

**Public and Private Interests in Korea:
Views on Moral Hazard and Crisis Resolution**

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Contents

GOVERNMENT'S ROLE THROUGH 1992.....	2
LIBERALIZATION.....	5
THE CRISIS	7
THE CURRENT DILEMMA.....	8
FUTURE POLICY DIRECTIONS.....	13
BIBLIOGRAPHY	17

TABLES

TABLE 1: SIMPLIFIED FINANCIAL STRUCTURE OF A HYPOTHETICAL <i>CHAEBOL</i> , 1996	9
TABLE 2: SIMPLIFIED FINANCIAL STRUCTURE OF A HYPOTHETICAL <i>CHAEBOL</i> , 1998	9

FIGURES

FIGURE 1: POLITICAL ECONOMY BALANCE SHEET	12
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BOXES

BOX 1: POLICY ACTIONS TO BE TAKEN.....	14
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D.M. Leipziger

Introduction

An old Korean proverb advises “set up camp with your back to the river.” This perhaps epitomizes the risk-taking nature of Korean society. The implications of this for moral hazard behavior, whereby economic agents take on more risk than they would normally in the expectation that some of their potential liabilities will be covered by others, is an important aspect of Korea’s economic development history¹. The significance of moral hazard behavior in Korea is that it forms part of what has come to be known as the socialization of risk and it underpins the unique relationship between the public and private sectors in Korea over the last three decades.

Moral hazard is at the core of the recent financial crisis in Korea. It is seen in both the behavior of domestic and foreign lenders: in the case of the domestic banking system, it is seen in the lack of due diligence on the part of lenders towards the *chaebol*, the Korean conglomerates, and it is a reflection of the past interventionist industrial policies of the government which made the *chaebol* both the agents of and the partners in Korea’s model of economic development. In this partnership the banks were largely an instrument of public policy and therefore not expected to perform the function that lenders normally perform in a financial system. Moral hazard is at the center of the current payments crisis because external lenders also failed to do due diligence, with the expectation that at the end of the day all obligations of Korean banks and other financial entities would be considered sovereign debt. In the event, this was validated by an announcement early in the crisis that the government would stand behind all Korean obligations².

This announcement should come as no surprise to observers of Korean development as Government had traditionally taken a strong role in the allocation of credit, even in the years subsequent to the HCI (heavy and chemical industries) intervention period in the 1970s³. During the 1980s the government played both the role of advisor to resource allocation and later work-out agent in the event that allocation decisions proved to be incorrect. Put differently, bankruptcy in the Korean sense was something managed by the government, and in some cases orchestrated by the government (viz., the Kukje experience of the mid- 1980s) and therefore there was a serious vacuum of institutional capacity to deal with private sector bankruptcy. Whereas Government was dominant in controlling the economy through the end of the 1980s, its

¹ The narrow definition of moral hazard refers to actions of economic agents maximizing their own utility to the detriment of others in situations where they do not bear the full consequences (or benefits) of their actions because of uncertainty, incomplete information or the nature of the particular contract in force.

² Announcement by Government on August 25, 1997.

³ See Leipziger and Petri (1993), Sakong (1993), Stern et al. (1992), Yoo (1990), Leipziger and Petri (1989), Amsden (1989), World Bank (1987).

powers began to be circumscribed in the 1990s, and there were numerous papers written about the increasing power of the *chaebol* and the need to restrain them and strengthen regulation⁴. Despite significant political reforms in Korea, the basic economic structure had not changed significantly over the years, thereby leaving the country extremely vulnerable to the questionable actions of the conglomerates.

Chaebol behavior can be analyzed as an economic issue within the confines of regulation and competition policy or as a financial supervision matter, but it should also be seen as an issue of governance and it therefore has a political and social dimension as well. At the core of Korea's development progress, which has been spectacular by any measure, was an implicit understanding that the *chaebol* were to act in the national interest. That bargain struck between government and industry was aimed at propelling Korea into the ranks of the OECD countries before the turn of the century, a goal that was met. As part of this bargain, there was the belief that Korea would continue to maintain some semblance of equality in its income distribution and that even in the absence of strong regulatory structures, the national interest would be paramount. With the corruption scandals of the Kim Young-Sam administration as well as those related to previous Presidents, it became clear that resource allocation decisions were beginning to be made outside of the boundaries of national interest and that great quantities of wealth were being amassed by the owners of the *chaebol* and their extended families. Thus, there was a fundamental breakdown in the early 1990s of the social compact that had been operative for previous decades.

A thorough understanding of this changing relationship between the public and the private sector is important when examining Korea's policy responses in the aftermath of the Thailand crisis, which spread contiguously throughout the region. This paper analyzes (a) Government's role through 1992 when the Kim Young-Sam administration took power; (b) the 1992-97 period, including the so-called financial liberalization policy; (c) certain aspects of the financial crisis of 1997-1998; (d) the current policy dilemma facing Government; and (e) possible future policy directions for Korea.

