

A Comparative Perspective on Two Financial Crises in Korea

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1. Introduction

- South Korea has experienced two financial crises in 1997-1998 and in 2008-2009
 - the crisis in 1997-1998 was a twin crisis with both foreign exchange crisis and domestic banking crisis
 - the crisis in 2008-2009 was part of global financial crisis originated from the US financial market.

The purpose of this paper

- To outline two recent financial crises (1997-1998 and 2008-2009) in Korea
- To analyze their similarities and differences in causes, consequences and the pattern of recovery from each crisis

2. The Twin Financial Crisis of 1997-1998 in Korea

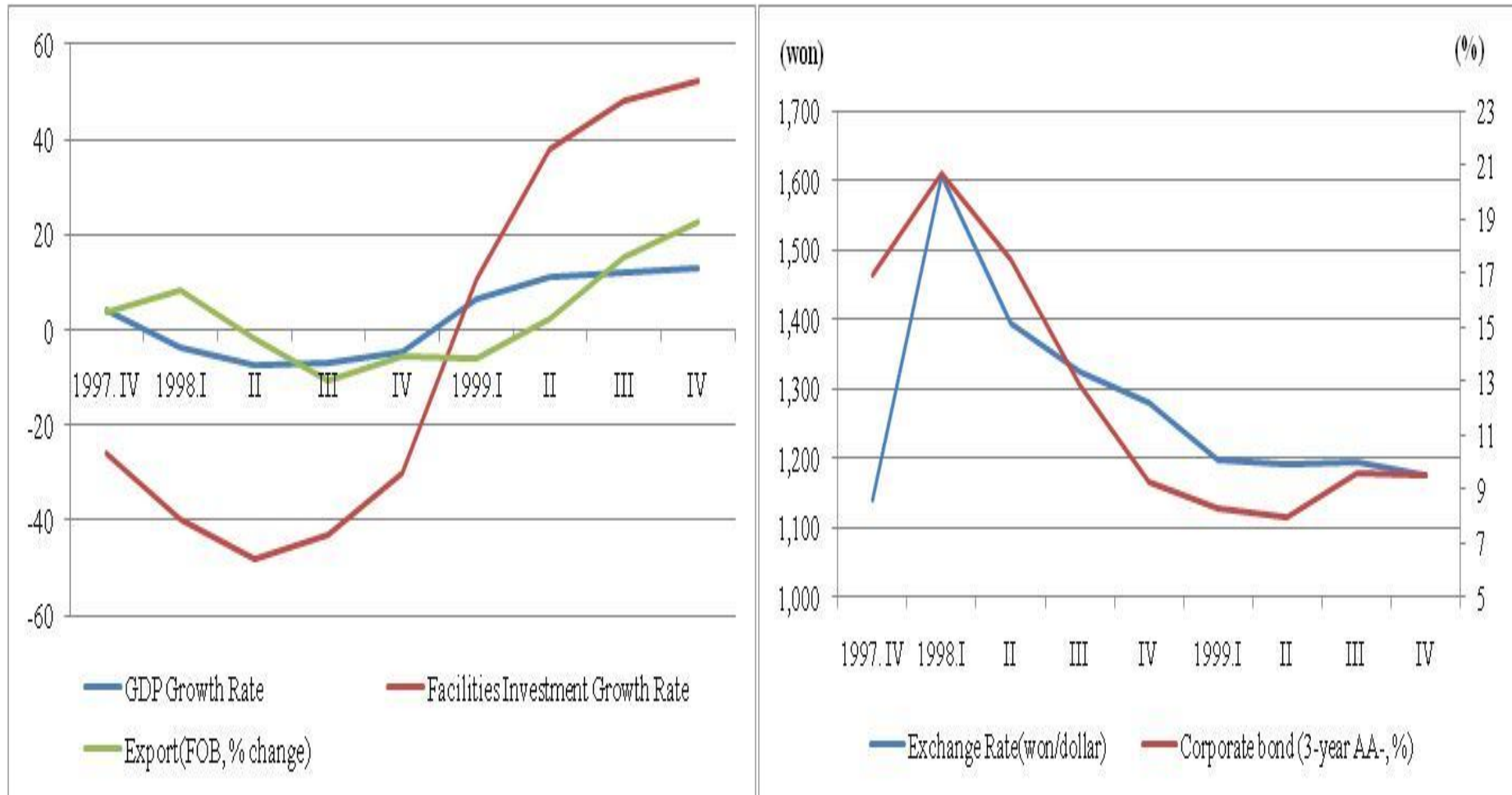
- Three crucial elements contributed to the outbreak of the 1997 financial crisis in Korea.
 - 1) The contagion from Southeast Asia particularly from Thailand
 - 2) The corporate failure
 - 3) The lack of political stability during the transition period from authoritarian or semi-authoritarian regime to a democratic one

Table 1-1. Principal Economic Indicators of Korea (1997 IV – 1999 IV)

		1997	1998				1999			
		Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP growth rate		4.0	-3.5	-7.3	-7.1	-4.7	6.4	11.2	11.9	13.0
Private Consumption		0.8	-12.9	-14.5	-12.8	-10.1	8.0	11.4	13.5	14.5
Facilities Investment		-25.9	-39.8	-48.2	-43.0	-29.9	10.7	37.9	48.3	52.3
Production Index by Industry		2.9	-4.8	-11.3	-9.0	-0.4	14.4	24.9	28.9	29.1
Manufacturing Capacity Operation Rate		100.8	82.9	85.2	82.2	89.7	86.4	97.0	95.9	103.2
Exchange Rate	won/dollar(average rate)	1,140.9	1,606.1	1,394.5	1,325.2	1,279.9	1,198.7	1,191.4	1,194.2	1,174.5
	yen/dollar(average rate)	125.3	128.2	135.7	139.8	119.0	116.5	120.8	113.8	104.5
Interest Rate	Corporate bond (3-year AA-, %)	17.0	20.7	17.5	12.9	9.3	8.3	8.0	9.6	9.5
	Treasury Bond (3-year, %)	13.0	15.0	16.3	12.0	8.3	6.9	6.7	8.7	8.5
Stock Price Index (KOSPI, average)		489.5	507.8	371.3	317.6	437.6	572.3	769.3	943.8	921.1
Export(billion dollars, FOB)		36.7	32.2	34.9	30.5	34.7	30.3	35.7	35.1	42.6
(% change)		3.6	8.4	-1.8	-10.8	-5.5	-6.1	2.5	15.1	22.7
Import(billion dollars, CIF)		34.5	23.7	23.5	21.5	24.6	25.6	28.8	29.8	35.7
(% change)		-14.8	-36.2	-37.0	-39.9	-28.7	8.1	22.2	38.7	44.8
Current Account (billion dollars)		3.9	10.7	11.0	9.7	8.9	6.1	6.2	6.6	5.7
Unemployment Rate		2.6	5.8	6.9	7.5	7.5	8.5	6.7	5.6	4.7
Unemployed Person(1,000persons)		573.0	1,211.0	1,505.0	1,627.0	1,618.0	1,776.0	1,457.0	1,235.0	1,029.0
Consumer Price Index (% change)		1.5	5.3	0.3	-0.1	0.5	0.0	0.2	0.0	1.1
International Reserves (billion dollars)		20.4	29.7	40.9	47.0	52.0	57.5	62.0	65.5	74.1
Total External Liabilities(a billion dollar)		174.2	169.4	171.1	167.5	163.8	161.4	156.7	154.4	152.9

Sources: The Bank of Korea; Korea National Statistical Office ; Korea Customs Service

