EVALUATING KOREA'S SIX-MONTH "IMF ERA"

by Hong-Rae Cho

Overview

The year 1997 was one of the worst years for the Korean economy. A record number of firms went bankrupt, the Korean won suffered a massive depreciation, and the KOSPI stock market plunged to the lowest level in a decade. After a continued downgrading of the national credibility and the crash in Asian stock markets, Korea faced a severe shortage in its foreign exchange reserves, which lead to the IMF bailout program. However, under the so-called "IMF Conditionality," Korea has been making an all-out effort to remedy the situation. Since the end of last year, a number of important reform bills affecting the financial, corporate and labor sectors have been or being passed. In light of the changed legal framework as well as their own internal needs, Korean businesses have started to restructure their businesses to enhance their competitiveness and to keep their financial structures healthy. Meanwhile, the Korean government succeeded in extending its short-term national debt and thus stabilized its debt structure. Also, for the first time in Korea's economic history, Koreans worked out a tri-partite agreement among three parties -- the government, labor unions, and businesses. This agreement is expected to help stabilize wage levels and to harness the rising rate of unemployment and inflation.

Korea's determined drive to reform its economy seems to have been recognized by the international community. Since February, major international rating agencies have stopped downgrading Korea's credit ratings and are maintaining a stable outlook. Many renowned economists inside and outside Korea agree that if these reform policies succeed, Korea will regain its capability to overcome the present hardships in 2-3 years. Another encouraging sign is Korea's eye-popping current account surpluses since last November.

However, problems still remain. The domestic financial market is still shaky. With an overly-tight monetary policy and ensuing annual interest rate over 17~18%, no firm can survive more than several months. Supposing this situation continues, the Korean economy's fundamental capabilities will soon be severely undermined and as a result, Korea will lose its ability to repay its foreign debts.

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Reasons behind the Current Crisis

The current situation of the Korean economy is basically due to a combination of structural deficiencies as well as a prolonged cyclical downturn. The structural deficiencies include not only the weakened competitiveness in some industries, but also an inefficient financial sector. While the lack of competitiveness in major industries led to a greater deficit in the current account, the financial sector and the Korean Government (including the Bank of Korea) failed to maintain enough foreign currency reserves relative to the mounting current account deficit and foreign debts. While facing the opening of the domestic capital market to a greater extent, the Korean Government and the financial sector did not successfully adapt themselves to the changes. An example is the fact that they failed to properly recognize the importance of foreigners' assessment of Korea's credibility (credit ratings, in other words).

A more direct reason for the present crisis is the series of big corporate bankruptcies that started early in 1997. The Korean Government's policy responses to this phenomenon were neither efficient nor timely in any sense. Another important factor is the financial crisis which started earlier in Southeast Asian countries such as Thailand, Indonesia, and the Philippines. Korean financial institutions had heavily invested their short-term assets in high-yield bonds issued in the region. Along with the growing amount of non-performing loans due to the big company bankruptcies, the collapse of the financial markets in Southeast Asia brought about a sudden credit crunch among Korean financial institutions.

In order to compensate for the capital depletion, the Korean banks took two measures. One was to seek more foreign currency loans on shorter terms, and the other was to call in their loans extended to domestic companies. These two measures, however, resulted in two vicious cycles. As Korean financial institutions sought more foreign currency loans abroad, they found that their credibility assessment (ratings by Moody's or S&P's) was falling rapidly, making it harder to borrow even at higher interest rates. Their second measure led to a credit crunch situation in the domestic financial market and only resulted in more bankruptcies.

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Differences between Korea and Other Cases

While the current hardships are rooted in structural problems, as opposed to cyclical variations. The actual crisis was set off by the shortage of foreign exchange reserves. This means that the IMF bailout program should try to guarantee Korea's ability to repay its external debt, and at the same time emphasize the reorganization and restructuring of the national economy. Before properly assessing the IMF program, one should recognize the differences between the Korean case and the cases of other countries, especially in South America or in Southeast Asia, that underwent similar currency crises. Some differences include :

