Chapter VI

Financial Reorganization in South Korea after the IMF

1. The IMF Support for Korea and What Lay Behind It

1-1. IMF Support

In order to avoid a critical shortage of foreign reserves, South Korea requested support from the IMF on November 22, 1997. Its usable foreign exchange reserve had fell to a mere 7 billion dollars, an amount sufficient to cover no more than three weeks of imports. The support that the IMF announced for South Korea was on the scale of 20 billion dollars. At the same time, the Asian Development Bank and the World Bank also decided to supply funds. Japan, the United States, and European countries announced to offer funds; totalling more than 20 billion dollars as so-called second-tier support, of which 10 billion would come from Japan. The total support announced from both international institutions such as the IMF and the developed countries amounted to 58.3 billion dollars. This amount was equivalent to 43 percent of annual exports and 13 percent of GDP for 1997.

1-2. The IMF Conditionalities

Accepting South Korea's request for funding, the IMF imposed on Korea the so-called IMF conditionalities. These are broadly composed of the following: macroeconomic adjustment, financial reform, and chaebol (industrial conglomerate) reform. The IMF imposed strict obligations on South Korea in each of these areas. The initial agreement of December 3, 1997 held the 1998 growth rate to 3 percent and the inflation rate to 5 percent. It also imposed a balanced fiscal policy with a current account deficit of 5 billion dollars. In comparison with South Korea's past macro economic performance, it was quite a reduction. In addition to devaluing the won and controlling the money supply, the IMF imposed fundamental reforms, including reorganization of unsound financial institutions. As for Chaebol reforms, modification of mutual debt guarantee practices and rapid introduction of financial statements based on international accounting standards were demanded. With these restrictions in place, a deflationary mentality spread rapidly throughout all the economic entities in South Korea in early 1998.

1-3. Background

(1) Increased Current Account Deficits

Among the reasons given for South Korea's foreign currency crisis, we may first mention the increase in current account deficits. In 1996, the year before the crisis first surfaced, South Korea's current account deficit reached 23 billion dollars, an increase of 14.5 billion dollars over the previous year. This deficit corresponded to 4.7 percent of GDP. Among the particular factors that led to this imbalance were (1) decreased resistance to import goods and service, along with (2) lagging technological strength, which was a more structural factor.

The increase in imports came about when wide-ranging deregulation was introduced in an effort to bring South Korea into the ranks of the OECD countries during Kim Young Sam's administration. For this reason, people all at once began purchasing imported consumer goods and traveling abroad, although they formerly would have hesitated to indulge in such unimaginable luxuries. Imports in 1996 were 15.9 billion dollars greater than in the pervious year, and the balance of service trade worsened by 3.2 billion dollars up to 6.2 billion dollars.

The lag in technological power manifested itself in the unfavorable balance of payments with Japan. Most of the capital goods and intermediate goods that South Korea needed for manufacturing were imported from Japan, but exports to Japan did not show a remarkable increase facing the insurmountable characteristics of the market. In 1996, the trade deficit with Japan recorded 15.7 billion dollars, a figure amounting to 3/4 of South Korea's deficit with the entire world (20.6 billion dollars, customs clearance basis).

(2) Company Bankruptcies and Increasing Uneasiness About Financial Institutions

The history of company bankruptcies and financial anxiety was nothing new. Example of company bankruptcies stirring up financial anxiety include the Cheon-Yu-Sa incident of 1969 and the reorganization order of underground loans in 1973. These incidents preluded the so-called "unsound company" problem, which hung over in the other side of the success story of the Korean miracle. In the process of South Korea's high economic growth, the banks were nationalized (1962) on the pretext of making effective use of limited domestic funds, and funds were preferentially invested in the strategic industries of the time. Successors to Chun Doo Hwan's regime, which was established in 1981, sold out the government-held bank stocks, and as a result private ownership of the banking sector spread. However, there was a strong tendency for bank presidents to be chosen according to the government's preferences, and the banks did not find it easy to release themselves from their historic role as a pipeline for funds for the strategic industries. This led to insufficient inspection capabilities that would have allowed them to reject unprofitable ventures. The same lack of inspection capabilities led to preferential lending to the chaebol. Even if a particular indebted chaebol company was strapped for funds, it was usually possible to collect on loans to a chaebol company, according to the mutual payment guarantees that were common within chaebol.

Before the current crisis, even if a company failure stirred up financial anxiety, it was usually cleared up in the end. The difference between the current situation and the past lies in the degree of openness of the financial markets to other countries. Formerly, South Korean financial markets were closed to foreign countries, and any confusion that erupted could be straightened out by appropriate measures on the part of the financial authorities. However, things are different now, as the myth of the invincible chaebol was shattered by the stalemate connected with the scandal surrounding the medium-sized chaebol Hanbo in February 1997. After that domestic financial institutions began taking a serious look at chaebol investments. At the same time, the foreign interests who had been providing overseas funding to the secondary financial sector most typified by merchant banking corporations, began to withdraw their fund. At the end of August of the same year, it was revealed that the automobile manufacturer Kia was strapped for funds, and foreign interests increased their efforts to recoup their funds. Although this was to be expected, it brought about a severe credit crunch and worsened the foreign exchange position of the country. This is why South Korea was driven to request funding from the IMF.

