

Keynote Speech

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I am pleased and honored to be here today with notable scholars and participants to focus on and discuss the many complex issues related to the Korean economy.

Today I hope to offer a few observations about the past and present state of the Korean economy and identify challenges related to economic reform that will provide you with some “food for thought”. Some issues might have been discussed earlier, but I will focus on what I feel merit additional reflection.

The Korean economy’s macroeconomic indexes had shown an overall improvement up until a few years ago, except for the sharp increases of the budget deficit and government debt. We saw the economic growth rate, current account balance, and interest rates recover to pre-crisis levels or better. However, the improvement of an economy’s macroeconomic indexes is one thing and the state of its micro-foundation is another. Positive macro indicators just reflected a one-time recovery owing to short-term fiscal and monetary stimuli together with near-sighted economic policy. The Korean economy only seemed to have muscle. But steroid injection just makes you look stronger, it doesn’t mean you are physically healthier.

Ironically, rapid macroeconomic recovery was a mixed blessing for the Korean economy because by its very nature, bound to established government policy and big business practices, it created a resistance to change and actually hindered reform. The rapid economic recovery generated a culture of complacency that tended to mask many critical

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problems beneath the surface of the Korean economy. These characteristics consequently delayed a painful reform process that was fundamental to solving the various underlying structural problems. What was needed was the closing down of unprofitable firms in the real sector and the resolution of non-performing loans in the financial sector.

Although we have seen a huge amount of public funding – (more than 150 trillion won) – poured into the restructuring program since 1997, the actual commitment to restructuring was not enough to overcome a debilitating resistance from established interests groups and institutions. This failure to restructure finally gave way to the economic downturn that began in the second half of 2000. Yet the government again focused on an expansionary macroeconomic policy rather than on micro-structural reform. As a result, the real sector still lacks a system to enforce the dismantling of non-viable firms and the financial sector's non-performing loans are still a burden to the economy.

What should be the response? In order to reduce the vulnerability of the Korean economy there must be an ongoing commitment to a restructuring process in the real and financial sectors. I cannot state enough the importance of prioritizing this policy decision over and beyond superficial macro-economic indexes. The objectives of a restructuring program should be to establish a new environment governed by the principles of “survival of the fittest” and transparency in business.

Let's take a look at the critical issues on the reform agenda for the real sector. Forcing the close of ailing firms is at the core of its restructuring in that it effectively corrects inefficient resource allocations already in place, and, in a wider sense, reduces the probability of future redundant and excessive investment. What you end up with is the “survival of the fittest.” Unfortunately, this important principle was given short shrift by political and economic decision makers. The implementation of so-called structural reform became a matter of preventing large-scale corporate failure and unemployment by extending loan deadlines and offering favorable interest rates rather than actually closing down troubled companies or seriously

restructuring them.

The Korean government essentially went soft on its resolution to perform painful and costly restructuring, especially in the face of serious problems with and resistance from large conglomerates. It was the fall of the Daewoo Group in 1999 that marked the downturn of the reform process and served as a case to show that the “too big to fail” maxim no longer held true. The impact of the Daewoo’s collapse was profound, and the Korean government moved to prevent any further bankruptcies of that size. Most notably, when the Hyundai Group experienced financial difficulties in 2000, the government mobilized a Fast-Track Underwriting to prevent its bankruptcy.

So the move to effect real reform faltered. Indeed, the most direct evidence of the failure of the reform process is indicated by the still large number of firms in latent insolvency. What we really need is to see the large conglomerates becoming more enthusiastic about reducing their fat and improving profitability. We need to see a government that is resolute in enforcing strong policy measures that will effect a real restructuring and not simply, as the saying goes, rearrange the deckchairs on the Titanic.

I know that ailing firms and financial institutions cannot be eliminated overnight – painlessly or otherwise; however, the opportunity is now and the cost is too great to continue injecting limited resources into distressed sectors or propping up oversized corporations. Just think of the additional public funds that would be required to transform ailing banks into sound ones. I would instead recommend using public funds to minimize the probability of a financial crisis that might erupt when ailing banks are dissolved and, in addition, to contain any fallout that may arise in the process.

