The Developing Economies, XXXVII-4 (December 1999): 460–513

IMF BAILOUT AND FINANCIAL AND CORPORATE RESTRUCTURING IN THE REPUBLIC OF KOREA

KIM DOHYUNG

INTRODUCTION

THERE is a good deal of opinion at present, inside and outside of the Republic of Korea, that the country has been moving ahead with financial and corporate restructuring as prescribed by the International Monetary Fund and is extracting itself from the economic crisis that struck East Asia.

Without doubt, Korea at the early stages of the currency crisis did accede to the IMF's stringent macroeconomic stabilization policies and the Fund's call for structural reform. The government introduced high interest rates and tight fiscal policies which paved the way for the opening of the financial market along with which other structural adjustments were put into effect. The result was that by the middle of 1998, interest rates could be brought down allowing the government to take stimulus measures through fiscal expansion which worked to offset the deflationary factors brought on by the structural adjustments. These steps led to the stabilization of the financial market and recovery of the real economy (Table I).

However, Korea was given little choice about accepting the IMF's prescribed regimen (what in Korea has been dubbed the IMF bailout), and when the process of coping with this regimen is examined closely, one sees that it has not been such a simple task. Even now Korea has yet to fully overcome the impact of the IMF bailout.

TABLE I

KOREA'S ECONOMIC AND FINANCIAL INDICATORS AFTER RECEIVING IMF SUPPORT FINANCING

	December 1997	June 1998	December 1998	June 1999
Foreign currency reserves/ short-term foreign bonds	0.31	0.96	–1.22	1.89*
Dollar/won	1,695	1,370	1,200	1,157
Call-money rate (per annum)	35.0	14.3	6.8	4.8
Stock price index	376	298	563	883

Source: Samsung Economic Research Institute, July 1999.
* As of the end of March.

This study will begin by examining the causes for Korea's foreign exchange crisis, the implications of the reforms contained in the IMF support programs, and the different stages that Korea has gone through to cope with and overcome the crisis. Such an examination will help clarify the relationship of the IMF with the Korean economy. This will be followed by an analysis of the way that financial and corporate restructuring has been carried out which will also point out the role and the limitations of government in this process. Along with this analysis I would also like to bring out issues that will need to be dealt with in the future. Following this I would like to take a look at the government's reform package for large-scale enterprises and at the nature of Korea's conglomerates, the *chaebol*, which has come to light in the process of coping with the crisis.

I. A HIGH-COST ECONOMY AND LOAN-DEPENDENT BUSINESS MANAGEMENT

There have been essentially four factors contributing to the cause of Korea's financial and currency crisis: (1) the overlapping of a downturn in the long-term business cycle (a twenty-year cycle) with that in the investment cycle (a ten-year cycle), (2) the propensity for loan-dependent management in industries, (3) the worsening business performance of the financial sector, and (4) the lack of any preparation to cope quickly with instabilities in international financial markets.

A. *Overlapping of Downturns in the Long-Term Business and Investment Cycles*

Starting in the 1960s, Korea under government guidance embarked on a path of rapid economic development. At the same time, however, government regulation and support of industries became overly prolonged, responsible business management and compensation based on market principles failed to become well established, and the system's economic actors fell into a state of so-called moral hazard. Competitive principles based on self-restraint and responsibility were not observed, inefficiencies in resource allocation increased, and the substantiveness of the economy itself weakened.

The beginning of the recent recession set in during the fourth quarter of 1995. Real GDP growth rate fell from 8.6 per cent in 1994 to 6.0 per cent in 1997. During the same period investment in plant and equipment as a percentage of GDP fell from 40 per cent to 15 per cent, and the export growth rate plummeted from 30 per cent to 3.7 per cent.

Much of this was due to the effects of the weak Japanese yen. The movements of the yen had been affecting the Korean economy since the 1980s, and there came to be an extremely strong interrelationship between a weaker yen hurting the competitiveness of Korean products and a stronger yen improving it. As a result of this effect, in 1996 Korea registered a trade deficit of 20 billion dollars and a current account deficit of 23.7 billion dollars, both record highs.

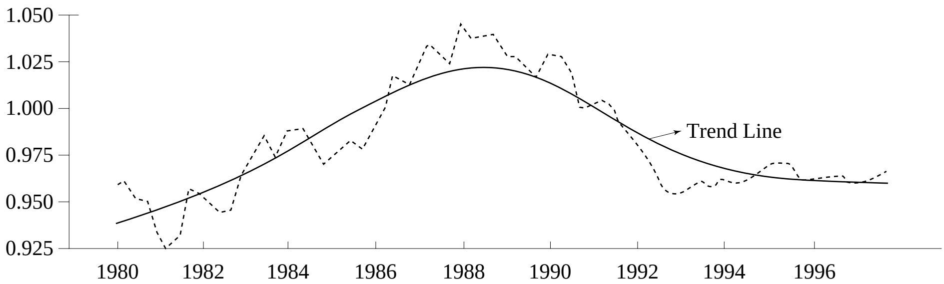
In the past it had always been that when the U.S. economy was doing well, Japanese exports, particularly capital goods, to the United States expanded while Korean exports to Japan and Japanese capital and intermediate goods exports to Korea expanded in a mutual interdependent relationship. In recent years, however, even with the good performance of the U.S. economy, Korea continued to feel the strong effects of a weak yen, and Korean exports did not recover significantly. The upshot was the overlapping of downward phases of the long-term business and investment cycles which made the recession all the more severe. It was at this juncture that Korea's economic crisis broke out.

Korea's total factor productivity (TFP) rose continuously during the period from 1980 to 1988, the year of the Seoul Olympics, but from around 1989 it dropped rapidly (KIET 1997). Cyclical and structural factors played a part in this fall, and both need to be examined more closely (Figure 1).

Looking at the cyclical factors first, during the upward phase of TFP, the so-called three lows phenomenon of a weak Korean won, low interest rates, and low petroleum prices increased Korea's price competitiveness. However, from around 1989 this competitiveness weakened due to such influences as the democratization of the political process in 1987, and the substantial growth of wage rates which exceeded the productivity growth rate thereby weakening price competitiveness. This trend continued until 1992.

Looking next at the structural factors, when these are viewed as non-price competitiveness, then these can also include rises in private investment productivity and government productivity. Such non-price productivity continued improving from 1980 to 1989, but during the 1990s it declined. As a result, since 1990 the overall

Fig. 1. Trend of Total Factor Productivity



Source: Korea Institute for Industrial Economics & Trade (1997).

Notes: 1. Estimated results of TFP: $\ln A(t) = \ln Y(t) - 0.6986\ln K(t) - 0.3014\ln L(t)$.

2. Total factor productivity: $\ln A(t) = SA(t) + CA(t)$, where $SA(t)$ denotes growth trend and $CA(t)$ cyclical factor portion.

efficiency of the economy has dropped markedly.

The low productivity of the government is pretty much taken as a given, but in the financial sector also, due to the long years of government regulation and intervention, management practices based on profitability had never become firmly established among financial institutions. Likewise for the majority of business enterprises, rather than seeking to maximize profits based on impartial rules, they preferred to rely on rent-seeking and sought to expand quantitatively through collusive political and economic relationships. Moreover, among shareholders and ordinary consumers there was no interest in watching over or restraining these business methods; rather it seemed that they were much more concerned with the short-term pursuit of capital gains and overconsumption.

The social discord and dissension that built up over the many years within the process of promoting economic development were controlled largely through administrative directives. There were no means available for thorough debate of policy decisions through citizen participation, which heightened the possibility for policy failures and increased the people's distrust of government. Efforts had been made to rectify these shortcomings and introduce reforms that could link democracy together with a market economy, but no national consensus had been forth coming. The result was that the whole socio-economy in Korea evolved into a high-cost structure.

B. *The Liquidation of Loan-Dependent Business Management*

It is now clear that Korea's 1997 economic crisis was triggered by the loan-dependence of medium-sized conglomerates like Hanbo and Kia and the irresponsible actions of their top management, the effects of both having been worsened by the collusive ties among big business, finance, and government.

Korean industry had long been under the guidance of the government, and the government itself decided which sectors of private enterprises should be intensively supported. The government concentrated its resources on these enterprises, and what was in effect an industrial policy of picking the winners continued for many years. The result was the growth of industries with a high propensity for loan-dependence. The myth arose that businesses and financial institutions were safe if they were of large enough scale because they were too big to fail. This led to the unquestioned acceptance of financing long-term investment with short-term borrowing.

There are three features which characterize Korean manufacturing enterprises. The first is the very high average debt-equity ratio which stood at 396.3 per cent in 1997, two to four times higher than that of competing nations such as the United States which stood at 153.5 per cent (1996), Japan at 193.2 per cent (1996), or Taiwan at 85.7 per cent (1995). For the thirty major conglomerates (as determined by the Fair Trade Commission), the debt-equity ratio in 1998 was 518.9 per cent, far worse than what it had been in 1997. There were no conglomerates with a ratio under 200 per cent.

Because of such an excess of debt, even a slight rise in interest rates or fall in sales was enough to damage profitability and cause anxiety among creditors. The fact that five of the eleven companies that went bankrupt following Hanbo's collapse in 1997 were conglomerates included among the thirty largest *chaebol* suggests that these bankruptcies were due not so much to a temporary credit crunch or creditors calling in loans as to the loan-dependent disposition of the companies.

The second feature has been the excessive investment by Korean enterprises in the midst of fierce international competition which has continued to push profitability ever lower. In the mid-1980s the manufacturing sector's return on total liabilities and net worth was well over 9 per cent, but thereafter with the exception of the boom in 1994–95 it has remained at 6 per cent. This has been due to the continuous fall in the turnover ratio of total assets (i.e., the ratio of sales to total assets) which peaked in 1984 at 1.3, then turned downward and has continued to fall below 1 during the 1990s (standing at 0.5 in 1995). These figures tell how inefficiently companies have used their assets notably through excessive investment.

According to the financial accounts of enterprises in 1996, the ratio of breakeven point to sales for companies with a debt-equity ratio of 100 per cent was 92.1 per cent and the average interest rate on borrowings was 19.96 per cent; for companies with a debt-equity ratio of 500 per cent, the figures were 98.9 per cent and 11.97 per cent respectively. Thus for Korean manufacturing with a debt-equity ratio of 317 per cent (1996 end-of-year average), the ratio of breakeven point to sales was 97.4 per cent, meaning that a 2.6 per cent fall in sales (given interest rates as constant) would be sufficient to cause a company to suffer an ordinary loss.

With the imposition of the IMF-supported system, lending interest rates rose and sales fell which presumably caused sizable ordinary losses to businesses even without the inclusion of exchange rate losses. For conglomerates with debt-equity ratios exceeding 400 per cent, the imposition of the IMF system would mean inevitable bankruptcy.

The third feature of the Korean manufacturing sector was that under its protective government-guided conditions, there were no devices for correcting the excessive debt and investment of poorly performing enterprises and financial institutions. Moreover, artificial intervention on the part of the government could not take place to eliminate the concentration of economic power in the conglomerates. Also market principles did not function well because of incomplete and imperfect information.

The affiliate companies within a conglomerate, in particular, have been interlinked through cross debt guarantees, and have monopolized the limited capital funds; therefore if one company in the group performs poorly, there is the danger that the well-performing companies in the group will also be exposed to the effects of this poor performance. In 1996 the cross debt guarantees of the thirty major conglomerates reached 67.5 trillion won. Despite this situation, government regulations and intervention have limited competition among enterprises, and management have grown accustomed to their overprotected situation. Business managers and controlling shareholders have little interest in improving the efficiency of their companies, while surveillance of these companies by ordinary shareholders and creditors with interest in these companies has also been inadequate. Also boards of directors and other forms of internal supervision and checking mechanisms have remained weak. At the same time, it has been possible for controlling shareholders in major enterprises, even when their ratio of stockholdings is low, to control the majority of the companies within a group through interlinking capital subscriptions in affiliate companies. Moreover, the legal status of their control and their responsibilities has remained extremely unclear. All in all, the principles and discipline of the market that could have curbed the irresponsible management and moral hazard have been lacking in Korea to an extreme degree.

C. *The Deterioration of Financial Institutions*

As can be seen from the above, Korean enterprises have relied much more on indirect financing, the borrowing of funds from banks, rather than on direct financing through the issuing of stocks and bonds. Thus one would have expected that as the creditors of origin, the financial institutions providing the funds to enterprises would have used their positions to check on the operations of these enterprises. Unfortunately the institutions undertook no such oversight which has been a factor contributing to the present crisis.

During the course of Korea's government-guided economic development, the nation's financial institutions neglected to assess the business performance of companies in any careful way. Instead they followed the directions of the government which was the biggest shareholder in the system. This approach strengthened the role of these institutions as bodies rationing credit to enterprises in accordance with government directives. In other words, a bureaucratically controlled form of credit financing came into being.

These financial institutions never worried about their own collapse; they did not bother to set up facilities for screening loans to companies; so it is hardly surprising that business done in this fashion led to the issuance of the present huge amounts of "secured" loans. But security for these loans did not have to be land or other property. Something as intangible as the approving words of an influential person was enough to act as security. Such intangible security was all the more strong if it was from a politician or other powerful person who carried clout in high places.

The ultimate result was that financial institutions abandoned their original creditor's role of keeping a check on the financial conditions of companies reliant on short-term loans and watching over business investing to keep companies from veering off into diversified fields far from their core business. The upshot of this abandonment is that financial institutions are now saddled with enormous amounts of nonperforming loans left behind by bankrupt enterprises, so much so that these institutions have lost their financial intermediation function.

The government has long regulated the total credit ceiling for banks lending to conglomerates. The government-regulated interest rates of the primary financial sector (commercial banks) are set lower than those in the much less regulated secondary financial sector (investment trust companies, nonbanks, insurance companies, securities companies). However, the commercial banks alone have not been able to fulfill all the needs of the conglomerates for financing, and the latter have increasingly relied on the secondary financial sector to make up for the shortage. In response, the commercial banks and nonbanks (which included merchant banking corporations), after 1989 and the gradual liberalization of financial and capital markets, proceeded to expand their networks of overseas branches and increase their short-term borrowing. Ultimately, with Korea's financial markets on the verge of complete liberalization but the domestic high interest rate system still remaining protected by regulations, the conglomerates and financial institutions raced against each other to secure market shares, playing on the gap between overseas and domestic interest rates. The conglomerates' rising debt-equity ratio and the financial institutions' growing short-term debt to overseas banks were the two sides of the same coin. The proportion of the latter's short-term foreign bonds rose from 44 per cent in 1991 to 58 per cent in 1997.

The government overlooked the market failure inherent in the economy as it failed to deduce correctly the fact that excess demand existed under an economy of high domestic interest rates. For this reason, the government only sought to lower financing costs, and made it easier to borrow from overseas by amending in 1996 the Merchant Banking Corporation Act along with giving approval for financial institutions to move overseas.

