Financial Crisis in Korea and IMF: Analysis and Perspectives

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Introduction

IMF crisis in December 1997 was a painful blow to Koreans who have not seen a major recession during the last fifteen years. There had not been a major corporate shake up during the time of continued expansion. Korean companies competed in borrowing from domestic and foreign firms to grow in assets that further appreciated 10% on the average.

The prospect of IMF bailout was a humiliating blow to the Korean people who achieved an economic miracle with 8.2% annual GDP growth over three decades. During the time, Koreans raised annual incomes from $80 in 1960 to over $10,000. Korean government supported conglomerates such as Samsung, Hyundai to borrow and grow, which gotten out of the hand.

In early November 1997, banks that lent wantonly to chaebols held at least $52 billion dollars in bad debts-17% of their total debt. Sensing blood, traders attacked the Korean currency, driving the won from 844 won to the dollar in January to almost 1,000 in November, and pushing it further to almost 2,000 one time in December. As of February 1998, the ratio remained as 1600 to one dollar.

11 chaebols collapsed during 1997 and 10 more out of the 50 largest chaebol were at the risk of bankruptcy. Bankrupt chaebol cost South Korea $100 billion, 20% of the country's half-a-trillion-dollar economy. Example is auto maker, Kia, collapsed with $10.7 billion dollars of debt, and 60,000 jobs in jeopardy.

Trouble with chaebols pushed the banking system over the edge. Debt-choked companies have triggered a bank crisis and the government ran low on foreign reserves. Feared investors dumped their stocks and amassed dollars, depressing the won. In early November 1997, American experts believed that Korea might need as much as $40 billion from IMF for a bailout. December election delayed government's aggressive move towards IMF and labor issues. Eventually, $60 billion dollars were promised to Korea by IMF in December.

IMF crisis in Korea made foreign investment vulnerable to financial risks such as payment default and country moratorium. American, Japanese, and European banks had some $60 billion at stake in exposure to Korea. Bank of America, Chase, Citibank, and Japanese Sanwa bank each had more than $2 billion in Korean loans. European banks such as Deutsche bank, Societe General, and Credit Lyonnais, Bank Nationale de Paris each had more than $1 billion in Korean loan at the time of the crisis.

Causes for the Korean Crisis

Ten major causes for the Korean financial crisis are listed below.

1. Over-capacity led over-borrowing. On the average, the top 30 conglomerates debts are four times greater than their equity bases. Korean chaebol overbuilt in the areas of auto, steel, petrochemical, and semiconductor industries.

2. Currency crisis in other Asian countries led capital outflow from Korea

3. Wages are no longer any lower than in most Western countries.

4. The inability of the Korean government to respond early to potential crisis made the crisis worse. Korean government officials' attempt to cover up their lack of foreign reserve to prevent the government's popularity from falling apart, especially at the critical juncture of the time-election in December, also contributed to the deterioration of the situation.. The approval rating of then-president Kim Young Sam was only 10% (compare this to 70% approval rating of Clinton despite the scandal).

5. Corrupt government-chaebol strategic alliance contributed to the crisis. Politicians needed money for their political campaigns, and chaebols needed funding for their expansion.

6. Asset-based business rather than profit-based business characterizes the Korean way of running a company. Asset value appreciation for the last three decades planted a wrong confidence in the power of assets. Once the asset values started declining in 1991, the chaebol started borrowing and buying lands, instead of selling and contracting for profit. The assets values declined further.

7. Continued trade deficit (accumulated 30 billion) for the last three years in a row reduced Korea's foreign currency reserve to a dangerous level.

8. Large proportion (60%) of short-term debt from foreign banks affected liquidity negatively.

9. 30 savings and loans institutions were allowed to borrow from foreign sources. These institutions borrowed recklessly on a short-term and loaned to Korean chaebol companies.

10. Foreign investors including many banks feared the lack of transparency in Korean firms' financial reports. Korean government, like many other Asian governments, developed an opaque financial system in which outsiders don't know where the state ends and corporations begin. Korean government, for example, has pledged its foreign currency reserves to bail out banks and guarantee foreign loans to corporate borrowers that push its export policy. Consequently, foreign investors lost confidence in Korean firms and hesitated investment.

Impact of IMF on the Korean Economy

Korean economy showed signs of recovery in such areas as current account surplus, trade surplus, debt restructuring, and chaebols' announcement of restructuring plan. In its desperate attempt to invite foreign direct investment to the country, Korean government implemented drastic reforms allowing 100% foreign ownership of Korean listed companies by the end of 1998. The IMF had asked for 55% ownership earlier. Also, Korean currency was allowed to float freely, while abolishing 2.5% limit a day. Stock price also was allowed to fluctuate within 10% a day from the previous 6% limit.

Despite some positive impact on the horizon, Korean government, companies, and labor had to share bitter realities that were imposed upon them the IMF crisis.

High Interest Rates

The chaebol have to offer interest rates of up to 30% on their corporate bonds to attract any takers. It was 13% in November 1997, three months before the crisis. Small and medium companies suffer more because of the rates that have doubled. The vast majority of Korean manufacturers owe some $300 billion of won-denominated debt to local banks and other Korean firms, just when rates are hitting record highs.

