

*Economic reforms ex-post financial crisis:
how far did we come and what lies ahead*

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The Korean Experiences with Economic Reform

- Economic reforms are geared to improve long-term living standards through higher productivity and labor utilization
- However, crisis-triggered reform efforts remain a half-baked drive: Crisis itself provides background for reform efforts, which dissipates as stability sets in
- Governance-related core part remains unchanged with other peripheries increasingly subordinated
- By all practical means, is inclusive reform feasible after all?
- What is the right reform drive for Serbia given Korea's mixed results of the post-crisis reform drive?

The 1997-98's Asian Financial Crisis

- Decrease of -7.8% GDP growth in Q1 1998
- Lack of risk management in business sectors led to excessive debts and successive bankruptcies
- Lack of war chests, especially usable FX reserves, in times of crisis
- IMF bailout with conditions of:
 - *Relaxing regulations for foreign investors*
 - *Switching from managed floating to free floating system*
- Capital market is virtually open and stabilization burden has been coupled with risk management needs: **Conflicted role and responsibility among market participants**

The 1997-98's Asian Financial Crisis

- Excessive borrowing eroded overall market confidence.
- Expectations of depreciation with the widening current account deficit
- Contagion effect started from the plunge in the Thai Baht (July 1997) then spread to Indonesia and Malaysia
- “Too big to fail” and “moral hazard” were prevalent among the ‘chaebols’
- South Korea was forced to request bailout loans from the IMF due to unmanageable external liabilities (Nov 21, 1997)

Origins of the crisis

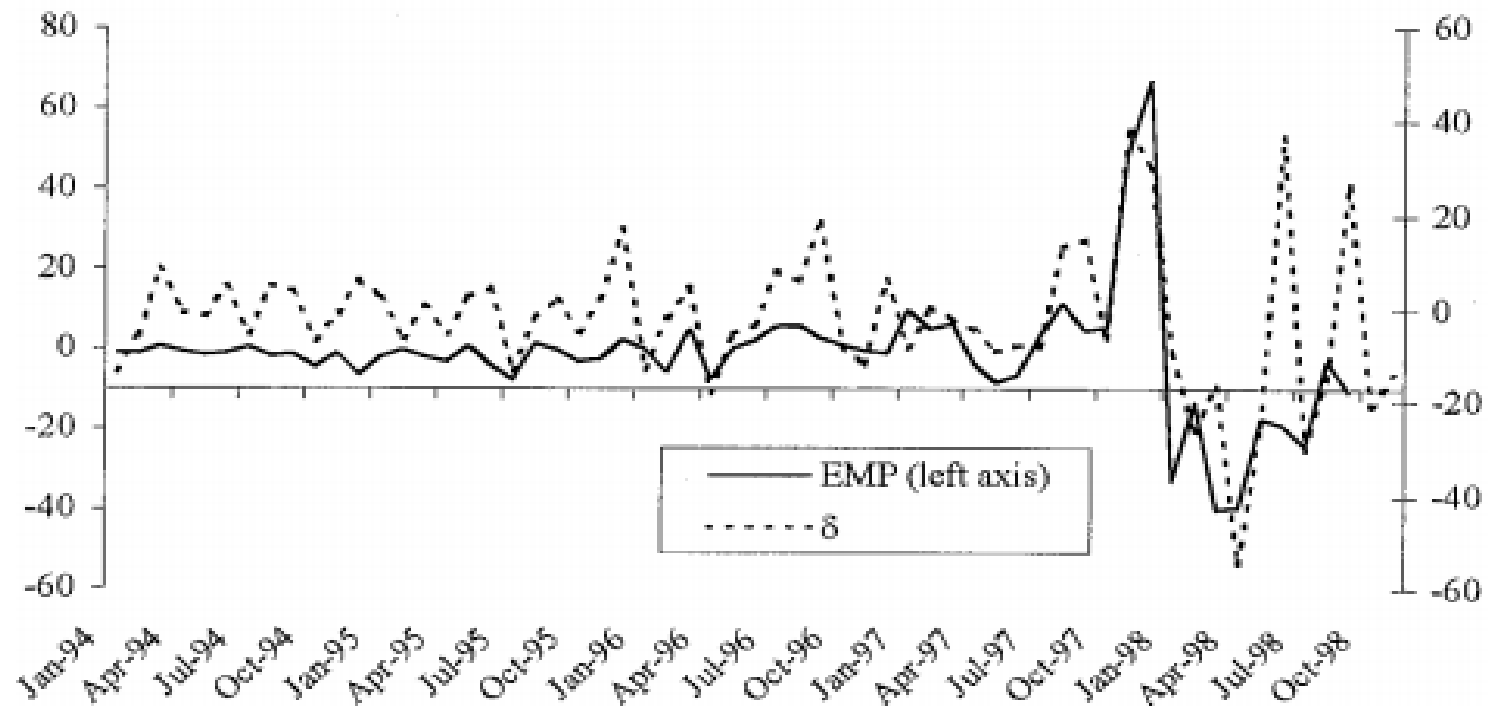
- Total lack of supervision and monitoring: Subjugated financial sector
- Lack of transparency: the scale of the conglomerates' bad loans were understated due to the companies' cross payment guarantees.
- Ignored market principles: the chaebols enjoyed implicit government support and subtle entry-barriers.
- Financial liberalization: While Korea's industrial base was mostly export-oriented, Korea suffered lower international competitiveness due to capital inflow

“Unsustainable debt-financed high-growth strategy”

- Rapid increase in production capacity of major industries caused huge sunk costs.
 - Low profitability at Korean enterprises; when most of their investment was financed by borrowing, not through retained earnings or cash flows.
 - Huge current account deficits
 - Excessive short-term borrowing overseas after joining the OECD
- *These factors made Korea vulnerable to external shocks.***

Exchange Market Pressure

Korea: EMP, Credit Growth (δ) and Interest Differential (ϕ), 1994-98



Source: E. Tanner, Exchange Market Pressure and Monetary Policy: Asia and Latin America in the 1990s, IMF, 1999. 8.

The IMF loans with conditionality: Any link with the Reform Efforts?

- Received 58.3 billion dollars with the conditions of:
 - Relaxation and removal of regulations on foreign investors
 - Managed floating exchange rate system to free floating system
- However, the conditions were not geared to fixing the fundamental problem, but mainly to stabilize the foreign exchange market.

Policies to overcome the crisis

1. Macroeconomic policies:

- Shifted to a free-floating exchange rate system, letting the won depreciate against the dollar
- The aim later changed from stability in FX market to striking a balance between stability and growth

2. Financial sector reforms:

- 5 commercial banks were closed and the Financial Supervisory Commission (FSC) was established
- Strengthened prudential regulation and FLC(forward-looking criteria) adopted

3. Corporate sector reforms:

- Chaebols contributed to the economic growth, but also to the financial crisis through their cross payment guarantees and overburdened financial costs.
- The five largest chaebols—whose combined exports account for half of the country's total—signed an agreement with the FSC that they will slash subsidiaries by half and focus on their core competencies.
- The FSC agreement seeks greater transparency, accountability and competition.

4. Labor Market Reform:

- Under the revised Labor Standard Act, layoffs due to managerial difficulties and transferring workers between firms were made possible.
- Employment Insurance Fund of 9 trillion won for improving social safety net for displaced workers

5. Capital Account Liberalization:

- The ceiling on foreign investment was entirely abolished in May 1998.

