Mr. Chon speaks on the topic "Korea: moving on from the crisis" Address by the Governor of the Bank of Korea, Mr. Chol-Hwan Chon, at the 1999 Emerging Markets Roundtable hosted by Euromoney on 8/10/98.

I am very happy to be with you today to explain our efforts to reshape the economic and financial fabric of Korea. This is all the more so since I am keenly conscious of the vital role that you as investors play in the international economy.

Just under a year ago, Korea faced a very difficult situation. But the worst of the specific Korean problems now appear to be over. Some sectors of the economy are gradually returning to a stable track. Let me take this opportunity to express my hearty thanks to all of you for your cooperative support. I hope that my words today will help you gain a clear picture of what has been happening in the Korean economy.

Development and Causes of the Crisis

The alarm bells should already have been sounding by the mid-nineties. With trade and capital market liberalization, firms had found themselves drawn into the global market. Nevertheless, they did not adjust to the new environment in which the market ruled, but simply pursued the expansion strategies of an earlier development era. Also, the government failed to establish a market system well geared to the changing world. The consequent ambitious but imprudent investment brought high growth at first, but deepened the high costs-low efficiency structure of the Korean economy.

Deteriorating corporate sector competitiveness pushed up the ratio of the current account deficit to GDP from 1 percent in 1994 to 4.7 percent in 1996. Furthermore, from early last year, a number of highly leveraged large companies that had been hit by sluggish sales and low profitability finally collapsed under their huge debt. These failures in turn undermined the soundness of financial institutions with large corporate exposures. A vicious downward spiral was set in motion.

Meanwhile, the contagion of the Thai baht's devaluation last July spread like wildfire. This further unsettled foreign investors who had been apprehensively eyeing the weakening of both companies and financial institutions in Korea. Reflecting this, S&P's and Moody's downgraded Korea's long-term sovereign rating very sharply last October, which caused foreign investors to withdraw their credit lines hastily. Liquid foreign exchange reserves drained away rapidly leaving Korea on the brink of national insolvency. The government then had to turn to the IMF in late November.

The jury is still out on what actually caused the Korean crisis, but there were three major contributory factors; namely, inefficiency caused by a failure to observe market principles, the loss of market confidence caused by a lack of transparency, and inappropriate policy responses to the evolving problems.

The first of these was perhaps the most fundamental. The Korean economy had been largely government-directed for many years and lacked true market discipline. In pursuit of rapid growth, “big” had been the name of the game so that the principle of too-big-to-fail had become an unwritten law.

Financial institutions, under the government’s wing, routinely made loans to the corporate sector without thoroughly screening investment plans. Workers and depositors also turned a blind eye to market principles. Moral hazard was widespread and high cost-low efficiency problems persisted.

The second factor I mentioned was, however, the more immediate cause of the financial crisis. The accounting and disclosure systems of Korea fell short of global norms, making it difficult to grasp a true picture of firms’ condition. This lack of transparency, as the symptoms of a crisis emerged, led to a rush for the exit since no discrimination could be made as to quality. But it should be also borne in mind that before the crisis, this obscurity had led foreigners to invest in Korea without scrutinizing carefully the actual status of firms.

Last, but not the least, was that the policy responses to the looming crisis were woefully inadequate; that they were mistimed; and that the markets were sent confusing signals by inconsistencies among them. One prime example was the retention of a narrow currency band despite the mounting downward pressure on the won. This several times brought the foreign exchange market to a halt as the won hit its lower limit shortly after opening. Another example was the dithering over what to do with the distressed Kia group. The failure to proceed swiftly, fairly and on the basis of market principles destroyed the incumbent administration’s remaining credibility.

Response to the Crisis

Economic policies have since last December been closely coordinated with the IMF. On the macroeconomic policy front, the Bank of Korea raised its market intervention rate from 12 percent to over 30 percent to stabilize the foreign exchange market. Korea also shifted to a free-floating exchange rate system.

Along with stringent macroeconomic policy, structural reforms are now underway throughout the financial and corporate sectors.

The focus of financial sector restructuring is on the exit of unsound financial institutions, the resolution of the overhang of bad loans and the strengthening of prudential supervision and disclosure requirements.

Five ailing banks have been resolved through a “Purchase and Assumption” formula. Korea First Bank and Seoul Bank whose capital was reduced in January were recapitalized by the government’s subscription of public enterprise stocks. Government-held shares in these two banks will be sold under open bidding to domestic and foreign investors before the end of October. Sixteen out of thirty merchant banking corporations, which had contributed to the crisis, have been already shut down, and a number of distressed nonbank financial institutions, such as securities companies and insurance companies, have been closed or suspended.