As of September 1997, the equity capital of the five major financial sectors (commercial banks, investment trust companies, nonbanks, insurance companies, and securities companies) totaled 34 trillion won. Meanwhile the nonperforming loans of the commercial banks and nonbanks combined had climbed to 33 trillion won, reaching a total credit extension of 5.5 per cent, or 7.7 per cent of GDP (Table II).

When this bad-loan figure was added in with the 10 trillion won in stock valuation losses (based on 1996) sustained by commercial banks, securities companies, investment trust companies, and insurance companies, the bad debt of financial institutions became all the more enormous. By this point in time Korea was already losing its creditworthiness. Thus when foreign creditors began to restrict lending and call in loans, the value of the won and Korean stocks quickly plunged.

TABLE II

SIZE OF NONPERFORMING LOANS

(Trillion won; %)

	Nonperforming Loans (A)	Total Credit Extended (B)	(A)/(B)	% to GDP
Commercial banks[a]	28.5	453.3	6.3	6.8
Merchant banking corporations[b]	3.9	133.5	2.9	0.9
Total	32.4	586.8	5.5	7.7

Source: Ministry of Finance and Economy, April 1998.
[a] As of the end of September 1997.
[b] As of the end of October 1997.

D. *International Financial Instability and Inadequate Check on Unsound Business Practices*

With the liberalization of the movement of international short-term capital, international financial markets grew more unstable, and the fundamentals of the Korean economy weakened; nevertheless the economy remained overconfident and without policy. Three groups of developments reveal this.

Firstly, from the start of the 1990s, the Korean industrial materials industry undertook a general expansion of capacity and succeeded in raising quantitative growth, as exemplified by the boom in the semiconductor industry. This caused a rapid increase in the current account deficit from around 1994 onward, but this did not create any serious concerns; and although the current account deficit persisted, there was a general strengthening of the won against the dollar which led to a weakening of Korea's international competitiveness.

Along with the above, the Korean government did not do a good job of managing the nation's foreign currency reserves. With the liberalization of capital and the increase in short-term debts of financial institutions, the possibility of insufficient liquidity became a major concern; nevertheless starting in the early 1990s, the government began using its foreign reserves to support domestic enterprises and financial institutions, and the country was unable to maintain these reserves at a sufficient level. As a result, the current account deficit persisted, and from the latter part of October 1997, Korea's creditworthiness with foreign lenders began falling. It was feared that some of the commercial banks and merchant banking corporations would not be able to meet their foreign obligations, so the government came to their support using its foreign reserves which led to a sharp drop in the level of the country's available reserves. In June 1997 these had stood at 25.3 billion dollars; by December 1997 they had fallen to 8.9 billion dollars, a level that could not cover even one month's worth of imports.

Secondly, with its entry into the OECD, Korea moved ahead with financial liberalization and self-regulation, but it did not put in place any system for overseeing the soundness of financial practices that would uphold an international-grade financial system in keeping with these liberalizing moves.

There was a ceiling on the extension of credit to the conglomerates (i.e., a single exposure limit), but the level of credit exposure that a bank could have toward one conglomerate was set at 45 per cent of the bank's equity capital. When compared with the 25 per cent limit set by the Bank of International Settlements (BIS) and the same 25 per cent level set by the United States, one can see the preferential treatment that Korea's conglomerates were getting.

Moreover, there was inadequate oversight of the soundness of business borrowers, and standards for categorizing nonperforming loans were lenient. Standards for the probability of redemption used in the United States categorize loans that are three months or longer in arrears as nonperforming irrespective of collateral; in Korea it is six months or longer but only loans with insufficient collateral have been classified as nonperforming.

Thirdly, financial institutions were not well prepared for implementing prudential supervision on nonbanks' and corporations' dollar assets management. The present Asian currency crisis was caused essentially by liquidity risks due to the mismatching of maturity dates on foreign currency loans (i.e., short-term borrowing used for long-term investment). In Korea, 64.4 per cent of the funds borrowed by merchant banking corporations (as of October 1997) were short-term loans and 83.3 per cent of these funds were in long-term investments. These funds were overinvested in assets that while offering high returns also posed high risks, and as such were exposed to liquidity risks.

At this point the government laid out plans for reforming the public sector (to let market forces work), reforming the financial sector (to promote restructuring and more efficient financial supervision), and reforming the labor market (to improve labor market flexibility). However, nothing came of these plans due to the wheeling and dealing of interest groups wanting to protect their spheres. There was also the lack of strong political will and fortitude to push reform policy which had the effect of lowering foreign lender confidence. All these factors caused foreign financial institutions to quicken the pace of calling in their short-term loans.

II. THE IMF PROGRAM AND RESTRUCTURING POLICY

With the nation's finances verging on default, the Korean government on November 21, 1997 turned to the IMF for financial support. By December 3 support from the IMF, World Bank (IBRD), and Asian Development Bank (ADB) along with joint financing from the United States, Japan, and other countries had been arranged totaling 56.8 billion dollars (of which 35 billion dollars was to be financial support and 21.8 billion was to come from the rollover of short-term foreign debt owed by financial institutions). In return Korea would have to comply with stringent IMF demands.

These demands included setting quarterly macroeconomic targets, tight monetary and fiscal policies, speeding up liberalization of trade and capital markets, and setting down targets for promoting economic reforms between 1998 and 2000. By accepting these demands, Korea essentially put its financial affairs under the control of the IMF, and from early on the citizenry looked upon this as a loss of economic sovereignty.

A. *IMF High Interest Rate Policy*

Since it began functioning after the Second World War, the IMF has pursued the same policy toward a variety of countries, and likewise toward Korea it demanded high interest rates, tight money, and tight fiscal policy. Following in the footsteps of the Marshall Plan, such demands for ultra-balanced finances and tight money based on neoclassical theories have been followed consistently toward the countries of Central and South America and the former socialist economies which have been IMF support recipients and the targets of economic restructuring.

Although there is some dissatisfaction with the close identification of the IMF's directorship with the United States, countries receiving support recognize that IMF programs do reflect to an appreciable degree the policy intentions of the United States.[1]

By restraining aggregate demand, these IMF policies aim at reducing restrictions on imports, stabilizing domestic prices, and lowering dependence on exporting by strengthening domestic demand; over the long term these policies seek to strengthen a country's international competitiveness and establish a firm base for building a current account surplus. In this sense, the economic belt-tightening of the present becomes linked with the future stable expansion of exports.

However, the IMF has paid too little attention to the harmful effects caused by the high interest rates of its tight fiscal and monetary policies. It has too easily regarded its tight economic policies as the only effective means for restraining the borrowing of highly loan-dependent enterprises and for pushing low-profit marginal companies out of the market. But these policies become unjustifiable when they work to bankrupt enterprises that are profitable but cash poor. In effect the IMF has disregarded the possibilities for creating a vicious circle of high interest rates causing a worsening of enterprise debt structure leading to a deterioration of financial institution business performance which causes an upsurge in loan collec-

[1] In the author's opinion, the prototype of the IMF's present program can be seen in the policies of the GHQ (general headquarters) that were pursued toward Japan more than fifty years ago. See Kim Dohyung (1999).

tion and the credit crunch which retard business restructuring and bring on a multi-elemental recession.

At an early stage in Korea's crisis, the IMF demanded that the government bring down the growth of total liquidity (M3) from 18 per cent to 13.5 per cent. With the market interest rate having jumped up to over 30 per cent, this sort of currency tightening caused the dishonored bill rate to soar to a record high of 0.78 in December 1997, and the number of companies issuing dishonored bills averaged 128 per day. The reduction in total liquidity along with the sharp drop in the velocity of money in circulation worked to reduce effective money supply which resulted in a shrinkage of the real economy, an outcome that became clearly visible to everyone.

From the second quarter of 1998, restrictions on money supply were eased. If the initial ultra-tight policies had been continued, the bankruptcy of profitable but cash-poor companies would have continued due to the credit crunch and call-in of bad loans, thereby causing the breakdown of the economy's industrial base which would have increased the difficulty of restructuring.

Within Korea during this time, there were debates for and against the IMF's high interest rate policy. Those who emphasized the need for the policy noted that the high interest rates: (1) reduced excessive financing which was the main culprit for the excessive investment by the conglomerates, (2) were advantageous for inducing foreign investment and preventing the outflow of domestic capital, and (3) contributed greatly to improving the current account balance by reducing investment and increasing savings. And considering the need at the time to stabilize the foreign exchange market and rectify the weak won through the introduction of foreign capital and improvement in the current account balance, there seemed little choice other than following a high interest rate policy.

But fierce arguments against high interest rates came from in and outside the country. These stressed that: (1) With many companies under the threat of bankruptcies, and M&A and credit markets still not well established, it was difficult to attract foreign capital. (2) High interest rates brought on the contraction of investment which broke down the economy's industrial base. (3) High interest rates had only a weak impact on badly performing companies because these companies' monetary elasticity of demand was low. Instead of reducing the demand for funds, high interest rates increased financing costs which put pressure on sound companies that needed funds. (4) High interest rates made income inequality more acute which detrimentally affected the health of the economy.

While many argued strongly against the high interest rate policy, its early implementation does seem to have contributed to the later stabilization of the foreign exchange market. Soon after the outbreak of the currency crisis, the won exchange rate plummeted, but this was apparently due to domestic financial institutions purchasing dollars on the domestic exchange market using low interest won borrowed with discount loans from the Bank of Korea, the country's central bank. Given this situation, had interest rates not been raised at an early stage, the exchange rate probably would not have been stabilized. What can at least be said is that bringing the interest rate on the central bank's foreign currency lending into line with the interest rate on foreign loans borrowed by private institutions prevented the outbreak of a vicious circle whereby a rapidly depreciating won accelerated foreign currency borrowing.

High interest rates continued even when the Korean government successfully issued 4 billion dollars worth of foreign currency denominated bonds (the Korea Fund) in March 1998. The reason for the high interest rates was basically because of rising domestic commodity prices (9 per cent per annum) due to the rising exchange rate, and also because of the climbing rate of dishonored bills; it was not simply because of the IMF's high interest rate policy. This meant that without enterprises decreasing their demand for funds and reducing their debt-equity ratio, interest and exchange rates could not be stabilized.

If an artificially low interest rate policy were to have been taken, it probably would have stimulated an extremely excessive demand for funds. However, it was impossible to expect financial institutions which had already lost their function of controlling the selection of healthy enterprises to carry out the selective rationing of credit. Moreover, if the government had continued rationing credit to financial institutions through a low interest rate policy, this would have simply delayed the restructuring of poorly performing banks and enterprises and nothing more.

On February 18, 1998 the Korean government and the IMF reached an agreement on the following matters concerning the macroeconomy.

1. Monetary policy: With the currency crisis easing, the call-money rate was to be lowered while keeping a close watch on the changing conditions of the crisis.

2. Exchange rate policy: The Bank of Korea would intervene in the exchange rate market only when there were sharp changes in the rate. At the same time, Bank of Korea support for commercial banks would be allowed only after the rollover of the Korean government's short-term debt had been accepted and when it was judged that usable foreign reserves had reached an appropriate level.

3. Foreign reserve management: The target level for usable foreign currency reserves was to be 20 billion dollars by the end of March 1998 and 30 billion dollars by the end of June 1998. Foreign currency support provided by the Bank of Korea was to be used only for the redemption of short-term debt. The redemption period for support funds used for such purposes as withdrawals by Korean residents from their foreign currency accounts was shortened from one month to two weeks.

4. Fiscal policy: The ratio of fiscal deficit to GDP was to be set at 0.8 per cent. However if economic growth fell and unemployment rose, the situation would be reviewed toward allowing a ratio up to 1.5 per cent.

Through this agreement the IMF leaned toward accepting lowering interest rates while at the same time not breaking away from its long-standing position of securing specific levels of usable foreign currency reserves and putting first priority on stabilizing exchange markets. Without doubt, the situation at that time was at the stage where private foreign debt was finally being converted into government foreign debt, and economic restructuring was just beginning to take place; therefore it was still premature to lower interest rates.

However, on May 7, 1998 the IMF and Korean government agreed to amend the proposals for the second quarter of 1998 by which the artificially high interest rate policy was terminated, and the real interest rate was left to find its own level.

B. *IMF Tight Fiscal Policy*

Regarding how the IMF's tight fiscal policy was carried out at the time of Korea's currency crisis, one group of people argued that despite the fact that Korea had maintained sound finances right up until the crisis broke out, the IMF insisted on implementing excessively tight fiscal measures. However, if the difference between Korea's methods of calculating the government's consolidated balance and the methods for calculating consolidated accounts recognized internationally is taken into consideration, this criticism cannot be seen as legitimate. On the contrary, it seems that the IMF allowed for a sizable amount of expenditure expansion.

By Korean methods of measuring consolidated expenditures, the government's deficit is considerably undercalculated because funding used by government-operated financial institutions and foundations are not included within the scope of government finances. Foundations such as the public employees' pension fund, for example, are recorded under "other foundations" and are left out of the government's consolidated accounts. Even some primary functions that should be performed by public finance have been left to the financial sector under the name of policy finance. Funds in the name of policy finance pass through development institutions like the Industrial Bank of Korea and the Export-Import Bank of Korea giving the strong impression that these are subsidies to particular sectors; nevertheless, these funds are left out of the government's financial accounts. Government financial institutions, other foundations, and development finance institutions are all operated by the government, nevertheless, the public bonds issued by these bodies are not classified as government bonds and are not calculated in the deficit of the government's consolidated balance. When recalculating the government account balance between 1971 and 1992 to include government financial institutions and other foundations, the deficit average to GDP during that period expands from 1.98 per cent to 4.19 per cent.

To overcome Korea's currency crisis, the IMF called for restructuring the financial sector, expanding the export insurance fund and the credit insurance fund, along with appropriating 5.6 trillion won from the general account to deal with unemployment. To meet the cost of these measures, expenditures were cut back by 8.4 trillion won (which included reducing the social capital budget by 13.1 per cent), and revenues were increased through such measures as raising the special consumption tax and expanding the tax base by curtailing the range of exemptions and reductions for value-added, corporate, and income taxes. Looking at the above figures alone, perhaps it was natural for the Korean government, which hitherto had a general account surplus, to look upon this IMF policy as coerced fiscal belt-tightening. However, looking at the amount of government bonds and public bonds which have been issued to cope with the currency crisis, one may assume that the government's deficit would have been substantially bigger than reported. It was estimated that government and public bonds issued for the Nonperforming Assets Disposal Fund, Korea Deposit Insurance Corporation, and Korea Labor Welfare Corporation as well as foreign currency denominated bonds issued by the government reached upwards to around 47.6 trillion won. When the cost of interest payments was also added in, the IMF estimated that the government's deficit to GDP increased from the original 0.8 per cent (which included the 3.6 trillion won in interest on bonds for financial restructuring) to 1.5 per cent.

Following the first additional supplementary budget, drawn up in March 1998, the economy continued to perform poorly and unemployment rose much more than expected. At the conference with the IMF for the second quarter that took place from April 20 to 29, 1998, discussion took place to increase expenditures to counter unemployment, and it was decided to raise the deficit to 7.8 trillion won, a ratio of 1.7 per cent to GDP.

