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The Post-Crisis Changes in the Financial System in Korea: Problems of Neoliberal Restructuring and Financial Opening After 1997

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Chapter 1

INTRODUCTION

THE Korean economy, once called the "East Asian miracle" due to its rapid economic growth with relatively equal income distribution, went through a sea change after the financial crisis in 1997. While some quarters pointed to problems of careless capital account liberalization and financial globalization, mainstream economists and the Korean government considered the old development model based on strong government financial control to be a main cause of the crisis. After the crisis, the government introduced neoliberal economic restructuring together with all-out financial opening, and the economy became fully liberalized and globalized. However, the performance of the Korean economy since then has been disappointing. The paragon of the East Asian model now became a mediocre economy with lower growth and worse income distribution.

The financial sector was at the centre of the changes to the economic system in Korea. Financial restructuring following the crisis, and further liberalization and opening in finance resulted in the breakup of the old development regime in the end. Many argue that the reform in the financial sector helped the economy to recover from the economic collapse by stimulating efficiency of investment and encouraging foreign investment into Korea. But there are serious concerns about the potential problems of these measures. The current Korean financial system is not working well for financing long-term industrial investment and financial instability became more serious. Strong foreign control of the economy along with the increase in foreign capital inflows contributed to this. Moreover, recent financial instability after late 2008 with a currency depreciation indeed highlights the vulnerability of the financial sector in Korea. This runs counter to the mainstream belief that more financial liberalization, deregulation and opening should bring about more efficiency and economic growth.

This paper aims at examining the structural changes in the Korean financial system after the 1997 crisis and presenting the current situation of the financial sector and the economy in Korea. Chapter 2 discusses the state-led financial system which succeeded in supporting rapid economic growth and its demise before the 1997 crisis. Chapter 3 examines measures for financial restructuring and full capital account liberalization introduced after 1997. Chapter 4 discusses the disappointing economic performance and problems of the liberalized and open financial system. It also critically investigates the increase of foreign investment and changes in the capital account after the financial crisis and its problems, especially in the financial sector. Chapter 5 looks at the recent financial turmoil in Korea after late 2008 against the backdrop of the global financial crisis which originated in the US. This study underscores the problems and dangers of blind financial opening and a foreign-capital-dependent growth strategy influenced by strong market fundamentalism. The experience of Korea gives important lessons to other developing countries that the government should make efforts to manage and regulate the financial sector effectively and be careful about financial opening.

Chapter 2

FROM MIRACLE TO DEBACLE: THE FINANCIAL SYSTEM, ECONOMIC DEVELOPMENT AND THE 1997 FINANCIAL CRISIS

Economic Miracle Under Financial and Capital Controls

RAPID economic development in Korea was guided by a government that strongly intervened in the economy from the early 1960s (Amsden, 1989). Contrary to neoclassical arguments, the role of the state was crucial in Korea's growth, represented by strong industrial policy, financial control, trade protection and capital controls. The success of this intervention was thanks to the developmental state, which had a characteristic of embedded autonomy and high capacity (Evans, 1995). The state in Korea had strong autonomy because no powerful economic interest groups existed and it had highly capable officials who were strongly development-oriented. There was also a close government-business relationship, which mitigated information problems and limited unproductive rent-seeking.

The Korean government established a state-led financial system by effectively nationalizing all commercial banks in 1962. It allocated financial resources to priority industries and firms in line with industrial policy.[1] In the process of industrialization, domestic business groups called *chaebols* were strongly supported by the government via preferential credit from banks that were owned and controlled by the government. The share of policy loans in all loans of deposit money banks was higher than 60% from 1960 to 1991

1 The major purpose of industrial policy was export promotion in the 1960s and the development of heavy and chemical industries in the 1970s.

(Cho and Kim, 1997). It is crucial to understand that the government support for businesses was not unconditional but came with effective discipline. The government provided preferential credit in return for export performance of firms, thereby minimizing unproductive rent-seeking. This unique combination of the market and state mechanism resulted in high and productive investment in the private sector, and thus rapid economic growth for some 30 years.

The external economic policy of the developmental state of Korea was also unique. The Korean government did not undertake mere opening of the economy but pursued a strategic integration into the global economy by managing openness (Singh, 1994). Firstly, the trade regime was not totally open because the government adopted the two-track approach of both export promotion and import substitution simultaneously (Chang, 1994). More importantly, the government actively used extensive capital controls incorporated into the state-led financial system (Lee, 2008; Nembhard, 1996). The Foreign Capital Inducement Act in 1961 legally stipulated capital controls in a broad range of areas from foreign exchange and currency restrictions to foreign investment. Current accounts were also controlled and strict exchange restrictions were applied to all capital outflows till the 1980s. The tight regulations imposed on foreign direct investment (FDI) in Korea for the purpose of making FDI a conduit of advanced technology and managerial expertise for national development were well known (Mardon, 1990). The government inspected foreign investment projects thoroughly and limited foreigners' ownership of domestic industry.[2] FDI that might compete with domestic firms was not permitted and foreign companies were required to use domestically produced parts.

As a result, FDI played only a minor role in capital formation in Korea. The share of FDI in total long-term foreign capital and domestic investment was much lower than those of other Asian newly industrializing countries (NICs), let alone Latin America (Haggard and Cheng, 1987, p. 95). However,

2 Only joint ventures between foreign and domestic capital were permitted and moreover it was compulsory for foreign investors to resell their share after some years.

foreign loans were not hindered but promoted by the government itself which aimed to mobilize foreign capital to complement domestic savings. The government let state-controlled banks guarantee the payment of long-term foreign loans of the private sector by enacting and amending the relevant laws. As the creditworthiness of private businesses was not yet established, this policy was essential to their procurement of foreign capital. Due to these measures, long-term commercial loans soared starting from the mid-1960s.[3] The Korean government also made efforts to encourage productive investment of the private sector using these foreign loans (Lee, 2008). The share of foreign savings in GDP between 1966 and 1982 was high, about 5.5%, which financed high investment and the trade deficit. Thus, though the government controlled foreign capital and the role of FDI was small, investment and economic growth in Korea banked highly on foreign capital.[4]

This specific approach by the Korean government to foreign capital management was effective and contributed considerably to national development. First, controls over capital outflows operated well, helping contain domestic capital within the economy. Second, efforts to screen and examine foreign capital inflows made contributions to restricting foreign dominance of the economy and developing domestic industries. Most of all, the developmental government successfully mobilized foreign loans and allocated them to priority sectors through the state-led financial system. Capital controls worked as an important element of the state-led development strategy.

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3 The ratio of payment guarantees on foreign borrowings to total deposit money bank loans jumped from 11% in 1965 to 71% in 1967 and 94% in 1970. The average amount of long-term loans rose from $124 million in the 1960s to $1.2 billion in the 1970s. That of FDI also increased from $6 million to $82 million but its share in total foreign capital flows was still significantly lower than that of long-term loans.

4 This high dependence on foreign loans aggravated the external debt problem later in the early 1980s, but the crisis was overcome with political support from the US and Japan, and by the huge trade surplus in the late 1980s.

Financial Liberalization, Opening and the 1997 Crisis

Financial Liberalization and Opening in the 1990s

In Korea, it was not until the early 1990s that the government introduced extensive domestic financial deregulation and capital account liberalization (Lee, 2008). Several measures including privatization of banks and interest rate deregulation were introduced in the 1980s but these were very limited. However, economic development and changes in the financial system strengthened demands for more liberalization and opening in finance (Lee et al., 2002). In the financial market, non-bank financial institutions (NBFIs), less regulated by the government and dominated by *chaebols*, grew rapidly, and capital markets also developed rapidly in the 1980s. These weakened the government's financial control, while intensifying the financial power of the *chaebols*. The *chaebols* wanted more freedom in investment and financing, and strongly requested financial opening to utilize cheaper foreign capital. The government also began to retreat from the economy after the 1980s, seized by a strong neoliberal ideology which gained further momentum in the civilian government from 1993. There was also external pressure for financial opening from the US government, reflecting changes in international politics and the end of the Cold War. These changes since the late 1980s led to the demise of the developmental state regime and government financial control.

Against the backdrop of these changes, extensive financial and capital account liberalization was introduced in the early 1990s (Cho, 1999). Domestically, the government carried out significant short-term interest rate liberalization and implemented more deregulation in NBFI sectors. These shortened the term structure of domestic loans (Cho and McCauley, 2003). From 1991 to 1996, the annual average growth rate of short-term loans such as commercial paper (CP) was relatively higher than for other loans. The government also introduced measures for financial opening along with the decision to join the Organization for Economic Cooperation and Development (OECD) under pressure from domestic businesses and international capital.

But capital market opening for portfolio investment proceeded only gradually and long-term borrowing such as issuing corporate bonds abroad was still regulated in effect.[5] This was because the Korean government was concerned about economic instability with volatile foreign capital flows and the weakening of the government's macroeconomic management.

However, short-term foreign borrowings by financial institutions and firms were rapidly deregulated by the new civilian government (Lee et al., 2002). The government abolished the ceiling on foreign currency loans by financial institutions and reduced the required ratio of their long-term foreign loans in 1993. Furthermore, between 1994 and 1996, 24 finance companies were allowed to be transformed into merchant banks that dealt in foreign exchange, and banks were allowed to open 28 new foreign branches. The government naively expected that short-term loans would be automatically rolled over and the private sector craved the low interest rates available on short-term foreign loans. But this asymmetric financial opening was haphazard because it made Korea financially vulnerable. While the financial opening was extensive, the financial supervision system was weak and inadequate without an effective monitoring structure (Balino and Ubide, 1999). The problem was especially serious for newly licensed merchant banks, which were connected to the *chaebols* and were exposed to high risk due to short-term borrowing and risky long-term investment.[6]

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5 In January 1992, the limit on foreign ownership in Korean companies was 10% for groups of foreigners and 3% for individuals. The limit for groups was raised to 12% in December 1994, 15% in July 1995, 18% in April 1996, 20% in October 1996, 23% in May 1997, and 26% in November 1997.

6 The restriction on loans given to the same persons for merchant banks was 150% of equity capital, compared with 45% for banks, and there was no restriction on loans for affiliate companies in the same group. As of March 1997, the share of loans by merchant banks given to the top 30 *chaebols* was more than half of total lending.

Growing Financial Vulnerability and the 1997 Financial Crisis

This careless financial opening resulted in a rapid increase in short-term capital inflows and external debt, as seen in Table 1. External debt surged from some $43 billion in 1992 to more than $120 billion at the end of 1997, mainly due to short-term borrowing by financial institutions and firms. More than half of the increase in external debt between 1993 and 1996 was spent on *chaebols*' investment, worsening the trade deficit because they imported massive amounts of capital goods (Korean National Assembly,

Table 1. External debt and net capital inflows into Korea in the 1990s
($ billion)

	1992	1993	1994	1995	1996	1997
Total external debt	42.8	43.9	56.8	78.4	104.7	120.8
Long-term	24.3	24.7	26.5	33.1	43.7	69.6
Short-term	18.5	19.2	30.4	45.3	61.0	51.2
Short-term debt/foreign reserves[1]	--	1.05	1.36	1.54	2.07	5.77
Net capital inflows (1+2+3)	6.99	3.22	10.73	17.22	23.92	6.03
1. Net direct investment	-0.43	-0.75	-1.65	-1.78	-2.34	-1.95
2. Net portfolio investment	5.8	10.0	6.12	11.59	15.18	14.76
3. Other net capital inflows	1.62	-6.05	6.26	7.46	11.08	-6.79
Financial institutions' borrowing	2.43	1.2	8.98	13.40	14.15	-14.12
Long-term	1.2	0.08	1.95	1.61	1.53	0.72
Banks	0.9	0.15	2.18	2.03	2.49	0.66
Development institutions	0.08	-0.08	0.01	-0.35	-0.85	-0.01
Merchant banks	0.22	0.01	-0.24	-0.07	-0.11	0.07
Short-term	1.23	1.12	7.03	11.79	12.62	-14.84
Banks	0.7	0.39	5.38	8.52	7.19	-10.31
Development institutions	0.59	0.56	0.78	1.56	2.24	-2.43
Merchant banks	-0.06	0.17	0.87	1.71	3.19	-2.10
Other debts (trade credit et al.)	2.49	-2.66	4.65	8.05	10.42	18.07

Source: Bank of Korea, International Balance of Payments.
Note: [1] Available foreign reserves base.

1999). Total foreign capital procured by the non-financial sector also rose rapidly. Of course, it should be noted that the changes in the international financial markets due to high growth in East Asia and low interest rates in developed countries were another factor behind the increase in capital flows into Korea.