Staff-cut in public sector (`98~`00)

(thousands)

	# of Staff	Target # of Staff Cut	Actual # of Staff Cut		Staff Cut Ratio
Total	727	130.3	131.1	101%	18.3%
Central Department	162	21.9	21.41	98%	13.2%
Local Government	298	49.5	49.5	100%	16.6%
Public Enterprise	166	41.2	41.72	101%	25.1%
Affiliated Organization	101	17.7	18.53	105%	18.3%

Source: T. Kim, Labor in Public sector: Situation and Direction, May 2001

Public enterprise privatization ('98~'00)

Public Enterprise	Date	Process	Money Earned (trillion Won)	Owner
Government-designated Textbook	Nov 1998	<ul style="list-style-type: none"> Competitive bidding (86.5%) 	46.0	Daehan Textbook
Korea Technology Banking Corporation	Jan 1999	<ul style="list-style-type: none"> Competitive bidding (10.2%) Stock sold (2.0%) 	11.6	Mirae Textbook
Daehan Oil Pipeline Corporation	Apr 2000	<ul style="list-style-type: none"> Taken over by 4 oil companies as contracted (36.8%) 	166.9	4 oil companies
POSCO (Pohang Iron and Steel Company)	Oct 2000	<ul style="list-style-type: none"> Depository receipts (18.5%) Treasury stock (8.2%) 	2,780.1	Ownership distributed
Korea Integrated Chemical	Nov 2000	<ul style="list-style-type: none"> Liquidated due to heavy loss 	-	-
Korea Heavy Industries and Construction Company	Dec 2000	<ul style="list-style-type: none"> Public offering (24%) Competitive bidding (36%) 	429.0	Doosan
Korea Telecom	May 2002	<ul style="list-style-type: none"> Foreign investors (44.1%) Domestic investors (29.5%) 	12,699.9	Ownership distributed
Korea Tobacco	Oct 2002	<ul style="list-style-type: none"> Foreign investors (39.7%) Domestic investors (41.9%) 	351.3	Ownership distributed

Source: MPB, White Book of Public Innovation, Dec 2002

Reform efforts largely ignored among the core pillars

- Chaebols essentially retained outdated governance
- Reform efforts resulted in greater Polarization
- “Forced Reforms” led to greater market instability and increased stabilization costs
- Outside pressure to reform largely backfired and intensified social resistance against inclusive economy
 - ***Lessons: reform drive should be voluntarily driven market efforts, not dictated by authorities***
 - ***Economy lost its vibrant character, requiring constant government intervention going forward***

Ongoing challenge: Chaebol-dominated economic structure

- **“Iron-triangle”**: a tripartite system of bureaucrats, the chaebols, and politicians
- IMF reform caused damage to SMEs while relatively strengthened the large conglomerates: SMEs shrank 20 percent in the first half, 35 percent in the second half, when overall industrial production only shrank 7.4%
- **Implicit government intervention was the cause of moral hazard and market failures.**
 - *Despite the pressure for structural reform of chaebols, business swaps among them and meeting debt ratio requirement by re-evaluating assets, were the only progress.*

The Global Financial Crisis of 2008:

South Korea is the only OECD country to avoid the recession in 2009?

- GDP growth was -5.1% in Q4 2008
- Steep fall in export by 40% in Q4 2008
- Sudden reversal of capital flow dried up domestic and international liquidity

- GDP growth was 2.6% in Q2 2009,
- 3.2% in Q3 2009
- Core inflation remained stable within the inflation target range of 2.5-3.5%

The Bank of Korea's Policies

1. Currency Swap

- To stabilize the foreign exchange market by securing the supply of foreign currency liquidity

	US Federal Reserve	People's Bank of China	Bank of Japan
Ceiling	USD 30 billion	CNY 180 billion	USD 20 billion equivalent
Date of announcement	30 Oct 2008	12 Dec 2008	12 Dec 2008
Expiry date	1 Feb 2010	3 years	1 Feb 2010

Source: Bank of Korea

2. Reduction of the base interest rate

- Lowered the base rate six times (Oct 2008-Jun 2009)
- Decrease of 3.25%p: from 5.25% to the historical lowest rate of 2.00%

3. Bank Recapitalization Fund

- To expand banks' credit supply capacity through purchase of related subordinated debt and hybrid bonds

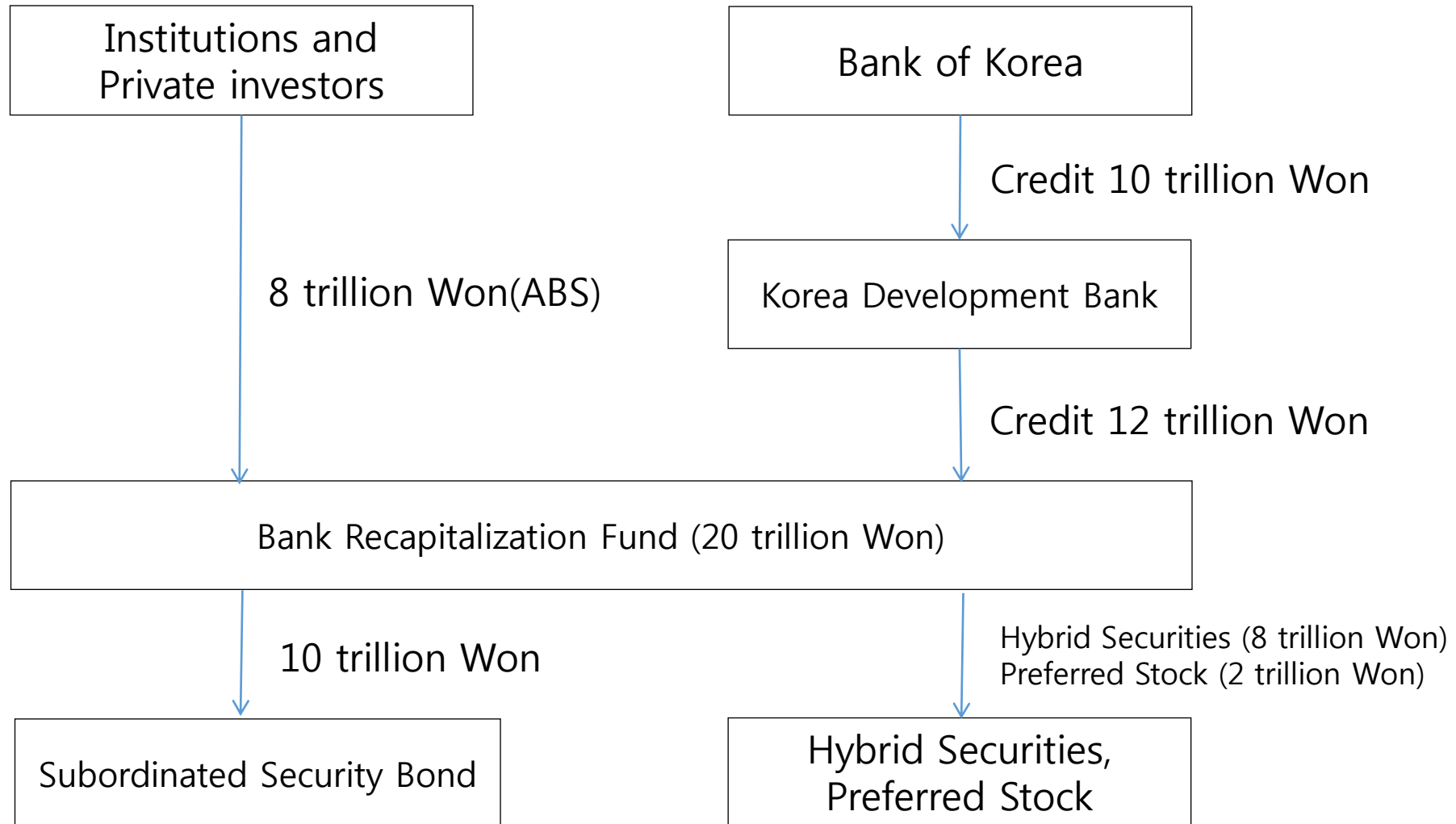
4. Bond Market Stabilization Fund

- To ensure circulation of funds in money and bond markets

Fiscal Expansionary Policies

- **Immediate increase in government expenditure:**
 - Modified budget of 11 trillion won, Nov 2008
 - Supplementary budget of 28 trillion won, Mar 2009
- Funding in response to the crisis was over 6% of its GDP.
- Instant policies were possible due to its low sovereign debt, 30% of its GDP.

