

Korea's Financial Crisis

Korea's Financial Crisis, 23 January 1998

The following is an explanation of the economic crisis that unfolded in Korea in 1997. This document is divided into four sections as follows:

1. Historical Origin of the Crisis – Why it Happened
2. The Current Environment – Where We are Now
3. Solutions – How to Fix It
4. Future Outlook – Where We are Going

1. HISTORICAL ORIGIN OF THE CRISIS – WHY IT HAPPENED

Korea's economy has been on a steady growth path for the past 30 years. However, the economic miracle has generated structural contradictions which have become exacerbated in recent years and are causing the current crisis.

Government Stimulated Industrialization: In the mid-1960's, the government decided to jump start the economy and stimulate industrialization. However, rapid economic growth required a massive infusion of capital. Unwilling to wait for the slow accumulation of equity capital and equally unwilling to "sell out" the economy to foreign investors (which was both politically unacceptable and would result in an economy which was difficult to control), the government resorted to debt financing through massive infusions of sovereign loans throughout the 1960's and 1970's. The government developed a series of Five Year Economic and Social Development Plans which determined which industrial sectors would be fostered and promoted.

Chaebol system: The sovereign loans were deposited into the nationalized banking system. Capital was allocated exclusively to the large, family controlled conglomerates (known as chaebol). Loans were restricted to investment only in those projects and industrial sectors defined in the five year plans. Chaebol which "played the game" were given more loans and permission to enter more sectors and thus grew in size and power, those which did not were shut down and their assets given to the ones in favor.

As the government determined how loans would be allocated, the chaebol had no option but to follow the government's plan. However, they were quite happy with this system. The five year plan clearly defined which sectors of the economy would develop. Protection against imports provided them with oligopolistic or monopolistic home markets. Government supported exports which helped, pay off external debt and brought Korean products into the international market.

The chaebol and their families became very wealthy. Workers' wages and standards of living grew at amazing rates. This created a widening domestic market of goods-hungry Koreans with disposable income and goods available they could only dream of just a few years previously.

Early Success: In the 1960's and 1970's, this system was very effective. The economy was small enough that a handful of government technocrats could effectively guide the economy. Key investments generated high returns and brought about full employment. The privileged position of the chaebol generated sufficient income to pay back their loans to the banks which in turn could pay back their international loans. Korea had a good credit rating and borrowed even more from confident international lenders.

Under this sheltered environment, the chaebol enjoyed rapid, relatively risk free growth. They penetrated every sector of the economy: textiles, shoes, shipbuilding, automotive, electronics, resorts, entertainment, insurance, communication services, publishing, education, media, and on and on. (The Daewoo groups' corporate advertising promotes their involvement in everything from A to Z.)

The chaebols' privileged position and access to financing gave them many competitive advantages. They capitalized on the traditional system of post-dated promissory notes to force the burden of financing onto their suppliers (at higher "non-privileged" interest rates). They squeezed smaller firms, drove them into bankruptcy and then absorbed them into their conglomerates. Through the combination of privileged access to loans, government favors for supporting the five year plans and absorption of smaller firms, productive resources became more and more concentrated into a small number of entities. The top 4 conglomerates each had multiple subsidiaries (over 50 in most cases) and accounted for 50% of the GNP. The top 30 conglomerates account for 87% of the GNP.

Chaebol Begin to Dominate: In the late 1970's and 1980's the chaebol's power grew to alarming levels. They were able to lobby the government to include in the five year plans industrial sectors in which they wanted to participate. The chaebol were in effect partly controlling central government planning. At this point, government controls to limit entry of chaebol into competing industrial areas broke down, as chaebol began multiple investments in similar areas, for example: automotive, shipbuilding, construction, electronics and chemicals.

Size provided not only prestige but also huge turnover which offered protection against economic downturns and provided access to more capital through domestic and international financing. The chaebol' objectives thus became growth and market share. Profitability was largely irrelevant because chaebol owners had total control and could ignore minority shareholders. Because growth was debt financed, the chaebol' razor thin margins provided high return on equity.

Korea has long been noted as having the lowest profitability among the Asian 'tigers'. Due to the focus on growth at the expense of profitability, there was grossly insufficient accumulation of retained earnings. Equity was stagnant and corporate growth continued to be financed by debt. Intra-group cross guarantees transferred debt burdens of weak companies onto their strong affiliates.

