The Korean financial crisis: Diagnosis, remedies and prospects,
Journal of the Asia Pacific Economy

Abstract
Pulling down the curtain on its economic miracle of the last three decades, South Korea suddenly fell into a financial crisis in 1997, and was rescued by the IMF. The causes of the crisis are identified in four different sectors of the Korean economy: the real sector, the banking sector, the securities market and the foreign exchange market. Underlying the numerous causes identified for the crisis is the failure of the very institutions and economic structure that propelled Korea to its economic success, in adapting to emerging changes in domestic and international environments. The IMF rescue package is therefore intended to remedy the institutional and structural flaws. The Korean economy is at a crossroads. If it complies well with the IMF conditionality, the economy will be revitalized based on a firmer institutional and structural foundation within a few years. If, however, Korea fails to do so, it will remain an IMF recidivist. Although it has made substantial progress, Korea still faces serious challenges for a successful completion of the IMF programme.

Keywords: Korean financial crisis, diagnosis, remedies, prospects.

INTRODUCTION
South Korea’s economic success is well documented. It recorded an annual growth rate of 8.8 per cent during the period from 1963 to 1996 (Kwon 1997), and has become a textbook example of successful economic development.

Suddenly in November 1997, however, the Korean economy collapsed from a financial crisis. This crisis started with a number of insolvent businesses. These business failures resulted in non-performing loans for banks that have heavily depended on short-term foreign borrowings. This rendered some banks insolvent. Witnessing these developments, foreign investors and creditors started to withdraw their investment in Korea’s securities market and cut back their short-term loans to Korea. This led the stock price and the Korean currency value to plummet. The Bank of Korea attempted in vain to maintain the value of the won, thereby drastically depleting its foreign reserves.

This series of events led Korea to a financial crisis. Facing a real prospect, Journal of the Asia Pacific Economy 3(3) 1998:331–357 1354–7860 © Routledge 1998 0. YUL KWON
of foreign debt default, the Korean government applied for IMF financial assistance on 21 November 1997 in order to overcome the financial crisis. After vigorous negotiations, the Korean government and the IMF reached an agreement on 3 December 1997 under which the IMF would provide $58 billion of standby loans, extending for three years, with a complex policy package attached. The objectives of this paper are: to analyse the causes of the financial crisis including the triggering (self-fulfilling) mechanism; to review the IMF policy package; to assess the prospects of Korea’s implementation of the agreed policy provisions of the IMF programme; and to evaluate the effects of the IMF programme on the Korean economy.

CAUSES OF THE KOREAN FINANCIAL CRISIS
The underlying causes of the Korean financial crisis would be better analysed by investigating the specific sectors that were the main sources of the crisis. They are the real sector, the banking sector, the securities market
and the foreign exchange market. Since institutions involved in each of these sectors are different, such categorization will be helpful in understanding institutional issues related to the crisis.

The real sector of the Korean economy
High current account deficit was one of the important causes of the Korean financial crisis, as it resulted in an accumulation of foreign debt. After achieving annual surpluses over four consecutive years (1986-89), Korea's current account recorded deficits annually since 1990, except for 1993 with some surplus. As shown in Table 1, the magnitude of the current account deficits was not that serious as compared to GDP until 1995. However, the ratio of current account deficits to GDP increased to 4.9 per cent in 1996, which is regarded as unsustainably high.

Korea's high current account deficits were attributable to a number of factors including a loss of competitiveness of domestic industries. From the beginning of the 1990s, domestic industries were losing competitiveness at home and abroad because of high factor costs (wages, interest rates, and land and distribution costs). Because of the inflexible labour market and sustained low unemployment over a long period of time, the wage rate increased to be the highest among Asian countries in 1995, except for Japan (KDI1996: 7). Owing to the underdeveloped and inefficient financial institutions under tight government control, as further analysed shortly, the financial cost was also highest in Korea among Asian countries (KDI 1996: 9).

Korea's current account deficits were financed largely by capital inflows (Table 1). If the current account deficit were financed by foreign direct investment (FDI), it would not result in accumulation of foreign debt.

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However, in effect Korea had continuously net outflows of FDI since 1990
The loss of competitiveness at home and abroad resulted in declines in export earnings, which in turn prolonged the economic recession that started around January 1996 until the financial crisis occurred in November 1997 (MOF 1998b: 20). In the process of this long recession, a number of firms became insolvent, dumping their non-performing debts on domestic banks. This was part of the genesis of the financial crisis.

Concentration of economic power in a limited number of business conglomerates (chaebols) also attributed to Korea’s high external debt. Economic power concentration in chaebols developed through the implementation of government industrial and export promotion policy, as the government sought to achieve the policy goals through chaebols by providing them with a variety of incentives and protection. This was the genesis of the collusion between the government and chaebols, and generated a perception of chaebols as being 'too big to fail' or being 'bailed out by the government if needed'. This reduced the expected business risk. In addition, chaebols took advantage of their sizes and intersubsidiary loan guarantees in raising debt capital. These factors contributed to chaebols’ excessive expansion and diversification by debt capital, as reflected in a high debt-equity ratio of 449.4 per cent in 1997 (Korea Economic Weekly, 6 April 1998). Their unhealthy structure and financial weaknesses rendered chaebols vulnerable to financial crises.

Another important cause of the Korean financial crisis was the failure of the government to take appropriate action in advance. In the early 1990s, in response to rising globalization and regionalism, Korea gradually opened up its economy. However, the very structure and institutions that propelled the Korean economy to its miracle did not adapt quickly to the emerging changes. Although the problems with the real sector of the Korean economy such as an inflexible labour market, concentration of economic power in chaebols and chaebols’ unhealthy structure have been extensively analysed and prescribed, the government failed to take appropriate action to remedy them over several years. This might be attributable to a lack of agreement on the nature and severity of the problems, a lack of appropriate institutions and leadership and the presidential election on 8 December 1997. It was also highly likely that the Kim Young Sam government would engage in 'forbearance', hoping the situation would improve itself or hide the problems until the end of his mandate in February 1998.

**The Korean banking sector**

The Korean financial crisis was also attributable to the inefficiency and the lack of transparency and accountability of banking institutions and inefficient supervision thereof. The Korean banking sector consists of the Bank of Korea (the central bank), commercial banks, merchant banks, specialized banks established for policy purposes, and the Superintendent of Banks. Korea’s banking institutions were characterized by a lack of independence from the government. The Bank of Korea had a lack of autonomy in its monetary policy because it was the Minister of Finance and
Economy who chaired the Monetary Board, the supreme policy-making body of the Bank, and who recommended a candidate to the President for appointment of the governor of the Bank. The Superintendent of Banks was part of the Bank of Korea and appointed by the President on the recommendation of the Minister of Finance and Economy.

