Korea’s Policy Responses to Global Financial Crisis

Korea-India Forum
December 3, 2008

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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 mismatches of both currency and maturity
  - Near depletion of foreign exchange reserve in Dec. 1997
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?

- 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
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