

Assessment of Korea's Financial Liberalization

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I. Introduction

Korea has pursued trade and financial liberalization since the early 1980s when the government began to respect the market mechanism. The stance of liberalization policy was both gradual and cautious. The sequencing of liberalization was emphasized from the beginning so that trade liberalization preceded the financial liberalization in the 1980s, followed by financial liberalization in the 1990s. A wave of financial liberalization emerged in other developing countries during the same period.

Before the financial liberalization, the economic performance of many countries deteriorated under financial repression. However, market-based financial liberalization did not always bring the efficient allocation of financial resources. Many developing countries including Korea experienced financial crisis with financial liberalization. Surges in capital inflows after liberalization that stimulate corporate overborrowing and bank's overlending can lead to a crisis of boom-bust type, unless the liberalization is well phased and financial regulation and supervision are well instituted.

In retrospect, Korea's financial liberalization seemed ill-sequenced to contribute to the crisis, although it is not the primary cause for the crisis. The internal and external liberalization helped borrowers to secure funds. The middle-sized chaebols had a better chance for borrowing with financial liberalization and financial institutions underestimated the risks of loans to those groups. The liberalization encountered many problems as the banking skills, supervisory agencies, and the legal infrastructure cannot develop quickly. However, Korean crisis is different from the typical boom-bust crisis after the liberalization, because the refusal of foreign creditors to roll over their loans for fear of corporate insolvency, instead of the collapse of the asset bubble, resulted in the crisis.

The paper is organized as follows. Section 2 reviews the financial liberalization in Korea. Section 3 discusses the role of financial liberalization in Korea's financial crisis. Section 4 provides the concluding remarks.

II. Financial Liberalization in Korea

Korea's financial liberalization has been both gradual and cautious until the liberalization measures of the big bang style were implemented after the crisis in 1997. Korea started the liberalization program in the early 1980s after the government intervention in the 1970s created various forms of distortions in the economy. The poor economic performance in the beginning of the 1980s provided the momentum to consider the costs of interventionist development policy and switch to the market-oriented development strategy. Table 1 summarizes major deregulatory measures since the early 1980s up to 1996.

Financial deregulation began with the privatization of nationwide commercial banks and the abolition of various restrictions on bank management in the early 1980s. The government's control of credit and interest rates was also loosened. In June 1982, most preferential interest rates on policy loans

were abolished. In 1984, financial institutions were allowed to set their lending rates within a band. The government announced the plan to decontrol bank and non-bank lending rates in December 1988, but it was turned down just after the decontrol brought in the rise in interest rates and the economic slowdown in 1989. The interest rate liberalization plan resumed in August 1991 when the economy recovered from the setbacks related to the democratization movements and frequent labor strikes.

To promote the competition among financial intermediaries, the relaxation of entry barriers and opening of the financial industry including banks, life insurances, securities, lease, and investment trust progressed after 1988. Meanwhile, the current account surpluses in 1986-89 stimulated liberalization in foreign exchange and capital account.

The liberalization has accelerated since the latter half of the 1980s. The current account surpluses in 1986-89 helped deregulate foreign exchange transactions in areas such as position management, document requirements, and the international use of the won. Korea accepted the IMF's Article VIII in November 1988. The significant step was taken in March 1990 with the introduction of the Market Average Exchange Rate System in which exchange rates were allowed to fluctuate within a band.

The liberalization of the financial sector and capital account proceeded faster in the 1990s. The highlights were the announcement of the third-stage blueprint for the liberalization and opening of the financial sector (June 1993), the five-year plan for the liberalization of foreign direct investment (1993), and the five-year plan for the reform of the foreign exchange system (December 1994). The watershed is certainly Korea's participation in OECD in 1996.