Bank Recapitalization Fund (2009)



Quick fixes led to sluggish structural adjustments!

Speedy restoration of main growth engine at the cost of eroding social capital

1. Immediate counter-measures

- Instant conventional monetary measures—reduction of interest rates and the expansion of liquidity by means of loans and open market operations—played a critical role in diminishing the impact of the global crisis.
- It was possible to have fiscal expansionary policies fully carried into effect from the beginning of 2009, because of its low public debt.

2. Faster recovery in export

- Domestic industrial structure consists of export-sensitive manufacturers including semiconductors and IT industries which have economic precedence.
- Main export partner - China's stimulated demand
- Depreciation of KRW against the USD, leading to trade surplus (recession surplus, where import was reduced more than export was).

3. International cooperation

- Currency Swap:
 - Resolved foreign currency liquidity problem
 - Restored investor confidence at home and abroad
- The need of international cooperation was once again emphasized while overcoming the global shock of financial crisis

Quick Recovery vs. Structural Reform

- Quick fixes require front-loading of macro policy measures
- Structural reform requires longer-term fixes with possible resistance and adjustment costs
 - **Quick fixes with visible results are always favored over structural reform with no clear results**
- However, we cannot raise growth potential without structural reform
- Balancing act is required at all costs

Sluggish structural reform

- 234 firms (1 out of 7 listed companies) record ICR less than 1 for three consecutive years (2012-2014) – Virtual Zombies! (KIF and FnGuide)
- Among 55 industries, 33 have zombie ratio above 10%.
- 17 out of 30 major groups have ICR less than 1!
- Energy, shipping, and bio industries are among the greatest risk groups
- Number of zombies is shrinking, but the size of defaulted debt quadrupled during the past three years

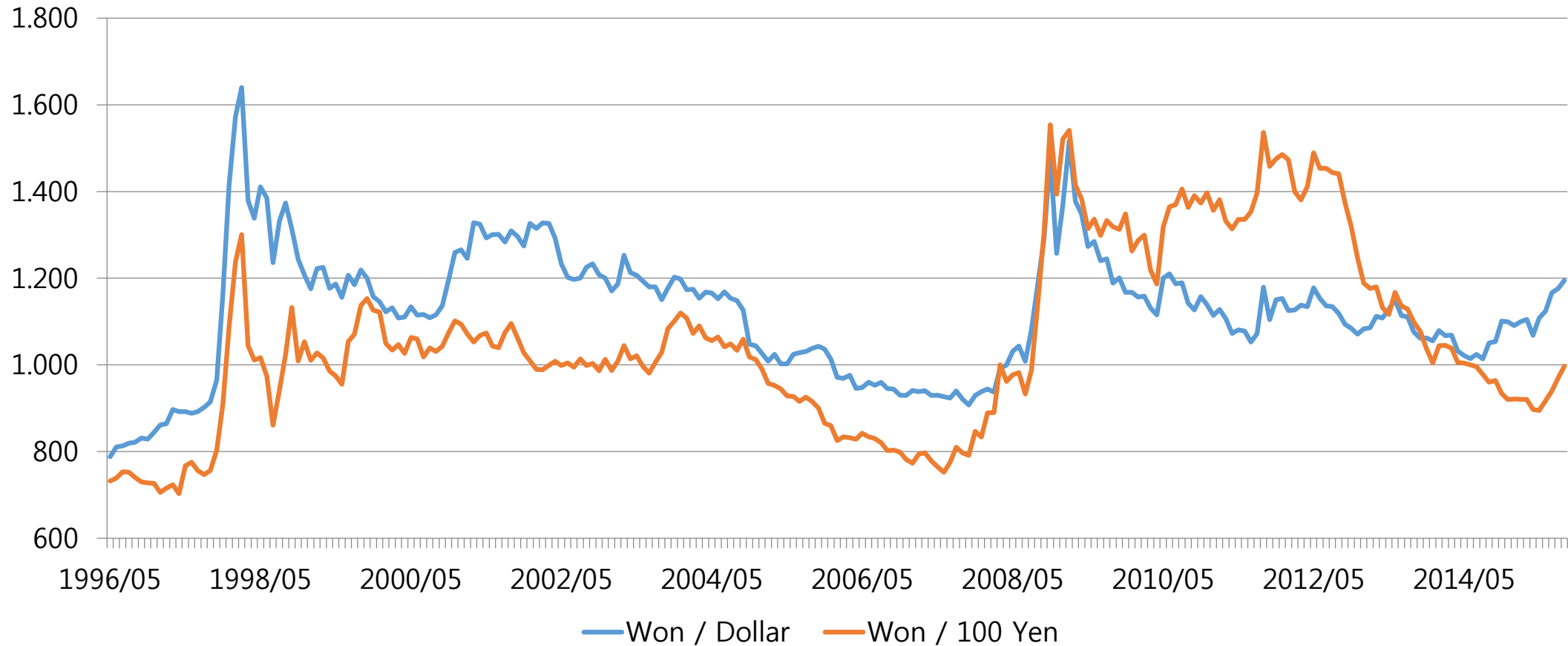
Structural reforms triggered by crisis-related conditionalities have proven transitory

- Two episodes: 1) Asian Financial crisis 2) Global Financial crisis
- Korea followed IMF remedies: successful in eliminating excesses and securing foothold for a strong rebound
- However, it is a recovery with a streamlined chaebol base and polarized economy-SME continues to struggle
- During the GFC, Korea engaged in gradual incrementalism, protecting the economy from external shocks via expansionary policy mix
- It resulted in protracted structural reform, excess reliance on debt, and sagging productivity across non-tradable sectors
- What appears as structural reform outcome are essentially macro-based, crisis-driven and could not be sustained: We are back to where we used to be!
- Market-based private changes cannot be replaced with government initiated policy measures!
- Sustainable reform needs to be privately-driven and market-based.

“Structural Reform” needs to be forward-looking to minimize social costs

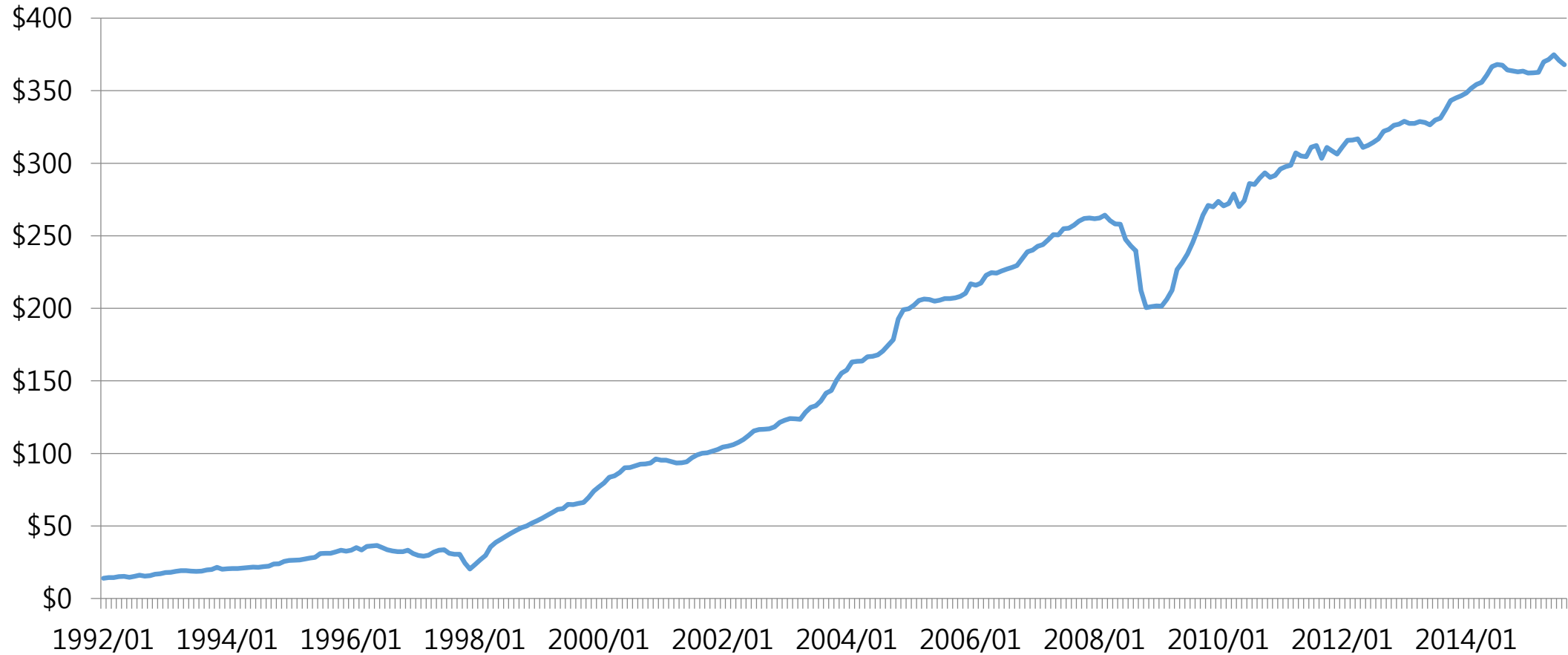
- Connected market and customers: The Penguin and the Leviathan
- Two-sided and multi-sided market: Needs for Openness and Collaboration
- Distributed and decentralized governance, API(application programming interface) and crypto-currency
- Nurturing Platform Ecosystems: Architecture, Governance and Strategy
- “Constructing Mega Open-platform” + “Gig Economy” are potential areas of economic cooperation between ROK and Serbia (manufacturing + service)

