Capital Account Liberalization: The Case of Korea

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March 2002

We have witnessed an unprecedented rise in net private capital flows to emerging market economies in the 1990s, from just over US$40 billion in 1990 to about US$298 billion in 1997. Many emerging market economies have relaxed and removed statutory restrictions on capital account transactions and liberalized domestic financial markets to capture the benefits of capital inflows. However, in a number of cases, capital account liberalization and ensuing capital surges seem to be associated with financial crises. While capital account liberalization does not necessarily lead to financial crisis, it is true that high capital mobility can easily drive an emerging country to be more vulnerable to outside shocks by complicating macroeconomic management.

Moreover, post-crisis performances of the East Asian crisis countries have perplexed many economists in evaluating the effects of capital account liberalization. Even though Korea and Malaysia adopted two extremely opposite policies in terms of capital market opening in response to the crisis, Korea pursuing further drastic liberalization of capital account while Malaysia implementing more stringent capital controls, both countries recovered successfully. This adds another dimension to evaluating the benefits and costs of effects of capital account liberalization.

Capital inflows invited by capital account liberalization are a mixed blessing. Capital inflows provide important resources for economic development, while surges and drastic reversals in capital flows may create new sources of systemic risks. These tensions do not go unnoticed by policy makers in emerging market economies; capital account liberalization would be the most difficult examination for a developing country to pass in joining a group of developed countries.
Benefits of capital account liberalization are based on growth, intertemporal optimization, risk-sharing through portfolio diversification and efficiency gains. Developing countries that are traditionally short of capital can gain from foreign capital inflows. Investment is no longer restricted by the amount of domestic savings. Foreign capital inflows can contribute to an economy’s growth rate by increasing the rate of capital accumulation and by spurring technological innovation. In theory, capital flows from developed countries to developing countries in order to equalize the marginal productivity of capital across countries and to efficiently allocate capital, increasing the world welfare.

In terms of intertemporal optimization, free capital flows enable a country in a temporary recession to borrow from the rest of the world and to smooth its consumption stream. Ability to borrow and lend across countries can thus dampen malicious effects on domestic demand generated by business cycles, thereby increasing the country’s welfare as well as the world’s welfare. However, a question will emerge whether a country’s external debt can be sustainable if its borrowing becomes persistent rather than temporary.

Countries can gain from international portfolio diversification, following outward and inward liberalization of capital markets. Investment in foreign equity markets allows domestic agents to diversify country-specific risks that cannot be diversified within the domestic equity market. However, these gains are limited to developed countries that have access to cross-country equity markets because most asset transactions in developing countries are limited to banking transactions and FDI.

Efficiency gains can be achieved through various sources including spillovers or international transfers of technology and efficient allocation of resources through financial deepening (development of financial intermediates, direct and indirect financing, and more activities in banking sector and stock markets). Exposure to higher standards in accounting, auditing, regulations on disclosure and operating procedures introduced by foreign players can improve efficiency of domestic financial institutions.
and firms. Also, capital account liberalization is usually accompanied by liberalization of financial services, which tends to increase competition in the provision of financial services, lower monopolistic profits, and thus erode franchise values of domestic financial institutions. However, this increased international competition can force domestic players to become more efficient, stimulate innovation, and improve productivity.

In general, potential costs of capital account liberalization include overheating of the economy due to capital surge and excessive expansion of aggregate demand, and increasing volatility in prices and exchange rates due to volatile movement of capital flows and transmission of foreign shocks. The most serious problem arises if there is a reversal of capital flows on a large scale.

Many economists warn that capital account liberalization can cause excessive investment in risky projects due to the moral hazard problem if there is asymmetric information in the domestic economy. Under symmetric information and efficient markets, benefits of open capital accounts can be easily achieved. However, under asymmetric information, markets become inefficient and negative effects of liberalization such as adverse selection, moral hazard and herd behavior can emerge. Similarly, in the presence of serious domestic market distortions, capital account liberalization can worsen the situation. If domestic resources are concentrated in less efficient sectors due to distortions such as tax, subsidy and tariffs, then capital inflows can intensify this concentration and worsen domestic welfare.