During this time, a domestic debate had arisen over the pros and cons of the country's deficit financing. The conclusion that generally came to prevail was that such financing was unavoidable, and with the second additional supplementary budget of 1998, the consolidated account deficit to GDP was increased to 5 per cent or 21.3 trillion won. An agreement clearly noting this fact was accepted at the fourth quarter conference with the IMF. In such manner, Korea's 1998 financial policy and its implementation were approved and overseen on a quarterly basis through consultations with the IMF, and policy was adjusted in a flexible manner to deal with changes in the economic environment (Table III).

Ultimately the IMF relaxed the severity of its tight fiscal policy, becoming more heedful not to weaken the economy's fundamentals for growth, and acknowledging a more active role for fiscal policy in countering unemployment and stimulating the economy. It was not at all a situation where an ultra-tight policy had been forced on the Korean government. And it is important to note that the Korean government itself drew up a medium- and long-term policy for managing its deficit. According to this policy, the size of the deficit is to be reduced starting in 2000, and in order to bring finances back into balance by the year 2006, the policy requires the government to work more actively to broaden its tax revenue base by reducing tax and

TABLE III

CHANGE IN THE AMOUNT AND THE BALANCE OF CONSOLIDATED BUDGET SETTLED AT QUARTERLY CONFERENCES WITH THE IMF

(Billion won)

	Initial Budget for 1998	1st Quarter (Feb. 9–17)	2nd Quarter (Apr. 20–29)	3rd Quarter (July 8–22)	4th Quarter (Oct. 12–27)	Budget for 1999
Amount of consolidated budget	106,162	107,348	110,048	117,948	118,223	126,350
Consolidated budgetary balance	1,064	–3,600	–7,800	–17,500	–21,366	–22,666
(% to GDP)	(0.3)	(–0.8)	(–1.7)	(–4.0)	(–5.0)	(–5.1)

Source: Ministry of Finance and Economy (1999).
Note: Dates in parentheses are for the IMF quarterly conferences.

non-tax exemptions and reductions, by increasing efforts to prevent tax avoidance, and by strengthening tax collection on underground (unreported) income.

C. *IMF Restructuring Policy*

The IMF's initial high interest rate policy contributed to stabilizing the exchange rate market, but this alone had limited effects on restraining the excessive demand of poorly performing companies for funds and on supplying sound companies with enough funds. This is why business and financial restructuring was needed.

Under the condition of excess demand for funds (i.e., the inelasticity of demand for funds) that prevailed in Korea, an increase in the volume of money did not bring about much of a fall in interest rates (i.e., the elasticity of interest rates was low). Meanwhile, the government had to implement measures that raised the elasticity of interest rates in order to promote the inflow of foreign capital. For this to happen there needed to be a bond market, an M&A market, and a futures market; there had to be procedures for managing bankruptcies, and there had to be greater flexibility in the labor market in order to cope with unemployment from restructuring. Such measures were needed to stop the excess demand for funds coming from poorly-performing financial institutions and marginally viable enterprises. Moreover, the government's deficit financing increased the likelihood of interest rates rising again. All these conditions compelled businesses and the financial sector to undertake restructuring.

The IMF's restructuring program was clearly laid out for the financial sector. More generally, the program also aimed at enhancing the transparency of business management through stringent structural and financial reforms, and eliminating the loan-dependent management methods of the conglomerates. The IMF also wanted early liberalization of trade and capital, and greater flexibility in the labor market.

1. *Removing poorly performing financial institutions from the market*

As the first step in dealing with troubled financial institutions, the Office of Bank Supervision announced measures for a capital reduction affecting Korea First Bank and Seoul Bank, two commercial banks, to take place by January 15, 1998. Through this process the Korea Assets Management Corporation, a disposition company in charge of buying up troubled debts, would purchase nonperforming loans from the two banks, and the support for the two banks coming from the government and government-operated institutions was to be clearly recorded in the government's financial accounts.

The IMF and the Korean government then agreed that by the middle of February 1998: (1) internationally recognized businessmen and specialists would examine the preliminary rehabilitation plans and audit the balance sheets of the merchant banking corporations, (2) all of the merchant banking corporations would submit revised rehabilitation plans, (3) the government would temporarily take control of the two above-mentioned commercial banks and the current directors would resign, and (4) the applied interest rate on the emergency exchange rate support funds extended by the Bank of Korea to financial institutions would be raised in stages to Libor + 8 per cent by February 15.

Then on February 18, 1998, the IMF and the Korean government concurred on a memorandum setting down the following points for restructuring financial institutions. (1) For merchant banking corporations whose management reform plans were accepted, the memorandum of understanding (MOU) to enhance their equity capital ratios would be concluded between the government and the merchant banking corporations. Those corporations whose reform plans were not accepted would have their licenses revoked. (2) Public bidding would take place for the two above-mentioned commercial banks. A task force would be set up to handle the banks' restructuring and the publicly provided funds; then a schedule would be quickly drawn up to transfer the task force functions to the Korea Assets Management Corporation. (3) Banks not meeting the BIS capital adequacy ratio of 8 per cent would be required to submit plans for restoring their capital base. Following an examination of these plans, agreements would be concluded to implement the plans. Banks that violated the agreed on plans would be appropriately punished. (4) There would be a review of the allowable rate for doubtful debts that commercial banks and merchant banking corporations could carry, and regulations for determining the financial soundness of banking institutions were to be strengthened. (5) The amount of credit that could be extended to a single conglomerate (up to 45 per cent of a bank's equity capital) was to be lowered as soon as possible, and additions to the limit were also to be lowered.

2. *Short-term capital market*

Korea had always been very negative about liberalizing its short-term capital market. It had delayed liberalization as much as possible while at the same time allowing domestic financial institutions to borrow low interest funds overseas. The result of this indirect market liberalization was reckless overseas borrowing, bad loans, offshore financial speculation, and poor management of exchange rate risks, all which opened the way for the country's currency crisis. It was the same with the bond market. The issuance of short-term bonds was regulated; there had been no effort to open up the market. So when the currency crisis struck, there was no system in place to prevent the outflow of foreign currency funds by means of raising interest rates.

In response, following discussions with the IMF, the Korean government completely liberalized the issuing of products by financial institutions. It approved the issuance of short-term government bonds maturing in less than one year. It abolished the system of restricting short-term business borrowing maturing in one to three years. However, it put controls on excess overseas borrowing by financial institutions. The government also completely did away with restrictions on equity investment by foreigner, but at the same time it drew up guidelines for foreign investors buying into domestic financial institutions.

3. *Trade liberalization*

A bill was submitted to the national assembly to terminate three subsidies affecting trade: the subsidy compensating for export losses, the subsidy for promoting development of overseas markets, and the tax credit for equipment investment. Import approval procedures were simplified, and a plan for reforming the remaining import subsidies was drawn up. Along with this the termination of the import diversification program, originally scheduled for the end of 1999, was advanced by six months.

4. *Restructuring the corporate management*

Reforms were introduced for the thirty largest conglomerates and the enterprises listed on the stock exchange which would require the formation of external auditing committee composed of internal auditors, shareholders, outside directors, and creditor representatives. This measure was aimed at ensuring the transparency of management and reforming the control structure of the conglomerates and large enterprises.

III. OVERCOMING THE ECONOMIC CRISIS IN THREE STAGES

Between December 1997 and April 1998, Korea first moved to shore up its problem of insufficient foreign exchange liquidity, then it set about laying the groundwork for restructuring the financial sector, as already discussed in the previous chapter. In preparing this groundwork the government needed to enact and revise laws on financial reform, revise labor laws, strengthen the corporate governance of the conglomerates, and strengthen financial supervisory functions. The need for all such changes was well understood and had been stressed repeatedly over the past thirty years. But because of the maneuvering and opposition of interest groups and the lack of political will, no framework for reforms existed, and this intensified the effects of the currency crisis.

Knowing full well that there had to be reforms and restructuring, the government used the opportunity of the crisis to begin the process. In effect it used the pressure from the IMF, the outside foreign pressure, to overcome the delays and opposition to undertaking fundamental reforms of the economy. Having said this, however, the government also did not plunge ahead into restructuring all at once. If the government had pushed ahead with restructuring before having overcome the foreign exchange crisis, the deflationary factors caused by the restructuring would have accumulated, the credit crunch and call-in of bad debts would have intensified which conceivably could have led to the breakdown of the fundamentals of the real economy itself. Considering these facts, it would be reasonable to give credit to the three-stage restructuring program that the government laid out for coping with the economic crisis (Table IV).

Stage one: Priority would be given to attracting foreign investment and increasing the country's foreign reserves which would stabilize the foreign exchange market.

Stage two: Financial and corporate restructuring would be intensified and financial supervisory functions strengthened in order to reform or close down badly performing financial institutions and to stabilize the financial system. Measures would have to be devised to counter the credit crunch, the call-in of bad loans, and the unemployment caused by these reforms.

Stage three: Effort would be directed at resuscitating the real economy by building on the positive effects of the stabilized exchange market and restructuring carried out in stages one and two.

A. *Enhancing Foreign Currency Liquidity and Laying the Groundwork for Reforms*

The growing intensity of Korea's currency crisis increased the possibility of a default on its sovereign debt. A few statistics from late 1997 show how critical the situation became. Foreign reserves fell from 22.4 billion dollars in September to 3.9 billion dollars on December 18; the won exchange rate against the dollar weakened from 1,164 in November to 1,995 on December 23; and the short-term call rate rose sharply from 14 per cent in November to 32.4 per cent on December 30.

TABLE IV

KOREA'S THREE-STAGE PROGRAM FOR OVERCOMING THE ECONOMIC CRISIS

Stages	Main Objectives	Primary Measures
Stage one (from Dec. 1997 to Apr. 1998)	Stabilizing the foreign exchange market	Rollover of maturing foreign loans and issuance of foreign currency denominated bonds (the Korea Fund) High interest rates and tight fiscal/monetary policy Enactment/revision of financial restructuring laws, revision of labor laws, agreement on 5 main principles to restructure the 5 largest *chaebol*
	Laying out a basic framework for restructuring	Formulation of basic plan for enterprise/financial institution restructuring
Stage two (from May to June 1998)	Countering the credit crunch, bad loan call-in, unemployment	Interest rate reduction and increasing funds to small/medium-sized enterprises and export/housing sectors Unemployment countermeasures (8.5 trillion won) Funding for financial restructuring (64 trillion won) Further liberalization of foreign investment to promote market openness
	Restructuring through bank/enterprise closures	Closure of 5 major commercial banks and selection of 55 enterprises for closure
Stage three (from July 1998 onward)	Reviving the real economy	Increasing the deficit to GDP ratio to 5% End of first financial restructuring
	Restructuring to rehabilitate enterprises	Promoting genuine management reform (workout) and setting policy for restructuring the 5 top *chaebol*

Such financial deterioration quickly pushed Korea's credit rating down to speculative grade.

Faced with defaulting on its sovereign debt, the Korean government turned to the IMF for financial relief which meant that it would have to accept the IMF's stringent policy of high interest rates along with enacting and revising laws for financial reform, revising labor laws, and laying down the legal basis for promoting autonomous corporate restructuring.

The IMF agreed to provide a total of 35 billion dollars in financial support of which 21.4 billion was supplied by March 1998. In addition the maturing short-term foreign loans of financial institutions were to be rolled over, and the government was able to issue successfully 4 billion dollars in foreign currency denominated bonds (the Korea Fund).

There has been no public disclosure of the contents of negotiations that took place between Korean government officials and the representatives of the international institutions and creditor groups regarding IMF financial support, the rollover of short-term loans, and the issuance of foreign currency denominated bonds. But it seems that the two sides had a considerable difference of understanding and confidence about the state of the Korean economy and the prospects for its future. Nevertheless, the discussions led to a tentative agreement because it seems that basically the Korean officials displayed a very rational attitude toward the negotiations.

Most of these officials had taken part in and experienced the economic reforms of Korea's high growth period. They possessed the self-confidence to point out to IMF officials the problems in the policy being pressed onto Korea, and it seems that the Korean side exhibited ample logical thinking and action when arguing for revisions in policy conditions. Essentially they argued strongly that the IMF's ultra-tight financial policies ignored Korea's economic potential, and in the end they were able to extract more favorable terms.

Also at the time of the negotiations, the institutional rigidity of the IMF and its insufficient understanding of the variegated characteristics of the countries it aided were coming under a rising tide of international criticism which the Korean government seems to have skillfully employed to its advantage in the negotiations.

It seems that the Korean negotiators argued forcefully and effectively that: (1) Unlike in the other countries hit by the currency crisis, Korea's financial soundness and the high productivity of its manufacturing remained intact, and it was the rapid liberation of financial and capital markets that had brought on the country's financial troubles; therefore by dealing with the worst effects of liberalization, the Korean economy would be able to recover quickly. (2) If the IMF pushed excessively unfavorable conditions onto Korea, its economic recovery would be held back which would impose an increased burden on American taxpayers and the world economy. (3) Along with the receipt of emergency financial support came the worry that economic institutions could fall into a state of moral hazard; however, the Korean government promised to carry out the needed reforms of the legal system to cope with this problem.

Among the measures taken during the first stages of IMF assistance to reform the legal system, the important ones were: (1) enactment and revision of thirteen bills dealing with financial reform (during December 1997) which included revisions of the Bank of Korea Act and the act establishing the Consolidated Financial Supervisory Organization, (2) establishment of the Financial Supervisory Commission (FSC) in April 1998, (3) agreement (in January 1998) among the conglomerates, the government, and the creditor banks on five main principles for restructuring the top five *chaebol*s, and (4) enactment or revision (during February 1998) of laws for promoting restructuring. Of particular note was the establishment (in February 1998) of the Tripartite Commission, which was made up of representatives from labor, business, and the government/political parties, which made possible the introduction of an employment adjustment system allowing layoffs and a temporary help service system.

In sum, the government's quick and agile measures to cope with the economic crisis stabilized the foreign exchange market, prepared conditions for lowering interest rates, and laid the groundwork for financial and business restructuring.

B. *Restructuring through Business Closures and Eased IMF Policy Conditions*

By the end of April 1998 Korea's foreign reserves had risen to 30.8 billion dollars, and the won had settled at 1,338 to the dollar. However, the credit crunch had grown more severe even though the call rate had fallen to 18.3 per cent. The ratio of corporate dishonored bills had risen from 0.24 per cent in the third quarter of 1997 to 0.57 per cent in April 1998. Meanwhile the unemployment rate had jumped from 2.6 per cent in 1997 to 6.7 per cent in April 1998. By the end of 1998 the unemployment rate had surpassed 7 per cent, and it was estimated that 1.7 million people had lost their jobs. The ill-effects of the three highs, high interest rates, high exchange rates, and high unemployment, settled deeper into the economy. In response the government took the following four measures.

