Korea in the Asian Crisis of 1997 - 1998:

the IMF Crisis in Korea

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In January of 1997, as the fateful year began, many Koreans were looking forward to another good year in economic terms. The economy was projected to grow at 6.4 percent that year according to a report by the *New York Times* in late November (30 November) of 1996 which cited the Bank of Korea as the source of the projection. Even though exporting was easing and capital investment was slowing down, there was considerable momentum in the economy and the 6.4 percent expectation for growth reflected the lowest growth rate compared to historic rates achieved over the previous four years of the Kim Young Sam administration, it was not that far down on the growth rate that the Bank of Korea had announced for 1996. Thus many Koreans, along with a great many foreigners with business or other connections to Korea, were caught off-guard by the precipitate plunge in the economic outlook from early in 1997 that began with the collapse of a series of major chaebol groups, the unique family-owned and managed conglomerates of Korea.

The initial chaebol group that went into bankruptcy in late January of 1997 was Hanbo Steel, and as the headline in the *New York Times* (25th January, 1997) trumpeted, “Second-largest Steelmaker in Korea Goes Under”, this was one of the greatest corporate collapses in South Korea to that time. As such it was bound to have a major impact upon the economy in general--which was according to the IMF’s Director of Asia and the Pacific, Kunio Saito who presented a paper in January of 1998 that indicated that the Korean economy was scaled at about 440 trillion won and thus a collapse of a single company with debts of 5 trillion won or over 1 percent of the entire economy in scale, was of a magnitude as to have been quite shocking at the time.

There was soon even more to worry about in the wake of the bankruptcy of Hanbo as it was soon revealed that a number of Korean bankers and officials had been bribed by Hanbo’s major shareholder and chief executive, Chung Tae Soo. In June of 1997, Chung was convicted of bribery of banking officials and of certain politically well-connected individuals such as Kim Hyon Chul, the second son of president Kim Young Sam. Kim Hyon Chul was convicted of accepting bribes in October of having accepted bribes to ecourage banking officials to overlook their duties and provide assistance to Hanbo’s Chung.

The impending crisis of 1997 gathered pace through the rest of the year as an increasing number of chaebols came under financial pressure following Hanbo’s collapse. As Chung H. Lee and Kangkook Lee of the University of Hawaii phrased it in a paper presented in 2000 at a conference in Seoul, “Following Hanbo, eight of the top 30 chaebol went bankrupt in 1997” (paper posted on internet). Among the chaebol that went bust during the year were famous names such as Kia Motors, Jinro, the largest *soju* producer, and Haitai confectionary group. As the companies in these business groups and others that were under increasing financial stress looked to local banks to generate more funding to continue in business, Korean banks in turn began to increase their borrowing in foreign exchange from foreign banks. The amounts of funding that the Korean companies needed simply exceeded the ability of the Korean banks to provide funds in local currency.

The logical question that everyone who was watching the crisis unfold in those days was really quite straightforward: why were some of the biggest companies in Korea, units of major chaebol groups, in such desperate need of loan funding? The answer was perhaps not so readily apparent at the time, since most of the chaebol, including those that subsequently collapsed, insisted that they simply needed more access to loans from local Korean or foreign banks to ride out short term difficulties in their current business development circumstances. In fact, what had happened is that the chaebol were allowed by the Korean financial authorities to take on debt loads far in excess of what were then and still are today considered prudent debt levels for companies to maintain. In traditional business operations, a company can be said to be making considerable use of borrowing if its borrowings are anywhere from a ratio of 50 to 70 percent of its equity, and companies where the management succeed in raising debt levels to 100 percent of their equity resources are often thought of as taking leverage, or borrowing, to quite high levels. At western companies, levels of much beyond 100 percent are almost never encountered--but in 1997 the debt to equity ratio of the top 30 chaebols in Korea was over 396 percent! (paper presented by Ambassador Kim Kihwan, at an IMF conference in Singapore, July, 2006).

Debt levels of approximately 400 percent over their equity resources meant that far too many Korean companies were unable to pay current interest and principal scheduled repayments without additional borrowing--in other words piling up additional debts on top of current debts that they were completely unable to repay. This system of adding more debt on top of already existing debts that they were incabable of repaying simply delayed the inevitable bankruptcies of a number of the loss-making chaebol companies, and took earnings well down for those companies such as LG Electronics and Samsung Electronics which were never in any danger of failure. As noted above, if the Korean banks had been able to fund the rapidly increasing need for more funding on the part of many Korean companies, bankruptcies might have been avoided in some cases, particularly if the local banks could have tided these debt-ridden Korean companies over until their businesses were in better economic shape.

Unfortunately, so many of the chaebol were highly dependent upon exports, and as their exports were falling or not rising enough, earnings were consequently declining at so many of the chaebols as well. As a result, in many cases Korean chaebol companies found that not only were they unable to repay debts that were coming due for payment—they were unable to meet their needs for funding of current operations—in other words they had in accounting parlance become ‘capital destructive, not capital enhancing’. Again, if some of the Korean chaebols that failed had built up reserve funds to a major extent, they might have been able to fall back upon their corporate reserves and consequently needed less borrowing from banks and other financial institutions. But this was not the case and most of the companies that failed had very little to draw upon in their reserve accounts.