Won/\$ Exchange Rate



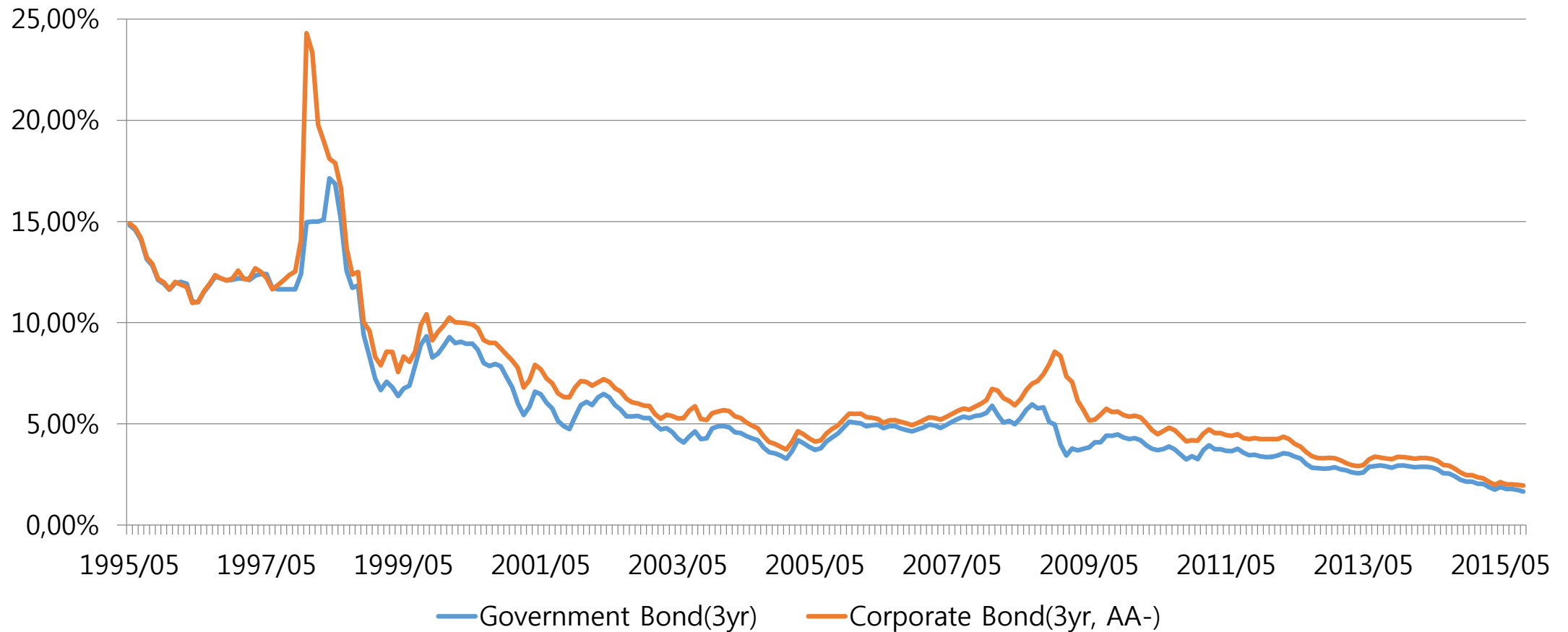
Source: Bank of Korea

Foreign Reserve(mil.\$)



