Korean Crisis and Recovery

Editors
David T. Coe and Se-Jik Kim

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KOREA INSTITUTE FOR INTERNATIONAL ECONOMIC POLICY

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Foreword

Four years after the outbreak of the Asian economic crisis and three and one-half years after the beginning of the IMF program with Korea, the International Monetary Fund (IMF) and the Korea Institute for International Economic Policy (KIEP) jointly sponsored a conference on the Korean crisis and recovery. The conference was held at the Shilla Hotel in Seoul on May 17-19, 2001.

The objective of the conference was to distill lessons from the Korean economic crisis and recovery, and the policies adopted by the government with support from the international community. The timing of the conference, coming after the three-year Stand-By Arrangement with the IMF ended on December 2, 2000, and following two years of remarkable economic recovery from the crisis, seemed appropriate for such an assessment. The conference brought together Korean and non-Korean economists with Korean policymakers and IMF and World Bank staff, some of whom were involved in designing and implementing the Korean program. Holding the conference in Seoul, with broadly equal participation by Koreans and non-Koreans, was considered essential to ensure that Korean perspectives on the crisis were well represented.

David Coe, who was IMF Senior Resident Representative in Seoul, and Se-Jik Kim, Visiting Research Fellow at KIEP, on leave from the Research Department of the IMF, proposed and organized the conference. Their proposal was strongly supported by Stanley Fischer, then First Deputy Managing Director of the IMF—whose planned participation in the conference, unfortunately, had to be cancelled at the last minute—by Kyung Tae Lee, then President of KIEP, and by the Asia and Pacific Department of the IMF.

This conference volume contains the 13 papers presented at the conference. Each paper is an important reference for scholars and policymakers seeking to understand the Korean crisis and recovery, and the policies adopted to address the crisis. We believe the conference accomplished its objective very successfully.

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We are particularly grateful to Jung Woon Kim, Young-Mok Yang, and Hyong Kun Lee of KIEP, and to Hyeon-Sook Shim of the IMF's Seoul office for their superb assistance in making local conference arrangements and taking care of a myriad of organizational details. We are also indebted to Audrey K. Lee, Maryse Dubé, and Seonhee Bae for their excellent assistance in editing and coordinating the production of this volume.

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Contents

1 Introduction

David T. Coe and Se-Jik Kim

Korea's rapid growth since the early 1960s has indeed been a wonder. Over three decades until the mid-1990s, annual real income growth in Korea averaged over 8 percent. If a country grows by 8 percent each year, its national income will double every decade; if that growth trend continues for thirty years, national income will record a stunning tenfold increase. The small city-state economies of Hong Kong SAR and Singapore also enjoyed rapid growth comparable to Korea's over the same period. But it was a much bigger accomplishment for a country of almost 50 million people to sustain such high growth for more than three decades.

In stark contrast to this remarkable achievement, the honor student of economic growth was down on its luck in the late 1990s when it suddenly faced a financial crisis and its economy crashed. In 1997, consecutive bankruptcies of several large chaebol (Korean industrial conglomerates), coupled with financial crises or foreign exchange instability in Thailand and other East Asian countries, weakened investor confidence in Korea. As a result, foreign banks refused to roll over credit lines to Korean financial institutions and foreign investors pulled out of Korea *en masse*. By mid-December 1997, Korea's foreign exchange reserves were almost depleted. Korea, like a number of other economically vulnerable crisis-hit countries, had no choice but to ask for a rescue package from the International Monetary Fund. The crisis led to a sharp contraction of economic activity in 1998—a *negative* 6.7 percent growth, the worst in modern Korean history. Many Koreans considered the 1997 crisis to be the most critical national crisis since the Korean War in the early 1950s, and the worst national disgrace since the 1910 Japanese Annexation.

How can this sharp contrast between high growth and economic debacle be explained? What caused Korea's three decades of high growth to come to an abrupt halt? Was the crisis a short-term liquidity shock that would be quickly overcome in the context of an otherwise strong economy, or did it reveal more fundamental underlying problems built up during the thirty-year period of rapid economic growth?

Regardless of the causes, Korea was on the brink of bankruptcy in November 1997. On December 3 of that year, Korea and the IMF signed a three-year Stand-By Arrangement. The arrangement included financing for a total of US$58 billion from the IMF, the World Bank, the Asian Development Bank, and a group of countries—the largest rescue package in the history of the IMF.

The financing was not provided unconditionally. The condition was that Korea had to agree with the IMF about macroeconomic as well as financial and corporate restructuring policies during the three years of the program. The Fund recommended to the Korean government a short-term macroeconomic policy focused on high interest rates to restore the plummeting confidence of overseas investors during the early months of the crisis. A concerted effort to persuade foreign creditors to roll over short-term debt was also launched in late December 1997, followed by a more comprehensive rescheduling of maturing debt. The Fund also recommended that the government implement various policies to restructure and reform the heavily indebted corporate sector dominated by the chaebol and the financial sector saddled with non-performing loans.

