

Restructuring private debt: South Korea

Abstract

The Republic of Korea's policies after 1997–98 crisis showed how quick and comprehensive intervention can reduce private sector insolvency and restart growth. Korea's corporate and financial sectors were heavily indebted when the East Asian financial crisis hit. A rapid-debt-reduction program brought the overhang under control. In manufacturing, the debt-to-equity ratio shifted from 396 percent in 1997 to 211 percent in 2000. The share of nonperforming loans moved from over 8 percent in 1999 to just below 2 percent in 2002. What can other countries learn? First, the policy response was comprehensive. All corporations, large and small, were included in the government's plan to restore solvency. Under government pressure, the country's largest conglomerates negotiated debt workout programs with the banks. Government intervention led to the rollover of 90 percent of small and medium enterprise loans between July and November 1998, the worst month of the crisis. Nonperforming loans fell in part due to the government's program to recapitalize healthier banks and merge or liquidate insolvent institutions. Second, new statutes allowed banks to go bust. The Korean Asset Management Corporation was created to handle bad loans and prevent "zombie banks". Third, the size of the government's response was proportionate to the crisis: financial sector support amounted to 13 percent of GDP between 1998 and 1999. Fourth, accommodative monetary policy managed deflation risks while the participation in an International Monetary Fund program and the introduction of central bank independence in 1998 sent strong signals to the markets. The timeliness and comprehensiveness of the Korean government's actions are strong reminders of the potential importance of public interventions in stabilizing an economy when they are properly targeted, efficiently implemented, and of sufficient scale.

When households and companies begin to borrow too much, countries may lack appropriate financial supervision that limits excessive lending of the private sector. Republic of Korea (henceforth Korea) can serve as a good example on how to reduce debt in the private sector and restore soundness of banks in times of crisis, when a regulatory framework is not fully in place. Moreover, the Korean experience may provide some insights into coping with private debt overhang when financial distress spreads beyond national borders.¹

Korean achievements

In Korea, private debt restructuring occurred mostly in the corporate and financial sectors. In manufacturing, the debt-to-equity ratio decreased from 396 percent in 1997 to 211 percent in 2000. This is an impressive achievement, since in 1997 the Korean manufacturing sector was much more indebted than the sector in other industrialized economies (figure 2). Moreover, restructuring of the banking sector improved the quality of loan portfolios. The share of nonperforming loans to total loans decreased from 8.3 percent in 1999 to 1.9 percent in 2002.

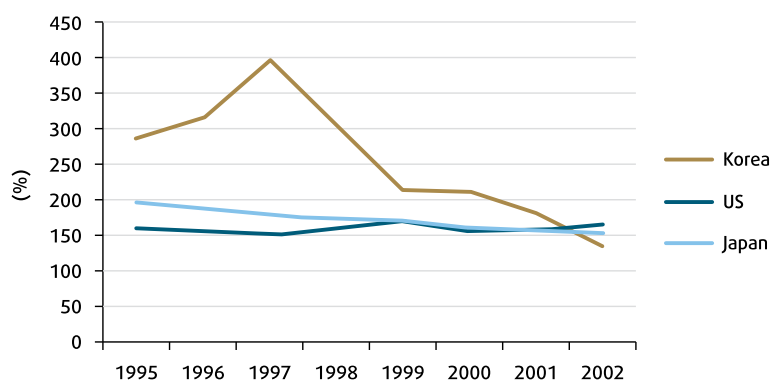
What happened in Korea in 1997?

In the 1980s and the beginning of the 1990s, Korea experienced impressive economic growth. Between 1985 and 1995 GDP grew by an annual average of 9 percent.² As Korea recorded current account deficits, economic growth was partly financed by capital inflows from abroad. On the corporate level, economic prosperity brought greater investment in the country, on occasion



leading to overinvestment. On average between 1988 and 1996, median capital investment amounted to 13.6 percent, in comparison to 10.4 percent in Singapore and 8.3 percent in Hong Kong.³ In many cases these new investments lacked proper risk-benefit analyses.⁴ As indicated by Corsetti et al. (1998), in 1996 in 20 out of the 30 biggest Korean conglomerates the cost of invested capital exceeded the respective rate of return. Lower profitability, however, did not decrease lending to the corporate sector, partly because the Korean government influenced the allocation of credit in the economy.⁵

Figure 2: Debt-to-equity ratio for the manufacturing sector in Korea, Japan, and the US, 1995-2002⁶



Source: Central Bank of Korea, US Census Bureau and Japan's Ministry of Finance.

