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Korean Economic Restructuring: Evaluation and Prospects

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Edited by
MikyungYun

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KOREA INSTITUTE FOR INTERNATIONAL ECONOMIC POLICY

KOREA INSTITUTE FOR INTERNATIONAL ECONOMIC POLICY (KIEP)
300-4 Yomgok-Dong, Socho-Gu, Seoul 137-747, Korea
Tel: (822) 3460-1182 Fax: (822) 3460-1077
URL: http:/ /www.kiep.go.kr

Kyung-Tae Lee, *President*

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Foreword

This November marks the not-so-celebratory-anniversary of the foreign exchange crisis, which in turn has led to a financial/ corporate crisis in Korea. Fortunately, the foreign exchange difficulties were eased relatively early on in the year, with successful foreign-debt roll overs and loans from the IMF and the World Bank. However, the weak financial system and highly leveraged corporate structure have been deeply destabilized from the impact of the crisis. Restoration of a working financial system and resolution of domestic debt have therefore been, and still is, the primary task of the new government.

Various reform measures have been successfully implemented since the outbreak of the crisis. Greater discretion and supervision in the financial sector have been introduced, aided by new legislations and set up of the Financial Supervisory Commission. Several insolvent banks have been closed and many firms are now under a workout process in consultation with their creditors. In addition, long term reform measures with respect to corporate governance, industrial restructuring, foreign investment regime and other government regulations have been legislated. While these measures are commendable and many of the macro economic indicators - such as balance of payment, exchange rate, and interest rates - have improved, much still needs to be done, especially with respect to corporate restructuring and non-performing loans.

Now, after a year of economic chaos and efforts at restructuring, it seems to be an appropriate time for an evaluation of reform policies that have been implemented so far and outline prospects for the future. This would be essential for establishing a consistent and a coherent programme for the on-going restructuring process.

For this purpose, the Korea Institute for International Economic Policy (KIEP) organised an international seminar on Korean Economic Restructuring: Evaluation and Prospects. This book is a compilation of papers, comments and speeches from the seminar, held in Seoul on October 23,

1998. I would like to thank all the seminar participants for their invaluable contributions and hope that the proceedings will provide a useful benchmark for those concerned with the Korean restructuring process.

November 1998 *Kyung-Tae Lee*
Seoul President, KIEP

Introduction

Following the outbreak of the foreign currency crisis in November 1997, the resolution of domestic debt has emerged as the primary task for restoring economic stability in Korea. A year of economic turmoil and efforts at reform have now passed and it seems to be a good time for a reflection, evaluating the past reform efforts, identifying remaining problem areas, and setting out future agendas to address these problems. This has been the main purpose of the seminar, and appropriately, it focused on the two most important and intertwined aspects of economic reform: financial sector reform and corporate restructuring.

The financial sector reform has been reviewed by Dr. Stijn Claessens of the World Bank, and corporate restructuring by Dr. Ira Lieberman, also from the World Bank. The papers provide updated information on the reform process, presenting a succinct description of the current status of financial institutions and the top 50 chaebols as well as a summary of measures that have been implemented so far in the two sectors.

Both the papers identify the size of the debt and the size of funds to resolve it as the biggest and immediate problem to be taken care of. Both are at pains to point out that this should take priority to any long term measures, because the debt will grow bigger, the greater the delay since interest will accumulate and asset quality deteriorate as they migrate into worse categories with application of more strict standards. Given this background, the two World Bank experts argue that greater government role is paramount in setting the speed and providing a central guidepost. Among the proposals are greater use of fiscal policy (in view of comparatively low fiscal deficit in Korea and currently low demand for credit from the private sector) and setting up of funds or a special purpose vehicle (SPV) to purchase debt to turn it into equity. It is also suggested that these institutions should be a joint venture between the government and the private sector so that available public funds can be injected into the programme while managerial expertise can be hired from the private sector.

No serious disagreement was found in the discussion with respect to the cause of the crises nor the immediate problems to be resolved. Perhaps the greatest contention took place over the issue of interest rate. While it is true that high interest rate reflects credit risk than tight money supply, it is also true that interest rates must come down to improve corporate profitability and thereby reduce credit risk.

There was also a slight difference of opinion with respect to incentives for financial institutions and corporations to agree to a workout. While some argue that they have to be "bribed" into undertaking restructuring, others are more concerned about the moral hazard effects. The correct balance between the "bribe" and strict conditionality is certainly subject to greater conceptual as well as case- by-case analysis.

Of all the important decisions to be made in the future with respect to restructuring, the crucial factor seems to be the ability to evaluate and determine which institutions are worth saving using public funds while allowing others to face bankruptcy; and at the same time to give the right kind of signals about future government assistance. As one of the participants puts it, "we want to fix the problems of the past. We don't want to fix the problems of the future."

I

Financial Sector Reform

Korea Institute for International Economic Policy

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대외경제정책연구원

Korea's Financial Sector Reforms*

Stijn Claessens, Swati Ghosh, and David Scott
The World Bank

Ⅰ. The Development and Onset of Korea's Financial Crisis

Underlying Problems. Difficulties in the corporate and financial sectors have been at the core of Korea's financial crisis. The incentive framework for the financial sector did not lead to an efficient allocation of resources or promote the institutional development of financial institutions that adequately appraise risks. Poor credit culture and the lack of adequate risk analysis and management were two of the main weaknesses of Korea's financial system. Following a long period of government control over the financial system, liberalization measures in the late-1980s and 1990s were mostly half-hearted and often not backed up by improvements in the supervisory and disclosure framework. Merchant banks, for example, were allowed to operate under more liberal capital adequacy requirements than commercial banks while they are inherently more risky financial institutions. Prudential rules and their applications had fallen behind international best practices and differences existed between the treatment of various related financial instruments and financial institutions. Supervision of banks and other financial institutions was weak, scattered over various government agencies, and

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* This paper draws on work of other World Bank colleagues, in particular Ira Lieberman and Bill Mako. It also draws on information from the Korea government, in particular, its recently released *Korean government's economic reform progress report.* Helpful comments were received from Jose De Luna Martinez and participant in the conference, *Asia: An Analysis of Financial Crisis,* Chicago, October 8-10, 1998. Jointly organized by the Federal Reserve Bank of Chicago and IMF. The opinions expressed are the authors' own, however, and do not necessarily reflect those of the World Bank. For comments, please contact Stijn Claessens, EM: CClaessens@worldbank.org, fax: (202) 522-2031.

mostly focused on compliance with rules, rather that on assuring the soundness and proper management of individual financial institutions.

Especially in the area of dealing with troubled financial institutions was there a legal and institutional vacuum. Despite steps to increase openness, such as those negotiated with the OECD, Korea's financial system remained protected from foreign competition, with a low share of foreign investment in the capital markets and limited foreign ownership of financial institutions. Earlier reform plans, such as those suggested by a presidential financial reform commission in early 1997, failed to gain enough political support.

Adding to the financial sector problems were difficulties in the corporate sector and concerns about its competitiveness. Major corporations (chaebols) had undertaken ambitious expansion and diversification drives in the last few years, including numerous overseas investment projects in both domestic and emerging markets. The expansion drives were funded with very aggressive borrowings from Korean commercial and merchant banks, often short-term. Banks relied mainly on collateral in the allocation of credit and relatively little attention was paid to the earnings performance and cash flow generation, or the corporates' ability to repay. The chaebols generally supplied guarantees to their affiliates and subsidiaries to secure loans. Although most of the major subsidiaries of the chaebols are publicly listed, the Korean stock market is thinly capitalized, and chaebols have traditionally raised little in new equity. The government often supported this expansion and often directed chaebols into specific lines of business.

The policy of aggressive, leveraged expansion worked well as long as the economy and exports expanded vigorously and the returns on new investment exceeded the cost of capital. In recent years, however, all measures of group financial performance among the 30 largest chaebol worsened-free cash flow, return on equity, profit margin, debt coverage ratio-while their debt/equity ratios continued to rise. Rapid wage increases, a result of a highly unionized and strong labor force, often outstripped productivity growth. Declining demand and falling prices for Korean exports-particularly in semiconductors, chemicals, shipbuilding and steel markets-in part associated with a depressed Japanese economy and weakened Japanese yen, further weakened profitability in recent years.

The low internal profitability fuelled large borrowings in the last few years, from both domestic and foreign sources, and debt-equity ratios rose to over 300% by the end of 1996. The very complex system of cross guarantees from affiliates within the group, as well as personal guarantees from group executives, allowed loss-making affiliates to continue to borrow from banks and drain financial resources from healthier affiliates. Serious problems in the industrial sector began to surface starting early in 1997 and drew attention not only to the weakness of many conglomerates, but also to the banks closely related to the business groups. On January 23rd 1997, Hanbo Iron and Steel, Korea's second largest steel maker, was unable to honor its promissory notes and was forced to file for bankruptcy. The collapse of Hanbo was followed in quick succession by a series of other business failures. Key financial ratios deteriorated further and, by end-1997, the debt/equity ratio of the 30 largest chaebols reached an average of 500 percent (600 percent if the debt of their financial subsidiaries is included). This compares with an industrial country norm of below 200 percent, is twice the US ratio, and four times the Taiwanese. Total corporate debt is currently estimated to be on the order of $500 billion (or more than 150 percent of GDP at current exchange rates), of which around 90 percent is domestic.

Spillover from the region and initial policy responses. Following the devaluation of the Thai Baht which had heightened investor sensitivity investor concerns about Korea grew in the face of mounting evidence of difficulties in the corporate and financial sectors especially the liquidity positions of merchant banks. In response to the increasing nervousness of the markets, the government announced on August 25th 1997 that it was committed to providing financial support to commercial and merchant banks and that it would ensure repayment of foreign debt liabilities of Korean financial institutions. It also announced that all financial institutions would be required to submit restructuring plans to be implemented over a period of three to five years. The market, however, remained unsatisfied and the failure of the National Assembly to pass important bills to institute financial reforms, further weakened investor confidence. On November 19th, the Government announced another set of policy measures to deal with the growing financial crisis.[1] Once again, however, these measures did little to calm the markets, and when it was announced that the daily exchange band had been widened to plus/minus 10 percent and that there would be no more intervention on the foreign exchange market, the Korean Won began a free-fall in late November/ early in December, reaching a low of almost 2,000 won/dollar. In the end, the Korea crisis became a triple crisis-balance-of-payments, banking and corporate crisis.

Ⅱ. Policies to Deal with the Financial Crisis

Financial sector. Restoring confidence and expediting the resolution of troubled financial institutions was the most urgent priority in the first few months. While there was no significant loss of confidence among depositors, also as there was a general guarantee in place, financial distress was widespread. Significant improvements in the framework for the financial sector, many of which had been proposed earlier by the Presidential Reform Committee and which had been debated, but not enacted in Parliament, were passed in late December.

Resolution of financial institutions. The government first had to deal with the troubled merchant banks, and closed ten in the first weeks of January. Two major commercial banks (Korea First Bank and Seoul Bank) had run up substantial non-performing loans. The government imposed substantial losses on the owners of these banks, injected public resources to stabilize their capital position, and assumed ownership control. The government plans to privatize these two banks the near future, using the services of foreign investment bankers. The role of the

1) This included increased funding for the Korean Asset Management Corporation (KAMCO) to enhance its capacity to deal with distressed assets; incentives to promote mergers and acquisitions among financial institutions and rules that mandated the restructuring and exit of nonviable institutions; increased funding for the newly consolidated Deposit Insurance Corporation; further liberalized capital account transactions; and enhanced disclosure standards and loan classification requirements.

Korean Asset Management Corporation (KAMCO) in restoring bank portfolios was initially large as it bought substantial amounts of non-performing loans from many banks in December and early January. Commercial banks which did not meet the 8% BIS capital adequacy ratios as of end-1997 (12 out 25) were asked to provide recapitalization and rehabilitation plans.

Supervision and other legal reforms. A new supervisory structure was enacted in late December, consolidating various supervisory bodies (Financial Supervisory Board, FSB and Financial Supervisory Committee, FSC), covering banks, non-bank financial institutions and capital markets, in one body under the direct supervision of the prime minister. The Bank of Korea (BOK) Act was amended to provide for greater independence of the BOK in setting monetary and credit policy. Barriers between financial service providers were lowered to increase competition within the financial sector and enhance stability. Prudential rules for merchant banks were tightened and harmonized with other financial institutions. Legal changes were made to consolidate and improve the depositor protection schemes and to enhance the powers of the deposit insurance agency to undertake examinations of financial institutions, and intervene in and resolve troubled financial institutions.

Financial services and capital account liberalization. The government bound itself under the WTO Financial Services Agreement of December 1997 to the liberalization measures agreed earlier with the OECD. For capital account transactions, the IMF-program went much beyond the liberalization measures agreed with the OECD. Capital account liberalization measures included, among others, full liberalization of foreign exchange transactions over time, no limits on foreign investment in local bonds and short-term money markets, and no limits on foreign banks and brokerage houses to establish subsidiaries in Korea. The government also made general changes in the liberalization of the foreign direct investment regime, and issued clarifying guidelines rules governing foreign investment in financial institutions, including investment through mergers and acquisitions.

Corporate sector. Given the very high levels of indebtedness to banks (the top 30 chaebols account for over 60 percent of bank lending), the problems of the banking sector have been very closely linked to those of the corporate sector. With the onset of the economic crisis in late 1997 and the spike in interest rates in 1998, five major groups worth about $20 billion in assets quickly failed, unable to pay their debts. (At least five additional large groups have petitioned for bankruptcy since.) Moreover, it soon became apparent that 18 of the largest 30 groups were at risk of bankruptcy, with combined liabilities of about $75 billion. Not surprisingly, a series of syndicated emergency loans were provided by major banks to a number of major groups at risk, totaling some 2.5 trillion won. The problems of the largest groups quickly spread to SMEs, which often operate as satellites of the major groups. Also a complex system of payments from the big to small firms via promissory notes, traditionally discounted at banks, adversely affected the liquidity of the latter, as the terms of the notes were extended from an average of 30-60 days to 90-180 days and discounting rates rose from 12 to 30 percent. Moreover, exporting SMEs found it difficult to finance imports of needed raw material and other inputs.

Corporate sector reforms. A number of acts passed late 1997 and on February 14th 1998 provided for many changes in the framework for corporate transactions. These changes included permitting takeovers of non-strategic companies by foreign investors without government approval and raising the foreign stock ownership ceiling; accelerated introduction of consolidated financial statements and requirements for audit committees; and strengthening minority shareholders' rights. Measures adopted also prohibited any new debt guarantees and improved the operations of the bankruptcy act. The Composition and Reorganization Acts were revised to induce a more expedited process for financial restructuring by fixed deadlines, promoting expertise of the courts by creating a separate administrative body, and strengthening the creditors' role by allowing creditor committees. New cross guarantees were prohibited and all existing guarantees were to be dissolved by the year 2000.

Macroeconomic stabilization. The macroeconomic stabilization program aimed-in the first instance-at restoring exchange rate stability, rebuilding international reserves and containing potential inflationary pressures resulting from the economic shocks. This initially involved a relatively sharp tightening of monetary policy (benchmark interest rates rose from 12 to 30 percent), as well as some fiscal tightening. The program restored exchange rate stability, with the currency strengthening from a low of near 2000 won/$ to about 1300-1400 won/$, and over the past few months Korea has seen a significant improvement in its external reserves position. Output has fallen very sharply, however, and is now expected to register negative growth of 7 percent in 1997. And although greater stability in the foreign exchange market and the subsiding of inflationary pressures in recent months have led to an appreciable decline in nominal interest rates, real lending rates are still above those before the crisis, especially for SMEs.

As often in financial crises, macroeconomic developments and corporate and financial sector distress have reinforced each other. Given the very high leverage of Korean corporates, corporate financial positions, and consequently also the health of the portfolios of creditor financial institutions, have been particularly vulnerable to interest rate spikes.[21] Compounding the effect of higher interest rates, has been the depreciation of the won, albeit now stabilized, the plunge in domestic demand and the only slowly growing external demand (in value terms), which have all contributed to further lowering of corporate profitability. Corporates' financial difficulties, in turn, led to a cutback in demand for (and supply of) new lending. Financial system non-performing loans increased rapidly, and, including those classified as non-performing on precautionary basis, amounted to almost 9 percent of all bank loans in March 1998, compared to less than 1% in 1995. Banks, in the face of rising non-performing loans and the need to restructure and recapitalize, have resorted to loan recalls and higher spreads.

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2) The interest coverage (or the ratio of operating income before interest and taxes to net interest payments) of Korean corporations had already been declining progressively and was about 135 percent at end-1997-by comparison, interest coverage ratios range between 250-450 percent in other OECD countries. For every one-percentage point increase in domestic interest rates, interest coverage in Korea falls by about 3-4 percentage points.

III. Financial Sector Restructuring Program

Avoiding systemic risks, and restoring solvency of financial institutions, while keeping fiscal costs manageable, have been the main goals of the financial sector reform program. The government was also committed to conclude many aspects of the first phase of its bank-restructuring program by the end-of-September. As of end-of-September, a number of non-viable financial institutions-including 16 merchant banks, 2 securities companies, and 1 investment trust company-have been closed, while the operations of other troubled financial institutions, including insurance companies, have been suspended. In total, 94 financial institutions had their operations suspended or were closed as of the end of September. Table 1 provides an overview of the financial sector restructuring progress to date.

Table 1. Financial Institutions Suspended or Closed (as of September 1998)

	Total No. of Institutions (end-1997)	License Revoked	Suspended	Total Suspended or closed
Commercial Banks	26	-	5	5
Merchant Banks	30	16	-	16
Securities Companies	34	2	4	6
Insurance Companies	50	-	4	4
Investment Trust Companies	8	1	1	2
Mutual Savings and Finance Companies	230	1	21	22
Credit Unions	1,653	12 [1)]	27	39
Leasing Companies	25	-	-	-
Total	2,063	32	62	94

Note: 1) Bankruptcy.
Source: MOFE, Korea.

Commercial bank restructuring. Korea has a relatively concentrated banking system, with the six largest banks accounting for more than 50 percent of the assets of the banks. Korean banks are also large relative to GDP: assets of the 6 largest banks account each for about 10% of

GDP, compared to less than 5% for the largest banks in most other OECD-countries. Dealing with the large commercial banks has been a central part of the restructuring strategy. Of the 26 commercial banks in existence at the end of 1997-which includes 16 national banks and 10 regional banks-two as noted were taken over by the government and recapitalized in December. The government has initiated the privatization of these banks, with the objectives of attracting foreign capital and expertise into the system. Twelve commercial banks that failed to meet the 8 percent BIS capital adequacy standard at end-1997 were asked to submit rehabilitation plans and were subjected to asset quality diagnostic reviews. The FSC announced on June 28 that the rehabilitation plans of
5 of the 12 banks were deemed infeasible. These five banks had their business licenses suspended and have since been acquired by five stronger banks under purchase and assumption (P&A) transactions, with public support to ensure that the acquiring banks would not be weakened.[3)]

The remaining seven undercapitalized banks received conditional approval. These include four large banks that account for more than one third of total commercial bank assets (Cho Hung, Commercial, Hanil Bank, and Korea Exchange Bank). As noted, these four banks, together with the two banks in which government already intervened, account for more than 50% of all banking system assets. All seven banks were instructed to submit revised implementation plans by end-July containing proposed management changes, cost reductions, capital increases, and measures taken to limit the accumulation of non-performing assets. Currently, six large banks, including both conditionally approved banks and other banks, are, on a voluntary basis, proceeding with mergers so as to increase their scale economies and efficiency. Of these, the agreed merger of Commercial Bank of Korea and Hanil Bank is the largest. Other conditionally approved banks not involved in merger deals are

3) The Korea Deposit Insurance Corporation (KDIC) has covered any shortfalls in net worth of transferred assets and liabilities; KAMCO and KDIC are supporting the disposal of non-performing loans by the acquiring banks, and their recapitalization; and within a set time period after P&A transactions, the acquiring banks can exercise a put-back option by requesting KAMCO to purchase acquired assets if these are later found to be non-performing.

taking rehabilitation actions, such as disposing of non-performing loans, inducing new equity capital, and streamlining business operations. The nine healthy banks not involved in mergers, including the five receiving banks involved in P&As, are being reviewed for their financial soundness and management practices, and corrective actions have been imposed in September on banks deemed to have the potential to become distressed.