While watching this sad process of corporate self-inflicted collapse unfolding during the first half of 1997, foreign banks and financial institutions that had traditionally been lenders to Korean companies and even more importantly, to Korean banks, began to cut their levels of new funding to Korean entities and in many cases to call in existing loans. This process gained momentum following the bankruptcy of Kia Motors in July and from that point onwards the Korean banks had to plead with the Bank of Korea to obtain backing. Korean foreign exchange reserves maintained at the Bank of Korea had risen to over US$20 billion by the end of 1994 and were at nearly $30 billion at the end of 1996 and the beginning of 1997.

But during the second half of 1997 as the Bank of Korea became the only source of dollar funding for the Korean banks and non-banking financial companies that had to repay short term loans to global banks, the reserves began to be rapidly depleted until in the first few weeks of November they fell below US$10 billion—and at that point the Korean government felt that it had no choice but to do something that it had continually said that it would not do: call upon the International Monetary Fund for a relief and recovery loan. From the time that the IMF rescue package of over US$57 billion was announced in late November, the situation in regard to the banks began to stabilize—but even so by the end of that year the Bank of Korea’s usable foreign exchange reserves were only back up to just over US$9 billion. (source, IMF conference paper of 2006 by Kim Kihwan).

The dependence of Korean banks upon short term borrowing to fund their asset portfolios was a highly significant element in the headlong rush towards the foreign exchange crisis that built to a climatic point in November of 1997. At the end of the year, Korean banks had in borrowings short term loans of $49.2 billion and long term loans of $41.8 billion but by the end of 1998 they had repaid a considerable porportion of their short term debts which were down to $31.1 by the end of that year, although the long term debts were hardly reduced in falling to $41.4 billion by the end of 1998. But in the recovery year of 1999, by the end of the year Korean banks continued to keep short term borrowings at a relatively low level of $33.8 billion, but long term debts were down to $33.9 billion at the end of that year. (source, IMF conference paper by Kim Kihwan, 2006).

During the crisis year of 1998, Korean banks were forced to repay debts and focus on rebuilding their balance sheets, and thus many Korean companies were unable to continue in business since either credit was unavailable, or if credit was available, many Korean companies were unable to afford to borrow at the high interest rate levels that were imposed by the IMF as part of the agreement it made with the Korean government at the time the bailout agreement was arranged in November of 1997. At the beginning of December, an IMF team was in Korea for the formal signing of the bailout agreement with the Korean government, and the general outline of the terms of the agreement was announced on 3 December in Seoul. As the records of the IMF indicate, the outline agreement identified the essentially overwhelming nature of the crisis, and then stipulated a series of measures that the Korean government had agreed to implement in order to overcome the crisis and its ill-effects in the shortest possible time frame. (source: IMF website, Agreement between the IMF and the Korean government, 3 December, 1997).

As the Korean government-IMF agreement noted in a preface that explained the background of the crisis, “The bankruptcies spilled over into a sharp increase in non-performing loans (defined according to international standards) to won 32 trillion (7 percent of GDP) by end September, about double the level at end-1996. The won depreciated by about 20 percent against the US dollar through November 30; the stock market index fell by 30 percent to a ten-year low.” (source: IMF Agreement, 3 December, 1997). The nature of the problem was thus stated so that everyone in Korea and indeed around the world would understand the magnitude of the economic collapse that was confronting Korea. The IMF also made it clear in this statement that it had come to terms with the Korean government as to the steps that the Korean government was supposed to take in order to comply with the terms of the overall IMF bailout package of $57 billion dollars.

This agreement identified five basic steps that the Korean government would undertake: “The government’s economic program is built around: i) a strong macroeconomic framework designed to continue the orderly adjustment in the external account and contain inflationary pressures involving a tighter monetary stance and substantial fiscal adjustment; ii) a comprehensive strategy to restructure and recapitalize the financial sector, and make it more transparent, market-oriented, better supervised and free from political influence in business decisions; iii) measure to improve corporate governance; iv) accelerated liberalization of capital account transactions; v) further trade liberalization; vi) improve the transparency and timely reporting of economic data.” (source: IMF Agreement, 3 December, 1997).

In effect, the initial point made by the IMF agreement was that the Korean government would have to raise interest rates to stabilize the value of the won and contain any latent inflationary trend. This meant that as interest rates soon rose to double digit rates, many companies that were already in difficulty, particularly small and mid sized companies, soon went bankrupt and even large chaebol companies that were operating on a sound basis found that their interest payments for local currency loans soared to very high levels as rates approached the 20 percent level in short order. This process of raising rates to levels at which many companies found it impossible to continue in business, resulted in large scale job losses and a massive increase in unemployment. On the positive side, the action taken to raise interest rates did cap and then reverse the slide in the value of the won. But as there were few if any signs of inflation in Korea at that time, many felt that the interest rate rises were excessive and thus caused undue hardship on many small and mid sized companies and their employees in particular.