Even greater risks arose in the banking sector. Although the Korean financial system enjoyed greater freedom thanks to liberalization, it lacked proper regulatory framework that prevented excesses. Korean international banks borrowed short-term funds in foreign currencies to finance long-term loans in domestic currencies, partly for new investments. This currency and maturity mismatch gradually deteriorated the soundness of the banking sector. In the meantime, economic uncertainties together with structural fragility prompted a crisis in Thailand. The crisis hit Korea, when the country's banks were unable to roll over their short-term lending.⁷ The reversal of capital from East Asian markets prompted panic on the markets and plummeting of local currencies.

Due to the widespread crisis, corporations and banks faced pronounced difficulties. In Korea, the share of nonperforming loans among total loans amounted to 7.4 percent in 1997 and surged further to 8.3 percent in 1998.⁸ For the 30 biggest conglomerates, debt-to-equity ratios surpassed 500 percent in 1997, according to Spilimbergo et al. (2008). High interest rates together with a depreciating currency pushed most of the banks and many corporations to the edge of solvency. The interest coverage ratio in manufacturing halved from 129.1 in 1997 to 68.3 in 1998 and increased to 96.1 in 1999, in comparison to the US ratio of 354.0 and the Japanese ratio of 367.5.⁹

How did Korean authorities handle the crisis?

Resolving the crisis

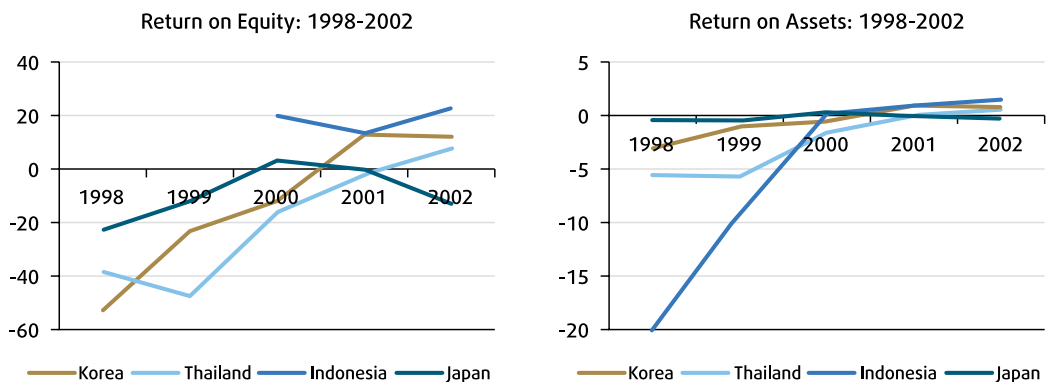
First, private debt restructuring focused on the companies balance sheets. The applied toolkit included asset sales, debt/equity swaps, foreign investments, and equity injections. According to Spilimbergo et al. (2008), in the Korean case debt/equity swaps proved to be particularly useful.

The authorities made sure that all companies, regardless of their size, could address their debt overhang. Big corporations, so-called chaebols, prepared their own workout plans that were later negotiated with banks.¹⁰ Indebted small and medium enterprises (SME) were not left behind. Thanks to pressure from the Korean authorities, between July and November 1998 banks rolled over around 90 percent of SME loans.

Second, Korean authorities focused on the underlying problems in the financial system. Most of the resources were used to restore the health of the financial and corporate sector rather than boosting demand through fiscal stimulus. Banks were recapitalized, merged, or liquidated. A special body was established (the Korea Asset Management Corporation) to handle bad loans. However, good managerial practices were a prerequisite for receiving governmental support.

Consequently, the share of nonperforming loans to total loans declined from 8.3 percent in 1999 to 2.9 percent in 2001 and 1.9 percent a year later.¹¹ Moreover, thanks to reforms at home Korean banks gradually became more profitable (figure 3).

Figure 3: Return on equity and return on assets in Korea, Thailand, Indonesia, and Japan, 1998-2002¹²



Source: IMF (2003).