Non-bank financial institutions. The FSC is applying basically the same scheme with regard to the restructuring of non-bank financial institutions (NBFis). Self-rehabilitation under the initiative of major shareholders is being encouraged, but is closely monitored by the FSC. If self-rehabilitation steps are deemed inadequate, the institutions will either be subject to corrective actions or face closure. Of the 30 merchant banks at the end-of-1997, 16 troubled merchant banks have had their licenses revoked and have been undergoing resolution procedures. The remaining 14 merchant banks will be monitored for the implementation of rehabilitation plans and the achievement of capital adequacy targets. Securities firms, insurance companies, leasing companies, and investment trust companies have had to submit rehabilitation plans, followed by review by the FSC and, if necessary, resolution through closure. The timetable for these actions differs somewhat across the types of institutions, but the first round of restructuring was completed in September, and some NBFis had their licenses revoked.

Supervision and regulations. The FSC, formally established in April 1998, is an integrated financial supervision body and all financial institutions (banks, securities, insurance and other NBFis) will be supervised by the FSC and its executing body, the Financial Supervisory Board (FSB). The four existing supervisory agencies (Banking Supervisory Authority, Securities Supervision Board, Insurance Supervisory Board, and the Non-Bank Financial Institution Supervisory Authority) are expected to be fully integrated into the FSB by end-1998. With the consolidation of supervisory organizations, supervisory arrangements for commercial banks will be extended to all NBFis. The FSC will also be granted powers to enforce supervisory actions against specialized and development banks, and prudential rules applied to commercial banks will be extended to other type of banks.

Since December, the regulatory framework has been strengthened to conform more closely to international norms. Changes have been made in rules for mark-to-market accounting, disclosure of non-performing loans, asset classification criteria, and foreign exchange liquidity and exposure criteria. On July 1, a number of additional prudential regulations and reporting requirements were announced: loan classification and provisioning,[4] accounting and disclosure of trust accounts, and short-term foreign borrowing and foreign exchange exposures. Limits on connected lending that apply to commercial banks will be extended to merchant banks, and full disclosure will be required of such lending. To reduce large exposures, single borrower and group exposure limits for commercial banks will be reduced over time, with a phased reduction of exposures in excess of these limits. Deposit insurance has been improved through its consolidation in KDIC and the present general protection will be narrowed.[5]

Fiscal support. Public support is being provided through purchases of non-performing loans by KAMCO and recapitalization and depositor protection by KDIC. During late 1997-early 1998, public support consisted of the reinforcement of commercial banks' capital through the subscription by the government of subordinated debt issued by these banks (equivalent to capital injections between 1-2 percent of assets); the assumption of impaired loans from some commercial banks by KAMCO; equity injections amounting to Won 3 trillion to recapitalize Korea First and Seoul Bank; and payments to the depositors of the fourteen merchant banks that were closed through KDIC. Support has since been provided to the five banks involved in the recent P&A transactions through purchases by KAMCO of non-performing loans and a put-back option, and KDIC capital injections. For other banks that merge as part of their

4) Until July, loans more than six months overdue were classified as non-performing. This has been changed so that the threshold is now more than three months overdue.

5) All deposits made until July 31 are fully protected until the year 2000. Under a revised deposit protection law, for deposits made after August 1, 1998, only the principal will be guaranteed until 2000 if the amount exceeds W20 million (both principal and interest will be guaranteed for smaller deposits).

rehabilitation plan, the government is committed to inject sufficient capital to bring these banks' capital adequacy ratio up to at least 10 percent (in the case of mergers between weak banks) and up to levels of sound banks (in the case of mergers between sound and troubled banks). In the case of the agreed merger of Commercial Bank of Korea and Hanil Bank, for instance, 3.7 trillion won of equity will be injected, while KAMCO will purchase 1.26 trillion won worth of non-performing loans. The Government will support stand-alone banks (i.e., those that are not merging as part of their rehabilitation plans) by matching new equity contributions if they raise new capital (under the condition of sufficient operational restructuring efforts).

At the end of September, the government budgeted a total of 64 trillion won or 14 percent of GDP for financial sector restructuring, of which approximately 38 trillion won has already been spent. The 64 trillion won is to cover equity injections, purchases of bad assets from commercial and merchant banks, purchase of subordinated debt from commercial banks, recapitalization of commercial banks and expenditures on depositor insurance for all commercial banks.[6] Fiscal resources are being mobilized largely by means of issuing public bonds (with KAMCO and KDIC as bond issuers). The government will provide a guarantee on these bond issues and will bear interest costs. These interest costs are estimated to be 3.6 trillion won for 1998 and 8 to 9 trillion won for 1999.

Strategy. The strategy for restructuring financial institutions is to provide government support in addition to private recapitalization efforts. The latter have been limited, however, with total domestic private equity raised by commercial banks in 1998 equal to $0.6 billion and foreign capital equal to $0.7 billion. Non-bank financial institutions have attracted another $0.7 billion in foreign capital, but the total raised ($2 billion) is still much less than the total government resources committed - $6 billion. Recapitalization with government resources has led to significant government ownership of financial institutions. Including the two intervened banks (KFB and SB) and Commercial Bank of Korea and

6) Some specialized banks (KDB, KEXIM, IBK and KCGF) will also receive support.

Hanil Bank, the government now controls banks which hold assets amounting to about 1 /3 of total bank assets, or, put differently, banks which assets' size Is equal to about 40% of GDP.[7] This effective nationalization of a substantial part of the banking system raises the question of interim governance. The government will have to assume the responsibilities of ownership, including contracting with experienced senior managers to undertake restructuring, until sales to strategic investors with sufficient capital and expertise to manage banks can be realized. This privatization will be difficult, however, given the lack of domestic, qualified capital, and the reluctance, so far, of foreign investors to provide resources. Deteriorating global conditions has made this task even more difficult. A substantial period of time may thus elapse before re-privatization.

Nevertheless, the importance of foreign know-how to help strengthen Korea's financial sector can not be understated. Korea, as many other East Asian countries, had before this crisis limited the entry by foreign financial institutions. Empirical evidence for Asia - and other countries - suggested then that this slowed the banks' institutional development and led to more costly financial services provisioning. It was then recognized that, going forward, Asian countries could benefit from accelerating the opening up of the financial sector. These benefits are even larger today as there is not only a severe shortage of bank capital, but also an even greater need for the introduction of ·foreign expertise to help in the restructuring of the corporate sector and in enhancing the quality of the financial sector in general. While most East Asian countries have opened up considerably officially, in practice, there are many barriers still to be overcome to make it attractive enough for foreign investors to come in on a large scale.

The strategy for non-bank financial institutions centers on the rationalization of the industry in a market-based manner. In the context of NBFI resolutions, only explicit government-guaranteed liabilities will be covered. In exceptional cases, and in the context of a comprehensive

7) To compare, the largest banks in the US represent only a few percentage points of GDP.

restructuring plan, support may be provided to NBFis if failure of these institutions poses a systemic risk.

N. Corporate financial restructuring

Status. The needed corporate restructuring involves both financial and operational restructuring. Overextended chaebols need to restructure their balance sheets, increase both equity and the maturity profile of their debt to create viable corporations. Reducing debt/equity ratios is also essential to reduce vulnerability to future financial shocks. The longer-term process of real restructuring will need to include improved corporate governance, product line rationalization, increases in productivity, and a fundamental change in corporate strategies and culture, focusing on profitability and liquidity versus aggressive expansion at virtually any cost.

The approach to restructuring has differed for the top 5 chaebols versus the other chaebols, 6 through 64. The top five (Hyundai, Samsung, LG, Daewoo, and SK) are generally considered to currently have a better cash flow position than the other chaebols. They have more access to external financing, particularly through capital markets, and have the ability to sell off some of their foreign assets acquired during their expansion. Some of this better liquidity position derives perhaps from their size-they may be considered too big to fail-and thus raises issues of its own. SMEs, as noted, have been more affected by the credit crunch directly and indirectly through links with chaebols. Separate government programs are adopted for these firms.

Policy actions to date. The immediate focus of restructuring efforts has been on restructuring the "non-Top 5" chaebols. In principle, all methods of financial restructuring are contemplated. In practice, market conditions and deadlines of the reform program may encourage initial emphasis on debt restructuring, including debt/equity conversions. Subsequent emphasis is likely to be on asset sales, foreign investment, and new equity infusions. Among the non-Top 5 chaebol in distress, some owners appear willing to give up control and restructuring efforts have been addressing the issue of cross guarantees. As noted, size, cross-ownership and cross-guarantees are insulating the top 5 chaebol to a larger degree from change. The government is responding with Fair Trade Commission actions against improper intra-chaebol transactions, statutory reductions in cross guarantees, more careful standards for future lending, and pressures for banks to exit from non-viable chaebol affiliates. This process is expected to take some more time. In the mean time, the risk is that cross-guarantees both postpone the reckoning for non-viable affiliates and continue to compromise the financial health of the whole group.

As mentioned above, supportive macroeconomic policies, involving the gradual easing of monetary policy-with due regard to maintaining exchange rate stability-and more expansionary fiscal policy is being pursued. In addition, changes have been underway in accelerating the role of commercial banks in corporate restructuring, including the enabling environment, framework for corporate restructuring, and the role of capital markets.

Recapitalization and restructuring of banks. The government has opted so far for bank-led voluntary corporate debt workouts for the non- top 5 chaebols. Hence the recapitalization and restructuring of banks is a central element in the strategy for corporate financial restructuring. Eight major creditor banks, identified as lead banks, are to take the responsibility for negotiating workouts with the 64 major corporate groups. Each of the banks has formed a workout unit. A series of policy measures are being implemented, which will strengthen incentives for banks and corporates to undertake debt restructuring. These include the following measures. *Curtailing emergency or rescue loans to corporates.* Emergency syndicated loans to troubled debtors, which had the effect of delaying the needed debt restructuring, will be curtailed in the future. Fresh capital will be provided to financially distressed but viable companies only in the context of the workout process, and subject to some guidelines. Only in exceptional cases, corporations not in the process of a workout, but due to be restructured, can be provided new loans for a maximum period of six months. *Tightening prudential limits on large exposures and connected lending by banks.* The government has adopted a schedule for implementing over time tighter prudential limits on connected lending and large exposures by banks, which will place further pressures on them to undertake corporate debt workouts. This is especially relevant for the larger chaebols where exposures are currently above the (future) lending limits. *Reducing cross guarantees*. The FSC is encouraging banks to reduce cross guarantees through the workout process, and is proposing market-based approaches to unwind these guarantees, such as exchanging the guarantees for equity or warrants.

Changes in the enabling environment. An integral element of the strategy for corporate financial restructuring has been changes in the legal and regulatory environment which remove impediments to corporate restructuring, encourage the infusion of new equity into the system and facilitate debt/equity conversions. Thus, the regulations governing foreign ownership in listed stocks has been changed (it now allows 100 percent foreign ownership); the M&A regime has been liberalized (it now also allows hostile takeovers by foreigners); tax incentives, e.g. on asset sales, have been introduced; the real estate market has been opened to foreigners; financial disclosure and reporting has been strengthened; and insolvency procedures have been improved. Changes have also been made to the labor law, which now allows layoffs and measures taken to improve labor market flexibility. This will facilitate the process of restructuring in the real sector, which will not only complement financial restructuring, but is needed to improve the efficiency of corporates over the medium term.

The stock of corporate debt is so large that sustainable debt/equity ratios cannot be achieved over a reasonable time frame only through the flow of new equity, asset sales and retirement of debt. In addition to such flows, stock adjustments in the form of conversion of debt into equity will be necessary. In the first instance, the banking law has been changed to allow banks to hold up to 15 percent of their equity in a corporation (and no more than 100 percent of their equity in total). Since banks can hold· only so much corporate equity however, and may, moreover, be ill-prepared to manage converted equity, equity will need to be unloaded over time. So far, indications are that the supply of equity capital is insufficient to allow an off-loading of equity over a reasonable period of time.

Development of a voluntary framework. The FSC has developed an out-of-court framework for corporate workouts. This framework, within which the banks and non-bank financial institutions and corporates will undertake the workouts, utilizes so-called London Rules, which basically call for extra-judicial resolution of problem debtors. A Corporate Restructuring Accord (CRA) has been signed by some 200 Korean banks and non-bank financial institutions, which commits them to follow the agreed workout procedures. In the event that the financial institutions cannot agree on a workout strategy among themselves or the Lead Bank and the debtor cannot reach agreement, an arbitration committee, the Corporate Restructuring Coordination Committee (CRCC), has been created to resolve these differences. If a CRA signatory fails to comply with an approved workout agreement or the CRCC arbitration decision, the CRCC has the power to impose penalties. The FSC will monitor the workouts agreed under the CRA to ensure consistency with the guidelines issued for the workouts.

Development of capital markets. The development of the capital markets is an important component in the corporate restructuring strategy. Deeper capital markets will help shift corporate finances away from debt and associated risk thus far carried by the banking system. A new regulatory framework, providing greater independence to market institutions is being put in place. The FSC will accord the securities market agencies increased authority to regulate and supervise their members. (The FSC will retain adequate regulatory and supervisory power over these agencies themselves). Prudential rules for securities markets activities are also being strengthened, including standards for risk management, adoption of mark-to-market accounting, and use of credit rating. Improvements in financial disclosure and minority shareholder rights will also support securities market development by enhancing investor confidence.

To develop a more liquid and active bond market the government is putting in the institutional setup to develop a clear, comprehensive funding strategy covering a rolling three year period and including financing of the costs associated with financial sector restructuring. Institutional investors will need to play an important role in the restructuring of government debt and the strengthening of the institutional investor base will be supported thorough changes in the legal and regulatory framework allowing the establishment of mutual funds and other corporate restructuring vehicles.[8] Improvements in the management of pension system reserves, which is also conducive to capital market development, are underway.

Role of KAMCO. A bridge bank has assumed distressed assets from merchant banks and KAMCO has bought non-performing loans from commercial banks (as of the end of September, 37 trillion won of such loans was purchased by KAMCO at a cost of 17.2 trillion won). KAMCO will have to restructure these loans and has a number of tools at its disposal to restructure loans: asset-backed securities; loan portfolio sale; asset sale; and M&A or direct investment. Potentially, KAMCO can be an important actor in the corporate restructuring process.

Support for SMEs. The Government has adopted a special program for SMEs caught in the wake of the financial crisis. Realizing that it could not address both the corporate restructuring needs of the large groups and assess the needs of the SMEs at the same time, the government decided to rollover the debts of the SMEs by extending working capital maturities. It has also put liquidity into the system to finance working capital needs of the SMEs, to discount promissory notes and to provide trade finance for critical imports to be re-exported. The scope of corporate workout programs is also being expanded to include SMEs. Creditor banks have evaluated the financial status of approximately 22,000 SMEs with outstanding loans of 1 billion won or more, and classified about 13,000 of these as viable. These viable SMEs were selected

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8) Corporate restructuring vehicles (CRVs), for example, are expected to play an important role in purchasing and/or managing converted equity. The CRVs, e. g. trusts or mutual funds, might operate by purchasing converted equity from banks, managing converted equity for a fee, or purchasing debt and converting it to equity. Such CRVs would be privately owned and managed. The Government has reviewed the tax and regulatory regime to remove any barriers that may exist to the establishment and operation of such vehicles. It has also undertaken to remove regulatory and tax disincentives to debt/equity conversions more broadly.

as candidate firms for workout programs. A special task force unit within each bank is reviewing the feasibility of rehabilitation plans and will soon devise specific measures and schedules for workout programs.

Corporate governance improvements. As part of the reform program, important changes in the corporate governance framework have been adopted. Transparency and accountability in corporate governance are being facilitated by the following measures: consolidated financial statements will be required from 1999; legal changes are being made so that domestic accounting practices conform to international standards; the representation requirement for class action suits was drastically relaxed from 1% to 0.01% in May;[9] restrictions on institutional investors' voting rights were eliminated in June; and all listed companies are required to appoint outside directors from 1998.

Strategy. The current approach to corporate restructuring can best be described as bank-led, under a "market-based" environment, which is enhanced by an out-of-court process (London rules). At the level of individual corporates, the main function of creditor banks will be to drive the operational restructuring process, reduce the level of debt to appropriate levels, and, if necessary, provide new money for working capital purposes. The government does not plan to intervene directly in the corporate sector restructuring process. All types of restructuring tools are in principle at the banks' disposal.[10] The presumption is that banks will to try to bring in genuine new equity from strategic investors to

9) Recently, a court ruling was handed down in favor of minority shareholders in a suit against the management of the Korea First Bank. The executives were held responsible for lending money in defiance of the shareholders' objections. This unprecedented ruling is expected to open the door for other small shareholders of corporations under financial difficulties to follow suit.

10) While the government has improved the enabling environment for enterprise restructuring, there are still some issues related to the process of restructuring to be resolved, e.g., what is the seniority status of various claims? What are the exact tax and regulatory implications of debt restructuring? How long can banks keep equity on their books? How will this equity be valued? All these questions will have to be resolved, mainly as the restructuring process evolves on a case-by-case basis. There may also be a need for a separate approach for small debtors. These issues are not discussed here.

take over some of the (converted) loans. Some additional sticks and carrots to accelerate corporate restructuring are in place. In particular, the recapitalization of banks will provide a carrot as it allows for debt rescheduling and debt relief. The recapitalization of the banking sector, together with the change in the banking law which now allows banks to hold up to 15% of their equity in a corporation, means that banks can convert loans into equity as part of the restructuring package. The CRA is a stick as it sets processes and deadlines and allows the imposition of penalties. And the revamped bankruptcy code is a stick to encourage voluntary agreements while maintaining payment discipline.

V. Challenges

The Korean government realizes the enormity of the task ahead. Several areas are of particular challenge: the size of the problem; the fiscal resources required; the tight links between bank restructuring and corporate restructuring; and the possibility of the credit crunch.

Size of the problem. The asset size of commercial banks and the entire financial system represented 171% and 344% of GDP, respectively, at the end of 1997. According to official estimates,rn as of the end of June 1998, estimated total non-performing loans of all financial institutions, broadly defined to include loans classified as "precautionary", was 136.0 trillion won, or 21.8% of total outstanding loans, up from 13.3% at the end of 1997 (see Table 2). Due to the tightened loan classification standards effective July 1, 1998, and continued economic decline, a substantial portion of precautionary loans are likely to migrate to the "substandard" category before the end of this year. Furthermore, the quality of some of the precautionary loans may deteriorate over the course of corporate restructuring process. In light of this, the government expects core non-performing loans, i.e., loans more than 3 months overdue, to peak at 100-120 trillion won by the end of this year, or about 25% of GDP. A potential migration of precautionary loans will raise this number further.

11) MOFE, *Korean government's economic reform progress report*, September 1998.

Table 2. Non-performing Loans (end of period)

unit: trillion won

Non-Performing Loans	Dec. 1997	Mar. 1998	June 1998	Dec. 1998(e)
Precautionary	42.8	57.7	72.5	-
Substandard	43.6	59.6	63.5	100-120
Or below (A)				
• Bank	31.6	38.8	40.0	-
• NBFI	12.0	20.8	23.5	-
Total Loan (B)	647.4	668.7	624.8	-
A/B (%)	6.7	8.9	10.2	-
Precautionary and below/Total Loans(%)	13.35	17.54	21.77	

Note: (e) Denotes estimated figures.
Source: MOFE, Korea.

Current private sector estimates already put non-performing loans at higher figures, 30 percent of GDP or more, with some estimates of non-performing loans at 50 percent of GDP or more by the end of the year. Analysis of corporates' financial positions also suggests higher figures. For a sample of large Korean firms, it has been found that, under current exchange and interest rates, total liabilities exceed assets for 40% of corporates, i.e., 40% of firms are technically insolvent.[12] Extrapolating this sample, non-performing bank loans could be 24.8% of GDP, and non-performing assets (including all forms of credit) 64.2% of GDP. The latter is probably a more appropriate measure in case of Korea given the large trust-account activities and the many capital markets instruments which are guaranteed by banks, but which are not captured in the first figure. The large size of the problem raises whether the fiscal resources required can be financed.

