Summary

Structural Reforms and Economic Prospects

1998. 5. 8

Korea Development Institute

The Korean economy is currently experiencing the most severe crisis since the Korean War. Although the current crisis takes the form of a currency crisis at a glance, there exist fundamental and deeply rooted structural flaws that are far more serious in nature.

The government-led development strategy of the past 30 years allowed the Korean government to routinely intervene in the private sector, which prevented the development of market disciplines.
As a result, the economy suffered from various forms of moral hazard, and its negative effects on the economy accumulated to the point of explosion.

Recognizing this, the only true remedy for the crisis is to establish a new order ruled by market principles. The successful recovery will necessarily require painful structural reforms across the board.

At the onset of the currency crisis in November 1997, the most urgent national task was to resolve the foreign exchange liquidity problem. The Korean government responded promptly to this task by successfully extending the maturity of short-term foreign debts, which restored stability in the foreign exchange market substantially.

In order to address the fundamental cause of the crisis, the government took ambitious steps toward comprehensive structural reform. The following table lists key reform policies that have been announced or implemented since December 1997.

What Has Been Done

❑ Financial Sector

- Suspended operation of insolvent non-bank financial institutions
- Increased funds for non-performing asset disposal and deposit insurance
- Increased autonomy of bank management
- Launched Financial Supervisory Commission

❑ Labor Market

- Enhanced labor market flexibility
- Expanded unemployment insurance
- Increased support for the unemployed
- Strengthened and partially privatized job placement services

❑ Corporate Sector

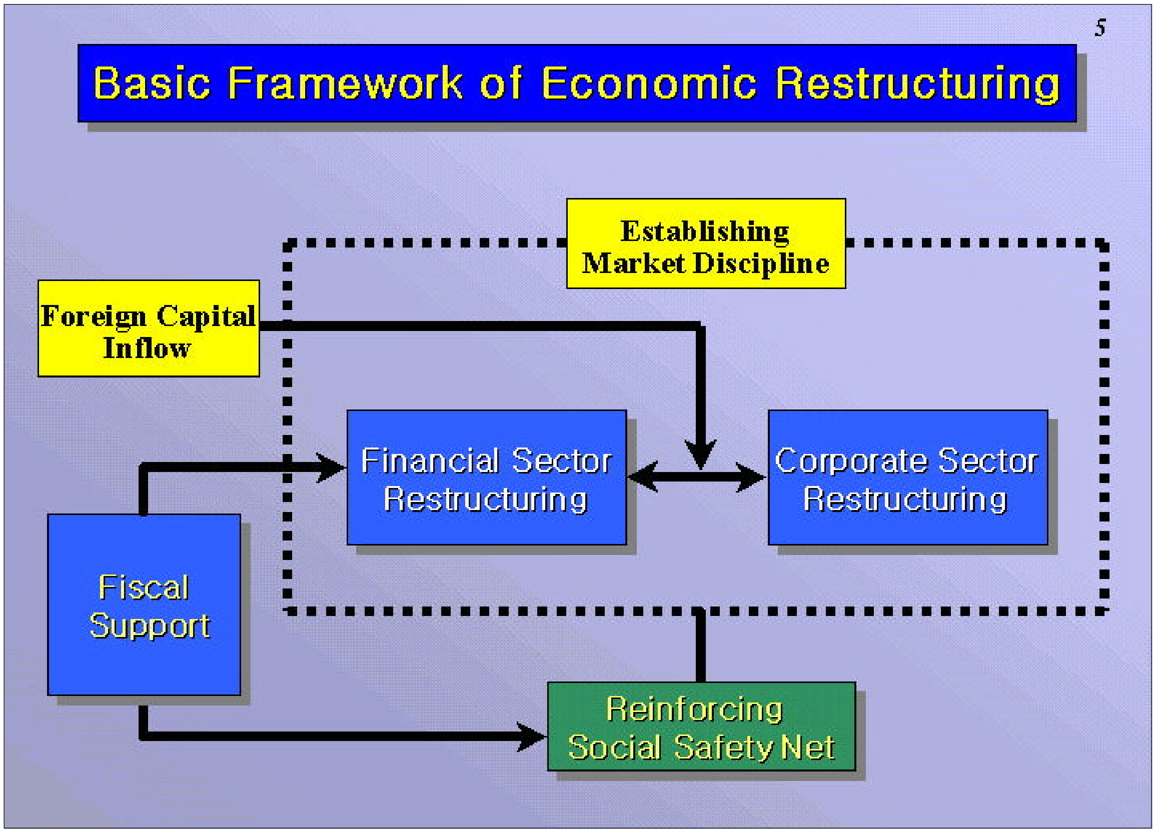
- Adopted combined financial statements
- Banned additional cross loan guarantees between subsidiaries of the chaebol
- Allowed M&A including hostile takeovers
- Achieved agreements between banks and firms to improve the capital structure of the latter
- Expanded the rights of small investors
- Liberalized rules on equity issue

