The Global Financial Crisis – A Korean Perspective

by Mr. Eui-yong Chung at the 8th Korea-India Dialogue

in New Delhi on Wednesday, May 20, 2009

Thank you very much for inviting me to this forum.

I am honored to have this opportunity to share with such a distinguished group of economists my take on the current global financial crisis and its impact on the Korean economy. As you may have guessed from my background, I have no claims to being an expert on financial issues. But I have witnessed first-hand our own financial crisis in late 1990s and our efforts to recover from it as a senior official in the government, and later during the economic boom as Ambassador in Geneva and a Member of Parliament leading up to the current crisis.

I would like to offer my perspective on what we could have done to better prepare ourselves for today' crisis. While optimism certainly plays an important role in shaping the economic policies, I would also like to say that, in good times and bad, it often proves be a double-edged sword that may distract policy makers from making the difficult but right decisions. I would welcome your thoughts and perspectives on this as well.

The Illusion of Success

When the current financial crisis hit last year, the general mood in Korea, both among the public at large and among the elite, was a sense of helplessness and even resent. Two decades ago, we began to fully embrace the Washington Consensus for an open market with the promise and hope that following its prescription would finally push Korea to the aspired level of an advanced economy. We began liberalizing our capital markets in the early 1990s as a means to join the OECD, which we succeeded in doing in late 1996. However, the hasty opening of the financial markets is believed to have partly contributed to the capital flight that led to the financial crisis in 1997. At that time, the IMF singled out Korea as perhaps the most vulnerable economy due to its uncontrolled borrowing. And in return for the $58 billion bailout package, we accepted all of IMF's conditionality. To regain confidence of the global markets, we went further for an even more dramatic opening of our financial markets by pledging "IMF plus" remedies.[1] We believed then that Korea needed to allow free flow of capital to improve our economic health.

As the Deputy Minister for Trade during the financial crisis, I remember leading government delegations around the world to convince foreign investors that Korea was a better, safer place to invest now that we had fully endorsed the West's practices. And some of the reforms that came out of it had been long overdue, such as government deregulation, corporate governance and restructuring, and labor sector reforms. In fact, I believe that we did not go as far as we should have in the public, corporate and labor sectors, due to strong resistance from the respective sectors. However, what was less understood, but equally emphasized as an integral part of the overall reform package, was the opening and deregulation of the financial sector.

There were many improvements brought about through the IMF-prescribed policies, and for a decade or so since our own crisis, things had been going relatively well until the recent collapse. Korea had recovered from the crisis faster than other Asian economies, and repaid its outstanding foreign debts earlier than its due time and became a net creditor. The economy grew annually at an average rate of 4%. The foreign reserves reached over $260 billion by the end of 2007 from a mere $5 billion level during the financial turmoil. The value of the Korean currency rose from more than 1,900 *won* to the US dollar at the peak of the crisis to around 950 *won* to the dollar in early 2008. Even President Lee Myung-bak's campaign pledge during the 2007 presidential election, dubbed the "Korea 747 Vision Plan," looked deliverable.[2] And it is only months ago that our brightest kids still dreamed of joining the ranks in Wall Street firms, or our government ambitiously laid out a blueprint to become the "financial hub of Northeast Asia." But the extent to which the current crisis have afflicted Korea as much as, if not more than, those economies that had not followed so meticulously the Washington Consensus, has left us with a sense of confusion and bitterness.

There is a saying, "nothing feeds success more than past success." Unfortunately, in our case, success only fed complacency. As the economy continued to prosper, and as Korea's trading

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1 The Case for an East Asian Caucus on global governance A Korean Perspective, by Dr. Soo-gil Young, Chair, KOPEC, Seoul, on April 12, 2009

2 As a presidential candidate during the 2007 election, Mr. Lee Myung-bak had pledged to increase annual economic growth rate to 7%, double the per-capita income to $40,000 and lift the economy to the world s 7th largest from the 12th by 2017.

with China surpassed that with the U.S. for the first time in history, government officials began to confidently pronounce that Korea was increasingly "decoupled" from the U.S. economy, which began showing strains from its housing market as early as the summer of 2007. Even when things really began to take a turn for the worse in early 2008, our officials maintained that the U.S. mortgage market troubles were an isolated event from which our economy would be shielded. They kept assuring us that we were not likely to run into another financial crisis, citing the country's stronger economic fundamentals compared to a decade ago. It is understandable, even forgivable, that our government did not have a clear grasp of the magnitude of the U.S. financial meltdown. However, it was irresponsible and naïve for the government not to have thought through a contingency for the impacts of a U.S. fallout on Korea's economy. Even if we had one, how we could have succeeded in protecting the economy from the global shock is still unclear to me – but, nevertheless, we should have at least been contemplating such a possibility.

