

**Korean Experience of Structural Reform:
Its Lessons and Implications to Japan**

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Introduction

The 1997 foreign exchange crisis exposed the structural weaknesses of the Korean economy and left the country teetering on the verge of bankruptcy. Tremendous efforts were made to restructure the economy and to rescue the economic growth that we had worked hard to achieve over the past decades. An unprecedented amount of public resources was injected into the economy, and the entire nation pulled its strength together and endured the painful and arduous reform in order to overcome the crisis.

I am glad to say that Korea has achieved much since. Although many tasks still remain in completing the reform, I am pleased to share with you some of the insights and lessons that I have gained from the Korean experience.

In Korea, structural reform was carried out in four sectors:

financial and corporate sectors, labor market and government sector including public enterprises. However, given the time constraint, I would like to focus on the restructuring that took place in the financial and corporate sectors, the two areas in which I was directly involved as the head of the Financial Supervisory Commission and Minister of Finance and Economy.

In particular, I would like to point out first, the conditions that lay the foundation of a successful reform; second, my thoughts on the interrelationship between structural reform and macroeconomic policy; third, the lessons I have gained about the speed and method of reform; and lastly, the remaining challenge of re-establishing the operational practices of the financial and corporate sectors and recovering public funds injected.

Conditions of Successful Restructuring

1. Recognizing the Problem : The first and foremost challenge in

launching the structural reform was getting all the different sectors of the society to recognize the problem as problem and acknowledge that reform was absolutely necessary. The financial institutions (FIs) and corporates that needed to undergo surgery to overcome the crisis resisted reform and fought to hide their problems. Strong and decisive political leadership was called for. And public support and consensus was crucial for reform of such unprecedented scale to take even one step forward.

Fortunately, the former Korean president Kim Dae Jung, who had just been elected when the crisis broke, understood the magnitude of the problem. President Kim implored the public to join hands and to endure the agonizing journey. Without backing from the very top, reform would have faced many obstacles. I also have great respect for the Korean people who made such tremendous sacrifice at such a crucial moment.

2. Transparent and Objective Procedures : One of the key tasks of

financial and corporate sector restructuring was allowing viable FIs and corporates to survive and non-viable ones to exit the market. This involved assessing the asset quality and future viability of the FIs and corporates. However, the process proved to be an extremely difficult task. Until then in Korea, such assessment was done in a mechanical and perfunctory manner. The existing practice relied only on addressing past performances without any forward-looking assessment of the future viability of those in question. It was up to me and my staff to create the new standards.

As you can imagine, because their survival was on the line, the affected institutions resisted with full force. It was absolutely crucial, therefore, that we establish the most transparent, coherent, and objective standards and procedures of assessment that were indisputable. This was also necessary to earn the support of the public.

It was not an easy task by any means. Korea lacked expertise and know-how in the field of such evaluation. Both the government and the private sector possessed limited experience in turn-around management, and there was no domestic pool of experts to draw from. The Korean Government had to turn to internationally reputable foreign accounting firms and investment banks, and we incorporated their expertise and experiences in establishing the new standards and procedures. I can say that, given our constraints, we did our best to be the most objective and transparent in our practice.

Structural Reform and Macroeconomic Policy : The IMF Lesson

One of the questions I am often asked is how to coordinate structural reform and macroeconomic policy, if at all. My personal opinion is that the implementation of structural reform and macroeconomic policy are two separate matters and should

remain so. By this I mean that macroeconomic policy should not be used intentionally as a tool for expediting reform. It can at times backfire and result in adverse effects that were not intended.

Having said this, I would add that macroeconomic environment, however, is very important to the successful implementation of reform. For example, if tight monetary and fiscal policy threatens business and banking activities to such a point that the market is about to collapse, then restructuring itself becomes impossible. No reform can take place if the market collapses. This would be equivalent to curing the cancer but killing the patient. Efforts must be made to manage the macroeconomic environment and keep the market afloat.

At the beginning of the crisis, the IMF prescribed harsh tightening of fiscal and monetary policy for Korea. This was the IMF's formula derived from its numerous experiences in rescuing other nations. However, in the case of Korea, the IMF prescription

worsened the problem. It created an extreme credit crunch that exacerbated the business environment, and led to a domino effect of corporate bankruptcies. The IMF prescription also resulted in negative side-effects such as the worsening of moral hazard in the financial sector and adverse selection by which FIs let sound companies go bankrupt while allowing non-viable ones to remain alive.

This is not to say that boosting the economy is the answer. It may provide temporary relief, but it will only postpone the necessary surgery until one day the problem erupts into a full-blown crisis. This would ultimately impose even higher costs and sacrifice on the society.