Fiscal resources required. The estimates of non-performing loans

12) Claessens, Stijn, Simeon Djankov and Giovanni Ferri, "corporate Distress in East Asia: Assessing the Impact of Interest and Exchange Rates Shocks," mimeo, World Bank, September 1998. They also find that in the post-crisis scenario, 49% of Korean firms are illiquid, that is their interest payments exceed their earnings (before interest and taxes but after depreciation).

suggest that the final fiscal costs will likely be sizably higher than 75 trillion won. At least 125-150 trillion won may be a more realistic assessment, or approximately 30-35 percent of GDP.Bl Assuming that the government would restore bank solvency quickly and finance the costs primarily by the issuance of government bonds, the stock of public debt would jump sharply. This raises the issue whether the stock of public debt would rise to too high levels, and, related, whether the annual financing costs would become unsustainable. From a point of simple public debt/GDP ratio, given Korea's very low initial public debt levels-10.7 percent of GDP In 1997, financial restructuring costs of 35 % of GDP would still result in levels of public debt that are lower than or comparable to other coun tries.[14]

Such higher public debt also appears sustainable. Taking the mid-range of current estimates-ISO trillion won-and using a simple debt sustainability calculation, reasonable medium term growth and real interest rate projections suggest that this initial debt/GDP of 46% can be brought down to about 20 percent of GDP over a decade by running primary surpluses on the order of 4%-5% of GDP. Although Korea has run relatively high primary surpluses in the past, it might not be necessary to run this level of primary surpluses as stabilizing the debt to GDP ratio might suffice. Primary surpluses on the order of only 1.4 percent of GDP, for example, would already stabilize Korea's debt/GDP at 46 percent.[15] Thus, there might not be a great urgency to run large primary surpluses. And, in any case, it needs to be assured that the way

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13) The bulk of the costs arise from the need to restore the net worth of financial institutions. Arguably, the costs of attaining the BIS capital adequacy ratios is an investment on the part of the government that could be recouped in the future through selling of equity stakes and hence is different from the capital injection needed to restore the net worth of institutions.

14) For example, the average (central government) debt/GDP ratios for high-income countries were around 60 percent, while that of OECD was 54 percent in 1995.

15) These calculations assume a medium-term, real growth rate of output of 5 percent of GDP and real interest rates of around 8 percent. While real interest rates have traditionally been relatively high in Korea, so has the rate of growth-which averaged around 7.5 percent per annum during 1990-96. Therefore the calculations above may well overestimate the primary surpluses required.

in which the primary surplus would be generated (by taxes, cut in expenditures, privatization proceeds, etc.) is the most efficient in restoring growth. Indeed, given the current macroeconomic downturn and need for expenditures in the social sector, it might be more appropriate to postpone running significant primary surpluses in the short-term, and achieve the decline in government debt/GDP on a more gradual path. In fact, the decline in the debt/GDP ratio could probably be phased in over an even longer period: if debt/GDP levels were brought down to only 30 percent in the next ten years (requiring average primary surpluses of under 4 percent of GDP), Korea's public debt ratio would still be comparable to that of other many countries at the end of the period.

Links between corporations and the financial system are large. As noted, Korea is following by-and-large a voluntary, bank-led corporate restructuring strategy (with supportive measures to encourage corporate restructuring). This approach to financial and corporate restructuring has benefits. It signals clearly to the market that the financial sector problems are being addressed. Since the government has already guaranteed the liabilities of banks, it formalizes some its responsibility and thus creates clarity. It mitigates, in appearance at least, the direct government involvement in corporate restructuring. And, provided it is accompanied by substantive changes in the corporate governance of and operations of banks, it can amount to an up-front investment that may lead to lower ultimate costs as the moral hazard of bailouts that are repeated may be avoided.

Yet, a bank-led approach has risks given the large exposures of banks, especially for the top 5 chaebols, the tight historical links and the lack of credit culture, and especially the lack of debt restructuring skills and experiences. This raises questions regarding whether banks can be expected to restructure the corporates on their own. Several specific risks can be identified. For one, recapitalization of banks in advance of substantial progress on debt restructuring has risks: many countries have gone through recurrent recapitalizations because the overhang of bad debts was not adequately dealt with and eliminated. Concurrent reforms-covering the governance of banks, the prudential and supervi- sory framework, and the role of markets in disciplining banks-are also necessary. Banks will also need enhanced technical capacity and institutional development to deal with the restructuring of a large number of corporates and a large magnitude of corporate debt. Related, banks will need to enhance their institutional capacity to manage and dispose of equity holdings (if banks end up with large amounts of equity holdings that they can not dispose off quickly, bank portfolios may become unstable and perverse incentives may result). Furthermore, it has been questioned whether banks would be strong enough vis--vis corporates. It has been argued, partly because of "too big to fail" reasons, as well as because of the social and political consequences associated with enterprise restructuring, that banks will not be able to hold their own vis--vis the chaebols. This may result in financial and operational restructuring plans not going far enough and thus a larger ultimate fiscal cost.[16] The risks are that restoration of competitiveness, and thereby economic growth, which depends on the quality of operational and financial restructuring of corporations, will not be attained.

Most notably, it is not clear whether this type of restructuring will achieve a fundamental change in the way corporates are controlled in Korea. The shortage of equity in the system will mean that current shareholders can not be completely diluted, as otherwise the government will own much of the corporate sector. It might also be necessary to retain the current owners as they have important managerial skills. Leaving the current shareholders too much in control of corporations, however, risks a repeat of risky structures and inefficient investments. Going forward, alternatives may be necessary which achieve both good short-term and medium-term outcomes. Certainly the government needs to continue to set the rules of the game, and let corporates, banks and third parties negotiate without direct interference. It is also essential that adequate safeguards are built in, market-based principles are accepted at the political and operational level, the current institutional structure used as much as possible, private involvement maximized, and no new

16) In addition to the banks, **KAMCO** will play a role in corporate restructuring. A beneficial role of KAMCO, a government agency, in corporate restructuring will, however, require an adequate institutional development, and appropriate checks and balances to assure that restructuring is done on market-principles.

mechanisms for financial support to corporates are created. Lastly, it should aim to achieve, over time, a better corporate financing and corporate governance structure.

One proposal to straddle these requirements, which has been put forward is to have corporates "apply" to a process in which they can have their debt restructured provided they undertake the necessary operational restructuring. Corporates can be encouraged to submit themselves to this process by instructing all banks to stop lending to a corporate with debt-servicing problems (defined as arrears on loans or other debt-servicing indicators) or by greatly increasing the provisioning requirements for loans to such corporates. The corporate then needs to provide an operational and financial restructuring plan to a committee of creditor banks, and other independent members. Various consultants and staff would support the committee. The plan should indicate the savings achieved through operational restructuring, asset sell-off, contribution in new equity by the rest of the chaebol group, and the degree of financial restructuring and relief sought and through what modalities. If an acceptable plan can not be agreed, the corporate is due for the standard bankruptcy process (alternatively or complementary, if social considerations are too large and the social safety net not yet sufficiently developed, corporates are referred to a social debt fund which itself is limited and time-bound).

In many ways, this is akin to the current process for corporate restructuring. The key additional feature of this approach would be to introduce to the workouts not just banks and corporations, but directly (new) private investors and a party representing government interests. The government could be represented by a privately managed fund (possibly with private-sector equity interest) and would negotiate as a potential equity investor in the restructured corporation. If the plan were rejected, the firm would be forced into bankruptcy. Financial relief provided by creditor banks would be mainly lengthening maturities and interest relief, and some (limited) debt-equity swaps. Creditor banks might also provide working capital, but only under strict conditions (for example, highly collateralized). The private investor and the government fund would take over some (market-priced) loans from creditor banks and swap these claims for equity. The bank could be compensated for losses on loans, through cash and perhaps a claim on the fund or a government bond.

All this requires participation of the private sector, by putting up capital and being heavily involved in management of the fund. One way to facilitate this would be to make the fund jointly owned (private and public) with private shareholders the ultimate claimholder. This would ensure those private shareholders in the fund, which have to make the final decision on the viability of financial restructuring, face the proper incentives. Public resources would only be provided at the point when all parties-creditor banks, other creditors, new private investors, and the private shareholders in the fund-have reached agreement with the corporation.

This could lead to deeper capital markets. As an equity holder, perhaps the largest one, the fund(s) would have responsibility to ensure that enterprises are properly managed. But the government should not be a permanent corporate owner. It should dispose of its holdings-through sales to strategic or portfolio investors-as quickly as it can at realistic prices. This may be difficult, however, given the limited supply of (domestic and foreign) capital in Korea. Options include making an equity distribution to taxpayers, or transferring the shares to an institution (or institutions) to be held in trust for the public's benefit. Or the public could be encouraged to buy shares on advantageous terms (for example, a small down payment and the balance paid over an extended period). This would lead to deeper capital markets, with attendant benefits in terms of improved corporate governance, better risk diversification, and better price signals.

Credit crunch. Availability of credit has emerged as one of the main issues. As of the second quarter of 1998 the nominal growth of domestic credit to the private sector was only 9 percent year-on-year-as compared to a growth of 21 percent year-on-year in the second quarter of 1997. As in other financial crises, the slowdown in credit is likely attributable to a mixture of supply and demand factors: bank lending capacity, in part affected by deteriorated capital adequacy positions and tighter prudential regulations, may play a role on the supply side, while the drop in aggregate demand (domestic and external), weakened balance sheets of corporations and increased risk (perceptions) may play a role on the demand side. Whether there is a credit crunch, i.e., whether there is excess demand for credit at prevailing lending rates, is unclear.

As noted, Korea has adopted a minimum of 8 percent capital adequacy ratio and tightened provisioning and other prudential requirements. These higher and more rigorous enforced standards could have affected the supply of loanable funds. Analysis based on reported data through May of this year suggests, however, that deposit money banks' capacity to lend remains higher than the volume of domestic credit extended to the private sector. Analyzing deposit money banks' lending capacity in aggregate (i.e., total liabilities, including borrowings from BOK, deposits, etc. minus reserve requirements, cash in vault, paid in capital, capital surplus, earned surplus), would suggest that banks have the capacity to lend. This is not to say, of course, that individual banks may not be constrained in making loans. It is also likely that reported figures underestimate the true capacity of banks to lend. Many banks may realize that their capital adequacy position in reality is much weaker than the figures suggests, and are therefore holding back lending to the private sector in an effort to restore (risk-weighted) capital positions. And, even if currently not the case, bank capacity to lend could become a constraining factor in the future.[17]

The main question is what is constraining the provision of domestic credit. Is it the banks' unwillingness to lend, or is it the lack of demand for credit, reflecting the corporate bankruptcies that have taken place, as well as the much more uncertain economic outlook? Preliminary analysis shows that historically domestic credit to the private sector has often tended to be supply-constrained. Currently, however, it appears that demand for credit, or lack thereof, has become the determining factor in

17) This would depend on several factors including the extent to which there is a change in asset classification that affects capital adequacy measures (i.e., if assets are more risky than presently recognized) and if banks' internal profitability and their ability to mobilize new capital, including through government support) does not let them meet the required increase in capital (for banks that do not meet the capital adequacy ratio).

aggregate.[18] The fact that many of the financing schemes for SMEs that the government has put in place are currently still underutilized, would appear to corroborate these findings. Of course, given the distribution of credit, there may be borrowers with unsatisfied credit demand-i.e., there may be particular borrowers or sectors that currently face a credit crunch. It has been reported, for example, that an increasing share of lending has gone to the largest chaebols, thus skewing the lending. Moreover, the tightening of credit and higher interest rates contributed to corporate sector distress early on, and may therefore have also contributed to lower credit demand.[19] Since SMEs are heavily dependent on bank financing, any credit crunch that occurred in the early stages of the crisis would have disproportionately affected them.[20]

This importance of demand factors reflects in part of course that at current (or any) interest rates, many corporates are not creditworthy or cannot borrow. To a large extent, these high lending rates are reflecting a large risk premium (which in turn is related to the problems in the financial and corporate sector). This suggests that a (further) loosening of credit would not necessarily lead to a larger extension of credit. Put differently, high lending rates are reflecting the financial/ corporate sector problems and general uncertainty in the economy as opposed to tight monetary policy. In addition to progress in financial and corporate sector restructuring, at the macro level, policies that help re-ignite the economy, and thus improve earnings prospects of corporates, might be the best course to bring down risk premiums and hence lending rates.

Other challenges. Asset problems are not just large in banks; many non-bank financial institutions, most notably insurance companies, have significant asset problems. In addition, management and corporate governance in these institutions needs to be improved. While the

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18) Due to data availability, the analysis has been done up through to the first quarter of 1998 (Korea: Credit Crunch or Lack of Demand? Swati Ghosh, World Bank, rnimeo, September 1998).

19) But lower interest rates alone will not restore this loss of corporations' creditworthiness.

20) See "The Real Impact of Financial Shocks: Evidence from Korea" Ilker Domac and Giovanni Ferri, mimeo, World Bank, for evidence that the credit channel is particularly operative for SMEs.

government has committed itself not to provide any resources for the restructuring of non-bank financial institutions,[21] the risk is that some of the problems in the non-bank financial institutions will spill over into the banking system, in part as there are many cross-ownership, financial and other links.

The external financing situation has improved significantly. Foreign exchange reserves have been restored to levels almost equivalent to short-term debt outstanding. A large debt service hump, from claims rescheduled in early 1998 as well as previous claims, exists, however, for 1999. Extending the maturity of such financing will thus remain an important issue.

Social consequences of reform have included a rapid rise in unemployment, now above 8%, up sharply from below 3% pre-crisis. Opposition to restructuring from labor unions has become an important factor in affecting the speed of corporate restructuring. Observers have drawn attention to the serious competitiveness problems in some sectors, notably cars and electronics. The depreciation of the won has alleviated some of this, but global import demand and a possible rise in protectionism in import demand may not allow a rapid export responses. In any case, the operational restructuring process will likely be long and intense and the risk of loss value is great if firms can not maintain sufficient investments in plant and equipment, and acquire the necessary inputs. Accelerated corporate financial and operational restructuring will be necessary to make firms creditworthy again.

There is little disagreement that in the medium, the role of capital markets in financing of corporations will increase. The issue of which model of corporate governance will emerge, and what the role of capital markets will be in the oversight of corporations, is much more unclear. Lastly, the degree of independence and authority supervisors and restructuring agencies and the speed of their institutional development will be important. Clearly Korea has the capacity, with the help of

21) In the context of NBFI resolutions, only explicit government-guaranteed liabilities will be covered. In exceptional cases, and in the context of a comprehensive restructuring plan, support may be provided to NBFis if failure of these institutions poses a systemic risk.

technical assistance, to develop over time a worthy and independent supervisory system, but it will require adequate political support.

VI. Conclusions

Korea has made great strides in its financial sector restructuring and reform. Nevertheless, the challenges facing Korea are large and the process of corporate restructuring has just started in earnest. Large amounts of fiscal resources will be needed to deal with the extensive repair of banks' and corporations' balance sheets. The operational restructuring of corporations will require a long time, and adequate external resources will need to be available. To achieve long-lasting solutions, the process of restructuring will need to be more decentralized so as also to limit the political backlash and develop a larger support base for the reforms. This will require bringing in other agents and investors to assist in financial and corporate sector restructuring. Further foreign direct investment can be beneficial as part of this process.

Comments

Yoon Je Cho
Graduate School of International Studies,
Sogang University

Stijn has been closely involved in the financial restructuring of Korea and actually he has been one of the key advisors to Korean authorities in financial restructuring issues. So, it is not surprising that his paper is accurate in accounting for the most important programs that have been made and laying out the remaining tasks that need to be addressed. However, I have a few points to dispute, though I agree with most of the points he raised and discussed in his paper.

I think there are four or five issues any restructuring of Korea must address. The first step is that of course the authorities must have a rigorous appraisal of the real picture of the status of the financial system and the amount of capital needed. Based on that they should establish clear principles and rules with which they are going to address these problems and develop a specific plan and road map on how they are going to address these problems. I think that is the first step the authorities must do and I believe the government knows this. I think Dr. Choi here from the government will mention about this. On top of that I think there are still many important issues that to be addressed. The first thing I think the government needs to come up with is sufficient resources to deal with this problem. In other words, the government should fill its chest to win the battles. On that regard, Stijn has already outlined the size and the complexity of the problem here and the size of the government commitment that has been put forward so far. I may discuss this later.

The second thing is that when the government comes up with sufficient resources, they should use these resources in such a way that they can induce management restructuring and improvement in efficiency of the financial system, including all the financial institutions; and also make sure that this problem would not be recurrent.

Another thing the government must do is that the government must use its resources to support the banks as I just mentioned and at the same time it should be able to orchestrate the change or the improvement of corporate financial structure or corporate debt structure because in Korea, as Stijn mentioned, the main problem of financial structure here has been caused by corporate insolvency and it is very closely linked. Unless Korea is able to orchestrate a successful corporate debt restructuring, financial restructuring here can not be complete and can not be successful.

The last issue the government has to address, in conjunction with this financial restructuring is that it should be able to induce the changes in financial market structure itself because we can not tell financial sector participants to improve their financial structure unless there is a change in financial *market* structure itself. So, in order to make financial restructuring successful, the government must address all of these areas successfully. Otherwise, there is the risk that financial instability or crisis will recur.

So let me say what has been done and what are the remaining tasks. As I said in the first issue, the government may have to come up with some specific plans and also some principles and rules. Again, I will leave that to Dr. Choi.

On the second issue-whether the government has come up with sufficient resources or funds-I think the government may have only come up with half of the needed amount given the size of the problem. So, if the government believes that they have dosed the gap or closed the hole, I think I would like to say that we will have to expect another round of recapitalization and purchasing of non-performing assets. The second issue is only half done.

The third issue, while the government has recapitalized and purchased an essential amount of non-performing assets by the deadline of September 30, I'm not sure [if it has been done in a way that] can induce the management restructuring and improving of their credit management and internal reorganizing. The government just pumped money without insuring that these things will come in conjunction with bank recapitalization. So, there is risk that the money the government has put in might have been wasted.

The fourth issue is corporate restructuring. I think there have been some good starts but overall, there has been little progress so far. While there are some plans for workout plans at commercial banks, the big five chaebols are outside of this and we still need credible workout plans and viable schemes to solve this problem.

The last issue of financial market structure - we do not have a dear plan to induce significant changes. Considering the huge debt that the corporate sector has, and Stijn has shown you the size of corporate debt and size of banking sector debt, the amount of debt that needs to be converted to equity. The banks can not hold debt for long because of their cash flow problems. The government needs to address this immediately. This requires the substantial development of capital market. But with this sheer size of debts, and that amount of debt which needs to be converted, one or two trillion will not be sufficient and maybe 10 or 20 trillion won will not be sufficient. That means that we have to think how we can transform our capital markets in a very short term. That is a really big challenge that remains.

Having said that, I would say that the Korean financial restructuring process is only just beginning and there is much more that remains to be done. One final point is about the physical size of the problem. We need substantial costs to share the whole burden. Stijn gave an optimistic view about the physical viability. Let me say here I don't think anyone knows clearly how much the outstanding debt really is. There is debt here and there. There are a lot of bonds that have been issued, not by the Ministry of Treasury, but by the corporations, the public enterprises and these are de facto government liabilities. If we take all of this into account, I am not quite sure our financial situation is sound enough to afford these kinds of things. Let me stop here.

Buhmsoo Choi
Financial Supervisory Commission and
Korea Development Institute

If I understood correctly, Dr. Claessens proposed a more aggressive role of the government to escape from this credit crunch situation. Dr. Lieberman also mentioned the same concern that now the banks are too weak to lead a workout process, or the incentives are too weak for the corporations and the banks to restructure deeply. [We are fully aware of this concern] and have to develop some effective schemes. For example, the loans to corporations already under workout programs can be shared by KAMCO and creditor banks so that the risk of the banks can be reduced while the BIS ratio can be increased. I think it needs consultation with the IMF and World Bank since it may be regarded as public money going into the private sector.