Figure 1. Principal Economic Indicators of Korea (1997 IV – 1999 IV)



Source: The Bank of Korea; Korea National Statistical Office, Korea Customs Service

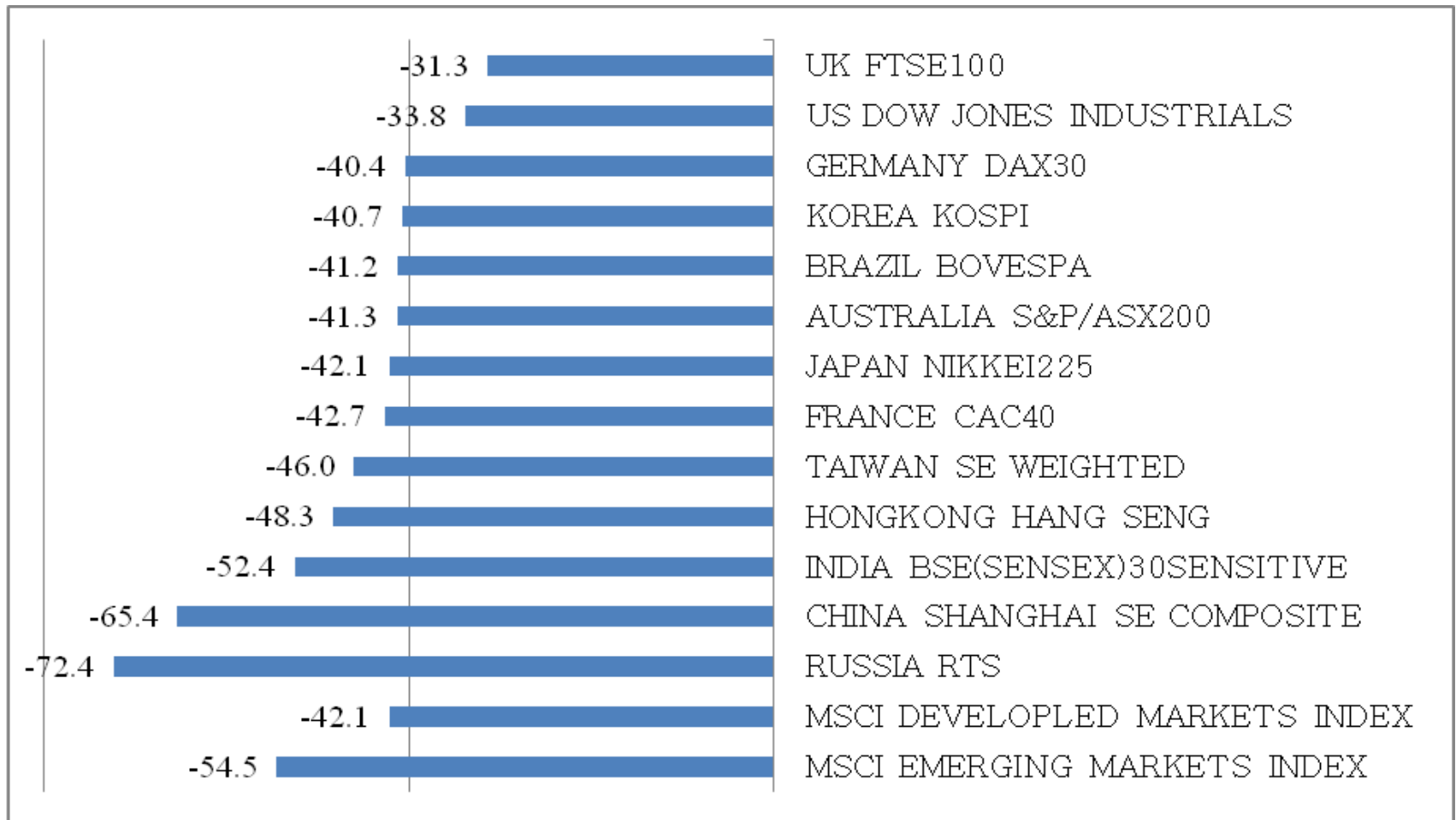
3. The Global Financial Crisis of 2008 and its Impact on Korean Economy

3.1 Immediate Impacts of the Global Financial Crisis

3.1 Immediate Impacts of the Global Financial Crisis

- The repercussion of the financial turmoil from the Wall Street
 - the Globe resulting in contraction in real sector (rising unemployment and lowering commodity prices including oil price)
- The emerging market economies
 - the sharp reduction of stock prices and exchange rates.

Figure 2. Selected Nations' Stock Price Change (31 Dec. 2007 - 31 Dec. 2008)