(1) To attract more foreign capital, the government greatly improved the environment for foreign investors by introducing tax advantages, eliminating restrictions on foreign M&As and real estate acquisitions, and by setting up a one-stop service system for foreign investors. The liberalization of capital was greatly accelerated by eliminating the aggregate ceiling on foreign investment in Korean equities and allowing foreigners to invest in short-term financial products.

(2) In May 1998, in agreement with the IMF, the restrictive fiscal and monetary policies were eased. The ratio of consolidated fiscal balance deficit to GDP was increased to 1.7 per cent, and the 22.2 per cent call-money rate (as of the end of March 1998) was lowered to 14.4 per cent in June 1998.

(3) Also in May 1998, the government decided to use a total of 64 trillion won in public funds for restructuring poorly performing financial institutions. Five commercial banks were to be closed down by the end of June, and fifty-five enterprises were targeted for closure. It was also decided that public funds worth 32.5 trillion won would be used to purchase nonperforming loans from troubled financial institutions; another 17.5 trillion won in public funds would be used for capital injections; and 14 trillion won more in public funds would be used to guarantee bank deposits. These quick decisions to close corporate and financial institutions and infuse public funds were taken because the Korean stock market had come to be dominated by the feeling that corporate and financial restructuring was not progressing and that a second financial crisis was in the offing.

(4) Because small and medium-sized enterprises and the export and housing construction sectors were already suffering badly from the credit crunch, and it would take time before the effects of restructuring would become apparent, the government stepped in to provide emergency support. This included the extension of payments on outstanding loans, 1 billion dollars in funds from IBRD to support imports of raw and intermediate materials, and special support for small and me-

dium-sized enterprises from ten strong banks. At the time there had been a significant loss of confidence overseas in the letters of credit issued by Korean exporters. It had become extremely difficult to import raw and intermediate materials, and the economic base of the export sector had begun to break down. The rate of dishonored commercial bills, particularly among small and medium-sized companies that were not subsidiaries or subcontractors of conglomerates, continued to rise.

C. *Accelerated Corporate and Financial Restructuring and Stimulating the Economy*

The real GDP growth rate of the Korean economy for the first half of 1998 fell by 5.4 per cent. Within aggregate private demand for the same first half, private consumption expenditure registered a 12 per cent drop while plant and equipment investment plunged 47 per cent. In other words, even before the government had begun to deal significantly with restructuring, the underpinnings of the real economy were already breaking away which made its structural weaknesses all the more apparent.

At this point, in September 1998, the government declared an end to the first stage of its financial restructuring program, as it realized that it had to switch to reviving the economy through fiscal stimulus policies. To accomplish this it laid down the following four measures.

(1) Of the 64 trillion won in public funds for restructuring financial institutions, 38 trillion was to be used for purchasing bank nonperforming loans and for recapitalization in order to bring bank equity capital up to the 8 per cent capital adequacy ratio set by the BIS.

(2) To push genuine reform of corporate management, companies in consultation with major creditor banks would have to pledge to restructure their corporate finances, and would be required to draw up plans for corporate reform in accordance with their pledges by the end of 1998 (these procedures are dubbed the "workout" program). Targeted for these reforms were all of the affiliates of the five top *chaebol*, as well as twenty-six affiliates each belonging to ten of the 6th–64th largest conglomerates.

(3) The government enhanced its fiscal policy measures to support restructuring and stimulating the economy. This enhancement included compiling a second supplementary budget, raising to 5 per cent (21.5 trillion won) the ratio of the 1998 fiscal deficit to GDP, and maintaining this 5 per cent ratio for 1999 (22.5 trillion won). These steps were taken to prevent the dissipation of the fiscal reflationary effects on the economy.

(4) In consultation with the IMF, the government was able to move away from the tight money regime that had kept interest and exchange rates closely linking. Then in November 1998 with the elimination of the total currency (M3) growth target, the government was again able to set fiscal and exchange rate policy on its own. Henceforth its aim was to maintain sovereignty over financial policy under

conditions of capital liberalization and floating exchange rates. In this way the government could more flexibly supply funds to sectors suffering from a contraction of credit, and continue to bring down interest rates.

In particular, the ceiling on credit guarantees for small and medium-sized enterprises and for the export and housing construction sectors was raised (using 500 billion won from the second supplementary budget and 1 billion dollars in support funds from IBRD). Also funds for countering unemployment were increased from 8.5 trillion won to 10 trillion won, and a safety net to safeguard the unemployed was set up.

IV. FINANCIAL RESTRUCTURING UNDER GOVERNMENT GUIDANCE

A. *Restructuring of Major Banks*

The already nationalized Korea First Bank and Seoul Bank exemplified the troubled commercial banks, and in March 1998 the government made the decision to reprivatize the two. The framework for a systematic restructuring of the banking sector was laid out, and five of the largest commercial banks, excluding the above two, were ordered to suspend their business operations. This substantial step marked the close of the first stage of the government's financial restructuring program and the opening of the second stage.

The restructuring process of the second stage necessitated the huge infusion of public funds along with the retirement and replacement of some bank executives. For the post part there was no thorough debate about problems of bank leadership and moral hazard. The government preferred to move ahead quickly with the unilateral and forceful infusion of public funds. This contrasted with the situation in Japan where the timely infusion of public funds was missed because of lengthy discussions and political negotiating over the conditions for infusing these funds.

The measures taken to restructure Korea's banking sector included closures of business operations, mergers with healthier financial institutions, sell-offs to foreign buyers, capital increases, and cuts in workforce levels. By March 1999 public funds worth 43.5 trillion won had been injected to support the restructuring process, and it was estimated that the figure would reach 64 trillion won by the end of 1999 (Table V).

Problems that were expected to arise with such an infusion of public funds included: (1) whether or not accurate information could be obtained about the size of bad loans, (2) the possibility of moral hazard occurring at badly performing financial institutions, (3) the possibility of the government overcompensating for losses without considering the goodwill value of banks that had been closed down,[2] and

[2] In its method of assessing assets and liabilities, the U.S. Federal Savings and Loan Insurance Cor-

TABLE V

INJECTED PUBLIC FUNDS FOR RESTRUCTURING FINANCIAL INSTITUTIONS

(End of March 1999; trillion won)

	Purchase of Bad Loans	Recapitalization	Deposit Guarantee	Total
Total public funds for financial restructuring	32.5	31.5		64.0
Commercial banks	14.0 (29.6)	8.6	5.8	28.4
Specialized banks	2.7 (5.7)	—	—	2.7
Nonbank financial institutions	3.2 (8.7)	—	9.2	12.4
Injected funds	19.9 (44.2)	8.6	15.0	43.5
Residual	12.6	7.9		20.5

Source: Financial Supervisory Commission, press release, April 5, 1999.
Note: Figures in parentheses denote book value of bad loans.

(4) the possibility of KAMCO (Korea Asset Management Corporation) purchasing bad debts at too high prices.[3] It was possible that problems such as these could occur, but the Korean government wanted to inject public funds before the amount of bad loans escalated, the intention being to stabilize the financial system as quickly as possible.

Estimates of the size of Korea's bad debts differ greatly. Recently the Korean government's Financial Supervisory Commission puts them at about 130 trillion won (12 trillion higher than its 118-trillion won estimate in 1998). The World Bank estimates them at 126–168 trillion won (30–40 per cent to GDP). Private research institutes figure them to be double the FSC's estimate.

But the important matter was not whether accurate figures could be agreed on. The need was for a quick injection of capital and the buy-up of nonperforming loans in order to regain favorable overseas credit ratings and stabilize the financial system as soon as possible. To achieve this the government took the BIS 8 per cent capital adequacy ratio as the standard for the targeted banks and made free and full use of strong measures to bring the banks up to this standard.

poration recognizes goodwill as an intangible asset, and when calculating bad debts, it evaluates it as an asset. In Korea, however, when assessing the assets of closed banks, the book value is used and goodwill is not taken into consideration. For this reason the amount paid by the Korean government in loss compensation tends to be excessive.

3 The Korean Asset Management Corporation was set up in 1998. It utilizes a debt restructuring fund to promote restructuring of bad debt held by financial institutions and support the rehabilitation of potentially viable companies. At the start of restructuring at the beginning of 1998, KAMCO purchased bank bad debt at 62.2 per cent of book value. Later it reduced this to 45 per cent. However, the usual rate of assessment when purchasing such debt in the United States, for example (taking the case of the vulture funds), is 10–20 per cent.

Poorly performing banks with equity capital below the 8 per cent level and which showed poor prospects for recovering were compelled to close. Other banks were urged to restructure through mergers and sales of assets to foreign buyers. Banks with equity ratios of 8 per cent and above were urged to increase their capitalization, merge with other healthy banks, and introduce foreign capital in order to improve their financial soundness. And most of the banks that were receiving government support were required to reduce the size of their workforce (Table VI).

With the imposition of these measures, on June 29, 1998 five big commercial banks disappeared from the market, the first major banks to be closed down in any of the Asian countries hit by the financial crisis. Foreign investors who had grown discontented with the delays in restructuring now began returning to the stock market, and at the same time there was a switch to buying shares on balance.

Despite these successes, it was inevitable that numerous problems of moral hazard and unfairness would occur in the course of bank restructuring. Banks ordered to close paid their employees retirement allowances. Banks acquiring the assets of other banks used and abused the ambiguous standards on put-back options to benefit themselves. Depositors resorted to the unfair use of the government's deposit guarantee program by transferring deposits to troubled banks to get the high interest rates they were paying.

Despite bad credit ratings, big banks like the Korea First Bank and Seoul Bank continued to survive while priority was given to closing down small banks, which raised questions and doubts about fairness and efficiency. While the capital stock of the troubled big banks was decreased to one-eighth of its former value, small banks had their stocks completely cancelled, and the banks themselves ceased to exist. The employees at big banks that were acquired most often remained working for the successor banks while most workers at small banks that were taken over lost their jobs.

Among banks that were compelled to merge, friction arose between the partners in the newly created organizations which significantly increased organizational and operational inefficiency.

The plans to sell off Seoul Bank and Korea First Bank to foreign buyers, and to attract foreign capital were appraised at the time of their announcement, but they did not progress smoothly. This raised doubts among some foreign investors about Korea's intentions to pursue reforms. Also there was too much rush to sell assets and attract foreign capital which sometimes led Korea to accept unfavorable terms for sale prices and put-back options.

The government's recapitalization of banks through its purchase of stocks using public funds and its capital injections would help to improve the financial health of banks. But, since these capital injections are essentially loans borrowed from the government, the banks are accordingly required to raise their provisioning allowances, which would mean that bank BIS capital adequacy ratios would fall. Never-

TABLE VI

RESTRUCTURING MEASURES OF COMMERCIAL BANKS

<table>
<tr><th rowspan="2">Standard of Soundness (End of 1997)</th><th rowspan="2">Banks to Be Restructured</th><th colspan="4">Restructuring Measures</th></tr>
<tr><th>Closure</th><th>Acquisition or Merger</th><th>Attracting Foreign Capital; Sale to Foreign Capital</th><th>Increasing Capital or Recapitalization</th></tr>
<tr><td rowspan="3">Banks under the 8% BIS capital adequacy ratio</td><td>Dongnam, Donghwa, Chungchong, Kyunggi, Daedong</td><td>Yes</td><td>—</td><td>—</td><td>—</td></tr>
<tr><td>Commercial, Hanil, Chohung, Kangwon, Chungbuk, Korea Exchange, Peace</td><td>—</td><td>• Commercial + Hanil
• Chohung + Kangwon + Hyundai International Merchant + Chungbuk</td><td>• Attracting foreign capital (Korea Exchange, Hanbit,[a] Chohung)</td><td>• Bank's own capital-raising (Korea Exchange)
• Government capital injection (Hanbit, Chohung, Peace)</td></tr>
<tr><td>Seoul, Korea First</td><td>—</td><td>—</td><td>• Sale to foreign capital</td><td>• Government capital injection</td></tr>
<tr><td rowspan="2">Banks over the 8% BIS capital adequacy ratio</td><td>Kookmin, Shinhan, Housing & Commercial, Hana, KorAm, Boram, Korea Long Term Credit, Daegu, Chonbuk, Kwangju</td><td>—</td><td>• Acquire 5 closed banks (Dongnam, Donghwa, Chungchong, Kyunggi, Daedong)
• Merger (Hana + Boram; Kookmin + Korea Long Term Credit)</td><td>• Attracting foreign capital (Kookmin, Hana)</td><td>• Healthy banks injected capital into 5 closed banks which they absorbed; government also injected capital into these 5
• Bank's own capital-raising (Kwangju, Chonbuk, Daegu)</td></tr>
<tr><td>Cheju, Pusan, Kyongnam</td><td>—</td><td>—</td><td>—</td><td>• Bank's own capital-raising</td></tr>
</table>

Source: Ministry of Finance and Economy, "Korea's Economic Reform, Progress," 1998.

[a] Of the four big banks, the Commercial Bank of Korea and Hanil Bank merged to become Hanbit Bank.

theless, if banks were to recapitalize on their own, it would be possible to prevent falls in the BIS ratio; in this case, however, other problems would emerge because some banks would likely resort to irregular methods such as: (1) striving to increase their capitalization even when the current price of their stocks was below book value, (2) carrying out recapitalization through a reassessment of their assets without any capital increase, and (3) making midterm settlements of accounts on the retirement funds of their employees and using the excess money gained at the time to purchase the bank's own stocks.

B. *The Effects of Restructuring*

By the end of 1998, as the restructuring process took effect, the size of the workforce in the banking sector (made up of commercial banks with nationwide networks and local banks) had fallen by 33.6 per cent from a year earlier to 75,332 workers. This caused a rise in the efficiency index of total assets and deposits per capita which brought the Korean banking sector close to the efficiency levels of banks in the economically advanced countries. A reduction in the workforce, especially of this magnitude, could be expected to help improve the sector's operating efficiency. It also induced a number of other changes.

For one, it destroyed the myth that banks in Korea never went bankrupt. Customers are gradually becoming more selective about banking institutions and financial products, looking at levels of stability and profitability.

Reorganization of the banking sector began. Before the financial crisis and IMF support, banks in Korea could be characterized by their size or locale; they were categorized as nationwide commercial banks, foreign branch banks, or local banks. But with the arrival of the IMF, the soundness of financial institutions became the criterion, and reorganization began toward classifying banks as approved, conditionally approved, or small regional banks. A shakeout is now under way in the banking sector where the healthy banks are becoming healthier and the weak ones weaker. This phenomenon is being intensified by the large-scale capital write-downs that the government is forcing on conditionally approved banks, something which can only widen the gap between sound approved banks and the others.

