# PROSPECTS FOR ECONOMIC RECOVERY AND FINANCIAL REFORM IN KOREA

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According to Bank of Korea's preliminary estimate of gross domestic income, the Korean economy shrank by 5.6 percent in 1998 in the aftermath of the currency and financial crises. Consumption declined by nearly 10 percent and fixed investment by as much as 21 percent. On the other hand, exports rose by 13.3 percent while import volume fell by 22 percent. This could not stop the economy from slipping, however. KDI's latest forecast foresees a growth rate of around 4 percent for 1999.

## Currency Crisis and the Domestic Financial Market

Now it seems safe to say that the currency crisis that swept across the Asian countries has passed Korea and that it is not likely to return immediately. In the international financial markets the risk premium on Korean securities, which once reached 1,000 basis points, declined to under 300 basis points late in March 1999, and credit rating agencies such as Moody's and Standard and Poor's upgraded the country's rating from non-investment grade to investment grade. The IMF's rescue operation and the Korean government's prompt policy reactions were essential to Korea's weathering the currency crisis.

However, to a certain extent this was a natural turn of events. Immediately after the outbreak of the currency crisis in November 1997, the Korean won depreciated nearly 50 percent[1], giving a subsequent big boost to exports. Imports, on the other hand, fell by 36 percent in value terms in tandem with the drastic decline in consumption and investment.

This fall in imports led to a current account surplus of $40 billion for 1998 and consequently usable foreign exchange reserves reached over $48.5 billion (12.5 percent of GDP) at the end of the year. This was more than a ten-fold increase over the level at the outbreak of the crisis. Thanks to these developments, the currency steadily appreciated throughout 1998 and it has now stabilized at around 1,220 won to the dollar. This represents a 27-percent depreciation from the pre-crisis level.

The stability regained in the foreign exchange market provided some room for the monetary authority to pursue a low-interest rate policy. In turn, the domestic financial market stabilized as is evidenced by the declines in interest rates and the dishonored bills ratio. The monthly average of overnight call rates dropped from over 25 percent in January 1998 to below 5 percent in March of this year. Over the same period, the monthly average of three-year corporate bond yields dropped from around 23 percent to 8 percent. Also, bank loan rates have resumed their pre-crisis levels.

The dishonored bills ratio shot up from around 0.5 percent to above 2.0 percent in December 1997 because of liquidity shortage and also because of the collapse of confidence. During 1998, it declined rapidly and now stands below the pre-crisis level of 0.3 percent. This seems to indicate that confidence has been restored to some extent between lenders and borrowers in the financial market and that a credit crunch is not a big threat at the moment.

## Consumption and Investment

Private consumption, the largest component of any country's GDP, used to account for roughly 54 percent in Korea. Consumption declined by 9.6 percent in 1998. The extent of decline was greatest in the second quarter and diminished in the third and fourth quarters. This suggests that the consumption expenditure began to increase over the previous quarter's level since the third quarter of 1998. In support of this conjecture, wholesale and retail trade show similar quarterly trends, and so does the shipment of consumer goods.

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[1] Average exchange rate in January 1998 is compared to that in October 1997.

Gross fixed investment, the second largest component of GDP used to account for 36 to 38 percent of GDP in Korea before falling 21 percent in 1998, as noted at the outset. Equipment investment tended to show smaller reductions in the second half of 1998 than in the first. Construction investment, in contrast, showed increasingly larger year-on-year reductions as 1998 progressed.

## Prospects

Given these trends in consumption and investment, it seems likely that the Korean economy will register some growth in 1999, which KDI forecasts to be around 4 percent.

Consumption is expected to increase as GDP resumes positive growth and consumers make up for their drastic cut in expenditure in 1998. It is not likely that people will reduce consumption by more than the reduction in income for two consecutive years. Indeed, as noted above, consumption seems to have begun rising.

Investment is expected to pick up somewhat, especially equipment investment, as lower interest rates and the currency appreciation during 1998 have reduced the cost of capital. The profitability of the corporate sector also improved by the fall in the nominal wage rate, which is the first such decline since Korea began rapid industrialization more than 30 years ago. However, construction investment is not likely to increase, as construction permits, which are regarded as the leading indicator, remain more than 60 percent lower than a year earlier.