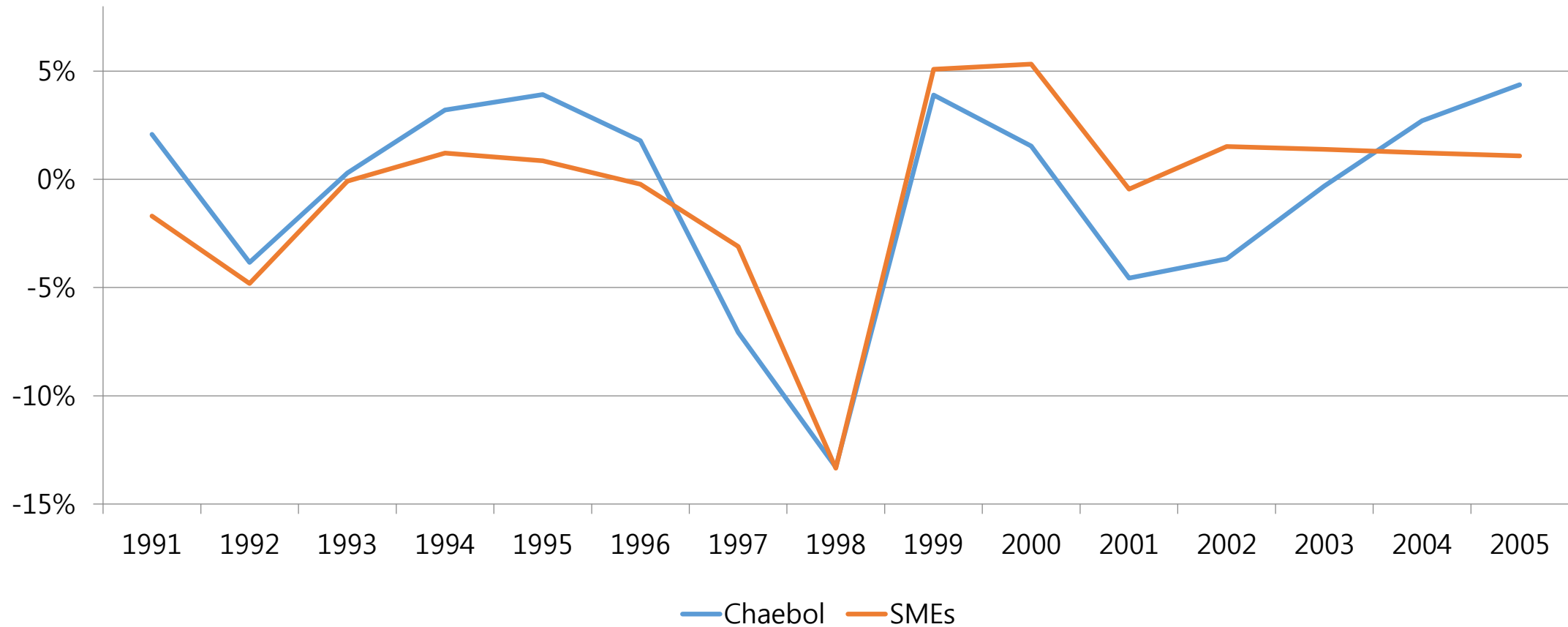
Source: Bank of Korea

Benchmark Interest Rate



Source: Bank of Korea

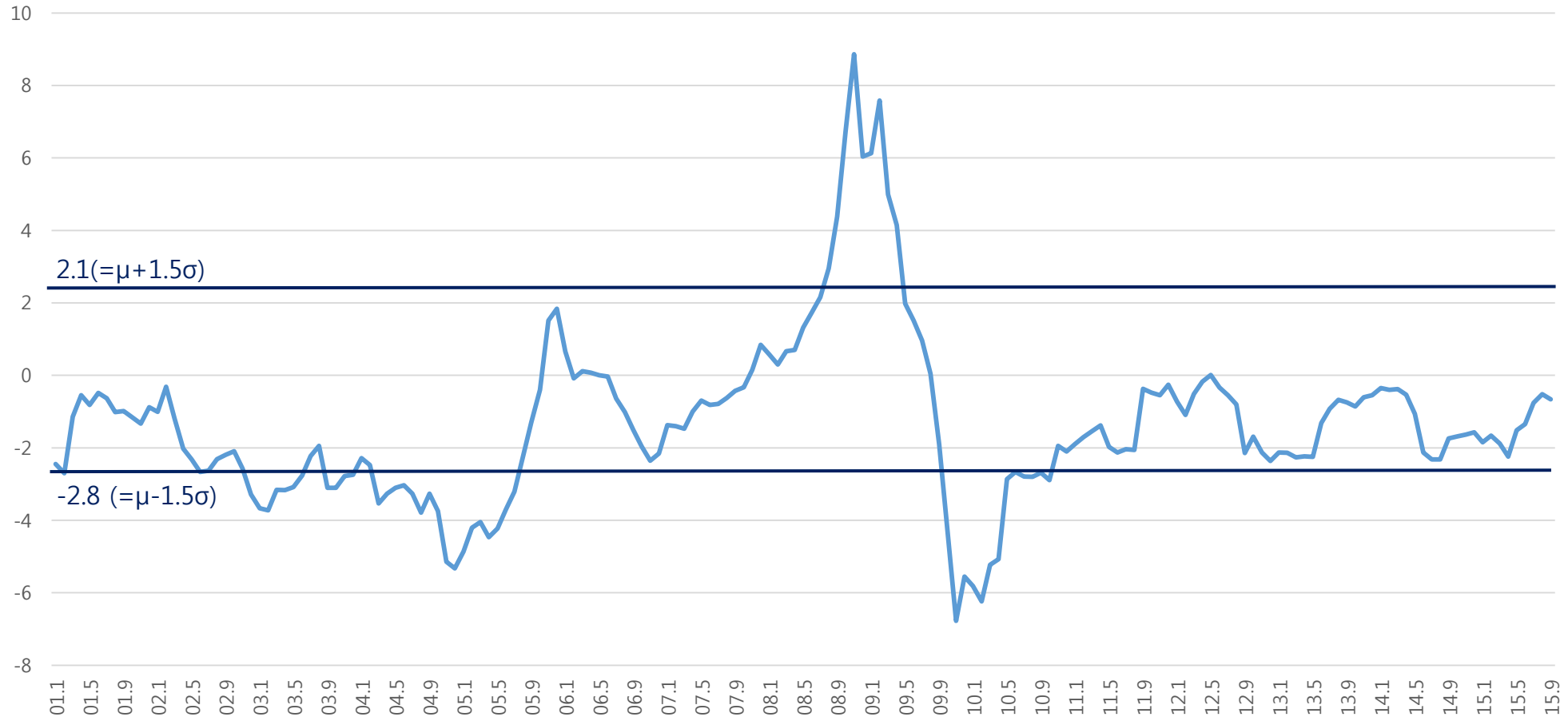
Payroll Growth (yoy)



Source: B. Lee, Analysis on firms' restructuring and performance during Pre- and post-crisis, KERI, 2008. 10.

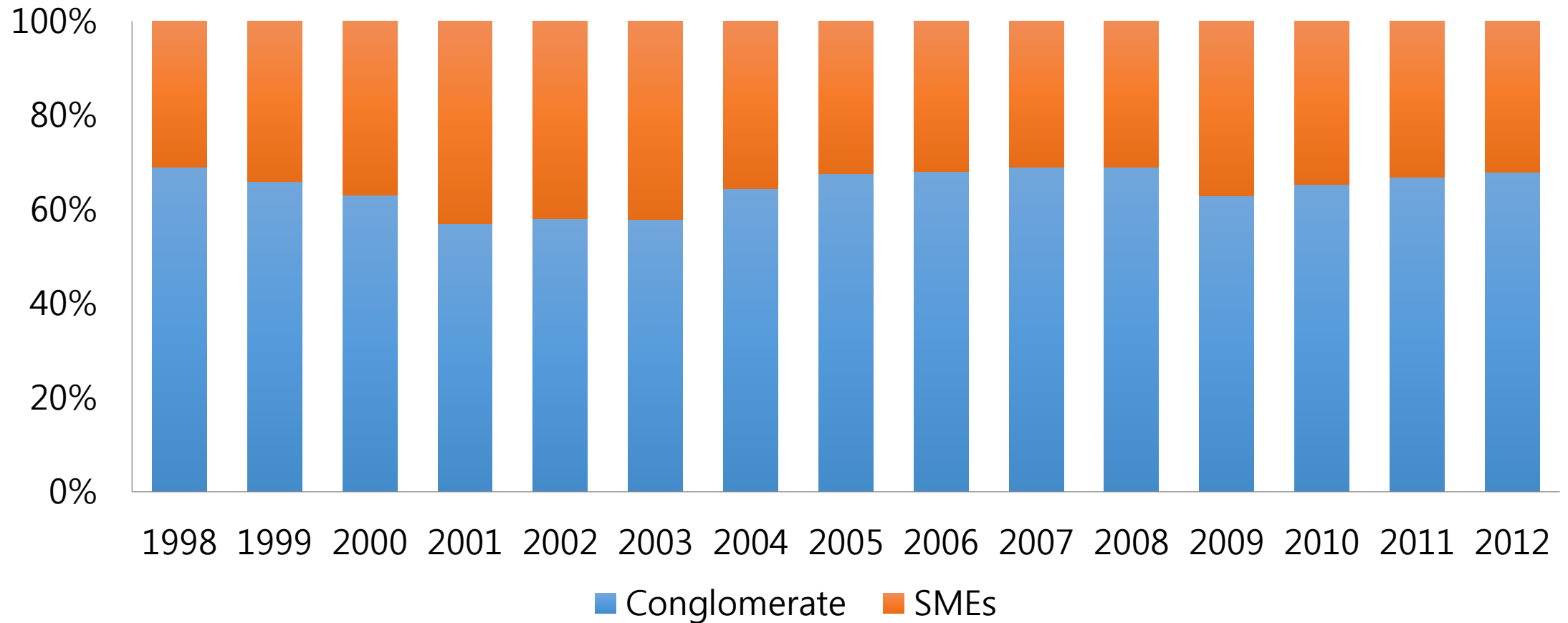
Exchange Market Pressure

(crises are defined as events outside the band)



