The Present Status of Structural Reforms in Korea's Financial and Corporate Sectors

By Seihoon Lee
Economic & Industrial Research Group

1. Introduction

In December 1997, Korea asked for approximately $55 billion in emergency aid from the IMF (who provided $21 billion) and other international organizations. Today, two and a half years later, the Korean economy has exceeded the expectations of that pessimistic time. The financial system has stabilized overall, and the Kim Dae Jung administration has been internationally praised for its financial and corporate sector reforms.

Nonetheless, an uncertain future awaits the government-led reforms following a poor showing in the April general election, in which the government party failed to win a clear majority (winning 115 of 274 seats).

In this paper, we examine the progress of Korea's structural reforms in the financial and corporate sectors, and consider what lies ahead.

2. Status of Economic Recovery Following the Financial Crisis

(1) The Conspicuous Recovery

Dragged down by the economic crisis started in Thailand in July 1997, the Asian economy dipped into negative growth of -0.5% in 1998, but promptly executed a v-shaped recovery in 1999 with a 6.3% growth rate. In the second half of 1999, the recovery spread to ASEAN economies, while China resumed its former pace of expansion. In all countries, the main contributors to recovery have been export growth coupled with short-term economic stimulants such as fiscal spending and low interest rates.

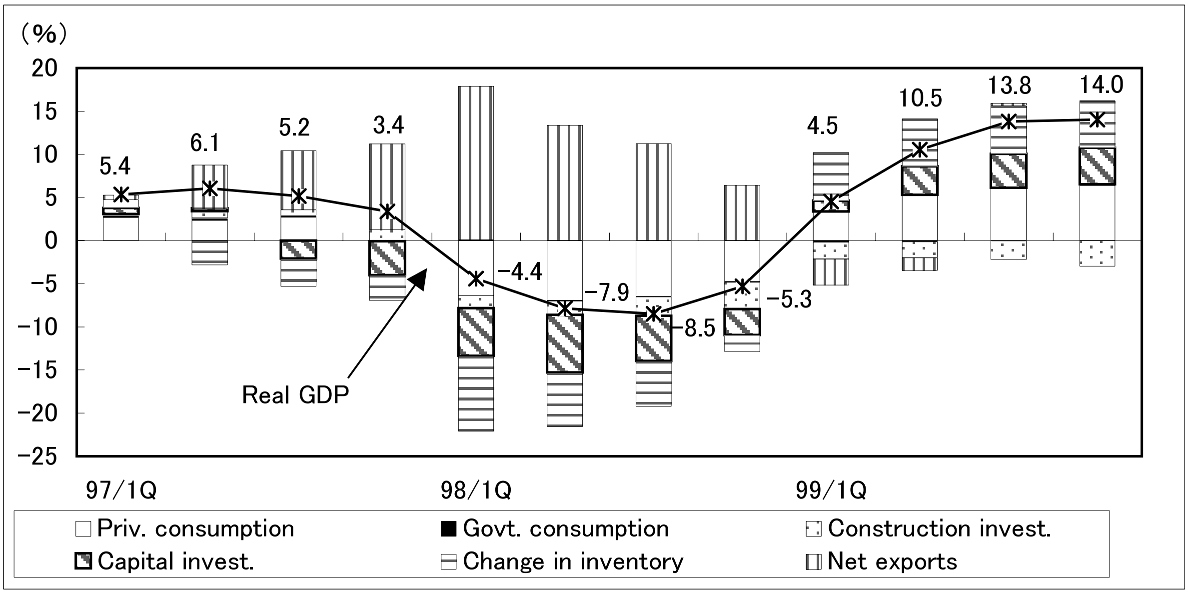
Figure 1 Real GDP Growth Rate of Asian Economies (% change yoy)

	Relative size of economy (%)	1997	1998	1999
China	37.3	8.8	7.8	7.1
Korea	18.0	5.0	−5.8	10.7
Taiwan	11.5	6.8	4.8	5.4
Hongkong	7.1	5.3	−5.1	2.9
Singapore	3.9	9.0	0.3	5.3
Thailand	6.2	−1.8	−10.0	4.4
Indonesia	8.7	4.7	−13.2	0.2
Malaysia	4.0	7.5	−7.5	5.4
Philippines	3.3	5.2	−0.5	3.2
Total (9 countries)	100.0	6.2	−0.5	6.3

Note: Relative size of economy is based on nominal GDP for 1997.
Sources: Foreign government data, BOJ and EPA overseas economic indicators, etc.