Banking regulations and supervision were fragmented and inefficient. Regulation and supervision of banking institutions were divided between the Bank of Korea and the Ministry of Finance and Economy. Commercial banks were under the central bank's supervision, while merchant banks and all other specialized banks were under direct supervision of the Ministry of Finance and Economy. Furthermore, the insurance and securities sectors, although closely linked to the nation's overall financial sector, were regulated by their own supervisory bodies that were in turn under the control of the Ministry of Finance and Economy.

The banking sector developed a cartel-type structure under government repression and protection over a long period of time. From the Park regime during the 1960s and 1970s, banks were a vehicle of government industrial policy under tight government control. This was the genesis of the system of government-directed finance. At the same time, the government imposed competition-limiting measures, prohibiting *chaebols* from being controlling shareholders of banks and shielding banks from international competition. As a result, the ownership of banks was so widely diversified that Korean banks were regarded as 'entities without owners'. They were thus accountable to no one except to political masters. At the same time, a strong perception has generated that 'banks will never fail' because of government protection. This created the typical principal-agent problem in the banking sector. Since only the agents (bankers) exist without the owners, the agents are bound to collaborate with regulators and politicians (the government).

Korea's banking sector was characterized by a lack of independence from the *chaebols* as well as from the government. *Chaebols* took the lion's share of banks' credit, but they did not provide consolidated financial statements. It also became public knowledge that *chaebols* had contributed large amounts in political donations. These are indicative of a lack of banks' independence from *chaebols*, or a lack of banks' prudence in monitoring their major debtors with regard to their usage of borrowed money. Under these circumstances, together with *chaebols'* insatiable demands for funds, reckless overlending toward *chaebols* was bound to arise.

Under such an institutional setting, the domestic money market could not run efficiently and independently from the government. The government interfered with the market extensively; the allocation of credits and interest rates were regulated extensively by the government. Market distortions and the lack of efficiency and competitiveness of the banking sector increased domestic interest rates (Table 3).

Korea significandy liberalized and internationalized die financial market since the early 1990s, and banks were allowed access to the international financial market. However, the supervisory structure of banks did not adapt to the changes in the financial sector, and the appropriate constraints on risk-taking behaviours of banks were not in place. A lack of proper supervision of banks instigated them in borrowing excessively from offshore financial markets. Given the fact that domestic interest rates were
Table 2 Foreign debt (US$ billion)

<table>
<thead>
<tr>
<th>Date</th>
<th>Long term</th>
<th>Short term</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>43.7</td>
<td>113.8</td>
<td>157.5</td>
</tr>
<tr>
<td>June 97</td>
<td>48.9</td>
<td>114.6</td>
<td>163.5</td>
</tr>
<tr>
<td>Sept. 97</td>
<td>54.1</td>
<td>116.5</td>
<td>170.6</td>
</tr>
<tr>
<td>Nov. 97</td>
<td>54.5</td>
<td>107.3</td>
<td>161.8</td>
</tr>
<tr>
<td>Dec. 97</td>
<td>69.6</td>
<td>84.8</td>
<td>154.4</td>
</tr>
<tr>
<td>31 Jan. 98</td>
<td>87.2</td>
<td>64.0</td>
<td>151.2*</td>
</tr>
</tbody>
</table>

*US$1.7 billion by domestic financial institutions; $17.8 billion by foreign branches of domestic banks; $40.6 billion by private, non-bank institutions; $21.0 billion by the public sector.

... substantially higher than those in the international market, and with the insatiable demands for funds from large corporations, Korean financial institutions took advantage of international financial markets. They relied heavily on short-term borrowings from abroad rather than long-term funds, because

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of lower interest rates for the former. This was reflected in the surge in short-term capital inflows from an annual average of about $600 million over the period 1990-93 to $5.2 billion in 1996 (Table 1) and in short-term debt amounting to $107.3 billion, or 66.6 per cent of total debt of $161.8 billion in November 1997 (Table 2). All of these foreign debts were denominated in foreign currencies (mainly in US dollars), because the Korean won was not listed in foreign mercantile exchange markets, and because hedging tools of exchange risks such as options, swaps and other derivatives have not developed for the Korean won. The extent and characteristics of foreign debts of banks and their lending practices represent a case of adverse selection and moral hazard resulting from the prevailing perception that 'banks will never fail' under government protection, and the lack of transparency in banks' financial information.

THE KOREAN FINANCIAL CRISIS

The securities market
The underdevelopment of the securities market also contributed to the Korean financial crisis because it led companies to rely on debt capital instead of equity capital. The Korean securities market was of only minor significance in mobilizing private savings for corporate financing. The stock market did not develop because private corporations, including chaebols, have been reluctant to list on the stock market, because of their concerns with the dilution of their family ownership and control. Since large corporations or chaebols had low expected business risk because of the perceived government protection, they naturally preferred to leverage themselves with debt capital.

Ordinary Koreans had little faith in the Korean stock market as a longterm stable financial vehicle that can guarantee returns. Returns on stock investment were far lower than those from alternative investments such as deposits in commercial banks. Dividend yields were low because of low profits that could in turn be manipulated by chaebols through cross-subsidization among their subsidiaries (BusinessWeek, 23 March 1998: 18). Since the main strategic objective of chaebols was to expand their market share through
investment, they would retain earnings and minimize dividend payments. Hence, individual investors in the stock market aimed at capital gains that were unstable and vulnerable to changes in political and economic environments.

Individual investors also lacked confidence on the stock market, because of the lack of transparency in financial information of businesses and fund managers. Also, individual investors did not have many rights as minority shareholders under the corporate law (BusinessWeek, 23 March 1998: 18).

The Korean government interference with the securities market through regulations and administrative guidance also inhibited development of the securities market. The government frequently attempted to influence the stock price index, and conducted quantitative controls on security issuance. It also controlled market entry by both domestic and foreign players. Direct investment by non-residents in the Korean stock market was permitted for the first time in January 1992.

Foreign investment in Korean stocks was only $811 million in 1990, but increased to $11.2 billion in 1996 (Table 1). The proportion of listed stocks owned by foreigners also increased from 1.7 per cent in 1990 to 11.6 per cent in 1996 (BOK 1997b: 82).

