

Financial Reform and  
Financial Crisis in Korea

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### Abstract

We assess the role of financial reforms and liberalization in Korea's financial crisis, which erupted in late 1997. We first examine financial reforms carried out since the early 1980s and their effects on corporate financing as well as the current account. We then analyze policy issues associated with the current financial crisis. Our main conclusion is that the crisis is due in no small measure to the unbalanced nature of Korea's financial reforms – extensive external liberalization combined with inadequate internal liberalization. Therefore, the key to Korea's recovery lies in successful restructuring of its financial institutions.

## 1.Introduction

An active industrial policy has been a prominent feature of the rapid economic growth Korea has achieved since the early 1960s. The Korean government has played a significant role in the allocation of resources within the economy. In particular, the government played an instrumental role in the promotion of heavy and chemical industries in the 1970s, when Korea moved away from an almost exclusive reliance on light industries toward a more diversified industrial structure. A by-product of the pervasive industrial policy has been the emergence and expansion of chaebols or large conglomerates which have come to dominate the Korean economy.

The key component of Korea's industrial policy has been the direction of credit toward favored sectors and firms although subsidies, tax concessions and protectionist barriers were also integral elements. The government extended loans at preferential rates to those sectors and firms. Such extensive interference has hampered the development of an efficient and competitive banking system. Due to the implicit guarantees of the government, lending banks had little incentive to undertake serious credit evaluation or ex-post monitoring. At the same time, the availability of artificially inexpensive credit did little to encourage firms to properly evaluate the profitability of their investment projects. The predictable result was a gradual deterioration in the efficiency of investment and weakening of the banking system.

The rapid economic growth meant that the economy reached a stage, in terms of both size and complexity, in which government initiative became clearly less efficient than the market mechanism as the tool for managing the economy. In recognition of this, the government implemented a broad range of structural reforms in the corporate sector since the early 1980s. To complement these corporate sector reforms, the government also undertook some preliminary reforms in the financial sector.

These incipient financial reforms gathered momentum in the 1990s. The reforms implemented in this period include interest rate deregulation, granting of greater managerial autonomy to financial institutions, the easing of restrictions on business activities of existing financial firms as well as entry into the financial industry, foreign exchange liberalization, capital market opening and other measures. The pace of the reforms were accelerated even further in connection with Korea's entry into the OECD in 1996, since financial liberalization was a major pre-condition for entry.

The financial reforms had noticeable impacts on both corporate financing and the current account. In the area of corporate financing, the remarkable growth of direct financing was the most notable consequence. In spite of this growth, however, the share of debt financing in total external financing remained high because the growth of corporate bonds and commercial paper far outpaced the growth of the stock market. With respect to the current account, it appears that the primary effect of the reforms has been to worsen the current account by inducing greater capital inflows, which lead to an appreciation of the currency and an increase in consumption.

In late 1997, a financial crisis of unprecedented proportions struck the Korean economy, forcing the government to turn to the IMF for assistance. The financial crisis has led to a deep recession in the real sector, with real GDP expected to shrink by 5-6% in 1998 and unemployment projected to reach around 7% by the end of 1998. Korea is currently in the midst of a painful process of structural adjustment.

A major cause of the crisis has been the unbalanced nature of the financial reforms. That is, the policy mix of inadequate domestic financial liberalization and rapid external financial liberalization inevitably meant that the domestic financial system could not efficiently allocate the large inflows of foreign capital. Consequently, a large portion of the inflows was invested in risky projects, contributing to the growth

of non-performing loans and more generally, weakening of the financial system. In terms of overcoming the current financial crisis, the top policy priority is to restructure the debilitated financial system into a sound one.

## 2. Financial Reforms since the 1980s

### 2.1 Financial Liberalization and Internationalization in the 1980s

Korea achieved remarkable economic growth during the 1960s and the 1970s under a series of economic development plans implemented by the government. As the economy matured, however, the central role of the government in economic management began to adversely affect the overall efficiency of the economy. Consequently, the government initiated a wide range of structural adjustments in the real sector with a view to expanding the role of market forces. To complement those changes in the real sector, the government also undertook a number of preliminary measures to liberalize and internationalize the financial sector.