The Asian Development Bank’s ADB Institute published a research paper that highlighted the magnitude of the crisis in unemployment during the IMF crisis period in Korea. It explains that, “Before the 1998 financial crisis, the Korean labor market was near full-employment status, with the unemployment rate less than 3 percent. When the Asian Financial Crisis struck in 1997, the financial market of Korea was totally paralyzed from the impact of the foreign exchange market and, consequently, the high interest rate policy driven by the International Monetary Fund (IMF) led to the closure of many businesses. Massive layoffs followed to reduce labor costs. As a result, the Korean labor market faced a record high unemployment rate of 7 percent in 1998 and 6.3 percent in 1999 for the first time since the 1960s. The number of unemployed skyrocketed from 568,000 in 1997 to 1,490,000 in 1998 and 1,374,000 in 1999.” (source: ADB Institute, working paper 214, published 10 May 2010).

During the height of the crisis period in 1998, the economy shrank 5.7 percent, and while that number is shocking, in every year since that period the Korean economy has grown at positive rates, even during the Global Financial Crisis year of 2008. (source: Yonhap News). But during the height of the IMF crisis in 1998 as tens of thousands of Koreans were losing their jobs, there was little to cheer about and the harsh terms of the IMF bailout program became something of a political football. Extradorinary measures were taken at the behest of the IMF as part of the recovery program, including foreign investors to buy holdings in most Korean stocks up to the 100 percent level, and as well the prior restrictions on the purchase of real estate by foreign investors were completely eliminated. As a result, at a time when many Koreans were suffering the loss of income as a direct result of having been made redundant from their jobs, foriegn investors were able to make substantial gains by investing into the Korean stock market and by buying property.

Even though the Korean economy began to show a strong growth trend from 1999, problems related to the IMF crisis continued to plague the Korean economy. In that year for example, the Daewoo Group, with $50 billion in debt, collapsed in what was then considered to be one of the largest bankruptcies in global business history. (source, The Economist, 19 August 1999). The ramifications of this particular bankruptcy would take years to sort out, but in the short term it meant that another round of corporate layoffs would take place and thus the pain of the crisis lingered on for many Koreans even in the ‘recovery’ years of 1998 and beyond.

As it began to sort out the financial sector, the Korean government closed some banks and non-banking financial companies, including almost the entire merchant banking sector. It also nationalized and merged several of the large banks that had failed such as Hanil Bank and Commercial Bank of Korea, which were taken over by the government, merged and renamed ‘Hanbit Bank’, but then the new bank’s name was further changed to ‘Woori Bank’, the current name of the bank. In the wake of the bankruptcy of Daewoo, a number of the major unit trust companies in Korea, including Korea Investment Trust and Daehan Investment Trust, failed as well. These companies had been managing investment funds that often invested into the debt of Daewoo group companies, and when the Daewoo group companies were unable to repay the bonds, then the value of the investment portfolios in the unit trust funds managed by Korea and Daehan as well as other unit trust managers collapsed as well.

However, the Korean government took over these major unit trust companies and subsequently ordered that investors be paid out at the initial par value of the funds so in this case investors were bailed out by the government. Similarly, no depositors at Korean banks lost any of their funds on deposit as the Korean government arranged for all funds in deposit accounts at the banks that failed to be paid back to depositors. In that instance, the Korean government did protect average Korean investors and depositors from the potential loss of their life savings.

The casuses of the IMF crisis in Korea were manifold and complex in many cases and cannot be described in a textbook manner. The crisis in Korea was unlike those that were happening in Thailand, Malaysia, Indonesia and in other Asian countries during 1997, although there were some similarities such as ‘crony capitalism’, the favoritism shown by the governments to particularly powerful business groups that sometimes led to overinvestment in particular companies and projects. This is little different that what has happened in many other regions at different times throughout history, including the South Sea Bubble in England in the 18th century and the tulip bubble in the Netherlands in the 17th century, and more recently the Global Financial Crisis that hit the economies of the USA, UK and various EU countries with such force.

There has never been a means of protecting a market economy, even modified market economies such as Korea, from periods of economic distress when certain imbalances occur. But it was very much to the credit of the Korean government, including its leader for much of the IMF crisis period, Kim Dae Jung, and to the people of Korea, who pulled up their economic bootstraps and simply agreed to accept the unprecedented foreign influence and investment in the Korean economy into what had been highly protected sectors previously, and made the best of a bad time by working hard to make their companies successful once again. In this effort they succeeded, and that success was transparent for all to see as within 15 years of the IMF crisis Korea had gained entry into the G-20 and was in fact an important participant and the host of this global meeting and ‘club’ of countries that represent the largest economies in the world today.

Many of the lessons that the Koreans learned during the crisis of 1997-1998 have been incorporated into the basic operation of the Korean economy and as a result there is much more economic stability and regulatory oversight of the operations of major financial companies and banks. As well, there has been a far greater oversight by the responsible entities of government over the operations of the major chaebol companies. The net result of these efforts is that to date the Korean government and the economy have not experienced anything like the magnitude of the shocks of the IMF crisis period, even in times of global economic stress. There is no room for complacency in these matters, but the Korean government, banks, non-banking financials and major companies have all made good progress and there is hope that this process will continue.

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