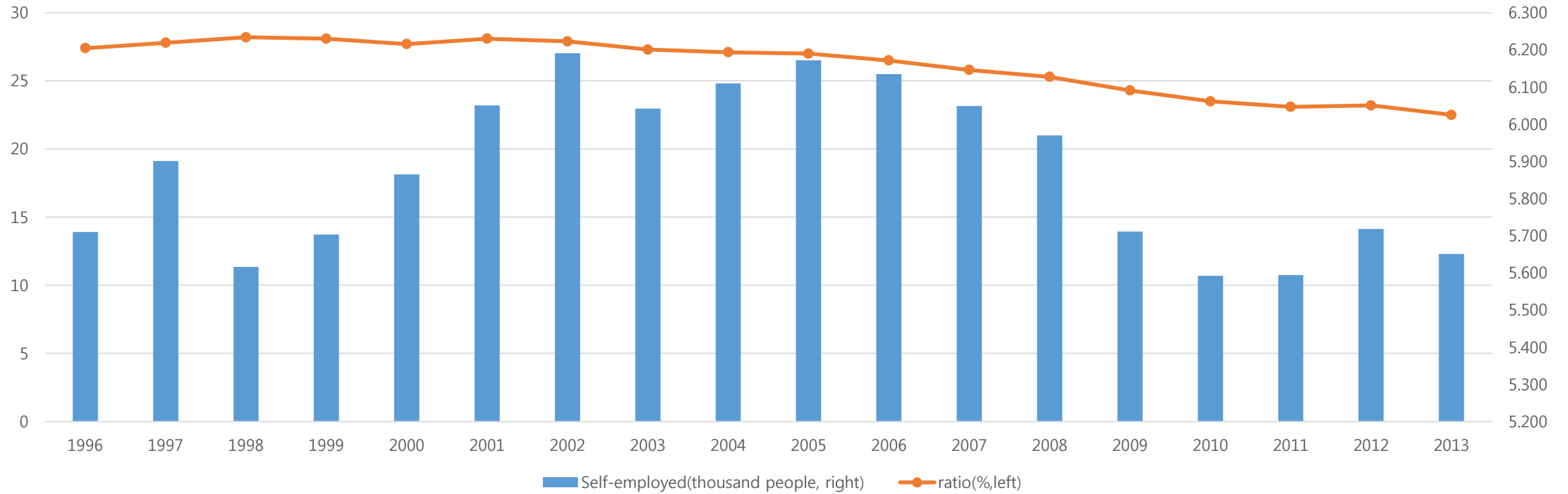
Author's calculation, Korea Institute of Finance

Share of Export by Firm Size



Source: Bank of Korea

Self-employed workers(%, thousand)



Source: KOSTAT

Unemployment vs. Underemployment

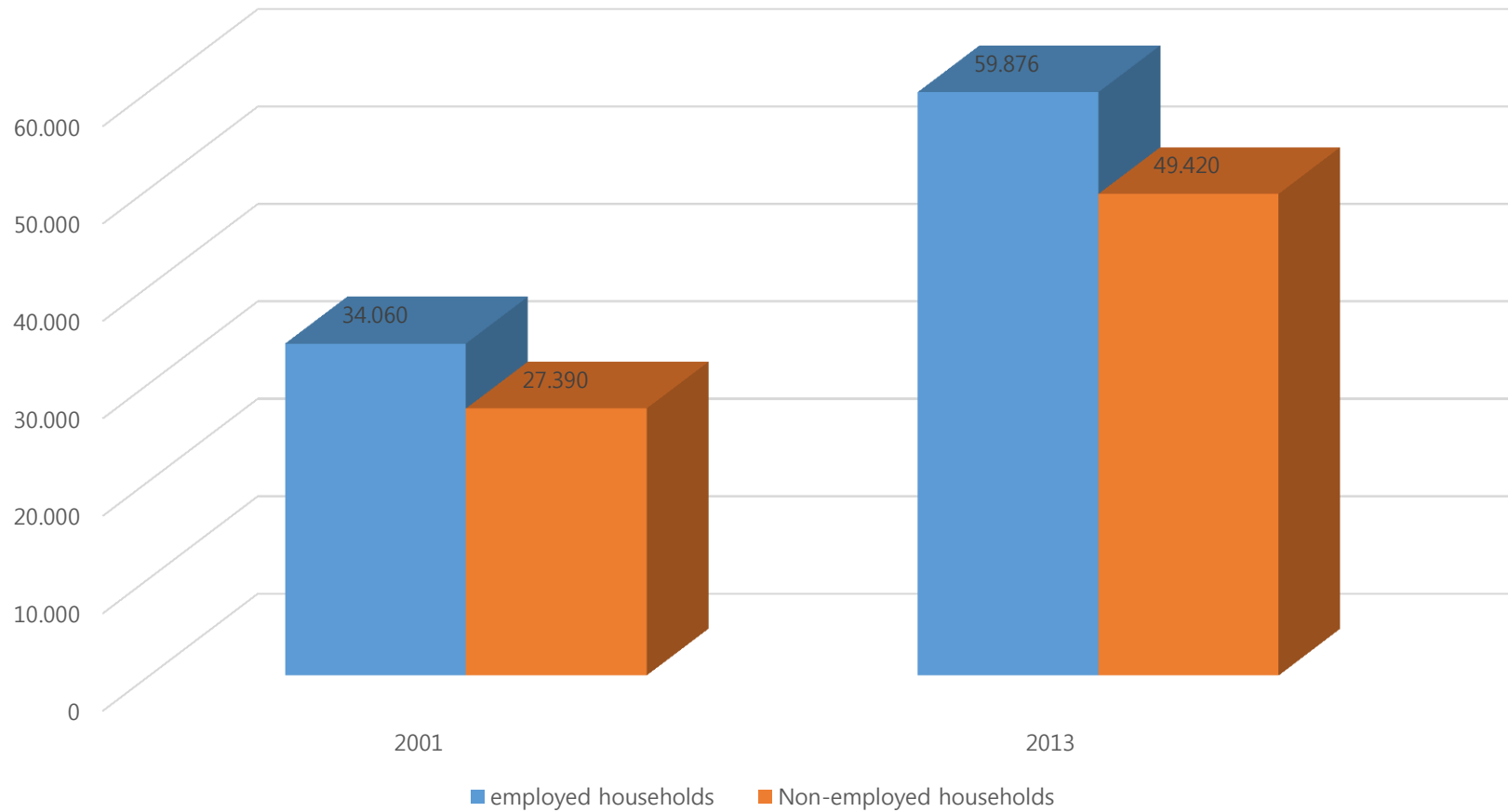
(%)

	Unemployment	Underemployment
US (Sep 2015)	5.1	9.6
EU-28 (1Q 2015)	10.2	19.4
UK	5.5	13.9
Germany	5.0	11.2
France	10.8	20.3
South Korea (Aug 2015)	3.4	11.5