After the reduction of the capital and the debt / equity swaps, the creditor banks would become the major shareholder of the firm. Because the major shareholders lose their control, they are very reluctant to agree to the workout. In order to provide some incentives, the chairman and high ranking officers can be re-appointed and can be provided with stock options if they are [considered to be able] to contribute to the prompt recovery of the corporation.

He also emphasized that the size of the problem is the biggest risk. Currently, the Korean government targets the disposal of 118 trillion won, roughly 25% of GDP, mobilizing 64 trillion won, about 14% of the GDP. Many estimates already put non-performing loans at higher figures. Some say its 40% others say other figures, the peak of the non-performing loans depends on when the credit crunch will end. Theoretically, if the peak never ends, then the peak will be 100%. Thus, what we have to decide is not the ceiling of public expenditure but the scheme. In other word, the 64 trillion won is a forecast that was allowed by the National Assembly, but we must decide how the money can be injected into the banks or the non-bank financial institutions to recover their normal management.

The non-performing assets will be purchased from only viable institutions or those financial institutions whose plans have been approved. That was the agreement between the World Bank and the Korean government. And capital will be injected into the merged bank in accordance with the accepted restructuring effort and the government also will help those who have successfully induced foreign capital.

The largest problem is whether the resources can be financed and Dr. Claessens provided a very encouraging analysis based on Korea having pretty low public debt levels. Even though Professor Cho has some different ideas, since we. are in a crisis we have to take some decisive action even though they may seem abnormal.

In 1997 the public debt was slightly more than 10% of GDP, while it may be higher than that, this is the government figure. Even if we double the current plan for public spending, the levels of public debt will be around 40% and lower than other countries and will be sustainable. If we include the public spending or the fiscal deficit occurred in order to stimulate the economy and provide unemployment benefits, altogether it will be about 30% if we double the public spending for the financial restructuring. But the average debt/GDP ratio for the high-income countries is about 60% and that of OECD countries is 55%. The significant portion of the new government debt will be paid off after selling non-performing assets and bank shares restructured by KAMCO and KDIC.

I also want to raise the old parable of the chicken and the egg. Currently, the high lending rates of the banks reflect the high credit risk of corporates that they are facing. I think that the reverse is also true. Because interest rates are so high, corporates can not gain profits. Once interest rates come down, credit risk can be reduced, as most corporates can be profitable.

Since banks have to be profitable to solve their non-performing assets and achieve capitalization, the margin between the lending rates and deposit rates has to be maintained at a certain level. That's why the key is the reduction of deposit rates. Fortunately, nowadays, sound banks have initiated lower deposit rates encouraged by historically low market rates. Then, the weighted average of the deposit rates comes down. The banks can have loans to reduce their lending rates. For example, say the debt/equity ratio is 500%. I think the top 30 chaebol rate might be even higher than that. A one percentage point lower borrowing rate means 5 percentage point higher ROE. That's why if interest rates come down there will be incentives for bond holders to switch to equity. If 1 /5 of bond holders want to shift to equity, the debt/equity ratio will be lowered to 200%, which is the average of advanced countries. That's also why the government wants to lower interest rates - to encourage investment in equities.

The greatest uncertainty is the world economic situation. According to the Deutch Bank analysis, the total amount of loans of emerging market countries that has to be rolled over within one year is about 300 billion US dollars. If the leading banks in the world try to reduce their assets to meet capital adequacy after suffering from their investment in Russia and Latin America, a serious credit crunch situation can happen, globally. But fortunately, the US initiated rolling interest rates and the EU followed and also Japan announced some plan to reverse their economic policy. But I think it will take a while for the world economy to revive and the Korean economy can not recover fully unless the Asian economy, especially the Japanese economy, recovers. Asian economy recovery in turn depends on the world economy. In the mean time I think Korea has to differentiate herself from other crisis-hit countries by pursuing the best restructuring possible to attract foreign capital continuously.

John Dodsworth
International Monetary Fund

I will talk today on the real constraints on financial sector restructuring. I was thinking last night, there are so many of these challenges, but what are the ultimate constraints? And I would like to go along with the paper and what Professor Cho said, is that to get a healthy banking system, you have to have healthy customers. And if you don't follow through on the corporate sector side, anything you do on the financial sector side will not amount to very much. That's the background. I'm not going to talk about corporate sector restructuring, but really if the corporate debt problem is not tackled, then all of the financial sector resources we're putting in is going to be ultimately wasted. Beyond that, however, let's see how the financial sector got into trouble in the first place. And, one, it was bad management and that is something that has to be dealt with and in that area we have a real problem of human resources. There are not enough good bank managers to go around, even if you keep changing bank managers, you know, it's difficult to find the managers that have the experience that can take us through this very difficult time. I don't, however, blame bank managers for all of the problems of the past because many of the problem loans that we see on the books today come from government interference and the government intervention in the banking system was a real problem in the past.

So, I think we have to tackle those two kinds of problems. I was very struck by the paper when it talked about nationalized banks, because in effect, that's what's really happening. All of the big banks have already gone that way. We don't know where that trend will stop. There is the potential for further parts of the banking system to be, quote, nationalized in the near future. I think that brings out more clearly the second problem that I mentioned and that is government interference in the banking system. Because clearly everything else apart, it is easier for the government if it owns the bank (to interfere) than if its a private bank. So, I think in the background of having some nationalized banks we've got to think what are the policies for that. And the first one of course is that we should have a commitment that the government will, as quickly as possible re-privatize those banks. Now, I understand it's very difficult. The market is not good *at* this time. We have *to* wait for good market conditions, but still, there should be a commitment that there will be as quickly as possible a re-privatization of the banks. If they can be re-privatized, and I'm thinking of Korea First and Seoul Bank, and bring in foreign management, then I think it tackles two of the problems at the same time. You know, we're hoping that Korea First and Seoul Bank will send a very good signal in terms of financial sector restructuring.

The second part is how do you have the government out of the day to day management of the banks. How do we ensure that the banks are run on a fully commercial basis? I think that while we are waiting for the re-privatization, it's important to take up some safeguards and various options are being considered at the moment-nothing is definite-but I think it's very important how the CEO of the bank is [appointed] is very important. We have to also see how the non-executive directors are appointed. And we have to at the same time, see how we can in some way enhance the human management of the banks. The critical element in the strengthening of the banks is the supervisors, the supervisory environment. I think we made a lot of progress in moving the regulations, the prudential regulations towards more international standards. You can't do that all of a sudden. You can't just walk into the country and say you have to follow international standards. You have to do it gradually. But I think very good progress has been made in that respect. What you need for a good supervision system is a very credible supervisor. And here I would say the most important aspect is that the supervisor, the supervisory agent, is independent. There has been a lot of progress made making FSC in Korea an independent organization and free from political pressure. But I would say that there are still some overlapping responsibilities that need to be clarified between different government agencies and there are parts of the financial system where the situation is not so clear. I would mention the Development bank as being one area of particular importance.

Let me say something about the issue of public funds and the issue of using public funds. I think it is important to have a realistic estimate of how much the government is likely to spend. But I tend to think that this is a very unknowable figure. I don't know how anyone can actually estimate it at this point in time. Part of the problem is even if you look at the current situation it's difficult because of classification problems. If we're looking ahead, then what we're going to see is that over the next two years we're going to have stricter prudential regulations. That will mean some migration of loans to worse categories. Also, as previous speakers have mentioned, it depends on how long the crisis goes on for. How long and how severe that crisis is and we've also got to take account of the ongoing restructuring going on in the corporate sector-how fast is that going to go? All of these factors point to the fact that the asset quality in the banks is likely to deteriorate over the next few years. And that should be something we have as a working assumption in moving forward with the financial sector reforms.

So, given that, how do we minimize the amount of government money? Actually, I'd like to say how can we minimize the taxpayer's money in fixing this problem. The first thing is to have very strict conditionality. And I think that is something which will prevent a moral hazard situation. We want to fix the problems of the past. We don't want to fix the problems of the future. We don't want to give the signal to the banks if you run into trouble then immediately you will be recapitalized or someone will come along and buy out your NPL. Secondly, I think that it's essential to with the corporate restructuring because the longer you leave the problem, the larger the problem is going to be. And thirdly, I think we have to be very discriminating in the kind of institutions where the public funds are placed. Now there is a temptation to try to fix everything. Now where you've got a deposit guarantee it may be that your cost-benefit analysis tells you that yes its better to go and fix it with public funds. Where there is no deposit guarantee or the institution is not of systemic importance, well, it may be cheaper, on the cost/benefit analysis to let that institution go. And I think very difficult decisions like that are lying ahead, over the next few years as we go through this financial sector restructuring. Thank you.

Richard Samuelson
SBC Warbourg

Let me just focus on an area where, as a member of an investment bank, we were particularly involved. And that is the whole issue of transactions. We are frankly dismayed by the pricing and the terms and conditions associated with some of the most high-profile transactions that have been presented to the investment community throughout this year beginning with the Kia auction.

One problem with the Kia auction is that the public debate never seemed to even entertain the possibility of shutting down the company. In other words, it was the way the whole auction was framed and the discussions leading up to that auction was framed was in terms of this being a viable enterprise, that Korea could survive with effectively three car companies, possibly four and the notion of simply shutting this entity down for the sake of the others, never seemed to us was seriously entertained. That, to our way of thinking is problematic because it implies that there is something of a hidden agenda in terms of sustaining this operation-mainly that of maintaining full employment.

To give you the fair facts, capacity utilization for the auto sector here now is around 50% and falling. There's no prospect over the next 2 years, probably the next 3 years of that level increasingly substantially. What that suggests is the final result of having Hyundai ownership of Kia, if indeed it's approved, really doesn't offer a solution to the problem. You're still going to have enormous over-capacity. You're still going to have very unprofitable enterprises. And you're still not going to achieve much apart from the debt forgiveness, the initial debt forgiveness, much reduction in the outstanding debt through internally generated cash flow. Therefore, that raises the question of whether the full scope of the options available is being discussed by the government and from a policy perspective whether we've hit upon an ideal solution. That's just one instance.

Another instance concerns the privatization. As many of you are aware the Korea Telecom privatization has been put off yet again. The third major time in so many years and invariably the reason cited is market conditions. Of course market conditions last time are better than they are now, when they were put off last year. There seems to be a perception, broadly held in both the public and private sector, that participation, whether it be through portfolio investment or through direct investment, participation in the Korean market is some sort of privilege and therefore a certain price needs to be extracted for that. And in the case of Korea Telecom, the price that was demanded, if you will, was well in excess of what the market would bear. Hence, the deal was put off. The same will probably happen with the two sales of Seoul Bank and Korea First bank. I don't want to predict the future, but my guess is the attitude of the government will be that these banks are probably worth more than international investors are willing to pay.

The reality is that Korea is in competition for scarce resources called capital, called international capital, called international expertise with many of the countries around the world, that investors who enter this market don't see it as a privilege. They perceive it as an opportunity to either make a return or not make a return and they will price that opportunity accordingly. So in that case, to take a little bit on what John mentioned a little bit earlier, there may be scope in this bank sale for turning the whole argument on its head. Namely that the benefits that Korea would receive by having a benchmark serious foreign player participating as quickly as possible. And when I say benchmark, I mean setting the kind of standards for credit analysis and lending that would force the rest of the banking community to measure up as it were. The benefits of that alone might be worth simply giving the bank away or even paying someone to take it.

I'm being deliberately radical here, but that point of view should very much be an active part of the discussion. It should not be viewed as a privilege to enter the banking community here. The banking community here, the banking function, the banking standards, the whole tenor of the business here is grossly unsatisfactory. It doesn't seem to me that out of that scenario - the government re-capitalizing, again with taxpayer funds, most of the banking system and then re-privatizing it at some later date, with who is going to buy this, of course, still obscure - a more professional and more adequate banking system is going to emerge automatically. I'm not suggesting that some of the prudential regulations that are going to change won't help at the margins, but it seems to me that the quickest way to force improved lending standards, improved credit analysis on the Korean banking system, is to bring in a foreign player, push the local competition to the wall, because that foreign player would earn a greater profit, would attract more deposits away from existing banks and so on and so forth. So the quickest way to push these reforms through would be to push the competition. So I would just put that out as an option, arguably a radical option, but an option that's worth considering.

I would say on the whole that investment bankers like ourselves are a bit disappointed with the history of proposed transactions because in the examples I've cited, we don't see a pattern emerging, of deals being facilitated, transactions being facilitated for the sake of what one might call a greater good in the future.

II

Corporate Restructuring

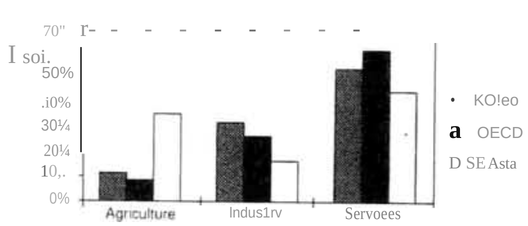
Korea's Corporate Crisis
Its Origins and a Strategy for Financial Restructuring

Ira W. Lieberman and William Mako
Private Sector Development Department, The World Bank

Ⅰ. Background

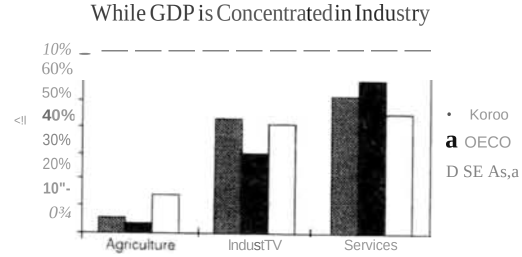
The current economic crisis in Korea is fundamentally a corporate crisis. Although triggered by contagion and currency speculation, it is in large part based on excessive debt amongst the major corporate groups known as chaebols. The fact that the crisis is industry-centered places Korea in especially deep distress; the Korean economy is more concentrated in industry than either its OECD counterparts or other crisis-hit Asian countries. Industry composes 42.9% of Korean GDP, compared with approximately 30% for the OECD as a whole; hence, corporate failures will have a relatively large impact on Korean national output. Furthermore, corporate layoffs as a result of bankruptcy or restructuring will affect a large proportion of the work force, as Korea lacks the cushion against unemployment provided by the large agricultural sector of SE Asia and the service sector of the OECD.

Corporate Distress Affects Large Proportion of Korean Workforce



So urce: OECD. ADB. World Development Indicato rs

While GDP is Concentrated in Industry



Source: OECD. World Development Indicators

Chaebol dominate the structure of the entir.e Korean economy. At the highest level are the "Top 5"--Hyundai, Samstihg, Daewoo, SK and

LG. These groups are both qualitatively and quantitatively distinct from the other "6-64" chaebol identified by the Financial Supervisory Commission. They command huge asset bases, are highly diversified conglomerates, and wield tremendous political clout. Furthermore, the Top 5 enjoy clear advantages in terms of experience, sophistication, and access to global markets.

The 6-64 also operate diverse lines of business, but on a much smaller scale and usually outside of strategic industries like semiconductors, heavy engineering industries, automotive assembly, and petrochemicals. Finally, medium size enterprises often operate as satellites of the major groups, dependent on them for business.

Over the last several decades, chaebol have expanded both in Korea and internationally through a very aggressive use of leveraging. They borrowed (often short term) from major Korean commercial banks, and more recently from merchant banks, to finance fixed or long-term investments. The Government (GOK) traditionally supported this expansion and often directed the chaebols into specific lines of business such as shipbuilding, petrochemicals, automobiles, and most recently semiconductors. Government licensing was used to control entry into new sectors; if the major groups adhered to government guidance, bank financing was assured. Hence, although most of the major subsidiaries of the largest groups are publicly listed, the Korean stock market is thinly capitalized, and chaebol have traditionally raised little new equity, either in Korea or abroad.

This policy of aggressive leveraged expansion worked well as long as the Korean economy expanded vigorously, and as long as the returns on new investments exceeded their cost of capital. Along with upside advantages, however, leverage entails considerable downside risks. At the onset of the economic crisis in 1997 and the upward spike in interest rates, five major groups--with a combined work force of 107,000 employees and Won 26.7 trillion in assets--quickly failed, unable to pay their debts. Unexpectedly, and without precedent, very large groups such as Kia, Halla, and Jinro were allowed to fail. Furthermore, in 1997 more than half of the 30 largest chaebol (with combined employment of 255,000 and liabilities of Won 103.4 trillion), were at risk of falling into bankruptcy;[22] many of these chaebol are currently in the workout process.

Thus there is an urgent need for corporate restructuring--especially by the chaebols--to prevent productive assets from sliding into bankruptcy and liquidation, and to minimize the social effects of this painful process. The restructuring of chaebols' balance sheets--increasing their equity and cash flows, and extending the maturity profile of their debt--is of highest priority. This initial step of financial restructuring is closely klinked to bank restructuring and recapitalization. Without resolving the problem loans due to the banks from the major corporations, bank restructuring will ultimately fail and recapitalization will need to be repeated. Financial restructuring is not the end, however. A longer-term process of restructuring needs to occur, including improved corporate governance, product line rationalization, increases in productivity; and a fundamental change in corporate strategies and corporate culture which focuses on profitability and liquidity rather than aggressive expansion at virtually any cost.[23] Without *both* financial and operations-level restructuring, Korea will remain vulnerable to systemic crises.

Ⅱ. Financial Situation of the Chaebol

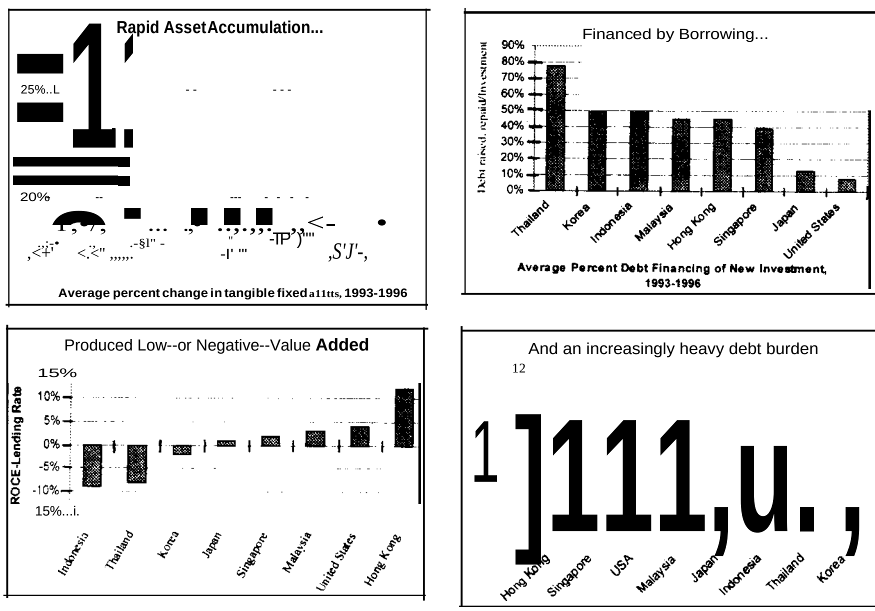
The firm-level conditions responsible for the Korean corporate debt crisis were present by the early 1990s; even before the East Asian financial crisis materialized, seven chaebol were experiencing heavy financial pressure and in January 1997 Hanbo petitioned for bankruptcy. The general problem of the 1990s was that chaebols' high investment and low profitability rates required heavy external financing, which took the form of bank debt. Although rapid investment drove output and sales growth, it did not create returns high enough to cover the cost of capital. Korea was not unique in these respects--the charts in Box 1 illustrate the rapid increase in fixed assets across East Asia; the reliance on debt

22) SBC Warburg Dillon Read, "Korea Market Strategy: The Scope for Survival," January 1998.