Table 1. Korea's Liberalization of the Financial Sector and the Capital Account since the Early 1980s

Financial Liberalization Programme

• Introduction of corporate paper (CP)	1981
• Privatization of nationwide commercial banks	1981-83
• Abolition of beneficial interest rate on policy loans	1982
• Alleviation of government intervention in the internal operation of banks	1984
• Introduction of negotiable certificate of deposit (CD)	1984
• Introduction of a band for bank loan rates	1984
• Indirect opening of the stock market through the Korea Fund	1984
• Introduction of cash management account by short-term finance companies	1987
• Introduction of bond management fund by securities companies	1987
• Relaxation of entry barriers to financial industry including banks, life insurance, lease, and investment trust	1987
• Opening of the life insurance industry to foreign firms	1988

- Announcement of phased deposit and loan rate deregulation Dec.1988
- Opening of the securities industry to foreign firms 1991
- Announcement of a four-step interest rate liberalization plan 1991
- Conversion of short-term finance companies to securities companies or banks 1991
- Allowing foreign investors to purchase individual equity stocks at the Korea Stock Exchange 1992
- Announcement of the Third-stage blueprint for the liberalization and opening of the financial sector 1993
- Plan for opening the financial sector announced with the start of the WTO 1994
- Plan for opening the financial sector announced with the Korea's participation in the OECD 1996

Foreign Exchange and Capital Account Liberalization

- Switch to a basket-peg exchange rate system from a dollar-peg 1980
- Foreign exchange forward transaction implemented 1981
- Interest rate swap allowed 1984
- Switch to a negative system in foreign direct investment policies 1984
- Issuance of CB, WB, DR allowed 1985
- Financial futures allowed 1987
- Transition to a IMF article ? country 1988
- Foreign exchange call market established 1989
- Switch to the Market Average Exchange Rate System 1990
- Switch to a negative system in foreign exchange management 1992
- Five-year plan for liberalization of foreign direct investment 1993
- Five-year plan for the reform of foreign exchange system 1994
- Five-year plan for the reform of foreign exchange system revised with Korea's participation in the OECD 1996

**Table 2. Third-Stage Blueprint for the Liberalization and Opening of the Financial Sector
(announced June 1993)**

Schedule	Items
Phase I (1993)	<ol style="list-style-type: none"> 1. Liberalize all bank and non-bank lending rates(except for policy loans) and long-term deposits over two-year maturity. 2. Issue Monetary Stabilization Bond and government bonds at close-to-market interest rates. 3. Operate M2 targets flexibly. 4. Liberalize call markets. 5. Widen the daily won-dollar trading margin from 0.8% to 1.0%. 6. Switch to the notification system for foreign direct investment into Korea.
Phase II (1994-1995)	<ol style="list-style-type: none"> 1. Liberalize all lending rates and rates for short-term marketable instruments. 2. Establish indirect monetary controls. 3. Deregulate loans to large conglomerates. 4. Develop short-term financial markets. 5. Further widen the daily won-dollar trading margin. 6. Further ease requirements for underlying documentation prior to foreign exchange transactions. 7. Expand limits on foreign investments in the stock market. 8. Allow the foreign participation in primary markets for some bonds. 9. Ease requirements for opening branches of foreign securities companies.
Phase III (1996-1997)	<ol style="list-style-type: none"> 1. Liberalize all deposit rates except for demand deposit (allow MMC, MMF). 2. Utilize open market operations as main monetary policy tool. 3. Operate the Loans Management System as a prudential regulation. 4. Introduce free floating exchange rate system. 5. Eliminate requirements for underlying documentation for the usual foreign exchange transactions. 6. Allow foreign borrowing through commercial loans. 7. Allow foreign financial institutions to hold stocks of domestic banks.

**Table 3. Outlines of the Five-Year Plan for the Reform of the Foreign Exchange System
(announced Dec. 1994)**

	First Step (1995)	Second Step (1996-1997)	Third Step (1998-1999)
Invisible Trade	• Abolish approval system, adopt notification system	• Further liberalize	• Liberalize travel expenses, approve moving expenses
Capital Outflows	• Loose the limits	• Liberalize overseas direct and portfolio investments	• Liberalize corporate real estate inv. and deposits abroad
Capital Inflows	• Loose the limits	• Gradually liberalize	<ul style="list-style-type: none"> • Liberalize trade credits • Examine the abolition of foreign stock inv. limits, Liberalize security issues abroad and commercial loan only for facility inv. • Very gradually open the domestic bond markets

The role of market competition became increasingly important in the 1990s, as the democratization movements weakened the government influence on the private sector and fueled wage hikes irrespective of productivity increases. The financial liberalization and financial opening began to be perceived as a crucial factor for enhancing market competition and raising the economic efficiency.

Reflecting these changes, the five-year plan for the Reform of the Foreign Exchange System was announced in December 1994. It laid the framework for capital account liberalization toward the end of the 1990s. It was very comprehensive, not to be compared with the previous liberalization plans. Table 4 outlines the key contents of the Reform of the Foreign Exchange System.