- *Korea's crisis is directly due to the lack of foreign exchange reserves while other countries suffered from macroeconomic difficulties such as high inflation and huge government deficits.*
- *When several Latin American countries faced national default crises in the 1980s and 1990s, major portions of their foreign debts were in the government or in the public sector. But Korea's foreign debts, especially the short-term debt, were mostly borrowed by the private sector.*
- *At the time, Korea was the world's 11th biggest economy, in terms of its GDP or the trade volume. Therefore, the prescription by IMF should focus on the revitalization of Korea's ability to repay its foreign debts.*

An Assessment of the IMF Policies

The IMF policy prescription, which started last December and was revised three times so far, has greatly influenced the Korean government's policy agenda since then and has admittedly stabilized Korea's economic situation to a certain degree. This prescription, however, can be criticized. In spite of the country-wise differences mentioned above, IMF initially required a tight macroeconomic policy which was "too standard" to directly implement in Korean economy. As a result, even elements of the normal recovery process such as the increase in exports are being threatened. The tight monetary policy resulted in extremely high interest rates, which in turn caused even firms that had fairly sound financial structures to go bankrupt. Through March, an average of 100 Korean firms went bankrupt everyday, simply because of the liquidity shortage. Many of them would have played vital roles in the recovery process of Korean economy. The high interest rate policy should be used with extra caution when applied to an economy with a high debt/equity ratio. A typical Korean firm's debt/equity ratio easily goes beyond 400%, while American or Japanese firms' ratios stay below 300%. Therefore, the tight money/ high interest policy might cause a domino effect of bankruptcies in the Korean economy. While the IMF package has helped Korea shore up its foreign exchange reserves, the IMF's policy recommendations should be ones that maintain and invigorate Korea's growth potential and thus the ability to repay its foreign debt.

Through three policy negotiations between Korean Government and the IMF, the policy prescription has evolved into a more lenient one at least in term of the monetary policy. In fact, many businessmen and economists in Korea strongly believe that high interest rates cannot guarantee the inflow of foreign capital which is necessary to restructure and rebuild the Korean economy. On the contrary, rapid restructuring in the financial sector including the exits of distressed banks and financial institutions should precede everything else. Once restructuring in financial sector takes place, the banks and other institutions can lead the restructuring of other areas of Korean economy. The sequence of restructuring, indeed, should be : financial sector → government sector → labor market → business sector.

Corporate Restructuring

Corporate restructuring basically implies reducing costs. Firms' production costs consist of financial and labor costs. Normally, the government can help firms reduce financial costs by lowering interest rates. Under the IMF guidelines, however, it has been very hard to lower interest rates because the IMF and foreign investors are asking the Korean Government to keep interest rates high. This is because doing so will help weed distressed businesses and marginal firms out of market and guarantee enough interest income for foreign investors. Therefore, Korean businesses have had no realoption but to sell off their assets to secure enough cash flow to survive the crisis. Concerning the sell-offs of corporate assets, several successful cases are often cited these days. Generally speaking, however, with the depressed real estate market it is very hard for a company to sell-off its assets (mostly in the form of real estate) and improve the financial structure. A solution to this problem is the inducement of foreign capital in the form of either equity investment or M&As. The Korean Government as well as businessmen are well aware of the fact that foreign capital is the "only" way to break through the current bottleneck.

Korean businesses can begin to reduce their labor costs. With a new legal system regarding the labor relations, it is now legally possible for a company to lay off employees. For a country of almost full employment through 1996, the rising unemployment rate, now approaching 7%, is definitely a constraint to reducing labor costs by layoffs. But the tripartite agreement should hopefully provide an acceptable and endurable solution to this problem in the near future. VIP *(e-mail: hrjo @ hri.co.kr)*

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〈Table 1〉 A Comparison of IMF Programs

	Korea (3rd revision)	Mexico		Thailand	
	1998	1994	1995	1997	1998
Real GDP growth rate	-1%	3.1%	1.5%	2.5%	3.5%
Current account/GDP	$20-23 bil. surplus	balance	0.3% deficit	5% deficit	3% deficit
Government budget/GDP	1.7% deficit	-	0.5% surplus	1.6% deficit	1% surplus
Consumer prices	below 10%	6.9%	19.9%	9.5%	5.0%
Restructuring	- exits of distressed banks - enhancement of business management - restructuring of big businesses	- reduced government spending - privatization of public companies		- tight fiscal policy - high competitiveness in agriculture and manufacturing sectors	