Financial Crisis and Structural Reform Plans in Korea

After experiencing severe turmoil for several months, the foreign exchange market in South Korea seems to be stabilizing (*Chart 1*). Recently we have seen some implementation of reform plans supported by the International Monetary Fund (IMF), extension of $24 billion in short-term loans to Korean commercial banks (with government guarantees), and four consecutive months of trade surplus ($11 billion in first quarter 1998). Are these signs of the end of Korea's financial crisis? Assessing the future of the Korean economy requires a review of the processes by which the structural reform plans are implemented.

The underlying conditions for the financial crisis in Korea have been nourished by the government's long-time control of and intervention in the economy. With the hope of expanding the economy, the Korean government deliberately managed the distribution of resources so that conglomerates, called *chaebols*, could grow without constraints. Consequently, the nation's private financial sector never seriously took off. The chaebols' inefficiencies increased as they became larger. The crisis broke when foreign investors realized that the chaebols' investments were not efficient and the government might no longer be able to feed all the ailing chaebols.

The structural reform plans in the IMF-supported program were designed to restructure the economy to function more efficiently in the long run as well as stabilize the foreign exchange market in the short run. Many of the reform measures represent a departure from the traditional Korean styles of economic and corporate management. So the question is whether the measures can be implemented effectively, thereby changing the traditional styles.

Although the Korean government promised to observe the structural reform plans, implementation has been slow. The only exception has been liberalization of capital inflows, which the government believes is urgently needed to stabilize the foreign exchange market.

In February the government ordered banks to grant loan extensions of $24 billion to small and mid-size companies for an additional six months (an exchange rate of 1,000 Korean won for one U.S. dollar is used throughout this article). It also declared that it would not allow further bankruptcy of big companies until the end of this year. However, this bankruptcy delay does not seem to accompany any concrete plan for recapitalizing the financial sector, which will cost an estimated $100 billion.

Since the crisis broke, the financial status of the chaebols has not improved. The debt–capital ratio of major chaebols has increased, and the practice of self-lending within the chaebols has continued. As of yet there are no significant signs that the chaebols are becoming more market driven. For example, Hyundai and Samsung are competing to take over defunct Kia Motors to increase size, not profits.

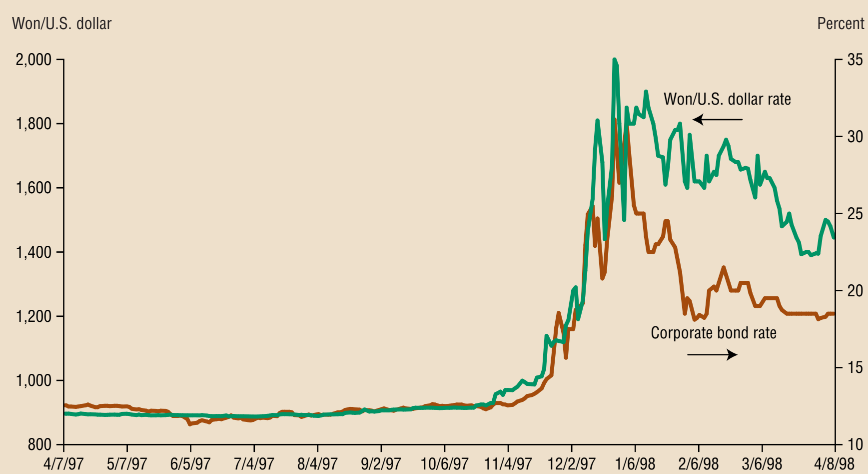
The labor laws have been amended to allow for a more flexible labor market and to make foreign investment in the highly unionized banking sector more attractive. But in a society with a poor safety net for the unemployed, social resistance against massive layoffs is strong.

So far the Korean government has been more concerned about dealing with the immediate foreign exchange problem than solving the long-term problem of a weak banking sector. The reform effort has been unfocused as there has been no single authority implementing the various government ministries' reforms. Furthermore, the structure of this hierarchical Confucian society is still rigid, with the feudal chaebols trying to keep their traditional privileges.

Unless the Korean government sets up a system to implement the reforms effectively and individuals view the changes as positive for the long-run health of the economy, Korea will continue to be vulnerable to relatively small shocks inside and outside the country.

—Jahyeong Koo

CHART 1
THREE-YEAR CORPORATE BOND RATE AND EXCHANGE RATE



SOURCE: Dow Jones.