The impacts of the crisis on our economy were indeed severe. The economy shrank 4.3% in the first quarter of this year compared to the same period of last year, following a 5.6% decline in the previous quarter, which was the worst performance since the first quarter of 1998 when the economy shrank 7.8%. On April 22, the IMF sharply lowered its 2010 growth outlook for Korea to 1.5% from its 4.2% prediction two months ago.[3] It was the sharpest downward adjustments of its growth forecasts among key economies. The IMF report came as government leaders were encouraged by some signs of recovery in recent months and publicly expressed their confidence about the earlier-than-expected recovery. The government now predicts that we will post a growth rate of 3 to 4% in 2010, after a 2% drop this year which is about half of the IMF's forecast of a 4% decline.

The Perils of Optimism

Optimism recently started to spread in Korea that our economic slump would soon hit the bottom. In dire times as now, optimism may be a good thing, but must be grounded in reality. In fact, the economy technically avoided a recession, or two straight quarters of contraction,

[3] Further, on May 5, 2009, the IMF, in its revised global economic outlook, forecast that the per-capita GDP of Korea will decline to $14,945 in 2009 and will not breach the $20,000 mark until beyond 2014, when it will reach $19,015. Korea s per-capita GDP had topped $20,000 mark in 2007. But, in 2008, it dropped to $19,015, thanks to the sluggish economy which grew only 2.2% and the weaker currency which tumbled 25.7%. The Korean government recently forecast that the per-capita GDP may surpass the $20,000 mark in 2011.

by growing 0.1% in the first quarter of this year over the previous quarter which resulted in a 5.1% quarterly plunge. Financial markets performed relatively well, with its stock price index having risen 24% in the four months of this year[4]. Foreign currency liquidity has been eased, as the country's foreign reserves began to increase again.[5] And the value of the *won* began to stabilize at around 1,300 *won* to the dollar since late April.[6] Such optimism gained some credence when the OECD announced that the leading indicators in February showed that Korea was ahead of other OECD members in its recovery from the current crisis.[7] But before we embrace this optimism, we need to take a reality check. Critics say that the signs of recent improvement were mainly powered by lavish government pump-priming[8] and cautioned against such optimism as concerns linger over the stagnant debt market and lackluster foreign investment. They warn that the Korean economy is not coming out of its slump in a V-shaped recovery as it did from the previous crisis, but rather it will experience a W-shaped "double-dip," or even an L-shaped recession, taking more time than anticipated before making a turnaround.

Another troubling example of our misguided optimism lies in our complacency towards foreign exchange reserves. After our financial crisis of 1997-98, we clung to the belief that as long as we had enough foreign currency reserves, we could enjoy a free-flowing capital

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[4] The stock price index, KOSPI, which fell below the 1,000 mark in early March 2009, now hovers around the 1,400 level.

[5] The foreign reserves began to rise again in January 2009 and amounted to $212.5 billion at the end of April, the highest since September 2008 when it amounted to $239.7 billion.

[6] The improvement in the country s foreign reserves has also helped to strengthen the *won*, which has gained nearly 300 *won* against the dollar within two months since March 2 when it reached 1,575 *won* to the dollar. The *won* rose to a four month high to 1,270 *won* to the dollar on May 5.

[7] On April 20, 2009, the OECD announced in a report that the composite leading indicator(CLI) for Korea increased to 94.5 in February, up 1.6 points from 92.9 in January. The CLI gauges how the economy will fare six months ahead. And a reading below 100 means the economy will continue to shrink. Korea posted the steepest improvement among 30 OECD member nations in the index. The OECD average stood at 92, down 0.7 points from a month earlier.

[8] On April 29, 2009, the Korean National Assembly approved the government s supplementary budget bill which included a 17.2 trillion won, or $13.6 billion, package of cash handouts, cheap loans, labor market aid and infrastructure spending. The package was in addition to 50 trillion won allocated earlier in relief measures. In addition, the government has frontloaded spending, by pouring as much of 40% of this year s budgetary expenditures into the economy during the first quarter.

market without fear of another capital flight. Korea had successfully accumulated the 6th largest amount of foreign reserves in the world in ten years since the last financial crisis. The perceived strength of a central bank's ability to intervene would provide enough protection. Moreover, we were led to believe that the U.S. financial markets with its highly sophisticated leverage mechanisms were optimizing the efficiency of capital allocations while its consumers were making rational choices as they piled on debt that were being financed by Korea and other exporting countries. We had confidence that our buildup of dollar reserves not only protected our economy but provided capital to the efficient and rational economy that is the United States. We all know what has happened since. Not only did the U.S. experience a devastating housing market burst, it spread its malaise through a "trade burst." As *BusinessWeek* reports**,** the false aura of wealth created by cheap debt and rising home values had led U.S. consumers to spend more than they earned, whose demand for imported goods fueled production and imports from countries like Korea, China and Japan.[9]