Third, the response was quick enough to tackle the mounting difficulties. A rapid reaction was possible, because Korean authorities planned changes in the financial system prior to the outbreak of the crisis. In January 1997 the Presidential Commission for Financial Reform was set up to make recommendations on reforms in the financial sector.¹³ Even more importantly, the response was not only rapid but also substantial. Support for the financial sector between 1998 and 1999 amounted to 13 percent of GDP.¹⁴

Fourth, Korea switched from a financial system that did not permit default to one that allows companies to go bust. In 1998, out of thirty-three banks five closed down. As indicated by Cargill and Parker (2002), regimes that allow for bankruptcy seem to have better economic results than state-directed regimes. The restructuring process was also supported by changes in the regulatory framework. Korean authorities loosened rules on hostile takeovers and lifted foreign ownership limits.

Finally, there were additional factors that contributed to Korea's strong recovery. Successful monetary policy prevented deflation. Regulatory changes granted the Central Bank of Korea



independence in 1998.¹⁵ Cargill and Patrick (2005) suggest that Korea's dependence on international markets together with the IMF assistance during the crisis facilitated the speed and depth of reforms.¹⁶ In 2000–2001 Korea took also part in Financial Sector Assessment Program of the World Bank and the IMF aimed at improving the soundness of its banking sector.

Crisis, debt, and the future

Korea was successful in restoring the soundness of its financial sector in an environment of economic crisis. Yet the regulatory framework tamed excessive household borrowing only for some time after the crisis of 1997. Lax lending standards in the credit card market resulted in a surge of credit card debt, amounting to 15 percent of GDP in 2002. Chung (2009) suggests that higher household debt levels since 2000 contributed to greater volatility of private consumption.

However, Korea did achieve a success with its policies. Unlike Japan, Korea managed to tackle the indebtedness of the private sector without depressing the demand in the economy.¹⁷ Rapid and appropriate measures allowed for successful debt restructuring and the country was able to return to economic growth in 1999. The most valuable insight that the Korean experience gives is that countries struck by financial turmoil can still successfully restructure debt in the private sector without jeopardizing their economic prospects.

Sources

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Notes

- 1 The timeframe of this country benchmark covers the years from 1985 until 2002. It is assumed that debt levels accumulated by Korean households and corporations were unsustainable, thus suggesting debt overhang in the private sector.
- 2 Staff estimations based on the IMF's World Economic Outlook Indicators on GDP growth rates.
- 3 Median capital investment equals new investment as a percentage of existing fixed assets.
- 4 Much of banking lending was regulated by the government, with emphasis put on large conglomerates.
- 5 Korean authorities introduced requirements on credit allocation that favored big conglomerates, according to Cargill and Patrick (2005).
- 6 The debt-to-equity ratio equals the total liabilities to shareholder's equity. In the case of Japan, time series data for shareholder's equity start from 2007. As a result, net assets were used instead, following the methodology of Iwaisako et al. (2011).
- 7 At the same time, Japanese banks previously heavily involved in the Korean financial sector started to withdraw from Korea due to mounting problems in the domestic market (e.g., deteriorating profitability and quality of loan portfolios).
- 8 Data on nonperforming loans ratios in Korea prior to 1997 is unavailable.
- 9 Interest coverage ratio equals (operating income*100)/ interest expenses.
- 10 According to Spilimbergo et al. (2008), 8 major banks negotiated with 64 corporations.
- 11 The quality of the loan portfolio in the Korean banking sector was much better than in other countries hit by the crisis. In 1998 the share of nonperforming loans among total loans hit 48.6 percent in Indonesia and 42.9 percent in Thailand, while it stood at 7.4 percent in Korea.
- 12 Data prior to 1998 for selected economies is unavailable.
- 13 The commission consisted of industry, academia representatives and experts from institutions.
- 14 Estimates of Spilimbergo et al. (2008).
- 15 For Korea, the Central Bank Independence index (0=dependent, 1=independent) by Crowe and Meade (2007) recorded an increase from 0.27 in 1980-1989 to 0.37 in 2003. In comparison, Japan's score in 2003 amounted to 0.38, while the US score stood at 0.48.
- 16 For example, IMF assistance was conditional on the implementation of domestic reforms.
- 17 It needs to be underlined that in Korea the indebtedness was concentrated mainly in the corporate sector, whereas Japan's crisis deteriorated corporate and households' balance sheets.