Source: U.S. Bureau of Labor Statistics, Eurostat, Statistics Korea

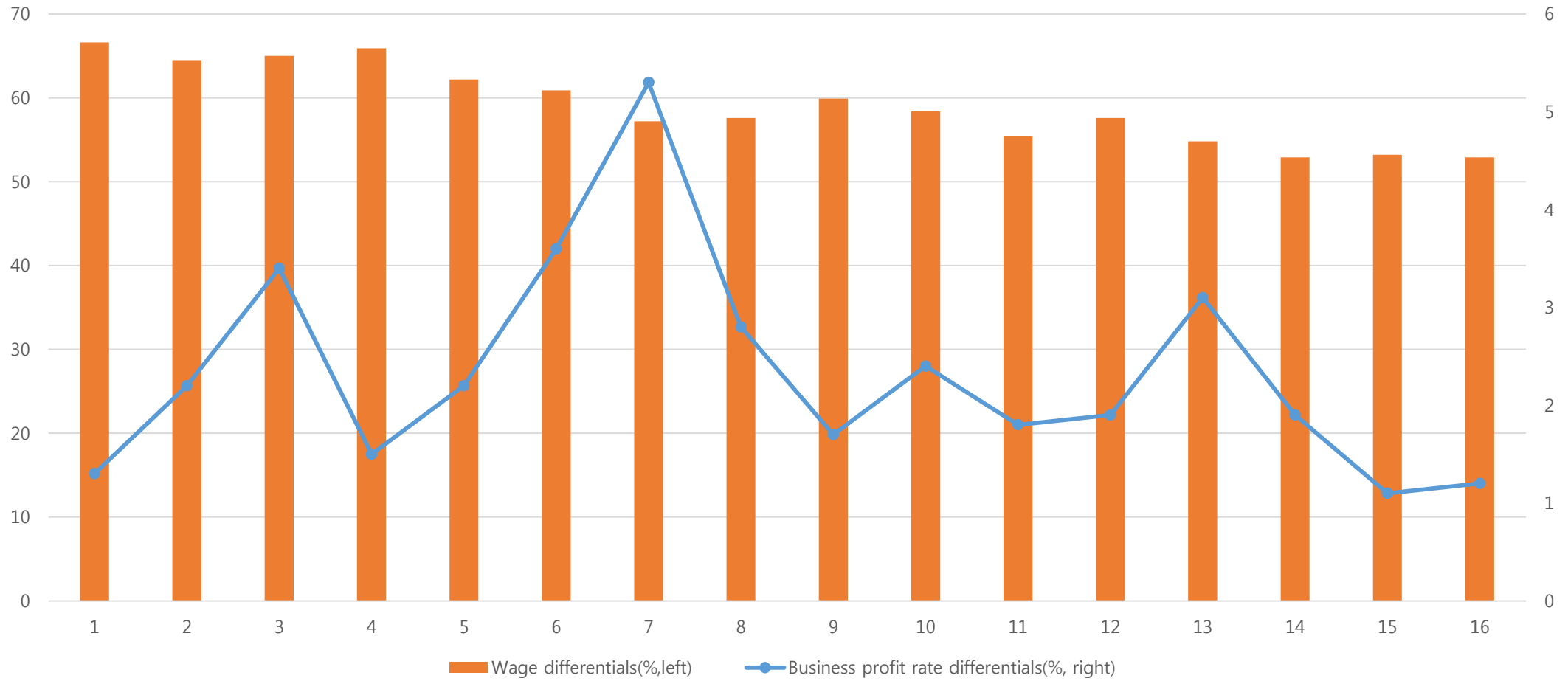
Household income by employment status

(Unit: thousand Won)



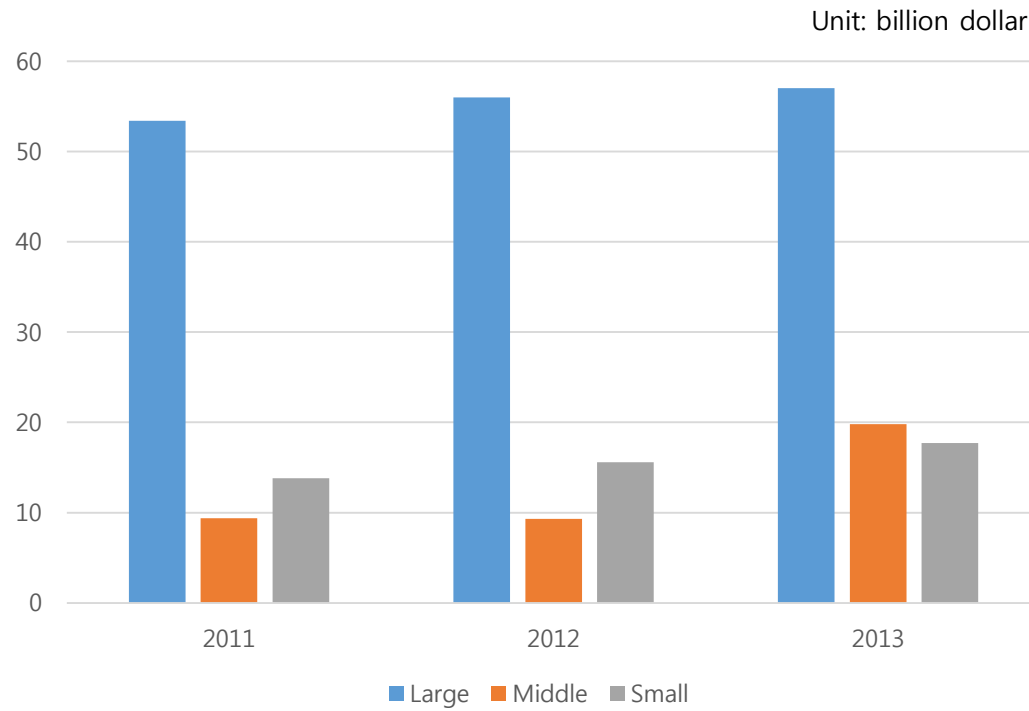
Source: KOSTAT

Wage and business profit rate differentials between large and SMEs



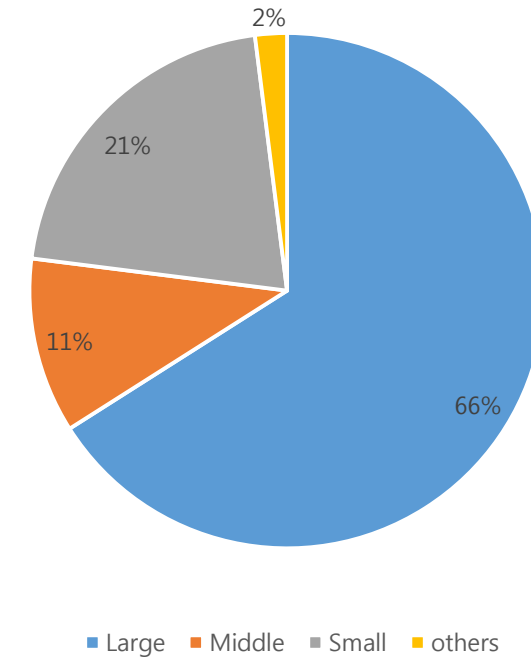
Source : BOK, Korea Federation of Small and Medium Business, Ministry of Science, IT and Future Planning