The strength of Korea's recovery stands out from the rest of Asia. For an economy that averaged 8.0% growth from 1971 to 1997, the -5.8% growth rate of 1998 was the first negative growth since falling to -2.7% in 1980. But in 1999, export expansion, recoveries in personal consumption and capital investment, and significant growth in inventory investment helped the economy turn around and post an impressive 10.7% growth rate.

Figure 2 Contribution to Real GDP Growth

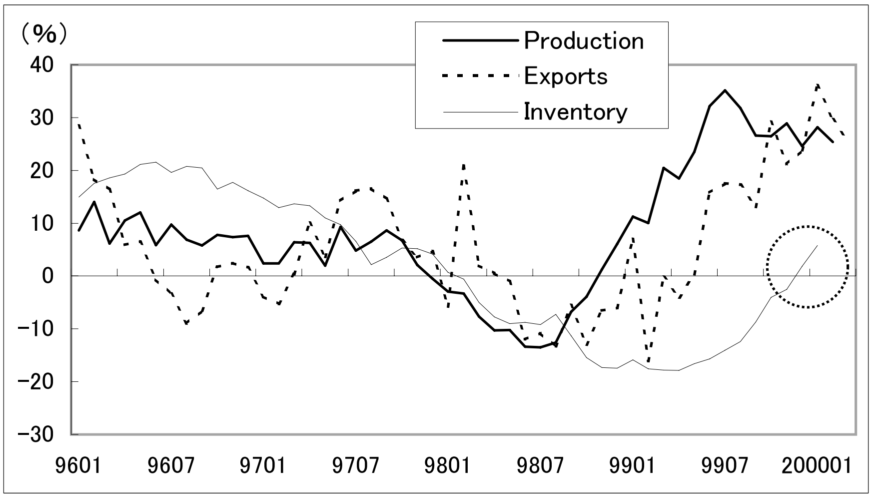


Source: Bank of Korea; others.

(2) Exports Lead the Recovery

The lead role in the recovery has belonged to export growth. By stimulating production, exports have improved both employment and income. A closer look at export trends in 1999 shows that strong growth in Korea's main exports — semiconductors, automobiles, shipbuilding, and steel — has spilled over into domestic demand and brought about the economy's overall recovery. In addition, business inventories have emerged from two years of rigorous adjustment and begun to grow aggressively (Figure 3).

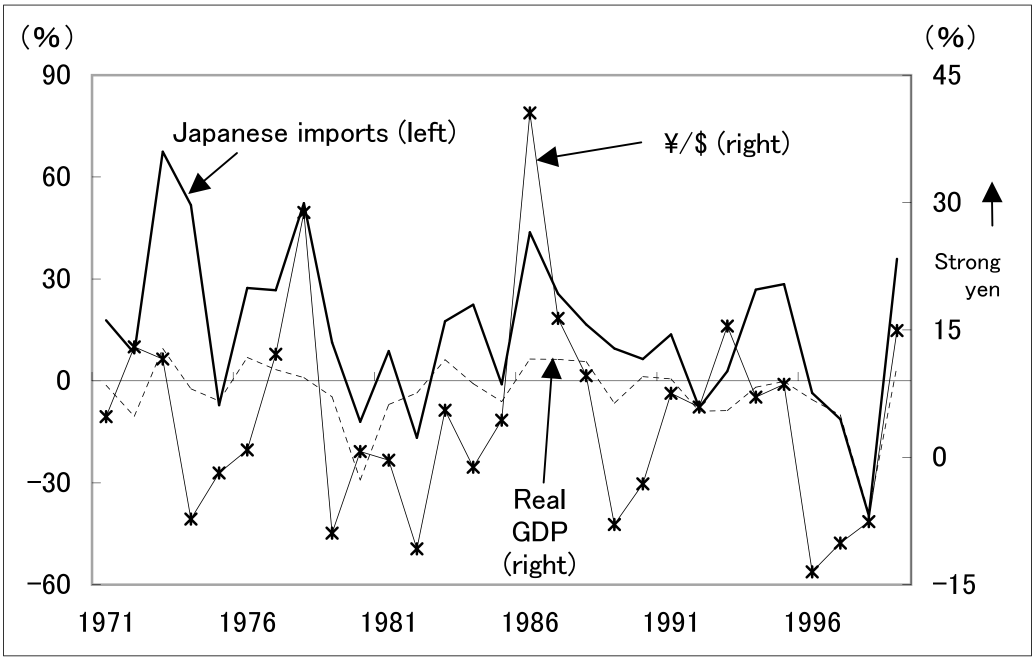
Figure 3 Industrial Production, Exports, and Inventories (% change yoy)