The consequence of the increase in short-term capital inflows was growing financial vulnerability. The share of short-term funds and foreign borrowings in the corporate financing structure rose significantly in the early 1990s. External debt as a proportion of all corporate debt also grew from 8.6% in 1992 to 10.0% in 1994 and 16.4% in 1996 (Hahm and Mishkin, 2000, p. 63). The financing structure of the *chaebols* was highly vulnerable. The top 30 *chaebols*' dependence on external finance in all their financing rose from 58.8% in 1994 to 77.6% in 1996, with the share of short-term borrowings rising faster (Kim, 1998, p. 407). Financial institutions also became fragile, taking excessive risk. The share of foreign borrowings in total liabilities in the financial sector jumped from 1.2% in 1992 to 9.2% and 10.7% in 1995 and 1996, with short-term borrowings taking the lion's share. The term structure and currency mismatch problems of financial institutions thus became acute. Merchant banks were in the biggest danger. They procured 64.4% of total foreign capital on a short-term basis but lent 83.7% of it long-term as of October 1997, as the *chaebols* utilized them as an easy pipeline for finance (Korean National Assembly, 1999).

In 1996, a huge external shock in the form of a collapse in the export market dealt a severe blow to the Korean economy. Several *chaebols* started to go bankrupt in the ensuing economic recession of early 1997, which left the financial sector in grave trouble with huge amounts of non-performing loans. As financial institutions, particularly troubled merchant banks, struggled to pull back their short-term loans from companies, the crisis spread to the whole economy. This turmoil and the dangerous structure of external debt exacerbated foreigners' lack of confidence and drove the foreign exchange market into a chaotic state. With the contagion effect of the Southeast Asian crisis and several mistakes by the government, foreign investors refused to roll over short-term foreign loans. This brought about an unprecedented financial crisis in Korea (Radelet and Sachs, 1998).[7] As the Korean economy plunged into crisis, the government could not help but turn to the International Monetary Fund (IMF) for an emergency loan in December.

There was a heated debate concerning the cause of the East Asian financial crisis. While mainstream economists stress problems of the old development model such as inefficient overinvestment caused by moral hazard and crony capitalism (Krueger and Yoo, 2001), heterodox economists emphasize careless financial opening and the problems of the international capital market (Chang, 1998). It is indeed true that there was aggressive investment spending by the *chaebols* in the early 1990s, but it was not overly irrational considering the temporary export market boom (Crotty and Lee, 2004).[8] The most important cause of the crisis in Korea was mismanaged financial opening, which made the Korean economy financially fragile. Many indicate that the lesson to be drawn from the financial crisis in Korea is that the government must be careful in financial opening, and effective regulation of volatile international capital flows is called for.

7 In 1997, the rollover rate of short-term foreign loans of commercial banks fell from 106.3% in June to 85.8% in September, 58.8% in November and a mere 32.2% in December.

8 Crotty and Lee (2004) contend that the argument emphasizing inefficiency of the Korean economy due to crony capitalism is not empirically grounded. Their investigation reports that profitability of the Korean corporate sector was rather high before the crisis in both historical and international terms, and there is hardly any evidence of inefficiency serious enough to cause the collapse of the economy in 1997.

Chapter 3

FINANCIAL OPENING AND LIBERALIZATION AFTER THE FINANCIAL CRISIS

Neoliberal Economic Restructuring and Changes in the Political Economy

THE financial crisis in 1997 was a watershed moment for full-blown neoliberalism in Korea's economy. The Kim Dae-Jung government accepted the mainstream view and implemented the restructuring programme suggested by the IMF. First, the government introduced very restrictive macroeconomic policy. However, this was no cure for Korea because the Korean economy was relatively sound in terms of macroeconomic fundamentals (Radelet and Sachs, 1998; IMF, 2003). In reality, the government gave up on restrictive monetary policy from mid-1998, and turned to a somewhat Keynesian approach by means of huge public spending. The government also executed microeconomic restructuring, of which the objective was to break up the old development model in earnest. The Korean economic system was supposed to be transformed into an Anglo-Saxon market-based system in the long term.

The post-crisis reform was directed by the government. After effectively nationalizing the banking system, it resorted to financial sanctions to push corporate restructuring forward. It also attempted to establish better financial regulation and promote the venture industry in the information technology (IT) sector using financial and tax support. However, this active role of the state was just temporary and the Korean state had become more neoliberal. After the crisis, the power of big *chaebols* remained intact and indeed became even stronger. The crucial change in the political economy, however, was that foreign capital became the most powerful player. Foreign capital reportedly demanded comprehensive financial opening and the layoff system in the agreement between the IMF and the government. The government made maximum efforts to attract foreign capital by introducing more deregulation and taming the trade unions. Public opinion was supportive of the IMF restructuring programme because the mainstream view of the cause of the crisis was widely accepted.[9]

The neoliberal economic restructuring covered various areas. With regard to labour market reform, in the middle of the turmoil of the crisis in early 1998, new capital-friendly labour laws were enacted that legalized the layoff system in cases deemed to be of "urgent managerial need", including mergers and acquisitions (M&A). Moreover, temporary help agencies were legally allowed after July 1998 and temporary workers, who were dispatched to firms for up to two years, were permitted in all occupations (MOFE, 1999). This flexibilization of the labour market was clearly intended to break the strength of the labour movement, as requested by the IMF immediately after the crisis and desired by both domestic and foreign capital. This raised the unemployment rate to some 7% in 1998 from less than 3% before the crisis. Another result of the flexible labour market was an increase in the number of irregular workers and job insecurity. Already prior to the crisis, over 40% of all workers in Korea were irregular or non-permanent, the highest in the OECD. The share of these workers rose to some 52% in 1999 and even higher in 2000 because Korean firms fired permanent workers and hired mainly temporary workers.[10] With all these changes, the social safety net would never be adequate in Korea even though social spending was substantially raised after the crisis.

As for the corporate sector, the Kim government announced five principles of corporate restructuring in 1998, including a drastic reduction

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9 Free-market ideology became even more prevalent because people considered government intervention to be the other side of the coin of dictatorship. This was reflected in the new government agenda, "democracy and market economy".

10 The labour market reform was clearly good news to businesses since it resulted in higher labour productivity growth and lower wage growth (Crotty and Lee, 2001).

of corporate debt, an improvement in transparency, the end of cross-debt guarantees by conglomerate firms, *chaebols*' concentration on core businesses, and greater managerial accountability to shareholders. The government policy had some success. The highly leveraged top 30 *chaebols* did reduce their debt ratio from about 500% in late 1997 to less than 200% in 2000 although a significant part of this was achieved by raising their capital base. The trend of declining debts continued thereafter, and the debt ratio for the 30 largest *chaebols* went down further to 118% in 2005 along with a fall in investment. Profitability in the corporate sector began to rise after 2002. Ordinary profit as a percentage of sales in manufacturing firms fell to minus 1.8% in 1998 but recovered rapidly from 2002, with the figure being 4.7% in 2002 and as high as 7.8% in 2004, thanks to the decrease in the debt ratio and lower interest rates, although *chaebols*' profitability did not recover that fast. The worst side-effect of the corporate restructuring was the decline of investment owing to the conservative management and financial restructuring. Another problem was the limited corporate governance reform. About a third of the former 30 largest *chaebols* went bankrupt, including Daewoo's bankruptcy and Hyundai's divestiture, but insider control based on the interlocking shareholdings in most *chaebols* remains intact. The corporate governance reform took a backseat and *chaebol* reform lost steam in the 2001 economic recession.[11]

Restructuring the Financial Sector After the 1997 Crisis

The financial sector saw the most sweeping changes under the neoliberal restructuring. After the crisis, the Korean government implemented financial restructuring to drive weak financial institutions out of the market, clean up non-performing loans, recapitalize viable financial institutions, and apply

[11] There were some measures to establish better corporate governance such as a requirement for external directors in a company's board of directors, but most were formal and not effective. Faced with a recession and *chaebols*' resistance from mid-2001, the government allowed more deregulation such as exceptions in the regulation of financial investment of affiliate firms (*Hankyore Shinmun*, June 1, 2001).

stricter prudential regulation (MOFE, 1999, pp. 87-104). By late 2001, as many as 550 financial institutions out of 2,072 had gone out of the market. The number of employees in all financial institutions and branches of banks also fell significantly (BOK, 2002). After 2001, the government encouraged mergers between financial institutions and struggled to attract foreign capital in an attempt to create larger and globally competitive institutions. By 2008, about 44% of all financial institutions had disappeared, including 16 out of 33 banks, 29 out of 30 merchant banks, and 15 out of 36 securities companies that were forced to go bankrupt.

Because almost all institutions involved in corporate lending effectively went bankrupt in 1998, the government was required to inject huge amounts of public money into the financial system. Public spending financed by issuing government bonds to buy out non-performing loans and increase equity investment through mid-2001 amounted to about 30% of total GDP. The total amount from late 1997 to early 2008 was as much as 168.5 trillion won, of which 86.9 trillion won was for the banking sector and 22.9 trillion won for failed merchant banks. The state-owned corporations Korea Asset Management Corporation (KAMCO), newly established after the crisis, and Korea Deposit Insurance Corporation (KDIC) played an important role to clean up non-performing loans.

In addition, strict prudential regulation was implemented immediately in the midst of the economic turmoil by introducing the Bank for International Settlements (BIS) capital adequacy standards. These specified that the capital of financial institutions must be larger than 8% of the value of their loans. The government required commercial banks and merchant banks to meet the BIS ratio when introducing the Prompt Corrective Action from April 1998. This ratio was actually used as a criterion in the government's shutting down of financial institutions. Subsequently, the Korean government went further to demand that banks attain a ratio higher than 10% until the recession in 2001 (SERI, 2009, p. 14). Also, the government tightened the criteria for non-performing loans by introducing forward-looking criteria from 2000. These measures forced financial institutions to reduce the supply of loans. The fragmented financial supervisory system was also reformulated by the government, which established a new Financial Supervisory Service (FSS) that was entitled to monitor all sections of the financial sector.

Thanks to the financial restructuring with massive infusion of public funds, the Korean financial sector became healthier quickly. The share of non-performing loans in all commercial bank loans fell sharply from 13.6% in 1999 to 8.8% in 2000 and 3.3% in 2001. The BIS ratio of commercial banks increased from 7.0% in 1997 and 8.2% in 1998 to 10.8% in 1999 and was constantly higher than 10% thereafter. In spite of this achievement, however, the direct effect of the financial restructuring together with a restrictive macroeconomic policy on the economy in 1998 was a severe credit crunch and a collapse of the economy (Crotty and Lee, 2001). With financial restructuring, commercial banks in Korea also shifted out of shaky industrial loans into high-margin household loans, which increased household debt and generated another financial bubble.

Post-Crisis Capital Account Liberalization and Financial Opening

Although careless capital account liberalization had been a main cause of the 1997 crisis, still more extensive financial opening was undertaken after the crisis, in part because of the urgent need for foreign exchange (Lee, 2008; MOFE, 1999). First, the government completely opened the domestic capital markets and short-term money markets to foreign investors. It lifted the foreign ownership ceiling in Korean companies up to 55% in December 1997 and finally abolished it in May 1998 (Table 2). From 1998, regulations on foreign investment in most corporate bonds and CPs were abolished or eased. The government also permitted hostile M&A by foreign investors from 1998 and raised the number of business categories open to foreign ownership. Furthermore, foreign borrowings of domestic firms and their issuance of bonds abroad were further liberalized and the opening of derivatives markets became complete in 1998.

From April 1999, more deregulation measures in the capital account were announced, in the first part of a “two-phase financial opening plan”. Most importantly, the system of regulating foreign capital transactions was

Table 2. Opening of the Korean stock markets

1) KSE (Korea Stock Exchange)

Date	92.1.3	94.12.1	95.7.1	96.4.1	96.10.1	97.5.2	97.11.3	97.12.11	97.12.30	98.5.25	00.11.15
Total											
Private	10%	12%	15%	18%	20%	23%	26%	50%	55%	100%	100%
Public	8%	8%	10%	12%	15%	18%	21%	25%	25%	30%	40%
Individual											
Private	3%	3%	3%	4%	5%	6%	7%	50%	50%	100%	100%
Public	1%	1%	1%	1%	1%	1%	1%	1%	1%	3%	3%

2) KOSDAQ (Korean Securities Dealers Automated Quotation)

Date	96.9	97.12.1	98.4.1	98.5.25
Total	10%	15%	55%	100%
Individual	3%	5%	50%	100%

changed from a positive system to a negative system, giving freedom in principle to all cross-border capital flows. Other changes included allowing long-term deposits by non-residents in domestic financial institutions, further deregulation of domestic firms' short-term foreign borrowing, partial deregulation of real estate investment abroad, and allowing foreign currency transactions by all financial institutions and individuals. Measures to develop the Non-Deliverable Forward (NDF) market were introduced and the principle of real demand for foreign currency for forward exchange was abolished.

The government announced that it would open the financial market entirely under the second phase of the financial opening plan from 2001 (*Hankook Kyoungje Shinmun*, April 23, 2000). In accordance with this plan, regulations on individuals' purchases of foreign currency and payments abroad were repealed, and residents' deposits in foreign financial institutions and purchases of foreign bonds were deregulated in 2001. The government also liberalized non-residents' bond issuance and borrowing in domestic currency by increasing their ceiling. All foreign capital transactions were supposed to be liberalized under the second stage of the plan starting from 2006, when another action plan including more liberalization in the foreign exchange operations of financial institutions was announced. In addition, as the Korean economy continued to record current account surpluses recently, the government endeavoured to encourage capital outflows by increasing the ceiling on domestic companies' overseas financial business investment from 2006. In 2007, there was deregulation in financial holding companies owning foreign financial institutions and the foreign operations of financial institutions (BOK, 2008a).