The foreign exchange market

Government interference in the foreign exchange market and the sustained overvaluation of the Korean won were causes of the financial crisis.80. YUL KWON

The foreign exchange market and the exchange rate were under government regulation, control and management for the last three decades. The Ministry of Finance and Economy had the authority for foreign exchange policy from 1962 until the early 1980s from which it has progressively entrusted the authority to the Bank of Korea (BOK 1995: 22). As a result, the Bank now holds and manages the nation’s external reserves, formulates exchange rate policy and regulates the foreign exchange market in cooperation.

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Table 3 Interest rate, inflation rate and real interest rate (interest rate on general loans by nation-wide commercial banks)

<table>
<thead>
<tr>
<th>Date</th>
<th>Nominal rate</th>
<th>Inflation rate</th>
<th>Real interest rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>11.25</td>
<td>8.6</td>
<td>2.65</td>
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<tr>
<td>1991</td>
<td>11.25</td>
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<td>1.95</td>
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<td>1992</td>
<td>11.25</td>
<td>6.2</td>
<td>5.05</td>
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<tr>
<td>1993</td>
<td>10.25</td>
<td>4.8</td>
<td>5.45</td>
</tr>
<tr>
<td>1994</td>
<td>10.50</td>
<td>6.2</td>
<td>4.30</td>
</tr>
<tr>
<td>1995</td>
<td>10.75</td>
<td>4.5</td>
<td>6.25</td>
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<tr>
<td>1996</td>
<td>11.10</td>
<td>4.9</td>
<td>6.20</td>
</tr>
<tr>
<td>Aug. 97</td>
<td>11.60</td>
<td>4.0</td>
<td>7.50</td>
</tr>
<tr>
<td>Sept. 97</td>
<td>11.83</td>
<td>4.2</td>
<td>7.65</td>
</tr>
<tr>
<td>Oct. 97</td>
<td>11.71</td>
<td>4.2</td>
<td>7.51</td>
</tr>
<tr>
<td>Nov. 97</td>
<td>12.31</td>
<td>4.3</td>
<td>8.01</td>
</tr>
<tr>
<td>Dec. 97</td>
<td>15.32</td>
<td>6.6</td>
<td>8.72</td>
</tr>
<tr>
<td>Jan. 98</td>
<td>17.58</td>
<td>8.3</td>
<td>9.25</td>
</tr>
</tbody>
</table>

with the Ministry of Finance and Economy. The Bank of Korea maintained a managed floating exchange rate system until the financial crisis in November 1997. Before 1990, the exchange system was a multi-currency pegged system. In 1990, the Bank introduced a market average exchange rate system. Under this system, all foreign exchange transactions were conducted on the basis of the market average rate, which was determined by the weighted average of the won-dollar exchange rates applied in spot transactions in the previous business day. The daily exchange rate was allowed to change within a certain band around the market average rate. Although the adoption of the market average rate system increased the role of market forces in the determination of the exchange rate, the perceived stability of the exchange rate under the managed system would have contributed to the increases in foreign borrowings.

Mismanagement of the exchange rate system was one of the causes of the Korean financial crisis. From the beginning of the 1990s, the Bank of Korea pursued a strong won policy, as shown in the appreciated real effective exchange rates during the 1990s until the financial crisis in November 1997 (Table 4). Recent overvaluation of the exchange rate in Korea would be attributable to various concerns and misunderstanding. Concerns with high inflation might have contributed to the policy of appreciated exchange rates. Although Korea has employed exchange rate policy as part of the export promotion instrument, the effect of a lower currency value in raising exports and improving current account balance has been diminished due to the diversification of the economy and high import-reliant industrial structure. Also the importance of non-price competition such as demand cycle was heightened in the world. The current account deficit has recently been worsened by a large deficit in the invisible trade including overseas investment income and increasing payments for fees and royalties. For invisible trade, Korea would save better by maintaining appreciated exchange rates. Furthermore, Korea has been concerned with increases in debt servicing charges resulting from the influx of foreign capital since the early 1990s. All this led the Bank of Korea to maintain the currency overvalued, thereby inducing Korean banks and businesses to take excessive foreign borrowings.

**THE KOREAN FINANCIAL CRISIS**

**Propagation of the financial crisis**
Now that each of the factors for the Korean financial crisis has been examined, the self-fulfilling mechanism through which these factors interacted to trigger the financial crisis will be investigated. In this regard, the triggering impetus for the Korean financial crisis started in early 1997 with highly publicized successive insolvency of some of the major business conglomerates including some *chaebols*. Their insolvency, which was attributed to their excessive borrowings and a prolonged economic recession, revealed *chaebols*’ unhealthy structure and financial weaknesses. By letting a number of *chaebols* go bankrupt, the government signalled a message that it would no longer bail out large companies, whereby their creditworthiness started to crumble. Business failures left non-performing loans to banks, spreading the impetus towards banks. As their non-performing loans accumulated, banks had to withdraw their existing loans and discontinue extending fresh loans, thereby increasing interest rates and further exacerbating business difficulties. This series of developments led foreign investors to lose confidence in the Korean economy and its financial institutions.
In addition, foreign investors, who witnessed the currency crises in East Asian countries from the middle of 1997, became suspicious about the sustainability of the value of the Korean currency that had remained persistently overvalued over a number of years. Devaluation of the currencies of Southeast Asian countries increased the relative value of the Korean currency, thereby putting more speculative pressure on its devaluation. Given the appreciated value of the won with a limited amount of foreign reserves held by the central bank as compared to the mounting short-term, dollar-denominated debt, foreign investors would lose confidence in the value of the won, and start to withdraw their investments from Korea.

Concomitantly, international credit raters rapidly downgraded Korea’s credit ratings. For instance, Standard and Poor’s downgraded the sovereignty credit rating of the Korea Development Bank from A+ on 24 October 1997 to A- on 25 November 1997 (BOK 1998a: 27). This accelerated further the momentum of capital outflows. All these rapid developments instigated foreign investors to engage in bank runs, before devaluation of the Korean won materialized. They withdrew $750 million from the Korean stock market in November 1997 alone (Table 1). This resulted in a sharp drop in Korea’s stock price from 677 in September 1997 to 494 in November 1997 (Table 1). During November 1997, net outflow of short-term capital reached $978 billion (Table 1), and the capital account recorded net capital flights of $3.6 billion (BOK 1998b: 93)

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Table 4 Exchange rates of the won (nominal won/US$)