Under this system of growth and development there was no need (or place) for professional financial planning, cost accounting and efficient operational management. Financial reports were often manipulated to qualify for loans, for listing on the stock market or for obtaining special funding. To achieve this, companies generated multiple books and did not (and still do not) use international standards of accounting. Therefore, many companies quite literally had little or no idea of their own profitability. Their balance sheets were so tangled by cross borrowings and cross guarantees that the chaebol' true financial status became virtually impossible to evaluate.

Financial service skills also were not developed. Korean financial institutions were permitted only to carry out the government's orders for lending. Banks were not allowed to lend according to their own evaluation of a firm's financial status or against cash flow projections of business plans. Banks were (and still are) "private" in name only; the presidents of all banks in Korea were appointed by the Ministry of Finance. Government allocated funds to banks with instructions for which amounts were to be lent to which specific industries for projects nominated in the 5 year plans. Business categories not designated in the five year plans (and thus not included in a bank's instructions for lending categories) were denied loans.

Growth of Capital Intensive Industries: In the 1980's, the five year plans directed the chaebol into more high tech endeavors which were much more capital intensive such as the automotive and electronics industries (especially semiconductors). This re-direction was considered much more prestigious (giving a "developed country" image to Korea) and therefore politically correct. Older, less value added light industries (especially textiles), although still highly profitable, were labeled "sunset industries" and were "out of favor" with technocrats. No longer allocated loans, these industries either folded or moved off shore and the companies either diversified (into the favored fields) or went bankrupt. Korea effectively killed the cash cow. After only two brief years of trade surpluses in the late 1980's, Korea again sank into the persistent trade deficits which have marked its 30 years of industrialization.

Throughout the 1980's, bankruptcies had little impact on the economy. The capitalization of these "sunset industries" was low so the economy could easily absorb the losses. With the chaebol' expansion proceeding apace labor quickly moved to growing industrial sectors and Korea appeared (to outsiders) to be following the natural order of development from light and heavy "low tech" to more high tech and greater value-added industries. However, financing costs rose as firms needed more capital to pursue more high tech industries.

Labor Movement Launched: A major blow to Korea's economic growth came in the late 1980's when democratic reforms permitted labor union activities. Massive demonstrations and demands for improved wages and working conditions caused labor costs to triple between 1988 and 1992. Low labor costs could no longer offset other high operating costs caused by management's operational and financial inefficiencies. Companies launched crash efforts to counter the effects of labor cost increases by investing even more heavily into high tech industries, labor saving equipment and cost reduction activities. Productivity increased, but not enough to totally offset labor cost increases and continuing infrastructural inefficiencies.

Failure to Adjust: Given the increasing operating complexities confronting many Korean industries in the mid 1990's, their already razor-thin margins now were reduced to losses in many cases. Regrettably, management was not able to analyze which components of their operations were causing their losses. When they did find the causes, they lacked the will to take decisive action, often due to political and prestige related objectives. Loss producing companies were kept operating by additional loans and bail outs from other profitable divisions of the same chaebol and additional bank finance (with cross guarantees from profitable units of the chaebol).

The growing losses in many firms, combined with their continuing massive expansion plans, created growing cash requirements. To meet the increase in demand for funds, the government liberalized foreign loans, bonds and equity issues thus permitting firms to borrow directly from overseas. Many large and small firms alike, attracted by lower cost international interest rates, took advantage of this access to international financial markets. Foreign currency denominated bonds, syndicated loans and equipment leases rose dramatically. These loans were secured by over-valued assets and cross guarantees within chaebol group firms.

Chaebol Uncontrollable: The government sensed a danger in the growing control of chaebol over the economy and attempted to force them to concentrate on "core" business areas and permit small and medium business a share of the growing economy. Government reduced the scope of loan categories available to the chaebol and applied political pressure. The chaebol, however, had become so large that they were able to access the international financial community directly and circumvent government controls on their borrowing ability.

As an alternative source of financing, the chaebol expanded rapidly into financial services, securities, short-term financing companies and insurance, especially life insurance. Investment decision of these financial service firms were determined by the capital needs of group companies rather than the profitability or return on assets of the specific business unit.

With Korea's credit rating at an all time high and an apparently excellent track record of business successes, international bankers lent heavily to Korea's top conglomerates for their massive expansion projects domestically and overseas. Here

too, little attention was paid to professional, credible business / cash flow planning. This further increased Korea's overall debt burden for projects with dubious pay back feasibility.

Simultaneously from the early 1990's, liberalization of the import markets of some industries caused increased competition at home. Additionally development of the economies of Southeast Asia and China cut into Korea's share of overseas markets. Prices of semiconductor chips, which accounted for nearly 10% of Korea's exports in 1995, dropped dramatically in 1996. Debt servicing became difficult as earnings from previously profitable sectors declined.