In a major step to loosen government control over the financial sector, the government returned the ownership of all nationwide commercial banks to the private sector by 1983. The government abolished or greatly simplified a large number of regulations governing the internal management and operations of commercial banks. Another major reform was the replacement of direct credit controls with a more indirect system of control based on orthodox monetary policy instruments in 1982.

As a further measure to create a more competitive banking environment, the government encouraged the establishment of new banks by lowering regulatory entry barriers. Two new nationwide commercial banks, namely Shinhan Bank and Boram Bank, came into existence in 1982 and 1983, respectively. They were joined by three other new commercial banks – Donghwa, Dongnam and Daedong – in 1989. The 1987 – 1989 period also witnessed the establishment of five securities investment

trust houses and nine domestic life insurance companies. The overall result was a notable upsurge in the number of banks as well as non-bank financial institutions and greater competition in the financial industry.

A related development was the relaxation of restrictions on business activities by financial institutions. This enabled commercial banks to expand into a wide range of new fields, including sales of commercial bills, credit cards, sales of government bonds under repurchase agreements (RPs), factoring, mutual installment savings, trusts, negotiable certificates of deposits (CDs), as well as the acceptance, discount and sale of trade bills. Among non-financial institutions, investment and finance companies and merchant banking corporations were permitted to offer commercial paper (CP) and cash management accounts (CMAs). At the same time, securities companies were allowed to guarantee corporate bonds, intermediate CDs, and offer bond management funds (BMFs).

There were also a number of measures aimed at deregulating interest rates during the 1980s. These included the abolition of preferential rates for policy loans, allowing banks greater discretion in setting loan rates, and freeing up the issue rates on some financial instruments. Most notably, in 1988, controls on most lending rates of both banks and financial institutions were lifted, along with restrictions on deposit rates on deposits of at least two years' maturity. This bold experiment in interest rate liberalization, however, ended abruptly due to a deteriorating economic environment.

Another key component of financial liberalization was the internationalization of financial markets. The total number of foreign bank branches in Korea rose from 18 in 1980 the beginning of the decade to 1989. Both open-end funds and closed-end funds such as the Korea Fund were set up for foreign investors. Foreign securities firms were allowed to establish representative offices and take limited equity stakes in

domestic securities companies. The Korean life insurance market was opened to foreign life insurance companies in 1987.

## 2.2 Financial Reforms in the 1990s

As stated earlier, the main impetus for financial reforms came from the growing size and complexity of the Korean economy, along with a concomitant realization that continued heavy-handed government intervention in the economy was neither feasible nor desirable. Unfortunately, the reforms have been less than effective because they were implemented in an ad hoc fashion. This lack of a clear overall strategy went hand in hand with a less than absolute political commitment to financial reform.

Drawing on the lessons of the 1980s, the Korean government began to take a more active approach to reform in the early 1990s. In particular, in July 1993 it unveiled a financial reform program for 1993 – 1997. This was a comprehensive and consistent plan designed to promote the efficiency and internationalization of the financial market. The reforms undertaken in the 1990s are far-reaching in their scope. They include full interest rate deregulation, the granting of greater managerial autonomy to financial institutions, the easing of restrictions on new entry and business activities, foreign exchange liberalization, capital market opening and opening up the financial industries to foreign participation.

The cornerstone of the reform program was a 4-stage plan for interest rate deregulation, initiated in 1991. In the first stage, most of the short-term lending rates of banks and non-bank financial institutions were deregulated, while deposit rate liberalization only applied to deposits with maturity of at least three years. The second stage covered all lending rates of banks and non-bank financial institutions excluding loans financed by the government or the Bank of Korea's rediscounts, as well as deposit rates on deposits with maturity of at least two years. In the third stage, deposit

rates on deposits with maturity of at least one year and rates on loans refinanced by the Bank of Korea were freed up. By July 1997, all four stages had been implemented according to schedule. Now, all lending rates and most deposit rates are determined more or less freely by the market players.