The stepped-up efforts to attract foreign capital and sell off assets to foreign buyers widened the prospects for foreign financial institutions to participate in the management of domestic companies. Negotiations were opened to transfer the management of Korea First Bank and Seoul Bank over to Newbridge Capital and HSBC respectively.[4] Commerzbank is making a large-scale capital investment in the Korea Exchange Bank and Goldman Sachs is doing the same in Kookmin Bank. By January 1999, foreign investors owned 51.7 per cent of the shares in the Hous-

[4] In September 1999, Newbridge Capital acquired Korea First Bank, while HSBC decided in the same month not to take over Seoul Bank.

ing and Commercial Bank, up from 45 per cent one month earlier and 21.5 per cent in October 1998. When the majority of a bank's shares are held by foreign investors, the bank's legal status is changed to a non-Korean entity. (See Table VII.)

To stop the deterioration of the banking sector and end the credit crunch and call-in of bad loans, the government had been compelled to step in with injections of public funds and restructuring. From here on, however, such heavy government intervention will militate against the growth of managerial autonomy and accountability in financial institutions. The government needs to limit its role to proactive policies that maintain the financial soundness of the banking sector, and reactive supervision to deal with failed financial institutions and the pursuit of executive responsibility. For restructuring of the financial sector to move ahead, consumer rather than government oversight has to grow, and the government has to encourage this growth. In this sense, the second stage of the government's restructuring program with its enforced reforms is drawing to a close. From now on financial institutions will have to rely on their own efforts to survive, and reorganization in the financial sector through self-initiated M&A will have to become a normal method of business (Table VIII).

For this reason the selling off of Korea First and Seoul Banks was conceived as an important step toward bank restructuring and it was expected to improve foreign investors' confidence in the country's economic status. It is probable that these two banks will soon emerge as the most influential banks in Korea with high corporate governance, excellent credit analysis, and financial services based on the best international practices (East Asia Analytical Unit 1999).

C. *Post-restructuring Problem*

Korea's financial industry is being compelled to restructure, and there are many problems concerning business methods and business areas which will have to be solved.

Since the latter half of the 1970s, banks have been allowed to pursue secondary lines of business in some areas of the securities industry, and since the 1980s they have been dealing in securities and the mutual savings and finance business through subsidiaries (although there are no bank subsidiaries operating in the insurance business). Since September 1998 they have also been able to sell beneficiary certificates and mutual funds. These secondary lines of business (carried on through direct management, subsidiaries, or holding companies) have progressed with no systematic legal basis in overall government planning, and this has left them very much subject to the vagaries and fluctuations of the market. There has also been no incentives for banks and their subsidiaries to share information or cooperate in developing various financial products.

From May 1998 the government began working on reforming the long-standing credit lending practices of Korean financial institutions which relied heavily on

TABLE VII

EQUITIES OF COMMERCIAL BANKS HELD BY FOREIGNERS (END OF 1998)

(%)

	Ratio of Equities Held by Foreigners	Major Foreign Shareholders (% Held)	Remarks
Chohung Bank	5.61	—	
Hanbit Bank	0.06	—	
Korea First Bank	0.01	—	51% of bank's equity to be sold to Newbridge Consortia (Jan.–Apr. 1999)
Korea Exchange Bank	34.87	• Commerzbank AG (32.39)	With an injection of capital from the Bank of Korea and Export-Import Bank of Korea, the government's share will rise to around 40%; the Commerzbank's share will fall to between 22% and 24%
Kookmin Bank	28.64	• Bank of New York (4.96) • MSS-Prudential Assurance Company Ltd. (2.17) • SR Investment Ltd. (2.10)	11.27% of bank's equity sold to Goldman Sachs (June 15, 1999)
Housing & Commercial Bank	44.93	• Bank of New York (9.89) • SR Investment Ltd. (3.32)	Foreign investors are interested in investing in the bank mainly due to the bank's strong financial status and business prospects; the bank's capital adequacy ratio is 13.3%
Shinhan Bank	19.19	• CMB-Schro CMCT PEMP (2.04) • City Securities (1.32) • SR Investment Ltd. (1.04)	
KorAm Bank	25.71	• Bank of America (16.83) • Lion Asset Management (2.22) • Deco Investment Ltd. (1.55) • Asian Opportunity Fund (1.38) • UBS AG (1.18) • Aldem Investment Ltd. (1.08)	Bank of America injected capital in May 1998
Hana Bank	27.70	• International Financial Corporation (6.22) • CMBL-Temp Glob Strategy (1.11) • CMB-Pub Inst Soc Sec Kuw (1.06)	IFC supplied funds in June 1998

Sources: Financial Supervisory Service; Korea Securities Depository; *Korea Herald*, January 29, 1999.

Note: The table lists foreign shareholders over the 1 per cent equity share.

TABLE VIII

RESTRUCTURING OF FINANCIAL INSTITUTIONS (AS OF JUNE 30, 1999)

Classified by Business	Share of Total Assets (End of 1997) (%)	Total Number of Financial Institutions (End of 1997) (A)	Restructuring Measures					Present Number of Institutions
			Licenses Revoked	Absorbed through Merger	Operations Suspended	Subtotal (B)	(B)/(A) (%)	
Commercial banks	54	33[a]	5	4	—	9	27.3	24
Merchant banking corporations	9	30	16	—	—	16	53.3	14
Securities companies	4	37	3	—	3	6	16.2	31
Insurance companies	12	50	4	1	—	5	10.0	45
Investment trust companies	11	6	1	—	1	2	33.3	4
Mutual savings and finance companies	4	230	25	28	14	67	29.1	163
Credit unions	2	1,666	1	130	—	131	7.9	1,535
Leasing companies	4	25	—	5	—	5	20.0	20
Total	100	2,044	55	168	18	241	11.6	1,836

Source: Data provided by the Financial Supervisory Commission, 1999.

[a] Includes twenty-six commercial banks (sixteen nationwide and ten regional) and seven specialized banks (government-owned banks including the Korea Development Bank).

collateral in extending loans. It developed a model for assessing borrowers creditworthiness and set up a corrective action system[5] that moved more strongly and promptly against bad loans. But the government through its scheme of policy finance has long allocated loans to the conglomerates, and these giant corporate groups have come to regard the receipt of such loans as standard procedure. This has led to their chronic excess demand for loans. In other words, the banks and companies have assured themselves of a stable, ongoing lender-borrower relationship. As a result bank credit screening of business loans has tended to be haphazard and careless. Moreover, banks remain wedded to their belief in collateral which requires the securing of collateral or the opening of a compulsory deposit account, as the condition for loans.

[5] Prompt corrective action measures include reforms of management personnel and organizational structure (including changes in senior management), capital reduction, restriction of profit dividends, the merger, purchase, assumption, or closure of institutions, and the sale of risky assets and subsidiaries.

The proportion of collateralized loans (which includes guaranteed loans) increased from 58.7 per cent in 1997 to 60.8 per cent in 1998. Some banks have even started to demand additional collateral when there is a deficit in the value of existent collateral, or lower the ceiling on the amount of their loans if they do not demand more collateral. Usually there is an insufficient number of personnel assigned to screening loans, and insufficient disclosure of information about the borrowing company. On top of these problems are the personnel changes and reassignments that take place as the result of bank closures during which large amounts of information on companies can get lost.

Korean banks have long worked in accommodation with government regulations that control interest rates, fund allocations, and the areas of business where banks can operate, and they have felt little incentive to develop new financial products and instruments. This approach to business still prevails even with the onset of restructuring. During the course of the past year to March 1999, financial product development has consisted of simply making a few improvements on already existing products. Compound products like sweeps and bancassurance (Bank of Korea 1999) as well as strategic tie-ups for cooperative marketing as seen in the West are just in their initial stages in Korea. The development of derivatives and risk management is also very far behind because there has been little accumulation of know-how on international financial instruments. Since 1998 the scale of transaction in swaps, options, and futures has actually been declining.

To upgrade the caliber of their business methods, Korean banks have begun introducing a variety of measures using top-ranking British and American banks as their models. But these measures have only just started, and there has not yet been time for them to take effect. The 1998 banking sector's return on total assets (ROA) and return on equity (ROE) were –3.25 per cent and –52.53 per cent respectively, a worse performance than in 1997. In 1999 operating profits have improved, but this has been due to appraisal gains on securities because of the upswing in the securities market which is only a temporary factor.

From now on banks will have to put priority on profitability. To do this they will have to accumulate competence in their core areas of business, and will have to lay down the organizational basis for management accountability and the prevention of moral hazard. Once the financial system has been stabilized, banks will have to realize their important role as institutions of the community; but until then restructuring should be the prime target for the banking sector to pursue.

V. CORPORATE AND *CHAEBOL* RESTRUCTURING

Following acceptance of IMF financial support, the Korean government began moving ahead with corporate restructuring. President-elect Kim Dae-jung, on January 13, 1998 directly before his inauguration as president, reached an agreement with the chairmen (*chongsu*)[6] of the five top *chaebol* (Hyundai, Samsung, Daewoo, LG, and SK) on five major principles for corporate structuring. These were: (1) enhancing the transparency of corporate management, (2) terminating cross debt guarantees between affiliate companies, (3) fundamental improvement of corporate financial structures, (4) determining the core business areas of the conglomerates and encouraging their cooperation with small and medium-sized enterprises, and (5) strengthening the accountability of controlling shareholders and executive management. This agreement was expected to pave the way for substantial restructuring of the business, finances, and management of the top five *chaebol*.

Korea's corporate restructuring effort can be divided largely into two categories. One is the restructuring of the affiliate companies belonging to the five largest *chaebol* (what can be termed *chaebol* reform). The other is improving and enhancing the management of the affiliates in *chaebol* from the sixth largest on down, along with the restructuring of leading small and medium-sized enterprises. The problem with Korea's corporate restructuring is that these enterprises, big or small, have not developed the capacity to adjust automatically to the market mechanism because this mechanism has not functioned. For this reason, here too it has been the government which has taken the lead in promoting corporate structural adjustment.

Looking first at the category of smaller *chaebol* and small and medium-sized enterprises, although businesses in this category are capable of competing on the market, the reluctance of financial institutions to extend loans and their efforts to call in outstanding debts since the onset of the financial crisis have greatly increased the pressure on these businesses by pushing up the level of their indebtedness. This had led, for example, to problems overseas where doubts have arisen about the worthiness of the export letters of credit issued by these businesses. Therefore the government's first efforts have been to restore the creditworthiness of the businesses in this category. This differs from the situation of the five top *chaebol* where restructuring is needed for reasons other than creditworthiness.

Even during the credit crunch of 1998, the five top *chaebol* maintained their high credit ratings and had no problems obtaining funds. In fact these top five accounted for over 80 per cent of the total amount of commercial paper (CP) issued in 1998. Given this monopolistic situation, the government concluded that the top five conglomerates had to be restructured in order to maintain and strengthen a system of fair competition. It also wanted to eliminate the problematic practices of loan-dependent management and bloated corporate groups.

Until this latest restructuring, government policy toward the conglomerates has been mostly that of direct regulatory measures such as putting limits on the levels

[6] The *chongsu* is usually a legal or de facto company head who can generally wield absolute corporate control despite the fact that he/she often represents only a small fraction of the total stock. This is made possible by taking advantage of complicated cross-shareholding arrangements and the government's regulations restricting the rights of institutional investors.

for their capital increases. But now the government is emphasizing the importance of market principles and on fairness which is far removed from the policy it has hitherto pursued toward the conglomerates. The market in Korea has matured greatly from what it used to be, and the economy continues to become more globalized. With the economy changing so greatly, repeated government intervention to enforce arbitrary regulations in all likelihood would end in failure, and the government is seeking to avoid causing any such failure.

The government realizes it has to break with its past methods of direct administrative intervention. It is now moving toward more indirect institutional and normative methods, and is basically trying to respect corporate autonomy while promoting reforms. It wants the financial institutions as creditors to commit themselves to overseeing and cooperating in restructuring while the government's duty is to see that the objectives of the five major principles are carried out and that factors hindering this are removed.

In general there has been a positive response to this change of direction in government policy toward the conglomerates. But several problems have arisen with the actual policy measures and their implementation. One is that despite government claims to the contrary, its new policy direction still retains a strong sense of arbitrary administrative guidance that ignores market principles (for example, the government's intention of going beyond the reform of affiliates and seeking the dissolution of the conglomerates themselves, or its pressuring companies to carry out Big Deal policies and reduce debt-equity ratios to under 200 per cent). Another problem is the friction and contradictions that have arisen over structural reform versus labor reform, financial restructuring versus corporate restructuring, and economic restructuring versus economic stimulation. Yet another problem is that major industrial corporations representing the five top *chaebol* have been drawing up plans to enter the financial business. These problems are impeding the present effort to carry out structural reform.

A. *The Chaebol Problem*

It is well known that Korea's *chaebol* account for a very large part of the national economy. Over the years these conglomerates have diversified haphazardly into many areas of business unrelated to their original core business operations which has left them with sprawling business structures. At the same time they have used their dominating size to enjoy monopolistic profits in the markets of the various fields of business they have moved into. These conglomerates have also long followed rigid, convoy-style methods of management at their numerous subsidiaries which has made *chaebol* management the symbol of inefficiency and unfairness.

The common denominator in all the criticism of the *chaebol* is the excessive concentration of economic power they have acquired. This concentration of economic power can be divided into four types: general concentration, complex concentration, market concentration, and ownership concentration. General concentration is economic power based on the proportion of the national economy accounted for by all conglomerates. Complex concentration is economic power based on the degree of conglomerate diversification. Market concentration is economic power based on the level of monopoly or oligopoly that *chaebol* affiliates hold in the markets of their respective areas of business. Ownership concentration is economic power based on the distribution of enterprise voting right equity.

The Korean government and the public in general perceive the *chaebol* problem in terms of all the aspects of the above four types of concentrated economic power (although the leaders of the top five *chaebol* do not necessarily see the problem in these terms). This perception of the concentration of economic power as a corollary of the *chaebol* problem can be seen in the words of the Fair Trade Commission which has defined this concentration as characterized by a small number of specific people who through blood relationships effectively own and/or control the majority of a conglomerate and thereby expand this corporate group not through individual enterprises operated independently but through convoy-type management, and monopolistically or oligopolistically control markets through the diversification of business operations. Thus government policy toward the conglomerates has been mainly concerned with restraining the concentration of economic power. However, it is impossible to devise a policy measure that can solve all of the four types of concentrated economic power at once.

1. *How effective are controls on size and fields of business?*

Looking at the effects of the government's *chaebol* policy, one is the government's efforts to have the conglomerates specialize in specific areas as their core business operations. In response the *chaebol* have started to select industries to specialize in and to concentrate their core competence on. This change will certainly work to restrain the conglomerates' complex concentration of economic power by restricting diversification, however a likely side-effect is that it will strengthen their monopolistic position in the markets they choose to specialize in. Thus there is a contradiction in this policy; on the one hand it works to restrain conglomerate size (general concentration) and business diversification (complex concentration), but it does so at the expense of the government's objective of promoting competition.