23) McKinsey & Company, "Productivity-led Growth for Korea," McKinsey Global Institute, Seoul, March 1998. Hen & Hamilton, 'Vision Korea," Seoul, October 1997.

financing to pay for these assets; and the frequently negative value-added of these investments, as measured by the return on capital employed minus the lending interest rate.[24] In the years leading up to the crisis, companies took on debts which they were increasingly hard-pressed to service, despite favorable macroeconomic conditions.

Box 1



Even within the context of East Asia, however, the degree of leverage in Korea is outstanding. The banks essentially allocated credit to the large corporations, relying on real collateral, a very complex system of cross guarantees from the various subsidiaries and affiliates of the group, and personal guarantees from the group chairman and directors, for repayment. Banks paid relatively little attention to the earnings performance and cash flow generation of their borrowers--that is, their ability to repay the loans. In an environment of low return on assets, declining sales growth, excess capacity, and stiff price competition, leverage continued to grow; measured as total debt divided by common equity, average corporate leverage in Korea rose from 246% in 1989 to 354% in 1996.[25] Factors contributing to this extraordinary level of debt

24) Michael Pomerleano, "The East Asia Crisis and Corporate Finances: The Untold Micro Story," August 6, 1998 draft.

include moral hazard (the assumption that the government would mitigate losses in times of trouble), cross-guarantees among chaebol affiliates, and dominance of chaebol over banks, which skewed the latter's credit allocation.[26] Thus, prior to mid-1997, corporate financial performance was fragile at best, and chaebol were especially vulnerable to cyclical downturns and changes in debt servicing costs. The sharp rise in interest rates used to defend the won served as a death knell for chaebols already on the brink-according to some analysts, the combination of interest rate and currency shocks left up to 49% of Korean firms illiquid and 40% technically insolvent.[27]

Table 1. Chaebol Financial Performance

Rank by asset size	% total employ-ees	% total assets	Net income (W billion)		Total Liabilities/ Equity (%)		Avg. Profit margin (%)		Avg. Interest coverage (times)	
	1997	1997	1996	1997	1996	1997	1996	1997	1996	1997
1-5	37.7	48.0	310	-1460	547.5	867.8	3.7	2.1	1.36	1.16
6-30	17.8	21.5	-497	-1839	388.2	653.9	3.7	-0.2	1.28	0.90
31-66	7.2	6.6	-66	-449	886.9	36.8	2.7	2.4	1.12	1.07
Not in 1-66	37.8	23.9	919	-2396	416.8	818.8	4.0	0.9	2.63	1.96
Workout*	2.7	4.3	-36	-384	1522	-395	5.6	3.1	1.17	0.93

* Employment data includes 42 out of the 58 companies currently under workout; financial data includes 37 companies. Totals are for all listed and registered companies in Korea that reported employment/financial data for 1995-1997.

The above table illustrates the importance of the largest chaebol in terms of employment and asset size, as well as the economy-wide

25) Stijn Claessens, Simeon Djankov, and Larry Lang, "East Asian Corporates: Growth, Financing and Risks over the Last Decade," World Bank, September 24, 1998, 19.

26) D. M. Leipziger, "Public and Private Interests in Korea: Views on Moral Hazard and Crisis Resolution," EDI Discussion Paper, July 28, 1998 draft.

27) Stijn Claessens, Simeon Djankov, and Giovanni Ferri, "Corporate Distress in East Asia: Assessing the Impact of Interest and Exchange Rate Shocks," World Bank, September 30, 1998 draft, 6-7.

deterioration in corporate financial performance. While the crisis seriously affected all groups, the 6-30 group was particularly vulnerable to its ravages, and is in particular need of financial restructuring. This data supports the workout process' initial emphasis on mid-size chaebol.

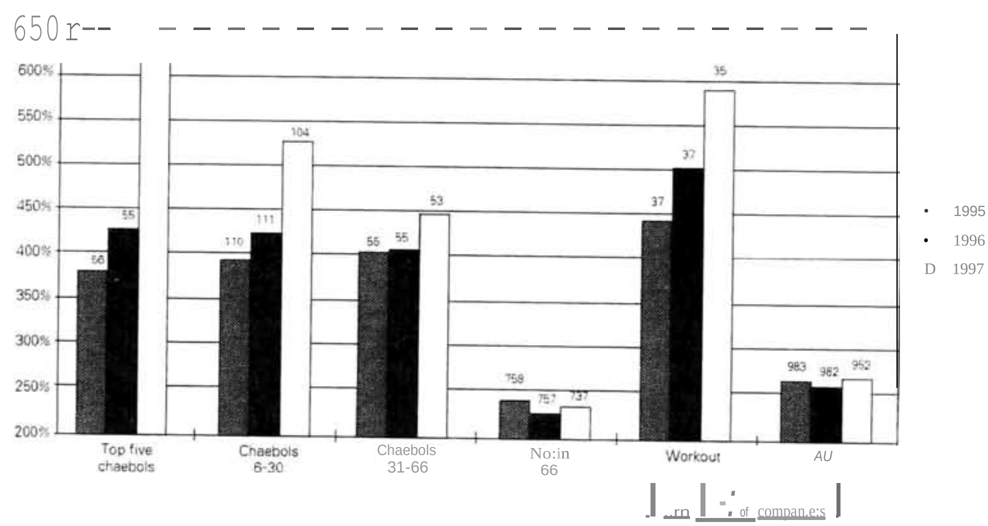
The total liabilities/ equity column in Table 1 accentuates a major problem in averaging financial ratios across chaebol. Although this average is commonly used in reference to chaebol, and is used in this paper for the sake of continuity, companies with small or negative equity can skew the average so much as to make it meaningless. Also, the distribution for liabilities/ equity is likely to have substantial outliers. This is what happened in the cases of chaebol 31-66 and the workout companies. Perversely, when the average is computed only for "healthy" companies with positive equity (Table 2), it appears worse than when "unhealthy" companies were included.

Table 2. Liability/Equity Measures

Rank by asset size	TL/E (%)		TL/E for positive E (%)		TL/TL+E (%)	
	1996	1997	1996	1997	1996	1997
1-5	547.5	867.8	643.5	1016.9	80.7	85.6
6-30	388.2	653.9	619.9	1244.6	79.1	83.7
31-66	886.9	36.8	1028.5	963.7	82.6	86.1
Not in 1-66	416.8	818.8	403.8	1033.9	70.5	72.6
Workout	1522	-395	479.2	1051.8	81.8	84.0

A more meaningful way to aggregate liability/ equity ratios is to average total liabilities/total liabilities + equity. Because this ratio is bounded-between O and 100 for companies with positive equity, and slightly higher for companies with negative equity-it eliminates the problem of large outliers and produces more meaningful results. One can also use only companies with positive equity and look at the median of the distribution, because· the median is more robust to outliers than is the average. These results again show the larger chaebol-those with the most access to both foreign and domestic credit-to be in the most trouble. It is important to remember, however, that although according

Medians of the Llabillties-to-Eaultv Distribution
(basedon companieswithdata for 1995-1997 and positive eauitv, excludini:t the two chaebols In default from the top 66)



to this measure the Top 5 are the most leveraged group, their continued access to credit puts them in less distress than the smaller chaebol.

*Chaebol and the **Banks***

Despite this grim financial performance, in 1997 bank lending to the thirty largest chaebol increased by over Won 33 trillion -- or 43 percent. Table 3 highlights a sample of these loans, which went to both large and small chaebol. About 30 percent of this lending increase went to chaebol categorized by SBC Warburg as posing medium or high financial risk based on 1996 financial performance and position. Year-end total liabilities/ equity ratios for the 30 largest chaebol (excluding financial affiliates) increased from 363 percent for 1996 to 519 percent for 1997. With the inclusion of financial affiliates, total liabilities/equity ratios for the 30 averaged 604 percent at year-end 1997.

The Top 5 chaebo ls are crowding out bank credit for other groups; they absorbed 70% of new bank loans in 1997. This crowding out has continued during 1998, but instead of borrowing from the commercial banks, the largest chaebol are using the bond market to raise substantial

Table 3. **Increases in Bank Debt**

Group	YE 1997 bank debt, (W billion)	% Change in Bank Debt, 96-97	Major Creditor Bank
Hyundai	19,026	60%	Korea Exchange Bank
Daewoo	15,105	59%	Korea First Bank
Hanjin	5,509	43%	Hanil Bank
Hanwha	3,923	28%	Hanil Bank
Lotte	1,060	28%	Com. Bank of Korea
Kumho	2,598	41%	Chohung Bank
Doosan	2,003	29%	Com. Bank of Korea
Dong-ah	1,889	41%	Com. Bank of Korea
Kohap	2,422	65%	Hanil Bank
Dongbu	828	26%	Seoul Bank

amounts of domestic debt. The Top 5 issued 78% of all new corporate bonds in the first seven months of 1998, compared to 40% for the same period in 1997. [28] (See Annex 1 for details) Their continued access to financing reduces their incentive to reform and does nothing to improve their financial situation, while curtailing credit opportunities for smaller groups that are actively trying to restructure.

A partial explanation for these high-risk loans is that individual Korean banks made a substantial percentage of their loans to specific chaebols. This created an incentive for banks to prop up ,groups with fresh loans rather than let them--and with them the banks--collapse. This situation, in which banks are de facto quasi-equity holders in corporates, highlights the necessity of simultaneous corporate and financial sector restructuring in Korea--one cannot succeed without the other.

The role of government intervention and moral hazard in bank lending is highlighted by the bankruptcy avoidance loans made by commercial banks, at the Government's direction, at the onset of the crisis. These loans to distressed corporates continued to be made into 1998, and now total at least Won 2.5 trillion. As shown in Table 4, some

28) Hunt Kim, "Recovery May Still Be Far Off for South Korea's Economy," September 3, 1998.

of the groups rece1vmg bankruptcy avoidance loans have such high indebtedness that their ability to avoid court-supervised restructuring or bankruptcy was questionable. Indeed, all of the Won2.4 trillion bankruptcy avoidance loans represented in Table 4 went to chaebol that subsequently entered court-supervised insolvency or voluntary workout programs. The lessons are that emergency lending should only be to viable corporates (or in support of efforts to assess viability), limited in scope, and integrated as part of a court-supervised insolvency or formal voluntary workout.

Table 4. Bankruptcy Avoidance Loans to Large Industrial Groups

Group	Profit Margin 1996	Debt/Equity YE1997	Emergency. Loans, Won billion.	Date
Haitai	1.3%	1501%	130	14-Oct-97
New Core	1.0%	1786%	55	20-Oct-97
Jindo	-10.5%	3075%*	106	19-Nov-97
Shinho	-0.5%	661%	80	27-Nov-97
Hanwha	-1.9%	1008%	300	17-Dec-97
Hanil	-9.6%	577%*	50	31-Dec-97
Dong-ah Construction		585%	220	10-Jan-98
Dong-ah Construction		585%	120	-98
Kohap	1.2%	469%	300	30-Jan-98
Hanwha	-1.9%	1008%	442	10-Feb-98
Woobang Construction		na	110	3-Mar-98
Dong-ah Construction		585%	600	21-May-98
Total			2,513	

Source: SBCWDR; Korea Herald, *1996

Cross *Guarantees*

The common practice of chaebols' leading affiliates of cross-guaranteeing the bank debt of other affiliates has exacerbated the precarious financial position of many chaebol. It appears that a profit-making cash-surplus chaebol affiliate cannot jettison a highly-leveraged loss-making affiliate for which cross-guarantees have been extended without throwing the cross-guarantor into insolvency. Thus, cross guarantees can drive an entire chaebol into insolvency, as has happened with Kia, New Core, Jinro, Haitai, and Halla.

While there seems to be no relation between the use of cross guarantees and a chaebol's leverage or profitability, it does appear that cross-guarantees generally cover higher percentages of liabilities within smaller chaebol. For the 30 as a whole, only about 12 percent of liabilities are covered by cross guarantees.

While leverage for Halla, Jinro, and New Core were extreme, it is noteworthy that debt/equity ratios and guarantee/liability ratios for Haitai and Kia were about average for the 30 chaebol as a group. The implication is that with such high leverage, the combination of a cash-flow disruption and cross-guarantees could easily drive an entire chaebol into bankruptcy. The descent of profitable Kia Motors into receivership -- dragged down by its bus-making, steel, and construction affiliates -- illustrates this point (see Box 2).

Box 2: Kia Group: The Good, the Bad, and the Ugly

Affiliate	Sales(Wonbn)	Net Profit/Loss (Won bn)	Debt/Equity
Kia Motors	6,607	7	427%
Asia Motors	1,679	-29	512%
Kia Intertrade	880	1	-3465%
Kisan Construction	703	-7	729%
Kia Heavy	508	1	943%
Kia Motors Service	420	1	290%
Kia Steel	321	-90	2762%
Kia Precision	292	1	216%
Works			
Total	**12,091**	**-119**	524%

Source: SBCWDR

As long as cross guarantees exist, chaebol may feel compelled to continue subsidizing cash-deficit affiliates--which may be non-viable and candidates for liquidation--in order to avoid chaebol-wide insolvency. Thus, the continued existence of cross guarantees may serve to (1) postpone reckoning for non-viable affiliates; (2) increase future non-performing loans; and (3) dissipate value of public shareholdings in cash-surplus affiliates. It also appears that the existence of cross guarantees significantly complicates due diligence by potential investors, because they represent off-balance sheet or contingent liabilities which need to be part of the valuation process in any merger or acquisition.

Corporate Restructuring and Debt-Equity Conversions

Given the immediate crisis of liquidity and debt service, financial restructuring is the first step in corporate restructuring. Chaebol must increase cash flow and lower their debt service requirements in order to preserve the value of viable business lines. Restructuring plans announced by chaebol typically feature sales of subsidiaries and joint venture stakes, both overseas and in Korea; sales of real estate and other assets; and

Table 5. Summary of Restructuring Plans for 5 Largest Chaebol

Group	Target(W billion)	Methods
Hyundai	9,640	Sale of home and overseas subsidiaries; joint ventures; overseas security offer-ings; personal equity injections.
Samsung	6,000	Joint venture investments; sale of sub-sidiaries; asset sales; new equity issues.
LG	20,800	Joint ventures; asset sales; sale of domestic subsidiaries.
Daewoo	8,400+	Foreign investment; sales of domestic subsidiaries.
Sk	2,400	Sale of subsidiaries; joint ventures.
Total	47,240+	

Source: Korea Times. Korea Herald

new equity issues. The initial capital adequacy plans submitted by the five largest chaebol to their Lead Banks (at the request of the Blue House) anticipate that they would raise over Won 47 trillion through such measures, as summarized in Table 5. The plans are overly optimistic, however, regarding the level of funds that can be raised in the present depressed asset and equity markets.

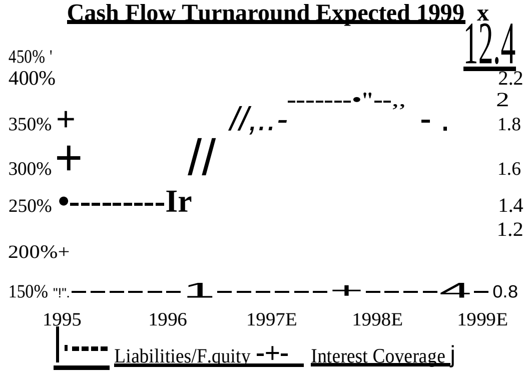
The other chaebol and medium-size companies are also trying to raise substantial cash through asset sales and foreign direct investment, particularly in an effort to reduce their debt/equity ratios. A Blue House mandate requires chaebols to reduce their total liabilities/ equity ratios from an average of 519% for the 30 largest chaebol (excluding financial affiliates) to 200 percent or less by the year 2000. Achieving this goal appears very problematic in light of the restructuring plans submitted by the chaebols. Furthermore, 200% is not necessarily a sufficient reduction in leverage, given the cyclicality of businesses like ship-building, autos, electronics, oil refining, cement, and paper. Yet the scale of the attempt raises an obvious question -- how much cash can chaebol realistically expect to raise through subsidiary and asset sales, joint ventures, and new equity issues?

Analyses by Dredsner Kleinwort Benson, SBC Warburg Dillon Read, and others answer clearly--in the near term, not enough. Asset and equity values are depressed and sales are slow. Foreigner investors are wary over issues like potential labor unrest, government interference, and negative net asset values. As Ford CEO Jack Nasser said regarding the auction of Kia Motors Corp., "I don't particularly want to swap cash for debt."[29]

Thus, despite a drastic 40% reduction in capital expenditures, Dredsner KB expects free cash flow to remain negative in 1998, turning positive only in 1999 for the 15 largest non-financial sectors. Similarly, it expects interest cover to fall below 1 in 1998--largely due to a 41% increase in interest expense--before rising to 1.42 in 1999. Given these projections, the scenario of chaebol quickly paying down their debt is

29) "Creditors invite five carmakers for third .Kia Motors auction," Agence France-Presse, September 29, 1998.

Cash Flow Turnaround Expected 1999



Source: Dredsner KB

unlikely to materialize on a significant scale.

Table 6 presents a brief assessment of the options for reducing chaebol total liabilities/ equity ratios from 604%[30] to 200% over a two- year period, emphasizing the inadequacy of conventional responses to deleveraging. If anything, these projections are on the optimistic end of likely actual outcomes.

Court-supervision. The analysis assumes that 7 of 1997's 30 largest chaebol, including four already under court supervision, will have entered court-supervised composition, reorganization, or liquidation by year-end 1999. These seven cumulatively showed 1997 year-end liabilities and equity of Won 48,647 billion and Won 1,947 billion, respectively, for a combined D/E ratio of 2499 percent. For simplicity, these chaebol are removed from this analysis and designated for separate treatment.

Foreign investment and asset sales. This analysis assumes that 1998-9 foreign investment and asset sales will total $10 billion (i.e., Won 1.2 trn), and that all proceeds will be used to retire debt. In practice, it appears that chaebol are using some of the proceeds from asset sales to finance their working capital requirements. Furthermore, negotiations with foreign buyers are progressing more slowly than initially expected, stalled over issues like debt write-offs, large bid-ask spreads, and concerns about government interference and labor issues.

Normal retained earnings. The top 30 chaebol have not been particularly profitable, earning only Won 608 billion profit on revenues

30) Analysis includes chaebol financial affiliates.

Table 6. Options for 1997-99 Improvement in D/E Ratios of 30 Largest Chaebol

unit: billion won

	Debt	Equity	*DIE* Ratio	Item
Balance at 31.12.97	456,308	75,592	604o/c	
Conventional Responses:				
	(48,647)	(1,947)		Court-supervised reorganization or bankruptcy of selected groups
	(12,000)			Foreign investment/ asset sales
		1,200		Normal increase in retained earnings
		2,500		Increase in retained earnings from restructuring
	(8,250)	8,250		Domestic equity issues
	(5,250)	5,250		Offshore equity issues
Subtotal	382,161	90,845	421o/c	
Unconventional Responses:				
	-	-		Asset revaluation
	(16,031)	16,031		Debt/ equity conversion by banks (to *lSo/c* of equity)
Subtotal	366,130	106,876	343o/c	
Other	(76,190)	38,095		Additional loan write-offs and debt/equity swaps
Balance at 31.12.99	289,940	144,971	200%	

of Won 356,165 billion in 1996. This analysis assumes Won 600 billion as "normal" annual profit and adds this amount to retained earnings for both 1998 and 1999.

Increase in retained earnings from restructuring. Based on financial performance for 1996, this analysis assumes that the thirty largest chaebol could increase retained earnings about Won 1.25 trillion a year by exiting loss-making businesses, by selling or otherwise shutting down these operations.[31]

31) Cumulative 1996 losses amounted to Won 1,112 trillion for the following:

Domestic equity financing. Domestic equity financing (i.e., new listings, rights issues, and convertible bonds less dividends paid) have averaged about 5 percent of market capitalization for the period 1989 through 1996. New equity issues substantially in excess of this run the risk of depressing the market. This analysis assumes that this 5 percent average will continue to hold; that market capitalization will increase to Won 100 trillion for 1998 and Won 120 trillion for 1999; that chaebol affiliates will absorb 75 percent of new equity financing (with the remainder going to financial institutions and non-chaebol corporates); and that all equity proceeds will be used to retire debt.