Regulations on entry barriers and business activities have steadily been relaxed. Peace Bank was established as a nationwide commercial bank in 1992. Provincial investment and finance companies were allowed to transform themselves into merchant banking corporations in 1994. A big specialized bank – the Citizens National Bank – was allowed to become a nationwide commercial bank in 1995. Furthermore, the legal and institutional framework has turned more favorable toward merger activity among market players.

With respect to the managerial autonomy of financial institutions, they are now free to select their chief executive officers, increase their capital, set dividends and establish new branches in line with their business judgment. The phasing out of policy loans to specific sectors such as export industries and small and medium enterprises helped further strengthen managerial autonomy. Moreover, rules governing the share of chaebols or Korean conglomerates in a bank's total loans have been streamlined.

A major step forward in foreign exchange liberalization was the introduction of the Market-Average Foreign Exchange Rate (MAR) System in March 1990. Under the system, the basic exchange rate of the Korean won against the U.S. dollar was determined by the weighted average of the interbank exchange rates applied in interbank spot transactions of the previous day. The main effect of the system was to remove the arbitrary influence of the government in the determination of foreign exchange rates. In another key development, a completely revised Foreign Exchange Management Act was passed in December 1991. The basis for regulation was

changed from a positive list to a negative list. Under a negative list, all transactions are permitted except those explicitly prohibited by legislation. In December 1994, the government reduced the negative list and laid out a detailed schedule for deregulation of current account transactions and liberalization of the capital account.

The 1990s witnessed an acceleration of capital market openings. Branches of foreign securities companies and joint-venture securities companies were allowed from 1991 while international investment company funds were given greater access. Major Korean companies were permitted to undertake more issues of convertible bonds and similar securities overseas. In September 1991, non-residents who had exchanged convertible bonds into stocks were permitted to sell them and to purchase the proceeds from other stocks listed on the Korea Stock Exchange. Above all, the stock market opening has gotten into high gear. Foreign investors were allowed invest directly into stocks in 1992, subject to a firm-specific ceiling. The ceiling has been raised to 55% of a firm's outstanding shares by the end of 1997, and is to be abolished by the end of 1998 in accordance with the IMF program. In addition, the opening of the bond market was accelerated in December 1997 as part of the same program.

Foreign participation in Korea's financial industries, which got under way in the late 1970s and 1980s, continued to grow rapidly during the 1990s. In particular, the government actively encouraged foreign banks to enter the domestic market. As of March 1998, there were 68 foreign bank branches and 23 representative offices in Korea. The government initially viewed foreign banks as a source of foreign capital. In more recent years, the relative importance of foreign banks as a source of foreign capital has declined but they are increasingly viewed as innovators who would impart advanced banking techniques to their Korean competitors. Prior to 1990, the treatment of foreign bank branches encompassed both regulatory advantages and discriminatory

restrictions. During the 1990s, both were steadily reduced so that foreign bank branches are granted national treatment de facto as well as de jure so that they can now compete with domestic banks on an equal footing.

### 2.3 Post-OECD Financial Liberalization and Internationalization

In connection with Korea's entry into the OECD in 1996, the pace of financial reforms was speeded up from its original timetable. Financial liberalization was the main pre-condition of quid pro quo for Korea's joining the rich countries' club. The agreement between the Korean government and the OECD on Korea's accession stipulated that remaining capital controls be progressively abolished over a 5-year period subject to macroeconomic stability. The main elements of the post-OECD liberalization and internationalization program are as follows:

- (i) The ceiling on individual foreign portfolio equity investments was to be raised to 10% by 2000, but it was already raised to 50% in December 12<sup>th</sup>, 1997.
- (ii) Foreigners were allowed to purchase long-term non-guaranteed bonds issued by SMEs and long-term non-guaranteed domestic CBs issued by large firms in June 1997. Foreigners were allowed to buy long-term non-guaranteed bonds issued by large firms from January 1998. The ceiling on foreign holdings of most bonds was completely abolished from December 30<sup>th</sup>, 1997.
- (iii) Private firms involved in major infrastructure projects were allowed to borrow overseas in January 1997. Overseas borrowing of private companies was liberalized for borrowings with a maturity of more than three years in December 16<sup>th</sup>, 1997.
- (iv) Borrowing related to foreign direct investment (FDI) was liberalized in

January 1997.