Source: Bank of Korea

However, one cloud in this picture is the persistent trade deficit with Japan, a feature of Korea's trade structure since the 1970s. The strong yen has helped Korea's economic growth by improving the competitiveness of Korean exports. However, this growth has been accompanied without exception by greater imports of capital goods from Japan. Most recently, the trade deficit with Japan fell from $13.1 billion in 1997 to $4.6 billion in 1998, and then ballooned again to $8.3 billion in 1999.

Figure 4 Korea's Heavy Reliance on Japanese Imports



Source: Bank of Korea

Despite the predictability of the situation, in June 1999 the government abolished the so-called import diversification program (aimed at limiting Japanese imports) which had been in effect for approximately 20 years. The trade deficit with Japan subsequently expanded due to imports of home electronics products and durable goods such as video decks, digital cameras, large televisions, and automobiles. The abolishment was prompted by a pledge to the IMF to abolish the restrictions as part of Korea's trade liberalization agenda.

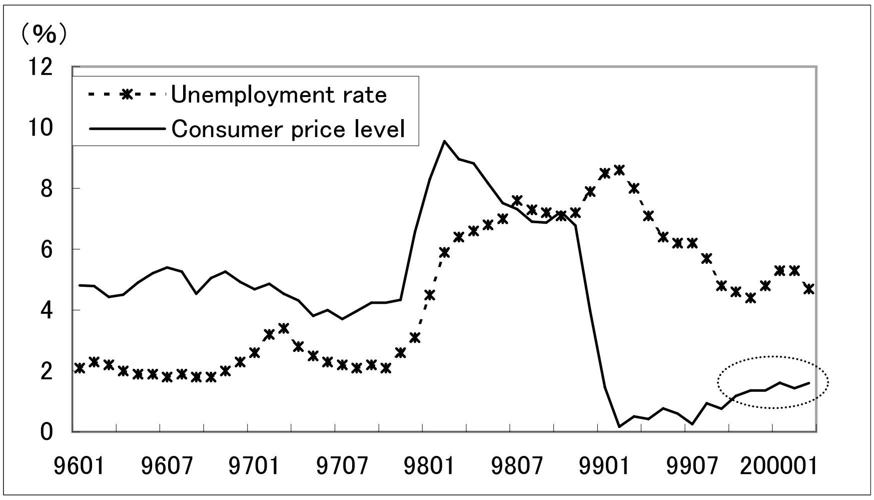
The only way to correct the trade imbalance with Japan is for Korean companies to improve their international competitiveness. And for this, the financial and corporate reforms discussed below are indispensable.

(3) Improvement in Employment and Price Stability

The unemployment rate, which before the economic crisis stood at the full employment level of approximately 2%, almost reached 9% during 1998. Corporate failures, financial institution closings, and hiring freezes brought the severity of unemployment home and instilled a sense of crisis among the public, spurring the government to take emergency measures. Recently, the unemployment rate has declined to around 5%, due in part to the economic recovery.

While inflation has edged up recently, prices have basically maintained a stable undertone since 1999.

Figure 5 Unemployment Rate and Consumer Price Level (% change yoy)