In particular, along with the progress of financial globalization, the Korean government has opened its financial markets to foreigners. It intended to encourage foreign investment in the financial sector and foreign takeovers of Korean banks in the financial restructuring process. Foreign capital was given freedom to invest directly in the Korean banking sector, mainly via the methods of acquisition, resulting in a rise in foreign ownership in the financial industry. In addition, there was a reduction of discriminatory business regulations imposed on foreign banks.

The financial opening measures taken were in reality far more advanced than those in the original plan agreed to with the OECD before the crisis. However, this all-out financial opening policy has raised concerns. For example, with total liberalization of residents' capital flows, the government may not stop capital flight anymore. Moreover, liberalization of non-residents' borrowing in domestic currency may provide foreigners with ammunition to attack the domestic currency. The government still retained regulation of short-term foreign borrowings of firms to some extent. New regulations on maturity mismatches in banks' foreign currency assets and safeguard systems such as variable deposit requirements (VDR) were also set up. However, it is reported that the institutional framework and regulatory capacity were still immature, compared with the speed of financial opening (*Hankook Kyoungje Shinmun*, March 24, 2000).

In addition to capital account liberalization, the Korean government became keen to attract FDI following the crisis. It enacted the Foreign Investment Promotion Act in November 1998, giving more incentives to foreigners. This act expanded tax exemption for FDI in high-tech and related industries and simplified the procedure of FDI. The Kim government also presented the "Northeast Asian business hub country" plan in 2002 which provided more deregulation for FDI (*Chosun Ilbo*, August 29, 2002), and the Roh Moo-hyun government from 2003 developed this into the "Northeast Asian Economy Hub State" plan. But the government plan lacked a strategic approach to maximize the benefits of FDI, only providing various incentives. It is indeed remarkable that Korea has totally changed its stance towards foreign capital.[12]

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[12] This stemmed from the strong belief that more financial opening and foreign investment would promote economic efficiency. However, a large number of studies report mixed results on the growth effect of financial globalization. Recently even the IMF has indicated that there is little evidence for this and presented a more cautious approach to financial opening by developing countries (Kose et al., 2006; Lee, 2008).

Recent Developments in Financial Deregulation

Another important change in the financial sector, introduced very recently, is enactment of the Capital Market and Financial Investment Service Act, frequently called the capital market integration act, in 2007. The Roh government propelled the institutional reform of the financial sector, and finally realized the legal change to encourage full-scale deregulation in the capital markets. This act merged six individual acts for the financial sector to bring about a financial “big bang” in Korea’s financial system (BOK, 2008a). First of all, financial institutions were allowed to function as financial investment companies which could engage in all types of capital market transactions. Second, the negative-list system and a broader definition of financial investment were introduced in the regulation of financial investment products, giving permission to all manner of financial products, including complex derivatives, in principle. Third, changes were made to the regulatory system such that it operated on the basis of the functions of the financial institutions, and all financial institutions that ran businesses in capital markets came under the same act. Fourth, financial institutions were required to explain the contents and the risk of financial investments to investors.

The breakup of the wall between institutions effected by this act will allow new financial investment companies to undertake all operations in the capital market and some banking businesses such as small amount settlements. Securities companies may become large financial investment companies and compete with banks. The government and its supporters argue that this act will contribute to the development of capital markets and the financial sector in Korea. Financial companies could benefit from synergy effects and economies of scale, by running various businesses including corporate financing, asset management and direct investment as well as businesses of securities companies. Thus, the argument goes, Korean financial companies can develop into globally competitive large-scale investment banks and the efficiency of the Korean capital markets will be enhanced. The supporters emphasize that when the financial sector becomes an important source of value added, this strategy would be essential to the future growth of Korea.

However, we have already seen the collapse of the investment bank model in the US. It is now well known how difficult financial regulation is when financial derivatives are so complicated and cannot reflect systemic risk adequately. In light of this, the move to develop capital markets and to expand financial institutions following the model of investment banks in the US could be dangerous.[13] It may inflate the asset market bubble and instability in the financial markets. Meanwhile, the financial power of the *chaebols* will be too great because most of them own securities companies though their ownership of banks is not permitted. Another concern is the possibility of conflicts of interests between investors and financial investment companies. Once they are allowed to run asset management and securities businesses, financial companies may act against the interest of investors.[14]

The new Lee Myung-bak government that came into power in 2008 announced several changes to strengthen the ongoing trend towards a finance-led economy. Deregulation of private equity funds (PEFs) and approval of hedge funds are expected to be introduced. The government also aims to introduce more deregulation for *chaebols* by revising banking and financial holding company laws. The proposed new bank act intends to intensify ownership of banks by industrial capital by changing the definition of industrial capital associated with private equity funds.[15] The revision in the financial holding company act is to permit financial holding companies to

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[13] In fact, it has been reported that the Korean government even promoted a plan to take over Lehman Brothers just a few months before its bankruptcy, via investment by the state-owned Korea Development Bank.

[14] For example, financial companies could increase the volume of transactions in stocks held by their funds so as to increase the fee revenues. They could have their funds purchase stocks issued by themselves. The government is aware of this possibility and has introduced some measures which emphasize the function of self-regulation of financial markets, but it is not certain whether they could be effective.

[15] The limit on bank ownership by industrial capital was already increased from 4% to 10% in 2002 but the part of the stake beyond 4% was not accorded voting rights. In the new act, a PEF will be considered as industrial capital only when industrial capital owns more than 30% of the shares. Hence, it will be easier for a *chaebol* to effectively control a bank by owning a direct 10% share in the bank and 30% of the shares of a PEF that has a stake in the bank.

hold non-financial companies more easily. These measures are to repeal regulations on control of banks by industrial capital, precisely what the *chaebols* had long requested. The finance-industry collusion is already very serious in Korea as corporate groups own large insurance companies, securities companies and credit card companies. These changes, if realized, will reinforce financial control by big conglomerates, which may be harmful to economic efficiency as well as equity.

The Korea-US Free Trade Agreement (FTA) is another factor behind changes in the financial sector. In 2007, the Korean government finally signed an FTA with the US although it is still subject to ratification in both countries. This agreement intends to liberalize all trades and investments between Korea and the US. Investment from the US into Korea would be treated as domestic investment and would not be subject to more regulation. US investors would be entitled to sue the Korean government when they judge that their rights are encroached upon by the domestic laws of Korea. Thus, the Korean government will effectively lose its ability to regulate foreign investment. The new capital market integration act will make things worse. The Korean government had boasted of achieving regulation of new financial services that have not been introduced in Korea by domestic law in the FTA negotiations. However, once transnational financial institutions establish subsidiaries in Korea, they will be able to freely provide new financial services in the country due to this agreement. This may result in the dominance of foreign investment banks in Korean capital markets.

Chapter 4

THE VULNERABLE FINANCIAL SYSTEM AND WEAK ECONOMY IN POST-CRISIS KOREA

Stagnant Growth and Worsening Income Distribution

IT has already been over 10 years since the financial crisis occurred in Korea. Neoliberal financial restructuring subsequently reshaped the Korean economy and transformed the financial system into a more open and liberalized one. The government and mainstream economists expected that the economy would become more efficient and that economic growth would be promoted. However, the reality has not borne this out. The economic performance of Korea in the post-crisis period is disappointing and at best mediocre (Crotty and Lee, 2006). The growth rate and investment fell significantly and the economy was more unstable, while income inequality and poverty became serious, leading to a vicious cycle of low growth and unequal income distribution as shown in Table 3 and Figure 1.

The policy responses following the crisis ran counter to normal measures to avert recession. Neoliberal economic restructuring together with excessively restrictive monetary policy paralyzed the financial system and the corporate sector. It led to a severe credit crunch and a vicious cycle of economic collapse, with the economy contracting by almost 7% in 1998 (Crotty and Lee, 2001). The dramatic drop in credit to the corporate sector caused firms to reduce investment, wages and employment, thereby aggravating the deficiency in aggregate demand, which again increased non-performing loans and cut bank lending further. The economy recovered quickly after 1999, but it was mainly on account of the huge trade surplus

Table 3. Korea's economic performance after the 1997 crisis (%)

	1993-97	1998	1999	2000	2001	2002	2003	2004	2005	2006
GDP growth	7.1	-6.7	9.5	8.5	3.8	7.0	3.1	4.7	4.2	5.0
Consumption growth	6.5	-10.6	9.7	7.1	4.9	7.6	-0.3	0.4	3.9	4.5
Fixed investment growth	12.3	-22.9	8.3	12.2	-0.2	6.6	4.0	2.2	2.4	3.2
Investment rate	37.1	25.2	29.3	31.1	29.4	29.1	30.1	30.4	30.2	29.9
Saving rate	36.1	37.5	35.3	33.7	31.7	31.3	32.8	34.9	32.9	31.4
Net exports/GDP	-1.1	12.9	6.7	3.2	2.3	1.4	2.4	4.3	2.4	1.1
Ordinary profitability	2.2	-1.8	1.7	1.3	0.4	4.7	4.7	7.8	6.5	5.7
Debt ratio	319.5	303.0	214.7	210.6	182.2	135.4	123.4	104.2	100.9	98.9

Source: Bank of Korea, Ministry of Finance and Economy.
Note:
1) Average value for 1993-97.
2) Profitability and debt ratio for the manufacturing sector.
3) Calculated based on 2000 real prices.

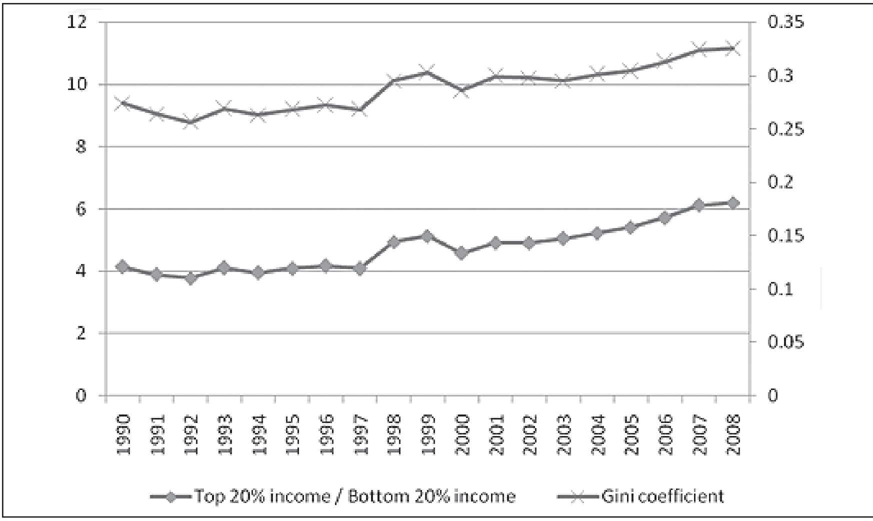
due to the global economic boom, government spending of public funds, and expansive macroeconomic policy.

After experiencing a mild recession against the backdrop of the global recession in 2001, the economy enjoyed a boom in 2002. This was because of deregulation in consumer finance and lax consumer credit that boosted consumption growth to nearly 8%. The Korean government introduced more financial deregulation to encourage domestic consumption, such as elimination of the limit on credit card usage in 1999. Also, the government cut interest rates several times since late 2001. The ratio of household debt to GDP rose rapidly from around 38% in 1998 to 61% in 2002. However, after late 2002 the economy fell into another recession and became structurally fragile when the credit card bubble finally burst. The growth rate fell in 2003 to 3.1%, led by a 0.3% downturn in consumption.

After 2004, the engine of economic growth was mainly the external sector. Though the recovery of consumption and domestic investment were still weak, exports increased rapidly and the trade surplus contributed to

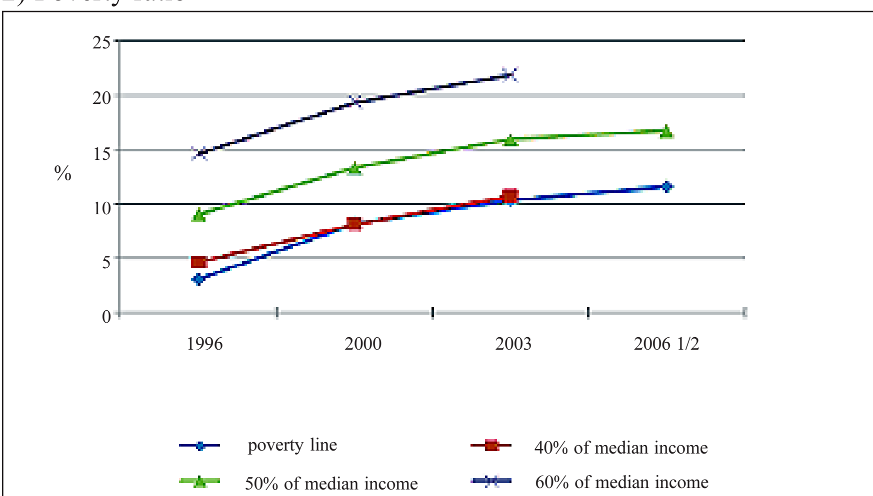
Figure 1. Income distribution and poverty in Korea

1) Gini coefficient and top 20%/bottom 20% income ratio



Source: Korea National Statistical Office.
Note:
1) Based on market income.
2) For households in urban areas, excluding single-person and farming households.
3) Gini coefficient on the right axis.

