Financial Globalization and Korea's Post-Crisis Reform: A Political Economy Perspective

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Summary

Well before the opening of capital markets in the 1990s, liberalization and democratization led to significant changes in Korea's developmental state model. However, while expectations for government protection against large bankruptcies remained strong, institutional reforms and credible market signals (e.g., large-scale corporate failures) designed to replace weakening government control with market-based discipline were not introduced in the pre-crisis period.

The weakening of investment discipline since the late 1980s served as the underlying cause of the 1997 economic crisis. Although financial globalization did not "cause" a series of major corporate failures that preceded the crisis, it played an important role in the outbreak and resolution of the crisis. In particular, increased exposure to short-term foreign debt made it all but impossible for the Korean government to adopt a wait-and-see approach, because it could not persuade foreign creditors to refrain from their run on Korean banks. The international nature of the 1997 crisis, as well as its magnitude, left the government with little option but to go to the IMF for immediate relief and address the underlying problem of nonperforming loans.

The crisis also had the effect of weakening the political clout of vested interests, which otherwise might have blocked reform. A newly elected reformist president took advantage of the crisis atmosphere to push major bills through the National Assembly, even though his coalition did not have a majority. Endorsed by international investors as well as non-governmental organizations campaigning for shareholder value, his reform initiative, in turn, strengthened market forces and made it increasingly difficult for the government to "suspend" bankruptcies and backtrack on reform. In addition, the absence of controlling shareholders at commercial banks helped to make large-scale financial sector restructuring a politically viable process, at least in comparison with other countries.

The most critical role played by foreign capital in Korea's reform process was in forcing the Korean government to recognize losses in the form of latent nonperforming loans. Yet foreign creditor banks and investors were reluctant to share the burden of losses, often demanding "special treatment"; whereas, international organizations as well as analysts advising portfolio investors supported accountability and transparency in the sharing of losses. Also, international organizations played an important supporting role in institutional reform to lay out a more transparent and accountable financial system while foreign direct investors introduced significant changes in business practices.

CHAPTER 1

Introduction

Korea's remarkable turnaround since the 1997 economic crisis has made it something of a poster child for the IMF.[1] In an about-face from their earlier condemnation of the Korean economic system as one of "crony capitalism," major news publications around the world have also praised Korea for its post-crisis reform. Korea's financial sector reform, in particular, has received spotlight, especially in comparison with Japan's slow progress in this area, and, as a possible benchmark for China, which is dealing with a nonperforming loans problem of its own.[2]

While it would be dangerous to believe everything that is written in news publications, Korea indeed appears to have made significant progress in reforming its economic system in the post-crisis period, at least in comparison with other countries. What has made this possible? And how has the Korean system changed as a result? In this paper, we address these two questions from a political economy perspective, and draw implications for the future of East Asian capitalism.

We look at how financial globalization, interacting with economic crisis and political mediation, has influenced Korea's financial sector reform and, ultimately, its economic system as a whole. By financial globalization, we mean the integration of financial markets under "global" rules and practices derived either through an international bargaining process (e.g., adoption of capital adequacy ratios) or as a response to market signals (e.g., increasing emphasis on shareholder value). Financial sector reform refers to institutional changes in the financial sector brought about by public policy as well as behavioral changes induced by market signals. In this context, institutional changes include the disposal of nonperforming loans through the recognition and sharing of "legacy costs" as well as forward-looking reform measures designed to improve the efficiency and stability of the financial sector.

This paper is organized as follows. Section 2 looks at the evolution of Korea's government-business risk partnership prior to the 1997 crisis, focusing on the problems created by one-sided financial sector liberalization in the years leading to the crisis. The limitations of pre-crisis reform efforts are also mentioned. Section 3 characterizes the nature of the 1997 crisis, especially in comparison with previous debt crises in Korea, and discusses its impact on the reform environment. Section 4 looks at the political economy of reform in a broad context, especially in the early post-crisis period when critical strategic decisions were made. It shows how a new political leadership committed to a democratic market economy adroitly used the crisis atmosphere to push ahead with reform. Section 5 then evaluates Korea's financial sector reform highlighting the role of foreign capital in various aspects and stages of restructuring. This section analyzes in some depth the relative contribution of the Korean government and foreign capital in recognizing and

[1] For instance, while giving the credit for Korea's successful turnaround to the Korean people and Korea's political leadership that took "firm ownership of the stabilization and reform program," Chopra et al. (2002) also regards Korea's achievements as vindication for the IMF program.

[2] See, for instance, David Pilling, "The Korean Renaissance: Lessons for a Humbled Japan," Financial Times, Oct. 25, 2002. See also the same newspaper's Korea Special on Oct. 29, 2002.

resolving losses as well as transforming Korea's financial system into a more market-based one. The role of foreign capital in helping to make this reform program credible and irreversible is also emphasized. Finally, Section 6 concludes.

CHAPTER 2

Pre-Crisis Financial System in Korea

2-1. Between a Developmental State and a Market Economy

When scholars refer to the Korean economic system as an example of "East Asian capitalism,"[3] what they have in mind is the government-business risk partnership that was formed in the 1960s.[4] Eager to promote economic development, the Korean government in the 1960s adopted drastic measures to share the investment risks of the private sector, channeling policy loans through state-owned banks and providing explicit repayment guarantees to foreign financial institutions on loans extended to Korean firms. The resulting government-business risk partnership, for which the export performance of private-sector firms was used as a selection criterion, defined the core of what later came to be known as "the Korean model of economic development" (Lim 2000, 2003).

However, the excesses of the government-orchestrated heavy and chemical industry (HCI) drive of the 1970s led to a reappraisal of the state-controlled financial system. Technocrats who initiated policy reform in the early 1980s believed that extensive government control in the financial sector had to be relaxed if the government was to escape from the vicious cycle of intervention.

Attempts at financial liberalization— in particular, the relaxation of entry restrictions into the non-bank financial sector— implied a structural weakening of the traditional risk partnership. Korea's family-based business groups, or the chaebol, expanded their influence in the financial sector through the control of non-bank financial institutions (NBFIs) such as merchant banks, security companies, investment trusts, and insurance companies.[5] Corporate financing behavior evolved in response to the structural shift, and NBFI financing and direct debt financing through the issuing of corporate bonds and commercial papers emerged as important financing vehicles by the early 1990s. Indeed, NBFI and direct debt financing accounted for a major share in corporate financing during the investment spree of the 1990s, which lasted up to the onset of the 1997 financial crisis. The overall change in the financing pattern implied that the chaebol were gaining an increasing degree of independence in their major investment decisions (Hahm 2003).

This shift in balance of power in the government-business risk partnership was, however, fraught with serious moral hazard risks, because expectations for government protection against large bankruptcies remained intact while various entry restrictions and investment controls were lifted. In other words, although the chaebol were no longer tightly reined in by the government, they— and almost everyone else— continued to believe that the government would come to their rescue should they fall into financial difficulties.

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[3] The notion of "East Asian capitalism" tends to emphasize the government's proactive role in promoting economic development. See, for example, Johnson (1982), Okimoto (1989), Wade (1990), World Bank (1992), Aoki, Kim, and Okuno-Fujiwara (1996), and Woo-Cumings (1999).

[4] See Amsden (1989), Cho (1989), Cho and Kim (1997) and Perkins (1997) among others, for the discussion on the relationship between the state and finance during the development stage of the Korean economy.

[5] See Lim, Haggard, and Kim (2003) for a comparative historical analysis of the chaebol as a corporate form.

This explosive combination of de-control without de-protection had serious implications for the financial system. Banks continued to extend loans to the chaebol without much regard for default risks. Moreover, by "guaranteeing" a much higher rate of return than the banks, the chaebol-controlled NBFIs were able to attract a great deal of financial resources. The chaebol in turn used NBFI financing to carry out their investment projects. The financing scheme implied that the chaebol were able to capture the benefits of one-sided financial liberalization policy (Lee et al 2000, Hahm 2003). Globalization accentuated this trend by making it easier for the chaebol to gain access to foreign capital without having to go through rigorous credit evaluations. Most of foreign capital inflows, in fact, took the form of inter-bank lending. Foreign creditors, for the most part, were content to make loans to Korean banks, which in turn made "care-free" loans to Korean firms.[6]

The dearth of autonomous financial institutions that could say no to the government and the chaebol proved to be the Achilles heel of the Korean economy. On the surface, Korea might appear to have had a bank-based financial system until the mid-1980s and a market-based system since then, with the rise of NBFIs controlled by the chaebol. However, Korea's bank-based system differed from the Japanese main bank system or the German system in that the banks were for the most part the agents of the government with little independent authority to monitor and discipline corporate management; Korea's market-based system was also very different from the Anglo-Saxon system in that shareholders and institutional investors exerted little influence on corporate management. What Korea basically had was a government-business risk partnership whose balance of power increasingly shifted to the chaebol with the gradual removal of government controls and the emergence of financial entities directly linked to the chaebol— without the establishment of market institutions to monitor and discipline corporate management (Lim 2001).

Although the progressive removal of entry barriers increased competition in most industries in the 1990s, the investment behavior of large business groups changed little. Because of expectations for implicit government protection from large bankruptcies, increased competition failed to make them become aware of the increased potential risks of the high-leverage strategy. The government phased out industrial policy and no longer capped the level of investment and restricted the number of firms in a given industrial sector; however, Korea's large business groups apparently felt that the government's implicit guarantee against their bankruptcy remained in force. The 1997 crisis may be regarded as a result of this explosive combination. In fact, what Korea had in 1997 was not the commonly understood example of East Asian capitalism, but rather a hybrid combining the problematic features of a developmental state and a market economy.