Our foreign exchange reserves declined more than $60 billion in 2008. In October alone, it dropped by more than $27 billion, or 11% of the total reserves, and an amount greater than the entire foreign reserves we had when the financial crisis occurred in 1997. The decline came as the government aggressively intervened in the currency market to prop up our weaker currency and provided dollars to local banks suffering from a liquidity crunch. However, as capital outflows by foreign investors continued, further decline in reserves and in the value of the currency had serious confidence effects, spurring further outflows. The balance of foreigners' investments in Korean companies, securities and other assets stood at $602 billion at the end of last year, a 27.5% drop or $224 billion lower than a year earlier. The value of the Korean *won* depreciated more than 50% in the six months period since September 2008, reaching 1,575 *won* to the dollar in early March this year, the steepest devaluation among the key Asian currencies. Overall, the situation demonstrated that a country with large war chests like Korea cannot fully insure against a "sudden stop" of capital inflows.[10]

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[9] The End of the Trade Bubble, by Michael Mandel, in *BusinessWeek*, on February 11, 2009

[10] Implications for Asia from the Global Financial Crisis and Policy Perspectives, by Takatoshi Kato, Deputy Managing director, IMF, on February 14, 2009

History teaches us that the markets are bound to fail without sufficient oversight. And when the market ceases to function, as it did in our currency markets – during which all attempts by our central bank failed to prevent the *won* from sliding – all of those previous assumptions go out the window. Like in most trade agreements, there are "safeguard" clauses in financial arrangements to be invoked in an emergency. But it seems that they were not given the same level of attention as would be given in comparable trade agreements. Capital controls of whatever nature and degree have been strongly discouraged, if not considered even taboo, by the Washington Consensus. It is not only glaringly apparent in hindsight but was also a matter of common sense that we cannot assume only the upside and ignore the possibility of the downside. And yet that is what seems to have happened not only to the U.S. financial system but also to the recommended approach to financial liberalization that we have followed. High levels of reserves are helpful but only up to a certain point, and are not necessarily able to insulate the economy. The blind embrace of the markets can be, and is, too much of a good thing.

The Moment of Truth

The impact of the global financial crisis is only a partial reason for Korea's trouble today. While our financial policies have trapped us in this hole, we first dug ourselves into it by not addressing our key weaknesses and challenges. Despite our relative growth and wealth, we failed to graduate from a generally "mercantilist mindset" of export-led growth. Even today, in many quarters, exporting goods to foreign markets is considered patriotic while importing goods is considered a luxury at best. This has not only undermined our interests in further expanding trade with other countries but also, more fundamentally, stifled our efforts to forging a more balanced economy. It must certainly bewilder the foreign observers that Korea, which is almost completely reliant on foreign trade for all of its energy and natural resources as well as food supply, is paralyzed for almost a year by demonstrations against U.S. beef imports while its parliament is consumed by the bitter division over the Free Trade Agreement with the U.S.

Having said that, I do recognize that Korea's economic future lies with trade, more exports and imports, not less. After all, Korea has a population density that is second only to Bangladesh and our dearth of arable land[11] and natural resources make us dependent on

[11] Incidentally, the size of arable land in Korea, which consists of about a quarter of the total land, further shrank 1.4% in 2008 thanks to construction of new roads, homes and factories.

imports to survive, and hence the foreign currency to fund them. Food and oil together account for one third of our total imports annually.

The consequences of the current global crisis are similar to the ones Korea had experienced during 1997-98. But this time the consequences seem even worse. There has been a drastic fall in our merchandise exports due to the world-wide recession. Our exports during the first quarter of this year dropped by 24.5% compared with the same period of last year, although monthly changes in exports began to show some signs of recovery since February after contraction by a record pace of 32.8% in January.[12] Some were encouraged by month-to-month increases in exports and the current account surplus that was widened to a monthly record of $6.65 billion in March. But again, this optimism is misguided. The news is not as rosy as it seems: the surplus was driven by the contraction of imports, not by the growth of exports. It is more a reflection of subdued domestic demand, and a weak currency, than it is a sign of a strong rebound of the economy. More importantly, the manufacturing sector, which is the main base for our exports, posted a contraction of 13.5% on a year-to-year basis in the first three months of 2009.[13] It is the worst number tallied since the Bank of Korea began compiling such a report in 1970.