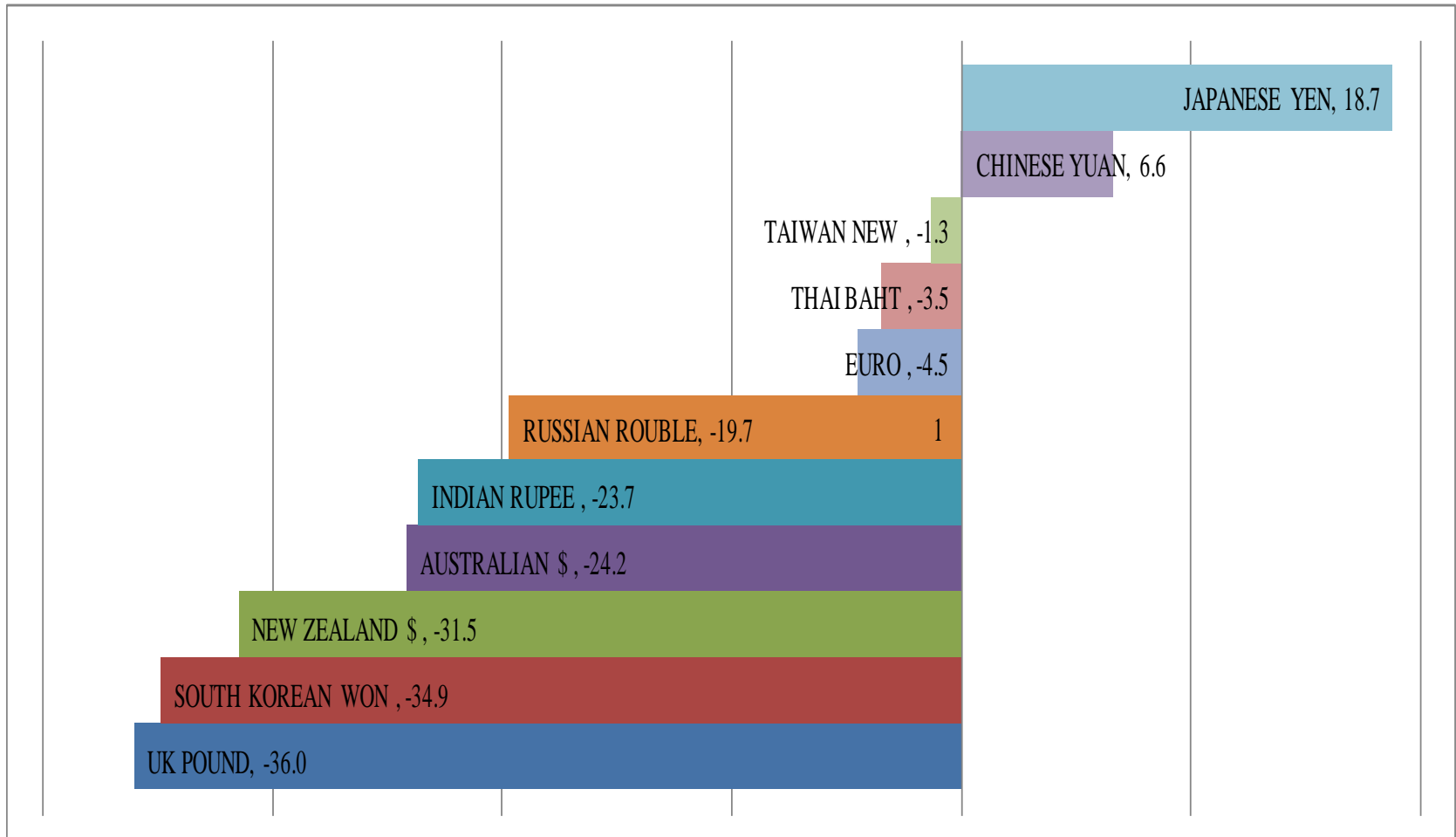


Source: Thomson Reuters Datastream

3.1 Immediate Impacts of the Global Financial Crisis

- The exchange rates of emerging market economies' currencies : significantly depreciated
 - ∴ The foreign capital in-flowed → abruptly out-flowed (replenishing the foreign investors' liquidity and preferring holding onto dollar-denominated assets to reduce risks with non-dollar assets)
- Why Korean Won was depreciated by the largest margin and the KOSPI index too by the substantial margin?

Figure 3. Selected Nations' Currency Revaluation Rate against the U.S Dollar (zero) (31 Dec. 2007 - 31 Dec. 2008)



Source: Thomson Reuters Datastream

3.2 Imbalance between Real Sector and Financial Sector

- The financial turmoil became to manifest itself through a series of incidents :

- Bears-Sterns' failure

- Freddie-Mac's financial troubles

- The filing of bankruptcy by Lehman Brothers Inc. (followed by the bail-out request by Big-3 US automobile manufacturers)

- The merge of Merrill-Lynch by Bank of America

- huge loss by Bank of America and Citi Group.

3.2 Imbalance between Real Sector and Financial Sector

- A core of the real cause of financial malaise and impending global recession :

The cumulated imbalance between the real sector and the financial sector

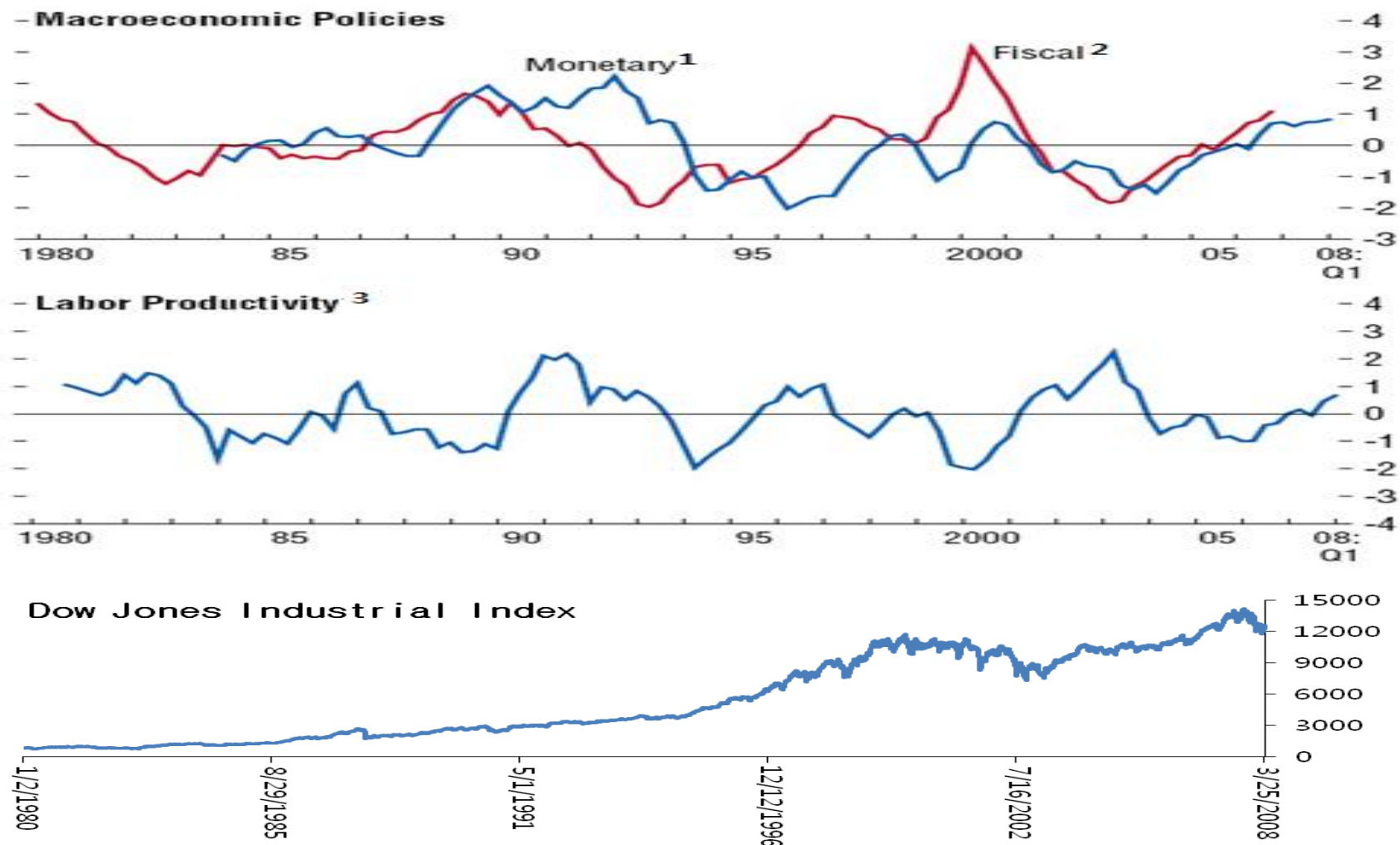
3.2 Imbalance between Real Sector and Financial Sector

- Labor productivity of the total economy (measured as the ratio of real GDP and total employment and represents deviations from Hodrick-Prescott trend)
 - sharp decline during 2003- 2006 after the IT-boom started to submerge
- But, both monetary and fiscal policies
 - excessively expansionary

3.2 Imbalance between Real Sector and Financial Sector

- The lower interest rate policy :
driving up prices of houses and stocks and ultimately commodity prices including the oil price
- The asset price bubble :the financial industries in the U.S. started creating derivatives after derivatives, which had been put outside of reserve regulations.

Figure 4. Macroeconomic Policies, Labor Productivity and Dow Jones Index



Sources: IMF, World Economic Outlook, October 2008, Figure 4.3; Thomson Reuter Datastream

3.2 Imbalance between Real Sector and Financial Sector

- Continuing speculative bubble in both the housing and financial sectors, which was not supported by a real income gain
- The imbalance between the two sectors :
The wage gap vis - a - vis real productivity gap between the two sectors (See Figure 5)

3.2 Imbalance between Real Sector and Financial Sector

- How the financial industries could have afforded such a high wage scale for their professional employees for such a prolonged period of time.
- The question of corporate governance and supervision over secondary banking:
 - System failure like the 1997 crises in Indonesia, South Korea, and Brazil.