2. Until the Present: the Current Problem is Measures Against Tight Lending

After South Korea accepted the IMF funding in December 1997, it experienced a drop in exchange rates and stock prices, and imports and exports virtually ceased, due to an extreme slowdown in foreign currency transactions. After that, however, the effects of the IMF funding became gradually apparent, and so far, there has been no shortage of foreign currency. At the end of January 1998, it was agreed that 24 billion dollars of short-term debt would be transformed into long-term debt, and due to an extreme curtailment of imports, the monthly current accounts added up to a surplus of more than 3 billion dollars. Because of this, the IMF loosened its tight credit posture for domestic finances by May of the same year, and the IMF permitted lower interest rates and a higher target of M2 increase. Even so, the favorable trends were limited to the monetary macro indicators. This financial loosening that showed up on the charts did not lead to a relaxation of the banks' lending postures, and the real economy remained in a trough. Since the banks are scrupulous about observing the BIS regulations, they are continuing their tight lending posture, and because of that, it seems that the harsh business environment for companies will continue. Due to this situation, the investor mindset is extremely cautious, and in turn, employment has worsened, leading to a freeze in private final consumption expenditure. The economic growth rate for the first half of the year was recorded at minus 5 percent, the worst collapse since the 1980 recession. In this severe environment, financial reform is the most important task, and it is currently under way as follows.

2-1. Importance of Financial Reform

Intervention in the financial sector by the government in connection with the "unsound companies" and chaebol was wide spread in South Korea. Even now, with privatization under way, not much progress has been made in seeking out profitable small and medium ventures, due to underdeveloped inspection capabilities. There has been repeated calls for fostering a healthy financial industry since the 1960s and 1970s, but each time a problem occurs, the government has gotten by with piecemeal measures, and it has never instituted fundamental reforms.

Concentration of finance in large companies means at the same time stinting on funds to small and medium companies and individuals. This is why these groups turned to the unsound underground market (personal debt market, etc.) seeking for finance. Interest rates in this kind of market are rather steep: at least 50 percent higher than in the so-called "authorized sector" of banks. Since the middle of the 1970s, the government has aimed to bring the underground market into the open and has fostered the development of a secondary financial sector (investment finance companies, etc.), but here, too, management of assets and debts has been lax, and a breeding ground for new unsound financial institutions remained.

Under the incentive system focusing on exports and major heavy industries that the government adopted as its major economic policies, preferential interest rates were applied to these industries. But the auxiliary sectors, such as the support industries producing consumer goods for the domestic market, received no benefit from that, and for a long time, they had to pay high interest rates. For this reason, the South Korean industrial system became gradually biased toward heavy industry, and the unprofitability of the high-cost industries began to seep through the industrial linkage, and influence even the industries assumed to be profitable.

There had been several times in which a mood for improving the situation became widespread in the past, but nothing came of them. Finally, through the external pressure of the IMF funding, reform of South Korea's long-troubled financial sector began.

2-2. The Compound Effects of the Chaebol Problem; the Low Profitability of the Chaebol Enterprises

The IMF had touched upon the chaebols problem in its conditionalities. But this matter is intimately connected with financial reform. There is the fact that the chaebols' mutual debt guarantees exacerbated the current crisis. During this crisis, many chaebols were strapped for funds, aggravating the situation. But the leading edge of a cash crunch for an entire chaebol was typically revealed when one of its subsidiary companies, particularly one in an unrelated industry that the chaebol had entered during the bubble period of the mid 1990s, collapsed due to a massive debt. This chaebol practice of getting involved in various industries was called *muneopal* ("octopus tentacle") management, which had been criticized since the birth of the chaebol system. For chaebols expanding their business was profitable because preferential treatment for exports and domestic public works expenditures was largely linked to domestic market share. For this reason, the chaebol began to aim for externally visible expansion and ignore earnings. The financial institutions were unable to gain a clear understanding of the actual status of the complex financial transactions within the chaebol, and they increasingly tended to make their choices based on superficial standards.

Before this crisis, the financial institutions lent to the chaebol with confidence in their stability, but when they actually made claims as the companies went bankrupt, the inherent unsoundness of their financial status combined with weakness brought on by the downturn in the economy was revealed. This meant that the chaebol, formerly believed to be "incapable of failing," incredibly began to collapse.

Because of this, reform of the financial sector itself is not expected to bear much fruit. It is only natural that the IMF proposed chaebol reform combined with the financial reform. Recently, measures have been taken, including the so-called "work out" operations (projects to regain firms' value) and orders to close unsound chaebol subsidiaries. Furthermore, there have been steady advances in bringing financial reports in line with international standards in accordance with the IMF agreement, and it is expected that this will have a positive effect.

