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FINANCIAL SYSTEM RESTRUCTURING IN KOREA: THE CRISIS AND ITS RESOLUTION

Abstract

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The present paper provides a comprehensive and systematic overview of the recent financial system restructuring in Korea. It also analyzes the structural causes of the recent financial crisis and discusses implications for the future financial system evolution in Korea.

Korea's economic crisis was not entirely unanticipated. Throughout the 1990s, Korea's economic structure became increasingly vulnerable to exogenous shocks. The structural vulnerability came from two sources - external and internal–both of which were in principal caused by the systemic failure of risk-allocating mechanisms. External vulnerability is characterized by excessively short-term oriented external financing. While the size of Korea's external debt is not considered unsustainable given Korea's economic growth potential, the rapid increases in short-term debt and term-mismatches resulting from the absence of prudential supervision were clearly signaling possible foreign exchange liquidity problems.

Internal vulnerability is characterized by highly leveraged corporate financial structure. Korea's corporate debt-to-GDP ratio has been rising substantially throughout the 1990s. The excessive dependence on borrowings mainly to finance risky investments would not have been possible without imprudent and inefficient credit allocations of the financial sector and distorted incentive mechanisms based on the 'too-big-to-fail' argument.

Indeed, major terms of trade shocks hit the economy, and the collapse of export prices in 1996 and 1997 significantly damaged the corporate sector. A spate of corporate bankruptcies undermined financial soundness and destabilized the financial market. To make matters worse the lack of transparency and the government policy mishmash aggravated the situation, all of which culminated in the financial crisis in 1997-98.

Given the imperatives for financial reform, the Presidential Commission prepared a comprehensive reform package to overhaul the nation's outmoded financial system into a 'Competitive, Convenient and Sound' one which will be driven by unfettered competition in an open environment under market principles. While the Commission's recommendations faced considerable resistance prior to the crisis, most of the recommendations were adopted for implementation under the IMF (International Monetary Fund) program in the aftermath of the financial crisis. Thirteen financial reform bills including the Bank of Korea Act and a bill establishing a consolidated financial supervisory system were passed by the National Assembly, and laws were amended to improve corporate financial transparency and labor market flexibility. There has also been substantial progresses in capital market and trade liberalization.

So far, at least, the policy directions seem to be on the right track. However, the restructuring process of the financial system needs to be considerably accelerated. Delays in the resolution of ailing and insolvent financial institutions and corporate firms are undermining the effectiveness of the financial sector re-capitalization program. Bankruptcy-related laws need to be streamlined and corporate debt rescheduling should be based on the autonomous and voluntary decisions of financial institutions. The prudential supervisory system also urgently needs to be strengthened. It must be recognized that the more painful and drastic the reform is, the faster the Korean economy will be able to return to a normal growth path.