While we are overly protective of our market in sentiment, the Korean economy is intrinsically outward oriented in structure. It is not a far stretch to describe our economy as being dominated by a handful of conglomerates with a manufacturing base that targets the global market while largely ignoring its own. This is not by any means a vice in itself; rather it is the preponderance, or stranglehold, of these conglomerates on the Korean economy that increases the latter's vulnerability to the whims of the former. If the U.S. suffers from a deficit of production of goods and services vis-à-vis consumption, Korea suffers from the opposite imbalance. If Korea is to become a more robust and self-sustaining economy, it will need to grow its domestic market.

Perhaps the worldwide recession is already reducing the global economic imbalances. The U.S. trade deficit, as a percentage of GDP, fell to 2.4% in the first quarter of this year. It is less than half the deficit shown in the same period a year ago and the fastest drop rate ever,

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[12] The government predicts that this year s exports would amount to $355 billion, a 16% decline from $422 billion in 2008.

[13] The first-quarter earnings of the two major exporting power houses, Samsung Electronics Co. and Hyundai Motor Co., also fell 72% and 43% respectively compared with their net profits a year ago.

according to the latest estimate by the Bureau of Economic Analysis in the U.S.[14] Similar to Korea, the shrinking trade deficit in the U.S. is not being caused by a rebound in U.S. exports, but by declining imports. U.S. exports peaked at 13.7% of GDP in the third quarter of 2008, but were down to 10.9% in the first quarter of this year. Over the same period, imports fell to 13.3% of GDP from a peak of 18.6%. Much of the decline in U.S. consumption will be felt in other countries, who supply products that the Americans are no longer buying. It is very much a zero-sum game. Declining trade deficits in the U.S. will be eventually matched by failing trade surpluses in countries that have historically been net exporters. We have been telling the U.S. to take actions to reduce its trade deficit. Now that the reduction has happened, it may be us who will be among the most hurt by it.

The supply-demand imbalance we face today, however, can only be met through more trade. When Korea was hit by the first financial crisis in late 1990s, we launched multi-track, high-level and comprehensive Free Trade Agreements (FTAs) with major trading partners. The main purpose was to secure market access overseas, but we also hoped to stimulate domestic economic reforms through opening our markets.[15] FTAs are, however, inherently preferential and discriminatory, derogating from the most-favored-nation (MFN) principle, the very foundation upon which the multilateral trading system (MTS) is based. Thus the rapid spread of FTAs is seen as one of the most serious challenges facing the MTS.[16] As Pascal Lamy, Director General of the WTO, recently said at a WTO General Council meeting, if we are serious about the prevalence of the MFN principle, we should collectively think about some way of gradually "multilateralizing" concessions made in FTAs.

Moreover, the current multilateral trade rules agreed in 1994, do not sufficiently cover all important elements of trade in the 21st century. More disturbingly, as financial markets became unstable and unemployment was rising, politicians found it increasingly tempting to paint protectionism as the cure for their national economic hardship. Trade negotiators are

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[14] Yanking U.S. trade into balance, by Floyd Norris, on *International Herald Tribune*, p. 16, May 2-3, 2009

[15] Since the first FTA with Chile in 2002, Korea has concluded FTA negotiations with Singapore, ASEAN, EFTA, the U.S. and India, and are now conducting negotiations with 45 other trading partners including the E.U., Japan, China, Canada, Australia and Mexico.

[16] Since January 1995, 196 new FTAs or RTAs have been notified to the WTO with an average of 11 notifications every year, compared with an annual average of less than 3 during the previous 47 years of the GATT.

conspicuously taciturn about the potential violations of the WTO subsidy rules by the stimulus packages. Now, the "moment of truth" has come – we must strengthen the MTS. The Doha round, launched in 2001, has been going nowhere. To successfully conclude the Doha round negotiations, we need to fundamentally change, among other things, a trading system of farm and manufactured goods. It will require enormous political courage by all participants in the negotiations. Rich nations should cut trade-distorting subsidies and tariffs, especially in the agricultural sector. Emerging nations need to open markets in exchange for greater market opportunities. An inability to strike a deal would not bode well in geopolitical terms either, and would not lead to successful negotiations in climate change or reform of global financial institutions.[17]

As I said earlier, economists and experts are split over the shape of our economic recovery. They are looking at the same set of data and coming to different conclusions based on their own politics and their own idiosyncratic perspectives. The current conundrums are also forcing policy makers to focus on short-term returns and further delaying other much-needed longer-term reforms to make our economy better. But one thing is clear and undeniable. Blind and misguided optimism is not only unhelpful. It can be critically damaging. Our current crisis shows that we cannot export our way out of our problems. We can no longer overly rely on exports as our primary engine of growth. While it is crucial that we expand our export markets and secure foreign currencies, we need to start paying equal attention to "economic rebalancing,"[18] in particular rectifying the imbalances at the other end of the scale. We need to move beyond our current life-support approach for farmers and undertake bold reforms to make our agricultural sector more sustainable and competitive.