3. Recent Measures

3-1. Treatment of Korea First Bank and Seoul Bank

On January 21, 1998, the government announced the de facto nationalization of the highly indebted Korea First Bank and the Seoul Bank through spot issues of stock from Korea Electric Power and the Tobacco and Ginseng Public Corporation. The two banks had Hanbo and Kia as major customers, and their lending assets had deteriorated markedly, so they seemed to be in desperate need of remedial measures. It was decided to auction them off through international bidding in November.

3-2. The Closure of Some Merchant Banking Corporations

On February 17, the government closed ten out of thirty merchant banking corporations whose assets had been steadily deteriorating. The government additionally closed six more companies by August 12. It was believed that the nonbank financial institutions, particularly the merchant banking corporations, heavily invested in Hanbo at the time of its bankruptcy, but the fund are thought to have been acquired through foreign borrowing. Due to the Hanbo bankruptcy, foreign lenders withdrew their funds, and this was the first step toward the current crisis. Compared to the banks, the merchant banking corporations had more marginal clients, and their risk of incurring bad debts was higher.

3-3. Selection and Reorganization of Banks

Beginning in the spring of 1998, the wave of reform reached the banks. On April 14, the "basic direction of financial reform" was established. There was an emphasis on the need for South Korea's financial system to break out of the crisis, first by reforming the banking system and then reforming the non-bank financial institutions. On May 20, the scope of funding for revival of the financial sector was set at 64 trillion won, including 14 trillion won already paid out. Of the new 50 trillion won, there was 25 trillion won of debt purchases by the Korea Asset Management Corporation (a disposition company in charge of buying up troubled debts) and 25 trillion won of increased funding and deposit payback novation by the Deposit Insurance Corporation. On June 26, the disposition of twelve banks that had not yet conformed to the BIS regulations (8 percent) was announced. Operations were suspended at five of the banks, based on the contract transfer policy, and seven were conditionally allowed to continue operations. The fact that such major banks as Chohung, Korea Exchange, Commercial, and Hanil were among the seven shows just how serious the problem was. After that, moves toward reform continued. In July, Korea Exchange Bank received financing from Germany's Kommerz Bank, and on August 24, a merger between Commercial Bank of Korea and Hanil Bank was announced. On September 2, government guarantees for deposit insurance and troubled loan reorganization fund passed the parliament, and in the same month, the Financial Industry Structural Improvement Law and associated bills passed the parliament. Then, on September 8 and 11, the mergers of Hana Bank and Boram Bank, and Kookmin Bank and Korea Long Term Credit Bank were announced.

3-4. Reorganization of Other Financial Institutions

In addition to the disposition of the 16 merchant banking corporations described above, there is continuous monitoring of the remaining 14 companies for compliance with the BIS 8 percent regulations. Liquidation procedures are under way for 10 of 25 leasing companies, and out of 50 insurance companies, 4 were judged to be unsound and are scheduled to close down in October. In addition, operations are under way in security brokers, securities investment trust companies, mutual savings of finance companies, and credit unions.

3-5. Public Funding for Financial Institutions

By August 1998, the government injected 16.7 trillion won, 8.6 trillion won for buying troubled debts (face value 16 trillion won), 8.1 trillion won for increased capital support (6.6 trillion won for capital increases to Seoul Bank and Korea First Bank and payouts and takeovers of institutions whose operations had been suspended). According to the public funding and investment plan announced by the Ministry of Finance and Economics on September 28, a huge amount totaling 21 trillion won will be invested by the end of September, with 9.1 trillion won going to buy up troubled debts (23 trillion won face value) and 11.9 trillion won as extra funding for raising the BIS ratios of healthy banks. The amount of investment planned for the future is about 27 trillion won, and this is supposed to be injected into non-bank financial institutions, disposition of new bad debts, and covering possible contingent losses from the disposing process of Seoul and Korea First Banks.

4. Issues Remaining

First we may mention the problem of public fund injection. As announced on May 20, 1998, the amount of public fund for buying debt and supporting capital increases is 64 million won, and almost all of it was raised through government bond issues. However, considering the small market size and the current severe funding conditions, there is anxiety about the risk of rising interest rates. Furthermore, the troubled debts disposed of by those operations have a maximum face value of 86 trillion won, but some have observed that the total amount of troubled debts exceeds 100 trillion won. If these observations are correct, it will be necessary to consider additional investment. The government is counting on an economic recovery and says that there is little prospect of the total amount of bad debts reaching that figure, but its statements are not very persuasive.

Next, there is the question of just how many years financial reconstruction will take. In the disposal plan announced at the end of September, public investment is scheduled to end in March 1999, but in the end, how long will it take until the economy is back on the road to recovery? If we look at the examples set by other countries, we find that reviving the financial sector takes years.

The final problem is how to minimize damage to the real economy. The goals of getting rid of unsound financial institutions and investing in healthy ones are to push the current corporate reform efforts forward and to impart basic strength to industries. Nevertheless, due to the financial turmoil, the employment situation has worsened, and even exports, the country's lifeline, have been affected. In order to minimize damage to the real economy, South Korea needs fast and flexible financial policies that do not lose sight of the goal of long-term reform.

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