- (v) The issuance of domestic capital market securities in foreign markets was allowed for financing major infrastructure projects in January 1997. The eligibility criteria for domestic firms wishing to issue domestic capital market securities abroad was changed from a positive list to a negative list in April 1997.
- (vi) The permitted deferment period for import payments was extended to 280 days from December 12<sup>th</sup>, 1997. The limit for export advances of Korean firms was temporarily abolished from December 1997 to December 1998.
- (vii) Friendly M & As by foreigners were allowed in January 1997.
- (viii) The self-financing requirement on foreign direct investment was abolished in January 1997.
- (ix) Foreign banks, investment trust companies and stockbrokerage firms were allowed to set up local subsidiaries from March 31<sup>st</sup>, 1998.

It should be noted that most elements of the post-OECD program were implemented ahead of schedule because extensive financial reforms were an integral part of the structural adjustment program that the Korean government had negotiated with the IMF in response to the financial crisis.

### 3. Effects of Financial Reforms on Corporate Financing and the Current Account

#### 3.1 Financial Liberalization and Corporate Financing

The deregulation of interest rates, the lowering of entry barriers, the introduction of new financial instruments and other financial liberalization measures have led to a sharp expansion in the accumulation of financial assets since the 1980s. The financial interrelation ration (FIR), or the ratio of total domestic financial assets to GNP, has shown a sustained increase from 3.09 in 1980 to 5.55 in 1996. Positive real interest

rates, new financial instruments, a more extensive network of financial services and the development of the securities market have all contributed to this remarkable financial development.

An increase in financial assets, however, does not necessarily lead to economic growth [see Levine (1997), Arestis and Demetriades (1997)]. The main channel of transmission from financial development to growth is through the efficiency rather than the volume of investment. Prudential regulation is essential in enhancing the efficiency of investment. Therefore, a poor regulatory environment, as in Latin America [see Gregorio and Guidotti (1992)], may result in a negative correlation between financial intermediation and growth.

In the case of Korea, rapid financial development has been accompanied by an increase in investment and vigorous economic growth largely because financial development has contributed to corporate financing. Direct financing in corporate fund-raising, in particular, has risen sharply. The share of direct financing – stocks, bonds and commercial paper - in total corporate external financing rose from 22.9 % in 1980 to 47% in 1996. This was due to the following factors. First, an increase in the demand for securities by institutional investors induced companies to make greater use of equity financing. Second, firms expanded their issuance of corporate bonds in order to secure medium and long-term investment funds. Third, the commercial paper market has become quite mature.

On the other hand, the share of indirect financing in total corporate external financing declined from 36% in 1980 to 31.3% in 1996. Most strikingly, the share of borrowing from banks fell from 20.8% to 15.7% during the same period. Meanwhile, the share of borrowing from non-bank financial institutions (NBFIs) rose substantially from 15.2% in 1980 to 23.8% in 1994. The increasing importance of NBFIs was due

largely to an asymmetric regulatory framework which favored them over banks. NBFIs were allowed greater freedom in asset and liability management, as well as in setting interest rates on deposits and loans. However, the share of NBFIs began to fall from 1985 due to greater deregulation of the banking sector.

In spite of the overall increase in the share of direct financing, debt financing through issuance of commercial paper and corporate bonds has grown much more rapidly than equity financing. As a result, the ratio of debt financing to total external financing remained at an extremely high level of 89% in 1996. Such an abnormally high debt-to-equity ratio implies that Korea's corporate sector is quite vulnerable to a change in the business environment. Therefore, further development of the stock market and a correspondingly greater role of equity financing are desirable.

Although financial liberalization has led to significantly greater availability of financing, it has not been sufficient to meet the increasing demand for corporate financing since corporate investment has expanded even more. In particular, the supply of long-term funds has been consistently insufficient and consequently, the share of short-term financing in total external financing has risen sharply. An increase in short-term interest rates due to interest rate deregulation has also contributed to the growing share of short-term financing. Companies that depend heavily on short-term financing are less likely to take a long-term perspective in making investment decisions and, more importantly, are likely to face greater risks from sudden changes in the financial environment. Accordingly, the development of long-term financial markets will benefit Korea by increasing the supply of long-term funds.