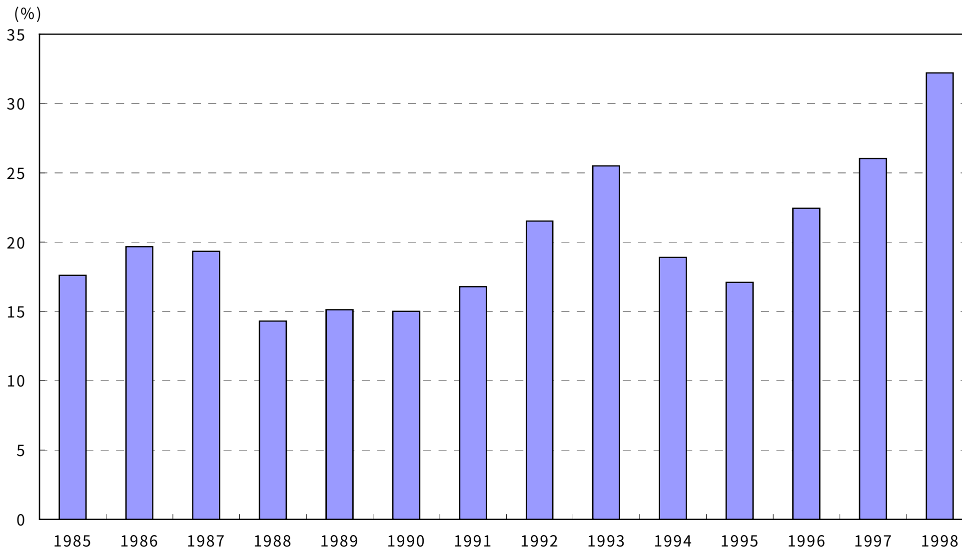
2-2. Deterioration of Balance Sheets and Failed Reform Efforts

Reflecting distortions in resource allocation under the legacy of government-business risk partnership and without effective market mechanism to control investment risks, balance sheets of financial institutions deteriorated substantially before the onset of the 1997 crisis. Figure 1 shows the percentage of loans extended to the firms whose interest overage ratio was less than one from 1985 to 1998 (Hahm and Mishkin 2000).[7] The asset

[6] For example, Korea First Bank, with a capital of 2 trillion won, provided 2 trillion won of credit to Hanbo. Although the working staff had given a D-rating to Hanbo, the chief executive of the bank overruled and decided to provide credit. Hanbo was the first of the major chaebol to fall in 1997.

[7] The interest coverage ratio is the ratio of a firm's EBITDA relative to interest payment, where EBITDA

Figure 1. The Ratio of Latent NPLs out of Total Corporate Sector Loans



Source: Hahm and Mishkin (2000)

quality of financial institutions kept deteriorating in the years leading to the crisis, as financial institutions propped up "zombie companies." In particular, Halla, Jinro, and Sammi, which would all go bankrupt in 1997, had debt-equity ratios of over 2,000 percent as early as 1995— more than five times the acceptable level of leverage in most countries.

Why was this problem not corrected? It was in part due to complacency and lack of awareness. In pre-crisis Korea, asset classification criteria and loan-loss provisioning requirements for commercial banks were quite lenient. As a result, it was difficult to assess the true magnitude of bank balance sheet problems. In fact, according to official data, nonperforming loans were estimated to be well below 10 percent of total credit. Moreover, the Korean economy in the mid-1990s was putting up stellar macroeconomic figures, thanks in part to aggressive corporate investment. Impressed by Korea's overall economic performance, few bothered to check if there were any hidden problems in the financial and corporate sector. Those few who compared the chaebol to "runaway locomotives" and pointed to potentially massive problems created by their reckless investment were dismissed as Cassandras.[8]

The failure to address the latent nonperforming loans problem also had something to do with political economy, for addressing this problem would have raised sensitive questions about corruption, incompetence, and negligence on the part of public officials and business executives.[9] Faced with the prospect of injecting a massive amount of public money to

denotes the earnings before interest payment and tax plus depreciation and amortization. If the interest coverage ratio is less than one, it means that the borrowing firm cannot meet its interest payment with its operating cash flow.

[8] For a prescient pre-crisis analysis of potential risks associated with moral hazard, see "The House that Park Built: A Survey of South Korea," Economist, June 3, 1995, as well as analyst reports in Marvin (1998).

[9] For example, the number of merchant banks had increased from six to thirty within a course of a few years before the crisis, and there were allegations of corruption in the issuing of new licenses. Had the government

clean up nonperforming loans, taxpayers naturally would have asked who was to blame. Moreover, 1997 happened to be the final year of the Kim Young Sam government, and the lame-duck government would have found it very difficult to win popular support for massive corporate and financial sector restructuring even if it had been clearly aware of the magnitude of the nonperforming loans problem.

This political environment combined with a blind faith in the "fundamentals" of the Korean economy and the virtues of market liberalization, skewed policy discussions in a particular direction. More often than not, the distinction between old-fashioned industrial policy and prudential regulation was ignored, and deregulation or termination of "government intervention" was equated with reform in the financial sector. As a result, financial sector liberalization in Korea in the pre-crisis period proceeded without an adequate build-up in the capacity to design and enforce prudential regulation and supervision. Although the government did review regulation and supervision issues prior to Korea's accession to the OECD in 1994, the focus was on controlling the flow of foreign capital rather than safeguarding the soundness of domestic financial institutions. The government opted for a gradual opening of the capital market to international investors, but neglected to take substantive measures to improve prudential regulation in the financial sector.

It was not until the fateful year of 1997 that the government made serious efforts to overhaul the outmoded financial system. The Presidential Commission for Financial Reform (PCFR), launched in January of that year, conducted a comprehensive study and submitted a number of policy recommendations that were to become essential components of the post-crisis reform program, including prescriptions to strengthen prudential regulation. However, these recommendations came too late.[10] A series of major bankruptcies, starting with Hanbo in January, had begun to rock the financial system. Faced with a political scandal in the wake of the Hanbo bankruptcy, which led to the arrest of President Kim Young Sam's son, the lame-duck government operating in a democratic environment could not avoid public scrutiny and indefinitely provide new credit to financially vulnerable companies. Nor could it attack the nonperforming loans problem head-on with the presidential election just around the corner. Instead, the government let financially vulnerable companies fail but pressured their creditors to agree to "suspend" formal bankruptcy proceedings. Government indecision precipitated a crisis of confidence. Foreign creditors became increasingly concerned with the security of their loans to Korean banks, which had provided credit to Korean firms, and they began to pull the plug on Korea. This formed the background of the 1997 crisis.

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tried to restructure distressed merchant banks and use taxpayers' money to clean up nonperforming loans, public officials would have been faced with tough questions about irregularities in the issuing of the licenses and subsequent failures in regulatory oversight. Unwilling to attract public scrutiny during their tenure, they delayed the day of reckoning. Most of the newly licensed merchant banks failed in the wake of the crisis.

[10] Besides, a jurisdictional fight between the Bank of Korea (BOK) and the Ministry of Finance and Economy (MOFE) over financial supervision delayed the legislative implementation of these recommendations.

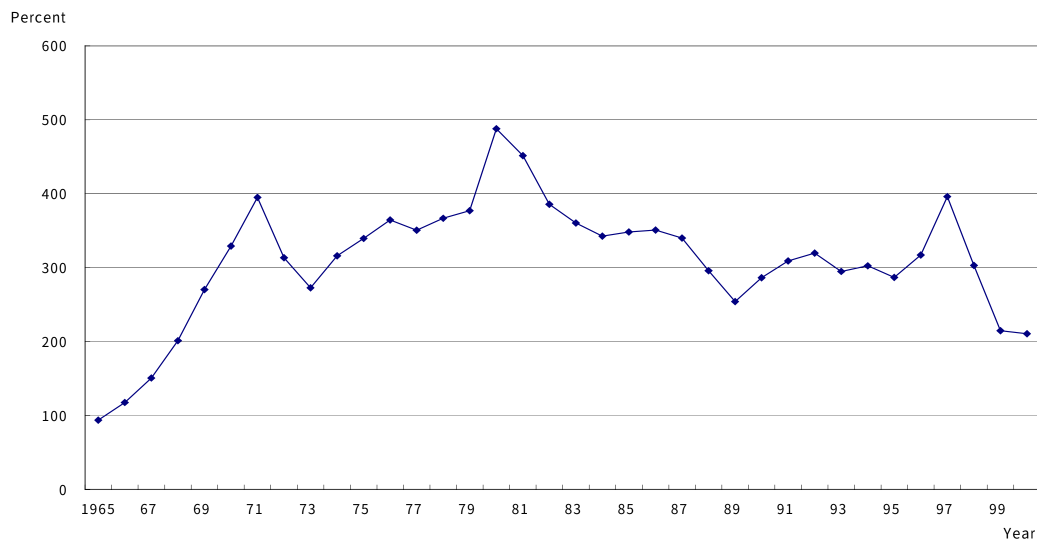
CHAPTER 3

The Nature of the Crisis and Reform Environment

The 1997 crisis was not the only major financial crisis that Korea experienced in its modern economic history. As Figure 2 shows, the financial vulnerability of the Korean economy, as indicated by the average debt-equity ratio for the Korean manufacturing sector, was at least as high in the early 1970s and early 1980s as in the years leading to the 1997 crisis. However, the nature of the previous financial crises was quite different from the 1997 crisis, and this difference had a significant impact on the subsequent course of reform.

The crisis in the early 1970s primarily had to do with Korean firms' dependence on short-term curb loans from the informal domestic financial sector. Speaking for "hard-working entrepreneurs" suffering from crushing debt, business leaders at the time went so far as to urge the Park Chung Hee government to reduce taxes, expand money supply, and have state-owned banks take over the "usurious" curb loans. In the end, the authoritarian Park government issued an emergency decree in 1972 and bailed out the debt-plagued corporate sector by placing a three-year moratorium on the repayment of curb loans and converting short-term high-interest loans into long-term loans on concessional terms. The government in effect sacrificed the property rights of underground curb lenders to relieve the debt burden of entrepreneurs it had come to trust as agents to carry out its ambitious economic development plans (Lim 2000: 31-36). Subsequently, there was very little financial sector reform other than efforts to bring in informal financial companies into the formal sector.

Figure 2. Average Debt-Equity Ratio for the Korean Manufacturing Sector



Source: Lim(2001)

The financial crisis in the early 1980s was a product of the ambitious government-led HCI drive of the 1970s. As such, the crisis had primarily to do with policy-oriented loans provided by state-owned banks, and the government could afford to take a gradual approach. In fact, after calling off the HCI drive in 1979, the government took a number of industrial rationalization measures— spiced with "special loans" from the Bank of Korea to commercial banks— and waited for the economy to grow out of the problem. The government could manage this domestic financial crisis without triggering a political problem.[11]

The 1997 crisis was different in that it involved a significant amount of short-term loans provided by foreign creditors in the private sector. With the liberalization of capital markets in the 1990s, the amount of capital inflow into Korea had greatly increased in the years leading to the crisis. As Table 1 shows, inward foreign investment in the pre-crisis period was primarily in the form of portfolio investment and bank lending rather than direct investment, which tends to be less sensitive to short-term factors. In fact, portfolio investment and bank lending accounted for more than 90 percent of total foreign investment, and their combined subtotal almost quadrupled between the 1990-93 period and the 1994-96 period.

Particularly problematic was the relative size of short-term foreign debt. In 1997, the amount of foreign debt coming due in a year was more than twice Korea's foreign currency reserves. The ratio between short-term foreign debt and foreign currency reserves rapidly deteriorated in the second half of the year. In fact, Table 1 shows that foreign bank lending (accounting for the lion's share of "Other Investment" in Table 1) declined sharply from the average of US$19.9 billion in 1994-96 to US$2.8 billion in 1997, as foreign creditors refused to roll over existing loans. Spooked by a series of major bankruptcies in Korea since the beginning of 1997 as well as the outbreak of the currency crisis in Southeast Asia, foreign creditors began to express doubts about the asset quality of Korean commercial banks that

Table 1. Composition of Foreign Investment Inflows to Korea

(unit: $ bil.)