High interest rates signal the signs pointing to a big deterioration in the business climate. In December 1997, 123 companies on the average failed each day-a 1,000% increase from a year earlier. One Korean expert expects as many as 30,000 small and medium companies will go bankrupt in 1998. This number represents 100% increase from 1997's 15,000, and 200% increase from 1996's 10,000.

Currency Crisis and Debt Burden

The currency crisis is not over yet even though the possibility of moratorium appears to be over. The dollar-won ratio hovers around 1300-1400 won to a dollar (it used to be 800 to one a year ago). Weak Korean currency gave Korean chaebols $8 billion extra burden on interest payment to foreign investors. Korean debt total of estimated $150 billion is the biggest among those of Indonesia ($130 billion), Thailand ($100 billion), Phillippines ($60 billion), and Malaysia ($40 billion).

Local debt crisis worsens. Chief corporate analysis at KEB Smith Barney Securities estimates that 137 out of 558 (24%) listed nonfinancial firms have debt burdens that are equal to or worse than those that have already gone bust.

Massive Layoff

Massive layoffs have just begun. The impact will be felt beginning the summer of 1998. In the absence of government welfare system like the U.S.'s and Western European countries, Korean public fears their future. In May 1998, the unemployment rate already reached at the level of 6.5%, from 2.5% before the crisis.

Untested Presidential Leadership

Despite the fact that Korea's president-elect Kim Dae Jung has pledged to push the chaebol to restructure and pass laws allowing layoffs, some doubt whether his economic advisers will push hard on key issues. A 12-member panel in charge of generating reform ideas has not presented any concrete proposals to improve business transparency and corporate governance.

Despite the chaebol's announcement to cut investment by 30%, many American experts do worry they will simply try to muddle along for now, then revert to old practices once the crisis calms down. This practice is termed, "lying down flat on the ground, toughing it out, and then resuming business as usual."

Kim Dae Jung, president-elect, who took office on February 25, 1998 remains a relatively untested leader. His advisers chosen to bend his ear can end up with more sway over him than any advisers in modern Korean history.

Government intervention was accelerated, rather than diminished. In a response to the crisis, Korean government encouraged debt-equity swap in which beleaguered chaebol and their Korean lenders trade debt for asset. For example, Korea Development Bank, Kia's main creditor, was instructed to forgive its loans to the car maker and accept equity instead. Foreign investors and IMF viewed this act as quite unacceptable government increase of control.

Corrupt alliance between the chaebol and the government has not be broken. Banks began to feel the need for control on the lending procedure by creating basic functions like credit committees to approve loans.

Recommendations

First, banks have to recapitalize and merge with others. The surviving banks must stop feeding loans to the hungry chaebol and extend more credit to smaller entrepreneurs.

Second, the chebol must focus on core businesses and profit, not aggressive expansion. For example, Korea may not need five automakers rather than five. Samsung's $6 billion push into the crowded car market look fanciful at best. Experts suggest that Samsung give up its car business as well as shipbuilding, heavy machinery, aerospace, and petrochemicals, and concentrate on semiconductors, financial services, liquid-crystal display panels, and computer monitors.

Third, make the chaebol's financial reporting more transparent. Many analysts believe that stated revenues are inflated by up to 30%, due to transactions within the chaebol that are mixed with external ones. Reported debt levels may also understate the degree of financial problems, given the common practice of one unit guaranteeing or even subsidizing another's debt.

Fouth, Korean government must allow M&A and let foreign companies buy Korean assets more easily. It also has to back off from economic micro management. Actually, Korean government moved boldly to allow Coca-Cola Co. Purchase Doosan, a beverage company that makes OB beer for $435 million dollars in November 1997. Korean government is now busy passing the proposed laws allowing the access of foreign firms to purchase Korean assets. Already, Korean government passed a law permitting foreigner to purchase 100% equity of Korean firms by the end of 1998. M&A is hot in Korea. Hotels in Seoul, Korea enjoy dramatic increase In occupancy rate thanks to visiting foreign investors.

Fifth, labor unions must accept layoffs and improve productivity. Labor union was criticized for its violent tactics to push up wages five fold in the past 12 year.

Sixth, improve trade surplus. Korean government and companies could benefit from the falling won to reignite exports. IMF and Korean government agreed to the surplus level of 8 billion dollars in 1998. In the first quarter of 1998 alone, Korea posted a surplus of $10 billion. The Korean public seem to rally behind these export drive campaigns by refraining from the purchase of foreign goods, and donating golds to the government for export, etc. A drastic decrease in import and cheap Korean currency helped boost trade surplus in recent months.

A few obstacles to the continued trade surplus for Korea do exist. More than 50% (52%) of all Korean exports go to the rest of Asia, which is also battered with financial crisis. Experts also voice pessimism on the long-term recovery of Korea's trade surplus. They say the current drive can spark a recovery-a short-term solution at best. Why? Due to global deflation, export volume growth of 20% globally would mean only 8% increase of export revenues and much lower percentage increase of profit due to the higher price of raw materials for their products for export. Expensive raw materials that must be purchased in expensive dollars for export also cut into the trade profitability. Korean government's drive toward public frugality campaign helps reduce import, but depresses Korea's domestic economy.