Figure 5. Per Capita Real Value-Added and Salaries in Manufacturing and Financial Industries (U.S., Japan, U.K., Germany, Korea)

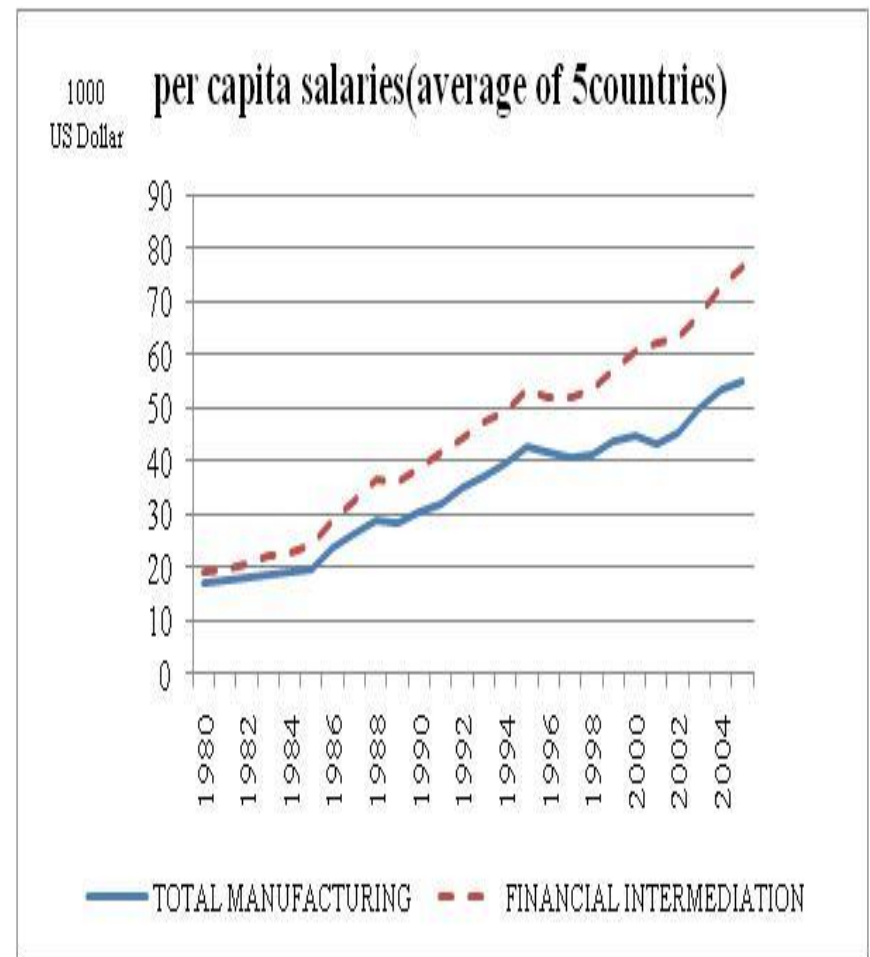
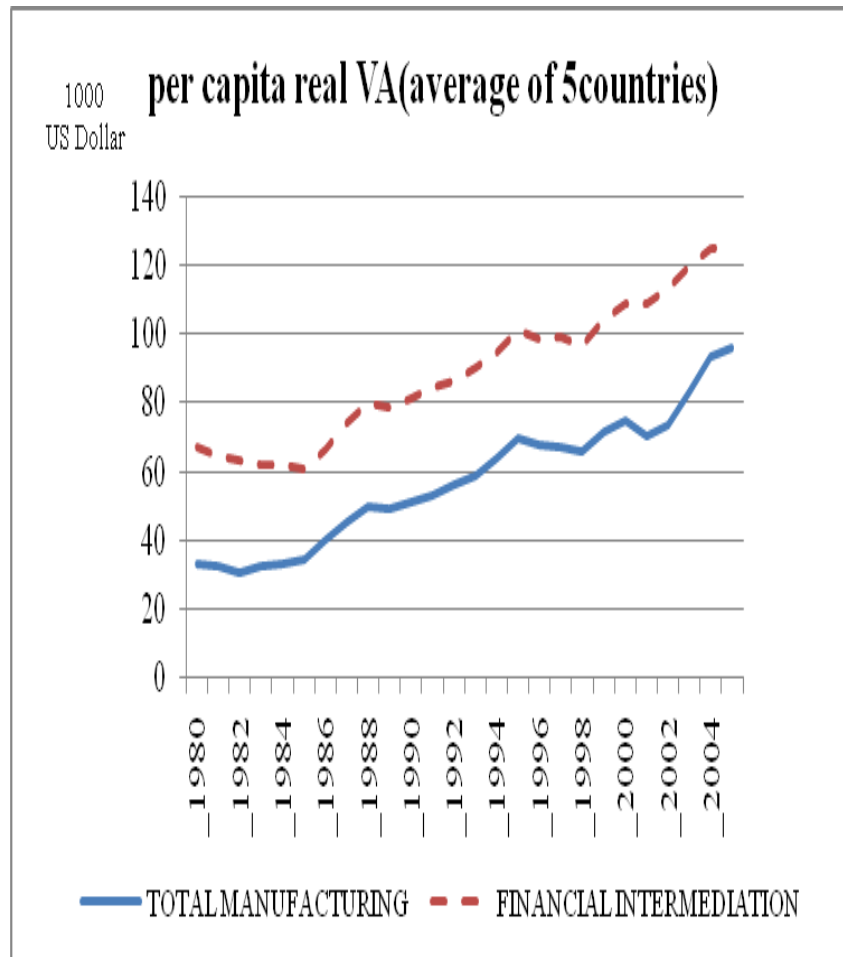


Figure 5. Per Capita Real Value-Added and Salaries in Manufacturing and Financial Industries (U.S., Japan, U.K., Germany, Korea)