	1986-1989[1)]	1990-1993[1)]	1994-1996[1)]	1997	1998	1999	2000
Total Inward Foreign Investment[2)]	-3.54 [-2.2]	9.33 [3.1]	35.92 [7.6]	17.93 [3.8]	-3.73 [-1.2]	7.55 [1.9]	19.23 [4.2]
Direct Investment	0.80	0.82	1.64	2.84	5.41	9.33	8.73
Portfolio Investment	-0.31	4.52	14.40	12.29	-0.29	6.99	11.96
- Equity	-	2.42	4.60	2.53	3.86	12.07	12.97
- Bonds	-0.31	2.10	9.81	9.76	-4.15	-5.08	-1.00
Other Investment[3)]	-4.04	3.99	19.88	2.80	-8.86	-8.78	-1.47

Note: 1) yearly averages
2) percentage ratio of inward foreign investment relative to nominal GDP in brackets
3) mostly bank lending
Source: Bank of Korea

[11] Korea's massive external debt in the early 1980s was also a problem, but Cold War security concerns apparently led the U.S. to provide relief. Korea was "too important to fail."

had provided substantial loans to failed companies. The foreign exchange liquidity problem in Korea was mainly caused by the creditors' run on Korean banks rather than by the speculation of short-term portfolio investors (Shin 2000).

The Korean government tried to buy time in dealing with corporate failures and used its considerable influence to persuade domestic creditors to abide by an aptly titled "bankruptcy suspension agreement" on an *ad hoc* basis. The government, however, did not have effective policy tools to prevent foreign creditors' bank run, because it could not credibly guarantee the repayment of foreign loans— short of taking over debt obligations from financial institutions. Because of the latent nonperforming loans problem, Korea would have had a financial problem of massive proportions even if it had been less exposed to foreign debt, but foreign creditors in effect forced the government to come to grips with the crisis by pulling out of Korea. The government had little choice but to go to the IMF for immediate relief, adopt internationally acceptable accounting standards, and promptly recognize the latent problem of nonperforming loans.[12] Although the weakening of investment discipline under one-sided liberalization was the underlying cause of the 1997 crisis, financial globalization thus played an important role in the outbreak of the crisis.

In addition to the international nature of the crisis, its severity also had a significant effect on the manner in which the crisis was resolved. Because of massive nonperforming loans, which amounted to 28 percent of Korea's GDP, it was unrealistic to expect affected financial institutions to grow out of their problems. Moreover, if financial institutions had been left to struggle to fight for their own survival, they would have called in loans to meet BIS-mandated capital adequacy ratios, and the ensuing credit crunch would have aggravated the crisis. The government could not muddle through if it was to avoid a social upheaval. If it was serious about dealing with the crisis, it had to turn to taxpayers and use public funds to clean up nonperforming loans.

The severity of the crisis and the subsequent burden it imposed on taxpayers had the effect of weakening the power and authority of those who might have opposed restructuring for fear of losing their control. This had significant implications for the politics of reform. It is often argued that because reform typically involves an asymmetric payoff matrix, reform provokes a highly lopsided political contest between fewer but better organized "losers" and more numerous but silent "winners." The economic crisis, however, had the effect of discrediting vested interests and emboldening entrepreneurial reformers. Long-delayed reforms had a better chance for implementation in the post-crisis period.

Yet it would be too simplistic to suggest that the crisis took care of reform. The window of opportunity for reform was not large. Recovering from their initial shock, vested interests in crisis-stricken countries typically put up a strong fight to protect their position.

In short, although the crisis forced the government to come to grips with the problem of nonperforming loans and affected the politics of reform, its role in promoting reform should not be overemphasized. After all, not every country buffeted by an economic crisis used it as an opportunity to implement long-awaited reform. In particular, as long as international creditors got their money back, they could care less about the content of the reform program. The crisis forced the government to recognize the underlying problem, but the manner in which the problem was addressed depended to a great extent on political mediation.

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[12] On November 21, 1997, Korea formally requested emergency assistance from the IMF. The IMF loan of US$19.5 billion consisted of US$13.5 billion in supplementary reserve facility (SRF) and US$6 billion in standby loan (SBL). The SRF was completely repaid by September 1999, and the redemption of the SBL also ended in August 2001.

CHAPTER 4

The Politics of Reform in the Transition Period

In looking at the politics of post-crisis reform in Korea, it may be useful to start out by debunking specious explanations. For instance, while the concentration of political and bureaucratic power in Korea might be an important factor to consider, especially in comparison with Japan, it has not always been a force conducive to reform. In fact, as previously mentioned, top bureaucrats exercised their considerable power to introduce a "bankruptcy suspension agreement" on an *ad hoc* basis in 1997, effectively delaying the resolution of corporate failures. It would be also wrong to infer that Korean politicians and bureaucrats had little concern about the stability of financial markets and the possibility of a political backlash against public funds— factors often cited in "explaining" Japan's failure to move decisively and effectively to dispose of nonperforming loans. As we shall see, Korean policymakers were all too aware of political risks involved in economic restructuring.

The actual dynamics of post-crisis reform in Korea was more complex, and involved some factors that might not be easily replicable in other countries. The severe economic crisis forced the government to tackle the nonperforming loans problem head-on and politically strengthened the position of entrepreneurial reformers, at least in the early post-crisis period. This immediate political impact of the crisis might be quite similar across crisis-stricken countries, but in Korea the outbreak of the crisis also coincided with a change of government, allowing the government to manage the crisis with a relatively clean slate. The change in political leadership brought about a change in policy paradigm as well. For over a quarter-century, Kim Dae Jung (or Kim Dae-jung), the newly elected president, had advocated that Korea make a transition from a developmental dictatorship to a democratic market economy, and he was more than willing to take full charge of the post-crisis reform program as a means of realizing his vision. As a result, the political commitment to reform in Korea was much stronger than in most other crisis-stricken countries.

Moreover, instead of blaming the crisis on "foreign speculators," Kim made serious efforts to attract foreign capital, not only as a source of hard currency and managerial know-how but perhaps also as a possible counterweight to the chaebol. The increased presence of demanding foreign investors, combined with institutional reforms designed to strengthen market discipline, helped to make Korea's post-crisis reform program credible and irreversible. While the government appealed to the patriotism of the Korean people, as evidenced by a public campaign to collect gold in the immediate wake of the crisis, it tried to ensure that this wave of patriotism did not turn into a nationalist backlash against foreign capital. Only a few other crisis-stricken countries seem to have used this combination of patriotism and openness to cope with their problems.

4-1. Changes in Political Leadership and Policy Paradigm

On December 18, 1997, barely two weeks after Korea had signed a financial rescue agreement with the IMF, Kim Dae Jung was elected President. His victory marked the first peaceful change of government in Korea since the inception of the republic in 1948. It was also a tremendous personal triumph for the 73-year-old former dissident, who had

endured imprisonment, house arrests, and assassination attempts during his fight for democracy.

Kim attracted strong passions from both his supporters and critics. He was a source of inspiration for many of his supporters at home and abroad. For instance, impressed by what he had to endure during his long struggle, an American journalist wrote that Kim Dae Jung was "a leader in a class with Nelson Mandela, someone who has experienced everything that is wrong in his society but still believes in pardon and redemption and can capture the world's imagination with his all but unbelievable personal saga."[13] Yet his critics remained deeply suspicious of him. They regarded him as a dangerous demagogue with a soft spot for communism. In the eyes of many voters, he was an anti-establishment candidate representing Korea's underdeveloped southwestern region, handicapped by his age and connections to old-fashioned money politics.[14]

There was also a question of experience and expertise. Although Kim claimed that he was a "well-prepared" candidate, his lack of experience in governing and his thin pool of advisors raised concern. As Korea was faced with an economic crisis, it did not seem like a good idea to entrust the presidency to a man widely thought to have only a rudimentary grasp of economics. In fact, investors and analysts tended to dismiss Kim Dae Jung as "an economic bumbler" who, however solid his credentials as a pro-democracy dissident, knew little about financial markets. Some feared that he would actively resist reform because of his political ties to labor unions. Those concerns were reinforced when he declared his intention to "renegotiate" the terms of the IMF agreement in the final days of the election campaign, raising questions about Korea's commitment to reform.[15]

They had their reasons to be concerned, but their expectations proved to be wrong. What Kim offered to the electorate was nothing less than "a democratic alternative for Korea." When he first ran for President in 1971, he advocated what he called "a mass-participatory economy" as an alternative to Korea's developmental dictatorship, which he argued was creating serious political and social distortions under the pretext of generating rapid economic growth. He wanted to restore market mechanism and dismantle collusive ties between the government and the chaebol so that all groups, including entrepreneurs, workers, farmers, and consumers, could benefit from the opportunities that a free market economy had to offer. He also wanted to "liberate" business executives from having to curry favor with the government and let them focus on running their companies (Kim 1985).

He regarded democracy as a universal value, and strongly argued that it would be imperative to guarantee democratic freedom in the age of knowledge-based economy. When Singapore's Lee Kuan Yew went on the offensive against western individualism and defended authoritarian rule in Asia, Kim Dae Jung contended that the anti-democratic bias of "Asian values" was a myth. Citing Mencius, he noted that the idea of popular sovereignty was an ancient concept in Asia. He argued that in order for Asian nations to foster innovation and make a transition to economic growth based on productivity improvement, Asia would have no practical alternative to democracy (Kim 1994).

These ideas formed the intellectual background of his presidency. As soon as he was elected President, Kim declared that he would make "the parallel development of democracy and a market economy" his governing philosophy. In a newspaper interview, he said: "Democracy is key to maintaining sound economic development. If we had had a

[13] Mary McGrory, "Can Kim Fix It?", Washington Post, December 28, 1997.

[14] "Kim Dae Jung's Triumph…," Washington Post, December 21, 1997.

[15] Clay Chandler, "S. Korea's Kim Proves Mettle in Financial Crisis: President-Elect Gains Support for Savvy Economic Strategy," Washington Post, December 29, 1997.

democratic system in the past, then there would be no corrupt connection between businessmen and political power, no government-controlled economy, and also no wrongdoing of businessmen. A major cause of our economic failure today comes from lack of democracy in this country."[16] He also made it clear that he would not use the economic crisis as an excuse to resort to authoritarian tactics. Instead, he indicated he would try to legitimize structural reform through a democratic process, such as tripartite consultation bringing in labor, management, and government representatives.