Export of consumer goods by size of business



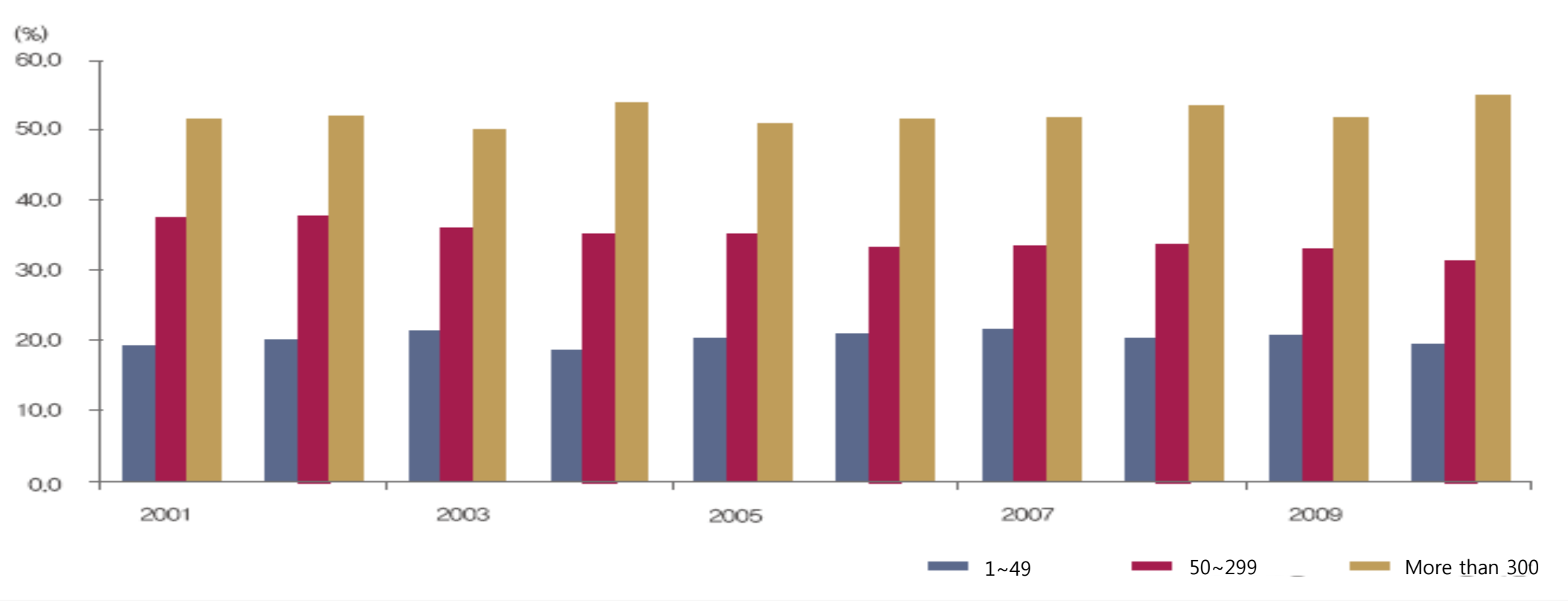
Source: Korea Customs Service

2013 Export ratio of consumer goods by business size



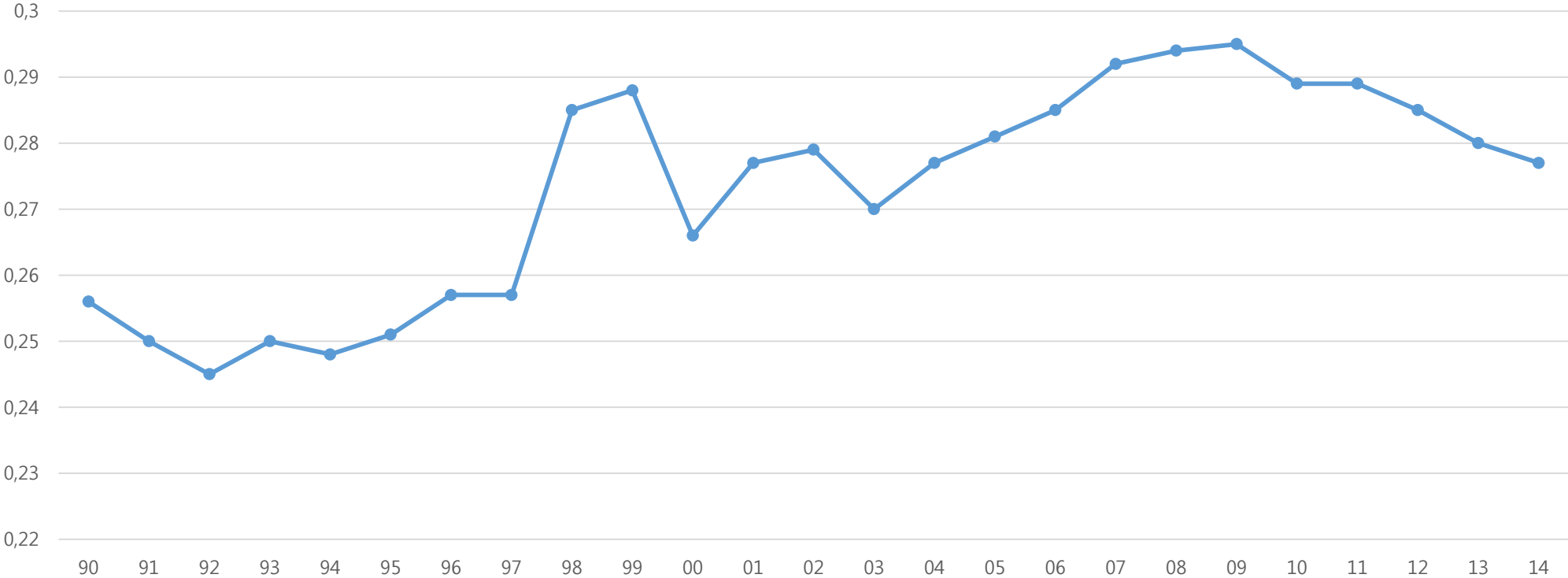
Source: Korea Customs Service

Value-added per employee in manufacturing



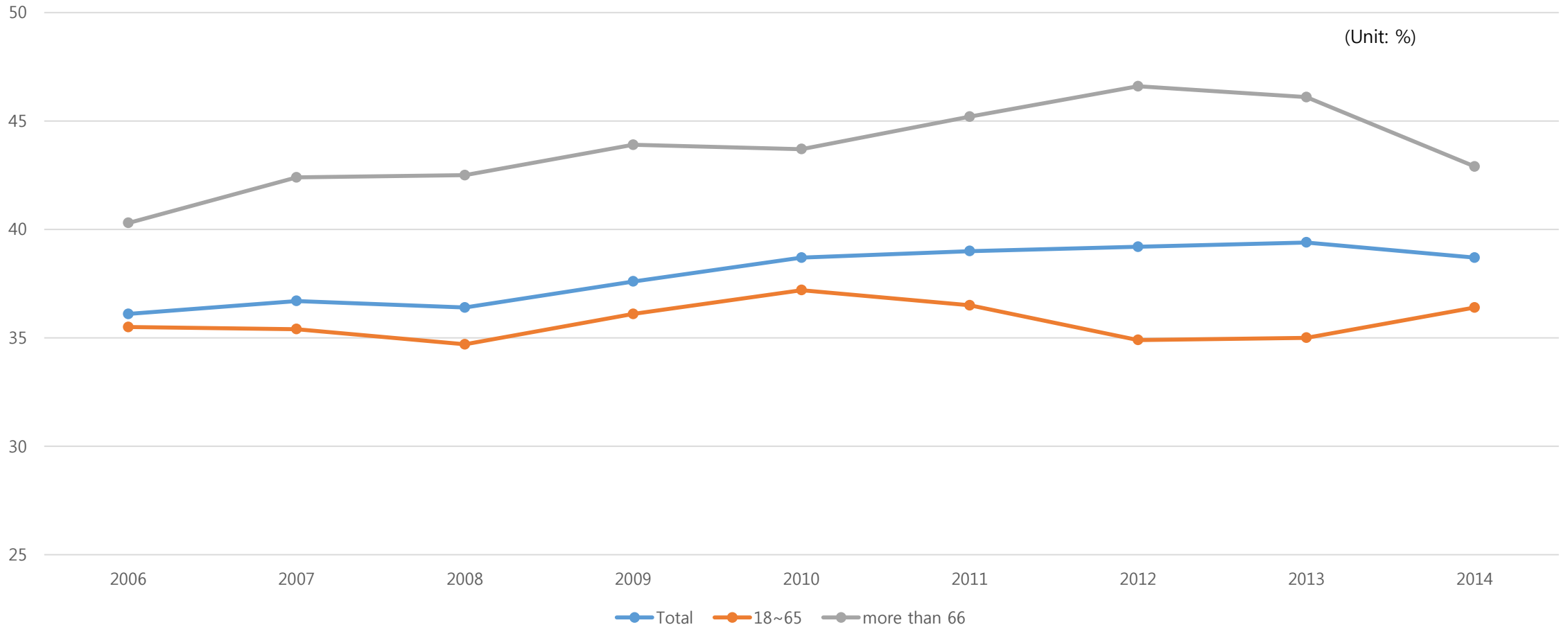
Source: KOSTAT, National Assembly Budget Office

Korea's Gini coefficient



Source: KOSTAT

Average poverty gap by age group



Source: KOSTAT

Note: Average poverty gap represents difference between the median earnings(50%) and the average of a specific income bracket (18-65, those > 66) that lies below the median. Bigger numbers reflect serious poverty situation.

Structural Economic Reform:

Cold Turkey (IMF as a reform catalyst) vs. Gradualist

	Cold Turkey	Gradualist
Benefits	Quick and Decisive	Evolutionary and less hiccups
Side Effects	Lingering Backlash Need for Further Government Intervention	No visible results, protracted Need "functioning market" for it to operate, e.g. M & A, hence difficult to adopt
Thrust	Exigency-driven market consensus, backed by IMF conditionalities	Weak momentum, lingering uncertainties
History	Crisis-related backdrop and social consensus required for transitory success	Market-based organic changes hardly happen in developing economies