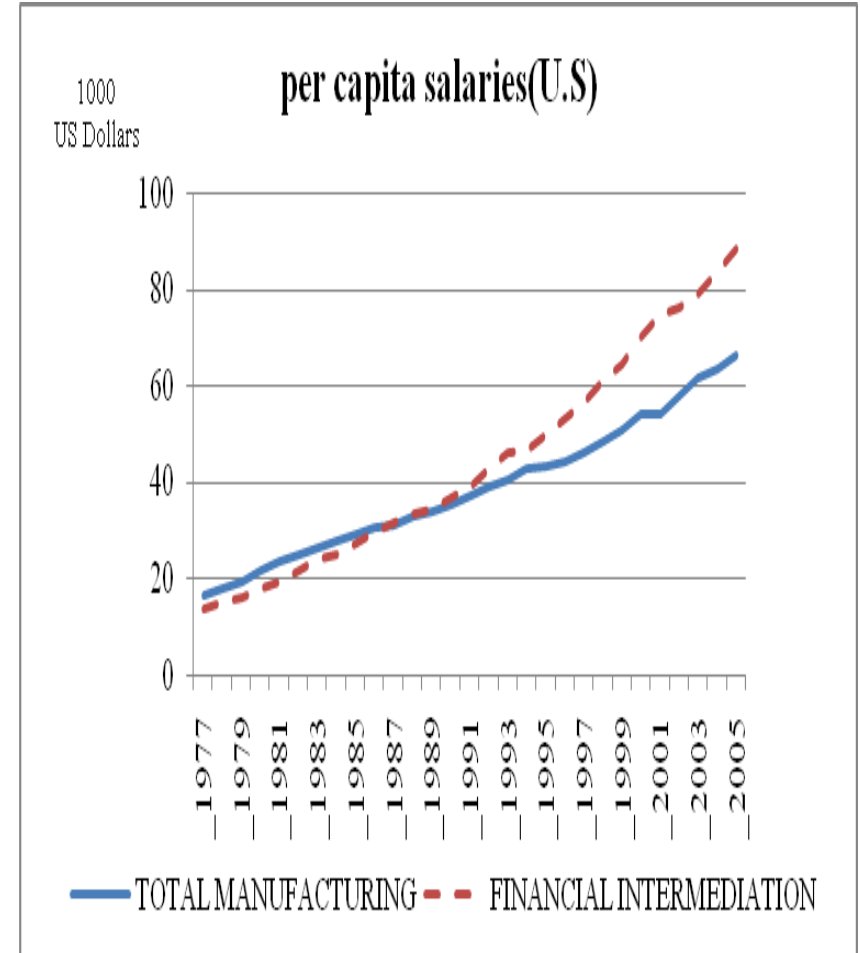
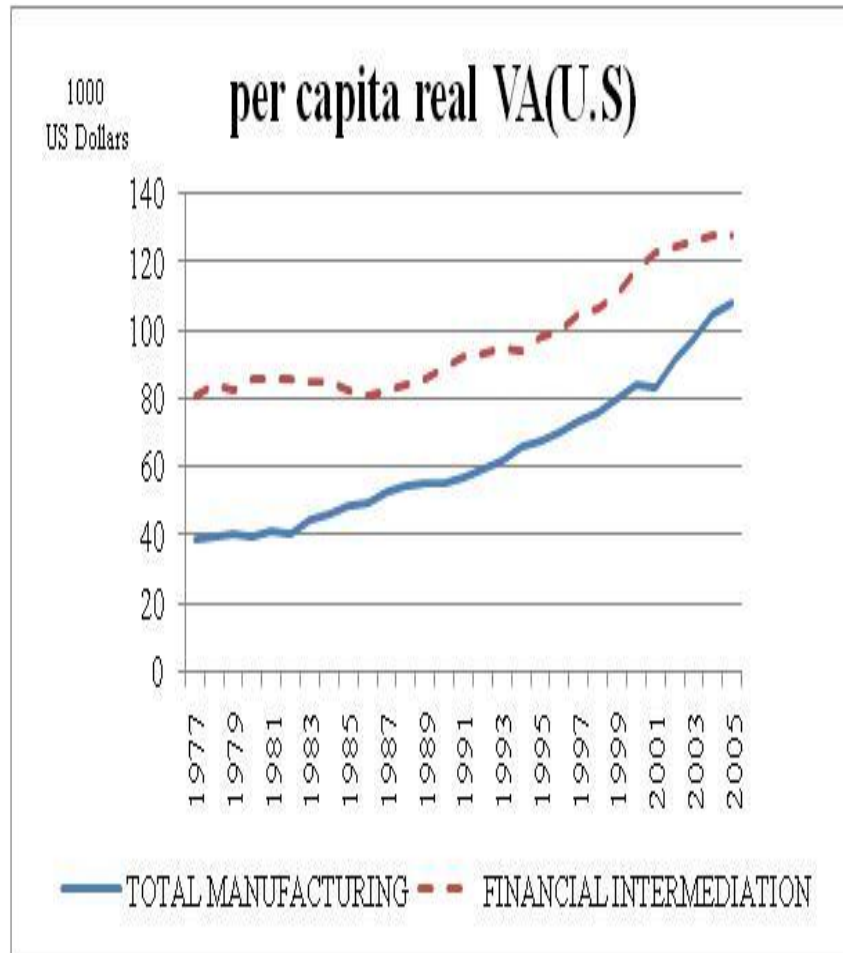
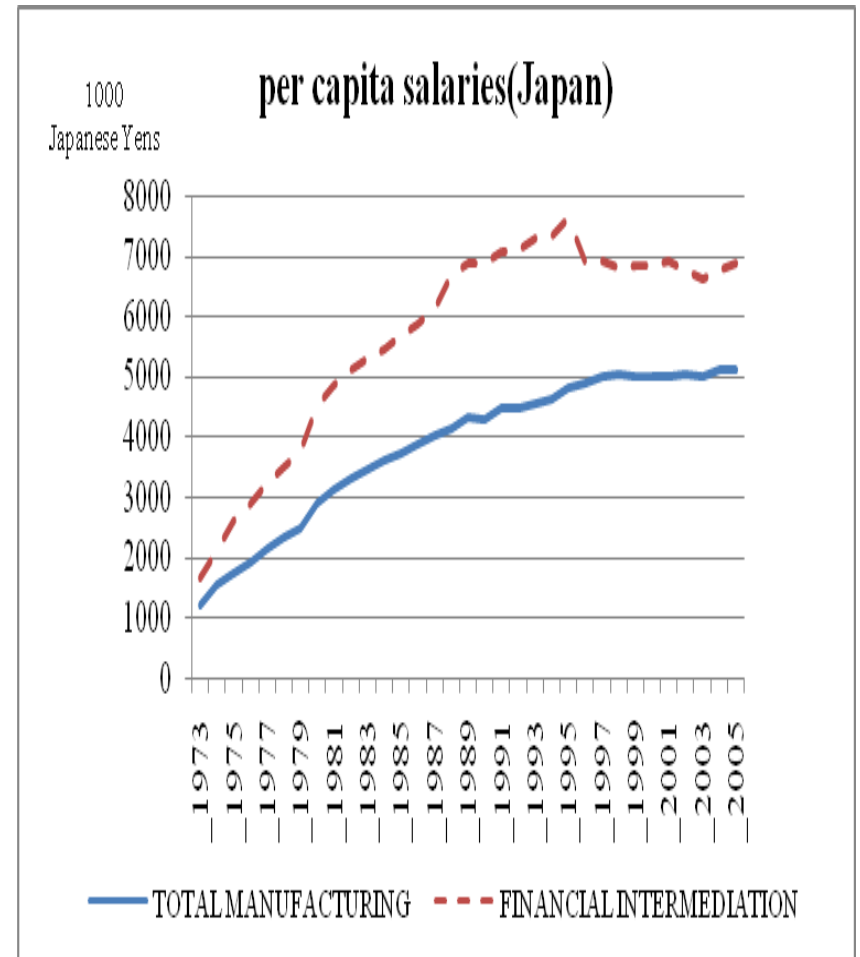
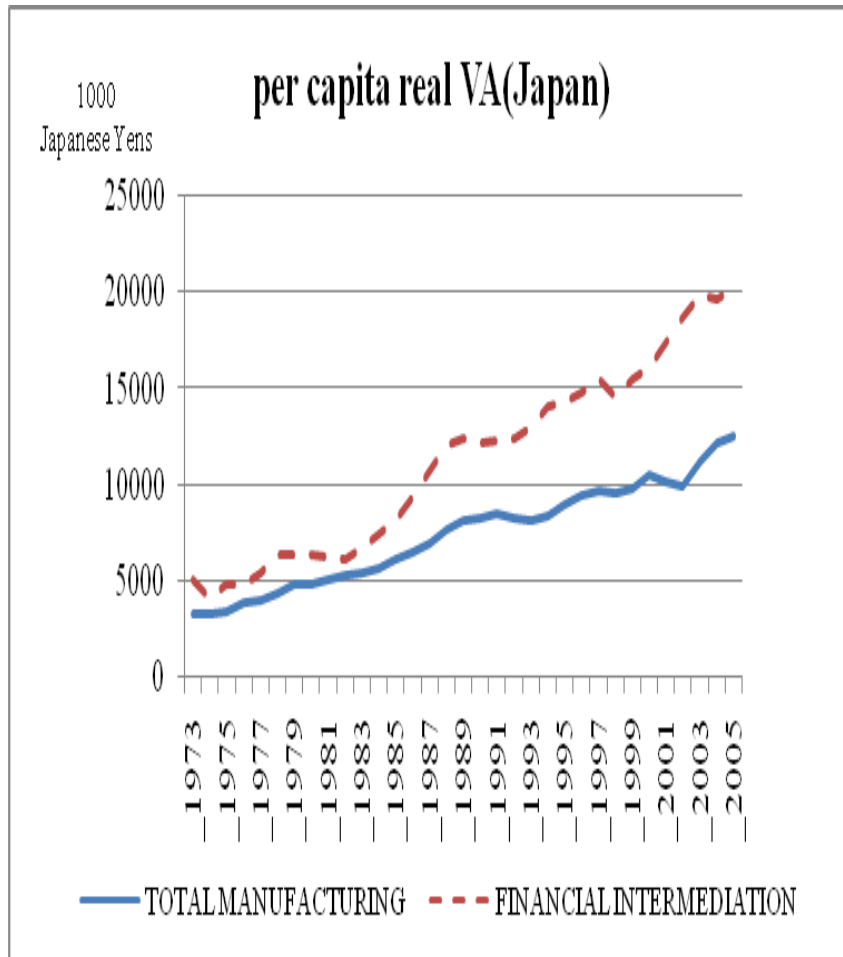