Another factor crucial to the success of restructuring is transparency. This needs to be rigorously enforced in the areas of financial reporting, corporation and financial institution transactions, and corporate governance. Without transparency, it is impossible to even begin accurate assessments of the financial health of firms and banks. Without transparency, one can hardly expect loan assessments to be normalized and bad debt to be reduced. Nor can investor confidence and a consequent development of the capital

market be expected. Furthermore, without transparency there is excessive investment and distorted resource allocations which only result in an economic bubble, all of which impede competition and compromise the signaling effect of prices. Transparency is an absolute must not only as a short-term restructuring goal but as a foundation principle for sustainable long-term growth.

Now, turning to the reform agenda for the financial sector, the core issue here is a problem that has plagued the Korean economy for too long and this is the astronomical number of non-performing bank loans. To counteract the problem, the government launched a financial sector restructuring program in 1998 by dissolving 5 commercial banks. This was promptly followed by an enormous amount of public funds - 64 trillion won – being pumped into the financial sector by the end of 1999 in the hope of bringing about financial normalization. Several other measures have been implemented to improve the soundness of the financial sector, including the Financial Supervisory Council being given range of comprehensive enforcement powers, the instituting of large-scale bank mergers, the increase in foreign investment, and the increase in equities to clear up the bad bank debts. However, despite such moves, nonperforming loans have not been reduced by much, because a soft and stalled restructuring of the corporate sector has simply caused their volume to rise again.

Another reason for the poor progress in financial restructuring can be found in the government's reluctance to dissolve more distressed banks. The gist of the second financial sector restructuring program launched by the government in late 2000 has been to encourage mergers between banks in relatively good financial condition, and to consolidate non-viable banks under financial holding companies. But considering the realities of the Korean financial system, it is doubtful whether bank mergers or financial holding companies can be expected to yield the intended results. Financial institutions consolidated under the umbrella of holding companies have invariably ended up in very poor shape. Combining bad elements in an effort to produce a good one rarely works in any field, so why should anyone

think it will work in banking? It is asking for trouble and will surely result in a greater demand for public funding. While it alleviates the pain of restructuring in the short-term, it cannot lead to long-term improvement across the banking industry.

A bill introduced in 2001 for amending the banking laws was supposed to encourage the emergence of healthy financial capital, promote autonomous bank management, and facilitate the recovery of public funds from the sale of banks taken over by the state. However, considering the underdeveloped financial supervisory system, unsatisfactory progress in financial restructuring, and, above all, the past record of big businesses and the damage done due to their dominance over non-bank financial institutions, it was easy to conclude that the amendment bill would never be a comprehensive solution.

For Korean firms in the past, size rather than profitability was important in their interactions with the market. Because the market evaluated firms by external rather than internal criteria, the “too big to fail” principle prevailed. Firms, therefore, concentrated on maximizing size rather than profits, inevitably leading to unsound investments and poor financial health. It went on for too long, buoyed by an economic growth that was sustained by a fortunate confluence of various external and internal circumstances together with a burgeoning industrialization. Finally, the bubble burst, and we were left with the reality of a micro-structural weakness that is still at the heart of Korea’s economic woes. This is what real reform must address and, it should be stressed, we also need an iron-willed government who can really make it happen.

To conclude, the Korean economy simply must have an established legal and institutional framework that will maintain the simple market principle: “survival of the fittest”. This principle applies to both the real and the financial sectors. Market efficiency depends on how strictly the “survival of the fittest” principle is upheld, that is, on whether non-viable firms are actually being closed down and not simply provided with cosmetic rejuvenation. Together with this, stronger accounting standards must be

introduced to raise the level of transparency, which will establish clear lines of accountability. These two key objectives, enforcing a “survival of the fittest” and establishing transparency, are critical to successful reform. These obvious solutions are still not in place, which is why the micro-structural reform efforts in Korea to date can only be described as disappointing.

Thank you very much.