According to the plan, Korea will follow the gradualist approach to the capital account liberalization. The current account will be opened first, and then the capital account. On the capital inflows side, it plans to achieve the substantial liberalization until 2000. The limits of imports on credits and exports on prepayments will be gradually extended to the international level. The limits on foreigner's stock investments will be abolished, but the individual investment will be limited to 10% of the total issues. The security issues abroad and commercial loans by the corporate sector will be liberalized but only for facility investment.

On the capital outflows side, the significant progress is planned in the overseas direct and portfolio investments. The overseas real estate investments that have concerned policymakers because of possibility of capital flights will be allowed only for the corporate sector, not for the individuals.

After the crisis, however, Korea chose the big bang style of liberalization. The exchange rate system was changed from the market average rate system to a free-floating system. The equity investment limit for foreigners was abolished by May 1998. The ceilings for foreign investment in all bonds were also abolished by the end of 1997 and the money market was fully liberalized by May 1998. The land acquisition by foreigners was allowed and takeovers by foreigners were fully liberalized in June 1998.

Why did Korea switch from the gradualist approach to the liberalization to the big bang approach after the crisis? Cho (2001) argues that the problem of Korea's financial liberalization is that of the sequencing: Korea encouraged the development of the short-term financing before the long-term capital market is developed and encouraged the development of the poorly regulated trust and near-bank financial intermediaries. Chopra et al. (2002) write that liberalization measures were typically part of the government's broader policy agenda and not subject to the IMF's structural performance criteria.

III. Financial Liberalization and Financial Crisis in Korea

If the process of financial liberalization is not appropriate in terms of timing, pace, and sequencing, it could end in the crisis as seen in many countries. Although it is not right to argue that the root of the Korean crisis can be found in the premature liberalization of the financial sector, financial crisis is associated with the financial liberalization. In this section, we trace the role of financial liberalization in Korea's financial crisis.

A. Financial Liberalization and Investment Boom

The government's efforts to liberalize financial market were accompanied by the pick up of investment in 1994-95. The increase in production capacity was dramatic, especially in the five major industries. The heavy-industry-based economy could respond only sluggishly to external shocks, such as worsening terms of trade. These industries maintained production levels even in the face of a decline in shipment, resulting in a sharp rise in the inventory/shipment ratio in 1994. Strong production and investment in heavy industries resulted in huge current account deficits from 1994.

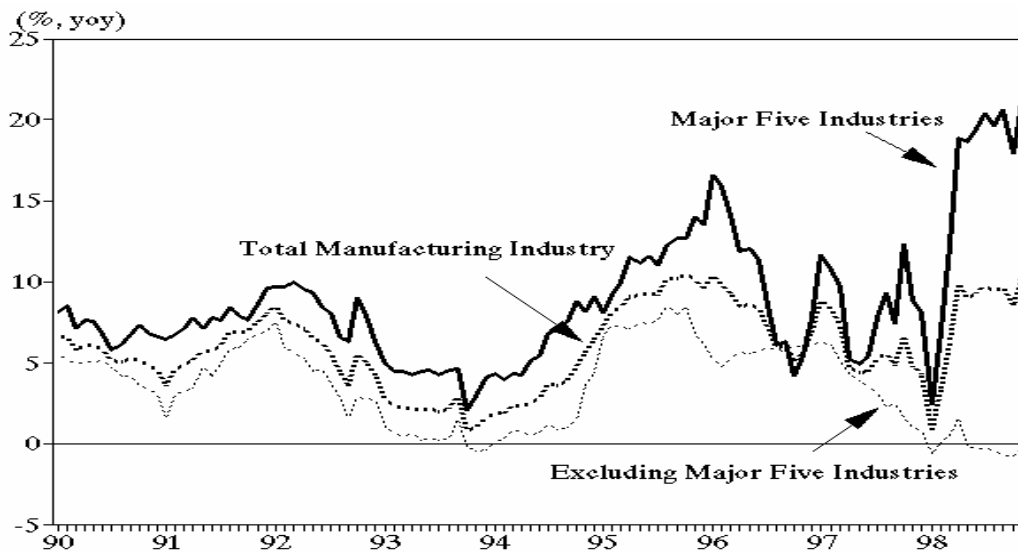
To make matters worse, heavier reliance on short-term financing at low interest rates brought about a huge mismatch of assets and liabilities. Korea became involved in a vicious circle of misplaced investment in low-profit heavy industries fed by excessive short-term external borrowing, which gradually eroded overseas confidence. Financial liberalization, even with its short-term effect of easing liquidity constraints, added to the pressure for won's appreciation, when Korea's industrial base was mostly export-oriented, resulting in lower international competitiveness.