Then there is the problem of which among the four types of concentration the government should choose to restrain. In the economically advanced countries the problem has been to control monopoly and oligopoly; in Korea the main emphasis has been on controlling general and complex concentrations. The reason these two types of concentrations are the primary targets for restraint is closely connected with the way that conglomerates took shape in Korea. As is well known, the *chaebol* arose as part of the process of "compressed economic development" that Korea pursued starting in the 1960s. Unlike enterprises in the advanced economies which start up and evolve in an economic environment of fierce competition, the *chaebol* were fostered through a process of government priority capital allocation and preferential treatment. The popular view is that such government favoritism opened the way for general and complex concentrations of economic power, and to a certain extent this view is correct.

However, Korea is not the only place where the phenomenon of concentrated economic power exists. Concentrations of economic power (especially of a general type based on the degree of concentrated employment, sales, total assets, and the like) can be found in many economies. Thus another way to understand the formation of these concentrations is that they are the result of rational responses by enterprises to the conditions that these latter are subjected to. This means that in Korea the system that provides the *chaebol* with incentives to concentrate economic power has long been established, and it would be irrational to regulate *chaebol* business operations without eliminating these conditions.

The biggest problem concerning Korea's *chaebol* is the lack of functioning market principles and corporate discipline whereby general shareholders can maintain ongoing oversight and control over the conduct of *chaebol* management. This phenomenon can be commonly observed either in conglomerates directly managed by a chairman who is the controlling shareholder or conglomerates managed by professional managers.

For the thirty largest *chaebol*, the average assets contribution (i.e., average ownership) of the controlling shareholders is less than 3 per cent (derived from: a 15 per cent effective holding ratio which includes cross-shareholdings × a 20 per cent of equity ownership ratio). For the ten largest *chaebol* it is only 1.63 per cent. This suggests that among Korea's conglomerates there are no large shareholders, and residual claims (one of the rights of investors that can claim assets priority liquidation right) are scattered amongst a large number of small shareholders, which acts to dilute small shareholders' authority while strengthening that of the controlling shareholder. This in turn makes it difficult for general shareholders to question the responsibility of the management represented by the controlling shareholder, which creates an "agency problem."[7] This makes it easy for moral hazard to occur and spawns inefficiencies like reckless diversification, sprawling business structures, and one-man management by owner-managers. To correct such abuses there have to be institutional means for protecting the assets of general shareholders.

The root of Korea's *chaebol* problem is the lack of sufficient competition among enterprises and the absence of corporate discipline. The government's *chaebol* policy has been a major part of the problem because it has long discouraged competition

[7] In this situation of diluted ownership, it is possible for a controlling shareholder who cleverly uses his residual claims even though he has only a small number of such claims to make free use of and dispose of a corporate group's entire assets as though they were his own assets. See, Korea Economic Research Institute (1998a).

among enterprises and neglected to foster corporate discipline. The popular view is that the *chaebol* problem lies in such factors as the concentration of economic power, in the lack of separation between ownership and management, in the *chaebol*'s sprawling diversification and the resultant octopus-like management structure, and in the centralized control of their convoy-style management. But the root cause for all of these deficiencies is the lack of sufficient competition and the absence of corporate discipline.

2. *How effective is the separation of ownership and management?*

As pointed out above, insufficient competition and absence of corporate discipline are at the root of Korea's *chaebol* problem. In this sense it was quite appropriate for the Korean government to accede to the measures for improving corporate governance that the IMF laid down as conditions for supplying funds. These measures included: (1) giving up the government's long-standing *chaebol* policy aimed at restraining only general and complex concentrations of economic power, (2) enhancing the transparency of corporate management, (3) allowing hostile M&As of conglomerates, and (4) improving corporate governance through structural reforms of *chaebol* boards of directors.

Problems that continue to plague corporate governance in Korea include: (1) the direct participation of controlling shareholders in the management of enterprises, (2) the hierarchical system for controlling conglomerates which has the office of the secretary to the chairman and the planning and coordination office at the top, and (3) the absence of any system or people inside or outside the *chaebol* group that can oversee and restrain the person in control when that person is both the owner and the manager of an enterprise.

Looking first at the problem of controlling shareholder's participating in management, all of the enterprises affiliated with a conglomerate are regarded by law as having separate independent management systems. In point of fact, however, the *chaebol* have group operating committees[8] that participate closely in the management of all the affiliates in the group, and these committees involve themselves in a wide variety of matters ranging from strategic decision making on new business, R&D, and capital procurement to daily affairs involving personnel and finance. To correct this problem, government policy has for sometime made it a clear objective to separate ownership and management. The government's intention has been to alleviate social inequality by dispersing the individual controlling corporate ownership of *chaebol* managers while at the same time correcting economic inefficiency through promoting corporate management by professional managers who are sepa-

[8] As holding companies have not been allowed in Korea, group operating committees have played the role of bringing affiliates together under the control of the group's central management by means of cross-shareholding and cross debt guarantees.

rate from the corporate owners. This has also been a basic measure that the Fair Trade Commission has taken to counter concentrations of economic power.

But it is questionable whether separating ownership and management will bring the desirable results. There is the example of Kia Motor Co. Its problems came to light shortly before the IMF came in when the company failed to honor a bill. This happened despite the fact that the company was under the control of a professional manager, which shows that even with professional management, when an enterprise lacks effective corporate discipline, it can suffer from moral hazard. It is this author's opinion that the participation of controlling shareholders in management should not be totally denied because once the agency problem is alleviated there is a possibility that the system would work more effectively.

Turning to the second problem of affiliate control, the *chaebol* moved into all areas of manufacturing and nonmanufacturing, and to organize and control all these businesses, they strengthened their centralized systems of internal control. There can be merit in this, but there is also a good deal of demerit. Because capital transfers and business transactions among affiliates within the group take place all the time, the independence of each affiliate is inhibited which in turn greatly infringes on the gains that accrue to the general shareholders.

The third problem is the nearly total absence of any means for general shareholders to exert their influence on *chaebol* management. Because these shareholders have no means to supervise controlling shareholders and owner-managers, these latter have been able to exercise unlimited management rights. Even now with Korea's restructuring well under way, some of these owner-managers have become big problems because they are balking at undertaking reforms.

One of the major reasons for the above three problems is that the government has for so many years overprotected the rights of *chaebol* management over those of general shareholders. Back in 1976 when the government began to promote public offerings of stock, it continued to limit through the Securities and Exchange Law the amount of stock a shareholder could own, and this was done to protect the rights of management from large shareholders, effectively incapacitating the M&A market. This regulation was abolished in 1997, but it continued to exert an effect right up until the IMF program began by protecting the rights of management from anyone seeking to acquire 25 per cent or more of a stock by requiring them to purchase over 50 per cent of this acquisition through public tender.

Another reason for these problems is that the financial and M&A markets have not performed the roles that they originally should have. Korean enterprises depend to a very high degree on borrowed capital. For this reason financial institutions as creditors should take upon themselves the responsibility for screening credit going to these corporate borrowers and for maintaining oversight and follow-up supervision to keep a check on their management. In Korea, however, financial institutions have always had their corporate borrowers designated by the government. This has given each financial institution a secure share of the financial market, and as a result their functions of screening and overseeing corporate borrowers have atrophied.

A third major reason for these problems is that general shareholders are by and large indifferent to corporate affairs, and boards of directors and general shareholder meetings function largely as institutional formalities. Rather than exercising powers such as their shareholder proposal rights or their right to pursue representative law suits, general shareholders (meaning both minority and institutional shareholders) have preferred to sell off stockholdings to get the capital gains and other short-term benefits. Particularly during the long period of high economic growth there was little incentive for investors to hold stocks for the long term and to check on the accountability of management or strive to increase the worth of the enterprises they held stock in. In the same way corporate boards of directors have by and large simply followed the intentions of the company owner-managers. The only thing that has been controlling these owner-managers has been the government. But this government regulation has come via administrative intervention and not through institutionalized functions of oversight and supervision, and this has opened the way for collusion between the government and the *chaebol*.[9]

Some people in Korea still advocate the merits of management by owners, and this mode of management was certainly suitable for the period of high economic growth when domestic supply was protected by government regulations. But now under conditions of low even minus economic growth and with Korea's markets maturing and rapidly globalizing, the continuation of corporate governance that ignores investors will make it difficult for enterprises to procure funds from sources outside their own corporate groups. This will reduce credibility with outside (especially foreign) lenders. The effects of such a reduction could ripple through all the industrial sectors of the economy which ultimately could bring on an economic crisis and national default. The spread of such a national crisis to other countries would be to repeat what we have experienced with the present Asian economic crisis.

B. *Institutional Changes Needed for Corporate Restructuring*

Along with gaining corporate acceptance of the five major principles for restructuring, the government took steps to eliminate bottlenecks in the process of structural reform. It called on financial institutions to fully take their responsibilities as creditors by properly monitoring their corporate borrowers. At the same time enterprises were told to: (1) improve their unhealthy financial structure and put priority on profitability rather than on quantitative growth, (2) operate businesses in accor-

[9] This has been exacerbated by the common practice of government officials becoming senior-level representatives of state-controlled financial institutions or state-owned enterprises (the practice is often dubbed "parachuting," which is similar to the Japanese practice of *amakudari*), which is likely to encourage the flourishing of cronyism and moral hazard.

dance with market principles and avoid arbitrary government interferences, and (3) enhance the transparency of their management and strengthen the internal oversight of their executive management.

Starting from February 14, 1998, over the course of the next twelve months the government laid out a quick succession of measures aimed at fulfilling the above objectives (Table IX). A great many measures were prepared over a short period of time, but it took some time to revise regulations to conform with the new measures and to prepare the offices that would be responsible for implementing them. Because of this, foreign companies in Korea had difficulty getting prompt information about these measures and adjusting their business operations accordingly. This caused some discontentment with the policy process even while the measures themselves were welcomed.

1. *Enhancing the transparency of management*

Looking more closely at the measures the government laid out, one required the establishment of selection committees for selecting outside auditors especially for corporations listed on the stock exchange and for the affiliates of thirty largest *chaebol*. These committees were to be composed of minority shareholders and creditor representatives. The government demanded the early introduction of consolidated financial statements (originally to be introduced from the year 2000 but moved forward to 1999), and it also demanded that corporate accounting standards conform with international standards (also to be applicable from 1999). A particular noteworthy step was the authority given to the Fair Trade Commission which enabled it to demand the submission of financial statements from the five top *chaebol*. This was aimed at controlling the inappropriate transactions carried on among affiliates within these five groups.

2. *Abolishing cross debt guarantees*

The conglomerates' great dependence on loans was seen as the main culprit causing Korea's financial and currency crisis. Therefore the first efforts of *chaebol* reform centered on abolishing cross debt guarantees among affiliate companies and the reduction of debt-equity ratios.

From April 1, 1998 conclusions of new cross debt guarantees were prohibited, and existing guarantees would have to be terminated by March 2000 (however, cross guarantees across different business fields could be switched to guarantees among the same business fields until the end of 1998). Also financial institutions were prohibited from demanding cross guarantees from corporate borrowers. As a result of these measures, the affiliates of thirty largest *chaebol* abolished 21 trillion won in cross loan guarantees by the end of December 1998 (the amount of mutually guaranteed debt falling from 33 trillion won as of April 1, 1997 to 12 trillion won at the end of December 1998).

TABLE IX

MAJOR CORPORATE RESTRUCTURING POLICIES

Policy Objectives		Main Measures
Enhancement of transparency; dissolution of cross debt guarantees		* Appoint external auditors and strengthen responsibility of accounting auditors * Introduce consolidated financial statements * Adopt internationally accepted accounting standards * Allow no new cross debt guarantees; dissolve existing guarantees * Strengthen regulations on unsound intra-*chaebol* transactions within the top 5 *chaebol*
Capital market	Merger & acquisition market	* Abolish the mandatory tender offer rule applied when a bidder intended to buy more than 25% of a company's shares (more than 50% of the bid had to be tendered publicly) * Abolish the limit on the total amount of investment in other companies (investment could be up to 25% of a purchasing company's net assets) * Eliminate regulations on foreign M&A of domestic firms * Raise the ceiling on buyback shares so that a company can defend its management rights
	Minority shareholders	* Strengthen minority shareholder rights to file representative lawsuits * Introduce the cumulative voting system under which minority shareholders can exercise their voting rights
	Other	* Eliminate conditions on capital increases; establish mutual funds; and introduce asset-backed securities (ABS)
Financial market	Financial restructuring	* Request that *chaebol* conclude the Capital Structure Improvement Agreement with their major creditor banks (the objectives of the agreement include corporate restructuring through the merger and reorganization of affiliate companies and reduction of *chaebol* debt-equity ratios to less than 200%) * Improve the soundness of financial system through financial restructuring
Corporate organization and systems	Corporate organization	* Increase the accountability of controlling shareholders and management * Seek the closure of the secretary's office or planning and coordination office under the chairman * Increase the accountability of the "de facto director" * Lift the ban on setting up pure holding companies
	Board of directors	* Require the appointment of outside directors and external auditors * Incorporate the fiduciary duty of board directors into the Commercial Law
Other		* Promote the merger and reorganization of affiliate companies * Promote the Big Deal * Strengthen the tax support for corporate restructuring * Introduce an employment adjustment (layoffs) system * Adopt a corporate-breakup system * Promote workout plans for affiliates and medium-sized companies * Relax the standards for judging the appropriateness of corporate mergers * Amend the exit policy for nonviable enterprises

Source: Ministry of Finance and Economy, 1998.

While the termination of cross debt guarantees raised the amount of risk for financial institutions, it was not all that great a task for the conglomerates to undertake. Thus this termination process was carried out pretty much as planned, and it did not have as much of an impact as the requirement that debt-equity ratios be brought down to 200 per cent or less (which will be discussed later).

3. *Improving corporate financial structure*

The government decided to exempt enterprises from excise taxes on assets when these were sold to repay debts to financial institutions (to be effective until 1999). But the government also decided that any interest paid on debt exceeding five times equity capital could not be declared as costs (to take effect from 2000). To foster the capital market the government eliminated requirements on capital increases, and it authorized the establishment of mutual funds. To attract foreign investment it fully opened the real estate and construction industries and allowed foreigners to acquire land and real estate. The government also set up a corporate restructuring fund (worth 1.6 trillion won) which began functioning in October 1998 to provide capital to healthy small and medium-sized enterprises and to assist with converting short-term loans into long-term loans. Also from October 1998 the Korea Land Corporation began buying up corporate-owned real estate.

With the above preparatory measures in place, in April 1998, the government called on the 6th–64th ranking conglomerates to conclude a Capital Structure Improvement Agreement with their main creditor banks whereby they would promise to reduce the ratio of their debt with these banks to 200 per cent or less by the end of 1999. The government also had companies submit corporate improvement (workout) plans, and as of the end of 1998, ninety-two companies (seventy-one *chaebol* affiliates and twenty-one medium-sized companies) had submitted plans with forty-seven of these gaining approval by creditor banks and the Financial Supervisory Commission.[10]

4. *Determining core business areas*

The diversification of conglomerates into a wide variety of unrelated businesses had led to low operation efficiency and numerous other problems and abuses. To do away with these deficiencies, the five top *chaebol* were expected to designate the areas of business where they had comparative advantages and draw up proposals to concentrate their core competence in these areas. A plan to this effect was accepted at a meeting of government ministers, business leaders, and major creditor bank chairmen and took place on December 7, 1998. According to this plan, the five

[10] Subsequent workout plans involve deferred payment of principal or interest, reduced interest rates, extended terms of loans, write-off of debts, new credit, cancelled existing debt payment guarantee obligations, debt-equity swaps, sale of non-core businesses, and new equity issues.

chaebol were to designate three to five areas as their primary businesses and were to concentrate their core competence in these areas. This was expected to reduce the number of their affiliates from 272 to 136 companies.