### 3.2 Capital Market Opening and the Current Account

Due to the opening of its financial markets, Korea's capital account balance experienced a sharp turnaround between 1987 and 1996, from - 4.3% to 3.6% of

GDP. In the early 1980s, the capital account was in surplus but this was mostly due to public sector borrowing, which declined from the mid-1980s. Outward foreign direct investment (FDI) began to outstrip inward FDI after 1990. As a result, the ratio of net FDI to GDP fell from 0.4% in 1988 to - 0.4% in 1996. In contrast, inward portfolio investment rose sharply in the 1990s due to the stock market opening. The ratio of net portfolio investment to GDP rose from 0.3% in 1990 to 2.3% in 1996. Thus, Korea's capital account surplus in the 1990s was mostly attributable to the upsurge in inward portfolio investment.

Capital inflows may contribute to a rise in productive investment and, as a result, an improvement of the current account but more likely, they help worsen the current account balance through currency appreciation. The extent to which capital inflows will produce an appreciation of the currency depends on: (i) the macroeconomic environment and (ii) the nature of the inflows – i.e. whether they are largely FDI or portfolio investment. Furthermore, the higher the proportion of inflows channeled into consumption rather than investment, the greater will be their negative effect on the current account balance. In particular, there is generally a close relationship between short-term capital inflows, including portfolio investment, and the current account.

As Oh (1997) notes, there are three main channels by which movements in the capital account induce movements in the current account. First, as noted above, short-term capital inflows produce appreciation of the domestic currency or, equivalently, fall in the real exchange rate. This makes domestic goods and services more expensive relative to foreign goods and services and so worsens the current account. Second, capital inflows may influence private consumption through two channels: an increase in domestic credit and rise in asset prices. The increase in domestic credit leads to greater availability of consumer credit while the appreciation of asset prices

creates a wealth effect. Choi and Song (1996) examine the rise in Korean asset prices due to Korea's financial market opening. An increase in consumption, of course, worsens the current account. Finally, higher investment due to capital inflows has ambiguous effects on the current account. On one hand, the increase in productive capacity may entail more exports and improve the current account. On the other hand, remittance of investment income and imports of intermediate goods will worsen it.

According to recent empirical studies by Oh (1997b, 1998), the evidence indicates that capital inflows have had the negative expected effect on the current account balance in Korea through significant effects on the real exchange rate and consumption. According to Oh, short-term inflows have had a particularly strong impact. He also finds that although capital flows encourage investment, investment does not influence the current account. Korea's current account balance had improved steadily during most of the 1980s but began to steadily deteriorate from 1989 and moved into progressively larger deficits. The ratio of the current account balance to GDP peaked at 7.8% but declined to - 4.9% in 1996. The significant negative effect of capital inflows on the current account balance suggests that policymakers should pay greater attention to exchange rate management and prudential supervision of the financial sector in liberalizing and opening up the financial sector.

### 3. Financial Crisis and Management Issues

#### 3.1 Recent Financial Market Instability and Policy Responses

Until the financial crisis broke out in late 1997, the Korean economy had been fundamentally sound and was recovering from a cyclical downturn. Macroeconomic indicators were also improving – GDP growth of over 6%, inflation of 4.5% and a current account deficit of about 3% of GDP were recorded in 1997. Fiscal policy had remained prudent, with the budget for 1997 recording a modest deficit. The monetary

aggregate had edged down to the bottom of its range for the inflation target.

However, warning signals were flashing in the markets. Since the beginning of 1997, an unprecedented number of highly leveraged chaebols have become insolvent. The high incidence of bankruptcies reflects a number of factors, including excessive investment in certain sectors, weaker prices for exports and political instability. The bankruptcies spilled over into a sharp increase in non-performing loans. The amount of non-performing loans rose sharply. Market sentiment was becoming increasingly uncertain and unstable, and banks were turning extremely reluctant to lend. A severe credit crunch was taking place.

