Keeping up the pace of financial reform

Global financial meltdown should not be allowed to dampen Korea's reform zeal: experts

By Kim Jung-min

Korea is reeling from the impact of the global credit crunch. But perhaps more importantly, from a long-term perspective, the collapse of some financial behemoths on Wall Street is having the effect of dampening Korea's zeal for overall financial market reform.

During the Asian financial crisis of 1997, the Korean government came under attack for indirectly inviting the region's financial contagion by suddenly deregulating its financial market system, thereby allowing a free outflow of foreign currencies.

This time, the U.S. decision to erect a $700 billion emergency rescue package to save Wall Street institutions from collapse has prompted opponents of market reform to delay — indeed reject — any systemic change.

In Korea's case, this can only have negative implications because its financial system is still not nearly as deregulated as its economic peers.

Government control of the local financial market, in many cases, has been an impediment to both growth and diversification of the capital market.

Many experts say the global financial crisis should not delay the pace of financial reform in Korea. Financial deregulation in the United States is facing a phase where systemic efficiency may not be compatible with stability, while Korea faces completely different regulatory conditions. They seem wary that the reform drive in Korea is running out of steam as the reform plans — including controversial bank ownership issues — would have to be compromised.

"We do not want to see Korea turn the clock back," said Cho Yoon-je, professor of international studies at Sogang University. Korea is on the right track of removing regulatory barriers to match international standards. He cautioned against any quick reversal on deregulation, urging officials to seek ways to improve the institutional framework in the context of the existing financial reform plan.

Yu Jong-il, professor at the KDI School of Public Policy and Management, represents skeptical voices that say Korea should not follow the U.S. capital market model. The financial crisis illustrates that neo-liberalism has failed a major test and markets are now self-correcting, allocating resources efficiently to serve the public interest.

"It sounds unconvincing that more emphasis on financial supervision would offset any adverse effects of deregulation," he said. "Such optimism seems to be overblown."

Some say the deregulation issue in Korea should be dealt with in an economic context to avoid complex entanglement with political and ideological disagreements. In Korea, politicians get their hands dirty in debates of economic and financial policy — and most of the time, more regulations translate to more management intervention, said Lee Young-tack, president of the Institute for Global Economics, a private think-tank in Seoul. "We are not only talking about paperwork needed to do business here. If you look at business practices and the relationship between regulators and the business community, there are more visible hands," he said.

Pedestrians walk outside of the New York Stock Exchange. Bloomberg

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Lessons for macroeconomic policy

One of the key lessons from the U.S. financial crisis is that the impact of ill-advised macroeconomic policy is detrimental to financial stability and growth. Asian economic policymakers have fallen behind the curve, and need to pursue more countercyclical policies.

In the United States, the Bush administration's American Dream policy five years ago encouraged financial institutions to become highly-leveraged in the housing market. Loose monetary policy and excessively low interest rates induced excess leverage, disguised through financial derivatives, driving risk-spreads below sustainable levels and creating bubbles in asset markets, economists say.

"The current U.S. financial crisis is the result of a failure to control liquidity," said Park Sang-yong, a professor of business administration at Yonsei University. Ample liquidity over the past few years caused financial institutions to become highly-leveraged and the lack of supervision failed to prevent the credit expansion from disrupting the entire financial system, he explains.

Korea is just as vulnerable as anyone else to risk stemming from macroeconomic policy failure. Many critics say ill-timed foreign currency policy has thrown the foreign currency market out of equilibrium and has increased economic hardship faced by corporations and households. The currency authorities, who favored a weak won, belatedly shifted their stance to combat the dollar shortage problem by lifting rules largely banning foreign borrowing by public companies.

Until then, the government played hardball to encourage more Koreans to invest in offshore funds and foreign property markets, which they believe would help curve a surge in the nation's foreign short-term borrowing.

Another issue at stake is how to contain leverage in the credit expansion period as the U.S. subprime mortgage market meltdown underlines the importance of household credit policy, experts say.

An excessive level of household debt increases the likelihood of households being unable to repay their loans when interest rates rise or housing prices fall. This leads to insolvency of financial institutions and financial market turbulence, which in turn, has a negative impact on the real economy.

In Korea, household lending accounted for 50 percent of banks total loans in 2006. It was only 28 percent in 1996, according to the Bank of Korea.

Systemic resilience

Seoul must take into account its own idiosyncratic factors in designing a supervisory framework, according to Yu from the KDI School of Public Policy.

Many experts recommend putting more emphasis on making Korea's economic system more resilient to external shocks.

Yu, who assisted former President Roh Moo-hyun in designing his economic policy, opposes the government's plan to ease rules on bank ownership and financial holding companies. He believes the eased regulations are a step toward family-run conglomerates, or chaebol, owning banks outright.

Seoul's current supervisory and legal frameworks will not prevent chaebol from abusing their status as shareholders, which play a dominant role in Korea's financial system. Recent experiences with mutual savings banks in real estate-related projects for financing loans provides dramatic evidence of the danger involved in ending the separation between banking and commerce, he notes. In Korea, many construction companies own a significant stake in mutual savings banks.

Korea doesn't seem to be ready to cope with conflicts of interest, which could become a serious issue when the Capital Market Consolidation Act takes effect in February 2009, many experts say. "It would be naive to expect that competition would automatically increase market discipline and mitigate the conflicts of interest issue," said Kang Jun-koo, distinguished professor of Finance at Nanyang Technological University of Singapore. Emerging markets like Korea need to diversify their financial systems to benefit from an integrated capital market model, he added.