Government's Role through 1992

A great deal has been written about the financial sector in Korea and its role in propelling Korean industry⁵. The important point about financial repression in Korea was that at the end of the day subsidized credit was made available for export purposes. The pre-eminent role of the Ministry of Finance in this endeavor cannot be underestimated, and the discussion of policy loans in Korea, either in the HCI period of the 1970s or in the more market driven era of the 1980s,

⁴ Note for example, Leipziger and Petri (1993) who wrote: "The *chaebol* dilemma has driven Korean industrial policy into gridlock. The government is reluctant to transfer decision-making authority to market institutions because it fears that the *chaebol* will capture the banks and abuse their power. At the same time, the government's continuing role in the economy prevents the emergence of independent private institutions, such as powerful banks, that could impose financial discipline on *chaebol* behavior. In the meantime, the government's instruments of control are becoming less effective, the directions of industrial policy are becoming confused, and the relationship between the government and business, instead of moving toward harmony, is turning confrontational." (p. 23)

⁵ See Cho (1988), Leipziger (1988), Nam (1991), Corbo and Suh (1992), Kim and Leipziger (1993), and Stiglitz and Uy (1993).

still involved the strong hand of the MOF in advising banks on credit decisions, in the sharing of risk, and as the ultimate role of arbiter between banks and the corporate sector. This can be seen most directly in the workouts of the shipping and textile sectors in the late 1980s⁶.

A number of the difficulties with this role were pointed out by Leipziger and Petri (1993), where they argued that *chaebol* domination of domestic banks was severely skewing the allocation of credit and that the failure of a viable system of bankruptcy operating without government intervention was encouraging enterprises to grow excessively, primarily through the build-up of debt. The fact that size had been used traditionally as the indicator of the strength of the conglomerate and its ability to undertake new business lines unfortunately gave very distorted signals to Korean resource allocators. Banks operated as quasi-lead banks, by which is meant that they were prime banks to industrial groups, but unlike the “keiretsu” in Japan, the commercial banks did not have a lead oversight role within conglomerate groups. From time to time, when the debt equity ratio of conglomerates looked excessive, the government would issue some pro-forma announcement to reduce their leverage; however, the high debt ratios prevalent in Korea, averaging 300-400 percent over a number of decades, made debt holders quasi-equity partners in the *chaebol* groups.

This is reflected in the first proposition:

$$\textit{domestic Korean debt} + \textit{moral hazard} - \textit{supervision} = \textit{quasi-equity}$$

With this proposition I argue that with an average leverage ratio for the top 30 conglomerates of 363 percent in 1996 and interest coverage, that is (pre-tax) net earnings divided by interest obligations, falling between 1988-1996 from 260 percent to 180 percent for these conglomerates, it became clear that domestic lenders were quasi-equity partners in industry; this perception also largely explains the lack of effective bank supervision, which under normal circumstances would have ruled a sizable portion of bank assets as being “at risk”. The fact that this was not done reflected the view that at the end of the day banks were to be partners with Korean conglomerates, the only difference being that the debt holders took all the downside risks and the equity holders the upside potential.

This mismatch is, I believe, the fundamental flaw of the moral hazard behavior which was encouraged through public policy in Korea. No respectable banker should have been lending to the *chaebol* under these circumstances were they not assured that Government would make sure that losses were managed in the event of a downturn. The fact that Korean banks held sizable levels of non-performing loans should have been apparent through the fundamental inconsistency between the high spreads between lending and deposit rates and the low profitability of Korean banks. This low bank profitability was pointed out by Leipziger (1988) and again by Leipziger and Petri (1993) who concluded that bank profitability was affected by non-performing policy loans, which instead of being called were compensated for by special overdraft privileges at BOK (*supra*, p.26). More generally, however, Government tried at various

⁶ See World Bank (1987) vol. II.

times in the past decade to control *chaebol* borrowing by administrative policies *inter alia* to: (i) limit cross guarantees, (ii) restrict *chaebol* to "three core businesses" for new credit access, and (iii) encourage the issuance of public stock. None of these policies substituted for normal due diligence of banks, and as a result the banks were increasingly at the mercy of borrowers.

The issue in the last few years has been whether the conglomerates were indeed being regulated by anyone. In the early 1990s, Government announced a new policy that conglomerates needed to select their core businesses and that their access to capital would be limited to those product lines. This policy turned out to be totally ineffective as conglomerates continued expand to areas outside their traditional business lines and tried to become even larger. For the smaller conglomerates in the top 30, behavior was even more reckless as they exhibited the highest leverage ratios and attempted at all costs to raise their standing among the top 30. The regulatory agency, the Korean Fair Trade Commission, was during this time particularly ineffective in restraining the big *chaebol* who continued to add subsidiaries using opaque collateralization, cross guarantees unquantifiable to shareholders, and obscure inter-firm pricing. By 1996 the top 30 *chaebols* were involved in a average of 18.5 three digit SITC industries.