<table>
<thead>
<tr>
<th>Date</th>
<th>Nominal</th>
<th>Real effective</th>
<th>Equilibrium</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 86</td>
<td>861.41</td>
<td>104.32</td>
<td>828.68</td>
</tr>
<tr>
<td>Dec. 87</td>
<td>792.30</td>
<td>104.19</td>
<td>762.78</td>
</tr>
<tr>
<td>Dec. 88</td>
<td>684.10</td>
<td>88.03</td>
<td>778.18</td>
</tr>
<tr>
<td>Dec. 89</td>
<td>679.60</td>
<td>81.90</td>
<td>824.38</td>
</tr>
<tr>
<td>Dec. 90</td>
<td>716.40</td>
<td>87.29</td>
<td>820.01</td>
</tr>
<tr>
<td>Dec. 91</td>
<td>760.80</td>
<td>87.63</td>
<td>864.20</td>
</tr>
<tr>
<td>Dec. 92</td>
<td>788.40</td>
<td>88.67</td>
<td>889.34</td>
</tr>
<tr>
<td>Dec. 93</td>
<td>808.10</td>
<td>89.78</td>
<td>901.56</td>
</tr>
<tr>
<td>Dec. 94</td>
<td>788.70</td>
<td>87.52</td>
<td>904.78</td>
</tr>
<tr>
<td>Dec. 95</td>
<td>774.70</td>
<td>83.74</td>
<td>920.77</td>
</tr>
<tr>
<td>Dec. 96</td>
<td>844.20</td>
<td>86.46</td>
<td>970.46</td>
</tr>
<tr>
<td>Mar. 97</td>
<td>897.10</td>
<td>88.92</td>
<td>1,007.82</td>
</tr>
<tr>
<td>June 97</td>
<td>888.10</td>
<td>89.62</td>
<td>992.47</td>
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<td>Sept. 97</td>
<td>914.80</td>
<td>87.25</td>
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<tr>
<td>Nov. 97</td>
<td>1,163.80</td>
<td>96.76</td>
<td>1,069.84</td>
</tr>
<tr>
<td>Dec. 97</td>
<td>1,415.20</td>
<td>134.77</td>
<td>1,108.56</td>
</tr>
<tr>
<td>Jan. 98</td>
<td>1,572.90</td>
<td>149.10</td>
<td>1,145.01</td>
</tr>
<tr>
<td>Feb. 98</td>
<td>1,630.00</td>
<td>140.40</td>
<td>1,159.81</td>
</tr>
</tbody>
</table>


1997 to A- on 25 November 1997 (BOK 1998a: 27). This accelerated further the momentum of capital outflows. All these rapid developments instigated foreign investors to engage in bank runs, before devaluation of the Korean won materialized. They withdrew $750 million from the Korean stock market in November 1997 alone (Table 1). This resulted in a sharp drop in Korea’s stock price from 677 in September 1997 to 494 in November 1997 (Table 1). During November 1997, net outflow of short-term capital reached $978 billion (Table 1), and the capital account recorded net capital flights of $3.6 billion (BOK 1998b: 93).
As a consequence, the value of the Korean won slid down steeply from 965 won per US dollar in October 1997 to 1,164 won in November 1997 (Table 4). The vain attempt to defend the Korean won by the Bank of Korea ended up with a dramatic reduction of its usable foreign reserves from $22.3 billion in October 1997 to $7.3 billion in November 1997 (Table 1). Contrary to the dwindling foreign reserves of the Bank, short-term foreign debt amounted to $107.3 billion in November 1997 (Table 2). Korea finally faced a financial crisis in the form of a banking crisis (debt defaults, bank closures and debt rescheduling) and a currency crisis in which the central bank was not able to defend its currency. Confronted with an imminent foreign debt default, Korea applied for assistance to the IMF on 21 November 1997. The IMF agreed to rescue Korea from its financial crisis on 3 December 1997 with $58 billion of standby loans, extending for three years, with its conditionality (a set of policy actions) attached (BOK 1998a: 28).

THE IMF RESCUE PACKAGE
The original agreement between the Korean government and the IMF was signed on 3 December 1997, but was amended twice on 8 January and 17 February 1998. The IMF policy package for Korea, as performance criteria for the release of successive amounts of financial assistance, consists of three components: (1) macroeconomic policy, (2) financial sector restructuring, and (3) other structural reform measures. The objective of macroeconomic policy appears to restrain aggregate domestic demand in order to restore a sustainable balance between aggregate demand and supply, thereby reducing the current account deficits and at the same time maintaining stable price. Other measures included in the macroeconomic policy are: to maintain a flexible exchange rate system without state intervention and to build up foreign reserves (MOFE 1997: 21).

The restructuring of the financial sector and other structural reform measures are both supply-side policies. They intend in essence to remedy all the institutional and structural causes of the financial crisis. This will then improve resource allocation by improving the efficiency, transparency and accountability of financial institutions and businesses and by eliminating economic distortions. The causes of distortions the IMF encompasses are numerous: price rigidity (wages and interest rates), adverse selections and moral hazard by financial institutions, monopolistic operations of chaebols and banking institutions, controls of foreign exchange rates, trade restrictions and capital account restrictions. It appears that the IMF package attempts to remove all the distortions simultaneously, perhaps based on the standard second-best considerations.

Consistent with the IMF conditionality, the Korean government submitted a Memorandum of Intent to the IMF on 7 February 1998. This Memorandum comprises a set of the agreed policy provisions of the IMF programme and identifies a number of performance criteria (in terms of the extent and timing of policy achievement) which will be monitored by the IMF. Access to the outstanding funds of the IMF is conditional on the observance of the performance criteria.

The key components of the Memorandum on the policy actions are as follows. First, the projections of macroeconomic policy for 1998 include: to shift the current account deficit to surplus, to contain inflation below double digits, and to limit the real GDP growth at 1 per cent. This requires
restraining monetary and fiscal policy. As part of monetary policy, money supply in terms of reserve money (currency in circulation and reserve deposits of commercial banks with the Bank of Korea) is restrained to grow at 9 per cent a year. For fiscal policy, the government is required to generate a small surplus in 1998. Also included in the projections are increases in the usable foreign reserves of the Bank of Korea to $20 billion by the end of March and further to $30 billion by the end of June 1998.

For the restructuring of the financial sector, which aims at remedying the structural and institutional flaws of the financial system, required policy actions include: (1) a passage of financial sector reform bills, and (2) other restructuring measures of the financial sector. The financial reform bills are to increase the central bank’s independence, to consolidate and strengthen the supervision of all financial institutions including banks, securities firms and insurance companies, and to make financial institutions provide transparent financial statements. Other measures are to recapitalize financial institutions, to liquidate and restructure insolvent financial institutions, to allow mergers and acquisitions of financial institutions, to dispose of nonperforming loans, and to allow foreign entry into the domestic financial sector.