The government also decided on a reorganization plan to deal with seven areas of business (petrochemicals, semiconductors, railroad rolling stock, aircraft, electric power generation, ship engines, and oil refining) where the five *chaebol* were plagued by excessive and overlapping investment. The contents of this plan were contained in an Agreement for Improving the Capital Structure which was concluded on December 15, 1998 based on discussions between the *chaebol* and their creditor financial institutions. This designation by the largest *chaebol* of core business areas came to be known as the Big Deal. The government then introduced a system for splitting off the non-core sections of enterprises thereby downsizing enterprises. The significant feature of this system is its use of tax incentives to support the enterprises with their efforts to specialize in their designated fields of business.

5. *Institutionalizing the accountability of management and controlling shareholders*

The government required enterprises listed on the stock exchange to appoint and empower outside directors. It relaxed conditions on the right of minority shareholders to file representative law suits, and it approved the right of institutional investors to vote. To clarify the legal responsibilities of controlling shareholders, the government took steps to make them de facto directors. It also introduced a cumulative voting system so that minority shareholders could also participate in appointing directors.

6. *Closing insolvent companies and stimulating M&As*

To stimulate the M&A market, the government abolished on February 14, 1998 the mandatory public tender rule, and the limit on the total amount that one enterprise could invest in another company. The former had required that anyone wanting to purchase 25 per cent or more of a publicly traded company's stock had to buy over 50 per cent of this stock through public tender, while the latter had allowed affiliates of the thirty largest *chaebol* to make such purchases only up to 25 per cent of their net assets. To facilitate the closure of insolvent companies and their withdrawal from the market, the government simplified the bankruptcy procedures involved in the Corporate Reorganization Act, the Composition Act, and the Bankruptcy Act, and it revised and enhanced the right of general shareholders and creditor institutions to oversee the company's management so that they will be able to prevent controlling shareholders from pursuing private benefits to the detriments of the firm's value. The government also eliminated restrictions on foreign M&As of domestic enterprises.

With these changes the Financial Supervisory Commission and creditor banks designated fifty-five companies for closure (which included twenty affiliates of the five largest *chaebol*), and banks stopped all new lending to these firms. These were the opening steps toward reforming the conglomerates' propensity for excessive borrowing and lax management which had brought on Korea's economic crisis, and they were well received and highly approved by foreign investors.

C. *Reduction of Debt-Equity Ratio to Less Than 200 per Cent and the Big Deal*

Theoretically the most desirable role for the government to play in handling restructuring is to advocate that companies carry out their own structural reforms based on market principles and institutional framework. This means that restructuring policy should be formulated and implemented with primary emphasis on strengthening the involvement of financial institutions and market participants in monitoring the management of companies. If the lending functions of banks and other financial institutions can be normalized, and if market discipline can be engendered through the stock and M&A markets, then the conglomerates will stop their overreliance on loans, their excessive diversification, and their lax, low-profit managerial methods. And if the transparency of management can be enhanced and corporate controlling structure can be reformed, then the various investor groups with interests in these conglomerates can continually monitor corporate operations with the expectation that this will lead to more efficient management decision making. This would induce improvement in corporate financial structure and business methods as these adjust to conform with the changes of restructuring. All this would mean that the government would no longer need to intervene directly in the management of companies.

However, it takes time to build up the market mechanism and institutional framework. But the government confronted with the imminent economic crisis could not waste time. The government took steps to overcome the crisis and put priority to a countermeasure which was aimed at reestablishing the country's international creditworthiness and moved quickly to straighten out the problem which was caused in the first place by government-controlled business financing and an over-protected domestic market. In the circumstances it may be justifiable that the government took leadership at the earliest stage of the crisis and tried to induce the conglomerates to press ahead with financial restructuring and rebuilding their businesses.

Once an economic and social environment is established where corporate restructuring based on market principles and institutional framework can be carried out smoothly, then enterprises themselves can determine such matters as whether to specialize or diversify their business, to operate independently or stick with convoy management methods, or to be managed by professional managers or by owner-managers, and the government does not have to intervene. The most important factor for all of this is to put in place institutional measures that will do away with the unfair and inappropriate internal transactions, the cross debt guarantees, and the wholly excessive and overlapping investment long pursued by the *chaebol*.

1. *The present state of corporate restructuring*

Looking first at the five largest *chaebol*, on December 7, 1998 the government, creditor banks, and these largest conglomerates finally reached an agreement on a plan for restructuring. It contained the following main points.

First, the three sides agreed on a plan for reorganizing semiconductors, petrochemicals, and five other areas of business (automobiles and electronics were later added) where the five had excessive and overlapping investment. This reorganization became known as the Big Deal. This plan called on the conglomerates to select three to five areas as their core businesses where they would focus their core competence (Table X). At the same time the five agreed to reduce the number of their affiliates from 272 to 136 companies.

Second, the five conglomerates would radically improve their financial structure by selling off affiliates and attracting foreign capital, and they would reduce their debt-equity ratio to 200 per cent or less by the end of 1999. At the same time, they would examine the possibility of creditor financial institutions converting their corporate loans into equity capital as a means of supporting financial restructuring on condition that enterprises make their own efforts to restructure and introduce foreign capital.

Third, regarding cross debt guarantees, it was agreed that those guarantees that extended across business sectors, worth a total of 12.7 trillion won, would be terminated by the end of 1998, and that all cross debt guarantees would be abolished by March 2000.

Fourth, the five top *chaebol* would make efforts to shift control of their management over to their boards of directors; outside directors who have always had only

TABLE X

BUSINESS RESTRUCTURING PLAN FOR SEVEN INDUSTRIES

Industry	Restructuring Plan
1. Semiconductors	LG and Hyundai will divest their semiconductor businesses and make them independent enterprises. They should nominate business entities responsible for managing the enterprise taking into account the evaluations made by external rating institutions.
2. Railroad rolling stock 3. Petrochemicals 4. Aircraft	Participants in the newly established business entities of these industries will divide ownership on a pro-rata basis according to their net assets. The total amount of domestic ownership will be limited to 50%, leaving the rest open to foreign investors.
5. Electric power generation 6. Ship engines	Samsung and Hyundai will transfer these businesses to Korea Heavy Industry.
7. Oil refining	The oil refining business of Hanhwa will be transferred to Hyundai.

Source: Ministry of Commerce, Industry and Energy, 1999.

nominal authority would get substantive powers; and a more advanced management control structure would be put in place which gave priority to the interests of shareholders.

In the government's view the five top conglomerates should be capable of carrying out the above restructuring measures on their own and is leaving it up to their own volition to push ahead with the reforms (Table XI). However, it called on the *chaebol* to conclude with their main creditor banks Capital Structure Improvement Agreements.

For the *chaebol* ranking from 6th to 64th and for other large enterprises, the government's opinion is that these corporate entities are too weak to reform their own management, so it has decided to have their creditor financial institutions take the lead in promoting the restructuring (workout) plans. Another reason that the government took this step was because these smaller *chaebol* and other large enterprises are involved with so many creditor banks. With leading small and medium-sized enterprises the government likewise has asked their creditor financial institutions to take the lead in working out restructuring plans and providing needed financial support.

TABLE XI

BUSINESS RESTRUCTURING PLAN FOR THE FIVE TOP *CHAEBOL*

Chaebol	Hyundai	Samsung	Daewoo	LG	SK
Core industries	Automobiles, electronics, heavy and chemical industries, construction, financial services	Electronics, financial services, trade, other services	Trade, construction, automobiles, heavy industry, financial services	Chemicals, energy, electronics, telecommunications, financial services	Chemicals, energy, financial services, information and telecommunications, construction, distribution
Number of affiliates:					
Before reduction	63	66	41	53	49
After reduction	32	40	10	32	22
Target of debt-equity ratio by the end of 1999 (%)	199.7	184.0	196.0	199.8	199.7
Non-core affiliates sold off (10 billion won)	1,172	1,466	1,906	903	495
Induced foreign investment (U.S.$ 100 million)	79.8	35.8	40.3	47.2	14.6

Source: Financial Supervisory Commission, 1998.

All of this restructuring has engendered losses, and the problem is how these should be borne by creditors and debtors. On the debtor side, enterprises have been working to reduce their debt burden by selling off unproductive assets and affiliate companies and by reducing their capitalization. For their part, creditor financial institutions have been converting debt into equity, converting short-term loans into long-term loans, and allowing exemptions on interest payments. In such way both sides have been cooperating to ease the corporate world's financial burden.

Looking at the organizational arrangements for implementing structural reform, for the five largest conglomerates, the main creditor banks have organized credit appraisal teams within the banks which examine the evaluation reports produced by the Appraisal Committee composed of international experts who were called on to evaluate corporate restructuring plans. Bank credit appraisal teams, taking over the role of overseeing the progress of corporate restructuring, conduct follow-up supervision and assistance. For the sixth-ranking and smaller *chaebol*, corporate management improvement teams (workout teams) have been set up in their respective creditor banks under the direct control of the bank presidents to oversee their restructuring. Similarly for leading small and medium-sized enterprises, special task forces for promoting reforms have been organized in each of their creditor banks directly under the bank presidents.

As of the end of February 1999, a check on the restructuring of the smaller *chaebol* (those ranking from 6th to 64th) showed that thirty-eight affiliates belonging to fifteen corporate groups had determined their workout plans. Among small and medium-sized enterprises, their main banks had categorized 37,449 of these companies (as of the end of December 1998) into three groups: (1) sound companies getting preferred financial support, (2) troubled companies getting conditional support, and (3) other. Companies in the first category have been getting new loans to counter the credit crunch, getting extensions on loan maturity dates, getting short-term loans converted into long-term loans, getting preferential interest rates, and getting conversions of debt into equity. Companies in the second category have not been getting new loans; instead they are being directed to reduce their debt-equity ratios, sell off assets, and increase their capitalization.

As for the five top *chaebol*, these have to reduce debt-equity ratio to 200 per cent or less, and to achieve this target they have been reorganizing or selling off affiliates and issuing new equity shares domestically and overseas in an effort to pay off debt. In addition, by the end of 1999 they will have had to end all cross debt guarantees (with some exceptions as allowed by the Fair Trade Act).[11] They are also in the

[11] Cross debt guarantees in the same fields of business among the affiliates of the five largest *chaebol* stood at 21.4 trillion won at the end of September 1998. During the fourth quarter of 1998, 15.1 trillion won in debt guarantees were terminated leaving 6.3 trillion won as of December 1998. The 13.1 trillion won in cross debt guarantees extending across differing business sectors have all been terminated.

process of downsizing as they reduce the number of their affiliates and carry out MBOs (management buyouts) with the intent of focusing their competence in core business areas.

2. *New problems*

As indicated above, as of July 1999, fifteen of the conglomerates ranked from 6th to 64th have had their restructuring plans approved and have begun moving ahead with structural reform; and measures to deal with the credit crunch and debt recalls facing small and medium-sized enterprises are being put into effect. The five largest *chaebol* have begun the task of reducing their debt-equity ratios and managed to reduce them to some extent, but during the course of dealing with this matter, numerous problematic side effects have come out. They have also been attempting to restructure their businesses, but results have not progressed as hoped.

According to the Fair Trade Commission, by April 1999 the five top *chaebol* had greatly reduced their debt-equity ratios compared with a year earlier, but at the same time the amount of their total debt had greatly increased. The figures for the thirty largest conglomerates show that the total amount of cross-shareholding among the affiliates of these conglomerates has reached 30 trillion won, 12 trillion won higher than a year earlier. It is not clear why this total amount of cross-shareholding grew so much, but it is possible that affiliates of these conglomerates took the funds they had acquired through the reevaluation and sale of assets and had borrowed from affiliated financial institutions and used them to purchase stock in other affiliates instead of using the money to pay off their own debts.

If for example Company A, an affiliate in a conglomerate, used cash to increase its equity holdings in Company B, a co-affiliate in the conglomerate, and Company B did the same in co-affiliate Company C, and Company C did likewise in Company A, the result would show an improvement in the debt-equity ratio of all three companies. If on the other hand these companies were to increase their equity via the stock market, the number of shareholders would increase causing concern about increased pressure on the existing executive management. For this reason conglomerate affiliates would prefer not to procure capital on the stock market to lower their debt-equity ratios. Up to now there has been a limit on the amount of cross-shareholding that affiliates can have among themselves, but this regulation has never applied to foreign-owned firms which domestic enterprises criticize as being a form of reverse discrimination. Therefore this limit has been abolished, and there is now no deterrent to cross-shareholding. In such an environment, if *chaebol* affiliates choose to make use of cross-shareholding, they can easily meet their objective of reducing debt-equity ratios to 200 per cent or less.

However, there is also a problem with cross-shareholding. In contrast to cross debt guarantees where guarantees will be terminated when debts do get repaid, cross-shareholdings will not be ended unless the stocks held in a co-affiliate are sold. Therefore, once an affiliate has bought shares in another, the former will suffer the burden of double taxation on the dividends paid by the latter, while the dividend payout by the latter will not be recognized as a tax write-off. Both companies suffer a loss which ultimately will be borne by the general shareholders. For this reason cross-shareholding is a bigger problem for society than cross debt guarantees, and it has now become necessary to regulate these holdings. The government has decided to levy additional interest on the amount of total corporate debt, and along with this it is going to calculate the real holding ratio of shareholders who have large cross-shareholdings. Also it will soon introduce consolidated financial statements.

Another growing problem is the expansion of the *chaebol* into the secondary financial sector (made up of such financial institutions as securities companies, non-life insurance companies, and investment trust companies). As already mentioned, much of the adjustment to bring debt-equity ratios down to 200 per cent and less has been carried out through secondary financial institutions affiliated with the *chaebol*. By present regulations, investment trust companies and mutual funds cannot purchase shares worth more than 10 per cent of their own total working assets when buying into other affiliates in the same *chaebol*; and they cannot purchase shares worth more than 20 per cent of their total working assets when buying into affiliates belonging to other *chaebol*. However, as the proportion of working capital of investment trusts and mutual funds grows, they can increase the amount of shares they are able to buy of co-affiliates. It seems to have become a common practice that mutual funds belonging to the different *chaebol* to buy up the shares of affiliates in each other's corporate groups. The growing control of the five top *chaebol* over the secondary financial sector has become apparent. As of March 1999, the securities companies affiliated with these *chaebol* had a 54.3 per cent share of the market; in March 1997 it had been 34.0 per cent. For affiliated investment trust and non-life insurance companies the share in March 1999 was 31.6 per cent and 50.8 per cent respectively, up from 6.2 per cent and 47.9 per cent two years earlier. These figures indicate the real possibility that companies in the secondary financial sector are becoming in-house sources through which the *chaebol* can procure capital resources.