Despite considerable success in trade liberalization, there were still problems of competition in domestic markets and there were restrictions on foreign ownership, especially those deemed to be potentially hostile takeovers. During the period 1992-96, with the demise of the Economic Planning Board and increasing difficulties in domestic governance, there was little regulation of Korean industry, either by lenders or regulators, leading to the second proposition below:

***deregulation by government without independent regulatory oversight =
unrestrained chaebol***

This is not to say that the *chaebol* were not successful internationally, but rather to indicate that corporate financial arrangements, were ad-hoc and corporate governance was inadequate. Most *chaebol* were dominated by original founding families and there were difficulties exercising shareholders rights with a web of financial guarantees linking the affiliates of subsidiaries in a way that neither the government nor the banking sector could fully comprehend. Evidence that all was not well with the *chaebol*, however, was available and it is captured in proposition three:

***assets of chaebols - liabilities of subsidiaries including mutual guarantees =
low net equity***

An indication of *chaebol* financial difficulty as was the fact that in 1996 only one of the top 30 *chaebols* had profitability above 2 percent of sales and practically half were losing money. Among the top 30 *chaebols* the average number of subsidiaries was 20 with the largest having as many as 50. Family and cross ownership by subsidiaries totaled more than 40 percent for most of these firms. Firms continued to pursue size rather than profitability objectives. A high

proportion of Korean transactions occurred through promissory notes and the *chaebol* name was sufficient to substitute for normal credit analysis. When denied further credit from commercial banks, firms could turn to the new merchant banks to finance new investments; these banks borrowed off-shore, short-term and in foreign currency. In this environment something had gone seriously wrong with the “Faustian bargain” between Government and Business, and Korea was about to pay the price for this.

Despite prodigious saving rates of 35 percent and basically stable macroeconomic management, resources were being misallocated. How else can one explain the fact that Samsung, which had been denied access into the car industry for decades by Korean bureaucrats, was now able to enter the car industry, an industry characterized by high capital intensity, over-capacity, and international trade restrictions. At the same time Hyundai invested heavily in steel despite the fact that Korea already had a number of large and very competitive steel facilities.

The story goes on and on among conglomerates who were able to borrow either from domestic commercial banks or through the fledgling merchant banking sector in order to pursue growth objective that were totally unrealistic and should have been judged so by diligent lenders. Were these risks to be taken by the banking sector itself or by external lenders, one could take an armchair view and watch market outcomes; however, given public-private risk-sharing, where the government and ultimately the tax-payer would bear the downside risk, there was a need on the part of Korean policymakers to substitute strong regulatory agencies and strong bank supervisory agencies for previous government oversight, imperfect though it may have been.

Liberalization

Under strong external pressure to liberalize the capital account, beginning in the early 1990s and reaching a high point in 1993-94, the Korean government did indeed begin some capital account liberalization. The traditional argument of Korean policymakers that Korean institutions, particularly Korean banks, were inadequately prepared to compete with international banks was long seen by those interested in capital market opening (like the United States), as an excuse for delay. While this claim had some validity, in the end the Korea began to liberalize, but it did so selectively and in a sequence that prove costly. In particular, previous restrictions on international borrowing which had been strengthened after the external debt crisis of the mid-1980s were relaxed; following decades of capital account restrictions, “liberalization” provided the fledgling Korean financial sector with what appeared to be golden opportunities.

Similar to the short term finance companies in Thailand, the merchant banking sector in Korea, previously known as non-bank financial intermediaries, were now able to borrow off-shore without restriction to lend to domestic customers. These loans were clearly at terms longer than those of their liabilities and were offered in domestic currency, often for projects that were high risk. In this context, the merchant banks fulfilled a role that had been previously played by the curb market in Korea, the traditional source for intermediating small savings at interest rates much higher than the controlled formal sector. In the case of the merchant banks, however, the interest rates did not reflect sufficiently the risks either of the projects to which they were lending or their asset liability mismatch, either in terms of maturities or currencies. The fact that

supervisory agencies allowed this type of financial intermediation to occur proved to be problematic as this became the Achilles heel of Korea in 1997.

Capital market opening was therefore was much more rapidly pursued outwardly than inwardly and domestic banks were still sheltered from vigorous competition, which would have proven difficult for them given their low profitability. This low profitability was most probably a reflection of a much higher level of non-performing assets that was officially reported. Although the formal portion of policy loans had fallen during the 1990s, banks continued to be influenced in lending decisions. Moreover, the method by which non-performing loans were generally calculated was antiquated and there was slow progress to adopt new risk based rules for measuring asset quality. Had such new methods been applied, it would have become clear that most Korean banks were severely undercapitalized. This was even more true for the merchant banking sector.