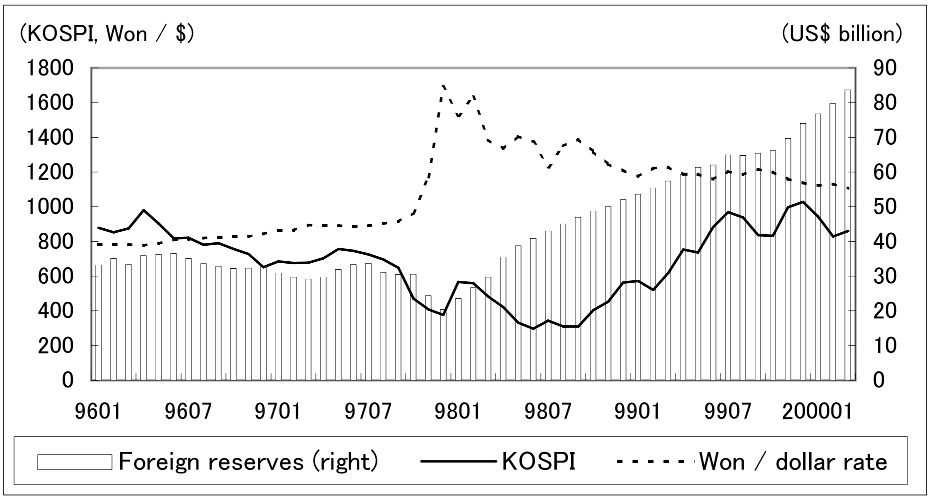


Source: Statistical Agency, Bank of Korea, others

(4) Financial Markets Regain Composure

The economic recovery has brought composure back to the financial markets. The stock market rose in 1999 due to improved corporate earnings and inflows of foreign capital. In the foreign exchange market, the won has gradually appreciated since 1998 against the backdrop of the recovering economy, stabilizing financial markets, and foreign capital inflows. It presently stands at approximately 1,100 won per dollar, and continues to approach pre-crisis levels. Foreign reserves, a frequently used gauge of the nation's declining international creditworthiness, have grown far above the pre-crisis level to over $80 billion due to the trade surplus and capital inflows.

Figure 6 Stock Price Index, Exchange Rate, and Foreign Reserve Level



Source: Bank of Korea, others

3. Compulsory Financial Reform

Coming just after Korea had gained its prestigious membership in the OECD, the Asian economic crisis was particularly humiliating to the Korean government and people. The most prominent cause of the crisis was the fragile financial sector. The government poured massive public funds into the financial sector and unilaterally imposed financial reforms, with a supportive public accepting the fiscal burden and use of tax money. Below we examine the progress in financial reforms by focusing on the banking sector.

(1) Consolidation of Banks

By the end of 1999, the 33 banks (including regional banks) that existed before the crisis had been consolidated into 23. Notably, the top 17 banks in total assets were consolidated into eleven through such activities as the merger of Hanil Bank (ranked third) and Commercial Bank of Korea (sixth), the temporary nationalization of Korea First (fifth) and Seoul (ninth), and relief mergers centered around the relatively healthy Kookmin Bank and Housing & Commercial Bank.

Figure 7 Consolidation Among the Top 17 Banks

1997 yearend (17 banks)	Net assets (W tril.)	Rank	Consolidation activity	Now (11 banks)
6 major banks				**5 major banks**
Commercial Bank of Korea Hanil Bank	32.9 34.9	6 3	Commercial Bank merged with Hanil in Dec. 98; public funds used; solociting foreign equity	Hanvit Bank
Korea Exchange Bank	43.9	1	Recapitalized with equity invest. from Commerz Bank (Germany), govt. purchase of new stock	Korea Exchange Bank
Korea First	33.0	5	Nationalized; public funds used; sold to Newbridge Capital consortium (US) in Dec. 99	Korea First Bank
Seoul	26.1	9	Nationalized; public funds used; sale being negotiated; Deutsche Bank is financial & restructuring advisor	Seoul Bank
Cho Hung Bank	39.1	2	Merged with two regional banks in Apr. 99; public funds used; foreign equity solicited	Cho Hung Bank
11 other banks				**6 other banks**
Hana Bank Boram Bank	11 8.8	11 13	Hana acquired Boram in Jan. 99; equity investments by IFC, etc.	Hana Bank
Kookmin Bank Korea Long-term Credit Bank Daedong Bank	33.9 19.1 5.5	4 10 16	Kookmin acquired Daedong in June 98, Korea Long-term Credit in Jan. 99; equity participation by Goldman Sachs, etc.	Kookmin Bank
Shinhan Bank Donghwa Bank	27.4 8.3	8 14	Shinhan acquired Donghwa in June 98; issued depository receipts abroad	Shinhan Bank
KorAm Bank	9.4	12	Negotiating DR underwriting with Deutsche Bank	KorAm Bank
Housing & Commercial Bank Dongnam Bank	31.5 6.7	7 15	Housing & Commercial Bank acquired Dongnam in June 98; equipty participation by ING, etc.	Housing & Commercial Bank
Pyunghwa	—		Pursuing restructuring plan	Pyunghwa

Note: Total assets are in trillion won as of June 1997, before the crisis.
Sources: Financial Supervisory Commission; *Analysis of Listed Companies*; media reports.