Figure 5. Per Capita Real Value-Added and Salaries in Manufacturing and Financial Industries (U.S., Japan, U.K., Germany, Korea)



Source: EU-KLEMS Database (March 2008 Release)

Figure 5. Per Capita Real Value-Added and Salaries in Manufacturing and Financial Industries (U.S., Japan, U.K., Germany, Korea)

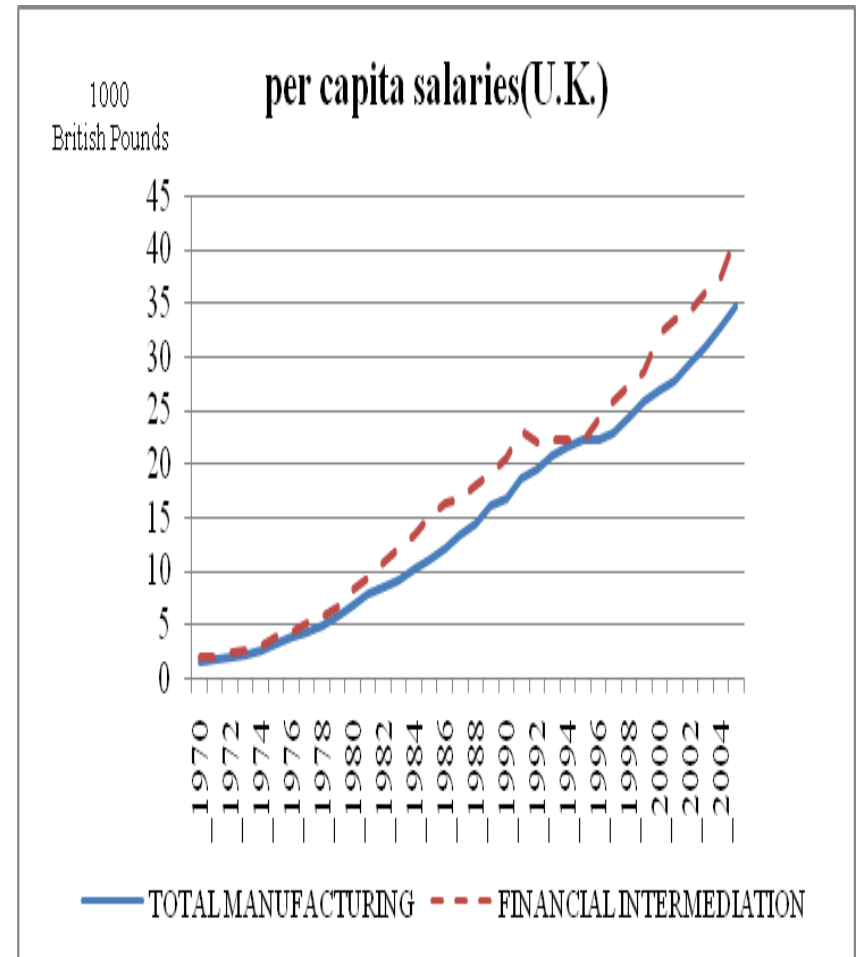
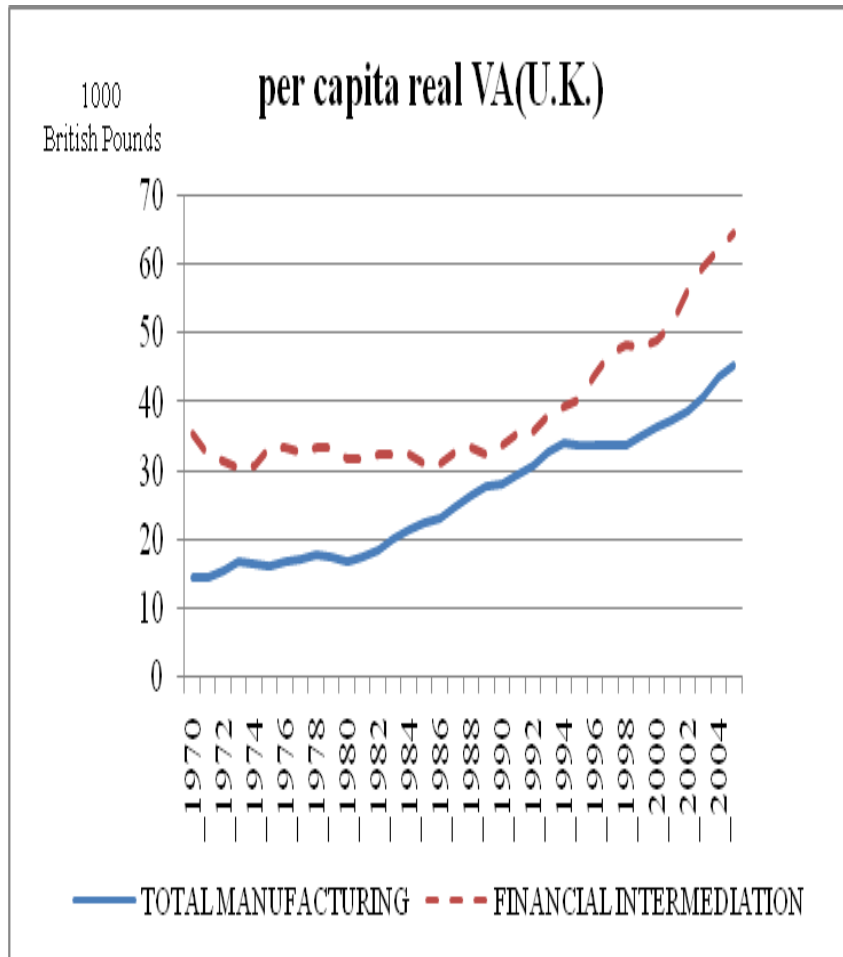