Table 4. Growth Rate of Facilities Investment

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Facilities Investment (percent, yoy)	13.0	14.7	18.8	12.1	-1.1	-0.1	23.6	15.8	8.3	11.3

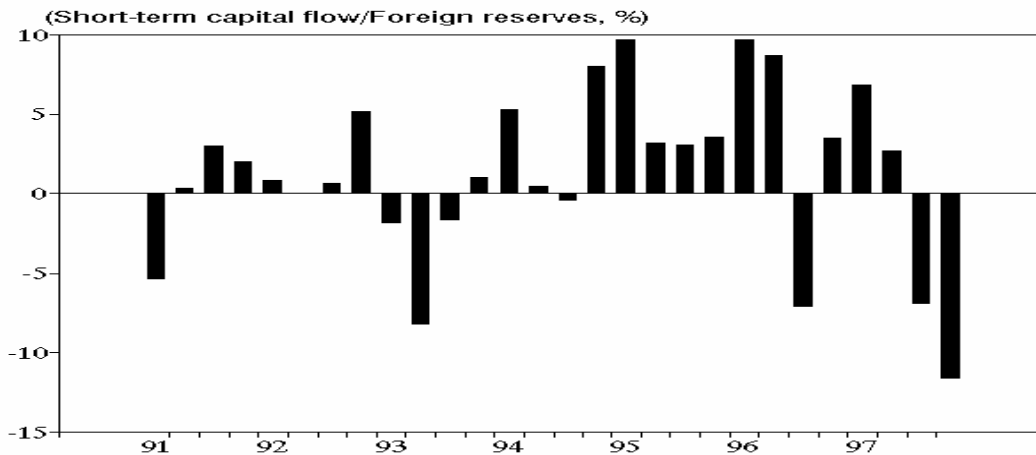
Source: The Bank of Korea, *National Income*, various issues

Figure 1. Capacity in Manufacturing



Source: National Statistical Office

Figure 2. Short-term Capital Flow/Foreign Reserves



Source: Bank of Korea

Table 5. Korea's Total External Liabilities (World Bank Standard)

(end of period, US\$ billion)

	Dec. 1992	Dec. 1993	Dec. 1994	Dec. 1995	Dec. 1996	Dec. 1997
Total External Liabilities	42.8	43.9	56.9	78.4	104.7	120.8
Short-Term Liability	18.5	19.2	30.4	45.3	61.0	69.6
Long-Term Liability	24.3	24.7	26.5	33.1	43.7	51.2

Source: Ministry of Finance and Economy

When the economy finally began to slow down in 1996, early symptoms of the impending financial crisis appeared. The real GDP growth rate stood around 9 percent in 1994-1995, but fell to 7.1 percent in 1996 and continued to fall to 6.2 percent in the first half of 1997. The current account deficit widened from 8.5 billion dollars in 1995 to 23 billion dollars in 1996, despite the slowdown in the economy. For the first half of 1997 alone, the deficit registered 9.9 billion dollars. The ratio of the current account deficit to GDP also rose to 4.7 percent in 1996 from below 2 percent in the two preceding years. This current account deficit was brought about by decreased export growth due to the fall in export unit prices, especially semiconductors, coupled with a rapid expansion of imports, most notably of capital goods and luxuries. As a result, this accumulating deficit was financed mainly by inflows of foreign capital, which caused a sharp increase in external debt.

