Korea’s Policy Responses to Global Financial Crisis

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Korea surprised the world twice during 1997/98 (I)

- Humiliated in Asian financial crisis as the representative economy of "East Asian Miracle" to seek for the largest ever the IMF bailout

- Korea's high growth model had serious caveats
  - Highly leveraged business expansion especially by chaebols having debt/equity ratio above 400 percent
  - Banks under the government administered credit allocation had resulted in shallow and depressed financial system
  - Militant labor union
  - Inefficient public enterprises
  - Serious double mismatchs of both currency and maturity
  - Near depletion of foreign exchange reserve in Dec. 1997

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Korea surprised the world twice during 1997/98 (II)

- The world surprised when Korea bounced back with the record trade surplus of US$ 41.7 billion in 1998 and did not need the IMF loan any more
- Korea was able to graduate rather quickly from the IMF conditionality
- This was feasible due to the favorable external conditions generated by the robust world economy

Korea's "Strong Fundamentals" before the Global Crisis Since Asian Financial Crisis

- Painful Restructuring of Korean Economy Produced "Strong Fundamentals" for Korea
- Foreign Exchange Reserve : US$ 240 billion placing Korea the sixth largest foreign exchange holder in the world
- Debt/Equity ratios of corporate sector on the average dropped to less than 100%
- Banking sector has satisfied the BIS capital adequacy ratio under BASEL II
- Korea set a multi-track FTA with U.S., EU, Chile, ASEAN, EFTA, India, Canada to become a competitive advanced open economy
- Active seeker of inbound FDI

Despite "Strong Fundamentals", why has Korea become one of the hardest hit victims(I)

- A record volatility of the Won/ dollar exchange rate like a rugby ball due to unmanageable external shocks during early period of global crisis
- Four months period, Won appreciated by nearly 50% and KOSPI index down by another 50%
- Middle income bracket people see that almost one half of their financial assets evaporate into air
- Foreign investors started to pull out of Korea after the collapse of the Lehman Brothers and major investment banks
- The "Sell Korea" exodus is a main culprit for Korea's financial meltdown

Despite "Strong Fundamentals", why has Korea become one of the hardest hit victims(II)

- Korea's export development economy(about 40% of GDP) is now seriously damaged as the global recession deepens
- Banks, excessively borrowing from lower interest bearing foreign capital such as dollar and Yen carry trades, face liquidity crisis and hence cause credit crunch to corporate sector, especially for SMEs
- Wide-spread de-leverage, deflationary pressure for real asset, and finally defaults of construction companies and small shipbuilders have been emerging
- At the early stage of the global crisis, Korean government has been resilient about "Strong Fundamentals"
- Now, the government has to workout decisive action implementing against clock

Hidden Caveats Emerging as Global Crisis Unfolds

- **Once beaten Koreans become twice wary as the global crisis encroaches Korea**
- **Korea's capital market has been most open among Asian economies so that foreign capital including hedge funds can easily in and out Korean market**
- **Korean banks proved to be again negligent about precautionary risk managements**
  - **Excessive borrowing from overseas to utilize foreign funds with lower interests than those in Korea**
  - **Dollar-carry and Yen-carry trade etc.**
  - **Easy credit-card policy to general consumers**
  - **Easy mortgage loans to cause housing bubbles in larger cities**

The Way Ahead (I)

Securitization : A Necessary Evil?

- **A technique to create securities by reshuffling cash flows produced by a diversified pool of assets**
- **Structured vehicles prove to be too complex to understand**
- **Negative Side**
  - **Promote reckless speculation ("irrational exuberance")**
  - **Increase market risk**
  - **Primary culprit of the current global financial crisis**
- **Positive Side**
  - **Increase liquidity**
  - **Provide an alternative form of financing**
  - **Help manage credit exposure more efficiently**

☞ ***Investment banks need to focus on "good part" of the coin***

The Way Ahead (II)

Financial Supervision (FS)

- What FS is all about boils down to the art of balancing between market statics and dynamics
  - **Statics : Stability, no insolvency, no bank-run**
  - **Dynamics : Efficiency, innovation, competition**

- How to set up an effective and transparent global supervision system with early warning and prompt corrective action sub-systems is key to the post-crisis financial management

New Opportunities for Korea

Revamping Again Korea's Financial System

- BIS ratio needs to be raised by recapitalizing through public funds so that banks can resume lending activities
- Korea needs to undergo a merger process to create "bigger universal banks"
- Korea needs to follow new regulatory regime on which international communities agree to establish more effective surveillance and supervision
- Korea should continue to emulate globally best practice and proven investment banks

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New Opportunities for Korea and India

Korea and India's Cooperation in Making a New Global Financial Architecture

- **Korea and India need to cooperate at G20**
- **Korea serves as co-chair economies**
- **To make more liquidity available to emerging economies**
- **To design new global financial architecture**
- **To speed up multi-nationalization of Chiangmai Initiative within ASEAN + China , Japan and Korea framework**
- **To expand the CMI into a Asian Monetary Fund**

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