Half a century ago, Korea was one of the poorest countries in the world. The Korean War erupted shortly after its independence from Japanese colonial rule, leaving Korea in economic devastation. In the 1950s, Korea relied on foreign assistance for its economic reconstruction. However, cuts in the U.S. financial aid forced Korea to seek alternative sources of foreign exchange. In the 1960s, the adoption of an outward-oriented development strategy triggered the take-off of the Korean economy. Since that time, government policy has been integral to Korea’s entire economic development process.
The new emphasis on export-oriented growth strategy went in hand in hand with the policy to welcome foreign capital to finance economic development. In conjunction with active mobilization of financial resources from home and abroad, Korea’s high-quality, low-cost manpower allowed Korea to experience a dramatic growth performance.

In the 1970s, advanced countries began to raise trade barriers against developing countries’ exports of labor-intensive goods. This prompted the Korean government to promote heavy and chemical industries. Excessive government intervention in resource allocation by taxation, finance and restriction of imports brought about inefficiency in the financial sector and a concentration of economic power. Excessive government support resulted in a drastic increase in the money supply. The oil crises also caused economic difficulties, which led to accelerated inflation and cost disadvantages of export goods.

During the early 1980s, a period of worldwide recession, the primary goal of the Korean government’s economic policy was to stabilize the economy. Since 1982, inflation has been controlled. By the mid-1980s, relatively uniform incentives, rather than selective preferences for a few targeted industries, were reinstated as the main economic policy instrument for resource allocation in industries.

Throughout the 1980s, the policy of the Korean government on capital flows has been residual: developments in the current account balance dictated the government’s interventions in the foreign exchange market and transactions related to capital account. Under the pegged exchange rate system, current account balances were determined autonomously. Then, policies on capital flows were used to accommodate the overall balance of payments.

In the first half of the 1980s, the current account continued to record deficits, although the size of the deficit was steadily declining. For the purpose of financing current account deficit, the Korean government undertook several measures to liberalize capital
inflows, while tightening regulations on capital outflows, mainly by restricting residents’ overseas investment. In particular, the Korean government encouraged domestic banks to borrow from abroad.

The period between 1986 and 1989 witnessed the emergence of a sizable current account surplus. This surplus resulted from the external factors, such as the recovery of the world economy and the rapid appreciation of the Japanese yen, which improved the competitiveness of Korean exports. Foreign exchange reserves, only $2.8 billion at the end of 1985, reached $12.6 billion a year later, and $15 billion by the end of 1989.

In order to reduce excessive foreign exchange holdings and maintain export competitiveness, the government dramatically changed policy stance toward capital flows by reimposing direct controls on capital inflows as well as easing restrictions on capital outflows. The government undertook various measures aimed at reducing capital inflows; encouraging the early repayment of external borrowing, tightening the regulations on foreign commercial loans and foreign bank borrowing, and imposing restrictions on the volume of foreign exchange that could be brought in and sold to domestic banks. The favorable balance of payment condition also paved the road for more active trade liberalization.

After four consecutive years of current account surplus over the period 1986-89, the Korean government formally accepted the obligations of Article VIII, Section 2-4 of the IMF’s Articles of Agreement in 1988. This move pushed Korea to abolish its remaining restrictions on payments and transfers for current account transactions. With limited but gradual capital account liberalization, the Korean government also found it increasingly more difficult to manage a pegged exchange rate system. As capital mobility increased, managing a pegged exchange rate became increasingly inconsistent with an independent monetary policy, since sterilization of capital inflows through sales of government securities became costly. Thus, in March 1990, the Korean government adopted a variant of managed floating exchange rate regime, which allowed for a more market-based determination of the exchange rate.
In 1990, the current account balance started to deteriorate again because of rising inflation, real appreciation of the Korean won, and recession of the world economy. The current account worsened in 1991, recording a deficit of $8.7 billion, which was more than four times the level of the preceding year. The amount of foreign exchange reserves held by the Bank of Korea fell sharply. Facing difficulties in financing the mounting current account deficit, the government responded by encouraging capital inflows. Some of the earlier measures aimed at limiting capital inflows were reversed. Furthermore, the capital account liberalization was once again significantly accelerated by amending the Foreign Exchange Management Act (FEMA) in 1991.