2) Poverty ratio



Source: Korea Institute for Health and Social Affairs.

economic growth. The ratio of exports and imports to GDP went up from about 57% in 2001 to about 70% in 2004 and even 92% in 2008. Domestic consumption began to increase from 2005 but investment did not grow significantly despite the rise in corporate sector profitability. Meanwhile, asset market bubbles swelled, as seen in the jump in the stock market index from 2005 to 2007 and the increase in land and apartment prices after 2002. Several measures for real estate market deregulation introduced after the crisis and the aggressive interest rate cuts after 2001 had created the bubbles.[16] Household credit rose again after 2005 and reached 67% of GDP in 2008. The bursting of the real estate market bubble, in particular apartment prices in Seoul, would end in another serious slump.

While growth and investment became stagnant, income distribution and poverty took a rapid turn for the worse as a result of serious recessions and structural changes such as labour market flexibilization that contributed to an increase in the number of irregular workers. The inequality in income distribution became marked after the crisis and has grown even more serious recently due in part to the recession, as can be seen in Figure 1. The poverty problem is even more severe. The poverty ratio almost tripled following the crisis; however, the social safety net is still not in place. This means that serious income inequality and poverty became a structural feature of the Korean economy even after the end of the crisis and the restructuring process, because of the neoliberal changes in the economic system. The growing income inequality and poverty resulted in depression of domestic demand and thereby hindered investment growth (Crotty and Lee, 2006). Considering that many studies report a negative relationship between serious income inequality and economic growth, the current Korean situation is quite worrisome. The vicious cycle of unequal income distribution, poverty, lower domestic demand and lower investment in the post-crisis period is the opposite of Korea's experience during the "miracle" period.

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[16] The Bank of Korea policy rate was continually reduced from 5% in early 2001 to 4% in September of 2001 and about 3% in late 2003. It was subsequently increased to 4% in early 2006 and 5% in mid-2007.

Investment Decline and Malfunctioning Financial System

One problem in the Korean economy after the crisis is the decline in investment. The total investment rate fell from 37% of GDP in the mid-1990s to some 30% after the crisis and did not recover even after 2002 when profitability recovered strongly. In Korea, investment had been higher than savings in the mid-1990s and this overinvestment was said to be a cause of the crisis.[17] However, the trend completely reversed following the crisis, with the gap between investment and savings around 2-4% of GDP from 1998 to 2005, though it narrowed thereafter.

Corporate investment collapsed in 1998, hit hard by the shock of the crisis and high interest rates, and fixed investment shrank by more than 20%. After a short recovery in 1999-2000, it stagnated again from 2001 even though profitability and corporate savings started to rise. Korean firms recorded the highest rate of ordinary profit in 2004 and yet they balked at increasing investment, opting instead to hold a large amount of cash after paying back their debts. The debt ratio of manufacturing companies in Korea became as low as only about 101% in 2005, almost four times less than the level before the crisis in 1997, and even lower than the corresponding figure of some 136% in both the US and Japan.[18] This depressed the growth of fixed assets. The investment decline is much more serious for small and medium companies that are financially constrained to a greater extent. It is reported that while investment growth for large *chaebol* companies recovered gradually from 2004, this never happened for small and medium companies.

The shock of the crisis and the subsequent changes in the economic system were certainly behind this fall in investment (Crotty and Lee, 2002).

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[17] But the empirical evidence to support the argument that overinvestment, spurred by crony capitalism, made the Korean economy so inefficient that it inevitably led to the crisis, is rather weak. The more important cause of the crisis was contingent inefficiency and, most of all, the bad financing structure of aggressive investment in the mid-1990s. See Crotty and Lee (2004).

[18] The share of cash in the total assets of Korean manufacturing firms also rose from 6.4% in 1997 to 10% in 2005. Taking only listed companies into account, the debt ratio was a mere 60% of the debt ratio of US or Japanese firms as of 2006.

Corporate restructuring forced big companies to lower the debt ratio substantially and to streamline their business structure. This made their management very conservative and hindered investment growth. Besides, measures to reform corporate governance and to promote the power of shareholders were introduced. It is argued that the increasing power of shareholders and foreign capital also checked corporate investment because Korean *chaebols* increased spending for dividends and share buybacks to avert interference in management.

The transformation of the financial system owing to neoliberal financial restructuring together with all-out financial opening was another crucial factor. The shutdown of many financial institutions in 1998 naturally resulted in a huge drop in external finance for investment. Moreover, the more market-oriented operation and the deterioration of the public role of banks after the financial restructuring weakened their role of supplying credit to the corporate sector. Instead, they started to make efforts to raise household loans, because these were a less risky and easier source of profits. This trend was reinforced by the escalating penetration of foreign capital into Korea's financial sector because foreign-controlled banks were much more reluctant to undertake corporate lending.

We can see serious credit crunches in 1998 and late 2000. The year 1998 was the worst in Korean economic history. Affected by the aftershock of the crisis and neoliberal financial restructuring, the economy suffered from a terrible credit crunch that depressed investment. Total funds made available to industrial firms fell from 118 trillion won in 1997 to a mere 28 trillion won in 1998, a major cause of the collapse of investment spending (Table 4). Financial institutions were forced to cut down lending in 1998 due to the combined effects of deep recession, bank closures and tighter prudential regulation. As a result, total indirect finance of the corporate sector was about negative 16 trillion won and total credit flows from the financial sector to the non-financial sector fell by about 109 trillion won from 1997 to 1998. Non-financial corporations had to turn to the capital market by issuing bonds but small and medium companies were excluded from this market. In early 1999, credit flows to the real sector began to increase but in July a bond market crisis erupted because of the third largest corporate group,

Table 4. External financing of the corporate sector after the crisis
(billion won)

	1997	1998	1999	2000	2001	
Indirect finance	43375	-15862	2198	11768	-313	
Borrowing from banks	15184	259	15525	23279	3196	
Borrowing from NBFIs	28191	-16550	-13267	-11551	-3690	
Direct finance	44087	49496	24792	17204	37735	
Commercial paper	4421	-11678	-16116	-4764	4399	
Corporate bonds	27460	45907	-2827	-2063	11444	
Stocks	8974	13515	41137	20751	16191	
Foreign borrowings	6563	-9809	12777	16820	633	
Others	23997	3839	13228	19967	12591	
Total	118022	27664	52995	65759	50645	
	2002	**2003**	**2004**	**2005**	**2006**	**2007**
Indirect finance	50102	34389	2944	23784	68055	102217
Borrowing from deposit banks	41137	41156	14929	20364	60412	92316
Other borrowing	8606	-6757	-11875	3420	7466	9731
Direct finance	20009	28887	29229	52912	79905	48139
Commercial paper	-3777	-2583	-1873	4125	14747	26496
Corporate bonds	-7857	-1063	1765	12539	25464	-8404
Stocks	28720	27536	22218	19207	28765	24785
Foreign borrowings	2446	4688	8695	5677	5903	5748
Others	10761	21199	26892	26689	36125	34320
Total	83318	89163	67760	109061	189987	190424

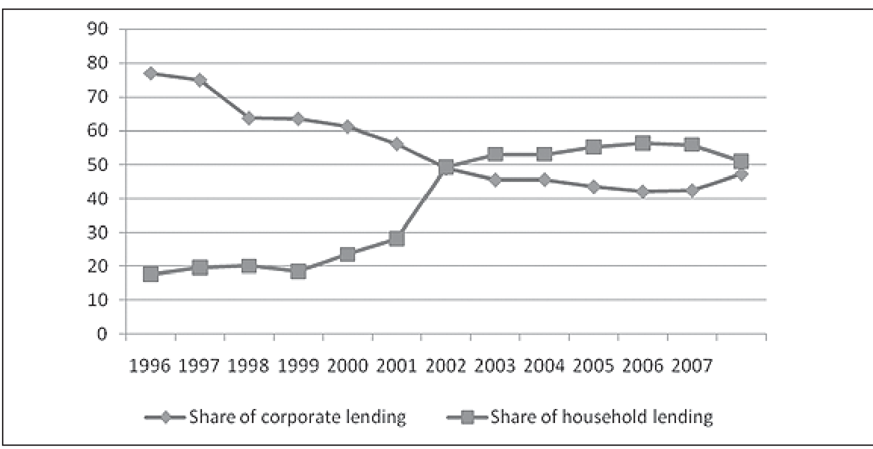
Source: Bank of Korea, Flow of Funds.
Note: "Others" include government loans and corporate credit.

Daewoo's bankruptcy decision. This paralyzed the CP and corporate bond markets. Things improved to some extent in early 2000 but again went bad from mid-2000 because of a liquidity crisis in Hyundai, the largest *chaebol*, which led to the government intervening in the capital market (Crotty and Lee, 2001). Even after the economic recovery in 2002, corporate access to external finance did not recover fully and the financial system did not become active in corporate lending. The amount of total external funds available to the corporate sector in 2005 was even less than that in 1997 due to a decline in indirect finance. Only after 2006 did the financial sector regain enthusiasm for making corporate loans, but this was mostly led by loans to the overheating construction industry such as real-estate-related project financing.

Thus, radical financial restructuring in Korea after the crisis resulted in a malfunction in financial intermediation. The share of corporate loans in all loans from the banking sector fell rapidly, while consumer loans shot up, as Figure 2 shows. Also, the share of external financing in equipment investment in the manufacturing sector fell from 68% before the crisis to about 22% in 2005 (BOK, 2006b). The risk-taking role of the financial sector that had backed up high investment in the past waned significantly under the market-oriented and liberalized financial system.

Several factors including a change in the industrial structure, lingering investment risk and competition from China were presented as causes of this investment decline in East Asian countries after the 1997 crisis (Kramer, 2006). In the Korean case, the negative effects of corporate and financial restructuring, especially of *chaebol* firms, are recognized by several empirical studies (BOK, 2006a; Hong et al., 2007). Other studies also point to several

Figure 2. The share of loans in Korean currency by commercial banks



Source: Financial Supervisory Service.

causes for the setback in investment associated with restructuring, including higher uncertainty and shrinking external financing (BOK, 2006b). The role of the growing foreign ownership is still controversial. Critics emphasize negative effects, arguing that the higher foreign ownership raised firms' cash holdings and decreased investment considerably (SERI, 2004; 2005; BOK, 2005b). However, others find no evidence to indicate a harmful influence exerted by foreign ownership on investment (Lee, 2005; Park and Lee, 2006).

The influence of exports and imports on investment should also be noted; growth and employment significantly dwindled after 2002 due to changes in the industrial structure and international trade. For most Korean IT firms, such as those producing cellular phones and semiconductors, their capital goods are largely imported, much more so than during the pre-crisis period (BOK, 2005a). Consequently, the recent increase in the share of the booming IT industry in the economy exerted a negative impact on investment. The share of imports in equipment investment rose from 30.2% in 1998 to 51.7% in 2005 because of the rapid growth of the IT industry (BOK, 2006b).[19]

In sum, neoliberal economic restructuring and opening enfeebled the dynamism of corporate investment. The post-crisis restructuring finally dismantled Korea's "high-debt model" and "high profit-investment nexus" in which high profits, high debts and high investment promoted a virtuous cycle.

Increase in Foreign Investment and Its Problems

Changes in Foreign Capital Flows and External Balances

One of the most prominent changes in the Korean economy after the 1997 crisis is that foreign capital inflows to Korea rose rapidly with the extensive financial opening. It is also certain that the deep depreciation of the Korean currency following the crisis strongly attracted foreign investors

[19] The dependence on imports in investment in the IT industry is much higher than in other industries. For example, import dependence in the semiconductor industry and wireless communications equipment industry is about 79% and 67% (BOK, 2006b).

seeking 'firesales'. Because it was only foreign capital that could afford to purchase the assets the *chaebols* were forced to sell, it comes as no surprise that the corporate restructuring-cum-financial opening promoted foreign capital inflows. Table 5 shows that foreign investment into Korea soared in the post-crisis period. FDI increased to $24.4 billion in 1998 and 1999 in total, almost the same as the total amount from 1962 to 1997. After slowing down in 2003 when the economy fell into recession and restructuring came to an end, it recovered quickly after 2004 and remained at more than $10 billion a year, about ten times the amount in the early 1990s.[20]

However, the benefits from FDI are still questionable. In theory, FDI is expected to bring more developed technology and management skills, and thereby encourage productivity and economic growth through spillover effects. However, it remains to be seen whether the benefits from FDI after the crisis in Korea are large enough. Some report its positive impacts on investment and employment (BOK, 2008c), while a study by World Bank economists finds scant evidence that FDI inflows contributed to the economic

Table 5. Foreign capital flows in Korea after the crisis

($ billion)

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
FDI inflows	3.2	6.9	8.8	15.5	15.2	11.3	9.1	6.5	12.8	11.5
Portfolio flows										
Inflows	12.6	13.2	16.5	41.7	60.1	43.9	65.4	81.6	116.0	148.1
Outflows	8.0	12.1	11.7	36.2	48.8	36.4	66.2	68.1	106.7	150.5
Net inflows	4.6	1.1	4.8	5.5	11.3	7.5	-0.8	13.5	9.3	-2.4
Total flows	20.6	25.3	28.2	77.9	108.9	80.3	131.6	149.7	222.7	298.6

Source: Bank of Korea and Ministry of Commerce, Industry and Energy.
Note:
1) FDI is report base, i.e., the amounts reported to the government.
2) Portfolio investment flows are calculated using the information from the foreigners' special account for portfolio investment.