The present difficulties of the financial sector stem from the lack of market orientation in financial institutions combined with lax prudential supervision. Financial institutions had priced risks poorly and proved too willing to finance the unrealistically ambitious investment plans of the corporate sector, which led to excessive leveraging and massive over-capacity in the real sector. At the same time, a steep decline in stock prices had cut the value of banks' equity and further reduced their net worth. These events led to successive downgrading of Korean financial institutions by international credit rating agencies and a sharp contraction in the availability of external financing.

Consequently, the Korean government introduced comprehensive preventive measures to stabilize market sentiment so as to minimize economic costs and facilitate the ongoing financial reform efforts. On August 25<sup>th</sup>, 1997, the government announced a comprehensive package to stabilize the domestic financial markets and enhance financial institutions' creditworthiness in the international financial markets. The package was aimed at eliminating the recent growing concern in both the domestic and international financial markets.

The package included emergency support for the troubled Korea First Bank, a large nationwide commercial bank, as well as some merchant banking corporations, including special loans. The government also helped Korea First Bank improve its capital adequacy by acquiring its stocks in exchange for government bonds. Merchant banking corporations were granted access to the Bank of Korea's short-term RP facilities in the hope that this would improve their short-term financing channels. Furthermore, the government established a Non-Performing Asset Management Fund in November 1997 to facilitate the disposal of non-performing loans and exempted financial institutions from the capital gains tax on the sale of collateralized real estate.

Above all, the government took every measure to assure the international community that Korean financial institutions would repay all their debts to foreign creditors. The government used its credit standing to ensure the payment of the foreign debt liabilities of Korean financial institutions. Of course, institutions benefiting from this arrangement were required to submit and implement restructuring plans. Prudential supervisory measures were also reinforced. The risk-adjusted capital standards recommended by the BIS were introduced and banks were advised to set aside sufficient provisions for expected losses from bad loans. Mandatory disclosure of banks' performance and the standing surveillance system were reinforced for improved monitoring of the banks.

Nevertheless, Korea's external financing situation continued to deteriorate sharply after October 23<sup>rd</sup>, 1997, following a plunge in the Hong Kong stock market and the downgrading of Korea's sovereign risk by Standard and Poor. New external financing virtually dried up and severe difficulties were encountered in rolling over the relatively large amount of short-term debts. The won depreciated sharply against the U.S. dollar while the stock index fell to a ten-year low. Official foreign exchange

reserves also collapsed, as large amounts were allocated to finance the repayment of the short-term foreign debts of commercial banks.

While the contagion effects of the events in Southeast Asia undoubtedly contributed to the current crisis, the speed and magnitude of the financial deterioration was largely due to the structural weaknesses of Korea's financial and corporate sectors. In particular, the problems of merchant banks lay at the heart of the turmoil. In Korea, thirty merchant banks specialized in short-term financing, selling such products as commercial paper, discounting corporate bills, and operating cash management accounts (CMAs). Many of them suffered big losses in the wake of the chain of corporate bankruptcies. Their problems spilled over directly to commercial banks which had made call loans to merchant banks. Accordingly, in early December, the government closed nine merchant banks.

### 3.2 IMF Bailout Funds and Policy Tasks

In spite of the preventive measures, the financial turmoil, in particular the speculative attacks on the Korean won, did not die down. Finally, on November 21<sup>st</sup>, 1997, the Korean government asked the IMF for a bailout. It signed an agreement on a US\$55 billion rescue package with the IMF on December 3<sup>rd</sup>, 1997, after intense negotiations over ten days. Of the US\$55 billion, the IMF, World Bank and Asian Development Bank (ADB) are to contribute US\$21 billion, US\$10 billion and US\$4 billion respectively.

The Memorandum on the Economic Program signed between the Korean government and the IMF covers three important areas – macroeconomic policies, financial restructuring and other structural measures. First of all, sound macroeconomic policies include a tighter monetary policy and substantial fiscal belt-tightening. These are required for orderly re-adjustment of the current account and to

contain inflationary pressures. The program involves a GDP contraction of about 3% in 1998 followed by modest positive growth in 1999, inflation of 5% or less, and building up foreign exchange reserves to more than two months' cover for imports by 1998.