❑ Market Liberalization

- Fully liberalized long- and short-term financial markets
- Raised the ceilings on foreigners' equity ownership
- Deregulated the use of commercial loans by foreign-owned firms
- Abolished limits on foreign ownership of real estates
- Expanded the list of industries open to foreign investment

Nevertheless, there remain a great deal of uncertainties and challenges. While visible structural adjustments of the financial and corporate sectors not being made at sufficient speed, the real sectors went into a deep recession. Given the vulnerable financial status of conglomerates and the massive amount of non-performing loans outstanding in the financial sector, the Korean economy cannot delay structural adjustments any longer.

Today, the sincere leadership of the government is needed more than ever. Drastic reforms are bound to face resistance from various interest groups, and only a government with a clear vision can overcome these obstacles. In addition, only the government can mobilize the huge amount of resources necessary to facilitate the structural adjustments needed at this point of time.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Basic Framework of Economic Restructuring
Establishing Market Discipline
Foreign Capital Inflow
Financial Sector Restructuring
Corporate Sector Restructuring
Fiscal Support
Reinforcing Social Safety Net

The following charts present the overall plans for the structural reforms in the financial market and corporate sector, along with the provision for the social safety net.

The next group of charts explain the plans for the government reform not only to enhance its efficiency but also to provide the resources for the financial sector restructuring and social policies.

The final group of charts shows projections of the Korean economy with two scenarios for structural reforms, namely, the case of successful reform implementation versus the case of failure to implement reforms.

Basic Framework of Financial Restructuring

Stabilize Financial Markets through Swift and Extensive Reform	Sort out insolvent from sound financial institutions Initiate recapitalization of sound banks
Conform to Internationally Practiced Standards	Strictly apply the prompt corrective action scheme Enhance information transparency and strengthen disclosure standards
Set Transparent Principles of Accountability among the Concerned Parties	Clarify burden sharing rules among shareholders, management, and depositors • Write off equity capital • Reinforce management's accountability
Prevent Collapse of Financial System through Timely Fiscal Support	Increase the deposit insurance fund Minimize the public burden by linking fiscal support to self-rehabilitation efforts

Strategies for Financial Restructuring

Early Stabilization of the Banking Sector

- Facilitate disposal of non-performing assets and support bank recapitalization
- Establish leading banks through M&A
- Sell Seoul Bank and Korea First Bank ahead of the announced schedule

Restructuring of Non-Bank Financial Institutions

- Induce self-rehabilitation efforts of major shareholders and management by strictly applying prompt corrective action
- Minimize the costs of closure through Purchase & Assumption and/or Bridge Financial Institution method

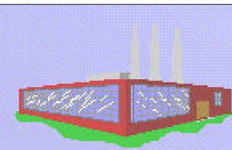
Developing Financial Sectors into a Strategic Industry