Globally, consolidation of supervision will be a critical issue over the coming years. The segmentation of financial supervision functions in Korea makes it harder for regulatory bodies to assess the risks of the overall system, said Park of Yonsei University. The Finance Ministry is mainly responsible for foreign currency and international finance-related policies, while both the Financial Services Commission and the Financial Supervisory Services are in charge of policymaking and implementation, respectively.

"It's even hard to schedule a meeting for people from all the different organizations," said an FSS official.

(jungmin@heraldm.com)

Improving communication key to weathering uncertain times

By Kim Jung-min

This is an excerpt from an interview with Peter Verrengia, president and senior partner of Communications Consulting Worldwide, a business consulting unit of Fleishman-Hillard. CCW, co-founded by Verrengia in 2004, assists global companies in identifying ways to address the risks and opportunities that companies face in managing their corporate reputations. Throughout his 30-year career as a communications consultant, Verrengia provided consultation services for global Fortune 50 enterprises and startups and non-for-profit organizations. He led the team that supported ExxonMobil in its merger communications and provided communications advice to both sides of JP Morgan Chase combination. Over the past five years, he has been extensively involved in assisting many Asian companies with the establishment of their global communication strategies. — Ed.

Peter Verrengia

Korea Herald: Why is communication with shareholders such a big issue both at the national level and the corporate level?

Verrengia: Communication is essential to the successful functioning of the capital markets. Without the expectation that a market will require a flow of information from companies that is reliable, timely and fair, nations and their capital markets face a discount from investors. Investors have an expectation they will have information that they can trust, and access to management to ask questions about that information, regarding results, planned expenditures, and cash flow, as well as management's view of the market and competitors and strategies. The more information, the better they are able to manage risk. Less information and less personal interaction between investors and management lead to a discount the value of a company's securities. Good communications serves everyone's interest.

KH: What is your assessment of the way Korean companies and government officials handle communications with foreign shareholders? Any good examples or bad examples?

Verrengia: Korean companies and government officials have gotten more comfortable with the kind of open, two way dialogue that is the norm in major financial centers. For example, companies have to seek out and address the questions that shareholders have, and they need to accept doubt or criticism as part of the investment process. The major Korean companies have all faced challenges or transactions that have led them to adapt to the expectations of foreign investors. At the same time, investors are learning to expect a productive relationship with Korean companies.

KH: What is general perception of foreign investors on corporate governance of Korean conglomerates? And what should be done to enhance the image of Korea Inc. or dispel the image of "Korea discount" in the mid-to-long term strategy?

Verrengia: Corporate governance is important in every market, and every market has a history of governance evolution or issues. There is no perfect governance system and many choices. But in major financial markets, certain standards apply. One important feature of good governance is independent directors who put the interests all of shareholders ahead of management's self-interest, and who can challenge or reject management's initiatives or strategies. And that includes independent, qualified directors who can provide oversight for reliable scrutiny of financial reporting systems and financial results. That is beginning to happen in Korea, for example at SK. Another important issue for foreign investors is the structure of Korean companies. Cross shareholdings and lack of transparency prevent investors from understanding where value is created in the organization and how accountability works. They tend to dislike money from the listed company they invested in going to support investments or activities in another company belonging to the group. It limits returns on their investment, and violates a core principle that most investors believe—they see the company's money as the shareholders' money, not the group's money, even thought the group itself is an investor. Improving governance, transparency, shareholder communications, and moving to a holding company structure can help to address a few reasons for the discount.

KH: There's been growing discontent with the role of foreign capital among the Korean public. What do you think should be done to help the public overcome the misconception?

Verrengia: It is up to regulators and corporate executives to help the public understand that access to foreign capital is essential in the global economy, especially if Korean companies are to continue to grow and create opportunities for employees and growth for the economy. The fear of abusive investors can be addressed by demonstrating the successful relationship many Korean companies have with overseas shareholders. The best defense against hostile investors is full valuation versus similar investments in other markets. There will always be individual companies with short-term problems that make them targets. But, by continuing to produce business success, and by developing a more transparent, interactive relationship with all investors, Korean companies will have less to fear, and more to gain.

KH: Korea has a handful number of global brands such as Samsung Electronics, LG Electronics and Hyundai Motor. What are the major shortcomings to keep up with its international or Asian rivals in building strategic relationship with global investors?

Verrengia: Today, Korean products are visible and respected around the world. Not all Korean companies are yet as are well know or well understood as their global business plans require. By the notion of "made in Korea" is not a handicap for corporate success. That is not true yet for most Chinese companies, but they are growing so fast that companies like Lenovo and Hwawei will not be exceptions for long. The same is true in India, also their brands are a step behind China's. Korean brands and companies have a small window to push ahead. They should use the opportunity presented by the challenges in the western economies, and the more aggressively communicate the balance of quality and price Korean brands are now beginning to known for. That, plus an open attitude to changes in corporate governance and transparency, and a more active approach to the ongoing dialogue with global investors will give Korea and its companies a larger place on the world stage. Finally, the leaders of Korean companies need to think of themselves and their companies as members of a global marketplace as much as representatives of Korea as a nation and an economy. This evolution will take time.