We should also aggressively pursue an energy plan that decreases our reliance on imported fossil fuels. In this respect, the government's "green growth" initiative should be commended, which commits $36 billion, about 3% of our GDP, over 2009 to 2012, to a variety of investments to reduce carbon dependency, improve water management and enhance forest protection.[19] This initiative contains many of the national actions

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[17] A memorandum to the world s trade ministers, by Pascal Lamy, Director General of the World Trade Organization, on *International Herald Tribune*, July 3, 2008

[18] Rebalancing Asia s economies, by Jong-wha Lee, Chief Economist, ADB, on *The Japan Times*, on April 6,2009

[19] The initiative aims at creating 960,000 jobs, including 149,000 jobs in 2009 mainly in construction. The low-carbon projects under this initiative include developing railroads and mass transit, fuel efficient

recommended in the UNEP's Global Green New Deal (GGND), which were also reflected in the stimulus packages of some G-20 nations.[20] However, the effectiveness of such green initiatives depends crucially on implementing complementary policies, which should include removing perverse subsidies and other distortions in energy, transport and similar markets. In Korea, this would entail rationalizing our energy markets that are currently heavily skewed to favor businesses and other interest groups.[21]

I do not deny my bias as a trade negotiator on the value of the trade in goods as opposed to that of the less material financial transactions. In the end, however, the long-term challenges of correcting the problem of proportions and directions in exports and imports are eclipsed by the more immediate need to address the largely undeserved havoc created by financial flows that are beyond our own making. In fact, its effects have almost simultaneously spread throughout the world, underscoring the level of global integration, and hence vulnerability, of the global financial system. However deserved it may be for those involved in greedy financial manipulation, there is little to gain from the "schadenfreude of the West's malaise." In this regard, the April G-20 meeting in London deserves some credit for changing the trends that the global economy is handled. It is premature to declare "the end of the Washington Consensus." A new architecture to replace it is yet to emerge. But the agreement to create a Financial Stability Board that will monitor the financial system for signs of risks can be a very important first step towards strengthening the global financial regulation.

It is also significant that it is the G-20, not the G-7 or the IMF, that is seen as the key-decision-making body.[22] Economic power has now dispersed. There is no mistaking the need for all governments to respond to the crisis in a concerted and coordinated way. There is no standing aside and letting others bear the burden. For export-oriented countries like

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vehicles and clean fuels, energy conservation and environmentally friendly buildings.

[20] The U.S. included $100 billion in its $787 billion recovery package for green investments to be implemented over the next two years and are expected to create or save around 2 million jobs, while China allocated 12% of its $586 billion stimulus package for direct energy efficiency and environmental improvements, according to the UNEP.

[21] For instance, Korea may need to deregulate its electricity markets so that it brings more competition and cuts back on undue subsidies that distort prices and hinders efficient allocation of resources.

[22] Editorial on *The Japan Times*, April 5, 2009

Korea and China, and to a lesser extent Japan and India, we need to more focus on cultivating robust domestic markets and making their economies less vulnerable to global shocks, and becoming more balanced and hence more actively engaged in the international economic system. Diversifying economic ties, which for most of them had been too focused historically on the U.S. market, will be helpful in reducing systemic risk and fostering a sense of community in Asia leading to greater regional cohesion. The recent efforts to further strengthen the Chiang Mai Initiative can be a right step in this direction.[23] In the longer term, Asia's place in the global economic scene will only get larger and so will our weight and voice. We may have greater influence on how the post-Bretton Woods is shaped in the coming years if we can forge a common platform in subsequent G-20 and other international fora.

As I said earlier, at difficult times like this, we need optimism. But we should ensure that our optimism is firmly rooted in realism.

Thank you.

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[23] On May 3, 2009, the Finance Ministers of ASEAN plus Three nations agreed in Bali to establish $120 billion pool of common reserves which the countries can draw on in the event of a financial crisis, replacing a network of bilateral currency swap agreements worth $80 billion sealed under the CMI after the financial crisis of 1997. China and Japan will shoulder 32% each, and Korea and ten ASEAN nations 16% and 20% respectively.