Supervision had been divided between the Bank of Korea, responsible for the commercial banking sector, and the Ministry of Finance and Economy (having absorbed EPB and now the prime Ministry in Korea), responsible for securities, insurance, and merchant banking sectors. Although some progress had been made in improving the quality of supervision, it can be argued that capital account liberalization and other “stroke of the pen” reforms proceeded without adequate institutional strengthening of the supervisory agencies in Korea. In the absence of serious competition in the banking sector, with opaque accounting practice and interwoven sets of guarantees among conglomerate subsidiaries, bank fragility increased. The weakest segment, the merchant banks, were undersupervised and with a sudden drying-up of short-term funds and exchange rate pressures, they were the first to fall. Prior to the fall, however, regional contagion had weakened Korea's access to international credit and the Government acted on August 25, 1997 to reassure markets by stressing the backing of the public sector for the private sector's international borrowing. The government therefore validated past moral hazard behavior by external lenders and took on a contingent liability of unknown size. This is reflected in proposition four:

$$\textit{external private Korean debt + liberalization - supervision + moral hazard = publicly guaranteed private sector debt}$$

Later in the crisis, the government would extend its liability further by issuing a blanket guarantee to all depositors. All risks taken by depositors and lenders was now effective sovereign risk. Externally, as the crisis would prove, Korea lacked the international reserves to back all the obligations of its private sector banks. Domestically, the government would have to infuse capital into insolvent banks as well as fund a public agency to take bad debts off the books of troubled banks. All this due to the external payments crisis of November-December 1997.

The Crisis

The pathology of the crisis of October-December 1997, the most severe of Korea's history can , of course, be linked to regional contagion and a generalized loss of confidence in the

Region. While the proximate causes include a radical re-assessment of country risk after the mishandling of the Thai foreign exchange crisis, the existing cracks in the Korean economy were clearly exacerbated by political dysfunctionality or governance problems. Reserve levels proved to be inadequate to deal with the excessive short-term borrowing by the private sector and the massive flight of foreign capital which revealed itself in shrinking rollover rates for short-term debt and a drying-up of foreign sources of finance, especially in Japan and Europe. The result as of early December 1997 was a mismatch between short-term loans coming due of \$20 billion in the month and net usable reserves (before infusions from the IFIs) being essentially nil. This situation occurred because:

- ÷ The authorities were apparently not sufficiently aware of the total amount of short-term borrowing by the off-shore branches of Korean banks.
- ÷ Supervision of merchant banks had not been sufficiently aggressive with respect to asset-liability management and the need for capital.
- ÷ The maturity profile on Korea's private debt had been shrinking.
- ÷ International banks had been led to believe that all Korean debt had sovereign backing.
- ÷ Reserves were proving inadequate in light of the regional crisis and access to new borrowing was hindered by regional contagion, domestic governance issues, Presidential elections, and broader concerns about the health of Korean banks.

The announcement of the IMF package in the first days of December did not stabilize markets and the exchange rate hit its lower band quickly. The band was extended from 2 1/2% to 10% but the freefall continued. The stock market suffered huge losses. At its depth, the Korean Won had seen its value fall by half and the stock market by more than 40%. The IMF package of \$57 billion had a \$5.5 billion first tranche, which could only cover a quarter of the Bank of Korea's December liabilities. Even with accelerated disbursements by the Fund, and emergency loans from the ADB (\$2 billion) and World Bank (\$3 billion), lenders knew that reserves were insufficient. Thus, the crisis deepened.

Although the authorities hoped for additional official support, whether from the U.S. Treasury or the Bank of Japan, neither was forthcoming. By mid-December, even with immediate disbursements by the World Bank and ADB, Korea was days away from inconvertibility. Finally, after the successful completion of democratic elections, and clear statements by President-elect Kim Dae Jung, a discussion between foreign lenders and the authorities was facilitated and a kind of standstill agreement reached while short-term bank debt was exchanged for longer-term government instruments.

With this immediate relief hand and given Korea's overall reasonable level of external indebtedness, the balance of payments situation became more manageable. Reserve levels have since been restored at a reasonable pace, and the focus has shifted to the domestic banking system and the state of corporate finances. The crisis had brought the government explicitly in-between foreign creditors and private borrowers. It had also put the government back into the

majority (and subsequently) sole ownership of 2 of 5 major commercial banks. And implicitly it had put the government into the role of lender-of-last-resort for the *chaebol*!

The Current Dilemma

Korea now finds itself in an extremely difficult position as the corporate sector faces a possible meltdown. The very high real interest rates have turned the external payments crisis into a massive domestic credit crunch. Domestic banks are faced with high levels of non-performing loans, difficulties in attracting new equity, and strains in meeting minimum capital adequacy requirements, part of the IMF agreement. The Government of President Kim Dae Jung is facing rising unemployment and higher inflation, and faces the twin and conflicting objectives of (i) trying to restore of soundness of commercial banks by having them recognize losses, force repayment of loans by the corporate sector, and disentangle the system of mutual guarantees which underlies *chaebol*-bank financial relationships, and (ii) helping the corporate sector to reschedule its loan obligations in order to survive in the current financial situation, while at the same time not continuing to encourage the poor corporate practices of the past.