For the other structural reform measures, required policy actions include: (1) trade liberalization, (2) capital account liberalization, (3) corporate governance and structural reform and (4) labour market reform. Trade liberalization aims at advancing the timetables of complying with Korea’s WTO commitments such as elimination of trade-related subsidies and trade restrictions, and streamlining import procedures. The capital account liberalization is to open up the securities market - both stocks and bonds - to foreign investors, to eliminate restrictions on incoming foreign direct investments, and to allow Korean corporations to borrow from abroad. The corporate governance and structural reform intends to improve the transparency of companies’ financial statements, to reduce the debt-equity ratio of corporations, to prevent the system of mutual guarantees within chaebols, and to make chaebols produce consolidated financial statements. Finally, the labour market reform is to improve labour market flexibility.

IMPLEMENTATION OF THE IMF POLICY PROVISIONS
It is self-evident that IMF financial assistance has succeeded so far in rescuing Korea from the verge of foreign debt default. In view of the sequence of events that rapidly developed towards the financial crisis in late 1997, no one would expect that Korea had any choice but to apply for IMF assistance. The severity of the initial situation and Korea’s inability to prevent the propagating crisis vindicate the agreement between the Korean government and the IMF. In view of the fact that Japanese and US creditors rebuffed Korea’s request of rolling over short-term debts prior to the crisis, the IMF rescue package was also the catalyst in rolling over $21.4 billion, or 94.8 per cent of Korea’s international short-term debts to long-term debt with maturity ranging between one and three years (Korea Herald, 14 March 1998).

In order to assess the effects of the IMF programme on the Korean economy, one has to estimate first the extent to which Korea will implement the agreed policy actions indicated in the Memorandum of Intent. In this regard, each of the major components of the IMF conditions will be examined in terms of its implementation, difficulties thereof and implications
for the Korean economy. The Memorandum was signed by the
Korean government, and Korea has to comply with the IMF conditionality
in order to have access to successive IMF financial assistance. However,
there is no guarantee that Korea will comply, fully and faithfully, with the
policy actions as originally set: Korea can choose to rescind the agreement
with the IMF and give up part of the funds, because of any reasons including
political costs.12

THE KOREAN FINANCIAL CRISIS
Although it is too early to assess the extent of compliance with the IMF
package, Korea appears to have political will and leadership to implement
the IMF programme faithfully. The new Kim Dae-jung government was
inaugurated on 25 February 1998 with a de facto mandate of reshaping the
economy and rescuing it from the crisis. President Kim Dae^ung is the first
to have come to power without any obligations to giant businesses, and this
would be one of the important advantages President Kim has in
implementing these reforms as compared to his predecessors. Besides, with his
five-year term of presidency, President Kim Dae^ung may not engage in
forbearance

- hiding or delaying the problem.

Macroeconomic policy
So far the Korea government has complied with the required macroeconomic
policy actions faithfully. However, the restraining monetary and
fiscal policy would be an onerous task. The permitted increase in money
supply at 9 per cent a year is quite a contractionary policy, as compared to
17.7 per cent annual growth over 1986-96 period (BOK 1997b: 16).
Required generation of a budget surplus in 1998 will be a daunting task
with a weaker growth outlook of the economy together with rising new
expenditures for social safety nets including unemployment insurance
expenditures. In addition, government expenditure for purchasing and
managing non-performing loans of banks is expected to reach 0.8 per cent
of GDP in 1998.

Contractionary monetary and fiscal policies will all exacerbate credit

- crunch that results from the restructuring of banks. These banks, together

- with their mounting non-performing loans, have to meet the required
capital adequacy ratio of 8.0 per cent based on the standard of the Bank for
International Settlement (BIS). This will surely raise interest rates, further
aggravating economic and business difficulties. It appears that the IMF
allows the rising interest rates as a principal way of attracting foreign capital
and recovering the value of the Korean currency. It should be noted that
foreign capital flew out and the won lost its value because of the loss of

- confidence on profitability arising from investing in Korea or

- holding the Korean won. Such confidence depends not only on expected
returns (or interest rates) but also on risk. Aggravation of the economic
condition arising from high interest rates will erode foreigners’ confidence
in the Korean economy and its currency, thereby inhibiting capital
inflows.13

Financial sector restructuring
One of the areas that has substantially met the IMF conditions is financial
sector reform. On 29 December 1997, the National Assembly passed a set
of financial reform bills (BOK 1998a: 100-10). Key parts of the bills were
the revision of the Bank of Korea law and an establishment of a unified
financial supervisory organization (the Financial Supervisory Commission)
for banking, securities and insurance sectors. Under the revised Bank of
Korea law, the central bank has gained substantial independence from the government in its operation of monetary policy. For instance, the Bank’s governor, appointed by the President through a deliberation of the Cabinet, will chair the Monetary Board of Korea. Under the old law, the governor of the Bank was appointed by the President on the recommendation of the Minister of Finance and Economy, and the Minister was the chair of the Monetary Board. Also the number of the Monetary Board members was nine, with five members recommended by the government, while under the new law the number of Board members decreased to seven, with only two being recommended by the government. At the same time, the Bank of Korea is specifically assigned the primary goal of controlling inflation, and its responsibility and transparency have been enhanced. For this purpose, the Bank will be audited by outside auditors, and has to table an annual report on its operation to the National Assembly.

The new Financial Supervisory Commission has also gained substantial independence from the government. First, all the supervisory functions of financial sectors are unified under the Commission, which is placed under the control of the Prime Minister’s Office. The President appoints the Chair of the Commission through a deliberation of the Cabinet. The Commission has its administration body, the Financial Superintendent, chaired by the chairperson of the Commission. This is in contrast to past practices in which the President appointed the chairs of the three financial supervisory organizations — banking, securities and insurance — on recommendations of the Minister of Finance and Economy, and all the supervisory bodies were under the control of the same minister.14

With the establishment of the Financial Supervisory Commission, macroeconomic policies will be led by three axes: the Ministry of Finance and Economy for economic planning and fiscal policy, the Bank of Korea for monetary and foreign exchange rate policy, and the Financial Supervisory Commission for supervising and controlling the financial sector. This is a significant improvement over the earlier institutional framework under which the Ministry of Finance and Economy exerted full control in almost all economic policy areas, including macroeconomic policy, budget, taxation, financial markets and foreign exchange. At the same time, the financial sector will be governed by three axes under the new financial laws: the Minister of Finance and Economy for opening, closing and merging of financial institutions, the Financial Supervisory Commission for their ownership and control, and the Financial Superintendent for actual administration of auditing, regulations and supervision of financial institutions. This is a significant improvement in the supervision of the financial sector.