Were the policies agreed with the IMF and pursued during the crisis appropriate? For example, did the high interest rate policy induce a fast economic recovery by stabilizing the foreign exchange market, or did it deepen the crisis and delay economic recovery? Was it really necessary to restructure the financial and corporate sectors, which, after all, had contributed importantly to thirty years of rapid growth? Indeed, was not there the risk that potentially misguided changes to the fundamental structure of the economy in reaction to a transitory shock would damage Korea's long-run growth potential? Or was it necessary to exorcise long-standing weaknesses masked by rapid economic growth?

There are many questions about the nature of the Korean crisis and the effectiveness of the policies adopted to resolve the crisis. In the early stage of the crisis, IMF recommendations to Korea and other crisis-hit Asian countries sparked heated debates, both in Korea and abroad. The disparity between arguments in favor of and against the IMF's policy recommendations was as sharp as the contrast between the high-growth period and the crisis. During the crisis and the early post-crisis period, it was difficult to judge which side—the critics or supporters of the IMF program—was correct, since the full effects of the policies adopted during the program were not yet apparent. A considered evaluation of the effectiveness and appropriateness of the IMF's policy recommendations during the crisis would require the passage of a certain amount of time.

In May 2001, three and one-half years after the outbreak of the crisis, the Korea Institute for International Economic Policy and the IMF organized a conference on the Korean crisis and recovery. The objective of the conference was to distill lessons based on an analysis of the crisis and recovery, and the effects of the policies implemented under the IMF-supported program. At the time of the conference, considerable data on the effects of the policies under the program were available, enabling serious study and analysis. In addition, as the IMF program came to an end in December 2000, the conference was able to review all policies implemented during the three years of the program. It was recognized, of course, that the papers presented at the conference would not provide unambiguous answers to all, or indeed even to most, of the key questions about the nature of the Korean crisis and the policies recommended by the IMF and implemented by the Korean government during the program.

There were a number of features that distinguished the conference from other conferences on currency or financial crises. First, most of the papers presented in the conference focused on a single country. Second, a wide spectrum of authors contributed papers, ranging from economists who were critical of IMF policies to staff of the IMF and the World Bank and Korean government officials who participated in the design, development, and implementation of economic policies. The organizers of the conference intended to invite diverse views and methodologies that would allow a balanced perspective on policies recommended by the IMF. Third, one-half of the papers were written by Korean economists from the crisis-hit country and one-half by foreign economists, and similarly for the discussants. This arrangement was intended to enhance synergy between studies by foreign experts with a comparative advantage of looking at the Korean crisis from a global perspective, and those by Korean economists with a comparative advantage in understanding the Korean economy, institutions, political economy, culture, data, and so on.

Thirteen papers on the Korean crisis and policy issues were presented at the two day conference. The first session was an overview of the Korean crisis and recovery and an overall assessment of the policies implemented during the IMF program. To begin, an "umbrella" paper by Ajai Chopra, Kenneth Kang, Meral Karasulu, Hong Liang, Henry Ma, and Anthony Richards—members of the IMF's Asia and Pacific Department then working on Korea—reviews the origins of the crisis and the macroeconomic stabilization and structural reform policies of the IMF-supported program (Chapter 2). Based on their review of the crisis and policies, they suggest that the primary factors causing the 1997 crisis were structural weaknesses—notably a weak financial sector with limited ability to assess risk and an over-leveraged corporate sector with insufficient attention to profitability—that left the Korean economy vulnerable to external shocks. Regarding monetary policy, the authors conclude that the initial policy of high interest rates, quickly supplemented by the coordinated debt rollover, helped stabilize the exchange rate and financial markets. On financial sector reforms, the authors underline achievements, such as closures of nonviable financial institutions and reforms of prudential regulations and supervision, but stress the need for the government to privatize its stake in a number of large banks. Corporate sector reforms also made progress in terms of financial disclosure and corporate governance, but Korea's corporate sector remains highly leveraged and continues to suffer from low profitability, indicating the need for more operational reforms. Based on this review, the authors draw lessons from the Korean experience, focusing on crisis prevention and management and also the sequencing of structural reforms.

The second paper, reflecting a Korean scholar's view of the overall IMF program, was presented by Yoon Je Cho (Chapter 3). While agreeing that the Korean crisis mainly reflected deep-rooted structural problems, he raises several concerns about the program. First, he conjectures that the high interest rate policy recommended by the IMF during the early stage of the crisis may have deepened the financial crisis rather than stabilized the exchange rate. A second problem was that the financial restructuring focused primarily on the banks without also improving regulatory oversight of the investment trust companies (ITCs). The rapid expansion of the ITCs contributed to the quick recovery in 1999, but delayed corporate restructuring and deepened financial sector problems. Cho also notes that money growth in a crisis-hit country may be affected more strongly by the regulatory actions of the supervisory authorities than by the policies of the monetary authorities, since the strengthening of regulatory rules may limit money creation by financial intermediaries. Finally, he emphasizes that too ambitious a reform program, such as the rapid introduction of global standards into the banking system, may not be digestible by the political economy of the country, and hence may backfire.