Table 6. Major Bankruptcies or Near-bankruptcies in 1997

Date	Company	Major Businesses	Rank in Korea*	Estimated Loans By Banks (W billion)	Estimated Loans by Non-Banks (W billion)
Jan. 23	Hanbo	Steel	14	3,345	2,130
Mar. 19	Sammi	Steel	26	371	452
Apr. 21	Jinro	Retail	19	868	2,342
May 19	Daenong	Retail & Textiles	34	483	668
July 17	Kia	Autos	8	2,805	5,011
Nov. 1	Haitai	Food & Electronics	24	1,488	1,880
Nov. 4	New Core	Retail	25	905	293
Dec. 8	Halla	Heavy Industry	12	3,036	3,440

Note: The figures are the national rankings of firms in terms of asset size

Source: Ministry of Finance and Economy

Signs of system fatigue stemming from debt overburden eventually began to surface in 1997. At the beginning of 1997, a number of large companies collapsed under the huge burden of financial costs. On January 23, Hanbo Steel, the fourteenth largest conglomerate, went bankrupt with 6 billion dollars of debt, the first bankruptcy of a leading Korean conglomerate. Korea's third largest carmaker, Kia, suffered from a credit shortage and also asked for emergency loans on July 15. A series of unprecedented major bankruptcies should have been given serious attention, since it signaled the government's break from the old practice of supporting large groups through various schemes, including coordinated lending or bridge loans arranged via political pressure. As was the case in Mexico, the authorities were in the awkward position of needing to emphasize market principles in politically sensitive periods while struggling with the reality of the "too big to fail" symptom. This change in governmental attitude toward large conglomerates, especially with respect to supports and guarantees, essentially caused the series of bankruptcies and subsequent bad loans. Of course, the growing size of *chaebols* under the more open environment made it increasingly difficult for the government to arrange any kind of assistance program.

B. Fragile Financial sector and Lax Supervision

Excessive investment in several key industries became serious burden and squeezed cash flow led to asset quality deterioration for most banks. Undoubtedly, the large corporations' insolvency deteriorated the soundness of financial institutions with large exposure to these conglomerates. Nonperforming loans (NPLs)¹ of commercial banks and merchant banks as of the end of 1996 stood at about 13 trillion won. NPLs almost tripled to about 43 trillion won by December 1997. In particular, merchant banking

¹ Sum of substandard, doubtful, and estimated loss loans.

corporations, which were under lax supervision by financial authorities because of their recent upgrade from small finance companies, recorded NPLs of 3.9 trillion won at the end of October 1997, nearly three times the 1.3 trillion won at the end of 1996. Non-performing loans of the entire financial sector rapidly accumulated, amounting to 59.6 trillion won at the end of March 1998, equivalent to 13 percent of nominal GDP. Lack of international competitiveness eventually weighed down the already fragile financial sector with huge NPLs. However, increased vulnerability was not well reflected in macro indicators that seemed relatively sound in view of the first generation crisis models.

Table 7. Nonperforming Loans at Financial Institutions

(KRW trillion)

	Dec.1996	Dec.1997	Mar. 1998	June 1998
Precautionary	-	42.8	57.7	72.5
Nonperforming Loans (A)	13.5 ^{b)}	43.6	59.6	63.5
Bank				
NBF ^{a)}	12.2	31.6	38.8	40.0
Total Loan (B)	434.4 ^{b)}	647.4	668.7	624.8
A/B (percent)	3.1	6.7	8.9	10.2

Notes: a) Non-Bank Financial Institution

b) Bank + Merchant Bank only

Source: Ministry of Finance and Economy

One of the serious problems of the Korean economy is the lack of transparency. Figures provided by the government and private corporations did not reflect the true economic situation. In the industrial sector, conglomerates composed of many seemingly independent affiliates have played a major role in Korean economic growth since the 1960s. But their profitability was often overstated by inside transactions and cross payment guarantees among affiliates. Because cross payment guarantees were not illegal and internal transactions were not known of outside, the supervisory authorities could not control conglomerates' unfair inside activities properly. In this sense, the system contained the seed of crisis long before the crisis actually occurred.

In the case of financial institutions, the scale of their bad loans was understated because of the companies' cross payment guarantees. To make matters worse, figures for banks' non-performing loans excluded substandard loans. Thus the profitability of financial institutions was falling fast, but this was not observed before the crisis. Since figures did not reflect the true status of corporations or financial institutions in an increasingly open environment, a proper response was inherently infeasible.