How Korea deals with this dilemma will set the stage for the next round of Korean development. It may well provide the indication as to whether Korea is able to more fully embrace market oriented principles or whether Korea's *chaebol* will be slightly reconfigured but remain embedded in a system of public-private partnership that was both the basis for past success and at the root cause of much of the difficulties of 1997-98.

The difficulty of the corporate sector is shown in the simplified financial statements of a hypothetical *chaebol*, Tables 1 and 2, which were constructed using average financial data for the top 30 firms. The over-reliance on debt financing, especially bank financing, has increased the vulnerability of the corporate sector. As is shown the already high debt/equity ratio of 360% had risen to at least 450% as of January, 1998, and with interest rates at 25%, corporates will either lose at least half their equity or they will need very significant debt rescheduling.

Table 1
SIMPLIFIED FINANCIAL STRUCTURE OF A HYPOTHETICAL *CHAEBOL*, 1996

Balance Sheet		Income Statement	
Assets	Liabilities	Revenue	100
92	72 debt	- Costs	85
		EBIT	15
	Equity		
	20	Interest	9.36
		Tax	5.44
		Profit	0.20
Debt/Equity:	360%		
Average Interest Rate:	13%		
Interest Coverage:	EBIT/Interest: 160%		
ROE:	1%		

Table 2
SIMPLIFIED FINANCIAL STRUCTURE OF A HYPOTHETICAL *CHAEBOL*, 1998

Balance Sheet		Income Statement	
Assets	Liabilities	Revenue	110
110	90 debt	- Costs	94
		EBIT	16
	Equity		
	20	Interest	18.0
		Tax	6.4
		Profit	(8.4)
Debt/Equity:	450%		
Average Interest Rate:	20%		
Interest Coverage:	EBIT/Interest: 89%		
ROE:	42% of Equity		

In order to examine the policy tradeoffs in the short and medium term between restoration of confidence in the domestic banking system and restructuring and realignment of the corporate sector, it is important to list the requirements for both the bank and corporate restructuring endeavors to be followed in the next 12 months. On the side of banks the following is important:

- ÷ a clear identification of the collateral backing for individual loans; namely, the system of cross guarantees must be desolved and the myth surrounding the collateralization of loans by using unrealistically high asset prices, particularly for real estate, must be strongly addressed. There are implications for the capital adequacy of banks of this assets reclassification is to occur; however, I believe it is more important to transparently reassess portfolios and provide forbearance if necessary on capital adequacy (for example in the form tier-two capital being added to bank's balance sheets), rather to perpetuate the current system;
- ÷ an infusion of new management into commercial banks, one which is unaffected by previous commitments and possible entanglements with conglomerates in questionable lending practices;
- ÷ a clear understanding that from this point forward the government will not provide implicit guarantees for any private sector lending; and
- ÷ changes in accounting practices to standardize international best practices, increase compliance and disclosure, and encourage sound corporate governance in banking.

On the side of corporate restructuring, the following reforms are warranted:

- ÷ changes in corporate governance which make it more difficult for family managers to make decisions at variance with economic realities; for example, if profitability of conglomerates has been low or negative for many years, it seems inconceivable that lending would continue unabated -- therefore there must be a major change in external audits and accounting practices in Korea, as part of corporate governance reform;
- ÷ conglomerates which have long pursued size as their major goal in the hope of either increasing their political leverage or becoming "too big to fail," must be immediately face revised incentives and one way of doing so is to use the new powers of the Korea Fair Trade Commission to vigorously enforce competition policies and immediately publish consolidated financial data for all subsidiary of the conglomerates;
- ÷ begin to delink conglomerates and perhaps consider a holding company structure which would make transactions among affiliates transparent -- this can initially be pursued by accelerating mandatory consolidation of balance sheets and enforcing policy recommendations to limit the interest deductions for tax purposes earlier than their current implementation dates (2002).
- ÷ force the *chaebol* to dismantle their system of mutual guarantees, a vitally important step if one is to break the quasi-pyramid scheme that reflects the financial arrangements between conglomerates, and the lack of disclosure of shareholder liabilities