Under the amended FEMA, those transactions classified as capital inflows were liberalized first. Conditions under which residents could raise funds by issuing securities abroad were eased by stage, first in 1991 and in the following years. Foreign direct investment was considerably liberalized: lifting the ceilings on the amounts of direct investment inflows automatically approved (investments with a foreign participation of less than 50 percent in manufacturing projects were made subject to notification in place of approval); providing tax incentives; and expanding sectors where foreign direct investment was permissible. Most importantly, effective from January 1992, nonresidents were allowed to directly purchase Korean stocks up to three percent of the outstanding shares of each company per individual, but no more than ten percent of a company in total.\(^1\) Furthermore, the Korean government in June 1993 announced a blueprint for financial liberalization and opening of the financial sector, which aimed at substantial progress in the deregulation of domestic financial markets. The plan envisaged further easing of requirements for foreign exchange transactions, widening the daily won-dollar trading margins, expanding limits on foreign investment in the stock market, and permitting long-term commercial loans.

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\(^1\) Total ceiling was raised to 12 percent in December 1994, 15 percent in July 1995, 18 percent in April 1996, 20 percent in October 1996, 23 percent in May 1997, 26 percent in November 1997, and 50 percent in December 1997 (completely lifted in May 1998). Individual ceiling was also gradually raised and completely lifted in May 1998.
As a result of these liberalization measures, capital inflows, mainly in the form of portfolio investment, began to surge in 1991. The surge in portfolio investment in the 1990s resulted largely from opening the Korean stock market in 1992 and allowing domestic firms to issue securities abroad to take advantage of lower interest rates in the international financial market. Strong economic performance and bright prospects of the economy made Korea one of the most attractive emerging markets to international investors. The major type of foreign portfolio investment, even after the stock market opening in 1992, was issuance of securities by Korean firms in the international capital market. The dominance is particularly noticeable between 1994 and 1995, when the Korean stock market performed relatively poorly.2

Even the partial nature of capital account liberalization undertaken during the early 1990s triggered massive capital inflows. Policy makers were particularly concerned about the appreciation of the Korean won, which could undermine the competitiveness of Korean exports, rather than the financial instability generated by volatile capital flows. The government took several steps to liberalize capital outflows. Residents’ overseas direct investment was significantly liberalized, except for specifically restricted businesses.

Despite a series of capital account liberalization measures, the Korean government maintained a gradual approach and thus a considerable number of capital controls on foreign exchange and cross-border capital transactions still remained. For example, the opening of the domestic bond market was given special attention because interest rate differentials were still large. While most capital outflows were in general liberalized, capital inflows in the form of foreign portfolio investment remained subject to various ceilings and certain other regulations. However, domestic firms, particularly large business companies (the so-called chaebol), were severely critical of remaining restrictions and thus claimed that the rigid control on capital inflows undermined the international competitiveness of domestic firms in the world market due to high financial

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2 The Korean stock price index (KOSPI) hit its highest level (1,138.75) on November 8, 1994, and then it began to slide well before the crisis broke out.
costs. Amidst these complaints and the foreign pressure for further deregulation, the Korean government unveiled the new Foreign Exchange System Reform Plan in December 1994.