Table 8. Excess Guarantees of Major 30 Conglomerates (the end of February, 1998)

(KRW trillion, percent)

	Loans (A)	Guarantees			Excess Guarantee (B-A)	Ratio (B/A)
		Debt guarantee	Guarantee offer	Sum (B)		
Total	25.3	33.5	6.9	40.4	15.1	159
Duplication	6.2	9.5	6.9	16.4	10.2	262
Repeat	0.9	2.3	-	2.3	1.4	267
Other	18.2	21.7	-	21.7	3.5	119

Source: Korea Fair Trade Commission

Table 9. Debt Ratio and Number of Affiliated Companies of Major 30 Conglomerates

	1995	1996	1997	1998
Debt ratio (%)	355.7	347.5	386.5	518.9
Number of affiliated companies	623	669	819	804

Source: Korea Fair Trade Commission

Another serious problem of the Korean economy was that viable market principles did not exist. For example, moral hazard was prevalent among almost all economic actors, including corporations, financial institutions, workers and depositors. Corporations, especially large-scale enterprises including *chaebols*, enjoyed governmental protection and import restrictions in the domestic market. In addition, they could borrow at low interest rates from financial institutions, creating strong incentives to expand without careful consideration of risk and returns. As a consequence, the debt to equity ratios of Korean enterprises rose sharply. At the end of 1997, the thirty largest Korean conglomerates had an average debt-to-equity ratio of 519 percent, in contrast to 154 percent in the U.S., 193 percent in Japan and 86 percent in Taiwan. The highly leveraged state of corporations played a major role in successive collapses of large enterprises in 1997.

Table 10. Major Financial Ratios in the Manufacturing Sector

	1992	1993	1994	1995	1996	1997
Equity to total assets	23.9	25.3	24.8	25.9	24.0	20.2
Debt ratio	318.7	294.9	302.5	286.8	317.1	396.3
Total borrowings and total assets	47.2	46.8	44.5	44.8	47.7	54.2
Current ratio	92.8	94.1	94.6	95.4	91.9	91.8
Fixed ratio	227.4	218.5	220.2	212.5	237.0	261.1
Ordinary income to sales	1.5	1.7	2.7	3.6	1.0	-0.3

Source: The Bank of Korea, *Financial Statement Analysis For 1997*

Table 11. Profitability of Manufacturing Companies

	1992	1993	1994	1995	1996	1997
ROE	3.7	4.2	7.6	11.0	2.0	-4.2
ROA	0.9	1.0	1.9	2.8	0.5	-0.9

Source: The Bank of Korea, *Financial Statement Analysis For 1997*

The crisis was the result, rather than the cause of low profitability at Korean enterprises. Huge sales volumes were necessary for the survival of most Korean firms in the presence of little cushion for negative external shocks. Operating costs consisted mostly of huge fixed costs that characterized heavy industries with high external borrowing. The lack of adequate cash flows was largely compensated for by borrowing, which resulted in still higher leveraging for most Korean firms before the crisis. It is clear that most investment expansion was financed by borrowing, not through retained earnings or cash flows as in major corporations in advanced countries.

Similarly, market principles were not properly observed in the financial sector. The government often controlled 'private' financial institutions as government-run banks, and overly protected financial institutions in areas of personnel management and operations. Banks and financial institutions were therefore not run as profit-maximizing concerns and eventually accumulated massive non-performing loans. Banks allowed firms to waste resources through inefficient and duplicate investments, and therefore contributed to the crisis. State-controlled financial institutions had a weak profit motive and merely acted as intermediaries for channeling funds from foreign sources to domestic enterprises without due supervision.

The outrageous negligence in both corporate and financial sectors discussed above is ultimately due to a sociopolitical system that fostered close ties between industry and the government. Growth was able to cover up these problems, and the public would generally ignore inefficiency as long as enough jobs were created. The independent media was also suppressed or marginalized with the advent of *chaebol* media groups, which mainly promoted the interests of pseudo-elite groups and new capitalists.

C. Exchange Rate Policy and Contagion

The contagion played the important role in causing crisis. Starting with the plunge of the Thai baht in July 1997, the currency crisis quickly spread through the neighboring countries. With investors nervous about emerging markets in general and Asia in particular, it is not surprising that the Korean won came under attack. In November, the rollover ratio of short-term external debt fell rapidly, and the flight of foreign funds in stock and bond markets started. The rollover ratio of the seven largest commercial banks fell to 58.8 percent in November 1997 from 86.5 percent in October.

An increase in international financial linkages in addition to the traditional trade links among Asian countries helped transmit shocks from one country to another. As the crisis situation gradually worsened, Japanese banks began to cut credit lines and withdraw their money from the crisis-prone region, including Korea. Even if Japanese banks were not the immediate trigger of financial contagion, it surely contributed to a pronounced spillover effects as explained by “common lender problem (Kaminsky and Schmukler 1999, Masson 1998).”