- Enhance competitiveness for global competition

Maintain the Stability of Financial System

- Let the market work by announcing a clear blue print in advance
- Develop the measures to minimize the expected side-effects of financial restructuring

Corporate Restructuring



Policy Measures Announced

- Resolution of existing cross loan guarantees of large business conglomerates (2000)
- Adoption of combined financial statements (1999)
- Agreement between banks and corporations to improve capital structure of the latter (1998)
- Adoption of internationally accepted accounting principles (1998)
- Liberalization of foreign ownership of real estates (1998)
- Introduction of the corporate-split system in the Commercial Code (1998)

Additional Policy Recommendations

Corporate Bankruptcy

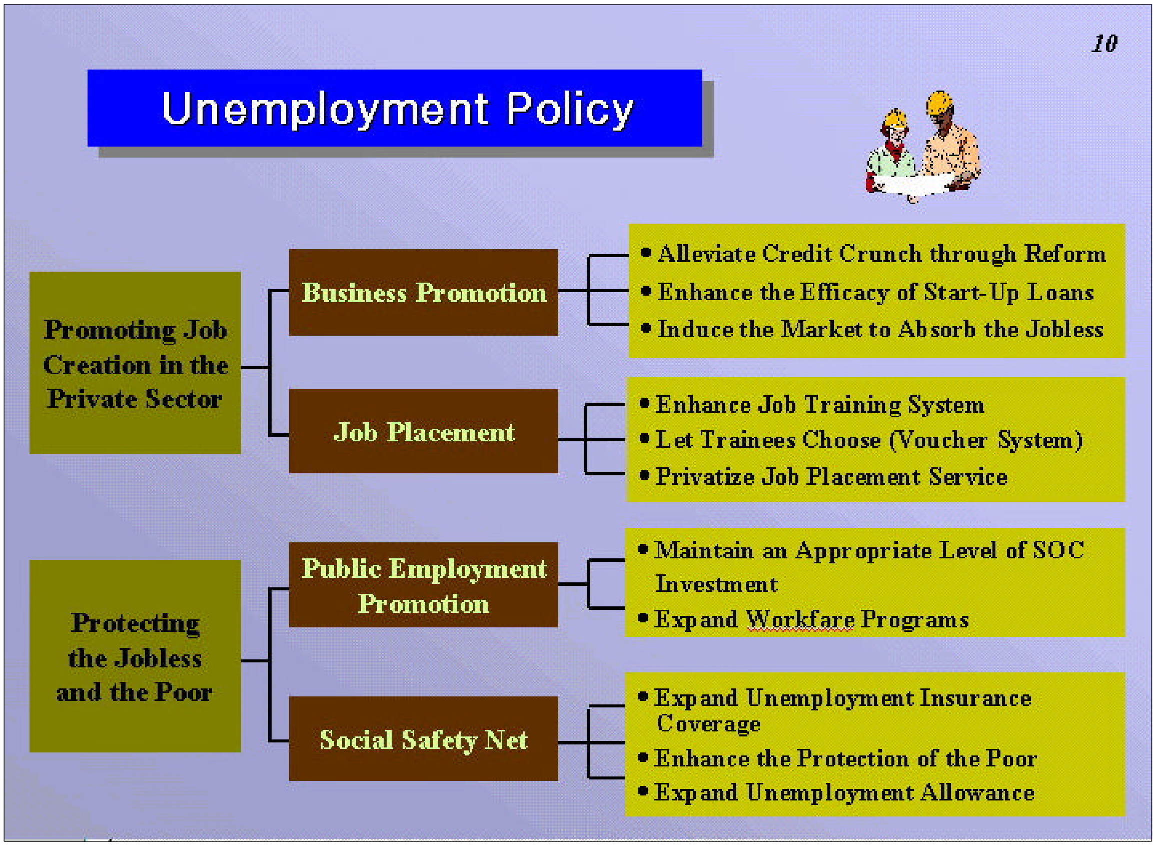
- Speed up the bankruptcy procedure of Kia and Hanbo
- Stop additional syndicated loans to failing firms
- Apply bankruptcy procedures more strictly