[20] Of course, the effects of foreign capital inflows were offset by outward investment from Korea, which has been increasing with a recent rise in foreign direct investment to China.

recovery in East Asia after the crisis (Mody and Negishi, 2001). In fact, the share of productive greenfield investment in FDI is reported to have been small, while the lion's share was related to M&A and asset purchases.[21]

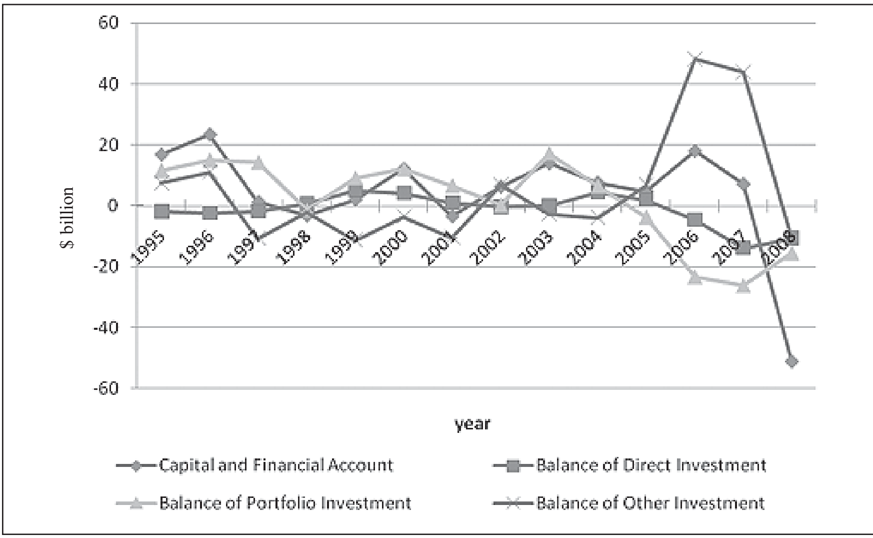
Portfolio capital inflows and total flows also rose rapidly. Net foreign portfolio investment inflows, after falling to $1.1 billion in 1997, recovered to $4.8 billion in 1998 and jumped to $11.3 billion in 2000. But portfolio flows have been largely unstable, aggravating economic volatility. They recorded negative values in 2002, and after a surge in 2003 and 2004, they turned negative again. Sharply rising foreign portfolio capital outflows, under the global financial unrest, have destabilized the Korean financial markets since late 2007. The daily volume of foreign exchange transactions continuously increased from $3.8 billion in 1998 to $8.4 billion in 2001, influenced by foreign portfolio investment, which has now become an important factor behind the volatility in the foreign exchange rate. Other capital inflows, including foreign borrowings of financial institutions and firms, did not recover as fast, and their balance was still negative in most years from 1998 till 2004.

But starting from 2006, the picture has been changing abruptly. First, the direct investment balance turned into a deficit of $4.5 billion in 2006 and $13.8 billion in 2007 because of a continuous increase in outward direct investment. Second, the balance of portfolio investment also turned negative in 2006 and 2007 due to a great increase in outward portfolio investment and a rise in net foreign portfolio outflows. As a result of foreigners' "sell Korea" strategy in order to reap financial gains from the Korean market, foreigners' investment in Korean stocks recorded negative flows of $13.2 billion in 2006 and $28.9 billion in 2007. This was offset by foreigners' investment in domestic bonds in 2007 but because of the continuing increase in Koreans' outward portfolio investment with a boom in foreign funds, the portfolio

[21] M&A-type FDI in the broad sense, including asset acquisitions, in 1998 was reported to be more than 50% of all FDI, and the share of greenfield investment was less than 10% in total FDI in early 2000 (*Hankook Kyoungje Shinmun*, April 12, 2000). According to a United Nations report, FDI related to M&A was around 80% after the crisis, and Mody and Negishi (2001) confirm this.

investment balance registered a large deficit in 2006 and 2007. Third, the balance of other investment recorded a huge surplus in 2006 and 2007 because of skyrocketing foreign borrowing, from $1.0 billion in 2005 to $44.2 billion in 2006 and $42.0 billion in 2007. Deposit money banks were at the centre of this by making short-term foreign borrowings to a great extent, in part related to transactions in derivatives markets and their aggressive domestic lending as well. This created a capital account surplus in spite of the outflows of portfolio and direct investment in 2006 and 2007 (Figure 3).

Figure 3. Changes in the capital and financial account balance



Source: Bank of Korea. The International Balance of Payments.

Concerns about Growing Foreign Control

The rising capital inflows after 1998 have strengthened foreign control of the Korean economy. In the process of economic restructuring and capital account opening, foreign ownership in the domestic capital market expanded substantially. Foreigners' share in the Korean stock market had risen from 14.6% in late 1997 to 21.9% in 1999, 36.6% in 2001 and some 43% in early 2004, after which it fell to less than 30% in 2008. Foreigners have gained

Table 6. Change of foreign ownership in major companies (%)

	Nov. 1997	Dec. 2000	Mar. 2004
Samsung Electronics (1)	24.2	54.2	59.4
SK Telecom (2)	26.0	53.2	48.9
Korea Telecom (3)	—	19.4	49.0
Korea Electric Power Corporation (4)	10.6	26.1	29.0
POSCO (5)	20.8	49.0	66.8
Kookmin Bank (6)	25.8	58.2	75.3
Housing Bank (7)	37.0	65.4	*
Korea Exchange Bank preferred stock (9)	—	100	**
Hyundai Auto (12)	23.6	41.0	52.1
Shinhan Bank (13)	21.9	48.9	64.3
Samsung Electronic Machinery (15)	5.1	30.0	28.1
Hyundai Electronics (17)	7.2	35.5	5.1***
SK (20)	13.7	25.3	56.2
Samsung Electronics preferred stock (21)	26.0	33.8	17.0
LG Chemical (27)	17.4	28.0	34.1
Kor-Am Bank (30)	31.3	61.5	91.2
Shinsegye (39)	10.7	39.3	49.8
Korea Exchange Bank (42)	3.6	26.4	70.1

Source: Financial Supervisory Service. Unpublished data.
Note: Number in parenthesis refers to ranking in the stock market.
* Merged with Kookmin Bank.
** Preferred stock disappeared.
*** Changed into Hynix.

strong influence over important industries such as semiconductors, automobiles, petrochemicals and finance, as seen in Table 6. Dividend payments to foreigners rose sharply, and its share in GDP jumped from 0.15% in 1998 to 0.55% in 2003.

It is reported that foreign penetration has assumed substantial proportions in the paper-making, seedling and pharmaceutical industries, where foreigners control more than 60% of the whole market. The recent price increase in the pharmaceutical and cement industries was reportedly the result of collusion among foreigners (Ohmynews, June 3, 2003). Foreigners appear to have been interested in reaping profits in the short run, and this may be harmful to consumer welfare and domestic industrial development.[22]

For now, the *chaebols*' ownership structure remains intact since insiders' control based on interlocking ownership is strong. However, the growing power of foreigners was felt by the *chaebols* as they raised their voice on investment decisions and corporate governance. There was even an attempt by a foreign fund, Sovereign Capital, to take control of the SK group, the third largest *chaebol* (*Financial Times*, April 14, 2003). Since the *chaebol* owners' share is small, they became concerned and tend to hold more cash to protect management rights rather than increase investment for long-term growth.

Foreign control is the most salient in the financial sector. As a result of financial opening and restructuring, foreign capital invested directly in the Korean banking industry, via acquisition or equity participation. In consequence, foreign ownership in the financial sector has risen rapidly. Now foreigners are major shareholders of most of the nationwide commercial banks and many important NBFIs. The foreigners' share in the banking industry rose from 16.4% in 1997 to 50.2% in 2003 and 57.8% in September 2007.[23] This is much higher than the corresponding share in other Asian countries and similar to the situation in Latin America. Up to 38% of all financial institutions had more than 50% foreign shareholding as at the end of 2007.

Though many welcomed this change, foreign control of the financial system could be detrimental to the economy. In fact, it is related to a sharp fall in corporate lending as foreign-controlled banks aggressively increased

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22 For example, the foreign IT companies repatriated 98% of profits with almost no domestic investment and R&D in 2002 (*Seoul Kyoungje Shinmun*, November 23, 2003).

23 Foreign capital inflows through financial restructuring led to surprising control of banks by foreigners. At end-2008, the share of foreign ownership was higher than 50% in six out of seven nationwide commercial banks, with Woori Bank, which was owned by the Korean government, being the sole exception. Foreigners are also controlling shareholders in most securities companies.

household loans (Table 7). From 1998 to mid-2003, corporate lending by foreign-controlled banks dropped by 33%, while household lending increased by 35%, almost two times higher than domestic banks. The banks controlled by foreign capital also cut down on loans to small and medium companies much more than others. This aggravated the household debt problem and the constraints on investment by small and medium companies (BOK, 2003). The foreign-controlled banks were also more conservative in that they increased holdings of safe assets including government bonds and reduced holdings of risky securities such as corporate bonds in comparison with other banks. However, there are no meaningful differences in asset growth, profitability and the BIS ratio between foreign-controlled and other banks.

Control of the Korean economy by foreign capital and the speculative activities of foreign private equity funds were the subject of public concern and heated debate. Critics argued that foreign equity funds were not qualified

Table 7. Changes in corporate lending by Korean banks

(%, percentage points)

		1998 (A)	**1999**	**2000**	**2001**	**2002**	**Sep. 2003 (B)**	**B - A**
Corporate lending	Foreign	82.9	73.4	63.5	54.8	50.1	49.6	-33.3
	Mixed	47.6	47.0	42.8	38.1	37.4	37.2	-10.4
	Domestic	80.6	75.0	69.9	58.2	54.2	55.8	-24.8
Household lending	Foreign	10.4	17.9	26.1	38.6	44.0	45.6	35.2
	Mixed	48.8	46.2	48.1	56.2	59.9	59.4	10.6
	Domestic	14.3	19.3	23.6	35.7	42.1	40.7	26.4

Source: BOK (2003).

Note:

1) Foreign-controlled banks are Korea First Bank, Korea Exchange Bank and Kor-Am Bank. These are banks whose controlling shareholders are foreigners and they participated in the management.

2) “Mixed” banks are Kookmin Bank and Hana Bank. These are banks of which more than 5% of shares are owned by foreigners and more than one foreigner is included in the board of directors.

3) Domestic banks are other banks including Woori Bank, Choheung Bank and other local banks.

to take over financial institutions and that the government gave them overly generous incentives without taxing them in spite of their huge windfall profits. In December 1999, the US-based private equity fund Newbridge purchased Korea First Bank for only 0.5 trillion won with a put-back option that the government would buy back all assets that turned non-performing in three years, after the government had already spent 8.5 trillion won for its bailout.[24] Newbridge eventually sold Korea First to Standard Chartered Bank for as much as 1.65 trillion won, while the government spent 17.7 trillion won for the bank in total. The same thing happened when the Korean government sold Korea Exchange Bank to another US private equity fund, Lone Star, in 2003. This sale led to a number of lawsuits, and the Board of Audit and Inspection later determined that it was problematic.

After the preferential sales, foreign-controlled banks did not follow the government guidance in the financial market. When the government announced its plan to rescue the faltering bond market in late 2000, Korea First and Kor-Am banks, owned by foreign private equity funds, refused to cooperate with the government. Besides, Korea First led all banks in increasing household loans. This suggests that foreign financial control impedes adequate financing for economic development and may obstruct the government's economic management.

The Korean public called for taxing foreign capital and regulating illegal activities. The Bank of Korea, the country's central bank, also published a report about speculative foreign capital and its problems (BOK, 2005b). The deterioration of the management stability of *chaebol* firms is one of the adverse effects that made Korean *chaebols* increase dividend payments and share buybacks, thereby reducing investment. Secondly, foreign control checked firms' growth and resulted in an outflow of national wealth because foreigners attempted to withdraw their money as soon as possible. Finally, it weakened the public nature of the financial system and repressed financial

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24 Many argue that the government did not need to sell Korea First to Newbridge because the bank had already been stabilized. Thus, they charge that the sale of Korea First was a special favour for Newbridge. The government later partly admitted to problems with the sale of Korea First (*Hankyore Shinmun*, September 3, 2004).

intermediation. The Roh government reportedly considered a tax investigation and regulatory measures in relation to private equity funds in 2005.[25] However, the government continued to take a foreign-capital-friendly stance, and under the more conservative Lee government which took office in 2008, these arguments lost steam.