Table 12. In-and Outflows of Foreign Portfolio Investment

(US\$ billion)

	1992	1993	1994	1995	1996	1997	1997						
							Jan.~ Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
Net Inflow	2.0	5.7	2.0	2.2	4.4	0.8	2.2	2.1	-0.0	-0.3	-0.8	-0.8	0.3
Inflow	2.7	7.6	8.6	10.0	12.4	12.6	7.0	1.2	0.8	0.8	0.8	1.1	1.0
Outflow(-)	0.7	1.9	6.6	7.8	8.0	11.8	4.8	0.9	0.8	1.1	1.5	-0.8	0.7

Source: The Bank of Korea

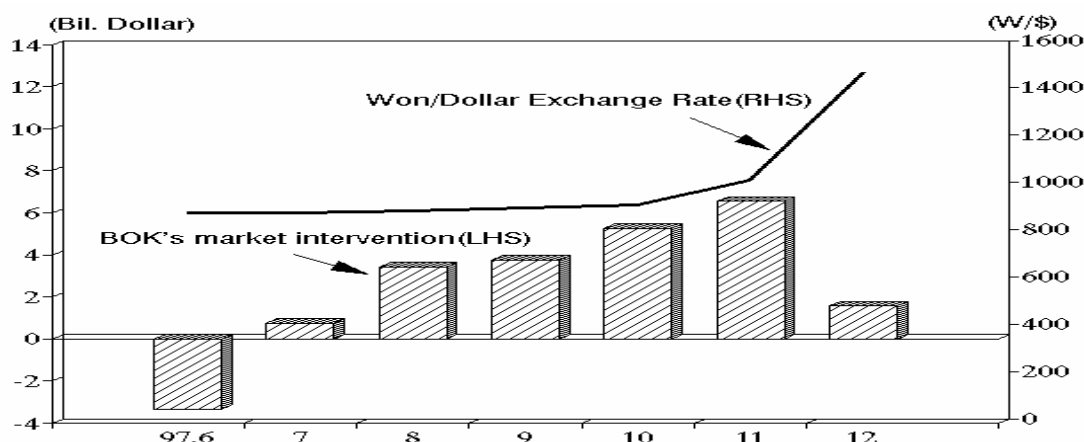
Table 13. Foreign Reserves at the Bank of Korea

(end of period, US\$ billion)

	1996	1997					
		March	June	Sep.	Oct.	Nov.	Dec.
Official Foreign Reserves (A)	33.2	29.2	33.3	30.4	30.5	24.4	20.4
Deposits at Overseas Branches (B)	3.8	8.0	8.0	8.0	8.0	16.9	11.3
Other (C)	-	-	-	-	0.2	0.2	0.2
Usable Reserves (A-B-C)	29.4	21.1	25.3	22.4	22.3	7.3	8.9

Source: The Bank of Korea

Figure 3. Bank of Korea's Foreign Exchange Market Intervention



Source: Bank of Korea

The contagion is also rooted in the exchange rate policy. Even when signs of trouble, such as a massive current account deficit, had appeared in 1996, the authorities emphasized the importance of stable exchange rates for exports and capital-market access. Whatever the case, the incompatibility of monetary independence, a stable exchange rate, and free capital mobility manifested itself in the growing stress and heightened vulnerability. In particular, limited exchange rate flexibility encouraged unhedged, short-term borrowing by merchant banks from overseas.

IV. Concluding Remarks

Korea's financial liberalization since the early 1980s has been gradual and paid attention to the sequencing. However, financial opening and increased pressure to liberalize the system served to destabilize what had been a well-performing growth machine. Policy measures were primarily based on the status quo because the implications of liberalization were not obvious and did not fully manifest themselves during the transition period toward the market mechanism. The exchange rate regime did not allow for any cushioning effect, and the higher risks of the open environment were passed on to the system. The high growth strategy and the associated exchange rate regime rendered the financial sector vulnerable to erratic shifts in investor sentiment, more so with the progress of financial opening.

After the crisis, Korea implemented the big bang liberalization. It is still to be discussed that the rapid liberalization in the midst of the severe disruptions in the financial and corporate sector right after the crisis was desirable.

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