The Plan attempted in three stages to completely liberalize current and capital account transactions with a few exceptions and to develop an efficient foreign exchange market over a five-year period. It stipulates a gradual and staged liberalization process, with the speed of liberalization adjusted depending on the state of the economy. Implementation of the first stage of capital account liberalization, which focuses on the liberalization of capital outflows, began in February 1995. However, the cautious approach toward capital market opening continued when Korea joined the OECD in 1996. The Korean government maintained many reservations to the Code of Liberalization of Capital Movements and Current Invisible Operations. According to the membership negotiations, the government was reluctant to liberalize the capital account because of its concern about a dramatic increase in foreign capital inflows due to the interest rate differentials and excess demand for investment. The government had thus planned to delay liberalizing the long-term bond market and commercial loans until the interest rates would significantly converge.

With respect to capital account liberalization, few economists doubt that the large exposure to short-term external debt left East Asian countries vulnerable to sudden changes in market sentiment. Short-term capital flows comprise a wide array of financial transactions: trade credits, commercial bank loans with a maturity of less than one year, and short-term private and public debt (both in local and foreign currencies) issued abroad or sold to nonresidents. In the early 1990s, restrictions on foreign currency loans for imports remained and were further strengthened because of the rising trend of current account deficit. However, various restrictions on deferred import payments and the receipts of advance payments for exports were lifted step by step since 1992. Along with trade liberalization, liberalization of trade-related short-term credit, particularly for imports, would contribute to the increase of current account deficit. Thus, the Korean
government maintained restrictions on trade credits by the need to prevent the abuse of trade credits for interest-rate arbitrage.

The major portion of the increase in foreign capital inflows was made through the borrowing of the banking sector. Despite the government’s frequent interference through discretionary window guidance, banks enjoyed relatively greater freedom in borrowing from foreign creditors. No explicit quantity regulation existed on long-term or short-term borrowings of banks in foreign currencies.

While domestic banks rapidly expanded their foreign currency operations, the magnitude of the expansion was not correctly captured in domestic monetary indicators. This was because about half of the foreign currency operations of the banking sector was handled by overseas branches whose transactions were not reflected in domestic monetary indicators. Had the short-term external liabilities of overseas branches been taken into account, the authorities would have recognized a far less than sufficient amount of foreign reserves for buffering against possible liquidity runs by foreign creditors. Moreover, the management of foreign currency liquidity risks at the individual bank level was not adequate enough to forestall the liquidity crisis, either.

A huge part of excessive short-term external liabilities can be explained by asymmetric regulations on short-term vis-à-vis long-term borrowing. The government boosted incentives for short-term debts by making it mandatory to provide detailed information and obtain permission from the regulatory authorities in the case of long-term borrowing, whereas short-term borrowing was regarded as trade related financing and therefore not strictly regulated under the Foreign Exchange Management Law. Thus, banks and firms had been operating on a long-term basis with short-term foreign borrowings, leading to significant discrepancy in the maturity structure.

Furthermore, maturity mismatch was more serious for merchant banks. 30 merchant banks were heavily engaged in offshore operations by borrowing cheap short-term Japanese funds from Hong Kong to finance mostly long-term investment projects. With
80 percent short-term debts put into 70 percent long-term assets, the maturity mismatch blew up when Korea’s credibility plummeted. Pressured to get foreign currency to repay their debts, merchant banks ultimately ended up buying foreign currency on the spot market with won-denominated call loans from commercial banks. Furthermore, those merchant banks were not properly supervised. Neither unified accounting standards nor standards for classifying non-performing loans existed, and supervision had been perfunctory at best. This lax supervision allowed merchant banks to enjoy freedom without any discipline. When Korea embarked on the IMF structural adjustment program, merchant banks were the first to go through restructuring because their voluminous short-term external debts and imprudent investments were inconsistent with the customary practices of the world financial market.

The East Asian financial crisis emerged as Thailand’s currency crisis in July 1997 spread to the neighboring countries, which eventually forced Indonesia and Korea to request assistance from the IMF. The Korean government had officially made the request on November 21 after nearly all of its foreign reserves were depleted in defense of the Korean won. For the short run, the IMF program stressed on a tight aggregate demand policy to stabilize the foreign exchange market. For the intermediate and long run, it stressed on the structural reform of the financial and corporate sectors, which were the underlying causes of the currency crisis.