To the president-elect, the unprecedented economic crisis was not only a tremendous challenge but also a monumental opportunity to turn his long-held vision into reality. Although he was closer to social democrats or ordo-liberals than to neo-liberals in his thinking, his vision for a democratic market economy was not in serious conflict with the demands of the IMF program. On issues connected with corporate and financial sector reform, the new government actually wanted to do more than what the IMF required. Moreover, although the IMF typically demands cutbacks in welfare, Korea had only a minimal program of welfare at the time of the crisis and actually had to strengthen its social safety net.[17] Even the IMF agreed that an increase in the welfare program was necessary to maintain social stability.

4-2. Crisis Management and Coalition-Building

Politically, Kim Dae Jung had to persuade two relatively sympathetic, but widely divergent audiences, while protecting his position from a possible counterattack by those with vested interests in the old system, including the chaebol. On the one hand, to keep Korea from insolvency, he had to convince international creditors that he understood the importance of the IMF program and was fully committed to painful reform. On the other, he had to persuade the general public who were concerned about job losses and were highly suspicious of "foreign intrusion." His solution was to pre-empt the demands of international creditors and go beyond what the IMF required in terms of structural reform. To the general public, including his longtime supporters, he offered a strengthened social safety net instead of blanket protection from unemployment,[18] and made a strong case for the benefits of foreign direct investment.[19] Just like Charles DeGaulle on Algeria's

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[16] Bernard Krisher, "Kim Dae Jung: Linking Liberal Democracy to Economic Growth in South Korea," Los Angeles Times, January 11, 1998.

[17] In Indonesia, which had fallen prey to a currency crisis a few months before Korea in 1997, the IMF's demand to cut public subsidies in the midst of the crisis was widely criticized.

[18] Strong job security in exchange for weak workers' rights had been an integral part of the implicit social contract under the authoritarian regime in Korea. After Korea was democratized in 1987, this arrangement came under attack from both labor and management. Workers demanded wage increases as well as full-fledged rights to organize and take collective action. Business executives complained that lifetime employment practices impeded corporate restructuring and flexible adjustment to changes in the global market. A grand bargain between labor and management would have involved enhanced workers' rights and social security in exchange for increased labor market flexibility. In the pre-crisis period, however, repeated attempts by the government to broker such an agreement between the two sides resulted in protracted gridlocks.

[19] From the outset, foreign investors occupied an important position in Kim Dae Jung's reform coalition. In his first TV town hall meeting, Kim forcefully argued that Toyota USA was a much more American company than IBM Japan. To the stunned audience who had been accustomed to the "patriotic" protectionist practices of "Korea, Inc.," he said Korea should make every effort to attract foreign investment. Foreign executives were stunned as well. Although they knew the president-elect had few allegiances to the chaebol, foreign executives feared he lacked a sophisticated understanding of Korea's economic problems and that his support for labor would be a major obstacle to structural reform. In an unprecedented face-to-face meeting with foreign executives, however, he promised that discrimination against foreign companies would be terminated, as would the collusive ties between the government and the chaebol. While some might have suspected this new openness was simply

independence and Richard Nixon on the normalization of U.S. diplomatic relations with China, Kim Dae Jung took advantage of his track record as a champion of workers and persuaded his supporters that economic conditions had changed. To the chaebol and other vested interests wary of his reform policy, he emphasized that the old system based on collusive business-government relations had run its course. At the same time, however, he made it clear that he would support the honest efforts of business executives. He skillfully took advantage of the crisis atmosphere to deliver his messages.

His first test with his "international constituents" came on December 22, 1997, when he met with David Lipton, U.S. Treasury undersecretary for international finance, who wanted to gauge the president-elect's commitment to reform. Kim told Lipton that, while he was sympathetic to workers' plight, job losses were inevitable because of the harsh terms of the IMF-led rescue package, and he promised he would work closely with labor unions to gain their cooperation. Kim's comments helped to reassure international creditors that Korea was serious about reform and if they agreed to roll over their loans to Korea they would eventually be repaid.[20] He thus passed his "job interview" in flying colors and won the support of his international constituents (Kim et al. 2003: 17-26).

Kim then used the crisis atmosphere to persuade his domestic constituents. In a meeting with national lawmakers on December 23, the president-elect said, "We don't know whether we'll default tomorrow or the day after tomorrow. The cash vault is empty…. I can't believe how the government has been so negligent." By the Election Day on December 18, Korea's foreign currency reserves had dwindled to US$3.9 billion , and, without an immediate infusion of hard currency, were projected to reach *minus* US$6 to 9 billion by the end of the year. It was, however, one thing for the president-elect to be aware of the near-default situation and quite another for him to go public with the alarming news. Combined with the downgrading of Korea's credit rating to "junk bond" status announced on the same day, Kim's comments threw financial markets into a tailspin. Yet, in retrospect, his move might have been a calculated gamble to deliver a wake-up call to the Korean people and persuade them their sacrifice would be needed.

In his subsequent meeting with labor leaders, he basically repeated what he had told Lipton and said job losses were inevitable. He promised he would expand unemployment insurance and guarantee workers' rights in return for increased labor market flexibility.[21] Some labor union members felt betrayed by his turnaround on the need for layoffs, but under the crisis atmosphere, they could not openly protest and risk becoming a "scapegoat" for damaging Korea's credibility in the eyes of international investors. The president-elect then turned his attention to the chaebol. In January 1998, he used a highly publicized meeting with business leaders to lay out basic principles of corporate restructuring that emphasized accountability, transparency, and financial soundness.[22]

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born out of expediency, it proved to be a much more profound change. See Sandra Sugawara, "In S. Korea, Business Anything but Usual: A Surprisingly Aggressive Kim Stuns Foreign, Korean Investors Alike," Washington Post, February 24, 1998.

[20] Paul Blustein and Clay Chandler, "Behind the S. Korean Bailout: Speed, Stealth, Consensus," Washington Post, December 28, 1997.

[21] Unemployment insurance was introduced in Korea in 1995. When the economic crisis broke, its coverage was limited to companies with more than 30 regular employees. In 1998, the minimum number of regular employees required to qualify for unemployment insurance was lowered to ten in January and five in March. In October, the coverage was extended to all companies and temporary/part-time workers. The compensation rate was also raised from 50 percent to 70 percent of previous wages, and the minimum benefit period was doubled to 60 days. In 1998, a total of 441,000 unemployed workers received some insurance benefits. In the wake of the crisis, the unemployment rate reached 8 percent at its peak, more than three times the pre-crisis level. To push ahead with structural reform, it was essential that the government maintain social stability

[22] Donald Kirk, "Corporate Chiefs' Pledge Raises Spirits in Seoul," International Herald Tribune, January 14, 1998. These principles were subsequently incorporated into capital structure improvement plans (CSIPs) that

Through TV town hall meetings, he also urged citizens to work together to overcome the economic crisis. The nation quickly rallied around the president-elect "with a survival instinct and patriotic fervor reminiscent of World War II America."[23] Perhaps the best example of this patriotic fervor came in the form of a public campaign to collect gold in the immediate wake of the crisis. In a few months, more than 2 billion dollars in gold were collected to help pay the nation's foreign debt.[24] Unlike some crisis countries marred by capital flights and "dollarization," Korea drew strength from the nation's collective will to overcome the crisis.

The crisis atmosphere also helped Kim Dae Jung to overcome his limitations as a minority president, especially in the early post-crisis period. The new government was based on a coalition between the reformist National Congress for New Politics (NCNP) and the conservative United Liberal Democrats (ULD).[25] The NCNP-ULD coalition remained a minority in the parliament. In the 299-member National Assembly, NCNP and ULD had 78 and 42 seats, respectively, while the opposition Grand National Party (GNP) had 161 seats. However, GNP, the former ruling party, was widely blamed for having mismanaged the economy, and was too much discredited to put up active resistance, at least in the early days of the new government.[26] For that matter, no party, including ULD, could defend old business-government relations with a straight face in the post-crisis environment. Although the NCNP-ULD coalition did not have a parliamentary majority, it took advantage of the crisis atmosphere to enact major reform bills with a little help from the IMF.[27]

Once the new government set its sight on reforming Korea's economic system, the concentration of political power in Korea came in handy. President Kim proactively defined his reform agenda and directed professional bureaucracy to implement specific measures. Korea's meritocratic bureaucracy, relatively insulated from particularistic interests and trained to be loyal to the president, played a critical role in implementing reform (Kim 2002). The professional bureaucracy supplemented President Kim's thin pool of advisors, although they did not always agree on the pace and scope of reform.

Unlike in the authoritarian period, non-governmental organizations (NGOs) also became important players in the politics of reform. In particular, People's Solidarity for Participatory Democracy (PSPD) led a campaign to introduce reforms designed to improve corporate governance and monitored progress in corporate and financial sector restructuring. Lacking a parliamentary majority, the government frequently drew strength from civil society, which in turn urged the government to push ahead with reform.

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companies signed with their main creditor banks under the guidance of the Financial Supervisory Commission (FSC). Corporate sector restructuring was thus linked to financial sector restructuring.

[23] Evelyn Iritani, "S. Koreans' Crisis Mentality: Patriotism," Los Angeles Times, January 14, 1998.

[24] John Burton, "South Korea: Kim stands tall before bowed nation," Financial Times, February 25, 1998.

[25] Kim had been defeated in 1987 and 1992 when the opposition parties could not unite, but in 1997, to reassure conservative voters and improve his "electability," he struck a deal with Kim Jong Pil and Park Tae Joon, two of the stalwarts of the Park Chung Hee regime. The less institutionalized party system in Korea, which revolved around personalities rather than ideological beliefs, helped to facilitate such a strange coalition. When a maverick politician who had defected from the ruling party split the establishment vote, Kim slipped through with a narrow margin of victory. His victory was thus a triumph of electoral calculus and luck, as well as a reflection of voter dissatisfaction with the old collusive system that had brought about the economic crisis.

[26] In the early post-crisis period, GNP could not openly defend old business-government relations nor advocate one-sided deregulation. It had to go along with reform measures designed to improve accountability and transparency. When it did criticize the new government, it resorted to "free market" rhetoric and argued that the government should stop meddling in economic affairs under the pretext of implementing reform. On other occasions, GNP also criticized the government for selling off valuable companies to foreigners.

[27] However, any hopes of an extended political honeymoon for Kim Dae Jung were quickly dashed. Hours after the inauguration on February 25, 1998, conservative opponents in the National Assembly moved to block approval of his choice for prime minister.

