

Structural reform and macroeconomic policy in Korea

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The reform measures being adopted in the wake of the 1998 financial crisis represent a watershed in Korean economic development. Korea is attempting to compress into a relatively short period of time, structural reforms that would normally be expected to take much longer in other industrial economies. These reforms involve banking sector overhaul, capital market opening, corporate sector restructuring and labour market reform.

To date, most of the progress has been achieved in financial sector restructuring. Those banks that by June 1998 had failed to meet capital adequacy guidelines and showed little prospect of being able to be rehabilitated have been closed. The remaining banks are being restructured through the injection of public funds for the purchase of



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non-performing loans, and through recapitalisation via mergers and the injection of foreign capital. A total amount of 64 trillion won (equivalent to 15 per cent of 1997 GDP) is to be raised by the government to facilitate financial sector restructuring. However, with non-performing loans estimated to peak between 100-120 trillion won during 1999, there are concerns that these funds may be insufficient.

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Corporate restructuring is proceeding at a slower pace. Ultimately, reform of Korea's industrial structure will be the benchmark against which President Kim Dae-jung's administration will be judged. Under the government's reform plan, the *chaebol* are required to lower their debt-equity ratios to 200 per cent by the end of 1999 and to eliminate existing cross-debt guarantees amongst subsidiaries by March 2000. To meet these targets, the *chaebol* will have to streamline and refocus on their core business lines. At present, this is a government-led rather than *chaebol*-led process. The government has sought to enforce structural reform of the top five *chaebol* by requiring them to halve their subsidiaries through sales, mergers, and swapping business lines among each other.

There is a clearly a dilemma here. The *chaebol* are unlikely to willingly scale down their activities. Bank-led restructuring of the *chaebol* is also problematic. Commercial banks have little experience in handling corporate failures and have weak bargaining power over the *chaebol*. But it is not yet clear what the government's ultimate objective is—to streamline or to dismantle some of the top *chaebol*. Forcing the top four *chaebol* to swap their subsidiaries will see an increased concentration and monopolisation of key sectors such as autos, semiconductors and electronics, which is in clear breach of the government's existing competition policy guidelines.

Policy lessons

That Korea has probably adhered more faithfully to IMF policy

prescriptions than other crisis countries represents an interesting test case of the merits of orthodox stabilisation policy and deep structural adjustment policy. It remains an open question whether the tight monetary policy adopted in December 1998 actually helped to stabilise the exchange rate. There is more of a consensus that the damage to the corporate sector through a continuation of tight monetary policy during the first half of 1998 and increasing perceptions of risk in the economy, probably outweighed the stabilising effect on the exchange rate. The double squeeze of financial restructuring and depressed domestic and external demand created severe liquidity problems in the banking sector which in turn triggered more corporate failures.

Perhaps the real policy errors occurred in the realm of fiscal policy. In retrospect, an earlier decisive shift towards fiscal expansion than what occurred would have been desirable. Initial fiscal targets proved unrealistic as the descent into recession and the fiscal impact of financial sector rehabilitation cut into government revenue far more than originally anticipated.

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One consequence of this was the delayed operationalisation of badly needed fiscal stimulus in the first half of 1998. Delays in implementation, combined with the inherent fiscal conservatism of the Korean government, led to an outcome whereby the budget in the first half of 1998 was balanced, with most spending targets on social welfare programs not being met. There is now considerable scope for demand expansion using both monetary and fiscal policy, although in practice there is probably less scope for monetary policy to play an effective role given the current structural constraints within the banking sector.

Path to recovery

Despite the recent improvement in several external indicators, there are still risks to the recovery process. These are: the capacity to sustain recent external sector improvement at a time of slowing world trade growth; the possibility of shocks from weaknesses in the asset quality of the banking sector being greater than is currently foreseen; the risk that foreign and domestic confidence will not be restored quickly, particularly if corporate restructuring stalls; and the risk of worsening labour market conditions and social disruption.

The chances of these risks will diminish with signs of progress in the domestic economy. The political momentum for reform will also more likely continue with the return of positive growth. Other factors though have yet to be fully played out. The lessons that the community and influential parts of society draw about the causes of the crisis, and who is to blame for the crisis, will have quite a large effect on the interaction between the political system and the economy in the period ahead.

These issues were discussed at a conference entitled Financial Reform and Macroeconomic Policy Management in Korea held at the Australian National University on 3 November. Participants included scholars, policymakers and financial market participants from Korea and Australia. Drs Inseok Shin and Seong Min Yoo from the Korea Development Institute, Drs Donghyun Ji and Sunho Kim from the Korea Institute of Finance and Dr Jae-Jung Kwon from the Financial Supervisory Commission were among those who presented material at the conference and a public forum. The Australian National University gratefully acknowledges the support of the Australia-Korea Foundation in its support of the conference.

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