Offshore equity issues. SBCWDR suggests that Korean companies could annually raise another Won 3.5 trillion in offshore equity issues. This analysis assumes that 75 percent would go to chaebol affiliates for the retirement of debt.

These measures reduce liabilities to Won 382,161 billion and raise equity to Won 90,845 billion, for a cumulative *DIE* ratio of 421 percent. The implication is that substantial financial restructuring assistance will be necessary to achieve *DIE* of 200 percent.

Asset revaluation. In the past, chaebol have revalued fixed assets upward to reflect inflation, and added the increment to equity. Since asset prices in Korea are probably deflating, this is not now a credible option; in fact, if assets such as real estate were marked to market, equity would need to be reduced. Furthermore, asset revaluation is a bookkeeping measure that provides corporates with no new cash. Asset revaluation appears, however, to be the primary source of leverage ratio improvement in 1998; one third of all listed companies on the Korea Stock Exchange revalued their assets this year, for a total change in book value of W46.67 trillion.[32]

Samsung Heavy, Westin Chosin, Hyundai Securities, LG Securities, Sunkyong Securities, Ssangyong Motors (50%), Ssangyong Securities, Hanwha Energy Plaza, Kyongyang Paper, Hanwha Chemical, Hanwha Securities, Dong-ah Securities, Halla group, Oriental Brewery, Asiana Airlines, Seoul Securities, Dongbu Securities, Tongyang Securities, Haitai group, Jinro group, New Core group, and Anam group.

32) SBC Warburg Market Strategy Draft, September 1998.

Debt/equity conversion by banks. Given their preference for interest income, inexperience in equity management, and concerns about meeting capital adequacy requirements, banks are reluctant to exchange debt for equity. Debt/equity conversion is an option, however, and Korean law was recently amended to allow banks to hold up to 15 percent of the equity in a corporation. This analysis assumes that chaebol affiliates would issue new equity in exchange for about Won 16 trillion in debt and that banks would end up owning 15 percent of an expanded chaebol equity base. These holdings could be in the form of preferred shares or convertible bonds.

This still leaves the thirty largest chaebol with Won 366,130 billion in liabilities against equity of Won 106,876 billion, for an D/E ratio of 343 percent. Thus it appears that attainment of 200% D/E cannot be achieved without some combination of additional loan write-offs and additional debt/equity conversions. For illustrative purposes, this analysis assumes debt and equity are adjusted in 2:1 proportion to achieve a 200% D /E ratio. Converted equity will do nothing for the balance sheets of financial institutions. Moreover, financial institutions are not prepared to manage converted equity. Thus it is important to begin thinking about special purpose vehicles (SPVs) which could purchase and/or manage converted equity acquired by financial institutions.

ill . Government Strategy

The GOK has reacted· promptly and comprehensively to the need to restructure the corporate sector. However, the scope and depth of the problem is unprecedented and will not be easily or rapidly resolved. There are inherent risks in any program of this complexity. Key elements of the Government's approach include, inter alia the following: enhanced legal/regulatory support for corporate restructuring; creation of the Financial Supervisory Commission (FSC), an independent agency with the mandate to restructure both the corporate sector and the financial institutions; a focus on voluntary workouts for the "6 to 64" chaebol; a longer-term approach to restructuring the Top 5 chaebol; and special relief for small and medium enterprises (SMEs).

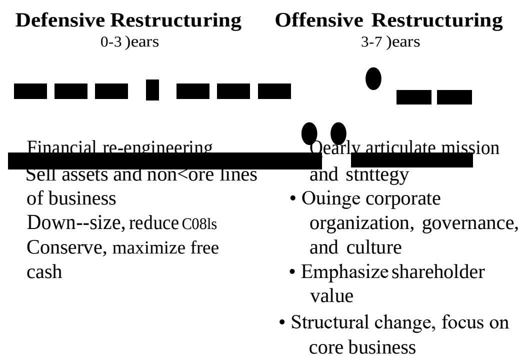
Legal/Regulatory Framework

Soon after the current Government took office, the National Assembly passed a series of acts to make the legal/regulatory environment more conducive to corporate restructuring. Key initiatives include the following:

- Tax Exemption and Reduction Act: provides tax breaks for restructuring of firms, including exemption of SMEs from capital gains on sale of real estate used to repay debt to financial institutions and on real estate transfers via mergers and acquisition;
- Bank Act: increases the ceiling on bank ownership of other firms' equity from 10 percent to 15 percent, or higher subject to Financial Supervisory Commission (FSC) approval;
- Corporation Tax Act: advances removal of deductibility of interest on excessive debt from 2002 to 2000;
- Foreign Direct Investment and Foreign Capital Inducement Act: permits takeovers of non-strategic companies by foreign investors without Government approval and raises the foreign stock ownership ceiling (subsequently raised to 100 percent for non-strategic listed companies);
- Securities Exchange Act: liberalizes mergers and acquisition activity by increasing the portion of shares that can be acquired without board approval from 10 percent to 33 percent;
- Antitrust and Fair Trade Act: prohibits any new debt guarantees and eliminates all existing cross guarantees by 2000;
- Employment Insurance Act: temporarily reduces the minimum contribution period and increases the minimum benefit period; and
- Labor Standards Act: legalizes employee layoffs as a result of mergers and acquisition activity or to avoid financial distress. The Hyundai strike raises serious questions about the ease of formal labor shedding, however.

All of these measures are important for restoring the health of Korea's corporate sector. Their impact, however, is medium term, and not crisis management. Policy makers must take immediate steps to reduce systemic risk and the potential for secondary crisis by restoring potentially viable chaebols to creditworthiness and lowering their debt service requirements in line with their projected cash flow. To this end, the Government has established a framework for voluntary corporate financial restructuring, designed to expedite agreements between debtors and creditors.

Model for Corporate Restructuring



Voluntary Workouts for "6 *to* 64" *Chaebol*

a. The Framework

The Government, under the auspices of the Financial Supervisory Commission (FSC), js encouraging Lead Banks to focus first on voluntary (i.e., out of court) workouts of the "6 to 64" chaebol for several reasons. As illustrated in Table 1, the 6-64 tend to be the chaebol in deepest distress, and generally lack the financial resources and clout to restructure themselves on their own. A large number of insolvencies among this group could create an upsurge in unemployment, bringing severe social distress and political pressure on the Government to abandon its reform program. Moreover, a series of major defaults could provoke a secondary financial crisis, leading to pressure on the currency and interest rates. The 6-to-64 chaebol also tend to be less complex and, therefore, potentially easier to restructure than the Top 5. In the FSC's view, experience gained in restructuring chaebol from among the 6-to-64 group will prepare Lead Banks (and their professional advisors) to take on the Top 5 chaebol.

To support restructuring of the 6-to-64 chaebol, the FSC has promoted a Corporate Restructuring Accord (CRA), signed since June 25th by over 200 bank and non-bank financial institutions. Key provisions of the CRA include the following:

- A Steering Committee consisting of 10 representatives from participating financial institutions will be responsible for implementing, amending, and terminating the CRA. The CRA will run until 31 December 1999 unless the term is amended by the Steering Committee.
- A Corporate Restructuring Coordination Committee (CRCC), consisting of a chairman and 6 individuals appointed by the Steering Committee, will act as an arbitration committee. The CRCC is responsible for assessing the viability of corporate candidates for restructuring, arbitrating differences among creditors, enforcing CRCC decisions, and -- if necessary -- modifying workout plans proposed by participating creditors. The CRCC is supported by about 10 technical and administrative staff. To date the CRCC has advised Lead Banks in specific workout cases; its arbitration role will likely increase as workout cases progress.
- Six Lead Banks--Commercial Bank of Korea, Chohung Bank, Hanil Bank, Korea Exchange Bank, Korea First Bank, and Seoul Bank--have been nominated to take charge of corporate restructuring for the 64 large corporate groups. All commercial banks focused on corporate restructuring have created internal Workout Units. In addition, the Workout Units within the Lead Banks added staff in September, and will be assisted by external financial advisors retained under the World Bank's technical assistance loan.
- A Council of Creditor Financial Institutions ("Council") will be formed when creditor financial institutions must cooperate in a corporate restructuring. Organization and operation of each Council will be managed by a Presiding Bank, i.e., either the Lead Bank or the bank holding the largest amount of debt for a corporate. Each Council will be convened within 10 days of a request from any financial institution(s) that holds more than 25 percent of a

debtor's financial institution debt. A Council's work may be supported by an Implementation Committee.

- Financial institutional creditors holding a majority of financial institution credits in a chaebol affiliate may decide to pursue joint workouts with one or more other chaebol affiliates if a majority of their financial institution creditors agree.[33]
- From the date of notice that a Council will be convened, CRA signatories will defer rights for discharge of debts, including debt repayment, and their claims for discharge of guarantee obligations. The initial term of this standstill, which will be determined at the first Council meeting, is limited to 1 month -- or to 3 months if an "investigation of assets" is required. The Council may extend the standstill once for up to 1 additional month.
- A workout may involve debt/equity conversions, term extensions, deferred payment of principal or interest, reduction of interest rates, waiver of indebtedness, provision of new credits, cancellation of existing guarantee obligations, sale of non-core businesses, and new equity issues.
- Council decisions will require approval by financial institution creditors holding at least 75 percent of the financial institution credits. A Presiding Bank may apply to the CRCC for arbitration after having failed three times to get voluntary agreement among creditors on a proposed workout
- The CRCC will begin arbitration proceedings as soon as possible after receiving an application from a Presiding Bank. The CRCC may request attendance and advice from participating creditors, the debtor's management, and outside professionals. The cost of outside professionals will be borne proportionally by participating creditors.
- Within 1 month of an application for arbitration from a Presiding Bank, the CRCC will provide a written opinion to all the debtor's financial institution creditors as well as the relevant regulatory

33) The expectation is that 6-to-64 chaebol workouts will proceed at the chaebol-level, while workouts involving the Top 5 will proceed at the affiliate-level.

agencies. This arbitration period may be extended 1 additional month.

- CRCC decisions will require 3/ 4 approval of attending members, with a requirement for 2/3 attendance.
- The CRCC's operating budget will be approved, advanced, and controlled by the Steering Committee, and participating financial institution creditors will provide these operating costs according to their shares of outstanding financial institution credits.
- If a CRA signatory fails to comply with an approved workout agreement or CRCC arbitration decision, the CRCC may fine this signatory up to 30 percent of the credit amount in question or up to 50 percent of the cost of non-compliance. The Council will decide upon criteria for distributing any fine among the other financial institutions.

Thus, the CRA provides for expedited procedures and tight deadlines. Key appointments to the CRCC have already been made, the banks have set up their Workout Units, and recruitment of external financial advisors is complete. Only 75 percent agreement is needed for creditor approval of proposed workouts and for CRCC rulings. It is expected that agreements on voluntary corporate workouts will proceed over the next 12 months, whereas the actual workouts will of course stretch over several years. These aggressive time frames will encourage an initial emphasis on balance sheet restructuring prior to asset sales and new equity investment, which tend to be more time consuming.

The FSC considered Bank suggestions for a more centralized approach to corporate restructuring, closer links between corporate restructuring and bank recapitalizations, and official review of proposed corporate restructuring to avoid minimalist "window dressing" restructurings, but opted for the approach described above. This reflects the FSC's desire to have Korean banks assume greater responsibility for acting according to commercial principles and to avoid the appearance of corporate bailouts by the Government. To achieve serious restructurings, the FSC is relying upon the following factors:

(a) its ability to supervise or guide the banks to improve the process, if in its opinion theirs is a tendency towards weak solutions. The FSC is reluctant to intervene on a case by case basis, but will retain oversight over the process and can intervene directly if it chooses or utilize the CRCC to intervene.

(b) the extent of NBFI credit positions, which typically exceed 25 percent of corporate debt. Non-bank financial institutions' (NBFI) management is more sensitive to shareholders' interest than bank management is, increasing its reluctance to risk future losses by further supporting non-viable corporates. The CRA's requirement for 75 percent creditor approval of a proposed corporate workout, and the CRCC's mandate over cases submitted for arbitration, mean that NBFI interests will be represented in most workouts.

Nevertheless, a number of risks still exist that the program will not succeed as envisioned. The CRA provides a useful structure for pursuing voluntary workouts, but is light on principles to guide creditors and debtors. CRA signatories and the CRCC might find it useful to supplement the CRA with a set of operating principles similar to the London rules or the framework for corporate restructuring recently developed in Thailand.

b. Progress to date in corporate workouts

As of the end of September some 58 corporations from 13 chaebol, 18 large corporations and 4 medium size companies were under workout. These corporations[34] make up 2.6% of total employment and 3.9% of total assets for all listed and registered companies reporting financial data in 1997. We anticipate that the number of workout participants will grow rapidly as firms need to finance their operations. We would expect that a diagnostic could be completed by calendar year end, and debt restructuring largely agreed upon within the first half of 1999. A more realistic view of timing will be available once the initial cases are addressed, the bank workout units have gained some experience, and

34) Data for 42 of the 57 companies under workout, as a percentage of all listed and registered companies reporting financial data in 1997.

external advisors are in place. Our initial estimate is that most of the debt workout agreements could be completed within 12 months, since the debt is mostly held by domestic financial institutions. New financing, outside of that provided by existing creditors, will occur in a series of operations and may take several years to complete.

FSC management recognizes the need for measures to promote debt/equity conversions as part of voluntary workouts. The FSC has asked the Bank for help in identifying potential tax, legal, and regulatory impediments as well as private-sector asset managers who might run Corporate Restructuring Vehicles (CRVs), which could be organized as funds, trusts, or partnerships.

The FSC expects that voluntary corporate workouts will include negotiations on elimination of cross guarantees. The need to untangle cross guarantees encouraged the FSC to emphasize chaebol-wide workouts for the 6-to-64 group. The FSC has also agreed to evaluate or inventory the stock of cross guarantees that will not be totally eliminated, as it is urgent that they be reduced.

Restructuring of "Top 5" Chaebol

In 1997 the Top 5 had significantly larger asset bases, larger revenue streams, and generally below-average debt/equity and cross-guarantee ratios, and poor but above-average profit margins relative to the 30 largest chaebol as a group. An analysis by SBC Warburg, based on 1996 financial statements, concluded that the Top 5 posed a low risk of insolvency -- versus medium-to-high risk for almost all of the other 30 largest chaebol. While apparently committed to Top 5 restructuring, the Government sees a prior need to build the workout capacity of the banks and to enter into a more extensive dialogue with the Top 5 with respect to their own restructuring programs. Key elements in the Government's approach to "softening up" the Top 5 include the following: more critical review of capital structure improvement programs (the external financial advisors hired by the six Lead Banks are expected to assist in this process); Fair Trade Commission (FTC) actions against improper intra-chaebol transactions; and more stringent limits on bank exposure *to* corporate borrowers.

A restructuring option open only to the Top 5 are "Big Deals" -- business swaps, mergers and acquisitions among themselves. Designed to streamline business lines and reduce overcapacity, deals are strongly advocated by the Government and highly susceptible to moral hazard. Although the September 30 deadline to submit plans to their creditor banks has passed, the chaebols have yet to reach an agreement on details, including who should manage the newly merged entities.

Financial supervision regulations require agreement between each chaebol and its Lead Bank on a capital structure improvement program (CSIP) at the time of a new loan or term extension on existing loans. Each CSIP is supposed to address the following items: phased reduction of debt/equity ratios; asset sales and issuance of new equity; removal of cross guarantees; improved corporate governance; and, if necessary, debt/equity conversions. The chaebol should consult with its Lead Bank on material developments (e.g., entry into a new business) and report semi-annually on CSIP implementation. If a chaebol does not fully comply with its CSIP, the Lead Bank may suspend new loans and withdraw existing loans to the chaebol. The initial CSIPs were variously criticized for being vague and unrealistic.[35] CSIPs represent a potentially useful tool for promoting sound restructuring of the Top 5 chaebol. The FSC has indicated it plans to provide more rigorous criteria for CSIPs and encourage Lead Banks to use financial advisors to evaluate CSIPs from Top 5 chaebol. The FSC expects this work to be completed by calendar year end, but realistically we would expect that this may take through the first quarter of 1999 given the complexity of the Top 5.

The FTC is investigating allegations that chaebol have used a variety of means (e.g., artificial transfer prices, free use of resources) to reduce taxes and transfer resources from stronger cash-surplus affiliates to weaker cash-deficit affiliates, often to the detriment of public shareholders in the former. For instance, in December 1997, the FTC "found that SK Telecom had paid inflated prices for equipment and services from its

35) As noted earlier, for instance, the Top 5 chaebol have publicly announced plans to raise Won47 trillion through sales of assets, subsidiaries, and joint venture stakes as well as through issuance of new equity.

affiliates as a way of transferring assets to them. This lowered SK Telecom's operating profits...and eased the pressure to pay higher taxes and corporate dividends."[36] In July 1998, the *FTC* fined Hyundai, Samsung, LG, Daewoo, and SK over Won72 billion for unfair intra-chaebol trading. This allegedly involved purchases by financially healthy affiliates of subordinated bonds or commercial paper from unhealthy affiliates at interest rates substantially below-market.

Lastly, the Government is looking at amendments to the General Banking Act and similar legislation for merchant banks in order to redefine single borrower and group exposure limits. These could involve, for example, the following: (i) reducing both limits to 25 percent of total capital and incorporating all off-balance sheet exposures as from July 2000 and (ii) subjecting exposures in excess of 25 percent to progressive reduction over the following three years.

These three items -- increased rigor in CSIPs, *FTC* probes of intra-chaebol transactions, and more stringent standards for loan exposure -- should encourage serious restructuring of Top 5 chaebol. FTC actions -- and a general trend toward greater financial disclosure, enhanced corporate governance, and protection of minority shareholders -- will hinder or preclude the use of established cash-surplus affiliates to finance new cash-needy affiliates. Closer policing of CSIPs will encourage chaebol management to assess their businesses in a more systematic manner; sell or close non-viable or uncompetitive affiliates; eliminate cross guarantees; and restructure balance sheets in a manner designed to achieve debt/equity ratios that can be sustained by projected cash flows. Tighter loan exposure standards will strengthen the position of banks and NBFis in promoting serious restructuring of Top 5 chaebol.

N. Policy support

The Government has agreed to undertake a series of policy measures to support corporate restructuring. These include the following:

Curtailing emergency loans. The Government has agreed not to direct

36) *Business Week*, 23 February 1998.

financial institutions to make such loans in the future. It has also agreed to guidelines under which fresh capital could be provided to corporations undergoing voluntary workouts. These guidelines would also cover corporations due for restructuring, but which have not yet entered the process. Distressed but viable corporates need access to capital. The provision of capital is a major incentive to collaborate with financial institutions on corporate restructuring. These new directives address previous shortcomings -- e.g., a lack of control over the amount of emergency financing and insufficient rigor in assessing corporate viability and how to maximize returns to creditors.

Facilitating debt/equity conversions. As suggested earlier, it appears that the stock of corporate debt is so large that sustainable debt/equity ratios cannot be achieved through sales of assets, new equity, and joint venture stakes alone and that debt/equity conversions and other forms of debt restructuring will play a major role. The Government needs to rapidly evaluate any tax disincentives and regulatory impediments to debt/equity conversions. Because banks are ill-prepared to manage converted equity, "corporate restructuring vehicles" (CRVs) will play an important part in purchasing and/or managing converted equity. Possible forms for CRVs include trusts, partnerships, funds for qualified investors, or closed-end mutual funds. CRVs might operate by purchasing debt from financial institutions and converting it into equity, purchasing converted equity, or managing converted equity for a fee. It is expected that CRVs would be privately financed and managed by experienced asset managers and turnaround specialists, whose compensation would include substantial performance incentives. This approach may raise regulatory issues in a number of areas: e.g., taxation, form of business, corporate governance, prudential regulation, and securities. If necessary, the Government will then submit legislation to the National Assembly enabling and regulating CRVs and removing tax, legal, and regulatory impediments to CRV formation and operation.