As regards capital account liberalization, the Korean government aimed for a far more extensive capital market opening than what had been agreed with the IMF. A variety of policies to induce foreign capital in an attempt to overcome the currency crisis were developed, and measures for capital account liberalization have been undertaken. The individual shareholding limit of foreigners has increased drastically from 7 to 50 percent on December 11, 1997, and the ceiling was lifted completely on May 25, 1998. All regulations on foreign purchase of debt securities were eliminated in December 1997. As of December 1997, all domestic enterprises, regardless of size, were allowed to borrow without limit from overseas as long as the maturity would not exceed one year. All the short-term money market instruments, such as commercial paper and trade bills, were
also completely liberalized on May 25, 1998, and this brought Korea’s capital markets on a par with the level of openness of advanced economies.

To induce foreign direct investment, all institutional restraints on the takeovers and acquisitions of domestic firms by foreign investors, including hostile mergers and acquisitions (M&As), were completely abolished. A legislation to liberalize the acquisition of real estates by foreigners has also been passed on May 15, 1998 and went into effect on July 1, 1998. As an institutional response to the need for improvement of environment for foreign direct investment, the previously-interspersed counseling and service support functions for foreign investors were unified under the Korea Trade and Investment Promotion Agency (KOTRA) through the creation of a ‘one-stop service’ system on April 30, 1998. Thirty additional industries, which include insurance and leasing, were opened to foreigners on two occasions in April and May of 1998.

The Korean government responded to the currency crisis by adopting a free floating exchange rate regime and by more actively pursuing capital account liberalization. Thus, the liberalization of restrictions on capital movement was accompanied by relaxation of rules governing the use of foreign exchange. The Korean government established a simple and transparent framework to replace the cumbersome laws and regulations that had governed such transactions. The new Foreign Exchange Transactions Law replaced the old Foreign Exchange Management Law and took effect in April 1999. In particular, it replaced the positive list system with a negative list system, which allows all capital account transactions except for those expressly forbidden by law. While foreign exchange dealings in the past had to be based on bona fide real demand, speculative forward transactions are now permitted. This far-reaching liberalization is important in bringing Korea closer to being in line with the market-oriented principles adopted by more advanced foreign exchange markets.

Korea widened its won trading band from 2.25 percent to 10 percent on November 19, 1997, and finally abolished its band and allowed the won to float on December 16, 1997.
The new system was implemented in two stages, in April 1999 and at the end of 2000, in order to allow sufficient time to improve prudential, regulatory and accounting standards before full liberalization. The first stage of the new system eliminated the one-year limit on commercial loans while liberalizing various short-term capital transactions by corporations and financial institutions. Moreover, foreign exchange dealing was opened to all financial institutions.

The government also implemented appropriate measures that could counter excessive instability in the foreign exchange market caused by further liberalization measures. As of January 1999, the supervisory authority on domestic financial institutions’ soundness in foreign assets and liabilities was transferred to the Financial Supervisory Commission, making it solely responsible for the nation’s financial supervisory function.

As described above, the Korean government opted for an additional big bang in capital account liberalization. This once again implies that the Korean crisis could have been prevented if appropriate prudential regulations were effectively implemented and enforced. The badly-sequenced capital account liberalization itself was not a major triggering factor for the Korean crisis. The Korean government was very cautious in implementing capital market opening, but it was not very cautious in supervising the banks. Avoiding future financial crises requires appropriate prudential regulation and enhanced risk management practices. Premature liberalization of the capital account without a proper regulatory framework and effective enforcement of improved regulations is likely to lead to the “double mismatch” problem. Accordingly, more impending policy challenges today are how to construct a more effective regulatory framework for bank supervision and encourage financial institutions to adopt better risk management practices. Unless supervisory authorities are deemed too weak to do a decent job of prudential supervision over domestic financial institutions, the conventional wisdom of capital controls will remain valid.