Structural adjustments aimed to restore banks to health were pursued through a variety of means, including government-led consolidation and temporary nationalization, insertion of public funds (to purchase and amortize nonperforming loans, recapitalize, etc.), and equity participation and business collaborations with foreign financial institutions.

As a result, from 1997 to 1999, the number of financial institutions decreased by approximately 350 (17%). In the non-banking sector, consolidations reduced the number of securities companies from 36 to 30, insurance companies from 50 to 44, and investment trusts from 31 to 23. The second phase of structural adjustments is presently underway in the banking and non-banking sectors.

Figure 8 Decline in the Number of Financial Institutions

	End of 1997	End of 1999	Rate of decline (%)
No. of financial institutions	2102	1755	−16.5
Banks	33	23	−30.3
Securities companies	36	30	−16.7
Insurance companies	50	44	−12.0
Investment trusts	31	23	−25.8

Source: Ministry of Finance and Economy, media reports

(2) Infusion of Public Funds

From 1997 to the end of 1999, total public funds injected into the financial system amounted to 64 trillion won, the equivalent of 14.3% of nominal GDP in 1998. (By comparison, public funds used for the same purpose in Japan under the Financial System Stabilization Law amounted to ¥25 trillion, or 5% of nominal GDP). Financing came mostly from government guaranteed bonds with maturities from 3 to 7 years. All of the funds have already been used: 32% to purchase bad loans, 29% to recapitalize banks, and 39% to guarantee redemption of deposits.

However, additional funds are still needed to complete structural adjustments in the insurance and investment trust industries of the non-banking sector. According to S&P and other financial industry estimates, the required amount will exceed 30 to 50 trillion won. Considering the future financial burden as well as risk of a lower credit rating abroad, the problem calls for serious attention in securing the necessary funding while ensuring transparency.

(3) BIS Ratio of Banks

As a result of the bold structural adjustment policy, the average BIS ratio of the top 11 banks improved to 10.8% by the end of 1999, up one percentage point from June 1999. However, BIS ratios remain below the average for Hanvit (8.7%), Korea Exchange (9.8%) and Cho Hung (9.8%), whose ratios are low from an international perspective as well. In fact, if the massive government bailout is not considered, the BIS ratios of the 11 major banks have actually declined, indicating that their financial condition remains grim.

(4) Bad Loan Ratio

At the end of 1999, total non-performing loans held by financial institutions declined from the previous year to 51 trillion won, while the ratio of bad loans to total loans also declined to 10.4% from

8.7%. However, when using the forward looking criteria of asset soundness (FLC), total non-performing loans increase to 67 trillion won, for an increase of 1.3 trillion won from March. While this includes the one-time effect of Daewoo's business failure in July 1999, progress in disposing non-performing loans clearly remains inadequate.

Figure 9 Bad Loan Situation of Financial Institutions (end of 1999)

	Mar. 1998	Dec. 1998	Mar. 1999	Dec. 1999
Total assets (W tril.)	668.7	576.5	571.6	590.2
Under previous accounting rules				
Non-performing loans (W tril.)	59.6	60.2	59.4	51.3
as ratio of total loans (%)	8.9	10.4	10.4	8.7
Under new rules (1999)				
Non-performing loans (W tril.)	—	—	65.4	66.7
as ratio of total loans (%)	—	—	11.4	11.3

Sources: Financial Supervisory Commission, media reports.

4. Corporate Reforms are Key to Survival in Global Markets

Of equal importance as the financial reforms are reforms in the corporate sector — particularly the reform of the chaebols (conglomerates), who are heavily dependent on indirect financing, weighted down by huge liabilities, and afflicted by missmanagement.

(1) Corporate Reform Issues

The government initially approached the chaebols with a five-point agenda for restructuring.