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It appears that operational efficiency of financial institutions would improve under the new financial framework. The state-run Korea Asset Management, funded by the government, was established in late 1997 to purchase and manage non-performing loans held by financial institutions. This will enable financial institutions to write off their bad loans. The Financial Supervisory Commission has directed all financial institutions with excessive risk exposures to undertake management adjustment, including suspension and liquidation, and to submit their recapitalization and selfrescue measures. Also, the new financial framework allows active mergers and acquisitions (M&A) and market entry/exit within the financial sector — either by foreign or domestic investors. The ownership limit of commercial banks by a single entity still remains at 4 per cent. However, an exception was introduced by which a foreign investor can purchase up to 10 per
cent of a bank’s shares.\textsuperscript{15} Permission of M&A within the financial sector together with permission of foreigners’ entry into the financial sector will break the previous cartel-type structure of the banking sector and enhance competition among banking institutions.\textsuperscript{16} In addition, the operational transparency of financial institutions will improve under the new law, because they are required to have complete contracts for external audits by internationally recognized accounting firms. Also banks are required to establish the board of directors, with director members selected by shareholders who will in turn help enhance the operational transparency.

Although Korea has succeeded in legislating reforms of the financial sector, actual implementations of reform and restructuring take time. One of the thorny tasks is how to deal with insolvent financial institutions under the new law. The government seeks to do this by promoting M&A by either domestic or foreign financial institutions. However, no M&A for troubled financial institutions had taken place by mid-1998. Another task is an achievement of the capital adequacy ratio of 8 per cent by commercial and merchant banks in line with the guideline of the BIS by the end of 1998. As banks seek to undertake their recapitalization up to the required level, they will withdraw existing loans and decline new loans. This will create credit crunch and high interest rates, adversely affecting the economy. This will in turn slow down the recovery of the confidence in the Korea market by foreigners.

**Capital account liberalization**

With regard to capital account liberalization, the government announced on 31 March 1998 that, beginning 1 July 1998, it would abolish all controls on capital movements (by both Koreans and foreigners). Koreans’ overseas investment and borrowing, incoming FDI and establishment of financial institutions \textit{(Korea Herald, 31 March 1998)}. This indicates the government intention to comply fully with the IMF requirements of capital account liberalization. In order to expedite the FDI procedure, the government has introduced the so-called ‘one-stop’ service system for incoming FDI and placed it under the Korea Trade-Investment Promotion Agency (KOTRA) \textit{(Korea Herald, 3 April 1998)}.\textsuperscript{17}

**Trade liberalization**

The Korean government announced its commitment to fulfil the trade liberalization requirements by the end of 1998 (MOFE 1998b: 27). This can be done because trade liberalization will be done mainly through administrative decrees and regulatory rulings without recourse to the National Assembly. It looks unlikely that the effects of trade liberalization would create seriously adverse impacts on the Korean economy.

**Reform of the labour market**

One of the most important reforms Korea has achieved so far is the change in the labour laws. The National Assembly passed a new labour law on 14 February 1998, which was one of the IMF conditions. Under the new law, companies are able to dismiss workers without consent from their unions when they face ‘emergent situations’ such as financial problems, mergers and acquisitions.\textsuperscript{18} The change in the labour laws will enhance the flexibility in the labour market, which in turn will mitigate the wage pressure on Korea’s international competitiveness and expedite corporate restructuring. It will also facilitate foreign investment including takeovers of Korean firms, because the inflexibility in the labour market under the old law was regarded as one of the serious impediments to foreign investments in Korea. However, Korea lacks experience in laying off workers and labour
management under the law that allows layoffs. Therefore, illegal labour practices such as unfair dismissals and illegal strikes are likely to occur. In addition, actual layoffs and accompanying increases in the number of unemployed workers will incite labour disputes. The IMF programme will also have effects on income distribution. The urban working class will be particularly at risk of dismissal and income reduction. This will exacerbate labour disputes and social unrest.

Corporate governance and restructuring
It appears that the most difficult part of the IMF conditionality is corporate structural reforms and sound and transparent business operation. In this respect, a significant improvement that has so far been achieved is the so-called five-point agreement between the government and chaebols on corporate restructuring. They are: mandatory reporting of consolidated financial statements by chaebols, eliminating the practice of cross-guarantees of debt between subsidiaries; improving corporate financial structure; focusing on a limited number of core operations; and making shareholders and executives more accountable (Newsreview, 25 April 1998: 6).

It was recognized that the financial structure of Korean businesses was not sound as reflected in the debt-equity ratio of thirty chaebols reaching 449.4 per cent in 1997 (Korea Economic Weekly, 6 April 1998: 6). This high ratio was one of the main sources of the financial crisis. In this regard, the government through the new Financial Supervisory Commission has recently ordered chaebols to reduce their debt ratio to 200 per cent by the end of 1999 (Korea Herald, 1 April 1998). It does not appear befitting to market economy principles to order private companies to reduce their debt ratio to a certain level. However, the government, if strongly determined, can achieve the target debt ratio by employing various legitimate instruments.

The Financial Supervisory Commission is empowered to order banks not to extend loans to companies with a debt ratio higher than a target level. The government appears to expect that chaebols would meet the required debt ratio by divesting some of their marginal companies.

Obviously the transparency and accountability of business operation has been highly emphasized. In order to meet the IMF requirements regarding business transparency, the government intends to undertake a host of reforms. First, the companies listed on the Korean Stock Exchange will be required to prepare and audit their financial statements in accordance with international standards, involving external directors and auditors. Second, chaebols will be required to publish consolidated financial statements and to reduce cross-guarantees by affiliates/subsidiaries. Third, in order to improve the accountability to their shareholders, listed companies will be required to have at least one outside director, to remove restrictions on voting rights of institutional investors, and to strengthen minority shareholders’ rights by lowering the thresholds on exercising their rights. The government intends to review the possibility of allowing the class action suits against corporate executives and auditors (Korea Economic Weekly, 2 March 1998: 4-5).

Despite the publicly announced government intent to undertake corporate restructuring, there are few concrete signs that corporate reforms are being taken seriously. There are practical difficulties in implementing corporate reforms. In order to eliminate cross-guarantees of loans and to raise the debt ratio to the required level, chaebols will need to dispose of assets or marginal companies. However, Korean accounting standards
differ from the international standards, and there is a serious lack of Korean accounting and legal professionals with experience in M&A. Therefore, it will take some time to produce adequate financial statements for assets or companies targeted for M&A.