2. The current ENVIRONMENT – WHERE WE ARE NOW

Korea today is suffering from:

- Excessive debt
- Corporate bankruptcies (more than 10% of listed companies)
- Stock market slump (50% decline between August and December 1997)
- Currency devaluation (won value vis-a-vis the US dollar fell in half in 1997)
- Down grading of credit ratings by major credit rating agencies resulting in an inability to borrow on international capital markets.

Historical debt-financed development policies led to an economy with an inordinately high debt to equity ratio officially averaging 3:1 but much higher in many cases. Debt servicing became more and more difficult.

The recent crisis was precipitated in January 1997 by the bankruptcy of Korea's 18th largest conglomerate, the Hanbo group. This was followed by a string of dramatic bankruptcies of major groups: Haitai (ranked 22nd), Halla (14th), Kia (8th), Dainong, Jinro, New Core, Ssangbangwol, and Sammi. By late October, the impact of these bankruptcies exposed the inadequacies of the financial sector and the traditional chaebol system to the world.

By 1996, as part of the "liberalization" process, the government no longer guaranteed loans made in support of the five year plan but banks were required to continue to make loans according to government guidelines. As a result, the banks were totally unprepared for the massive bankruptcies of major firms. Non-performing loans exceeded 20% of the total loan portfolio (and the entire shareholders' equity) at some banks and total irrecoverable loans were estimated at 32 trillion won (about US\$20 billion).

Government Reaction to the crisis: The government did not want to shake up the economy in 1997 which was an election year. The goal was to restore the confidence of domestic and international businessmen. The government's solution

was to attack the symptom rather than the problem. A Bankruptcy Prevention Committee made up of leaders of the major banks was established to save floundering companies and avoid bankruptcies. They injected massive “rescue” funds supplied by the central bank and propped up many shaky conglomerates. Unfortunately, there was no change to the fundamentals and these companies continue to operate only now losing state supplied funds.

The IMF Solution?: In late November, Korea appealed to the IMF for help. On December 3, an agreement was reached for the IMF to arrange loans of \$55 billion and for the Korean government to implement fundamental reforms. Unfortunately, the solutions which were successful in the UK and Mexico are not necessarily applicable to Korea and may not generate the anticipated results. A case in point was the BIS 8% capital reserve ratio requirement. Banks reacted to this requirement by immediately tightening lending even to the point of arbitrarily withholding legitimate payments to businesses. This has exacerbated the number of bankruptcies and further eroded the economy which only hinders efforts to recover from the current crisis.

3. SOLUTION – HOW to fix it

Given the failure of the “Korean economic model”, radical, fundamental changes must be rapidly implemented.

- **Government Must Surrender Control of the Economy:**

Most critically, the government must recognize that it is not and cannot be the sole guide and determinant of the economic direction of the country and that the interests of Korean businessmen, consumers and public is best served by natural adjustments provided by a free market economy. Although this requires a revolutionary change of attitude, the government must:

- Abandon Five Year Economic and Social Development Plans and allow the market to determine investments and the direction of the economy. The government must focus only on macro economic issues: stability, money supply, and inflation.
- Permit bankruptcies and sale of assets at market prices.
- Eliminate costly bureaucratic procedures and continue to liberalize regulations in all sectors; trade, financing, investment.
- Welcome foreign investment and create incentives to attract foreign firms to bring equity capital to Korea.

- **Replace Debt with Equity:**

Companies must restructure. To achieve lower debt burdens, management must concentrate on core business lines and spin off peripheral businesses. Assets must

be sold to reduce dependence on debt. Unfortunately for Korea, few Korean companies have cash to purchase assets. Therefore, the only source of equity capital is from abroad. Korean firms must attract foreign equity to purchase domestic assets and as much domestic equity investment as possible. Management must run their companies in a professional manner to the benefit of all equity investors rather than to satisfy the egos of chaebol leaders and the economic goals of government bureaucrats.

When it is obvious that a business will never survive (and thus will never be of interest to potential investors), it should be liquidated, not kept operating with additional debt.

- **Reform of the Financial Industry:**

Genuine financial reform is a must. Lending must be based on the ability to repay, i.e. expected future cash flows. This requires that banks estimate risk and attach risk premiums to reflect each firm's financial status. Korean banks must begin to evaluate future potential cash flows against the debt obligations of companies. They must become more adept at the credit analysis process. Banks must base estimates of the viability of companies upon solid financial precepts rather than simply abdicating lending decisions to a company's fit into the government's development plans. Corruption must be eliminated. These reforms would involve a major change in the way in which banks have generally operated.