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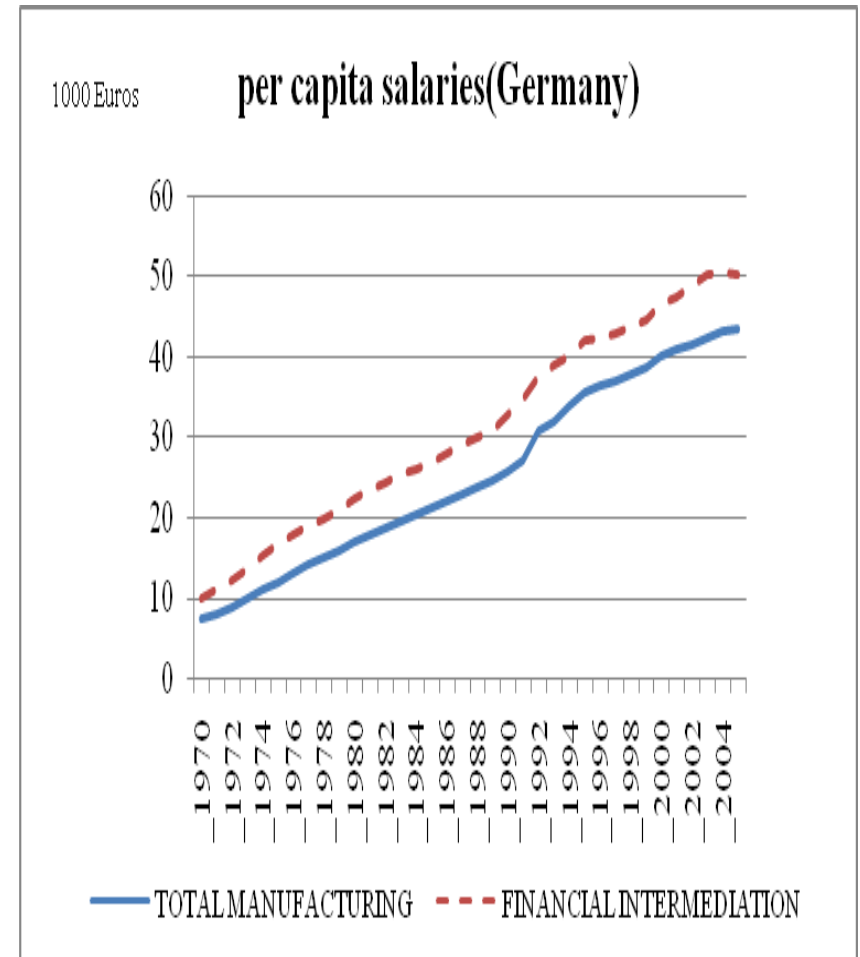
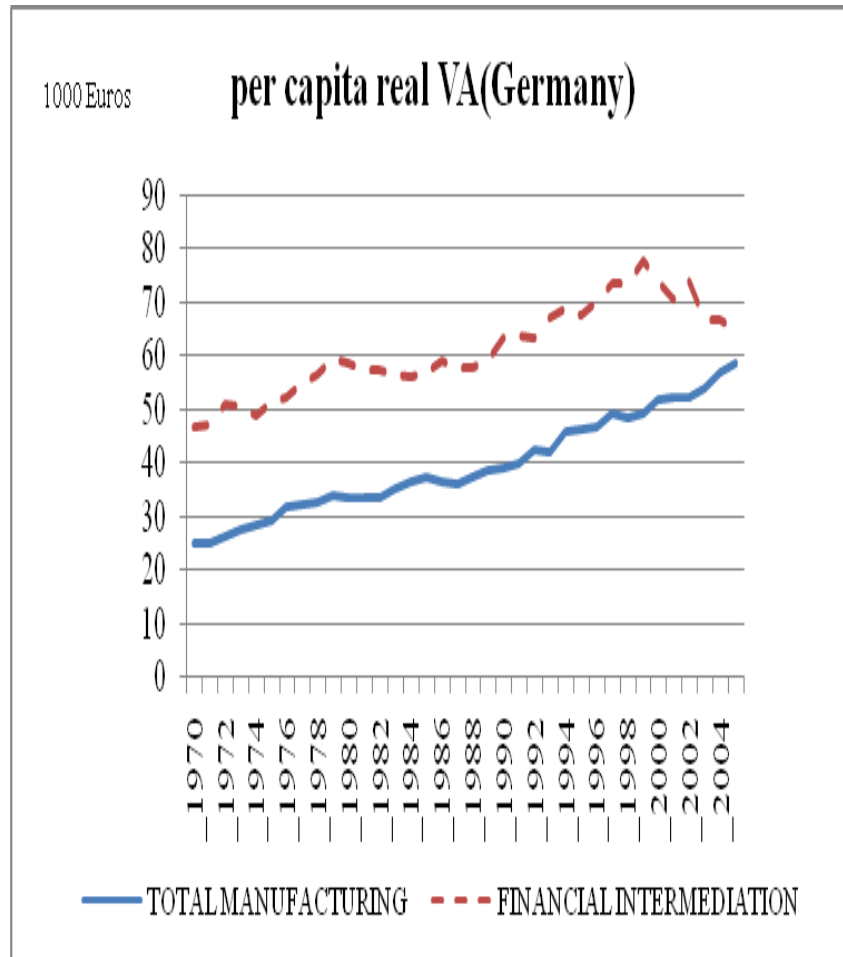
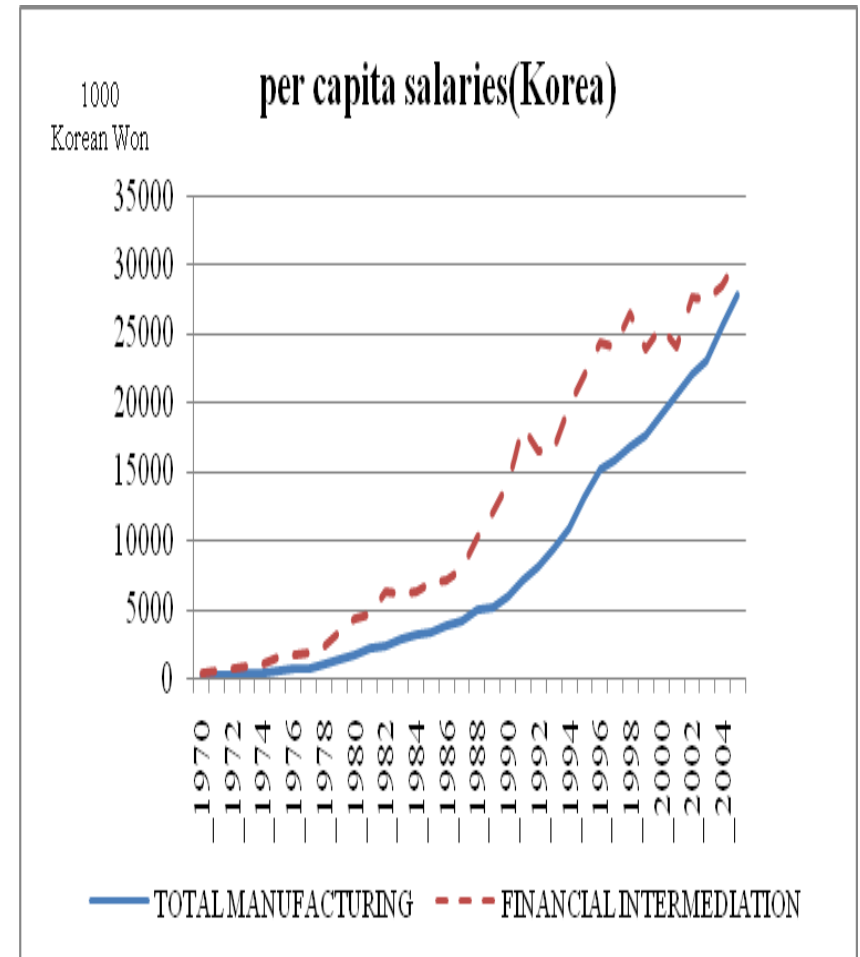
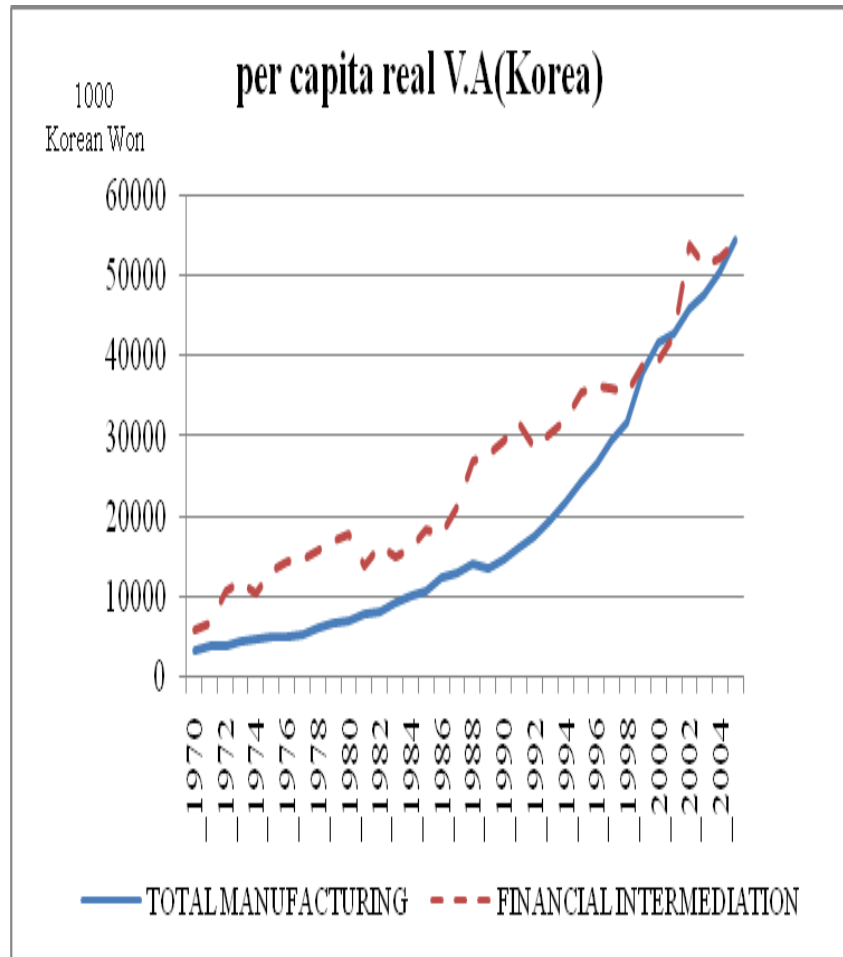