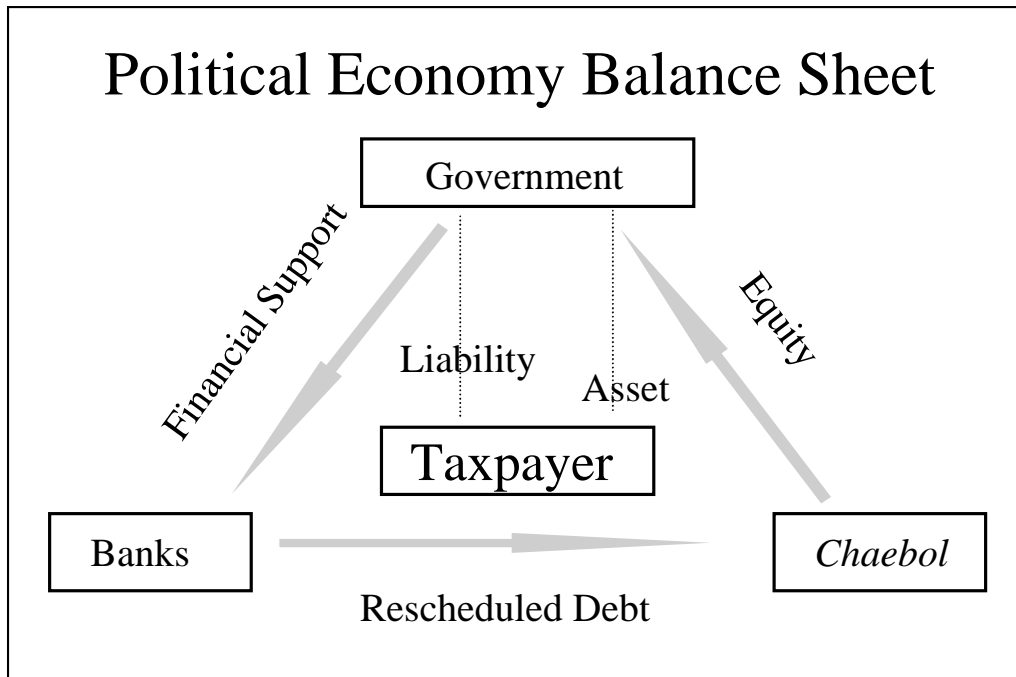
Of course there will be short term demands on both the banking and corporate side to provide **forbearance to banks** and **debt relief to corporations**. This is only natural given the current situation of both the banking and corporate sectors. I assume both of these policy actions will occur; however, it is imperative that there be a very strong **quid pro quo** for granting this form of relief to either, and that they be linked in a consistent way. In the case of banks, where in the absence of large equity infusion by foreigners, it might be necessary to rebuild balance sheets and capital through the issuance of limited recourse bonds which can perform the equivalent of tier-two capital. The ability of banks to engage in this recapitalization should be dependent on a risk based reassessment of the quality of portfolio. That this kind of forbearance is necessary is clear from the fact that corporations will be unable to service their debts properly given the extremely high real interest rates in Korea and the incentives long given to the corporations to pursue a high leverage policy. Therefore, a way must be found to both enable the corporations to survive while at the same time forcing them to conform to standards of behavior that the Korean public has a right to demand. It would seem intolerable to continue a situation in which the Korean public saves prodigiously only to receive minimal returns from the banking system which is lending to Korean corporations producing very low levels of profits.

The dilemma facing Korean policymakers cannot be divorced from the issue of governance. The scandals that riddled previous Korean administrations clearly reflect the fact that conglomerates influenced policies in ways that were detrimental to the public interest. The fact that one can now even talk of crony capitalism, (see Chang 1997), places the sacrifices of the Korean people and the ingenuity and drive of its entrepreneurs over the past 30 years in an unacceptable light. Moreover, it adds a further undesirable dimension to the social cost of corporate bailouts. This situation is reflected in the proposition:

*excessively risky investments - regulation + corruption + high interest rates =
corporate sector meltdown*

Since the government implicitly put itself in the role as ultimate guarantor of both domestic and foreign debts, it now faces the daunting challenge to extricate itself from that situation. As with any risk-return calculus, **the government should structure its support in a way that preserves for the Korean taxpayer the ability to benefit from the upside potential of this government intervention**. By this I mean to say that whereas in the short term the government has purchased bad assets and has had to substitute sovereign debt instruments for private obligations, the turnaround, whether it begins in 1998 or 1999, will ultimately put the Korea economy back on track. The key point is that the benefits of that rebound should not accrue to those whose losses were prevented: the government needs to ensure that it benefits from the inevitable recovery of the industrial sector. This objective is depicted in the Political Economy Balance Sheet (Figure 1).

Figure 1



A Specific Proposal. The situation as of May 1998 reveals an increase in the average leverage ratio of the largest 30 conglomerates from 363 percent in 1996 to above 500 percent, and given a major recession, it is unlikely that they will be able to service their debts. Rather than allowing the banking sector to roll these debts over under the implicit cover of government guarantees, government forbearance, and government capital infusions into the banks, is time for the conglomerates to give up sizable chunks of equity to the Korean public. One option would be to put ownership stakes in conglomerates who require this type of debt rescheduling in a public trust. To avoid using this “provident fund” to bail out banks or corporations, Government could place in a “national trust” some of the current and future equity of the corporations. This “trust” should be managed outside government channels to benefit the Korean citizenry, and would represent assets to match the public’s liability in funding the bank bailout/debt rescheduling.