The centerpiece of the program is a comprehensive restructuring and reform plan for the financial sector. It includes a detailed strategy to restructure and re-capitalize the financial sector and make it more transparent, market-oriented, better supervised and free of political interference. Prudential standards are to be upgraded, timetables will be established for all banks to meet the Basle standards of capital adequacy, the disposal of non-performing loans is to be accelerated, and accounting standards and disclosure rules are to be strengthened to meet international practice.

Other structural measures are aimed at, among other things, improving corporate governance, accelerating the liberalization of capital account transactions, further liberalizing foreign trade, and improving the transparency and timeliness of economic data. In particular, improving corporate governance by forcing the corporate sector to become more transparent is expected to contribute to a healthier financial system. In addition, the government will take measures to make the labor markets more flexible.

In spite of the arrival of funds from the IMF and the adoption of various stabilization measures by the government, the turmoil in the foreign exchange markets showed no signs of abating until late 1997. The won fell to a record low of 1965 to a dollar on December 23<sup>rd</sup>. Meanwhile, the stock market continued to stumble while interest rates remained high.

In response to the continuing crisis, the Bank of Korea provided liquidity of 11.3 trillion won to financial institutions from December 15. The government also accelerated the implementation of the IMF program, with many measures being

implemented well ahead of schedule. At the same time, the IMF agreed to release some of the bailout funds earlier than the original schedule.

A positive development was the reversal of the chronic current account deficit into a surplus of US\$545 million by November 1997. The surplus grew further to US\$3.6 billion in December, and US\$3.2 billion in January 1998. More importantly, in January 28<sup>th</sup>, 1998, the government negotiated the rescheduling of short-term debts owed by Korean financial institutions. Those debts were rolled over for a period of one to three years. Foreign portfolio investments seem to be gradually returning to the Korean market, with the net inflows during the first two months of 1998 totaling around US\$3 billion. At a more general level, the financial markets are at last beginning to show signs of normalization since March – as evidenced by the relatively stable exchange rate, declining interest rates, recovering stock market and rising international reserves.

In retrospect, the recent crisis has arisen from a massive shift of funds out of domestic financial markets. From the beginning of 1990 to October 1997, net portfolio investments in the Korean capital market amounted to US\$62 billion. Of these, US\$25 billion flowed in between 1996 and October 1997. Their sudden outflow in November 1997 triggered the financial crisis, leading to a sharp depreciation of the Korean won, the collapse of the stock market index to a 10-year low, and a sharp fall in international reserves. Market sentiment plays a central role whenever there is a sudden shift of funds. Restoring market confidence is thus critical to containing the current crisis and preventing further weakening of the financial system. In this connection, to send clear and credible signals to the market, insolvent financial institutions need to be closed so as to facilitate the restructuring and recapitalization of their weak but viable competitors.

Some important lessons emerge from the Korean financial crisis. First, as obvious as this may seem, financial intermediation does not simply mean a transfer of funds from lenders to borrowers but efficient allocation of funds to the most efficient investment projects. Efficiency must be the principal criterion by which the Korean financial system evaluates itself in the future. The information production function of financial institutions plays a central role in achieving efficiency.

However, Korean financial institutions have so far failed to perform this central function effectively. Due to heavy-handed government intervention and absence of managerial autonomy, there has been little incentive for financial institutions to undertake serious credit evaluation or ex-post monitoring. As a result, much of the capital inflows went into unproductive projects, which, in turn, have created a massive hangover of bad loans. Krugman (1998) points out that financial intermediaries whose liabilities are guaranteed by the government pose a serious moral hazard problem and distort the allocation of capital.

It is possible for us to argue that an imbalance between domestic financial reforms and external financial liberalization was one of the underlying causes of Korea's financial crisis. Until domestic reforms have rendered the domestic financial system efficient and internationally competitive, it may be premature to open up the financial sector to foreign players since an inefficient system cannot efficiently allocate the inflows of foreign capital to their most productive uses [see Park (1997)]. Yet in the case of Korea, it appears that external liberalization was accelerated even though internal reforms remained quite incomplete. The latter have to be completed as soon as possible in order for Korea to enjoy the full benefits of internationalization. For example, the ownership structure and managerial autonomy of the financial institutions have to be strengthened so that they will have sufficient incentive to

undertake serious ex-ante and ex-post monitoring of corporate borrowers.