CHAPTER 5

Financial Sector Reform and the Role of Foreign Capital

From the outset, the new government regarded foreign investors as partners in reform. Instead of blaming the crisis on "foreign speculators" and "conspiratorial forces," Kim Dae Jung contended that the crisis had its roots in distorted business-government relations. He promoted foreign investment not only as a means of obtaining hard currency but also as a source of advanced know-how and quite possibly as a countervailing force against Korea's vested interests including the chaebol. In fact, his enthusiasm for foreign investment would outlast Korea's need to attract foreign capital to help pay the national debt and improve its credit rating.[28]

As we discuss below, the role of foreign investors in supporting Korea's reform was perhaps most pronounced in the financial sector, as they played a direct role in the initial outbreak of the crisis but also made a major contribution to institutional reform in this area. To add credibility, major reform measures were typically introduced in connection with IMF conditionalities. Also, the government fundamentally changed its policy on foreign investment, counting on foreign investors to help provide market-based discipline and restore Korea's credit rating. Thanks to liberalizing measures and improved prospects for the Korean economy, the share of foreign investors in the market capitalization of companies listed on the Korea Stock Exchange more than doubled between 1997 and 2001, from 14.6 to 36.9 percent. In the financial sector, foreign direct investment as well as portfolio investment played a fairly important role in the recapitalization and equity build-up of some banks and non-bank financial institutions. In addition to the infusion of capital and managerial expertise, increased foreign direct investment also had political economy consequences. For example, the foreign management of Korea First Bank, taken over by Newbridge Capital in 1999, not only changed the bank's operations but flatly refused to support government efforts to orchestrate continued credit lines to firms deemed unworthy of further support. At times, the credible threat of exit by foreign portfolio investors put the government back on reform track.

Financial sector reform reflected the general political dynamics of reform in the post-crisis period. A number of important reformist bills were enacted during the transition period under the crisis atmosphere. Politically sensitive decisions, including the injection of public funds and closure of distressed financial institutions, were also made in the early post-crisis period. The first step in the post-crisis financial sector reform was laying out a statutory and regulatory framework to implement necessary reform measures. On December 29, 1997, thirteen financial reform bills, including a bill to establish a consolidated financial supervisory authority, were enacted by the National Assembly. According to the act, the Financial Supervisory Commission (FSC) was established in April 1998, and in January 1999, existing supervisory bodies were merged into a consolidated Financial Supervisory Service (FSS) as an administrative body under the FSC. In addition,

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[28] Even after a V-shaped recovery pulled the Korean economy out of the crisis in 1999, Kim continued to promote foreign investment. When the opposition GNP made "the drain of national wealth" an election issue in 2000, accusing the government of selling valuable companies at bargain prices to foreigners, the government responded that the sales had taken place through a competitive bidding process and that foreign investment offered substantial benefits in terms of job creation and productivity improvement.

the *Financial Industry Restructuring Act* was amended so as to give FSC and FSS effective statutory authority to order write-offs, mergers, suspension, and closures of ailing financial institutions. An NPL resolution fund was created within the Korea Asset Management Corporation (KAMCO) to purchase nonperforming loans from financial institutions.

The Presidential Commission for Financial Reform had recommended most of these reform measures earlier in 1997, but it was not until after the onset of the crisis the previous impasse was broken. In spite of the objections from the Bank of Korea, the Ministry of Finance and Economy had sought to play a greater role in financial supervision; chagrined by the crisis, however, the Ministry could no longer insist on expanding its powers—at least in the early post-crisis period. The IMF's endorsement of the existing reform package contributed to the relatively swift financial restructuring in Korea. This type of endorsement and enforcement was one of the main contributions of international organizations in Korea's financial reform.

Financial sector reform measures undertaken by the government under the advice of the IMF are summarized in the Appendix, which shows that not only urgent restructuring measures but also more fundamental structural reforms were implemented to overhaul and upgrade the financial system. Table 2 shows the basic framework of financial sector restructuring in Korea.

In addition to trying to make the financial system a more market-based one, the Korean government focused its efforts on disposing of nonperforming loans and reducing moral hazard in the financial sector. We now turn to look at the government's efforts and the role of foreign capital in each of these areas.

Table 2. Basic Framework of Financial Sector Restructuring

Principles	Actions
• Stabilize financial markets by swift and extensive reform	- Sort out insolvent financial institutions from viable ones - Support recapitalization of viable banks
• Conform to internationally practiced standards	- Strictly apply prompt corrective action provision - Enhance information transparency and strengthen disclosure requirements
• Establish transparent principles of accountability among concerned parties	- Clarify burden sharing rules among shareholders, management and depositors - Write off equity capital and reinforce management accountability
• Prevent collapse of financial system through timely fiscal support	- Increase deposit insurance fund - Minimize public burden by linking fiscal support to self-rehabilitation efforts

Source: Korea Development Institute (1998)

5-1. Disposal of Nonperforming Loans

Although the legal infrastructure for financial sector restructuring was laid out, actual progress was rather slow in the immediate post-crisis period. Financial institutions were neither willing nor able to take tough measures on nonperforming loans, for that would lead to a further deterioration of their balance sheets. Indeed, until their balance sheets improved sufficiently and their capital adequacy ratios substantially exceeded the BIS-mandated level (8 percent for banks, for instance), the creditor banks had little incentive to make a full provisioning for bad loans and realize large losses that might threaten their own survival. The corporate debtors, for their part, personally had little left to lose once the loss of corporate control became a virtual certainty, although the firm itself might be worth saving through court-led corporate reorganization. The individual incentives of the creditors and the debtors prevented them from taking actions to arrest the continuing destruction of firm value.

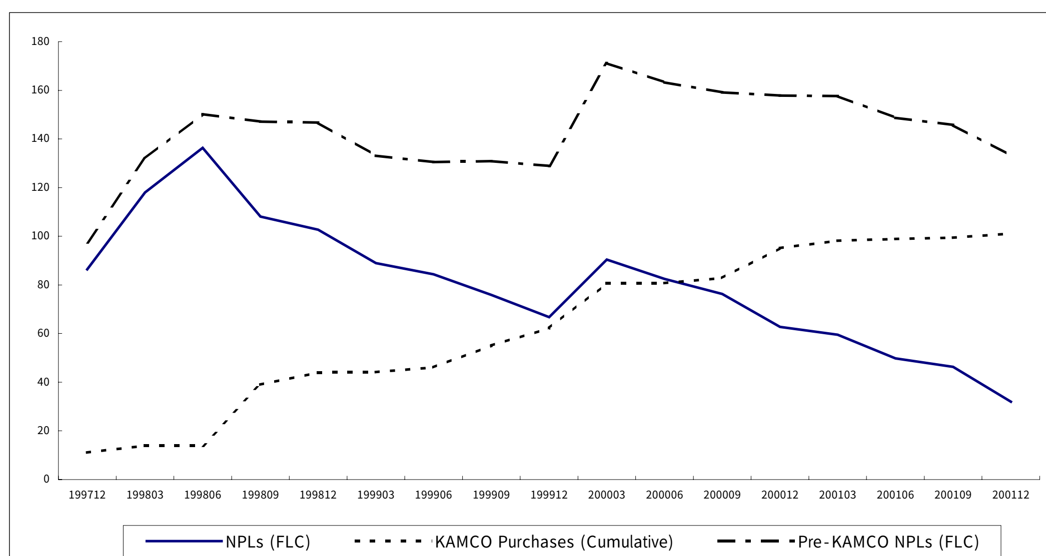
The government had to step in with public funds and urge financial institutions to take proactive measures against insolvent firms. Although the injection of public funds was likely to generate political controversy, the government decided to bite the bullet and stabilize the financial system. As nonperforming loans reflected the investment mistakes of the past, there was little point in delaying the resolution of this problem. Moreover, the magnitude of the problem was such that it was basically impossible for banks themselves to clean up NPLs. Although the injection of public funds would threaten the job security of bank managers, they did not have the political clout to derail the restructuring process.

Once the government decided to inject public funds to rehabilitate the financial sector, the question became what exactly constituted "nonperforming loans." Prior to the crisis, only loans in arrears of 6 months or more had been classified as NPLs. In estimating the "true" magnitude of NPLs at the end of March 1998, however, the government followed internationally acceptable standards and included loans in arrears of 3 months or more. The government arrived at the figure of 118.0 trillion won, or approximately 28 percent of Korea's GDP in 1997— twice as large as the estimated NPL total of 59.6 trillion won based on the old asset classification standards. The government initially estimated that the public cost required to complete financial sector restructuring would be around 64 trillion won.

In June 1998, five banks with negative BIS capital adequacy ratios, with the proportion of NPLs ranging from 21 percent to 49 percent of total credit, were closed and their healthy assets were transferred to financially strong banks through purchase and assumption (P & A). Seven other banks were required to submit restructuring plans by the end of July 1998. Eventually, five out of these banks were merged in the recapitalization process. Although bank employees concerned with job security did stage demonstrations, bank executives and shareholders did not have the political clout to block financial sector restructuring triggered by prudential regulation, which involved the injection of public funds in return for equity write-downs and managerial changes.

In December 1999, under the terms it agreed with the IMF, the government further strengthened prudential regulation by introducing a forward-looking approach in asset classification, taking into account the future performance of borrowers in addition to their track record in debt service. The forward-looking criteria (FLC) pushed creditors to make a more realistic assessment of loan risks based on borrowers' managerial competence, financial conditions, and future cash flow. Creditors classified loans as "substandard" when borrowers' ability to meet debt service obligations was deemed considerably weakened. In March 2000, the asset classification standards were further strengthened with the introduction of the enhanced FLC, which classify loans as "nonperforming" when future risks are significant—even if interest payments have been made without a problem

Figure 3. Non-Performing Loans before and after KAMCO Purchases



Source: MOFE and FSC (2000: 280-286), *White Paper on Public Funds*; MOFE and PFOC (2001: 215), *White Paper on the Oversight of Public Funds*; Korea Asset Management Corporation; Public Fund Oversight Committee

up to that point. Based on the enhanced criteria, NPLs would have increased from 66.7 trillion won to 88.0 trillion won at end-1999.

The introduction of the forward-looking criteria, combined with the collapse of Daewoo in 1999, Korea's second largest business group at the time, raised renewed concerns about the capital adequacy of financial institutions. Once again, given the magnitude of the problem, the injection of public funds appeared to be the only realistic option. However, facing a National Assembly election in April 2000, the government could not afford to risk a political backlash by pronouncing the need to raise additional public funds. The government waited until financial markets became turbulent enough to ask for an additional public fund of 50 trillion won. It persuaded the public that there was little alternative but to launch a second round of financial sector restructuring in September 2000.