Financial Opening and Difficulties in Macroeconomic Policy Management

Twin Surpluses and Macroeconomic Management

The changes in external balances after the crisis could be summarized as twin surpluses in both the current and capital accounts (Figure 4). The Korean economy had run a large current account surplus after 1998 and the surplus with the US and China grew significantly. Not only the current account but also the capital account was in surplus after 1998, as we examined in the above section. Hence, twin surpluses have emerged in Korea, different from the pre-crisis period that saw a current account deficit and capital account surplus. This gave rise to a rapid increase in foreign reserves, which soared from only $20.4 billion in December 1997 to $96.2 billion in December 2000, $155.4 billion in December 2003 and peaked at $261.2 billion as of end-2007. This change is associated with the structural changes after the 1997 crisis that led to a substantial investment drought in Korea (Eichengreen, 2006).[26]

The Korean government has faced difficulty in macroeconomic management using monetary policy due to the rising external surpluses,

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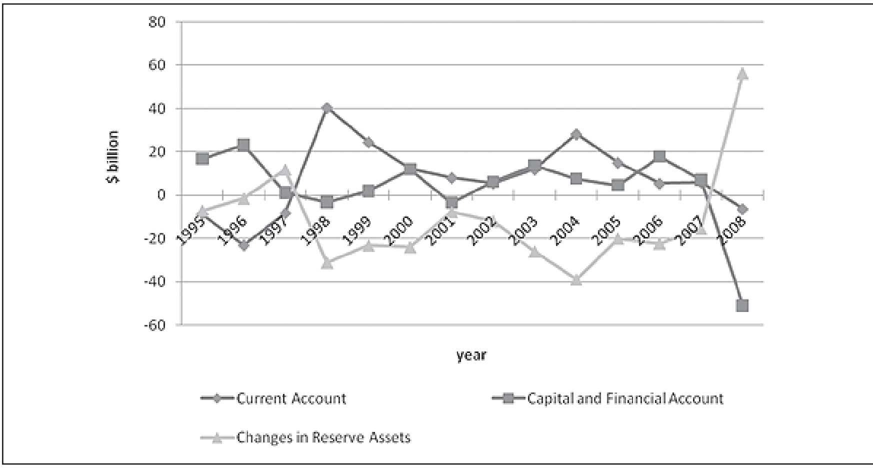
25 Some politicians attempted to introduce an act to limit foreign investment in strategic industries for national security, similar to the "Exon-Florio" act in the US, in late 2006 but it failed to materialize.

26 The large external surplus of the Korean economy reflects a change typical among East Asian emerging economies that has been another pillar of the so-called global imbalances. After 1998 Malaysia, Thailand and Indonesia recorded current account surpluses and drops in investment to an even larger degree than in Korea. See Lee and McKibbin (2006).

Figure 4. External balances of Korea after the crisis



Source: Bank of Korea. The International Balance of Payments.
Note:
1) There are differences in data on foreign investment in external balances and other sources.
2) Negative values of changes in foreign reserves mean their increase.

similar to other emerging markets (Mohanty and Turner, 2006). While foreign exchange reserves provide a useful cushion against external shocks, they also create problems of their own.

First of all, holding a huge amount of foreign reserves incurs a direct cost in reality. Many already contend that the level of foreign reserves in East Asia is too high in comparison with the normal level. While this reserve accumulation is not totally irrational and is mainly because of precautionary purposes, the annual return on foreign reserves is much lower than that on foreign investment in Korea and on bonds the Korean government issues for foreign exchange market intervention. Thus, the Korean government literally helps the US with financing the latter's current account deficit very cheaply, which may incur on Korea's part an estimated cost of more than 1% of GDP (Rodrik, 2006). According to Akyüz' method, the borrowed reserves from 1998 to 2002 were $85.1 billion out of the increase of $242.1 billion in reserves, after excluding the cumulative current account surplus (Akyüz, 2008). If we apply a moderate 500-basis-point margin between the return on foreign investment into Korea and that on foreign reserve holdings, the cost of holding this much reserves in Korea is about 0.44% of GDP as of 2007. Besides, the looming possibility of a depreciation of the dollar is another source of potential cost of holding a large amount of foreign reserves in dollars. It is reported that more than 60% of all foreign reserves are known to be dollar-denominated assets.[27]

Second, the external surpluses and rising capital inflows generate pressure on the currency to appreciate and on the monetary stock to increase, which, if it's hard to soak up, could encourage bubbles and inflation. Furthermore, the sterilization of foreign currency liquidity can result in additional capital inflows via an increase in domestic interest rates (Ocampo et al., 2007). The Korean government has struggled to sweep up foreign currency by issuing and selling Monetary Stabilization Bonds (MSB) with higher returns than that on dollars in the open market. The amount of MSB rose sharply from 23.4 trillion won in 1997 to 79.1 trillion won in 2001 and over 155 trillion won in 2005, and accordingly the interest payment also grew from less than 3 trillion won before the crisis to 6.1 trillion won in 2005. Thus, the increase in outstanding amounts of MSB brought a burden to the Bank of Korea's balance sheet.[28]

More importantly, drastic financial opening may exacerbate economic instability and aggravate difficulties in macroeconomic management. The volatility of the Korean stock market rose dramatically with a serious correlation with the US stock market during and after the crisis, and the turnover ratio is already the world's highest.[29] The government has been in a weaker position to manage the national economy under the development of

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27 US Treasury bonds account for about 40% of all foreign bonds, which in turn make up more than 80% of all foreign reserves. According to the US Treasury, Korea's holding of US Treasury bonds continuously rose from $29.6 billion in December 2000 to $63.1 billion in December 2003 and up to $72.8 billion in February 2006 at its peak (Lee, 2007).

28 During 2004-2007, when the won/dollar exchange rate was in a state of constant decline, the accounts of the Bank of Korea went into deficit. This deficit increased in 2005 and 2006, when the domestic and foreign interest rate differential reversed.

29 Foreign investors tended to engage in more positive feedback trading during and after the crisis, only to cause more volatility. According to Standard and Poor's, South Korea was the emerging market with the highest turnover in 1999, at 347% of market capitalization (*The Economist*, June 24, 2000).

financial globalization and potential currency attacks by hedge funds. Indeed, the Korean government has had a hard time in protecting the exchange rate against the speculation of foreign funds. The amount of the Foreign Exchange Equalization Fund, created for the purpose of stabilizing the exchange rate, rapidly rose from $10.3 billion in 2001 to $25.5 billion in 2003 and $46.3 billion in 2005. The government suffered a large loss of more than 10 trillion won in operating it.[30]

External Debt and Derivatives Markets

Korea's external debt began to increase rapidly again from 2006, led primarily by the rise in banks' foreign borrowing. The amount of external debt in 2008 was more than twice the figure in 2005, as shown in Table 8. Similar to the period before the 1997 crisis, short-term external debt soared in 2006 and 2007, and the ratio of floating external debt to foreign reserves rose significantly. The share of short-term debt in total external debt jumped from 35% in 2005 to about 44% in 2006 and 42% in 2007, and the share of short-term debt of banks in total external debt also rose from 27% in 2005 to about 37% in 2006 and 35% in 2007.

However, the recent increase in external debt is fairly different from that during the period before the 1997 crisis; a large part of it is attributable to loans related to trading in derivatives markets, which can be repayed by future foreign exchange revenue as Table 9 shows. Exporters, mainly shipbuilders, with scheduled foreign currency export revenue inflows, tended to hedge the related exchange rate risk by selling forward exchange contracts to banks. Asset management companies involved in overseas securities investment did the same thing, in preparation for sudden withdrawals by domestic investors. In response to the increased selling of forward exchange contracts, domestic banks, as the forward exchange contract purchasers,

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30 According to a hearing in the Korean legislative assembly, the loss from the Foreign Exchange Equalization Fund increased from 0.5 trillion won in 2003 to 10.2 trillion won in 2004 and 4.6 trillion won in 2005. It was mainly because of a sharp dollar depreciation and mistakes made in the government's transactions in the NDF derivatives market in 2004 (*Kyunghyang Shinmun*, September 15, 2006).

Table 8. External debt of Korea
($ million)

	2002	2003	2004	2005	2006	2007	2008
Total	141,471	157,394	172,259	187,882	260,061	383,152	380,495
Short-term	48,179	50,805	56,348	65,911	113,748	160,249	151,056
Long-term	93,291	106,589	115,912	121,971	146,312	222,903	229,439
Floating ratio	--	--	38.6	41.1	56.1	77.8	96.4
Government	17,587	11,573	10,389	8,465	10,279	31,749	21,128
Monetary authority	4,902	5,299	5,983	7,068	9,609	21,869	30,046
Banks	58,471	67,728	74,491	83,429	136,536	192,880	171,720
Short-term	38,154	40,775	44,450	51,276	96,094	133,987	112,978
Long-term	20,317	26,953	30,041	32,153	40,442	58,893	58,741
Domestic	39,244	45,339	50,574	58,388	82,113	108,959	99,394
Foreign	19,227	22,389	23,918	25,041	54,422	83,921	72,325
Others	60,510	72,794	81,395	88,920	103,637	136,654	157,601

Source: Bank of Korea.
Note: The floating ratio is the ratio (%) of floating debt to foreign reserves.

needed to adjust their foreign currency positions by selling foreign currency in the spot market. They should procure foreign currency for this by borrowing it short-term.

Besides, Korean domestic banks and Korean branches of foreign banks became very eager to make foreign short-term borrowings after 2006. This was because forward exchange rates were much lower than spot rates in comparison with the gap between domestic and international interest rates, which created an incentive for arbitrage trade called “dollar carry trading”.[31]

[31] The interest rate in Korea was lower than that in the US but forward rates were much lower than spot rates, reflecting the expectation of appreciation from early 2006. Thus, the swap rate was lower than the domestic/international interest rate spread, and financial institutions could have a risk-free chance to make profits by undertaking arbitrage trade to borrow dollars and buy forward exchange. Domestic branches of foreign banks, in particular, were devoted to running this business and contributed substantially to the increase in external debt (*Edaily*, May 29, 2006).

Table 9. Forward exchange sales and foreigners' bond investment
($ billion)

	2005	2006	2007 1st	2007 2nd	2008 1st
Selling of forward exchange contracts	71.7	99.7	53.5	72.5	92.8
Shipbuilding companies	22.3	43.1	24.4	37.8	40.3
Domestic investors	1.5	13.1	10.2	16.9	3.7
Foreigners' net bond investment	0.2	1.3	4.0	32.6	15.7

Source: BOK (2008d).

Starting from late 2007 when the US interest rate became lower than that in Korea, the arbitrage incentive widened further. This brought about a surge in foreigners' domestic bond investment, another factor behind the increase in external debt. This suggests that the progress of financial globalization and deregulation has become an important cause of cross-border capital flows and the increase in external debt.

Responding to the increase in the volume and volatility of international capital flows, the Korean government used various policy tools, such as sterilization and promotion of capital outflows. However, some of these policies were not successful (Kim et al., 2009). In particular, the effectiveness of monetary policy was constrained by arbitrage transactions in 2007. As a result of the expansion of arbitrage opportunities, foreign investors had drastically increased their net purchase of Korean bonds since mid-2007. This drove up demand for bonds and put downward pressure on long-term interest rates in financial markets. The Bank of Korea raised its policy rates several times, responding to the increase in liquidity, but market rates did not go up to the same extent owing to this. Branches of foreign banks were engaged in this arbitrage transaction via currency swaps, funded by overseas borrowing. Against the backdrop of financial opening and globalization, the transmission channel of monetary policy, that is, from the raising of interest rates by the central bank to a slowdown in liquidity growth, is not operating at full capacity because of foreigners' arbitrage transactions.

The Korean government also took measures to encourage capital outflows and discourage capital inflows, in order to ease pressures in the foreign exchange market. To promote capital outflows, the government revised the “Foreign Transaction Regulations” several times in 2006 and 2007. The revision included relaxation of restrictions on overseas real estate investment, encouragement of fund-type overseas portfolio investment, and deregulation to boost corporate expansions overseas. Accordingly, residents’ investment in overseas real estate rose rapidly from a mere $22 million in 2005 to $1.3 billion in 2006 and $2.7 billion in 2007. Overseas equity investment also increased substantially, from $11 billion in 2005 to $24 billion in 2006, and then to some $50 billion in 2007.

However, due to the international integration of financial markets and the development of financial derivatives markets, some government measures have resulted in unexpected outcomes opposite to the policy intent. Although capital outflows via overseas equity investment increased as a result of government measures, investors sold forward exchange on a large scale at the same time in an attempt to hedge against exchange rate risk from 2006. This led to a considerable increase in overseas foreign currency borrowing by banks, contrary to the original purpose. Selling of forward exchange associated with overseas equity investment skyrocketed from $1.5 billion to $27.7 billion from 2005 to 2007, causing external borrowing of banks to rise accordingly (BOK, 2008d). Thus, the effectiveness of the government policy effort to manage capital flows has weakened substantially recently because of investors’ arbitrage activity in the open and globalized financial market.