What is the specific proposal? Rather than continue to use the KAMC (Korea Asset Management Corporation) mechanism of a publicly-funded entity run by MOFE to take over troubled assets for commercial banks at unrealistic prices (average discount being 30% of value), an entity would be created standing between the domestic banks and corporations. Let’s refer to it as the **Korean Restructuring Agency (KRA)**, a profit-generating entity or operating arm of a **Korean National Trust (KNT)**.

Before providing details, it is worth noting that banks themselves could be the workout agents, a useful institutional development; however, given the systemic nature of the problem, government’s infusion of capital into the banks, and the remaining political (and employment clout) of the biggest *chaebol*, a purely market-led solution seems unlikely. Therefore, one public policy solution is to use an autonomous agent to stand between potentially insolvent banks and potentially bankrupt conglomerates.

The KRA would take a non-performing loan of a viable firm and agree to help pay its debt service provided the bank and firm can agree on a rescheduling of principal and a viable repayment schedule. The “fee” for this service would be a equity position in the firm and options for an increased undiluted ownership share if the restructuring succeeds, e.g., a kind of success fee. The KRA would be able to offer refinancing or guarantees, with initial funding provided by the Government. (Another variant would allow the KRA to issue shares to the public). KRA’s capital would come either from public shares in corporations (e.g., KEPCO), or designated bonds made available to the Trust. The KRA would exercise ownership rights on behalf of the KNT on the Board of Directors of the firm. It would be run according to commercial principles and be free of political pressures. Returns would accrue to the nation, to fully fund pension plans or some other socially beneficial purpose. The lending bank would have a guaranteed income stream and a higher quality asset, although it might need infusions of liquidity; this could take the form of short-term loans if the banks are adequately capitalized. Public infusions of capital have already been provided either as equity or subordinated debt (Tier two capital).

To be eligible for this debt restructuring, external audits would be required and consolidated balance sheets would be mandatory. Firms with NPAs would be given a brief period to find equity partners, file for bankruptcy or seek KRA restructuring. The KRA’s aim would be to engage in profitable transactions rather than to provide a soft-option. Of course, it could decline transactions entirely based on external audits and its own internal procedures, but it would also charge higher “fees” the riskier the transactions. Higher fees would take the form of a larger equity stake in the firm and/or more advantageous future options arrangements.

The argument being made is that at the end of the day the Korean government is standing behind the obligations of Korean banks and Korean firms and that this contingent liability is considerable (See Figure 1). The flip side of that liability should be the ability of the taxpayer to benefit from the recovery of the Korean corporate sector and at the same time to dilute the power of the family owned firms. This is not to say that one would wish to return to a previous situation in which government owns enterprises, and for this reason I argue that the shares be placed in a National Trust which would be managed in a financially prudent fashion and would not be subject to industrial policy or other political influences. This would reflect a new form of public private partnership, a model in which the average Korean again begins to gain from the benefit of industrial expansion⁷.

Future Policy Directions

A New Policy for Korea. Economic nationalism has been a strong force in Korea’s development history and it would be unwise to attempt to put Korea into an OECD box in which it does not belong. Therefore discussion about breaking the Korea Inc. and forcing it to resemble Western European corporate structures are misguided. Also mistaken, however, are policies which continue to insulate investment and banking decisions from market forces, perpetuating incentives which caused the crash of the Korean corporate sector, and not substantially reducing

⁷ This is said because it is clear that the income distribution has worsened in the last 10 years and that distribution of financial assets and real estate is highly skewed and detrimental to the average Korean. See Leipziger and Associates (1993).

vulnerability to future crises. Therefore, the reforms in corporate governance and political economy are indispensable for re-anchoring the corporate sector. In order to do so, however, a new corporate structure is required, one which both puts into place the proper regulatory and supervisory institutions, but one that also fashions a new role for government in Korea. Korea must be provide **independent bank supervision** and equally effective **competition regulation**. A list of **Action To Be Taken** is given in Table 3. There are no higher priorities in Korea at the present.