In an initial effort to create CRVs for debt/equity asset management, in September four equity funds were created under the auspices of the Ministry of Finance (MOFE). Their funding comes from Wl.6 trn in contributions from 25 financial institutions. The funds will be managed by experienced, internationally accredited asset managers--Rothschild will manage a W600 bn debt fund, and Templeton, Scudder/Kemper, and State Street will each manage W333 bn mixed debt and equity funds.

Reducing cross guarantees. The Government has prohibited new cross guarantees and mandated that existing cross guarantees be unwound by the year 2000. The FSC supports the reduction of cross guarantees as part of voluntary corporate workouts conducted according to the CRA. In addition, the FSC will issue guidelines to Banks suggesting market-based approaches to unwinding these cross guarantees, such as by exchanging guarantees for equity or equity warrants.

Constraints and Risks

The corporate restructuring process entails many risks as well as political and social constraints. Given the size of the potential losses the stakeholders (the large corporate groups, the major commercial banks, the unions/workers and the GOK) will need to sustain to clean-up the present situation, it is inevitable that corporate restructuring will become politically, socially and economically very controversial. The perceived risks are as follows:

(a) Low demand for Korean products prevents even restructured corporates from regaining profitability. The present situation in Japan, the risk of a Chinese devaluation, and a potential slowdown in the U.S. represent important exogenous risks to the Korean economy. The slowdown in domestic demand, similar to that of Japan, also implies that the restructuring efforts of large groups could be derailed by risks that are outside their control. This argues, however, for more accelerated and deeper measures so that firms can "ride out" a potentially extended period of economic malaise;

(b) A political struggle over the corporate restructuring process develops and some of the stakeholders hoping to be bailed out try to delay and slow the process down. Hence speed is paramount, and the Government's program must be given the utmost support while it retains a mandate to reform;

(c) A secondary crisis develops, due to some of the larger groups sliding into bankruptcy, and the Government feels compelled to provide emergency loans and reach ad hoc solutions to the crisis;

(d) The FSC in its desire not to intervene is too hands-off, and does not provide adequate direction to the corporate restructuring process;

(e) The banks are too weak managerially to lead a workout process. Moreover, restructuring of the banks in parallel to their leading corporate restructuring will stretch their existing management capacity too far. The FSC has required that all of the banks establish separate workout units and that the head of the unit be either a director or senior manager. In addition, the external advisors are important in augmenting the capacity of the Workout Units to drive the corporate restructuring process;

(f) The incentives are too weak for the corporations and the Lead Banks to restructure deeply. It will be tempting for the parties to paper over their mutual problems and attempt to muddle through. The incentive to the groups should be substantial debt relief if they restructure and to the banks support from the Government for recapitalization. Absent adequate incentives the process will not work

V. Conclusion

It should be clear based on our analysis of chaebol indebtedness that the corporate restructuring exercise being carried out through the lead banks is just the first phase of a much deeper financial restructuring program which many of the chaebol will need to undertake to restore their liquidity. Most of the liquidity will need to be generated internally through retained earnings and from a shift in corporate culture and strategies that focus on profitability versus rapid expansion and generation of liquidity versus large scale investments. The present business climate both within Korea and in Asia, will make it difficult for the chaebols to achieve such results. Therefore, financial restructuring appears as if it will be prolonged and take several years to achieve.

Based on a series of reports on the competitiveness and productivity of Korean industry and problems of internal structure and governance, including "Revitalizing the Korean Economy toward the 21st Century" by Booz Allen Hamilton, "Productivity-led by Growth for Korea" by Mc Kinsey and the Korean Development Institute, more fundamental corporate restructuring also needs to occur in areas like the consolidation and reduction of business lines, closure of loss making operations, improving financial operations, creation of independent boards of directors, and moving to international standards for accounting and information disclosure. These changes in corporate culture will only occur over time as the chaebols evolve from family controlled and operated to managerially operated businesses.

Annex 1

Bond Issuance by Top Conglomerates

Group/Company	Issue Amount (billion Won)
Hyundai Group	4,116
Samsung Group	5,080
LG Group	2,101
Daewoo Group	6,453
SK Group	1,862
Top 5 conglomerate total	19,612
Other Companies (except Top 5)	5,913
Total Issue Amount YTD	25,524

Source: SBCWarburg Market Strategy Draft Outline, September 1998

Annex 2

Market Cash Flow

For the 15 Largest Non-financial Sectors (Billion Won)

	1993	1994	1995	1996	1997£	1998£	1999£
Sales	187,754	222,522	281,196	323,971	377,132	412,000	425,000
Operating margin (%)	7.1	7.9	8.1	5.9	7.0	6.0	7.0
Operating profit	13,379	17,480	22,759	19,151	26,532	24,720	29,750
Depreciation	12,013	13,409	17,802	19,327	21,000	22,000	21,000
Interest income	2,943	3,223	4,041	4,828	5,280	5,356	5,950
Interest expense	(9,787)	(11,388)	(13,987)	(16,147)	(21,949)	(30,869)	(26,941)
Taxes	(1,513)	(2,112)	(2,737)	(1,677)	(1,000)	(1,000)	(1,500)
Gross cash flow	17,035	20,612	27,878	25,482	29,863	20,207	28,259
Increase in working capital	(7,570)	(6,880)	(9,297)	(5,249)	(16,411)	(11,442)	1,390
CAPEX	(18,481)	22,925	33,889	40,508	38,000	23,000	23,000
Dividends paid	(981)	(1,209)	(1,472)	(1,385)	(1,282)	(500)	(500)
Free Cash Flow	(9,997)	(10,402)	(16,780)	(21,660)	(25,830)	(14,735)	6,149
Total interest-bearing debt	92,035	108,712	131,737	159,396	223,154	221,889	199,740
Cash	8,839	11,566	14,561	14,068	15,085	16,480	17,000
Total liabilities	142,279	170,464	206,521	242,688	324,980	341,369	314,490
Shareholders equity	56,842	66,982	82,699	93,720	90,583	86,790	97,049

Source: "Korean Cash Outflow," Dresdner Kleinwort Benson Research, April 30, 1998

Assumptions:

- Overall sales growth of 9% in 1998 and 3% in 1999
- Operating margins of 6% in 1998 and 7% in 1999.
- Depreciation charges of W22 trn in 1998 and W21 trn in 1999.
- Interest income around 1.5% of sales.
- 50% of debt is short term, with the remainder having an average maturity of three years.
- 40% fall in capex in 1998 to W23 trn; capex in 1999 also W23 trn.
- Fall in debt of Wl.3 trn in 1998 due to W6 trn equity issuance, WlO trn disposals net of acquisitions, and negative free cash flow of W14.7 trn. Increase in 1999 free cash flow leads to W22.1 trn

fall in debt.

- Rise in total liabilites of 5% in 1998 and fall of 8% in 1999.
- 1998 fall in shareholders' equity by W3.8 trn; rise of Wl0.2 trn in 1999 as more equity is issued and profitability improves
- Average cost of borrowing Won of 18% in 1998 and 14.5% in 1999; average cost of borrowing dollars of 10% is 1998 and 9% in 1999.

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Comments

Jaques Beyssade
European Chamber of Commerce

I'm struck by the link between the financial and the corporate restructuring we are facing. I like the way Ira Lieberman described the previous unholy trinity that was ruling Korea, with the government deciding the bank's financing and the chaebols realizing the same projects. This system can not work in an open world and has to be reformed. The three, the government, finance and corporate sectors have to be reformed at the same time. Another way to look at this link is to notice that corporate difficulties basically created financial difficulties and now its up to the banks to solve the corporate problems through work uts. I think we all share the analysis of the causes for Korea's problems. I'm not going back on these over-expansion, building of over-capacity, over-indebtedness and all of this with very, very low profitability. I'm just going to say a few words about leverage and a few words about workouts.

About leverage, because everyone speaks of the high leveraging of Korean corporates and really as was very clear in Ira Lieberman's paper, the main problem is not the level of debt compared to the level of equity, it's the fact there is not enough cash to service this debt. And that's why asset reevaluation, which is a national sport in Korea, which still today is being performed quite actively. It doesn't bring any solution. It reduces leverage, but it doesn't increase cash flow and it doesn't reduce the cost of the debt. What's important is cash and people say, outside of Korea I guess, that cash is king. Another way to reduce leverage, which should be seriously looked at, is debt/equity swaps. I think this can be a solution but which has to be looked at very much on a case by case basis so that it is only applied to companies that have a serious chance to be profitable in the long-run. It's something that has to be reserved to the major creditors, I would think, to those who know the companies intimately and can have a serious idea of the value of the equity which they would get in exchange for their debt. It brings us to the corporate governance problem, because if you have new shares that are issued, you'll have a shift in the companies that would go through this exercise.

There again about leverage, it's not the main point, the main point is cash flow. I know cash flow is severely hurt by the level of interest costs, but that's not the only reason for Korea's problems. I think Korean corporates also are quite below international standards in terms of their industrial cash flow, their cash flow before interest costs. And in this respect, I think foreign investment can have a role. Not only because it brings money to the companies, but also because it brings externalities, because it brings technologies, managerial skills. It brings access to foreign markets and this would tremendously help Korean corporates, quite aside from the strictly financial standpoint.

Turning now briefly to workouts, which is the main topic today. I think that is quite legitimate to look at the top five chaebols separately from the rest of Korean corporates because of the importance they have in Korea's exports. Therefore, because of the role they've been able to play in the quick recovery from the macroeconomic standpoint, from the external standpoint of Korea's finances, I think it is a very good idea that we to make sure we don't break this machine able to produce foreign reserves even if obviously they have to reform as well. For the rest of Korean corporates, I think too much power is given, even in this workout process, to the banks, to the creditors, because who are these creditors? They are mostly Korean banks and they are the people who previously followed political orders and created the over-indebtedness of the chaebols. And they have, maybe there are some exceptions, but they have never really been willing to take responsibility. I think it is very dangerous to empower them with this level of responsibility. At the time the challenges are extremely important. Therefore, the oversight of the whole process by the authorities and the FSC in my view is absolutely essential. And the intervention by the government, I think, is legitimate because there is an issue of common benefit to the Korean society and an issue of foreign confidence in the way the reform process is being handled in Korea.

The last point about workouts that I'd like to point out is that we need to find a way to stop bankrupt companies from operating. First, because it is, and I share the view of Richard Samuelson in this respect, it is somewhat of a joke to invoke free market economies when there is no real possibility that a company that is insolvent might stop operating at one stage. And secondly because these insolvent companies that keep on operating, Kia, Hanbo, etc. there are many of them- reduce the market share of the other companies. They put some pressure on the prices of the products that affect the other companies. They take credit away from the other companies. And in many, many cases, by many, many sides, they have a very negative impact on the whole economy.

As a conclusion, I can say that foreign banks generally share the view of the World Bank that this restructuring process is going to be a very long process because it is not only financial or corporate restructuring, but a question of mentalities going to change. Nevertheless, we also share the view that Korea is going to get out of it and is going to get out of it much stronger than it was before the crisis.

Dong-Sung Cho
Seoul National University

In Dr. Lieberman's paper, he puts together the constraints and the risks. He has six issues. First, he addressed the criticality of this low demand for Korean products. Although I'm a professor at Seoul National University, presently, as the chairman has described, I'm a member of the Six-Member Committee of the Corporate Restructuring Coordination Committee. Perhaps I should be the one to present, partially, what the government is doing in that regard.

For one, in this Six-Member Committee of the Corporate Restructuring Coordination Committee, what we do is this workout, but indeed we are very understanding of this low demand of many of the industries in which the companies go through workouts are facing. So, indeed the purpose of corporate restructuring is not the restructuring of corporations, not the restructuring of the firms, but the restructuring of the industries. The companies we choose to let go through these workouts are the ones that are not capital intensive, because capital intensive industries are problematic due to the local excess capacity as well as worldwide excess capacity. And we know that the purpose of workouts is to save the company rather than to dismantle it. Therefore, we would not choose the companies in the capital intensive industries to survive and add to these chronic problems of oversupply. Sometimes we take care of the companies in capital intensive industries, but when the industry does not have a high asset barrier. The problem comes when a capital-intensive industry is coupled with high asset barriers, so that companies that are not competitive are reluctant to go out of the industry. Then this chronic oversupply continues. So we don't want to save the companies that are locked up by high asset barriers. Sometimes, we have to take care of companies in industries that have high asset barriers, but only when their market is so cyclical, that there is some slim chance that in the immediate future, if the companies survive, the companies might hit the jackpot of this cyclical, such as the opening up of the Chinese market. Only then will we consider a workout program.

The second point is political struggle in many countries. It seems to me, though, that it is not the political struggle, but the bureaucratic struggle that it is the critical problem. As some of you have pointed out, the Ministry of Trade and Industry seems to be more interested in boosting the economy than restructuring the corporations and industries. And probably the other extreme is those that take the position, akin to those of the financial supervisory committees. They're more interested in restructuring. I think the Ministry of Finance and Economy is somewhere in between. So the question is whether these ministries with different point of views can have consensus. And consultative views than policies. The third issue he mentioned is the possibility of a secondary crisis, as the government chooses to give emergency loans and other solutions. Indeed, that is a trouble, but one promising feature is that in the next year and a half we don't have an election. This window of opportunity of the next year and a half is a heavenly opportunity. If we were facing an election then I think politicians would be very tempted to slow down the process of restructuring. But since we don't, there is an opportunity and hope.

Number four, as Mr. Lieberman has mentioned, is the mildly criticized financial supervisory committee playing the role of patsy. But it seems to me that the kind of role the FSC should play is not an active role, but an objective role. Because if Mr. Lee Hyung Jae and his colleagues on the committee began to add their values to the process then that whole process will fall down. Probably, the better way is for them, the organization, to play the role of umpire and let the banks and companies go through the struggles and comprise.

In review, I'm quite impressed in the last month or so while I was tending this committee that the quality and the ability of the bankers in Korea have dramatically improved. Indeed, it was very disappointing that Korean bankers were not adequately educated, trained, and experienced. So we were quite pessimistic whether bankers would be able to cope with the managers of corporations. But it seems to us that bankers are able to improve themselves dramatically and we've found that they have the talent. And with the time, I think that bankers will be able to manage the process in a way that would be satisfactory to our economy. In that regards I really question the wisdom of privatizing the bank that someone in the previous session has described. Because the only bit of equity that can absorb the ownership of the banks currently are two. One is the chaebols, the other is international investors. And we know that chaebols are not clear from moral hazard. If chaebols get ownership of the banks, I question whether the banks would be run in a way that is expected by the people. If we compare the degree of moral hazard as well as the government appointed bank managers with the chaebols, I would argue the degree of [moral hazard would be bigger under the ownership of] chaebols. Because I have seen many government officers and professional bankers who can openly criticize their bosses. I've never seen any bankers of chaebols who can openly criticize their bosses. So, I think what is important is not privatization of the banks, but competition in the banking sector. Though I'd be happy to have government banks, but at the same time open up banks so that foreign companies can do business in Korea.

On the sixth point, there is the incentive to weaken the corporations. I think that is also a very important issue. But it seems to me that we have to distinguish the people versus the organization when we talk about incentives. Managers in the corporations, the majority shareholders of corporations that go through this restructuring needs to have some incentives. But the kind of incentives they should be receiving at the moment should be the opportunity to regain ownership after they go through this debt equity swap and the company does survive. The way for them to regain ownership is through market competition. But for the companies, the incentives should be the survival of the company itself. Through the equity swap this could be attained. Mr. Lieberman has criticized the debt-equity swap and I also agree that debt-equity swaps are not the best alternative. But it seems that with the current situation that we are facing, the debt-equity swap is a second best solution. In other words this is a satisfactory solution, maybe not the best solution. Finally, I'd like to point out that we should go through the following process, or the kind of package of restructuring. That is restructuring should be done by the banks, not by the government and then as Mr. Lieberman has said, that the stock exchange should regain its momentum and strengthening the stock exchange should be the way to solve our problems in the long-term.

Il-Sup Kim
Samii Accounting Corporation

I would like to emphasize some thoughts we have on workout programs. Currently, the workout program is the primary vehicle for corporate restructuring at this time. One of the concerns is that if these workout programs would make another form of bankruptcy suspension accords or emergency loan cooperation agreements. It should be very carefully monitored. This program should not endorse those programs that failed in the past nor provide emergency equity for those kinds of companies.

There is also a concern that those corporations under so-called voluntary, but not so voluntary work-out programs, are qualified as corporations subject to those kind of programs. That is distressed in the short-term, but viable in the long-term. That is some of the concern in the market in my view.

So, probably, here also, "too big to fail" doctrine can apply in these cases. Banks have incentives to keep those unviable companies under programs and thus defer the problem to a later period. The FSC should thus proceed very carefully in monitoring and advise as to provision to the actual implementation of these programs. These programs should not provide indulgence to those insolvent companies.

My next view is on the role of the government. The behavior of the government has been either direct, strong intervention and control, or to be more passive, too hands-off role. But I believe the Korean government has taken two extreme stances over its policy measures. We should make the role of government very clear - set very clear and consistent policy objectives and priorities and lay down the details of the guidelines-and then this should be followed by close monitoring and supervision of the actual execution.

I believe that this workout program depends on the credibility of the system. If you lose this credibility then we will lose the strength of the surgery of the corporate cancer. So, I think its very important that there is objective and rigorous and viability and cash flow and liability under the workout process. Further, I believe it is very important for the FSC to draw up very clear criteria for the companies subject to liquidation so that the markets can get a clear signal over which companies are subject to liquidation.

One more comment is the unwinding of the guarantee of payments. I believe this is the highest hurdle in corporate restructuring facing many of the chaebols. I understand that the IMF and the banks and the FEC is considering various measures to take relief from these kinds of payments and I believe that it should proceed and come up with the viable and sensible measures to unwind the guarantee of payments.

My last comment is that the real success of all of the workout programs depends on the fair evaluation of the going concern value of the corporation under the program. And, also this is a very rigorous and sophisticated process. They should not be muddled through. The banks and corporates and FEC should take a very serious view of the process.

Bonchun Koo
Korea Development Institute

I'd like to discuss a few points. One thing that I expected from this paper. I wish this paper had listed the reasons why or the sources why the Korean companies had the high debt/equity ratios. Without the analyses, I think the Korean corporations after this restructuring will again have the high debt/equity ratios after it goes down and will go up again.

I think three factors contributed to the high debt/equity ratios. One factor is the high growth rate of the Korean economy and owners' desire to keep their management control. The Korean economy has been growing over 8% over the last 30 years. Simple economic theory tells you if you are a debt holder you get a fixed amount of interest. However, if you are an equity holder you get a much higher rate of return. That's why the majority shareholders tried to keep their shares.

The second factor was the unattractive capital markets. Minority shareholder rights were not protected in the past. The hostile takeover has been just allowed in 1996. Insider trading has persisted and that's another factor that made shares unattractive.

The third factor is inefficient financial institutions. Banks relied on collateral or trust guarantees when they made loans to chaebols. They did not evaluate or analyze the cash flows of the corporations. Without resolving all of these difficulties, the past high-leveraging will not be resolved forever.

Another point I'd like to cover is the low profitability of Korean corporations. Yes, all listed companies on average made losses last year. They made about -1.5% compared to sales and -5% compared to their equity value. The reason of this low profitability is the high debt/equity ratio or because of the low profitability, they have a high debt/equity ratio. The problem circles. If you analyze more, if you look at the operating profit before interest payments, Korean companies made a higher profit than companies in Taiwan or Japan during the last 10 years. However, after deducting interest expenses, which is ordinary profit, Korean corporations made much lower profit than Japan and Taiwan. Therefore, after restructuring, if corporations get rid of this high leveraging, Korean companies have a much higher chance to have very profitable operations-if we go to this lower demand in 1998 and next year.