1. Greater transparency in corporate management

2. Dissolution of mutual debt guarantees among group companies

3. Improvement of financial structure

4. Focus on core business areas

5. Greater responsibility of dominant stockholders and management

In striving to reduce liabilities, improve financial conditions, and increase management transparency, chaebol companies pursued restructuring through a variety of methods including exchanges of business, spin-offs from the group, disposal or consolidation of unprofitable businesses, charged and uncharged capital increases, and sale of business interests to foreign companies.

(2) Financial Condition of Chaebols

As a result, the chaebol achieved their target debt-to-equity ratio of under 200% by the end of 1999. The average debt ratio of the five major chaebols plummeted from 460% in 1997 to 170% at the end of 1999 (excluding Daewoo). The number of affiliates of the top 30 chaebols also declined from 820 to 590, and corporate tie-ups also grew active. In particular, tie-ups with foreign companies increased from 54 in 1998 to 112 in 1999, punctuated by the prominent entry of large western capital including BASF, Motorola, DuPont, Coca Cola, J&J, P&G, and Volvo. In contrast, entries by Japanese companies such as Renown and Epson have been small-scale and apprehensive.

Figure 10 Restructuring Among Chaebols

	1997	1998	1999
Debt-to-equity ratio of top 5 chaebols	462%	302%	174% (excl. Daewoo)
Hyundai	579%	483%	181%
Samsung	371%	252%	166%
Affiliates of top 30 chaebols	819 cos.	804 cos.	589 cos.
M&As reported to FTC	417 cos.	486 cos.	557 cos.

Sources: Fair Trade Commission, media reports.

(3) Business Restructuring (Big Deal)

Moreover, business restructuring is being pursued to alleviate redundant and excess investments among the chaebols in select businesses against their opposition. Excluding home electronics and petrochemicals, these efforts have mostly been completed with favorable results.

However, since further restructuring and consolidation are necessary for global competitiveness in heavy industry sectors such as rail stock, ship engine, airplane, and power generation equipment, mergers and acquisitions remain the only viable strategy for survival.

Figure 11 Business Restructuring Among Chaebols (the "Big Deal")

Semiconductor	Hyundai Electronics acquires LG Semiconductor (completed June 30, 1999)
Oil refining	Hyundai Oil Refinery acquires Hanhwa Energy's refining unit (completed July 7, 1999) SK's acquisition of Ssangyong's refining unit fails due to Aramco's opposition; now seeking to sell stock to domestic/foreign financial institutions
Railcar	Consolidation of Hyundai Precision & Ind., Daewoo Heavy Industry, and Hanjin Heavy Industries (completed July 1, 1999)
Airplane	Consolidation of Hyundai Space & Aircraft, Samsung Aerospace Industries, and Daewoo Heavy Industry (completed Oct.1, 1999)
Elec. power generation	Consolidation of Korea Heavy Industries & Construction, Hyundai Heavy Industries, and Samsung Heavy Industries (completed Dec. 30, 1999)
Ship engine	Korea Heavy Industries & Construction, Samsung Heavy Industries merge ship engine divisions (completed Dec. 30, 1999)
Consumer electronics	Samsung Electronics merger with Daewoo Electronics fails; Daewoo now looking for a foreign buyer
Petrochemical	Samsung General Chemicals reaches merger agreement with Hyundai Petrochemical in May 1999, but talks are stalled by foreign participant's pulling out
Automobile	See Figure 12

Source: Ministry of Finance and Economy, media reports

(4) Global Intentions in the Automobile Industry

Before the economic crisis, Korea's five automakers were struggling to conduct an export drive while burdened with excess capacity. The economic crisis revealed this excess capacity with painful clarity.

Amid the restructuring of the global automobile industry, domestic makers are also restructuring through tie-ups and mergers with foreign companies. As they overcome resistance from affiliated sub-contractors and labor unions, their partners such as GM, Ford, and Renault are participating in the restructuring with the intention of building a production base in Korea for future entry into the Chinese market.

Figure 12 Restructuring of Korea's Five Automakers

Pre-consolidation entity	Major developments
Hyundai Motor	Acquired Kia Motors (Dec. 98); seeking tie-ups with Mitsubishi, Daimler Chrylser, and other foreign automakers.
Kia Motors	-
Daewoo Motor	Negotiating sale with GM, Ford, Hyundai, among others; sale opposed by labor union and subcontractors.
Ssangyong Motor	Merged with Daewoo but subsequently separated; negotiating sale with GM, Daimler Chrysler, others.
Samsung Motors	To be acquired by group led by Renault; targeting domestic and Chinese markets.