Box 1

POLICY ACTIONS TO BE TAKEN

1. Create a National Economic Policy Council to consist of the Head of the Supervision Agency, the Head of the Competition Agency, the Central Bank Governor, the Minister of Finance, the Senior Economic Secretary to the President and as its Chairman the Deputy Prime for Economic Affairs. This body, while not recreating the old Economic Planning Board, would have overall responsibility for providing a new institutional framework for Korean policy.
2. The new Financial Supervisory Commission must be given sufficient powers and should be given a new policy mandate based on best practices in other countries with respect to monitoring lending practices and of portfolio quality. All measures of forbearance should be fully reported and there should be an internationally recognized ranking system for banks. Rather than adopt Chilean style disincentives to short-term capital inflows, the FSA should require reporting of all offshore liabilities by term and currency and should require prudent asset-liability management. Only entities with the highest prudential ratings would be allowed to borrow offshore. Internal liberalization would be accelerated. Training programs, such as a twinning arrangement with an OECD Supervisory Agency, would be initiated.
3. The Korean Fair Trade Commission should receive expanded powers and should act on excessive concentration in particular industries and avoiding overlapping ownership in peripheral industries. (If a new form of holding company is sanctioned, its consolidated balance sheets would carefully scrutinized. Banks would report their exposure to those holding companies. There should be a regulatory dissentive to this type of industrial structure in the form of the higher collateralization requirements for lending to affiliated companies.)
4. The Ministry of Finance should be charged to draft a new set of tax incentives to reduce the attractiveness of debt financing and increase the attractiveness of equity financing. Along with this must be corporate governance reform which provides shareholders with greater rights to questions the actions of the management and rules for voting in Board members, including requirements for outside members on those Boards. In addition, family owned management should be required to post bond in terms of its personal pledges of assets in exchange for corporate control.
5. To bolster the national reserve position, once Korea's position in international capital markets is stabilized, the Central Bank should initiate a program of long-term bond issue, even if the fiscal stance is neutral, with proceeds held in short-term international assets. This kind of aggressive asset-liability management would keep shore up responsiveness to crises and raise reserves to levels more commensurate with swings in capital flows.
6. The Korea Asset Management Corporation (KAMC), should be spun off from the government and made into an independent entity, whose goal it is to maximize profits. Therefore, it should be charged with selling those assets to anyone willing to take them on, including foreigners and foreign mutual funds or other workout agents. KAMC be privatized immediately, and put on a commercial basis to end the interference of the government in which should be normal bankruptcy proceedings. It should be replaced by a new KRA concept.

Implications for Others in East Asia. Given the massive shift in capital flows towards East Asia, a volume which totaled some \$93 billion in inflows in 1996 and a net outflow of \$12 billion in 1997, the Region had to manage a turnaround of some \$105 billion, a considerable portion of total investment in the affected region. The first implication is that regional growth rates will suffer, recession-induced economies will save less, invest less, and face greater budgetary stringency. The only potentially positive component of aggregate demand will be exports, although the difficulty of securing credit from illiquid/insolvent domestic banks or “gun-shy” international lenders may well offset exchange rate advantages.

With contagious recession in the Region, and traditional sources of regional capital lacking both because of Japan’s internal difficulties of financial management and domestic confidence, and Chinese capital fears in Indonesia and Thailand, the only viable source of new growth for the 1998-1999 period is China, which itself is seeking to deal with deeply-rooted problems of state-owned enterprises and provincial banks. For new lending to resume to the Region and for capital market spreads to return to pre-crisis levels will require major advances in corporate governance and accounting transparency as well as renewed confidence in domestic banks.

All is not lost because East Asia as a Region has had prodigious savings rates and can be less reliant on foreign capital than other areas provided that it learns to allocate its savings more effectively. One obvious prerequisite for improved resource allocation rests with effective programs on the anti-corruption front. A second prerequisite for better allocation of savings involves a clarification of the role of government in sharing private sector risks. This discouragement to moral hazard behavior will increase private sector risk in the first instance, which can serve to lower investment levels, but it has the potential for a superior risk-adjusted allocation of capital in the medium-term. East Asia will need to learn what Latin America had already learned, namely, that the rules of the game have changed and that the minimum degree of transparency has increased. With that will have to come changes in corporate structure, corporate rights, and a more discerning foreign investor.

Implications for Other Regions. There are numerous lessons for other regions of the world, ranging from concerns in Russia about unhealthy links between the banking and corporate sectors in “financial-industrial groups or FIGs” to similar worries about “*grupos*” in Latin America. The inability of Korean banks or bank regulators to effectively disentangle the credit-worthiness of firms leads to a clear call for improved supervision, including efforts to insulate supervisors and strengthen the ability of banks to withstand shocks, be they domestic asset-price bubbles or the effects of international or regional contagion. Since globalization in financial markets is irreversible, the choice facing countries is either to cut themselves off from the beneficial effects of liberalization of capital markets or participate in those potential gains but invest heavily in reducing vulnerability.

The necessary investments are in the area of strengthened institutions.⁸ The lesson from Korea’s unfortunate experience is not to impose capital-account restrictions (although some

⁸ See, for example, G. Perry and SJ Burki, “Beyond the Washington Consensus: Institutions Matter.” The World Bank, 1998, for a view on Latin America.

public policies which indicate a policy preference for certain types of flows is defensible), but rather to sequence reforms in concert with the building of proper regulatory/supervision bodies. The costs of not doing so is high and the costs are always borne by the public⁹. Therefore, prudent public policy must seek to prevent systemic banking crises and deal forcefully with problems before they become crises. That at least is a clear lesson of Korea 1997.

⁹ See Caprio and Klingebiel (1997).

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