Speed and method of Structural Reform

When the Korean Government set out to implement structural reform, the advice from the international community and experts

was to execute it in “an orderly and sequential manner”. However, reform of such scale inevitably accompanies economic and social turbulence. Because market mechanisms are complex and inextricably intertwined, reform measure taken in one sector affects and spills over into the rest of the economy - sometimes in unpredictable ways. Although an orderly implementation of reform would be ideal, it is nearly impossible.

Another key and realistic concern is that public support for reform does not last forever. Reform of the financial and corporate sectors in Korea led to massive layoffs and bankruptcies and caused a tremendous amount of pain. In fact, after harsh measures were undertaken to overcome the initial blow of the crisis, I witnessed resistance to reform growing day by day.

Therefore, in my opinion, when carrying out massive and fundamental structural reform, it is best to prepare a well-planned strategy in advance and then execute it intensively and as swiftly

as possible as we did in Korea. Doing so would minimize the public's suffering and speed up the recovery. It will also allow the most important restructuring jobs to get done while public support still lasts.

One thing that was extremely helpful in this process was that President Kim Dae Jung gave full and unchallenged authority to the Financial Supervisory Commission (FSC), which I headed, to lead the restructuring of the financial and corporate sectors. This allowed the FSC to act decisively and in a speedy manner. It also enabled me to speak with authority and maintain a consistent voice in communicating with the public, a crucial part of building trust and support for the reform process.

Re-establishing Operational Practices

If the initial whirlwind of reform was the surgery that cut out the cancer cells, the task still remained to revive the physical

constitution of the Korean economy and prevent future crises from taking place. After cleaning up the balance sheets of FIs and corporates, we set out to create an environment in which companies could thrive and maintain sustainable growth.

This was a two-pronged task. On the one hand, we encouraged competition in the local market in order to foster businesses and financial institutions that could eventually compete in the global market. To this end, we launched bold deregulations to create a level playing field that would allow fair competition.

On the other hand, we also made efforts to ensure sound and fair market stability through prudent and principled regulation. We took measures to reform the government regulatory bodies, and gave examples of ‘best practices’ to FIs and corporates as guidelines to incorporate into their operation. Some of these ‘best practices’ included methods of risk management, ways to strengthen corporate governance and viable business models.

Needless to say, there is still much to be done in reforming the financial sector at the operational level. One difficulty that the banks face is that although they now have to compete fiercely for survival as the result of structural reform, their business models and operation have yet to reach global standards and will take considerable time to do. As short-term competition become increasingly intense among banks, however, getting the banks to take a long-term approach to operational reform has become difficult.

Therefore instead of developing new diverse sources of income, banks have resorted to their previous quick and familiar ways of doing business. For instance, when banks were no longer able to rely on corporate lending for profit, they rushed to switch to the consumer sector. In no time consumer loan skyrocketed and banks once again risked incurring huge losses. The problems that Korean credit card companies currently face are one of the grave side-effects of this phenomenon.

Another challenge is cleaning up the mess after reforming the banks. Once public funds are injected, banks become temporarily nationalized and their balance sheets become clean and healthy. But we still have to deal with the non-performing loans and distressed companies that were wiped off the banks' balance sheets.

As Korean banks lack experience and know-how to manage this job themselves, the government created the Korea Asset Management Corporation (KAMCO) to tackle these tasks. KAMCO took on the banks' non-performing loans as well as the distressed companies while FSC devised 'workout programs' to turn-around companies that were promising in the long-term but were experiencing short-term cash flow problems. We also institutionalized exit programs for non-performing companies and bankruptcy laws for post-crisis management.

Cleaning up non-performing loans and privatizing banks that

were nationalized with public funds require a high degree of expertise as well as large investment funds. Unfortunately, our FIs are still in the process of acquiring the necessary know-how for creating such large investment funds to execute these jobs. We have had little choice but to rely on foreign firms for their management techniques and capital, and this in turn has raised concerns about the Korean economy becoming overly dependent on foreign capital. Considering the huge amount of domestic savings in Korea, finding ways to tap into and utilize this resource is an important challenge for the future.

Conclusion

In closing, I would like to say once again that I feel privileged to share with you some of the lessons I learned from implementing structural reforms in Korea. Just as past examples of reform in other countries were only of limited help to the unique case of Korea, I do not dare to presume that what worked for Korea

would also be appropriate for Japan. I only hope that my thoughts would shed some light and serve as a modest reference for the reform efforts in Japan.

Thank you very much.