These developments have made it necessary to (1) prohibit secondary-sector financial institutions from providing financial support to affiliate companies and lower the limit on the amount of stock they can purchase, (2) restrict the percentage of ownership that *chaebol* can have in their affiliated investment trust companies, (3) increase the number of outside directors in investment trust companies, (4) prohibit the five *chaebol* from setting up new mutual funds, and (5) urge insurance and investment trust companies to go public. All these measures are intended to restrict the control of industrial capitalists over the financial institutions and at the same time strengthen market oversight functions. In effect, these five measures were conceived as an addition to the three principles of *chaebol* reforms, already put into practice, which were intended to (1) strengthen governance over secondary sector financial institutions, (2) restrict circular cross-shareholdings among affiliates, and (3) restrain illegal practices of bequests and gifts. But these restrictions on investment and stock ownership raise a reverse concern in that they clearly conflict with the important role of deregulation and the market mechanism in the present process of corporate restructuring.

A third problem involves the side effects of the Big Deal, whereby the top *chaebol* are realigning their businesses to focus on areas of core competence and eliminate overlap. As already explained, cross debt guarantees and cross-shareholding among *chaebol* affiliates, intra-group transactions, and the acquisition and merger of affiliates within the *chaebol* all increase the ability of the *chaebol* to control markets, infringe on the property rights of minority shareholders, and preserve the expansionary style of owner-management, all which are injurious to the functioning of a fair market system. Given these abuses, the government has justification for demanding *chaebol* reform. Its measures for conglomerates to specialize in business fields (by having *chaebol* sell off affiliates and exit sectors unrelated to their original spheres of business, through buy-ups and mergers of affiliates by employees and professional managers, and through the sale of affiliates to foreign buyers) and to reduce the number of their affiliates will make the principles of market competition work more effectively. At the same time, however, every effort has to be made to see that the determination of core business areas is based on the volition of each conglomerate. But under the Big Deal now being implemented, this last point of *chaebol* volition is not necessarily being observed, and this has created three problems.

(1) Under present economic conditions, there exists a so-called asymmetry of information between the business world and the government offices responsible for overseeing business specialization (including the Financial Supervisory Commission and the Fair Trade Commission). To policy officials the excess production capacity in semiconductors, electric power generation, ship engines, aircraft, railroad rolling stock, oil refining, automobiles, electronics, and petrochemicals should be scrapped as soon as possible. To the leaders in the business world, these sectors are greatly affected by the booms and recessions of the business cycle, and while there can be excess capacity during recessions, when the economy moves into an upswing, this capacity will be put back into use; therefore they see no need to scrap the present excess capacity.

(2) The government's efforts to assist the conglomerates with business rationalization and specialization can instead foster an environment for moral hazard which would greatly increase the chances for policy failure. In other words, while the government can prod the conglomerates into specializing their businesses, the conglomerates in turn can demand that the government bear the costs they incur by cooperating with official policy.

(3) When reducing the number of *chaebol* affiliates, it must be noted that if this reduction is achieved simply by means of mergers, there will be no linkage with *chaebol* financial restructuring or any enhancement of their core competence. The Big Deal has been completed in semiconductors and oil refining and it is under way in electric power generation, ship engines, aircraft, and railroad rolling stock. However, in automobiles and electronics its prospects remain unclear, while in petrochemicals the prospects look difficult because the *chaebol* have yet to devise plans for liquidating excess liabilities through such steps as selling off assets, increasing capitalization, and the repurchasing of nonperforming loans.

To counter these problems, it would be preferable over the short term for the government to set time limits, provide tax exemptions and reductions to promote the liquidation of excess capacity and assets and the realignment of businesses, and offer support for such activities as information dissemination and intermediation of transactions. Over the medium and long term the government should put greatest emphasis on improving corporate governance and strengthening the oversight functions of financial institutions. Fundamental in this whole process is that the government should not force on the restructuring enterprises measures they have not agreed with. The creditor financial institutions and the Financial Supervisory Commission should assume the central role of promoting the Big Deal. Nevertheless, it is probable that this effort will require the infusion of additional public funds into the process of dealing with nonperforming loans, and this can cause problems of the *chaebol* receiving preferential treatment. Therefore the most desirable approach to the *chaebol* problem would be to convert the Big Deal into corporate restructuring programs (workout plans) which have been applied to the sixth ranking and smaller conglomerates under the promotion of their creditor banks.

VI. CONCLUSION

At the time Korea let itself come under the IMF program, a strong sense of crisis pervaded the people that the country was losing its economic sovereignty. However, the government was able to play on this strong popular reaction to the IMF program and use this force to bring about an easing of the ultra-tight contractionary policies initially demanded by the IMF. At the same time the government set out to implement reforms aimed at overcoming the economic crisis and thereby recover Korea's international credibility. Thus Korea never simply accepted the IMF demands as originally dictated.

The government's objectives in its reform program have been to remove the many impediments that have restricted the functioning of a market economy and to build an open, market-based economic system. To achieve these aims, when it accepted financial relief from the IMF, it began a vigorous pursuit of major reforms in four areas along with implementing a plan for opening the economy to foreign competition (what became known as the 4 plus 1 policy).

Financial restructuring has been one area of major reforms. The government prepared 64 trillion won in public funds for the purchase of nonperforming loans and the recapitalization of businesses, and it pushed ahead with the withdrawal of nonviable financial institutions from the market or had them merged with other healthier institutions. Banks regarded as viable have had their capitalization increased and their nonperforming loans bought up. These measures have brought the equity capital of these banks up to 10 per cent which is transforming them into sound financial institutions capitalized well above the 8 per cent capital adequacy level required by the BIS. Along with these measures, the government is promoting the participation of foreign banks in the operations of domestic commercial banks, and it has been moving ahead with plans to sell two such banks (Seoul Bank and Korea First Bank) to foreign financial institutions. However there are still a number of urgent problems that banks have to deal with: (1) they have to improve their capabilities for assessing the creditworthiness of corporate borrowers; (2) they need to move away from the custom of only making collateralized loans; (3) they need to build up an autonomous, self-reliant banking system not dependent on government protection; and (4) they have to enhance their ability to compete with the financial institutions of the advanced economies.

The second area of major reforms has been corporate restructuring. The government wants the conglomerates to move away from their long-standing convoy management approach and shift as much as possible to management based on independent corporate units, and it has been carrying out the necessary deregulation and laying the needed institutional groundwork for this shift. Therefore the *chaebol* cannot go on existing in their present form. They are going to have to redouble their efforts to promote: (1) the transparency of their management, (2) the rights of their minority shareholders, and (3) the legal responsibilities of their controlling shareholders.

As a result of these reforms, the five largest *chaebol* substantially reduced their debts from 42 trillion won in 1997 to 29 trillion won as of April 1999. However, these same *chaebol* have been making significant inroads into the secondary financial sector through expansion into the securities, insurance, and investment trust fields, and their affiliates have greatly increased the amount of their cross-shareholdings. To counter these moves by the *chaebol*, the government has stepped up its oversight of *chaebol* activities and is trying to bring about a fairer competitive system, but at the same time it will have to make the needed changes in the legal system for promoting structural reform (such as removing the ban on setting up pure holding companies and amending corporate tax laws). Regarding the Big Deal, the government has to make sure that the *chaebol* go back to concentrating on their original core businesses; the creditor financial institutions take the lead in implementing restructuring plans and oversee that enterprises scrap their excess productive capacity in a timely manner (with the understanding that the government will for a limited time provide support for this scrapping); and the *chaebol* improve their competitiveness through the enhancement of their core business competence.

Apart from ongoing corporate governance reforms, the Fair Trade Commission will play a substantial role in restraining excessive *chaebol* power by upgrading the regulatory framework and legal enforcement of competition policy. The government also recognizes that it should further strengthen its monitoring capacity and enforce the Securities Exchange Law, the Commercial Code, and other relevant legislation.[12]

The third area of major reforms has been in the public sector. This area has lagged behind the restructuring in the private sector. At present deregulation is under way, and the government has, in principle, been moving to abolish official regulations. If new regulations should be needed, it is the responsibility of the government to fully explain the reason for the need. At the same time the government needs to overhaul the management of public enterprises and pursue their privatization for the purpose of realizing a smaller, more efficient government. The same has to be done at the local government level. There is a pressing need for local governments to undertake deregulation, administrative and fiscal reforms, and the decentralization of government authority.

The fourth area of reforms has been in the labor market. All levels of Korean society realize that the country's economy cannot survive in today's fierce international competition without greater flexibility in the labor market and a reform of the rigid wage structure. To cope with these difficult changes, labor, management, and the government have been striving to establish a program based on a tripartite agreement among the three sides for sharing the burden of economic restructuring. All three sides recognize that Korea's enhanced international competitiveness will safeguard the jobs of Korean workers. This mode of thinking is responsible for the introduction of annual salary structures and incentive systems for employees.

Along with the above reforms the government is pursuing plans to liberalize trade, investment, and capital. It has done away with the Import Diversification Program, and has pressed ahead with capital and exchange rate liberalization. This has removed the limits on the foreign ownership of stocks and land. The government has introduced a one-stop service system at government offices for handling foreign direct investment (all procedures are completed at one time) which has simplified the processing of such investment. These changes have greatly improved the environment for investment in the country by directing importance away from Korea-owned industry toward Korea-based industry.

As Korea has moved ahead with its numerous economic and financial reforms,

[12] These include more stringent civil, commercial, and criminal law enforcement on tax evasion, insider stock trading, bribery, misappropriation, embezzlement, and neglect of fiduciary duties by controlling shareholders and family members.

the real economy has begun to show signs of recovery. The number of unemployed, which rose from 1.5 million workers (a 6.9 per cent unemployment rate) at the start of reforms in February 1998 to 1.8 million workers (an 8.7 per cent rate) in February 1999, had improved to 1.4 million (6.5 per cent) by May 1999. Meanwhile the number of newly established enterprises (11,153 companies) set up in the seven major metropolitan areas during the first half of 1999 exceeded the number of business failures (1,059 companies) by about tenfold.

These signs of recovery indicate that Korea has now graduated from the IMF program. But to get its economy back on the path of self-sustaining growth, Korea needs to push forward with its own reform program and deal appropriately with its deflationary factors (meaning the great risk to the middle class posed by high unemployment).

The Korean economy is now confronting the problems of: (1) economic restructuring based on market principles, (2) establishing rules for fair competition, (3) building a social safety net, and (4) building a sounder financial system. The responsibility for overcoming these problems is in the hands of the government and all the people. The government's middle-term objectives have been to enhance the competitiveness of Korean industries by increasing competition in product and factor markets and to let market mechanisms dictate further corporate restructuring. Regulatory reforms have been gradually moving ahead but their speed and extent have been less than satisfactory. The government needs to accelerate the reforms particularly in such fields as management transparency, shareholders' rights, board of directors, and pure holding companies.

Although the economy has turned upward, the capital coefficient continues to rise rapidly, the obsolescence of plant and equipment continues apace, and unemployment among young workers remains high. Such factors indicate that although reforms are moving ahead, their beneficial effects have yet to be felt and will not soon be, meaning that there is a time lag until reforms begin to have an effect in improvements of productivity. It is also quite possible that the present reform process will confront the Korean economy with high levels of unemployment. This is a new prospect for Korean society, and it is essential that serious thought be directed at this possibility. Should a time of prolonged unemployment arise, the society will have to be equipped with new systems of self-help, mutual support, and government support to cope with this problem. But in surmounting these problems, Korea can be expected to achieve the status of a modern industrial economy to be realized early in the twenty-first century.

REFERENCES

Bank of Korea. 1999. "Kumyung sanup kujozojung ihu unhaeng kyungyoung haengtae e daehan pyongka" [Evaluating bank management methods after the restructuring of the financial industry]. July 5 (http://www.bok.or.kr).

East Asia Analytical Unit, Department of Foreign Affairs and Trade, Australia. 1999. *Korea Rebuilds: From Crisis to Opportunity*.

Jung, Yongseung, and Baak Saang Joon. 1998. "IMF Bail-Out and Korea's Economic Reform." *KIET Economic Review* 3, no. 1 (January): 3–15.

Kim Dohyung. 1998a. *Hanil kunyungyuki kukbok kwa kyungje hyubleok kangwha bankchaek* [Measures for overcoming Korea-Japan financial crisis and strengthening economic cooperation]. Seoul: KIET, April.

———. 1998b. "Kin'yū keizai kiki-ka no kōzō chōsei to shitsugyō" [Restructuring and unemployment at times of financial and economic crisis]. *Eco-repōto* (special issue), August, 37–65.

———. 1999. "GHQ kanri-ka no Nihon to IMF kanri-ka no Kankoku" [Japan under GHQ control and Korea under IMF control]. *Higashi-Ajia e no shiten* (ICSEAD) 10, no. 4 (June): 50.

Korea Economic Research Institute. 1998a. *IMF chaejeha kuzojojeong jungchock jumkyeom kwa kwaje* [Restructuring policy under the IMF program: An examination of the issues]. Seoul: Korea Economic Research Institute, August.

———. 1998b. "Chaekun kyungjehyeonan kwa daecheck" [Measures for overcoming recent economic problems]. Co-research report of private research institutes. Seoul, October.

Korea Institute for Industrial Economics & Trade (KIET). 1997. "Kuzojojeong kwa kyungje banhyang" [Structural reform and the direction of the economy]. Seoul: KIET, December.

———. 1999a. "Kiyeopkuzojojeong junggan jumkyeom" [Midterm assessment of corporate restructuring]. Policy seminar report. Seoul: KIET, March 18.

———. 1999b. "Kuknae kwaing seolbi hyunwhang kwa daecheck" [Measures for countering Korea's present excess capacity]. Policy recommendation report. Seoul: KIET, April.

———. Various issues. *IMF daecheck series* [A series of reports studying how to cope with the IMF program]. Seoul: KIET.

Kukjeong Gehyeok Gongdongtim (Task force for government's policy reform). 1998. "Jeikeonkuk gehyeok program useonsunwie seoljeong" [Setting priorities for the second national reconstruction program]. Report of the forum of national reform. Seoul, October.

Ministry of Commerce, Industry and Energy. 1999a. *21 segi Hankuk sanyeop bizon kwa baljeon jeonryalk* [The vision and development strategy of Korean industry in the 21st century]. Seoul, January.

———. 1999b. "Gurubgan jayulzayeop kuzojojeong" [Autonomous business restructuring among corporate groups]. Mimeographed.

Ministry of Finance and Economy. 1999. *Kukmin jungbu 1 yeon* [People's government after one year]. Seoul, February.