The third point is this 200% debt/equity ratio target set by the government. Of course, developed economy companies all have debt/e-quity ratios under 200% in the manufacturing sector. However, even Japan has a very high debt/equity ratio during the 1970s-about 400%. Even in the early 1980s, Japan had 300% debt/equity ratio of manufacturers. Only by the late 1980s did Japan have under a 200% debt/equity ratio. Therefore, I don't think we should set a target for all the corporations in Korea a low debt/equity ratio. Also, the Bank of Korea's data shows there is a large difference in debt/equity ratios between industries. For example, food, oil refiners, automobiles, publishing sectors all have over 500% debt/equity ratios, while chemical, office machinery and steel industries have under 20% debt/equity ratios. Therefore, the government should be more flexible on the debt/equity ratios.

The last, more minor point is that the paper said the proportion of shares that can be acquired has been increased from 10% to 33%. However, now the requirement has been removed and there is no limit on buying shares that requires board approval.

Thank you.

Appendices

Welcoming Remarks

Kyung-Tae Lee
President, KIEP

In behalf of the Korea Institute for International Economic Policy, I would like to welcome you to today's seminar on Korean economic restructuring. October is a busy month and we did not expect this large an audience. This shows how important the issues that we are going to discuss today. We are grateful to your attendance. We are also grateful to the participants, who have given us their valuable time to share their insights with us, and Ambassador Kiwhan Kim who agreed to give a key note speech at such a short notice.

In my view, economic restructuring in Korea can be summed up by three words, all initiated by the English alphabet E. Those three words are enormity, experiences and experts. Enormity means that the task of reforming our economy is very enormous. We have to bring about fundamental changes in our financial institutions, business corporations, the public sector, market structure, and even our way of thinking or way of doing things. This is an enormous task indeed.

But Korea lacks experiences and experts which are required for smooth and successful restructuring. In this sense, I think, today's seminar is very well placed because we can share the rich experiences and expertise of Dr. Claessens and Dr. Lieberman, and other discussants who undoubtedly have rich experiences and expert knowledge in financial restructuring and corporate sector restructuring.

I think Korea's restructuring needs international cooperation by all means - opinions, expert advice and technical assistance. Our institute, KIEP, is a gateway to enhancing these views from the international community into Korea. So, I hope that we can do exactly this today, in a very constructive way.

Thank you very much.

Key Note Address

Korea's Economic Reforms: Progress to Date and Challenges Ahead

Kihwan Kim
Korea's Ambassador-at-Large
for Economic Affairs

Let me first say what a great honor and pleasure it is to address you today at the very outset of this seminar organized by the Korea Institute for International Economic Policy with *The Korea Economic Daily's* sponsorship. I would like to compliment both the organizer and the sponsor not only for the outstanding speakers and discussants they have invited but also for the excellent timing of this seminar on Korea's economic restructuring efforts.

For the past ten months or more Korea has made enormous progress in restructuring its economy. However, much remains to be done. Thus, at this juncture, it is most useful to take note of what has been achieved, and identify what important challenges have yet to be met.

Korea's progress to date has been most noteworthy in improving its external position. Korea's usable foreign reserves rose from $8.9 billion in December, 1997 to $43.3 billion in September, 1998. The share of short-term debt in the total external debt also fell from 44% to 25% during the same period. Furthermore, the value of the Korean won seems to have stabilized. For the past two months or so, it has been fluctuating largely within the range of 1300 to 1350 to the dollar.

Since the outset of the crisis, the Korean government has concentrated its efforts on laying the legal and institutional foundations for long-term reform. To this end, over 500 laws and presidential decrees have either been enacted or amended. In addition, several new institutions, including a unified Financial Supervisory Commission (FSC) and the Korea Deposit Insurance Corporation (KDIC) have been established. Furthermore, the efforts to open virtually all markets have been accelerated, resulting in such important changes as the removal of ceilings on the foreign ownership of equity, the introduction of hostile M&As by foreign investors and the lifting of the ban on foreign ownership of real estate.

As for the reforms in the individual key sectors of the economy, it is most important to note that new labor legislation was adopted in February of this year. Thanks to this new legislation, the ability of companies to lay off excess workers, employ temporary workers, and introduce flexible working hours has been significantly expanded. Although the way the labor strike was settled at Hyundai Auto was somewhat disappointing, the subsequent actions taken by the government to deal with the labor dispute at Mando Machinery, and the threat of a nationwide strike by workers in the banking sector, were quite reassuring. Equally reassuring was the decision by the government to increase for this year its spending on the social safety net to over 10 trillion won, or about 2% of GDP.

With regard to reform in the financial sector, it is worthwhile to note that the government has already closed a record number of non-viable institutions, including five commercial banks. For the financially weak but viable banks, the government has required either mergers or self-rehabilitation actions as a condition for receiving its help. Over the past few months, some of the healthy banks have sought mergers with others on their own. As for the Korea First and the Seoul Banks, steps are being taken to auction them off to foreign buyers at the earliest possible date.

One of the most critical issues in restructuring the financial sector has been what to do with the non-performing loans and the eroding capital positions of the institutions involved. Under the new tightened loan classification standards, non-performing loans of the financial institutions have been estimated to peak at 100-120 trillion won. The basic strategy adopted by the government to deal with these problems has been to use public funds to purchase non-performing loans and assist in recapitalization. To date, the government has spent some 24 trillion won for these two purposes. Thanks to these efforts, the BIS capital adequacy ratios of most commercial banks have been raised to more than 8%, far ahead of the schedule agreed to with the IMF. With this improvement, the government hopes that the severe credit squeeze that has affected the country over the past eleven months or more will gradually ease, paving the way for economic recovery.

The objectives of the government in restructuring the corporate sector have been five-fold: (a) enhance transparency, (b) reduce unfair advantages enjoyed by large conglomerates in access to credit, (c) strengthen corporate governance, (d) improve capital structures, and (e) establish core competencies. To attain these interrelated objectives, the government has already taken such actions as banning new cross guarantees of debt by the affiliates of a conglomerate as of April this year and phasing out existing guarantees by March 2000, requiring consolidated financial statements beginning in 1999, a mandatory reduction of the average debt-equity ratios for the conglomerates to less than 200% by the end of 1999, and strengthening the rights of small shareholders. In addition, some 55 companies have been classified as non-viable by creditor banks, and are now in the process of being liquidated. A substantial number of the affiliates of chaebols are engaged in workout programs. The one area where both the government and general public feel not enough progress has been made concerns the so- called "big deals", especially among the top 5 chaebols. As a result, intense debate is under way in the country as to what further steps, if any, should be taken in this area.

In restructuring the public sector, the Korean government has been pursuing basically two aims: (a) reducing the size of the bureaucracy, and (b) privatizing major state-owned enterprises. The government plans to reduce the number of civil servants by approximately 105,000, or about 11% of the total, by the year 2000, of which about 43,000 have already been laid off. As far as the privatization of state-owned enterprises is concerned, 5 of them are to be privatized within the next eighteen months, while 6 additional enterprises will be privatized on a gradual basis by the year 2002 with the rest to be streamlined for greater efficiency.

A critical question to ask at this point is what should one think of the progress made so far?

With regard to the improvement in the external sector and laying institutional foundations, one has every reason to give the highest possible marks. However, the same cannot be said about the reforms in each of the key sectors.

As for the labor reforms, one should of course note that the adoption of the new legislation permitting layoffs, among other things, represents a major milestone, particularly in Korea, a country in which lifetime employment has been considered a birth right. However, at least three points need to be made. Largely because of the way the labor dispute at Hyundai Auto was settled, the international financial community is not yet fully convinced that the Korean government is genuinely committed to the idea of layoffs. Although the subsequent development at Mando and the potential strike by financial union workers were settled without compromising the objective of implementing necessary lay-offs, and thus, have gone far toward improving Korea's image in this area, more should be accomplished before Korea can win full confidence from potential international investors.

Another important point is that conditions attached to layoffs are still very onerous. Even under the new legislation, layoffs are permitted for all practical purposes only if and when a firm undergoes restructuring in order to resolve a severe financial emergency situation. One could easily argue that the primary reason for any firm to undergo restructuring is to avoid such an emergency. Thus, permitting layoffs for restructuring only in an emergency is analogous to a kind of medicine dispensed only after the patient has become terminally ill. One hopes that this issue will be adequately addressed during the Second Tripartite Dialogue involving labor, management, and government that is currently under way.

The third point concerns the social safety net. It is indeed laudable that the Korean government has seen the critical need to expand the social safety net, especially when the macroeconomic conditions have deteriorated beyond initial expectations. The real danger is, however, that while trying to meet the pressing needs of the moment, the government may inadvertently set policy precedents which are inimical to the long-term health of the economy.

With regard to the reforms in the financial sector, at least two concerns must be voiced. In carrying out the mergers of the non-viable banks with the viable ones, the government should have faithfully relied on genuine P&A (purchase and acquisition) transactions. The failure to do so not only infringed on the principles of a market economy but also created unnecessary confusion and shocks to the banking system, aggravating the credit crunch already in progress. In exiting the non-viable financial institutions, the government could have also made use of the so-called "bridge bank" approach. Such an approach would have reduced the financial shocks that had actually occurred. The point of these observations is not to undo what has already been done, but to suggest a better approach that the government should adopt if similar problems occur in the future.

The other concern has to do with the adequacy of the public funds for the disposal of NPLs and recapitalization of financial institutions. By committing to spend a total of 25 trillion won, the government hopes to purchase approximately 80 trillion face value of NPLs. An important question to ask is if the NPLs are to peak at 100-120 trillion won, who is going to take care of the difference between this figure and the 80 trillion won? The government position is that the financial institutions themselves can make up this difference by either using their existing provisions, selling assets or raising additional equity capital, either domestically or internationally. One cannot be sure if this approach is realistic given the current economic conditions in general. In any event, the record of private banks in inducing foreign investment has been anything but encouraging so far. Nor have they achieved a credible record in selling excess assets.

There has been a great deal of confusion both at home and abroad on the restructuring of the corporate sector. Although significant reform has been undertaken in most of the areas relating to cross-guarantees, transparency and the strengthening of the rights of small shareholders, many are fond of pointing out that visible results have not yet come about, particularly in the form of reducing debt-equity ratios and retreating from over-diversification through business swaps. These observers fail to realize that by its very nature, a substantial reduction of debt-equity ratios and overdiversification takes time. They also fail to see that the substantial progress already achieved in other areas will, in turn, surely bring about significant results in these two areas as well.

In my opinion, these oversights pose several dangers. For one thing, insisting on early outcomes in these two fronts inevitably invites greater government intervention, thus violating the market principles we all are trying to establish. For another, premature government intervention will delay rather than accelerate the restructuring efforts on the part of the chaebols themselves. What's more, such government intervention is bound to create serious political problems in the next administration. Parties that feel unfairly treated in any government-initiated moves will seek redress later. In view of these dangers, it would be most wise to allow the several key measures that have already been put into place to bring about changes in the conduct of the chaebols. One would do well to remember that apart from the measures I have already mentioned, other measures are in place including those designed to strengthen the managerial autonomy of banks, and intensify competition in all domestic markets. With all these measures in place, the days of economic dominance by chaebols are numbered.

Finally, on the public sector reforms, the first point one should make is that considering the extent of downsizing the government expects from the private sector, the 11% reduction in the bureaucracy seems to be rather modest. One could also argue that the real problem with the Korean bureaucracy today has less to do with its size than its quality. To this day, the Korean government relies almost exclusively on the system of recruiting civil servants through the government administered examinations. For a long time, this system worked well. However, the system has now outlived its usefulness. For one thing, by completely sealing the civil service against the inflow of experts from the outside, the system has made civil servants not only inward-looking but also behind the times especially when compared to the private sector. The seriousness of this problem cannot be overstated in these times of rapid technological change and globalization. As an inward-looking group, Korean civil servants, particularly on a working level, have been extremely resistant to liberalization, deregulation, and other reforms. In short, the current government would do well *to* reform its system of recruiting its civil servants.

In assessing the progress of the current reform, it is important to note that the reform agenda itself was largely dictated by the need to overcome the current crisis. A case can be made that even for this purpose, the agenda is not comprehensive enough. That is, the current agenda does not yet adequately address one key -- and perhaps the most crucial -- factor that was responsible for bringing about the crisis in the first place. In spite of the contagion that affected the East Asian region, the Korean economy would have been able to avoid the current crisis had the country undertaken in a timely manner fundamental reforms in several key sectors of the economy. But this did not occur due to the absence of effective political leadership. The critical question to ask then is why did such a leadership fail to emerge?

The answer has to do with the inadequacy of Korea's democracy itself. In one word, democracy means a political system which allows the people to make their choice with regard to candidates and their programs through a fair election. Korea's democracy, however, fails to make such a choice available to its people. For instance, for a person to become a viable political candidate under the present Korean law, he or she must for all practical purposes receive the official endorsement of an existing party. Anyone who fails to receive such an endorsement has little chance of winning the election. Winning an endorsement,for the most part, does not depend so much on the ability of the individual concerned, but rather on their loyalty over the years to the party. Failing this, one could get an endorsement by making a substantial financial contribution to the party. Incidentally, this system of party endorsement in Korea perpetuates the existence of political parties dominated by personalities rather than policy programs. What makes the Korean system all the more deplorable is the fact that once a person has been elected as a member of the national or local legislature, he or she cannot vote on the basis of his or her own conviction. Rather, he or she must vote strictly along the party lines. This eliminates incentive on the part of a legislator to either study seriously or develop policy options.

There are also problems with the campaign finance law. The current law places unrealistic ceilings on the amount of money a candidate can spend for an election campaign. The ceilings are so low that very few candidates can successfully campaign without violating the law. It goes without saying that anyone who has managed to get elected by violating the law always feels vulnerable in the fear that someone might question the legality of his election. Thus, he becomes an insecure person, incapable of acting on his convictions. There is little question that all these problems associated with the political system in Korea have lessened the chance of any bold initiative for reforms coming from the nation's political circles. In fact, one could make the case that instead of providing initiatives for reforms, over the past several years Korea's political circles seem to have done their best to stifle initiatives provided by other segments of society. In this regard , it is indeed fortunate that President D.J. Kim has recently launched what he calls the Second Nation Building. This movement represents an organized effort not only to overcome regional, generational, and ideological differences among the people, but also to reform the election campaign finance laws. One hopes this movement will bear fruit in due course.

There is one last point I would like to make before I conclude. I do not think a reform agenda that is focused only on the nation's recovery from the current crisis is sufficient. In order to motivate the whole population to accept the immense sacrifices and hardships that go with reform, people need to be presented with a vision for a future that goes beyond recovery.

I would like to take this opportunity to offer you my own version of such a vision. In my thinking, Korea should aim to become the premier business center in this part of the world in the next. century. There are a number of advantages associated with this new role. For one thing, by playing the role of the premier business center, Korea can ensure its prosperity by providing high value-added services to the neighboring countries in such fields as banking and finance, information and media, engineering, product design, management consulting, and culture and tourism. History has shown that a premier regional center usually succeeds in achieving a level of per capita GDP that is several times higher than those of the surrounding countries. A contemporary case in point is Singapore. For another, Korea's long-term security needs will be better met by becoming a regional business center. As a result of providing the invaluable services in the fields I have already mentioned, a regional business center makes itself indispensable in the eyes of its neighboring countries. In addition, if a country becomes an important regional business center, it will also serve as a home for many multinational corporations from all over the world. In short, virtually all the countries in the world will have a strong interest in preserving peace and stability in the country that serves as the business center.

If you accept my arguments in favor of Korea's becoming the premier regional business center in the next century, two questions naturally arise: (1) does Korea possess most of the prerequisites?, and (2) what further reforms should Korea undertake with this new role in mind? My answer to the first question is an unqualified yes. Korea has the most highly educated work force in this region. College graduates account for more than 20% of its current labor force. At present, about 40% of high school graduates in Korea go on to colleges and universities -- a figure only surpassed by the United States. A large number of young Koreans still want to cap their education with degrees from leading foreign universities. Moreover, we have an ever-increasing number of Koreans who are completely bilingual. What's more, thanks to the current crisis, the overly xenophobic attitude of ordinary Koreans toward foreigners is rapidly changing. A great majority of Koreans now keenly recognize the need to work much more closely with people of different ethnic backgrounds and cultural traditions. Finally, we should also remember that Korea has a geographic advantage to become a regional center in that it is a peninsula serving as a gateway to the Asian hinterlands.

As for the minimum reforms that Korea should undertake to play this new role, Korea should not only further liberalize its trade and investment regimes, but also reform its immigration policy in order to promote a greater inflow of professionals. In addition, Korea should certainly adopt a far more simple system of taxation. Furthermore, it should open its educational system, particularly at the university level. Last but not least, Korea should strive to become the model in Asia in establishing the rule of law.

In your discussions here today, I would be most grateful to you if you were to give some thought not only to the problems I have noted with regard to the current reforms in the key sectors of the economy, but also my views regarding what role Korea should strive to play in this region in the years ahead. Let me thank you once more for the great honor you have done me by asking me to be the keynote speaker at this important seminar.

Program

October 23, 1998

09:00-09:30 **Registration**

09:30-09:45 **Opening**

Opening Remarks:
- **Kyung Tae Lee,** President, KIEP

Keynote Address:
"Korea's Economic Reforms: Progress to Date and Challenges ahead"
- **Kihwan Kim,** Korea's Ambassador-at-Large for Economic Affairs

09:45-11:15 **Session** I **Financial Sector Reform**

Chair:
- **Unchan Chung,** Professor, Seoul National University

Presentation:
"Korea's Financial Sector Reforms"
- **Stijn Claessens,** Principal Economist, Financial Economics Unit, World Bank

Discussion:
- **Yoon Je Cho,** Professor, Graduate School of International Studies, Sogang University
- **Buhmsoo Choi,** Counsellor, Financial Supervisory Commission and Research Fellow, Korea Development

Institute

- **John Dodsworth,** Senior Resident Representative, IMF
- **Richard Samuelson,** Branch Manager, SBC Warbourg

11:15-11:30 **Coffee Break**

11:30-13:00 **Session** II **Corporate Restructuring**

Chair:

- **Sung-Hee Jwa,** President, The Korea Economic Research Institute

Presentation:

"Korea's Corporate Crisis: Its Origins and a Strategy for Financial Restructuring"

- **Ira Lieberman,** Senior Manager, Private Sector Development Department, World Bank

Discussion:

- **Jaques Beyssade,** Banking Committee Chairman, EU Chamber of Commerce
- **Dong-Sung Cho,** Professor, Seoul National University
- **11-Sup Kim,** Vice Chairman, Samii Accounting Corporation
- **Bonchun Koo,** Research Fellow, Korea Development Institute

List of Participants

Jaques Beyssade
Banking Committee Chairman, EU Chamber of Commerce and
Country Manager, Credit Lyonnais (Korea)

Dong-Sung Cho
Professor, Seoul National University

Yoon Je Cho
Professor, Graduate School of International Studies, Sogang University

Buhmsoo Choi
Counsellor, Financial Supervisory Commission (FSC) and
Fellow, Korea Development Institute (KDI)

Unchan Chung
Professor, Seoul National University

Stijn Claessens
Principal Economist, Financial Economics Unit (FSPEU), The World Bank

John Dodsworth
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Fellow, Korea Development Institute

Ira Lieberman
Senior Manager, Private Sector Development Department, The World Bank

Richard Samuelson
Branch Manager, SBC Warbourg

| Abstract |

- Following the outbreak of the foreign currency crisis in November 1997, the resolution of domestic debt has emerged as the primary task for restoring economic stability in Korea. A year of economic turmoil and efforts at reform have now passed and it seems to be a good time for a reflection; for this purpose, KIEP held an international seminar, focusing on the two most important and intertwined aspects of economic reform: financial sector reform and corporate restructuring.

- The financial sector reform has been reviewed by Dr. Stijn Claessens of the World Bank, and corporate restructuring by Dr. Ira Lieberman, also from the World Bank. The papers provide updated information on the reform process, and identify the size of the debt and the size of funds to resolve it as the biggest and immediate problem to be taken care of.

- Both argue that this should take priority to any long term measures, and that greater government role is paramount in setting the speed and providing a central guidepost through, for example, greater use of fiscal policy and setting up of funds or a special purpose vehicle (SPV) to purchase debt to turn it into equity.

국문요약

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