The imposition of stricter standards and additional corporate failures in the post-crisis period made NPLs something of a moving target. Between 1997 and end-2001, KAMCO purchased 101.2 trillion won of NPLs (face value) for the actual cost of 38.7 trillion won. Figure 3 shows NPLs before and after KAMCO purchases. In the figure, the size of NPLs before and after 2000 is re-estimated based on FLC and enhanced FLC, respectively. The spike in the trend line at the beginning of 2000 is due to this change in asset classification standards and the increase in NPLs after the collapse of Daewoo. NPLs before KAMCO purchases have been declining since 2000, and thanks to improved profitability, financial institutions on their own have been able to dispose of NPLs aggressively since 2001.

In Korea, there were also political economy factors specific to the financial sector that facilitated reform. In particular, the absence of controlling shareholders at commercial banks helped to make large-scale financial sector restructuring a politically viable process in Korea, at least in comparison with other crisis-stricken countries. In Thailand, for instance, large bankers were too powerful politically for the government to include in a financial sector restructuring program in which public money was injected in return for

equity write-downs, downsizing, and management change.[29] Consequently, the Thai government let large banks restructure "voluntarily" by setting up private asset management companies (Kim 2002: 206). In Korea, by contrast, the government was able to push through a comprehensive financial sector restructuring program with relatively little trouble because the appointment of top bank executives was in effect controlled by the government.

When there were controlling shareholders at distressed financial institutions, however, restructuring became an uphill battle for the government as these shareholders put up active resistance to avoid the loss of managerial control.[30] Although many of the smaller chaebol-controlled non-bank financial institutions (e.g., merchant banks and securities companies) were "restructured" through bankruptcies at the end of 1997 and beginning of 1998, it was much more difficult for the government to restructure larger NBFIs with strong controlling shareholders. For instance, the controlling shareholder of Daehan Life Insurance staged a tough legal battle against the government before the court finally ruled in favor of the government.[31]

As for the role of foreign capital, only a limited number of foreign creditors and investors took part in sharing the "legacy costs" of previous investment mistakes, even though they had played a critical role in forcing the Korean government to recognize these costs at the time of the crisis. Portfolio investors with stakes in Korean companies might have suffered investment losses when these companies subsequently went bankrupt; foreign creditor banks with loans to financially distressed firms such as Daewoo Motors and Hyundai Electronics (later renamed Hynix) had to take "a haircut" in subsequent debt restructuring negotiations; however, on the whole, the burden of paying for the legacy costs of previous investment mistakes fell largely on Korean taxpayers. International organizations such as the IMF and foreign investment analysts pushed the Korean government to be as transparent as possible about the magnitude of nonperforming loans by demanding strict asset classification criteria.

Despite various potential risks remaining in the financial sector, the overall outcome of the financial sector restructuring seems to be positive. As a result of the first and second round of financial restructuring, a total of 787 insolvent financial institutions (or 37.5 percent) have been either closed or merged as of June 2003. Table 3 summarizes changes in the number of financial institutions by group.

In this process, the government injected 160.4 trillion won, which is equivalent to approximately 30 percent of Korea's GDP in 2002. Two-thirds of public funds were raised through bonds issued by KAMCO and Korea Deposit Insurance Corporation (KDIC). More than 46 trillion won was used to settle deposit insurance obligations and to provide liquidity to distressed financial institutions (deposit payoffs and capital contribution). This money is presumed to be lost. Funds used for recapitalization and purchase of NPLs and other assets make up the rest, with better prospects for recovery. As of June 2002, it was estimated that a total of 69 trillion won would in effect be irrecoverable. Table 4 shows the uses of public funds.

As a result of the restructuring program, both capital adequacy and profitability of financial institutions have improved substantially. The BIS capital adequacy ratio has exceeded 10 percent since 1999, and the share of nonperforming loans has fallen sharply as

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[29] As of December 1997, 11 out of 15 Thai banks were controlled by Chinese emigrants or related firms in Thailand.

[30] In the corporate sector, too, the powerful chaebol strongly resisted reform. In fact, the top five business groups were initially placed outside the scope of corporate workouts that might threaten the governance rights of incumbents. The government let them "voluntarily" restructure themselves until the problems at Daewoo and Hyundai became too large to ignore (Haggard, Lim, and Kim 2003).

[31] For details, see Kim et al. (2003: 149-168).

Table 3. Financial Restructuring in Korea

(As of June 2003, unit: number of institution)

	Total No. (end-1997) (A)	Type of Resolution					New Entry	Total No. (end-June 2003)
		License Revoked	Merger	Others[1]	Subtotal (B)	Ratio (%) (B/A)		
Banks	33	5	10	-	15	45.5	1	19
Merchant Bank Corporations	30	22	6	-	28	93.3	1	3
Securities Companies	36	5	3	2	10	27.8	18	44
Insurance Companies	50	8	6	2	16	32.0	13	47
Investment Trust Companies	31	6	1	-	7	23.3	9	32
Mutual Savings and Finance Companies	231	100	27	1	128	55.4	12	115
Credit Unions	1,666	2	106	463	571	34.3	9	1,104
Leasing Companies	25	9	1	1	12	48.0	4	17
Total	2,101	157	161	469	787	37.5	67	1,381

Note: 1) Includes dissolution and asset transfers to bridge institutions.
Source: Public Fund Management Committee, Ministry of Finance and Economy, *White Paper on Public Funds*.

shown in Table 5. With continuous NPL resolution efforts and improved bank management environment, pre-provision profit began to exceed provisions from 2001, and commercial banks finally began recording profits.

5-2. Reduction of Moral Hazard

In addition to tightening asset classification criteria and cleaning up the legacy costs of nonperforming loans, the Korean government took forward-looking measures to improve the efficiency and stability of the financial system. Given the history of the government-business risk partnership in Korea, war on moral hazard constituted the most significant part of this program. It entailed formal institutional reforms as well as corporate failures and investors losses that enhanced the credibility of these reforms.

The most significant institutional reform in this area was the introduction of partial deposit insurance. Prior to the crisis, depositors and investors had typically assumed that their assets were fully protected by the government. Starting January 2001, the deposit insurance limit was set at 50 million won (approximately US$ 41,700) per person per financial institution.

Table 4. Sources and Uses of Public Funds, November 1997-June 2003

(unit: trillion won)

	KDIC and Others				KAMCO	Total
	Recapitalization	Capital Contribution	Deposit Payoffs	Purchase of Assets	Purchase of NPLs	
Banks	34.0	13.7	0	14.0	24.6	86.2
NBFIs	26.3	3.3	29.8	0.3	14.5	74.2
Merchant Banking Corporations	2.7	0.2	17.2	0.0	1.6	21.7
Insurance Companies	15.9	2.9	0.0	0.3	1.8	21.0
Securities and ITCs	7.7	0.0	0.01	0.0	8.5	16.2
Mutual Savings Banks	0.0	0.2	7.9	0.0	0.2	8.2
Credit Cooperatives	0.0	0.0	4.7	0.0	0.0	4.7
Others	0.0	0.0	0.0	0.0	2.4	2.4
Total	60.3	17.0	29.8	14.3	39.1	160.4

Source: Public Fund Management Committee, Ministry of Finance and Economy, *White Paper on Public Funds*.

Table 5. Nonperforming Loans Held by Banks and NBFIs, 1999-2001

(unit: trillion won)

		End-1999	End-2000	End-2001
NBFIs	NPLs (% of Total Credit)	21.1 (24.1)	20.6 (22.6)	13.2 (13.7)
	Total Credit	87.5	91.1	96.4
Banks	NPLs (% of Total Credit)	61.0 (12.9)	42.1 (8.0)	18.8 (3.4)
	Total Credit	474.3	526.3	551.1

Notes: 1) Loans classified as "substandard" or below are defined as NPLs.
2) NBFIs (non-bank financial institutions) include merchant banks, mutual savings banks, credit unions, and financial companies specializing in providing credit (e.g., credit card companies).
Source: Financial Supervisory Service.

Massive corporate failures served as credible signals that the government's implicit guarantee regime had indeed changed. Through both court-led corporate reorganizations and out-of-court workouts, the management of many leading chaebol was displaced and controlling shareholders saw their holdings either written down or altogether wiped out. In fact, of the 30 largest business groups in 1996, 14 had gone bankrupt or entered workout programs by the end of 1999.

The resolution of the Daewoo crisis marked the culmination of the government's efforts to reduce moral hazard. Investors, small and large alike, apparently believed that implicit government guarantees against bankruptcy continued to operate for the top five chaebol, even after smaller business groups had crumbled in 1997 and 1998. In fact, the government initially declared that the top five chaebol were formally shielded from out-of-court workouts, adding substance to investors' expectations. Implicit government guarantees and chaebol control of non-bank financial institutions created serious distortions in financial markets. Daewoo, in particular, had issued 17 trillion won of new corporate bonds and commercial papers by September 1998. Many investors snapped up Daewoo bonds, betting the government would come to its rescue. This episode showed that when market expectations themselves created serious distortions, "market-led" corporate restructuring could produce a perverse result. On October 28, 1998, frightened by Daewoo's snowballing debts, the government imposed a cap on exposure to corporate bonds issued by any single chaebol at 10 percent for banks and 15 percent for investment trust companies (ITCs).

The massive failure of Daewoo in August 1999 finally shattered "too-big-to-fail" expectations. The government did use taxpayers' money to bail out small individual investors rather generously, allowing them to redeem up to 95 percent of the face value of Daewoo corporate bonds. Nevertheless, imposing even a 5-percent loss rate represented a dramatic departure from the past regime. Convinced that corporate bonds no longer had the implicit backing of the government, investors converted corporate bonds and fled from ITCs to banks. This flight to quality forced the government to step in and bail out ITCs, which had suffered huge losses from Daewoo bonds.

The Daewoo crisis created an interesting transitional problem of missing markets. As investors became aware of default risks, many firms began to have trouble rolling over their corporate bonds. In effect, Korea's bond market became deluged with "junk bonds" without an operational junk bond market in place to handle them. In 1999 and twice in 2000, the government felt compelled to orchestrate market stabilization measures that included partial government guarantees. In effect, the government's implicit full guarantees were replaced by explicit partial guarantees.

The introduction of the forward-looking criteria at the end of 1999 was designed to address the problem of forbearance that received increased attention in the wake of the Daewoo fiasco, by encouraging financial institutions to take decisive actions on distressed firms. In July 2000, the government also expanded mark-to-market principles to cover all investment funds. Further progress in Korea's transition to a more market-oriented economy crucially depends on how quickly Korea can replace stopgap measures with market solutions and induce the orderly exit of nonviable firms.

Although the resolution of the Daewoo crisis marked a watershed in Korea's war on moral hazard, it was still not the end of the story. It is simply not true that the Korean government always moved decisively on the restructuring front. In fact, when large firms with potentially serious repercussions for the economy were on the verge of failure, the government tended to put off the day of reckoning in the hope that the companies themselves might take care of their problems through self-rescue programs. This wait-and-see policy, however, could not work for long in the changed institutional environment of post-crisis Korea. The government's reform program, in conjunction with financial

globalization, had greatly strengthened market forces, and "bankruptcy suspension" could not be sustained.