Transparency of transactions and all financial information is essential. Chaebol must publish consolidated financial statements produced by major international accountants and which accurately reflect reality.

- **Enlightened International Guidance:**

The IMF and other foreign advisors have accurately defined financial and industrial reform targets which Korea must achieve to be eligible for continued financial support. They must maintain pressure on the Korean government to insure unwavering commitment to implement these targets. However, the IMF must be careful to avoid the assumption that all economies are fundamentally the same. It must understand the unique dynamics of Asia in order to understand what solutions will achieve the required results. The IMF knows where Korea needs to be but unless they know where Korea is now, they will be unable to define the changes which will achieve the desired goals.

- **Close Managerial and Technology Gap:**

- Companies must concentrate more on genuine R&D rather than on copying technology from abroad (either through licensing and/or reverse engineering).

Korea requires unique, state of the art technology duplicating the success of the CDMA telecommunications technology in other fields.

- o Professional management must be developed, encouraged and rewarded; nepotism and cronyism must be eliminated.

- **Public Attitudes must Change:**

- o Korean attitudes must change to embrace free market concepts.
- o Foreign investment must be appreciated for the economic contribution it brings rather than perceived as a threat to national sovereignty.
- o Conglomerates must focus on core businesses and allow small and medium firms to thrive.

4. Future OUTLOOK – WHERE WE ARE GOING

Short Term Pain: The picture looks bleak in the short term. Tight credit, uncertainty and bankruptcy of major corporate customers will cause bankruptcies to continue for the coming months, perhaps peaking in March or April 1998. Forecasts anticipate that as many as 50,000 companies in Korea (one third) including a similar portion of the 770 listed companies will fold (already 11% of listed companies are bankrupt or under court receivership). Key IMF determined targets must be implemented by March. Achieving these targets will be painful.

Lame Duck Government: The current lame duck government has lost the will to lead. The people have lost faith in the government which is blamed for the current crisis. No political leadership can be expected until the new government takes power on 25 February bringing in a new team.

Political Mandate: No previous government has taken office amid such high public expectation as the new Kim, Dae-jung government. Korea's political system awards the presidency to the candidate with the plurality of votes in a multi-candidate field. This raised concerns that the president would win with weak public support. These concerns have vanished with Kim's better than expected showing (40%) and current political vacuum. Kim has a mandate to lead as no other newly inaugurated President has EVER had in the fifty-year history of the Republic of Korea.

Stock Market: The stock market has shown a surprising rally with a modest influx of foreign capital and massive buying demand by domestic investors. Prices have increased nearly 50% since the first of the year. This is an encouraging development.

Foreign Exchange: Forecasts for the exchange rate when the currency achieves stability span the spectrum from 900 won per dollar (the pre-crash level) to 1800 won per dollar (worse than now). Many forecasts for the exchange rate seem to be around the 1300 won level. The currency has traded between 1500 and 1800 won to the dollar in the first weeks of 1998.

CONCLUSION:

It is too soon to interpret the recent behavior of the stock and FX markets as precursors to stabilization, especially when bank interest rates remain well over 20%. However, perhaps there is a glimmer of hope. Nevertheless, very real problems remain.

The immediate key to financial stability is the rescheduling of Korea's short term international debt for longer maturities. Corporate restructuring (especially reduction of debt) and financial reform are essential. Government involvement in industry must be fundamentally changed. The way to achieve these objectives is not completely clear in every case but they will involve painful sacrifice. National default and moratorium on debts remain very real possibilities. However, with hard work, enlightened leadership and "a little help from our friends", stabilization will return in 1998.

In spite of the present difficulties and uncertain future, it is important to remember that the Korean people are resilient, determined and obstinate. Korea has surmounted every crisis in the past. Even if the economy collapses and Korea declares a moratorium on paying back loans becoming technically insolvent, Koreans will pick themselves up, shake off the dust and charge headlong into rebuilding the economy. The Koreans cannot be kept down and regardless of what happens in 1998, the Koreans will be back, stronger, tougher and wiser than before.

Foreign investors can capitalize on this crisis. The regulatory environment will become more equitable and transparent. Korean companies and individuals will become more appreciative of foreign involvement in the economy. Attractive modern industrial manufacturing assets can be acquired at distressed prices in local currency which means huge discounts in hard currency terms. For those who believe in the future of Korea and with the audacity to move quickly, there are unprecedented, immediate opportunities in Korea for foreign investors.