Starting with the second session, the papers looked into specific issues related to the Korean crisis and policies during the IMF-supported program. The first was the high interest rate policy recommended by the IMF during the early months of the crisis, one of the most hotly debated issues in the Korean program. Advocates argued that the high interest rate policy would help stabilize exchange rates by restoring confidence and fostering needed corporate restructuring, while critics, including Cho, argued that the policy is more likely to destabilize the exchange rate by raising corporate bankruptcies.

Chae-Shick Chung and Se-Jik Kim's paper empirically evaluates the effectiveness of the high interest rate policy in stabilizing the won/dollar exchange rate during the Korean crisis (Chapter 4). Using daily data for the exchange rate and Korean and U.S. interest rates during 1995-98, they estimate the underlying nonlinear dynamics of the exchange rate. Based on a nonlinear impulse response function analysis within the estimated model, they find that high interest rates induce depreciation for several days, followed by a substantial appreciation for an extended period of more than three months. In contrast, a low interest rate policy would not have a substantial impact on the exchange rate for very long, indicating an asymmetry in the exchange rate response to an interest rate shock. From the impulse function analysis, they also find that a reduction of interest rates to the pre-crisis level would not induce another serious depreciation. Their findings suggest that the interest rate policy recommended by the IMF, which was characterized by a sharp increase in interest rates at the onset of the crisis followed by a cutback after several months, contributed to the stabilization of the exchange rate.

A second issue addressed in this session was the role of the Korean chaebol. The corporate system based on chaebol has often been cast as a key culprit in the Korean financial crisis. But the specifics of how and to what extent the chaebol contributed to the financial crisis have received little attention.

The paper by Anne Krueger and Jungho Yoo addresses the role of the chaebol in the Korean crisis (Chapter 5). They find that the corporate sector's profitability fell to very low levels in the 1990s. Despite this deterioration, banks continued to "evergreen," or roll over, the chaebol's outstanding debt. When favorable circumstances did not materialize, the needed increase in evergreening by the banks was larger than their balance sheets could tolerate. The authors argue that the chaebol's low profitability, high leverage, and economic dominance meant that the Korean crisis was a disaster waiting to happen. Given the magnitude of leveraging of the chaebol prior to the crisis, the increase in the interest rate, not the foreign exchange crisis itself, probably triggered the financial crisis. The authors conclude, however, that failure to raise the interest rate would have resulted in larger capital outflows and perpetuated the foreign exchange crisis.

Session 3 addressed the issue of corporate sector reforms that are often considered, together with financial sector reform, as key structural reform policies of the IMF-supported program in Korea. Given the Korean corporate sector's endemic low profitability and heavy debt burden, as emphasized by Krueger and Yoo, the government has taken various measures to encourage corporate sector restructuring to overcome the crisis and lay the foundation for a sustained recovery in the real economy.

William Mako, a World Bank specialist who participated in the Korean program, derives lessons from Korea's recent experience in corporate restructuring in his paper (Chapter 6). He sets out a framework for corporate restructuring in a systemic crisis that emphasizes the importance of operational restructuring through discontinuation or sales of less profitable or loss-making non-core businesses, layoffs of excessive labor, and other cost-reduction measures to reduce corporate debt from unsustainable levels. Mako then documents a recurring pattern of corporate problems and restructuring in Korea during 1997-2000. Based on the experience of Korean firms, including those put into workout programs, he ascribes the recurrence of corporate problems to the failure to move beyond temporary financial stabilization measures—such as term extensions, rate reductions, and debt-equity conversions—and make substantial progress on operational restructuring of distressed corporations. He underlines that relatively few large corporations have emerged from court-supervised reorganization or been sold or liquidated since 1997. The slow operational restructuring is attributed partly to the reluctance of under-provisioned creditors to take additional losses on the sale of over-valued assets at realistic prices.

This session also addressed the government's policy of financial restructuring, which focused on the restructuring of banks with little attention paid, at least initially, to the investment trust companies. The bank-focused restructuring policy helped reduce banks' exposure to large corporates but allowed weak chaebol such as the Daewoo group to issue large amounts of corporate bonds through the ITCs, which were not closely supervised. Although the issuance of these bonds helped avoid a credit crunch in the late 1990s, the proceeds were used largely for further business expansion rather than restructuring. As a result, the corporate bond market faced another credit crunch in 2001 when the bonds matured.

The paper by Gyutaeg Oh and Changyong Rhee evaluates the downside of the bank-focused financial restructuring policy by measuring the amount of defaulted corporate bonds (Chapter 7). They find that issuers defaulted on 22 percent of the total value of corporate bonds issued from December 1997 to December 1999, and that 78 percent of the defaulted bonds were from the Daewoo group. This suggests that the bank-focused financial restructuring had large negative side effects, and that short-run liquidity problems could have recurred if there had not been significant corporate restructuring. The authors also find that the total amount of corporate debt remained virtually unchanged as a result of the bank-focused restructuring policy and the associated replacement of bank loans by corporate bonds, not by equities, suggesting that the corporate sector would remain vulnerable to adverse shocks. Finally,