Corporate Governance

- Strengthen the legal liability of shadow directors
- Legalize holding companies

M&A

- Facilitate redundancy layoffs more effectively
- Clarify Merger Guidelines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Unemployment Policy
Promoting Job Creation in the Private Sector
Business Promotion
• Alleviate Credit Crunch through Reform
• Enhance the Efficacy of Start-Up Loans
• Induce the Market to Absorb the Jobless
Job Placement
• Enhance Job Training System
• Let Trainees Choose (Voucher System)
• Privatize Job Placement Service
Protecting the Jobless and the Poor
Public Employment Promotion
• Maintain an Appropriate Level of SOC Investment
• Expand Workfare Programs
Social Safety Net
• Expand Unemployment Insurance Coverage
• Enhance the Protection of the Poor
• Expand Unemployment Allowance

Fiscal Supports for Restructuring

Items	Bond Issues and Repayment	Fiscal Burden	Principles of Support
Non-Performing Loans	Issue NPLDF Bonds Fund through sales of NPLs	Interest on Bonds	Buy only part of the total NPLs at the market price
Bank Recapitalization	Issue DIF Bonds Fund through sales of bank shares	Interest on Bonds	Induce private recapitali-zation as much as possible
Deposit Insurance	Issue DIF Bonds	Interest and part of the principal	Impose higher insurance premium on depositors
Support for the Unemployed	Issue long-term bonds, utilize ADB and IBRD loans, etc.	Costs of retrain-ing, public assis-tance, etc.	Minimize work disincen-tives and closely monitor the policy effectiveness

Notes) NPL : Non-Performing Loan
NPLDF : Non-Performing Loans Disposal Fund
DIF : Deposit Insurance Fund

Fiscal Reform

- Budget deficits are unavoidable during the first few years of restructuring
  - Fast and comprehensive restructuring is the only way to minimize the long-term costs
- Nevertheless, special efforts should be made to reestablish fiscal soundness as soon as possible

Deficit Reduction

- Privatize public enterprises
- Reduce sectoral expenditures selectively
- Strengthen performance monitoring of public expenditures
- Increase tax revenue through tax reform

Public Sector Reform

- Continue structural reorganization
- Create competitive environment within the public sector through outsourcing, etc.
- Enhance managerial flexibility and accountability

Economic Prospects (1998~2000)

- The Case of Successful Reform -

(year to year percentage change, 100 million US $)

	1998	1999	2000
Gross Domestic Product	-1.4	3.1	5.1
Consumption	-4.5	2.6	4.6
Investment	-34.2	13.0	10.9
Exports	22.9	6.3	5.7
Imports	-4.7	17.1	8.9
Current Account	286	155	116
Goods Exports	1,478	1,579	1,688
(Growth Rate)	(6.7)	(6.8)	(7.0)
Goods Imports	1,188	1,394	1,530
(Growth Rate)	(-16.6)	(17.3)	(12.0)
Consumer Price Index	8.7	4.5	4.3
Employment Growth Rate	-3.6	0.7	2.9

Economic Prospects (1998~2000)
- The Case of Failed Reform -

(year to year percentage change, 100 million US $)

	1998	1999	2000
Gross Domestic Product	-3.1	-0.4	1.4
Consumption	-5.6	1.0	3.4
Investment	-40.9	3.7	8.9
Exports	22.6	3.0	2.7
Imports	-8.4	14.2	10.1
Current Account	329	185	108
Goods Exports	1,464	1,518	1,624
(Growth Rate)	(5.6)	(3.7)	(4.0)
Goods Imports	1,130	1,288	1,464
(Growth Rate)	(-20.7)	(14.0)	(12.7)
Consumer Price Index	9.7	5.5	5.0
Employment Growth Rate	-4.6	-0.9	0.3