One of the highest hurdles in implementing the IMF reform requirements related to politics. President Kim Dae-jung is committed to economic reform. However, partisan politicians stand in the way. President Kim’s most immediate problem is that the former ruling party, the Grand National Party, still holds the majority of seats in the National Assembly. Although the urgency of the economic situation has so far ensured a swift passage of financial and labour reform bills, such political cooperation has ebbed lately. Koreans are patriotic and nationalistic, as demonstrated by the public campaign to collect gold - raising $1.84 billion during the two-month period of January and February 1998 (MOFE 1998c: 23). In such a country, foreign investment and takeover of domestic firms could generate political problems, as Koreans would view them as an intrusion of economic sovereignty. Also, as the unemployment rate and layoffs increase, more labour unrest is likely to occur, which may develop into political problems.

Korea has witnessed over the past several years that the bureaucrats have not been able to implement structural reforms in business and financial sectors. It is not enough to change laws: the bureaucrats who administer them should also be reformed. The IMF reforms are in essence to further liberalize and internationalize the overall Korean economic system. The IMF message regarding the role of government is clear. The government should abdicate the government-led economic system, eliminate economic interventions and regulations, and maintain the stability of the financial system based on market principles. The government’s economic role should thus be limited to sound macroeconomic policy. This requires a downsizing of the government as the Kim Dae-jung government has announced its plan to do so. However, as the agency theory indicates, bureaucrats would resist the downsizing of the government and be reluctant to cooperate in implementing the required reforms. Finally, supports from the general public are required. However, Korean psyche stands in the way of restructuring. Because of their nationalistic attitudes, Koreans appear to be resentful about the IMF conditionality, as they view it as an intrusion of economic sovereignty. Support from the public will taper off if economic hardship and injustice continue.

EFFECTS OF THE IMF PROGRAMME ON THE KOREAN ECONOMY
Assessment of the effects of the complex IMF policy package on the Korean economy is a difficult task. First, the impacts on the Korean economy of the IMF programme depend on the extent of the implementation of the programme.

As examined earlier, it is too early to estimate whether the IMF policy package will be implemented as originally set in Korea. For the purpose of assessment of the IMF impacts, it is assumed that the IMF policy actions will all be implemented, as originally committed by the Korean government. Conceptually, assessment will be conducted by comparing the Korean economy with the IMF policy package implemented with its counterfactual state in the absence of the same IMF package. Performing a counterfactual experiment cannot be done easily, and is beyond the scope of the present study. In the following, an attempt will be made to estimate the IMF policy impacts on the Korean economy by employing pertinent theoretical concepts and by bringing to bear the empirical evidence available in the literature on the task. It should be noted, therefore, that the
results of the present assessment are tentative. The assessment will be conducted in terms of the IMF impacts on the target variables consistent with the broad objectives of the IMF programme, including the current account balance, inflation, the exchange rate and economic growth. This will be done over the short-run and long-run contexts, given a general consensus in the literature that short-term (one year) effects of the IMF programmes on participating economies are different from long-term (three years) results (Khan and Knight 1985; Conway 1994).

The current account balance would improve in Korea following the implementation of the IMF programme. This would be attributable in part to devaluation of the won from its overvalued position prior to the crisis and restraining aggregate demand. Empirical findings of the effects of the IMF programmes on exchange rates have been controversial. Killick et al. (1992) have observed that devaluation of the exchange rate occurred with the IMF programme and sustained in the post-programme years, while Conway (1994) and Santaella (1996) have found no significant impacts on exchange rates. In the case of Korea, the value of the won depreciated remarkably from 965 won/dollar in October 1997 to 1,630 won/dollar in February 1998 - well below its equilibrium level (Table 4). This devaluation should not be attributable to the IMF programme. Rather it was expected that the won would recover its equilibrium value after IMF financial assistance was provided. It appears that the impact of the IMF programme on exchange rates has not been fully realized. Although the won recovered somewhat, its depressed value has been sustained at a level well below the equilibrium rate (real effective rate), largely because foreign investors have not recovered their confidence in the Korean economy, and foreign capital that had left Korea at the outset of the financial crisis has not yet returned. As the IMF programme is being further implemented over time, foreign investment will return to Korea, raising the value of the won.

Korea’s current account has improved significantly. Up until November 1997, Korea had a current account deficit, but it switched to surplus in December 1997. For the first two months of 1998, current account surplus amounted to $6.9 billion that was attributable to a surge in exports and a marked drop in imports (Korea Economic Weekly, 30 March 1998). This is a remarkable improvement in the current account, as compared to deficits of $23.7 billion and $8.9 billion, respectively, in 1996 and 1997. There are however some grounds for concern. The surge in exports is in part accounted for by $1.84 billion of exports of gold collected through the public campaign. Credit is not available for importing capital and intermediate goods on which Korean exports heavily rely. Korean exporters rely heavily on banks for short-term bridge financing between payments for imports and exports. Banks are currently not providing such finance. It appears therefore unlikely that the export surge will continue. Since Korea’s exports rely heavily on imports of raw materials and intermediate and capital goods, the short-term cutbacks in imports would damage export capability in the medium and long term.

The inflation rate is expected to increase immediately following the introduction of the IMF programme largely because of increases in import prices that are not necessarily attributable to the IMF programme. The inflation rate during the first quarter of 1998 was 8.9 per cent at an annual rate, as compared to the inflation rates of 4.9 per cent and 4.5 per cent, respectively, in 1996 and 1997. Over time when the tight monetary and fiscal policy takes effect, restrained aggregate demand would lower inflation. This is supported by an empirical study by Conway (1994) that
has observed no evidence of a significant effect of IMF programmes on inflation.

The most controversial and critically important area is the relationship between economic growth and the IMF programmes, as the enhanced economic growth performance reduces the probability for the participating countries to demand financial assistance again from the IMF (Bird 1996). There is a general consensus from empirical studies that IMF programmes have negative impacts on investment, which is one of the key factors for economic growth (Conway 1994; Killick et al 1992; Bird 1996). This is consistent with a conceptual relationship between investment and monetary policy for an open economy under the floating exchange rate (Mishkin 1995; Taylor 1995).

Restrictive monetary policy will adversely affect investment through a number of transmission channels: resulting high interest rates, lower asset (equity) price and lower availability of credit. Short-term investment in Korea would be worsened with the IMF programme. Adjustment costs, high interest rates, depressed asset (equity) price and a shortage of credit resulting from the required tight monetary policy will all have adverse effects on investment. One of the important factors for rapid growth in investment in Korea was the low risk of investment perceived by the business community, because of government protection or the prevailing perception of 'government bail-out if needed'. As the IMF programme is being implemented, such perception will recede, whereby the perceived investment risk increases and investment prospects worsen.

