized private domestic resources need to be identified. Since the credit-rating of most firms would consider them not "investment-worthy", the activation of a junk bond market was suggested as an instrument for mobilizing domestic resources. This market was expected to widen the portfolio selection for idle liquidities. For the same purpose, in parallel with the junk bond market, the debt-equity swaps could be employed. Indeed, the swap of banks' liabilities (i.e. deposits by the depositors) with their capital (i.e. bank shares) could reduce their liabilities, thereby easing the pressure on them to meet the required BIS ratio. Similarly, the swap of liabilities of firms (i.e. bank loans to firms) with the firms' capital (i.e. firms' shares) could reduce their liabilities, and thus ease the pressure on them to reduce their leverage ratio.

However, incentives are needed to encourage such debt-equity swaps. In the process of providing such incentives, the share prices of both firms and banks would have to be discounted.[13] Indeed, the discount implies a virtual cleaning up of troubled companies. The extent of the discount (and thereupon the swap rate) must be determined by the market. In order to create a market for numerous debt-equity swaps, investment banks, together with vulture funds and corporate restructuring companies, have to be activated.

Debt-equity swaps have a number of merits (relevant in the light of the misgivings expressed in the Korean reform process). First of all, they

rely mainly on internal resources, thereby allaying the fear of "fire sales" to foreigners. Secondly, they rely on private resources mobilized through the market mechanism, which reduces the potentially undesirable effects of using public funds. Thirdly, they contribute to the cleaning up process, since they improve the financial state of the companies concerned by reducing the size of their liabilities. They are a more direct way of resolving the debt trap than the indirect way using the BIS ratio or the debt-to-equity ratio. Fourthly, by increasing the proportion of direct financing, they address the problem of an unbalanced financial mix of the kind associated with the 1997 financial crisis. Fifthly, they make investment banks more conscious of the need for securitization of their finance.

Debt-equity swaps do not directly improve corporate governance or uphold the quality of management in troubled firms. Yet with the various swaps, the shares of firms are more widely distributed and the excessive influence of dominant owners is thus reduced. Similarly, through the processes of investment banking deals and auctions, an increasing number of stockholders will take an interest in the operation and management of their companies, necessitating greater information disclosure, which in turn will enhance the degree of transparency.

Recently, there appear to have been movements in this direction in the Republic of Korea, with strong pressure for the establishment and development of a junk bond market and aggressive attempts at corporate restructuring of companies.

NOTES

1 There is no indication of how the figures of 30 per cent and 60 per cent are obtained, but it does suggest that the role of the capital market needs to be considerably increased.
2 These include: the Bank of Korea Act, the Act for Establishing a Financial Supervisory Commission, the Bank Act, the Depositor Protection Act, the Act for Restructuring of the Financial Industry and others.
3 The economic test is an examination of profit-making in the short-run, whereas the time test examines whether profitability can be sustained over time. These tests were introduced in response to the recognition that many firms did not care much about short-term profitability.
4 When the BIS ratio equivalents were calculated for the first class banks that have their own risk management model, the results reportedly indicated a range between 1 per cent and 30 per cent (*The Economist,* 1–7 May 1999, "Banking regulation; Basle brush"). As this range is rather wide, the 8 per cent ratio may not be the most representative one. Even the BIS has discussed a possible revision of the ratio. One key issue is that the ratio does not properly reflect the alternative phases of the business cycle such that it remains the same across booms and recessions; it must be bigger to contain credit expansion in boom times and smaller to stimulate credit during recessions. Furthermore, the fact that the risk-weight for government agencies of lower-tier OECD countries is lower than that for the first class firms of upper-tier OECD countries has been pointed out as another sign of its inadequacy. Another shortcoming noted is the requirement that short-term lending be associated with less capital provisioning than long-term lending.
5 Barry Johnson of the IMF emphasized in his unpublished paper, *Use and Liberalization of Capital Control,* presented at the Sogang Institute of International and Area Studies, that the establishment of a risk management system with constant attention to risks was much more important than adhering to the BIS ratio.
6 It was reported that the average BIS ratio for deposit banks was 7.04 per cent at the end of 1997, and it increased to 10.83 per cent at the end of 1999, reflecting the obsession to achieve a higher BIS ratio.
7 Work-out programmes are less formal, less costly and speedier than liquidation and bankruptcy procedures, and thus they usually lead to maturity extension, deferred payment and/or a reduction of the principal and interest. During informal work-out programmes, the debtor firm and its creditors can negotiate rescheduling or restructuring in a flexible fashion.
8 Before the introduction of this scheme, all employees who had undergone two or three months of training in companies were considered de facto lifetime employees.
9 Personal communication with an economist of the Swedish central bank at the seminar, Banking Crisis Resolution Issues: International Lessons for Korea, organized by the World Bank and the Korea Institute of Finance, 15–16 May 1998.
10 Malaysia, which voluntarily carried out reforms without IMF loans, has similar institutions. The Danharta, which bought non-performing loans and assists banks to make their assets more sound, is equivalent to the KAMCO; the Dadamodal, which provided public funds for recapitalization, is equivalent to the KDIC; and the role of

the Corporate Debt Restructuring Committee, which led the restructuring of corporations, is similar to the de facto role played by the Financial Supervisory Commission.

11 US$ 1 billion is approximately 1.2 trillion Korean won.

12 Almost three years after the initial injection of public funds in early 1998, the Korean restructuring policy stance changed: a debt-equity swap was arranged for firms identified as being viable based on various criteria. This implied an injection of private funds, instead of public funds, to those firms.

13 It was realized that when the public resources were utilized for those banks that had non-performing loans in troubled companies – thus leaving such loans untouched – the banks would not necessarily become clean unless the companies themselves were cleaned up. Hence, two-and-a-half years after the start of the reforms it was recognized that both financial firms (lenders) and non-financial firms (borrowers) needed to be cleaned simultaneously.

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