Chapter 5

RECENT FINANCIAL INSTABILITY IN THE GLOBAL FINANCIAL CRISIS

The Recent Global Financial Crisis and the Korean Economy

IN mid-2007, a financial crisis broke out in the US caused by problems with subprime mortgage loans and complex financial derivatives such as collateralized debt obligations (CDOs). Their growth in recent times had been excessive. In addition, a bubble had formed in the real estate market encouraged by expansive monetary policy and recent financial deregulation measures. The bursting of the bubble brought about an increase in defaults on the subprime mortgage loans, which eventually hit many financial institutions such as investment banks hard (Crotty, 2008). Because the amount of CDOs and credit default swaps (CDSs) produced by the shadow banking system through structured finance was huge, some estimate the total loss of the US financial institutions from the current financial turmoil to be around \$3-5 trillion. Recently, an IMF report estimated that the loss due to this financial crisis in all advanced countries would be as large as \$4.1 trillion, including a loss of \$2.7 trillion in the US alone (IMF, 2009a). The IMF also envisages gloomy growth prospects for the global economy in 2009 because of the aftershock of the crisis: -2.8% in the US, -4.2% in the euro area, -6.2% in Japan, -5.6% in the newly industrialized Asian economies, and -1.3% in the global economy (IMF, 2009b, p. 10). Achieving economic recovery will not be easy and will take a long time despite the collaborative efforts of many developed countries to boost the economy. The IMF's 2010 growth estimate for the world economy is 1.9%, much lower than the 5.2% growth attained in 2007.

After its genesis in the US, the crisis quickly spread to the other parts of the global economy. Europe incurred substantial financial losses from the crisis and emerging market countries became extremely vulnerable because of the financial turmoil on a global scale. East Asian countries including Korea were also adversely affected because they relied heavily on the US as an outlet for their exports. Though China appears to have weathered the storm better than other countries, Japan's economy is reported to have sustained severe damage and its growth rate in the 4th quarter of 2008 was -4.5%. The IMF predicts that world trade volume will shrink by 11% and imports of advanced economies will decrease by 12.1% in 2009. A decline in international trade of this extent will be greatly detrimental to the East Asian economies.

The global financial crisis was associated not only with the domestic problems of the US economy but also with so-called global imbalances. The imbalances at the global level became serious from the early 2000s along with the rising current account deficit in the US and the increase in the surplus in emerging Asia and the oil exporters (Eichengreen, 2006). Many indicate that this was on account of too much consumption, which exceeded earnings, in the US economy, in both the private and public sectors. Surplus countries including China recycled the dollars back to the US to finance its deficit. Foreign capital inflows to the US contributed to the excessively high debt level and overconsumption of Americans and inflated the real estate market bubble. Of course, all this was hardly sustainable and it appears to have come to an end with the current crisis.

Korea also played a partial role in the worsening global imbalances as its economic growth was highly dependent on current account surpluses with the US. Many argue that the investment drought – relatively less domestic investment than saving – in East Asia was another main cause of the global imbalances (Lee and McKibbin, 2006). The current account surpluses of Korea with the US amounted to more than $71 billion in the period from 1998 to 2007. This was closely associated with the neoliberal economic and financial restructuring and opening in Korea because they made domestic investment systemically lower than domestic saving. After the 1997 crisis, Korea had adopted a growth strategy that relied on foreign markets and foreign capital along with this structural change. As a result, the ratio of exports and imports to GDP was about 92.3% in 2008, having constantly risen from less than 55% before the crisis. But this foreign-dependent growth strategy is vulnerable to external shocks and the current global financial crisis appears to have once again engulfed Korea in economic turmoil.

There are several channels through which the global financial crisis affects the Korean economy, similar to other emerging market countries (IMF, 2009b). First of all, the serious recession in the global economy will decrease Korean exports and aggravate economic downturn in Korea. As highlighted in Table 10, the Korean economy started to shrink rapidly from late 2008, affected by the global crisis. Korea's growth rate in the 4th quarter of 2008 compared with the previous quarter was actually the worst in the OECD, plummeting to -5.4%, due to overly high external dependence and financial fragility. The global recession, especially in the US, is expected to hurt the export-dependent Korean economy badly in 2009. From the last quarter of 2008, the growth rate of exports was lower than -10% for two consecutive

Table 10. Economic growth in Korea after 2006

	2007	**2008**	**2008**				**2009**
		annual	**I**	**II**	**III**	**IV**	**I**
GDP growth	5.1	2.2	5.5	4.3	3.1	-3.4	-4.3
Consumption growth	5.1	1.6	3.9	2.6	2.0	-1.9	-2
Private	5.1	0.9	4.0	2.3	1.4	-3.7	-4.4
Fixed investment growth	4.2	-1.7	-0.5	0.6	1.8	-7.3	-7.5
Equipment	9.3	-2.0	1.5	1.1	4.3	-14.0	-22.1
Export growth	12.6	5.7	11.0	10.9	8.5	-11.6	-10.5

Source: Bank of Korea, National Accounts.
Note:
1) Calculated as the change from the same period in the previous year.
2) Calculated based on new 2005 real prices, thus a little different from the old series before 2006.

quarters. Private consumption will also be more depressed with the economic recession, given the serious condition of income inequality and poverty. The Bank of Korea's estimate of the 2009 growth rate of the Korean economy was -2.4% in April 2009, much lower than the estimate of 2% in December 2008.

The second channel through which the global crisis was transmitted to Korea was on the financial front. Financial instability became very serious in Korea against the backdrop of the crisis as foreign investors' withdrawal of their investment from Korea was accelerated. Net equity investment of foreigners had already turned negative in 2006 owing to their realizing profits after huge inflows before then. The amount of portfolio investment outflows became enormous in 2007, affected by the global financial instability.[32] Besides, foreigners have caused turmoil in the banking sector by stopping the rollover of short-term lending and by not making any fresh loans to Korea. The Korean banking sector had grown vulnerable to external shocks since the banks had expanded loans by too much and borrowed heavily in short-term foreign funds after 2006. Once rapid outflows of foreign capital occur, it may wreak havoc on the whole financial sector. In Korea this resulted in recent financial turbulence, which we will examine in the next section.

Looming Financial Turmoil in Korea

As we have seen, the Korean financial sector did not function well in terms of financing corporate investment for a while after the 1997 crisis, even as Korean banks actively increased lending for the real estate sector and credit cards. More recently, the Korean banking sector adopted an aggressive approach in raising loans under intense competition in search of profits and scale economies. There were booms in housing loans with low interest rates from 2004 and in lending for project financing in the construction industry. Bank lending for small and medium companies also began to rise

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[32] Accordingly, the foreign share in the Korean stock market, which surpassed 40% in late 2004, fell to 27.4% in late 2008.

from 2006. The banks did this in spite of the relative deficiency of deposits by issuing and selling bonds to the financial market.[33] As a result, the ratio of loans to deposits of Korean banks increased from 78.4% in late 2001 to

Table 11. The risk of emerging market countries

Country	Current account as % of GDP*	Short-term debt as % of reserves*	Banks' loan/ deposit ratio	Overall risk ranking+
South Africa	-10.4	81	1.09	17
Hungary	-4.3	79	1.30	16
Poland	-8.0	38	1.03	14=
South Korea	1.3	102	1.30	14=
Mexico	-2.5	39	0.93	12=
Pakistan	-7.8	27	0.99	12=
Brazil	-1.5	22	1.36	10=
Turkey	-2.3	70	0.83	10=
Russia	1.5	28	1.51	9
Argentina	0.2	63	0.74	8
Venezuela	0.8	58	0.75	7
Indonesia	1.2	88	0.62	6
Thailand	0.3	17	0.88	5
India	-2.4	9	0.74	4
Taiwan	7.9	26	0.87	3
Malaysia	11.3	15	0.72	2
China	5.2	7	0.68	1

Sources: HSBC; Economist Intelligence Unit   * 2009 forecast   + Higher score implies higher risk

Source: Domino Theory. *The Economist*, February 26, 2009.

33 The amount of bonds issued by banks for financing purposes increased from about 20 trillion won in 2005 to 64 trillion won in 2006 and 100 trillion won in 2007.

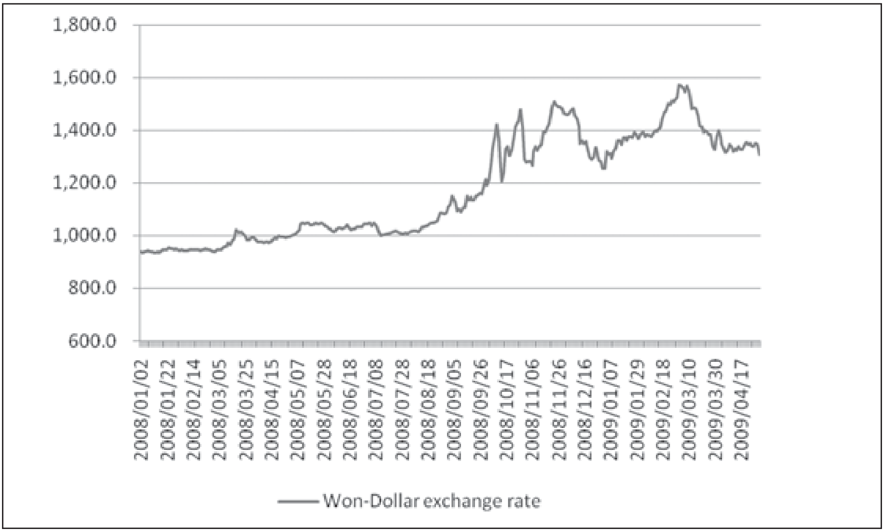
135.8% in late 2008. We also saw that more recently Korean banks zealously made foreign short-term borrowings, buying forward exchange sold by export companies and taking the opportunity of arbitrage trade to increase domestic lending. Though Korea held a large amount of foreign reserves – more than $200 billion in early 2009 – these changes made the Korean economy vulnerable in the global crisis. *The Economist* reports that the risk of a currency crisis in Korea is one of the highest among emerging economies (Table 11). According to the journal, Korea is riskier than Mexico, Pakistan and Russia in terms of several measures of economic vulnerability, including the floating external debt ratio and the ratio of bank loans to deposits (*The Economist*, February 26, 2009).[34]

The weakness of the Korean economy was apparent in the recent fluctuations in the exchange rate (Figure 5). The won-dollar exchange rate rose from about 1,000 won per dollar in mid-2008 to higher than 1,500 won in late 2008. The Korean currency experienced a great loss in value in late October and November 2008 when the global financial crisis intensified and the problems of the Korean financial sector began to surface. The Korean government responded by entering into currency swap agreements with the US, Japan and China, and the exchange rate quickly fell. But the Korean currency depreciated again from late February 2009 due to persistent concerns about the Korean economy, partly influenced by the crisis in Eastern European countries.[35] The won-dollar exchange rate jumped to 1,567.7 won on March

[34] *The Economist* uses the floating debt as the measure for short-term debt. Floating debt refers to debt with a maturity of less than one year as of the current period. It includes short-term external debt and longer-term debt of which the expiration date is within one year. The Korean government refutes this *Economist* article by arguing that most emerging market countries, unlike Korea, report just short-term debt as floating debt, and that the amount of Korea's debt is actually inflated because it includes foreign short-term borrowing related to trading in the derivatives market.

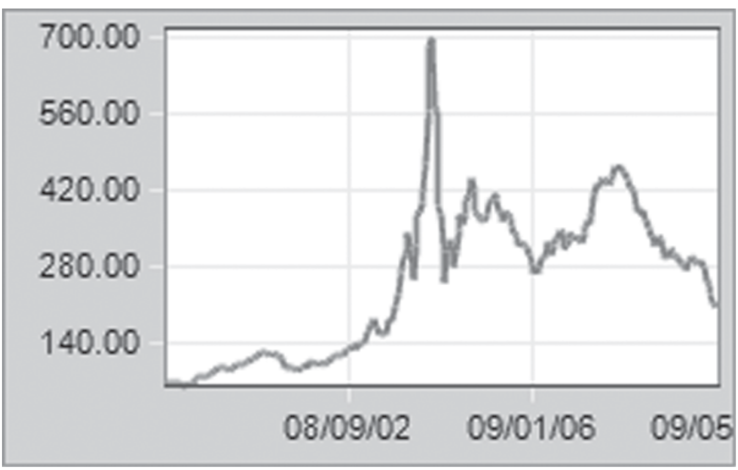
[35] In particular, the fact that the expiration dates of most foreign short-term borrowing by Korean banks were in February and March 2009 caused jitters in the financial market (*Hankyore 21*, March 13, 2009). Investors were concerned that Japanese banks would withdraw their lending to Korea in March because the end of the financial year in Japan is the end of March. They called it the possibility of a "March crisis". A "September crisis" had occurred in September 2008 when a large amount of foreign bonds expired then.

Figure 5. Won-dollar exchange rate



Source*:* Bank of Korea.

Figure 6. CDS premium of Korean government bonds for 5-year maturity



Source*:* Korea Center of International Finance.
Note: 1-year period (2008.5.7-2009.5.7).