These adverse effects on investment appear to be reflected in marked decreases in investment. In the manufacturing sector, domestic construction and machinery orders declined, respectively, by 70.8 per cent and 8.0 per cent in December 1997, below the level of December 1996 (MOFE 1998c: 49). Investment by the public sector will be adversely affected, although it accounts for a minor portion of about 14 per cent of the nation’s total investment.

The government is required to maintain a budgetary surplus in the face of rising costs for social safety nets and for the management of the Korea Asset Management Corporation. Under this circumstance, short-term political considerations are likely to lead the government to favour policies that reduce investment in preference to government current expenditure. Over the long run, however, the IMF programme will pay dividends with positive investment performance as foreign savings and foreign direct investment increase with capital account liberalization and with improvements on economic efficiency and institutions.

Tight monetary policy under the IMF programme will adversely affect economic growth not only by its negative impacts on investment but also through its adverse effects on consumption. Contractionary monetary policy would lower the asset (equity) price. This will lower consumption in so far as Modigliani’s life-cycle model of consumption holds true. This appears to be borne out in a marked reduction of consumption by 8.5 per cent in December 1997 below the level in December 1996 (MOFE...
Taking for granted that economic growth will be adversely affected by the implementation of the IMF programme in the short run, what would happen to the economy in the medium or long run? Khan and Knight (1985) and Conway (1994) have found empirical evidence that growth performance of participating countries improves significantly in the long run. While the restraint of aggregate demand exerts an adverse effect on economic growth in the short run, the supply-side or structural reform policies enhance the productive potential of the economy by improving the allocation of resources. Implementation of supply-side policies takes longer time, and their effects on output are realized after a significant delay.

If successful, these structural reform policies restore confidence of foreign investors in the economy and allow for a high sustainable level of foreign capital inflows. In addition, as the World Bank (1993) points out, macroeconomic stability itself which would result from the IMF programme is conducive to economic growth. These long-term beneficial effects on growth performance from the supply-side policies of the IMF programme would outweigh the short-term adverse effects on output. In so far as the supply-side policies eliminate inefficient structures and distortions, the potential economic growth would be enhanced permanently.

The empirical evidence by Khan and Knight (1985) and Conway (1994), and the underlying theoretical mechanism between the short-term and long-term effects of the IMF programmes, appear to hold up in Korea. As far as the structural reforms of the financial sector and other business sectors are undertaken, as indicated in the Memorandum of Intent, Korean economic structure and institutions will become streamlined, and distortions in resource allocation will be lessened to a considerable extent. This will raise long-run economic growth potential. Economic power has been overly concentrated in a limited number of chaebols, and they have practised monopolistic operation of business within the country. Monopolistic operation generates efficiency loss not only in the form of traditional deadweight loss but also in a number of different forms of losses such as X-efficiency (Leibenstein 1966), rent-seeking activities by monopolists (Posner 1975), and investment in excess capacity to prevent new entry (Lyons 1986). Hwang (1998) has estimated the loss from monopolistic business practices in Korea to range from 0.12 per cent to 2.89 per cent of GNP.

Once the Korean market is further open and chaebols’ monopolistic power diminishes, growth potential will be permanently enhanced. Finally, the financial sector restructuring, once successfully implemented, will substantially improve the functioning of the Korean financial system. As Levine (1997) shows, a growing body of empirical analysis demonstrates a strong positive link between the functioning of the financial system and long-run economic growth. Hence, the improved Korean financial system will bolster its long-run economic growth potential. Part of the causes of the financial crisis in Korea was its loss of competitiveness due to increases in factor costs.

The labour market reform and capital account liberalization will certainly mitigate factor cost pressures on international competitiveness, whereby long-term growth potential will enhance. Therefore, a conclusion can be drawn that it would take a few years for the Korean economy to recover from the initial setback and resume its potential growth.
CONCLUSIONS

After a successful performance over the last three decades, the Korean economy fell into a financial crisis in November 1997 and was rescued by the IMF. There are a number of causes of the financial crisis. They include: accumulation of current account deficits, sustained appreciation of the currency value, mismanagement of the financial sector, excessive short-term, foreign currency-denominated debt, and the contagion effect. These are common causes in the literature for financial crises. Unique to the Korean financial crisis is the concentration of economic power in a limited number of chaebols that have excessively expanded and diversified with debt capital. Above all, the very institutions and business structure that propelled Korea to its economic success have caused the crisis, simply because they have failed to adapt to emerging changes in domestic and international environments.

Upon request by the Korean government, the IMF agreed to provide financial assistance to save Korea from foreign debt default, but with a strict conditionality attached. The IMF conditionality includes sets of demand-side and supply-side policies. The former is intended to restrain aggregate domestic demand, and the latter aims at improving resource allocation by means of market opening and structural reforms of the financial and business sectors and the labour market.

Whether the Korean economy will recover and revitalize depends on the extent of implementation of the IMF conditionality. The new government appears to have committed itself to implement the IMF policy package, and liaison made substantial progress. However, for a successful completion of the IMF programme the government is in need of support from politicians, chaebols, bureaucrats, unions and the general public. This is a daunting task for the new government. In order to mobilize cooperation from these pertinent sectors of the society for the nation’s ultimate objective of economic recovery, the new government may have to appeal to the prevailing high patriotism in Korea. The national goal of economic prosperity has been reinforced by economic crises that Korea has experienced in the recent past. The 1997 financial crisis would prove to be a force that unites Koreans to rally their cooperation for the task of resolving the crisis.

The Korean economy is at a crossroads. If Korea complies faithfully and decisively with the agreed IMF conditionality, a firmer structural and institutional foundation will be established for future economic prosperity. Taking advantage of the strong economic fundamentals with a powerful industrial base, a high savings rate, a highly educated and industrious labour force, and well-developed R&D infrastructure, the Korean economy would recover, and the nation will emerge anew as an even more dynamic economic power. The 1997 financial crisis will then be considered as the necessary price for reform and transition, and will prove to be a blessing in disguise for the Korean economy. If, however, Korea does not fulfil its committed compliance with the IMF policy package, those causes of the financial crisis, as identified by the present study, will sooner or later return to haunt Korea, and Korea will remain an IMF recidivist.

A critical question is therefore how to enhance the probability of success
in implementing the IMF conditionality. Empirical evidence in the literature indicates that such probability improves with an encouragement of economic growth as a top priority. The IMF authority together with the Korean government may therefore have to relax the contraction of aggregate demand and exert a concerted effort on growth promotion policies. In addition, Korea should now forge a new economic strategy based on the essential market principles of competition, transparency and openness. The new strategy itself should be transparent and accountable, and include development of market-supporting institutions.

School of International Business, Griffith University

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