Source: Media reports

(5) Venture Business Boom

Along with the restructuring of chaebols, another notable feature of the economy has been the vigorous emergence of venture companies. According to government statistics, the number of ventures surged from 2,042 companies at the end of 1998 to 4,934 in 1999, while the ratio of newly established companies to failed companies also rose from 2.6 in 1998 to 12.3 in 1999.

As in the rest of the world, the Internet has arrived in Korea, and the number of Internet users reached 11 million at the end of 1999 (one-fourth of the population). These new developments are contributing significantly to economic growth.

5. International Acclaim for Korea's Reforms

Korea's bold financial and corporate sector reforms have been favorably received by the international community. In particular, there has been clear improvement in foreign credit ratings. Foreign debt, while still high, has been decreasing, and the recovery of its international credit rating has made possible the conversion of short-term debt into long-term debt. The strong inflow of investment funds from abroad has also reinvigorated the stock market.

For these reasons, Korea's sovereign credit rating by Moody's and Standard &Poors has recovered to investment grade level, while Korea ranked 28 overall in the International Institute for Management Development (IMD) world competitiveness ranking for 2000, up from 38 and near its pre-crisis ranking.

Figure 13 Recovery of Foreign Credit Rating and the Status of Foreign Debt

		1997	1998	1999
External debt	Total external debt	$159.2 bil.	$148.7 bil.	$136.4 bil.
	Private sector debt	$137.1 bil.	$132.2 bil.	$106.9 bil.
	Long-term debt ratio	60.0%	79.3%	72.1%
	Short-term debt ratio	40.0%	20.7%	27.9%
Country credit rating	Moody's (start of year)	A3	Ba1 negative	Baa3 positive
	(end of year)	Ba1 negative	Ba1 upgrade	Baa2 stable
	S&P (start of year)	A-	BB+ stable	BBB- positive
	(end of year)	B+	BB+ positive	BBB positive
IMD natl. competitive ranking	Overall	27→35	38	28
	Financial	40→45	41	34
	Corporate	28→34	42	33
Direct foreign investment inflow		$6.97 bil.	$8.85 bil.	$15.54 bil.
Net inflow of portfolio investment		$1.08 bil.	$4.78 bil.	$5.24 bil.
KOSPI stock price index (end of year)		390.3	524.7	984.5

Source: Media reports

6. The Need for Sustained Reforms

Despite praise from abroad, Korea's present condition is far from satisfactory. Economically, policy issues are surfacing including inflationary concerns, rising interest rates, labor disputes, and a worsening trade balance. Since the structural reforms in the financial and corporate sectors are works in progress, many issues remain to be addressed including the second phase of structural adjustments in the financial sector, additional funding, sale of public companies, and the ownership structure and management transparency of chaebols.

In particular, since the overriding priority has been to overcome the economic crisis, social and economic distortions that have been neglected thus far urgently need to be addressed. Left ignored, social stability problems could eventually hamper economic growth and interfere with financial and corporate reforms in their most critical time. Specifically, the top priorities here are employment stability and reduction of income disparities (Figure 14).

Figure 14 Social Changes After the Economic Crisis

	1997	1998
Per capita income	$10,300	$8,580
Employment structure		
Full-time workers	6.9 mil. (52%)	6.13 mil. (46%)
Part-time workers	4.43 mil. (34%)	4.47 mil. (34%)
Day workers	1.86 mil. (14%)	2.43 mil. (19%)
Income distribution		
Top 20% (A)	W 4.26 mil.	W 4.48 mil.
Middle 60%	W 2.08 mil.	W 1.93 mil.
Bottom 20% (B)	W 0.95 mil.	W 0.82 mil.
A / B (multiple)	4.5	5.5

Source: Media reports

Since the ruling party was unable to win a stable majority in the April 13 general election, concern is growing that the government will be unable to continue its structural reform agenda. The success of the financial and corporate sector reforms is not only necessary for Korea's economic growth and stability, but vital to opening new growth possibilities and restoring confidence in the rest of Asia.

Government policies should move forward from crisis coping policies to the next stage of improving the international competitiveness of the financial sector and chaebols. The financial and corporate sectors, for their part, need to take the initiative in pursuing reforms if they are to survive in the competitive global climate.