Also, the bank and merchant banks now in business are being monitored on the progress of their target BIS ratios and rehabilitation plans, which include mergers, recapitalization and sharp reductions in branches and staff. With this pressure to meet strict capital adequacy ratios and improve competitiveness, a wave of mergers is taking place in the financial industry. This is supported by the government through the purchase of non-performing loans and capital injection. Three large mergers among banks have already been announced. This consolidation of the banking sector is likely to continue for some time.

To improve transparency, standards for the classification of non-performing loans, the accumulation of loan loss provisions, and disclosure have all been brought into line with internationally accepted standards.

By revising the General Banking Act, the government allowed a foreign investor to hold more than 10% of a bank’s total stocks with the permission of the Financial Supervisory Commission.

Restructuring of the corporate sector is now underway across many dimensions.

First, all new mutual guarantees among companies belonging to a chaebol, which were a main tool in fund-raising for them, have been forbidden since April 1998. Member-firms will also be obliged to retire all outstanding cross-payment guarantees completely by March 2000.

Second, commercial banks are playing a vital role in the exit of failed firms through agreements between large firms and their main creditor banks on improving capital structure. A first round which slated fifty-five non-viable firms from sixty-four conglomerates for exit was announced last June. These firms will have their credit lifelines turned off by the denial of fresh bank credit and the calling-in of loans. The process will continue in the future.

Third, the chaebol will have to provide combined financial statements from the fiscal year 1999. This should strip away the veil that has hidden their true position. With regard to corporate governance, the rights of minority shareholders have also been greatly strengthened.

Fourth, ceilings on foreign investment in Korean equities have now been abolished and hostile takeovers by foreigners allowed. Foreigners may now also buy and sell real estate on a national treatment basis. This September, with the passage of the “Foreign Investment Promotion Act”, all foreign investors in foreign investment zones are given full exemption from corporation tax and income tax for the first seven years of operation, and after that a 50 percent exemption for a further three years.

All of these efforts are focused on shifting our economy from a government-directed to a market-oriented system. We all recognize that rebuilding the economy on market principles is the one and the only way to achieve a lasting recovery from the crisis.

Recent Economic Trends

Since the outbreak of the crisis, we have striven for foreign exchange market stabilization and overall structural reform. As a result, the exchange rate has gradually regained stability. The won tumbled to about 2,000 won per dollar at one stage but has recovered to around the 1,300 to 1,400 won range thanks to the big improvement in supply-demand conditions in the foreign exchange market helped by the large current account surplus. In step with the improved exchange market conditions, market interest rates have been easing back to their pre-crisis levels. For example, the CP rate dropped from a peak of over 40 percent last December to 11 percent level recently.

But the real sector has been going through serious hardships with the marked erosion of consumer and investor confidence, a deepening credit crunch, sharply negative GDP growth, a continuing stream of corporate insolvencies, and a steep rise in unemployment.

During the second quarter of 1998, the GDP growth rate registered -6.6 percent. The number of the unemployed increased to 1.58 million in August, which was more than three times the level of a year ago. And there is a concern that the present asset-price deflation may trigger more general deflation with the loss of purchasing power.

It is true that structural adjustment is never without pain. However, a deep and prolonged depression could sap the country’s growth potential. And with no adequate social safety net in place, a steep run-up in unemployment could unleash social unrest.

Concerned to prevent such scenarios, the Korean government decided to increase public spending in agreement with the IMF.

However, the government initiative should not be interpreted as full-scale pump priming. The overwhelming stress is still on structural reform. The worry is that too deep a depression might stand in the way of structural reform itself. A mild stimulus would, in contrast, be beneficial for the structural adjustment process.

This year will see sharply negative growth for the Korean economy. But provided restructuring is successful, there should be a renewal of confidence in the country on the part of international investors. Macroeconomic fundamentals should then start to look a bit better by the second half of next year, with a shift to mildly positive GDP growth, albeit at a meager level.

Concluding Remarks

To sum up, Korea has made a concerted national effort to recover from the crisis through bold structural reforms. I think, however, there was some trial and error and ill-conceived policies were adopted in the process of the structural reform. As you are well aware, it is very difficult to complete reform at a stroke without making mistakes, because reform calls for fairness in the sharing of the pain among all parties. I can, though, assert that Korea is quite determined to bring about a sound and vital economy on the basis of the market mechanism. Let me then earnestly request you not to write off the future of Korea because of previous shortsighted policies or temporary setbacks in pursuing structural reform.

A recent survey by the prominent journal “The Economist” pointed out that Koreans were optimistic and were confident that the future would be better although they were dissatisfied with present life. This attitude was cited as a driving force for Asian economic development, by the translation of future hopes into reality through hardwork and thrift.

Korea, which has endured many ordeals throughout its long history, will work another economic miracle with this courage and hope. I hope that you will take note of our efforts and be active in your support.