The resolution of problems at Hyundai Construction in 2000 and 2001 was a case in point. The government and government-controlled banks were slow to take tough measures, hoping the company would somehow take care of its problem through asset sales and other self-rescue programs. However, the business-as-usual scenario could not be sustained. Hyundai Construction ran out of viable assets to sell. Investors demanded a higher and higher risk premium on its corporate bonds. Fearing litigation, which had become a realistic threat in post-crisis Korea, the creditors objected to providing fresh loans for the company unless its vulnerable financial structure was fixed and its prospects materially improved. International financial institutions and credit-rating agencies held Hyundai Construction as a litmus test for Korea's reform prospects. In the end, after nearly a year of wavering, the creditors implemented a serious restructuring plan; the previous owner-manager's equity was wiped out, minority shareholders' equity was written down in the ratio of 6 to 1, and a new management team was brought in by the creditors.

Foreign capital played a somewhat mixed role in addressing the problem of moral hazard. Foreign creditors and investors with substantive stakes in financially distressed companies tried to minimize their losses and shift the burden of restructuring to the Korean government. By contrast, foreign investment analysts and credit-rating agencies advocated debt restructuring based on market principles and suggested that the government avoid socializing the losses. In the end, as the government tackled the problem of moral hazard, foreign creditors and investors had to take losses just like their Korean counterparts.[32]

5-3. Transition toward a More Market-based Financial System

The financial reform package agreed with the IMF and the World Bank included various measures to make Korea's financial system a considerably more open and more arm's-length, market-based system.[33] As summarized in the Appendix, with the restructuring and prudential regulatory measures, full-blown capital account opening and capital market liberalization measures also characterized Korea's reform package. These reform measures were more fundamental and focused on the deregulation and infrastructure building to ensure the transparency and credibility of market signals. Reform efforts were undertaken to strengthen corporate governance and to upgrade accounting and disclosure systems in order to facilitate investment and monitoring by capital market participants on their own account. In this context, outside directors, audit committee, internal accounting and compliance systems were introduced, and the rights of minority shareholders were significantly strengthened. Indeed, the qualitative nature of the Korean financial sector reform was more geared toward a market-based financial system.

It is a controversial issue whether this "Anglo-Saxon" style reform package was appropriate and effective for Korea. Indeed, a country's financial structure would be determined endogenously reflecting various economic and political factors of that

[32] When Daewoo went bankrupt in 1999, foreign creditors initially did not want to take on any losses. In the end, however, they had to accept a loss rate of about 40 percent. In 2003, foreign creditors demanded a preferential loss rate in the SK Global case, before domestic creditors threatened to take the company to court receivership.

[33] It is a common dichotomy to divide the financial systems into bank-based versus market-based systems or relationship-based versus arm's-length systems. While the former classification is a distinction based upon corporate financing behavior, the latter is based upon the nature of financial transactions and contracts.

country, and relative roles of banks and capital markets may also evolve over time as the country grows. Note, however, that recent literature on comparative financial systems suggests that financial systems tend to converge as international markets are increasingly integrated. For instance, Rajan and Zingales (1998) argued that, although the relationship-based system may be superior in countries where contracts are hard to enforce and it is relatively easy to identify profitable investment opportunities, the system is increasingly vulnerable to the risk of massive resource misallocation as the economy grows and capital becomes abundant because allocations by a few banks are not based upon price signals. They suggested that there could be a potential conflict between arm's-length foreign capital and relationship-based financial system and that for emerging market countries to continue to grow through financial globalization, it may be necessary to reform the financial system toward a more market-based one.

Then, given the nature of the reform package in Korea and the influence of arm's-length foreign capital at the onset of the financial crisis and at subsequent reform stages, is the Korean financial system indeed changing toward a more market-based system? It is interesting to note that Korea had relatively sizable and active capital markets prior to the 1997 crisis. According to Demirguc-Kunt and Levine (2001), pre-crisis Korean financial markets were sufficiently well developed that the country's financial system already deserved to be classified as market-based. They pointed out that Korea already had a relatively active and efficient equity market, and that the market share of non-bank financial institutions exceeded that of commercial banks.

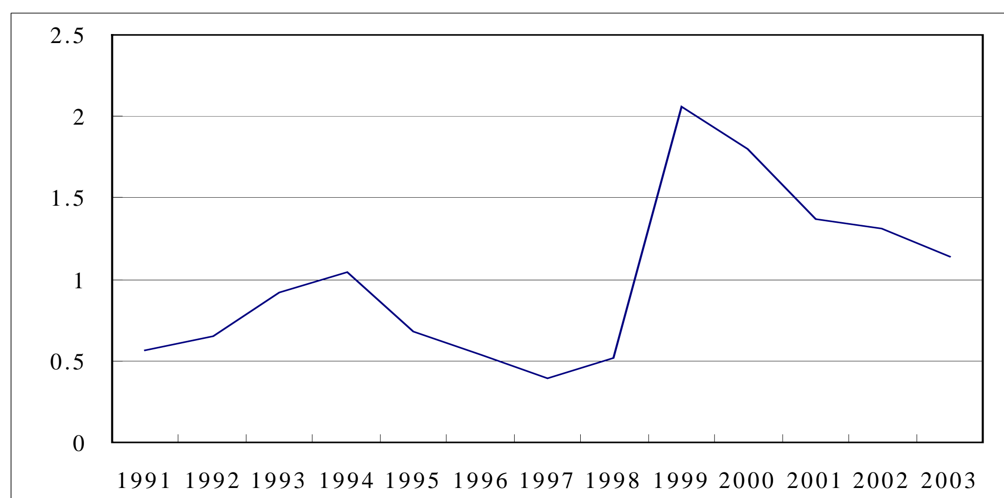
However, the growth of NBFIs and direct debt financing through such vehicles as corporate bonds and commercial papers during the 1990s was a result of unbalanced financial liberalization policies and the implicit guarantee extended by the government. As we emphasized above, direct debt instruments were often guaranteed by commercial banks, and NBFIs were heavily controlled by the chaebol that were regarded as "too-big-to-fail." Hence, the importance of capital markets and NBFIs was not a normal market development. Rather, as noted in Hahm (2004), the Korean financial system at the onset of the crisis was a "pseudo-market and quasi-bank-based system."

As noted above, in the aftermath of the financial crisis, the Korean government undertook a range of structural reforms, and the reform efforts were in part to establish a more market-based financial system. However, it is ironic to observe that the post-crisis financial flows were more concentrated in the banking sector rather than capital markets. In other words, the post-crisis financial transition is characterized by the resurgence of commercial banks. Bank assets increased from 472.6 trillion won in 1996 to 1,084.7 trillion won in March 2003 with an average annual growth rate of 17.2 percent—far exceeding the average nominal GDP growth rate. The share of banks in total financial assets also increased substantially from 63.6 percent in 1996 to 73.2 percent in 2002.

In an effort to characterize the transitional pattern of the financial system in Korea, Hahm (2004) computed the time-series of the size, activity, and efficiency indices of Demirguc-Kunt and Levine (2001). [34] In Figure 4, we follow Hahm and extend the time-

[34] Demirguc-Kunt and Levine (2001) constructed a composite index of financial structure based on measures of size, activity and efficiency to characterize the financial systems of 150 countries. The size index was the ratio of domestic stock market capitalization relative to the domestic assets of deposit money banks, and the activity index was the ratio of the total value of stock transactions on domestic exchanges relative to private credit provided by deposit money banks. They used two measures of efficiency index: total value of stock transactions/GDP multiplied by bank overhead costs, and total value of stock transactions/GDP multiplied by the bank net interest margin. The composite index was constructed as a demeaned average of the above three measures. Note that a higher composite index value indicates that the underlying system is relatively more market-based.

Figure 4. Financial Structure Composite Index for Korea



Source: Figure 8.3 in Hahm (2004) updated

series of the composite index. Note that the Korean system was evolving to a more market-based system immediately after the crisis. However, at least measured by the index, it is gradually going back to the bank based-system in recent years.

This limited success in financial transition and the resurgence of banks can be attributed to various factors. As noted above, the withdrawal of the government's implicit guarantee and reduction of moral hazard have resulted in shrinking capital markets for direct debt instruments such as corporate bonds and commercial papers. Delayed resolutions of corporate bankruptcies combined with heightened risk sensitivity have also caused a flight to quality toward relatively safe bank assets. Furthermore, the government's bank-first and NBFIs-later restructuring policies have contributed to the resurgence of banking institutions in post-crisis Korea.

The present gridlock in Korea's financial transition mainly reflects the fact that financial restructuring is still an on-going process in Korea. It is also noteworthy that, while financial globalization and arm's-length foreign capital has contributed to building institutional infrastructure for market-based financial system, domestic actors may still prefer bank-dominance especially in the political economy context. For instance, based upon recent median voter theories of endogenous financial systems (e. g. Perotti and Thadden 2003), Lee (2004) suggested that the relative emphasis of the new Roh Moo Hyun government on labor rights and income redistribution may create a political economy environment that favors bank dominance rather than market dominance. Note that this view also implies that, at least in their risk preferences, both chaebol and labor may share a common interest in maintaining the bank-dominated system rather than more transparent and capitalist-oriented market-based system. Furthermore, an industrial transition that favors small and medium enterprises (SMEs) and service industries may also deter development of a full-blown market-based system by making moral hazard uncertainties more important as banks are better in dealing with this type of information asymmetry.

As for the relative contribution of foreign capital, international organizations such as the IMF and the World Bank played an important role in incorporating more market-based and

arm's-length elements into the reform package. Furthermore, as we can see from the takeover attempt of the SK group in 2003, foreign portfolio investors and strategic investors such as private equity funds also contributed both directly and indirectly to the reform of business practices. However, while the nature of the reform package is more consistent with the transition toward a market-based system, it is rather premature to predict that the reform and transition will enter into a consolidation stage in the near future.