Second, the Korean economy urgently needs a sound financial system free of political interference and in line with the rules and practices of the advanced industrialized economies if it is to overcome its current crisis and return to a path of sustainable economic growth toward its potential productive capacity. Viable financial institutions need to be restructured and recapitalized while insolvent ones should be shut down. A set of comprehensive reforms, including those facilitating M & As, is required in order to strengthen the competitiveness of financial institutions.

Third, prudential supervision to maintain the systemic health of the financial sector has to be reinforced in line with the progress of financial reforms. More deregulated and competitive markets may increase the likelihood of certain types of risk, thus creating new threats to the stability of the financial system as a whole. It is therefore important for the Bank of Korea to encourage financial institutions to reinforce their risk management systems and capital adequacy.

Fourth, although financial liberalization and internationalization entail many benefits, they also give rise to undesirable side effects. As a result, it is imperative for the authorities to maintain macroeconomic stability. Monetary policy, exchange rate policy and fiscal policy should all be geared toward this end [see Haggard and Lee (1995)]. The pursuit of financial liberalization and internationalization in an unstable macroeconomic environment will not only accentuate an economy's existing sources of instability but also create new ones [see Mathieson and Rojas-Suarez (1993)].

## 5. Conclusions and Perspectives

There are a growing number of studies that analyze the causes of the Asian financial crisis. For instance, IMF (1997) points out some key factors responsible for the present difficulties of Asian economies: first, the failure to dampen overheating,

manifested in large current account deficits and bubbles in the stock markets as well as the property markets; second, rigid adherence to pegged exchange rate regimes that encouraged external borrowing; third, lax prudential standards and financial oversight that contributed to a sharp deterioration in the quality of bank loan portfolios; fourth, political uncertainties and doubts about the authorities' commitment and ability to implement necessary adjustments and reforms; and fifth, developments in the advanced industrial economies and global financial markets, specifically weak growth in Japan and Europe which drove large flows of capital to emerging markets.

As a whole, all the elements of the IMF analysis are relevant to the Korean crisis, except for the pegged exchange rate regime. Korea operated a kind of managed floating exchange rate regime until December 15<sup>th</sup>, 1997, when there was a shift to a free floating regime. However, in view of the chronic current account deficit, it is possible to argue that the exchange rates have been misaligned since the late 1980s.

But, as suggested earlier, what appears to have been the principal factor in the Korean crisis is the unbalanced nature of financial reforms. That is, external financial liberalization was carried out far faster than domestic financial liberalization even though the latter is a pre-condition for the former. In this connection, we should note that the government may have accelerated external liberalization in order to join the OECD. As a result, the domestic financial system could not efficiently allocate the large amount of foreign capital that began to flow in. In particular, the Korean financial institutions had only limited information production capability – competence in screening ex-ante screening and ex-post monitoring of borrowers. Nor did they face strong incentives to develop such a capability due to insufficient ownership interests and managerial autonomy. Prudential supervision to maintain the systemic safety of the financial industry also left a lot to be desired. As a result, a lot of the

foreign capital inflows were invested in risky, unproductive projects, which were likely to turn into non-performing loans.

Accordingly, the key to overcoming the current financial crisis is the transformation of the weak financial system into a sound one. The success of this endeavor depends to a large extent on the decisiveness with which the authorities facilitate the closure of insolvent financial institutions as well as the restructuring and recapitalization of weak but viable institutions so as to restore confidence in the financial system. The authorities should take measures to help foster the information production capability of financial institutions. In this connection, they need to strengthen ownership structures and managerial autonomy. Furthermore, prudential regulation and supervision need to be reinforced. Finally, a re-definition of the relationship between the banking sector and the corporate sector will help the latter, which is highly leveraged, restructure itself.

None of these tasks are likely to be easy or straightforward. However, if there is a genuine commitment to the reform process and a clear understanding that financial reforms are an integral part of a necessary structural adjustment process, the current challenges present an excellent opportunity for Korea to improve its own fundamentals. In this light, we can view the financial crisis as a blessing in disguise insofar as it serves as a catalyst for long overdue reforms which, if successfully implemented, will improve the long-term competitiveness of the Korean economy.

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