9, 2009, the highest since the 1997 financial crisis. On top of depreciation, the CDS premium of the Korean government bonds, a measure of the economy's default risk, rose rapidly when the global financial crisis was at its peak (Figure 6). It was lower than 100 basis points in early 2008 but soared after September of that year up to the record high level of 700 on October 29. It rose again in mid-March 2009 but dropped significantly after that along with a fall in the exchange rate and stabilization of the financial market.

The severe depreciation of the currency was primarily because of the mismatch between dollar demand and supply. Korean banks held large short-term external debts, some of which were associated with the purchase of forward exchange after 2006. They needed dollars to pay back these debts urgently due to foreign institutions' withdrawal of investment from Korea but they were not able to procure them amid the global financial crisis.[36] Continuing outflows of foreign portfolio investment after 2007 worsened the situation further. With the deepening of the unrest in global financial markets, foreign capital outflows rose in the process of financial institutions' deleveraging and withdrawal of global investment. In 2008, foreign capital fled Korea in a big way. The foreign short-term borrowing of Korean banks recorded a negative $22 billion, driven by the repayment after October of as much as $46.3 billion, a turnaround from about positive $77 billion in total in the previous two years. Also, the net inflow of foreign investment in Korean stocks amounted to negative $41 billion in 2008. These led to sharp falls in the value of the won and stock prices.

The Government Response and Future Prospects

It is argued that the failure of government policy in exchange rate management was partially responsible for the current turmoil. The new Lee

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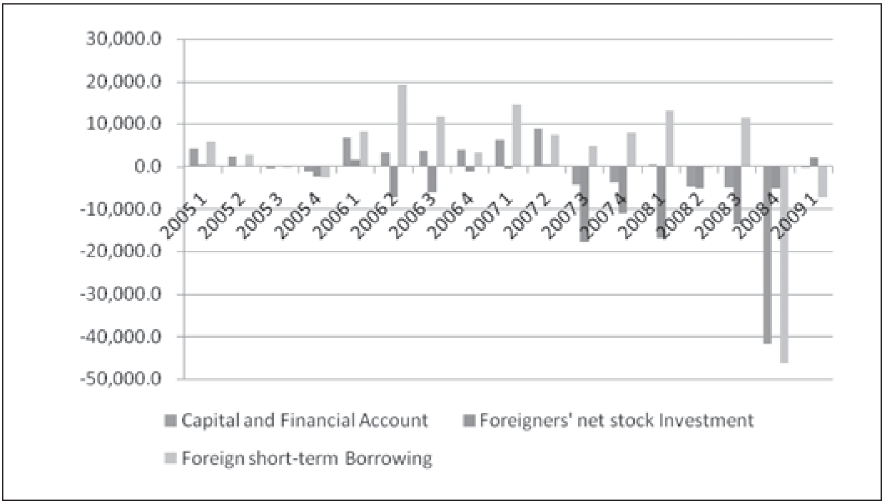
[36] According to the international balances table, the amount of repayment of external debts by Korean banks due to withdrawal of lending by foreign financial institutions was $20.4 billion in October, $10.2 billion in November, $14.3 billion in December of 2008, and $7.5 billion in January of 2009.

Figure 7. Changes in capital account balances and movement of foreign capital ($ million)



Source: Bank of Korea.

government originally introduced a high exchange rate policy in early 2008 because it expected depreciation to spur Korean exports. But its effects on exports were not certain, while import prices rose rapidly. Concerned about inflation, the government suddenly changed its position by making efforts to stop depreciation since mid-2008. This reversal supported foreign capital outflow from the stock market and the government just wasted foreign reserves in protecting the exchange rate.[37] This confusion made the Korean currency more unstable and vulnerable to attack by foreign speculators such as hedge funds. But the most important and fundamental cause of the current financial instability certainly lay in the excessive financial opening and deregulation introduced after the 1997 crisis. They gave total freedom to

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37 The government attempt gave foreigners a good opportunity to withdraw their investment from Korea and the outflow of foreign capital intensified currency depreciation, contrary to the government intent. The Korean government struggled to stop currency depreciation again in the middle of the global financial crisis after October but to no avail.

foreign capital to move across borders, and also encouraged Korean financial institutions to once again become over-dependent on foreign short-term borrowing. The need for effective financial regulation and capital controls on volatile short-term foreign capital was a crucial lesson of the 1997 financial crisis that the Korean government never learnt.

Of course, it is true that the current situation is very different from the situation prior to the 1997 crisis (Kim et al., 2009; *Chosun Ilbo*, March 14, 2009). First of all, with regard to the external debt, the risk of maturity mismatches between foreign currency assets and liabilities is not so large. The bulk of short-term external debt has been incurred by Korean branches of foreign banks and this cannot really be regarded as real external debt.[38] The Korean government also reports that if we consider the real capacity to repay external debt, taking into account the amount of about $50 billion as of mid-2008 related to transactions in derivatives markets by shipbuilding companies and overseas portfolio investors, there is no problem in Korea's external debt repayment (BOK, 2008b).[39] Furthermore, a high proportion of total external assets are short-term, held by the Bank of Korea, and these are much more than short-term liabilities as a whole. In the case of housing finance loans that account for a considerable share of overall household loans, their ratio to nominal GDP stood at only 32% as of end-2007, compared to more than 80% in the US and UK. The average Loan to Value (LTV) ratio in Korea stands at 50%, far below the corresponding ratios in the US and other developed countries.[40]

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[38] According to the Financial Services Commission, as of June 2008, 22% of total external debt and 45% of short-term external debt belonged to local branches of foreign banks. An additional 36% of external debt was free of repayment burdens, having been incurred by shipbuilders' currency hedging, etc.

[39] They report that the floating debt ratio in September 2008 was about 95% but if we exclude these transactions in derivatives markets from foreign debt, the ratio was about 74%.

[40] The share of securitized housing finance loans in Korea is a mere 3-4%, compared to the corresponding figure of over 50% in the US, and the average delinquency ratio remains at the 1% range.

However, there is still a possibility that a domestic banking crisis may occur together with a currency crisis in Korea in the form of “twin crises”. The bursting of the real estate market bubble has already partly begun and started to adversely affect the financial sector. The construction industry was hit hardest and the loan delinquency rate jumped from 2008, in particular that of smaller saving banks whose loan delinquency rate was more than 15% as of February 2009. The loan delinquency rate of commercial banks is not as high yet but it also increased to 1.5% in March 2009 from 0.9% a year before. The historically high level of household debt may be a source of future problems when the real estate market bubble bursts completely, given that the ratio of total household debt to disposable income in Korea has become as high as that in the US. Already from late 2008, credit extended by the financial sector to the economy was reduced drastically and this landed many small and medium companies in difficulty.

The Korean government has struggled to avert another financial crisis by taking several measures after late 2007. The Bank of Korea purchased government bonds in the market to reduce interest rate volatility in November 2007, and the government introduced measures to increase available foreign currency. In response to the recent turmoil in the foreign exchange market, the government desperately sought international support. The Bank of Korea introduced a competitive auction swap facility in October 2008 to promote stability in the foreign currency funding market. On October 30, 2008, the Bank of Korea entered into a temporary bilateral currency swap arrangement of $30 billion with the US Federal Reserve, which quickly stabilized the financial markets. There were also currency swap agreements with Japan and China, and their amounts were expanded in December. The government also announced that it would, like other major economies, provide guarantees on interbank transactions in October. And it signed a Memorandum of Understanding (MOU) with domestic banks in November in which the government will guarantee the repayment of their external debt up to $100 billion. The government also announced that it would inject more capital into the banking sector by establishing public funds amounting to as much as 30 trillion won in early 2009.

Plans to increase fiscal spending in order to stimulate the economy were also introduced. The government presented a new spending plan worth 10 trillion won more than the original in late 2008, announced additional fiscal spending of 28.4 trillion won (about 10% of the original budget) in April 2009, and executed the fiscal spending plans ahead of schedule in 2009. The IMF reports that the ratio of crisis-related discretionary spending to GDP in Korea is one of the highest among the Group of 20 (G20) major economies and is contributing to economic recovery. This was possible thanks to the healthy fiscal status of the Korean government but it will surely increase the fiscal deficit and government debt rapidly. People are also concerned that the government has introduced tax cuts for the rich and, seeking short-term effects, would introduce more spending for large construction projects instead of social welfare and R&D. The Bank of Korea also took part in the global effort to cut interest rates by reducing its policy rate six times between October 2008 and February 2009 by a total of 325 basis points, from 5.25% to 2.0%. It has also increased its provision of won liquidity to the financial markets through open market operations, by more than 20 trillion won after mid-September 2008.

However, it remains to be seen whether these measures will be successful. For example, there is no sign of recovery of credit creation in Korea although the base money supply has been rapidly increased since late 2008. This is because many banks have struggled to increase their BIS ratio, not increasing lending but just seeking safety. Many argue that it would take much effort to stabilize the Korean financial sector and to put the economy on the path to recovery. In light of this, it is really problematic that the government is still trying to excessively pump up the construction industry and bubbles and is still pushing for further financial opening and deregulation.

Chapter 6

CONCLUSIONS

THE Korean economy is now facing another severe trial, just over 10 years after the 1997 financial crisis. This is, of course, related to the present global financial crisis, but the structural cause of Korea's recent financial fragility lies in extensive financial opening and a growth strategy that is over-dependent on the external sector. The current financial turmoil highlights the probems of the neoliberal economic restructuring and all-out capital account liberalization after 1997, which made the Korean financial sector vulnerable again.

The Korean financial system was transformed from the old state-led system to an open and liberalized one by means of the restructuring and opening introduced by the government and the IMF. However, the performance of the post-crisis financial system has been disappointing. Economic growth and investment stagnated, while income inequality and poverty became serious, leading to a vicious cycle. In particular, the post-crisis financial system did not adequately play a role of financial intermediation to promote corporate investment, partly as a result of growing foreign control in the financial sector. Moreover, financial instability increased along with the progress of financial globalization and deregulation. The external debt rose rapidly due to the recent increase in foreign short-term borrowing, and domestic financial vulnerability heightened. As a result, the Korean economy experienced severe financial turmoil with a sharp currency depreciation in late 2008 and the future prospects are not so bright.

The current situation stands in stark contrast with the high-growth period when the government controlled and regulated domestic and foreign financial flows. The state-led financial system played the role of mobilizing financial resources, allocating them in line with industrial policy and risk-taking through corporate restructuring, and promoted long-term investment and thereby economic growth. The developmental state implemented strong capital controls effectively to make use of foreign capital for national development. But this system came to unravel in the late 1980s with the role of the state weakening and the rising power of domestic capital. The government carelessly introduced capital account liberalization in the early 1990s, reflecting this change in the political economy, which rendered the Korean economy financially vulnerable and finally brought about the financial crisis in 1997. The crisis was a watershed moment for the Korean economy, which subsequently underwent substantial transformation.

This paper has examined the historic change in the Korean financial system, including the post-crisis financial restructuring and its problems. The Korean government pushed forward neoliberal economic restructuring together with complete financial opening in an attempt to establish a more liberalized and open economic system. A strong neoliberal ideology and powerful foreign capital interests were important factors in facillitating this change. But it is now evident that the argument that free and deregulated financial markets spur efficiency and growth was deeply flawed, as borne out by the current global financial crisis.

It is time to rethink blind financial deregulation and capital account liberalization. The analysis in this paper criticizes the market-oriented financial reform and excessive financial opening in terms of their failure to promote investment and economic stability. Given the problems of the current financial system, we must make efforts to establish a more stable system and introduce effective financial regulation and capital controls, with a more active role for the state in national economic management in Korea. The Korean economy needs to adopt a more balanced and domestic-demand-led growth strategy in the medium and long term. Although the Korean government appears not to have learnt it, the crucial lesson from the country's experience is that taking this alternative approach is what needs to be done.

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THE POST-CRISIS CHANGES IN THE FINANCIAL SYSTEM IN KOREA: PROBLEMS OF NEOLIBERAL RESTRUCTURING AND FINANCIAL OPENING AFTER 1997

This paper looks at the structural changes in the South Korean financial system over the years and how they have influenced the course of development in one of East Asia's largest economies.

For some 30 years from the early 1960s, a state-led financial system played a key role in propelling Korea's rapid economic growth by allocating financial resources in line with the government's industrial policy priorities. However, this system unravelled in the 1990s as the government implemented financial liberalization measures – measures which would give rise to financial fragility culminating in a severe financial crisis in 1997.

After the crisis, still more extensive financial sector deregulation and capital account liberalization were undertaken by the government as part of a sweeping neoliberal economic restructuring programme agreed with the International Monetary Fund (IMF). However, this paper finds that Korea's economic performance under this post-crisis market-oriented regime has been disappointing, characterized by stagnant growth and worsening poverty and income inequality. Especially marked is a decline in investment levels crucial to catalyzing long-run growth. The volatility of liberalized capital flows has also exposed the Korean economy to a heightened risk of financial shocks, as the recent turmoil triggered by the global financial crisis so vividly illustrates.

The Korean experience examined in this paper amply underscores the dangers of reckless financial liberalization and the consequent need to effectively regulate the financial system and exercise caution in relation to financial market-opening.

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