5-4. Summary: Relative Contribution of Foreign Capital

Table 6 summarizes the role of foreign capital in post-crisis reform. International organizations such as the IMF and the World Bank played a critical role in forcing the Korean government to recognize the nonperforming loans problem, demanding strict asset classification criteria. However, they made little contribution to the sharing of losses resulting from investment and lending mistakes of the past. In playing the role of the lender of last resort, the IMF took sides with international creditors and imposed the burden of painful adjustment entirely on the borrowing country. International creditor banks played a critical role in forcing the government to recognize the "legacy cost" by running on Korean banks in 1997. Although foreign creditors had made their loans without prudent credit analysis, they actually wound up benefiting from the crisis as they rolled over their loans with a significant risk premium in the immediate wake of the crisis.[35]

The role of international organizations and creditors in supporting Korea's institutional reform was significant, but it must be placed in context. Most of market-opening measures merely accelerated the implementation of Korea's OECD accession commitments and liberalization plans.[36] The emphasis on prudential regulation was new,

Table 6. Relative Contribution of Foreign Capital in Post-Crisis Reform

	International Organizations	Creditor Banks	Portfolio Investors	Direct Investors
Recognition of Losses	⊙	⊙	○	-
Sharing of Losses	-	-	○	-
Recapitalization Equity Build-Up	-	-	○	○
Institutional Reform	⊙	○	○	○
Reform in Business Practices	-	-	○	⊙

Note: ⊙ strong contribution, ○ moderate contribution, - weak contribution

[35] Although foreign creditors initially demanded as high as a 1,000 basis-point (10 percentage-point) premium in debt restructuring negotiations, they themselves seem to have been aware that the chance of Korea defaulting on its loans was rather remote given Korea's proven ability to export its products and a significant devaluation of the won in the immediate wake of the crisis. In January 1998, the Korean government and foreign creditors settled on a premium of 275 basis points for one year, 300 basis points for two years, and 325 basis points for three years of maturity extension on existing loans.

[36] For example, the lifting of restrictions on foreign shareholdings and the abolition of the import diversification program accelerated Korea's liberalization schedule.

but much of this was contained in the policy prescriptions that had been submitted by the Presidential Commission for Financial Reform in 1997. In fact, in the area of structural reform, the Korean government and the IMF were basically in agreement. If anything, in the spirit of "IMF-plus," the Korean government pushed ahead with institutional reforms to enhance accountability and transparency and adopted measures to improve labor market flexibility. Their disagreement was mainly over the closure of distressed financial institutions and the scale and duration of tight monetary policy to stabilize the foreign exchange market in the immediate wake of the crisis. While both the Korean government and the IMF were concerned about the systemic risks involved in closing major commercial banks, unlike the Korean government, the IMF felt that the closing of much smaller merchant banks posed little threat to the stability of the financial system.[37]

While foreign creditors and investors with substantive stakes in financially distressed companies tried to minimize their losses and shift the burden of restructuring to the Korean government, foreign investment analysts and credit-rating agencies advocated debt restructuring based on market principles and sounded alarm bell whenever Korea seemed to be backtracking on reform. Once the initial debt restructuring negotiations were concluded in the immediate wake of the crisis, the IMF too supported these efforts to guard against the re-emergence of moral hazard in Korea.

Foreign direct investors and portfolio investors played a moderately important role in the recapitalization of distressed financial institutions and improvement in business practices. Foreign investors took significant equity positions in a number of prominent Korean banks as well as non-bank financial institutions. The increasing presence of foreign capital, combined with changes in risk assessment in the post-crisis period, has made it difficult for the government to intervene in the allocation of financial resources.

In short, the most critical contribution of foreign actors was in forcing the Korean government to recognize losses in the form of latent nonperforming loans. In particular, foreign creditor banks and international organizations such as the IMF played an important role in this area. Yet foreign creditor banks and investors were reluctant to share the burden of losses, often demanding "special treatment"; whereas, international organizations as well as analysts advising portfolio investors supported accountability and transparency in the sharing of losses. Also, international organizations played an important supporting role in institutional reform to lay out more transparent and accountable financial system while foreign direct investors introduced significant changes in business practices.

[37] Interview with Wanda Tseng (deputy director, Asia and Pacific Department, IMF), who was involved in the IMF negotiations with the Korean government in 1997, on December 4, 2003.

CHAPTER 6

Conclusion

In this paper, we have looked at Korea's financial sector restructuring in the post-crisis period from a political economy perspective. We first emphasized that the regime of *de-control without de-protection* during the financial liberalization period had provided an environment for excessive risk taking in the years leading to the 1997 financial crisis. As such, subsequent reform efforts focused on breaking off the legacy of moral hazard and establishing a system operating on market discipline. We described the political economy dynamics of the financial reform in Korea focusing on the interaction between the new political leadership and foreign capital. We also discussed relative contributions of diverse foreign actors at different stages of the reform process.

Although financial globalization did not "cause" a series of major corporate failures that preceded the crisis, it played an important role in the outbreak and resolution of the crisis. In particular, increased exposure to short-term foreign debt made it all but impossible for the Korean government to adopt a wait-and-see approach, because it could not persuade foreign creditors to refrain from their run on Korean banks. The international nature of the 1997 crisis, as well as its magnitude, left the government with little option but to go to the IMF for immediate relief and address the underlying problem of nonperforming loans.

The crisis also had the effect of weakening the political clout of vested interests, which otherwise might have blocked reform. A newly elected reformist president took advantage of the crisis atmosphere to push major bills through the National Assembly, even though his coalition did not have a majority. Endorsed by international investors as well as non-governmental organizations campaigning for shareholder value, his reform initiative, in turn, strengthened market forces and made it increasingly difficult for the government to "suspend" bankruptcies and backtrack on reform. In addition, the absence of controlling shareholders at commercial banks helped to make large-scale financial sector restructuring a politically viable process, at least in comparison with other countries.

International organizations such as the IMF and the World Bank played a critical role in forcing the Korean government to recognize the nonperforming loans problem and also made an important contribution to institutional reform through a series of agreements they negotiated with the government. Although foreign creditors and investors initially forced the government to recognize "the legacy costs," they themselves were rather reluctant to take on losses when they had substantive stakes in financially distressed companies. Foreign investment analysts and credit-rating agencies advocating the adoption of market principles helped the Korean government to stay on the reform track.

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Appendix: Major Financial Reform Measures in the Post-Crisis Period

Field	Measures
Central Bank and Financial Supervision Systems	- Strengthening of the independence of Monetary Policy Committee at the Bank of Korea (Dec. 1997) - Establishment of inflation targeting monetary policy framework (Dec. 1997) - Consolidation of deposit insurance organizations under Korea Deposit Insurance Corporation (KDIC) (Apr. 1998) - Creation of Financial Supervisory Commission (FSC) (Apr. 1998) and the Securities and Futures Commission (Apr. 1998) - Consolidation of financial supervisory organizations under Financial Supervisory Service (FSS) (Jan. 1999)
Financial Sector Restructuring	- Establishment of Korea Asset Management Corporation (KAMCO) and creation of the Non-performing Loan (NPL) Resolution Fund (Nov. 1997) - Enactment of asset backed securities (ABS) related laws to facilitate NPL resolution (Jun. 1998) - Closure of five insolvent commercial banks by purchase and assumption (Jun. 1998) - Merger of Commercial Bank of Korea and Hanil Bank (Sep. 1998) - Merger of Kookmin and Long-term Credit Bank (Oct. 1998) - Merger of Hana and Boram Bank (Nov. 1998) - Selling off of the Korea First Bank to Newbridge Capital (Dec. 1998) - Introduction of financial holding companies (FHC) and incorporation of Woori FHC (Apr. 2001) and Shinhan FHC (Sep. 2001) - Merger of Hanvit and Peace Bank (Dec. 2001) - Mobilization of public funds for recapitalization and NPL resolution of financial institutions (64 trillion won in May 1998, 50 trillion won in Sep. 2000) - Disbursement of 99 trillion won by KDIC for recapitalization and deposit payoffs (Nov. 1997- Jun. 2002) - Disbursement of 38.7 trillion won by KAMCO for NPL purchases (Nov. 1997-Jun. 2002) - Closure, liquidation and merger of 603 insolvent non-bank financial institutions (Nov. 1997-Jun. 2002) - Enactment of Special Act on Public Fund Management and creation of Public Fund Oversight Committee (Dec. 2000) - Adoption of the least cost resolution principle in the resolution of insolvent financial institutions (Dec. 2000) (Continued on the next page)

Major Financial Reform Measures in the Post-Crisis Period (continued)

Field	Measures
Prudential Regulations	- Amendment of Financial Industry Restructuring Act to establish statutory authorities of FSC in restructuring insolvent financial institutions such as orders of write-offs, suspension, mergers and closures. (Dec. 1997) - Introducing and strengthening of prompt corrective action provisions (Apr. 1998, Sep. 1998) - Strengthening of NPL criteria (for substandard loans previous 6 month criteria was changed to 3 month for interest payments in arrear) (Jul. 1998) - Adoption of forward looking asset classification (FLC) system (Jan. 2000) - Strengthening prudential regulations on bank short-term foreign borrowing and foreign exchange exposures (Jul. 1998) - Strengthening of the large exposure limit for bank lending to each borrower and their affiliates to 25% of bank equity capital (Jan. 2000) - Strengthening the aggregate exposure limit for bank loans in excess of 10 percent of total capital (Jan. 2000) - Strengthening disclosure requirements of financial institutions (Apr. 1998, Oct. 1998) - Limiting bank lending to large shareholders to 25% of equity capital (Apr. 2002)
Capital Account Liberalization	- Adoption of free floating foreign exchange rate system (Dec. 1997) - Abolition of restrictions on the M&As by foreigners (Feb. 1998) - Full liberalization of foreign investment in Korean equities listed in the Korea Stock Exchange and KOSDAQ (May 1998) - Full liberalization of foreign investment in Korean bonds listed (Dec. 1997), beneficiary certificates (Jul. 1998), and KOSPI futures and options (May 1998) - Full liberalization of money market instruments (May 1998) - Permitting equity investment in non-listed firms (Jul. 1998) - Abolition of restrictions on foreign ownership of land and real estate properties on the basis of national treatment (Jul. 1998) - Full liberalization of foreign exchange transactions and foreign investment by enacting Foreign Exchange Transaction Act (Sep. 1998) and changing the regulatory framework to a negative list system (Apr. 1999 for financial and non-financial firms and Dec. 2000 for individuals) (continued on the next page)

Major Financial Reform Measures in the Post-Crisis Period (continued)

Field	Measures
Governance of Financial Institutions	- Allowing foreigners to own commercial banks (Dec. 1997) - Allowing foreigners to become bank executives (May 1998) - Improving governance of financial institutions: introduction of outside directors, audit committee, compliance officer, etc. (Jan. 2000) - Strengthening rights of commercial bank minority shareholders (Jan. 2000) - Bank ownership limit of domestic residents raised to 10% from previous 4% (Apr. 2002)
Capital Market Reforms	- Introduction of mutual funds (Sep. 1998) - Introduction of mark to market accounting system for trust funds (Nov. 1998) - Reforms in Treasury bond markets: issuance (Nov. 1998), primary dealer system (Jul. 1999) - Reforms in KOSDAQ and establishment of KOSDAQ committee (Oct. 1998) - Reforms in credit information industry (Jul. 1998)