FISCAL BURDEN OF FINANCIAL REFORM IN KOREA

Jae-Chil Kim
(jckim@hri.co.kr)

Aspects of Korean Financial Reform

Most financial institutions in Korea are experiencing a widespread reform. A significant number of merchant banks were liquidated by the government almost a year ago. Five financially restricted commercial banks were absorbed by other banks through a purchase and assumption method. Three big banks emerged in the market through M&As. The other financial sectors are also facing the storms of reform and are expected to undergo sweeping changes in the course of this year.

In the course of reform, one of the most important roles of the government is supplying liquidity to financial institutions needed for clearing out bad loans, recapitalization and payments of insured deposits.

Trend in Financial Institutions' Bad Loans

Right after the currency crisis broke out, the total amount of bad loans in all financial institutions' stood at 69 trillion won. However, the amount of bad loans accumulated tremendously between the end of 1997 and March 1998, reaching 118 trillion won, because many firms went broke during this period due to the high interest rates and the credit crunch. Fortunately, there has been a declining trend in bad loans after that. The main reasons are the government's efforts to reduce them as well as the natural decline due to the restoration of financial stability.

Government's Financial Support for Reform

The government initially assumed that the amount of bad loans to be cleared out throughout the entire restructuring period was 120 trillion won. To clear out the target amount of bad loans, the government planned to purchase bad loans worth up to 70 trillion won at a discounted value of 32.5 trillion won. The

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Table 1. Trend in Financial Institutions' Total Bad Loans[1]

(the end of period, trillion won)

	1997	1998		
		3	9	12
All Financial Institutions	69.0	118.0	64.0	60.2

Sources: Bank Supervisory Units (for the data up to March 1998)
Financial Supervisory Service (for the data after March 1998)
Note: 1) Includes old standard of non-performing loans and "watch list" loans on which interest cannot be collected for 3~6 months

government assumed that private financial institutions would acquire extra money for remaining bad loans of 50 trillion won and assume losses on selling bad loans totalling 37.5 trillion won (70 trillion won minus 32.5 trillion won) by attracting foreign capital, issuing new shares in domestic stock market, and swapping debt for equity, among other measures. To assist financial institutions' own efforts, the government also assigned 22.5 trillion won for supporting financial institutions' recapitalization and 9 trillion won for the payment of insured deposits. As a whole, the government initially assigned 64 trillion won for clearing out the 120 trillion won worth of bad loans.

If the category of bad loans is extended to include normal loans which are given to businesses possibly unprofitable in the future, the amount of bad loans to be cleared out is expected to be increasing even more.

By the end of 1998, the government had completed some of its initial plan. First, KAMC (Korea Asset Management Corporation) purchased 44 trillion won of bad loans at a discounted value of 19.9 trillion won. Second, the government poured 6.3 trillion won into support for recapitalization, in accordance with the initial plan. Third, the government used 14.7 trillion won for the payment of insured deposits, which exceeded the intended amount in the initial plan by 5.7 trillion won.

Estimating the Fiscal Burden of Financial Reform and Its Implications

If the government's initial assumption about total bad loans to be cleared out is plausible, the total amount of public funds needed to be raised by issuing government bonds is 64 trillion won plus 5.7 trillion won. Our estimation of the fiscal burden in this case is between 47.2~58.2 trillion won with the assumption of appropriate interest rates on government bonds and losses on the principal of bonds.[1] This means that the fiscal burden of financial reform will exceed 10% of nominal GDP.

However, the total amount of bad loans to be cleared out during the entire restructuring period is likely to be higher than the government's initial assumption of 120 trillion won. The reason for this conjecture is that the government might introduce new standards for categorizing bad loans. If "watch list" loans includes loans for which interests has not been paid for 1~3 months, the amount of bad loans will increase

Table 2. Government's Financial Support for Reform

(trillion won)

	Purchasing Bad Loans	Injecting Fresh Capital	Paying Insured Deposits	Total
Planned	32.5	22.5	9.0	64.0
Actual	19.9[1]	6.3	14.7	40.9
Banks	16.7	6.3	5.8	28.8
Non-Banks	3.2	-	9.0	12.2
Remaining	12.6	16.2	-5.7	23.1

Source: Financial Supervisory Service, February 1998.
Note: 1) KAMC (Korea Asset Management Corporation) purchased 44.1 trillion won at discounted value of 19.9 trillion won

1) See the last table of this article for the estimation results and basic assumptions.

sharply. If the category of bad loans is extended to include normal loans which are given to businesses possibly unprofitable in the future, the amount of bad loans to be cleared out is expected to be increasing even more. If that is the case, our estimation for the fiscal burden of financial reform rises sharply. As is reported in the table, when the assumed amount of bad loans increases, the amount of public funds to be financed by bond issuance also rises accordingly. For instance, if the assumed amount of bad loans is 140 trillion won, the public funds to be financed amounts to over 81 trillion won and the eventual fiscal burden would be maximum 65.4 trillion won. And if the bad loan rises to 160 trillion won, the final fiscal burden would reach over 70 64illion won.

The accumulation of bad loans and resulting fiscal burden will have many negative effects on economic recovery. First of all, attracting foreign capital might be difficult since the accumulation of bad loans will lower the credibility on our economy. Second, the increased fiscal burden is likely to narrow the available policy options for economic recovery. Currently, a proper policy mix between monetary and fiscal policy is desirable for smooth economic recovery. However, the government may be reluctant to utilize fiscal policy for economic recovery with the rising fiscal burden of financial reform. Third, if the government hesitates in dealing with the bad loans in financial institutions due to the shortage of public funds, some financial institutions are likely to reduce their lending activities, resulting in another credit crunch.

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The government should resolve bad loan problem quickly but be careful in raising public funds. Therefore, providing a better environment for financial institutions' own efforts to solve their bad loans problem is a hopeful and desirable direction. VIP

Table 3. Estimating the Fiscal Burden of Financial Reform

(trillion won)

Assumed amount of bad loans to be cleared	Assumed amount of public funds financed by bonds issuance[1]	Interest on government's bonds(98~2003)[2]	Losses on principal of bonds[3]	Fiscal Burden
120	69.7	30.7	16.5~27.5	47.2~58.2
130	75.5	31.7	18.8~30.3	50.5~62.0
140	81.3	32.2	21.1~33.2	53.3~65.4
150	87.1	33.7	23.4~36.0	57.1~69.7
160	92.9	34.8	25.7~38.9	60.5~73.7

Notes : 1) First figure of 69.7 trillion won is based on the government's assumption that the total amount of bad loans to be cleared out within the whole restructuring period is 120 trillion won. Other figures are based on the assumption that the public funds needed to be raised by issuing government bonds increase monotonically as the amount of bad loans to be cleared out increases.

2) Interest rate on government bonds is assumed to be i3% for the first half of 1998 and 10% for second half of same year. From 1999 onward, it is assumed to be 7.5%.

3) Payments for insured deposits are assumed to be perfect losses, while purchased bad loans are assumed to be re-sold at a 40~60% discounted price. The public funds for financial institutions' recapitalization are assumed to be returned by the value of 130~150% of initial amount.