Inventory change is an important factor in the prospects for the Korean economy for 1999. The inventory depletion last year was so huge that it alone dragged GDP down by roughly 7 percent. Obviously, this cannot go on indefinitely. The depletion is bound to come to an end at some point and inventory buildup will start, making a positive contribution to growth.

Export growth will slow down in 1999 as a result of the won's appreciation, while imports are expected to increase rapidly in tandem with the increase in equipment investment and consumption. Thus, the current account surplus is likely to be reduced to $20 billion this year, compared to $40 billion in 1998.

Inflation in 1999 will be minimal, as the gap between aggregate supply capacity and aggregate demand is expected to remain large. Last year's won appreciation also puts downward pressure on consumer prices.

The unemployment rate which was below 3 percent prior to the crisis recently climbed to more than 8 percent. A little more than one percentage point of this increase is due to seasonal factors. The unemployment rate is expected to fall below 7 percent in the second half of the year.

This somewhat brightened prospect for 1999 should not be interpreted as an indication that the economy has fully recovered its health, however. It is to a large extent a reflection of the fact that there is a limit to how much things can worsen in the short run.

It also is the economy's response to the easing of macro-economic policy. The government has maintained its expansionary monetary policy for some time in fear of deflation or financial depression. This was one of the main reasons for the rapid decline in interest rates. Fiscal policy, which was somewhat restrictive last year, also turned expansionary in 1999 to counter the social problems brought on by mounting unemployment and increasing numbers of people living below the poverty line. As is well known, an economic expansion stimulated by lax monetary and fiscal policies cannot but be a temporary phenomenon.

Thus, structural reforms including financial reform are of utmost importance to sustain the economic recovery.

## Financial Reform

Commercial banks and other institutions in Korea's financial sector have been suffering from a large accumulation of non-performing loans (NPLs) and from over-capacity. For some, the accumulation was so large that equity was entirely eroded. Thus, the immediate short-run task of financial reform is to close insolvent institutions and resolve NPLs.

So far some progress has been made, more so among commercial bank, with the non-bank financial sector following some way behind. At the end of June 1998, the total amount of NPLs was around 100-120 trillion won. The government decided to use 64 trillion won (15% of GDP) of public money to purchase NPLs and re-capitalize the banks. At the end of 1998, 44 trillion won of NPLs were purchased at a cost of 20 trillion won. Mostly due to these restructuring efforts by the government, banks raised their capital adequacy ratios to above 10%. By the end of 1999, a total of 32.5 trillion won will have been used to purchase 72 trillion won of NPLs.

Many ailing financial institutions were closed or merged. As a result, the number of banks has been reduced from 27 to 17, while two major commercial banks are in the process of being sold to foreign institutions. The number of bank employees was reduced by 34 percent, and the banking sector's operating profit in 1998 rose by 57 percent.

While this progress is significant, the banking sector reform is far from complete. Deterioration of existing loans due to corporate sector restructuring is likely to increase the NPLs and the definition of "non-performing" needs to be further tightened to meet international standards. Moreover, restructuring the non-bank financial sector has merely begun.

Beyond the urgent short-run restructuring, banks should be able to play an active role in the efficient allocation of credit while exercising financial discipline over the corporate sector. This is essential for the economy not only to overcome the current financial crisis but also to recover its health and fully realize its potential in the long run.

In lieu of concluding words, it seems appropriate to restate the OECD's observation regarding the causes of Korea's financial crisis and its prescription for cure. As the causes underlying the financial sector's illness, the OECD points to "long-standing structural vulnerabilities such as excessive leverage in the corporate sector, lack of strong credit cultures and governance mechanisms in financial institutions, and pervasive official interference in financial markets in pursuit of industrial policy."[2]

For the financial sector to function properly, the OECD observes that, " . . . banks must be motivated by profit incentives while observing high prudential standards. To impart these motivations to banks, governance structures will have to be modified so that bank management achieve more independence from corporate borrowers and industrial policy and become primarily accountable to independent shareholders and banking supervisors. Bank management, corporate borrowers, and prospective foreign and domestic investors must all be convinced that the country is operating under a new financial regime in which the authorities insist on transparency while allowing banks considerable freedom to determine their own policies and in which the banks are held responsible for these decisions."[3]

This is a tall order for reform that has to be addressed.

[2] OECD Committee on Financial Markets, "Review of Korean Financial Policies". DAFFEE/CMF(98)4, 17 November 1998.

[3] Ibid.