Figure 5. Per Capita Real Value-Added and Salaries in Manufacturing and Financial Industries (U.S., Japan, U.K., Germany, Korea)

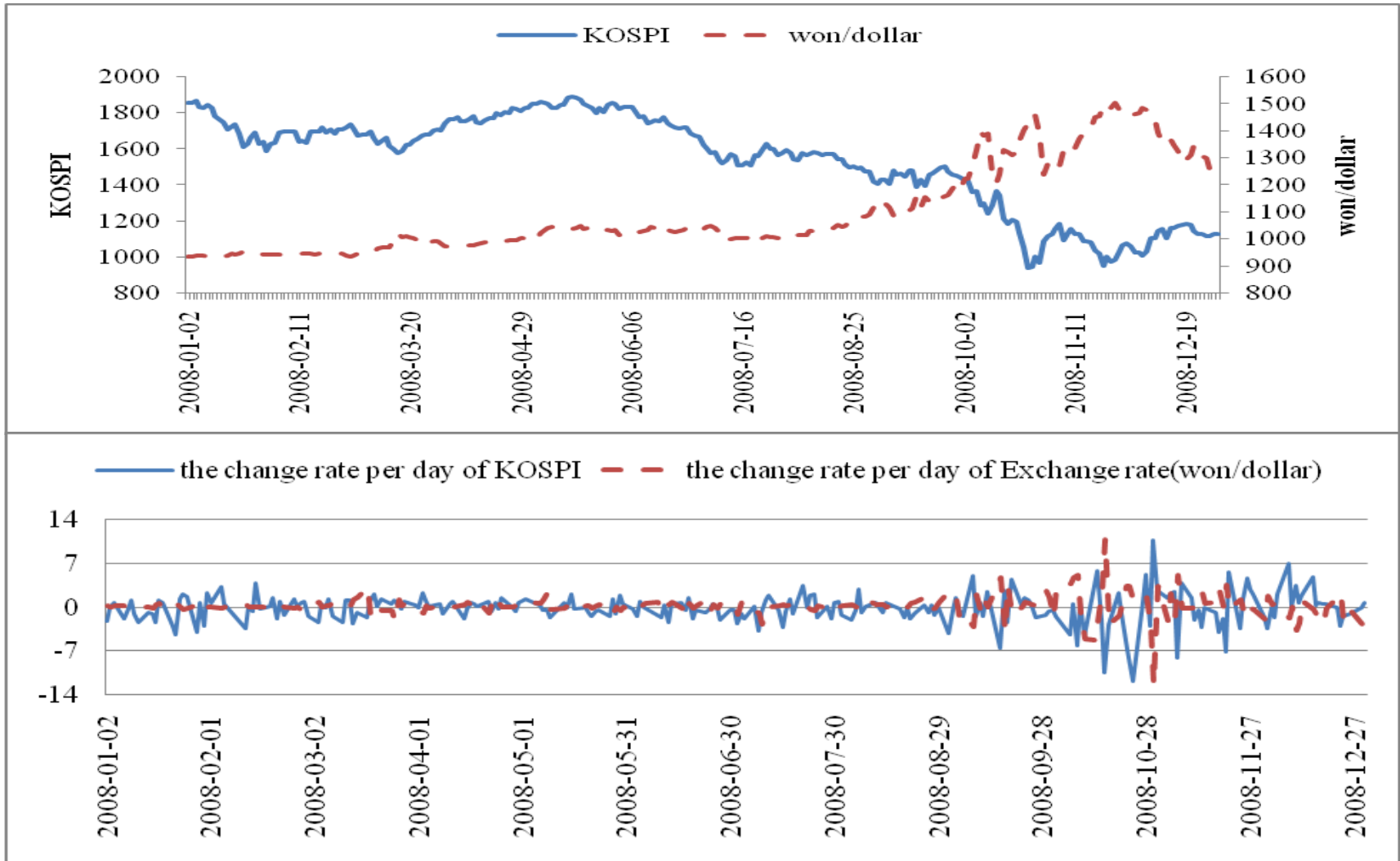


3.3 Volatility of Exchange Rate and Stock Market

- The strong co-movement between depreciating Won and declining stock prices observed during the final quarter of 2008 and the excessive volatility in foreign exchange market and stock market :
 - the lack of de-coupling in Korean markets from the US markets and Korean market's over-exposure to foreign portfolio investment.

Figure 6. Won/dollar Exchange Rate and Korean Stock Market Index (KOSPI)

(1 Jan. 2008 - 31 Dec. 2008)



Source: Thomson Reuters Datastream, and Korea Stock Exchange

3.3 Volatility of Exchange Rate and Stock Market

- The Financial Services Commission (FSC)
“Unlike banks in major developed countries, Korean lenders are able to boost their capital bases through common share offerings and have their own capacity to raise capital.”
- The Korean government
 - to pay due attention to the deleveraging costs of commercial banks and their relatively high loan-deposit ratios.

3.3 Volatility of Exchange Rate and Stock Market

- The post-crisis performance of Korean economy after 2007
: relatively resilient compared to other crisis-inflicted advanced nations.
- The quarterly GDP growth rate was turned around from negative to positive numbers starting from the third quarter of 2009 mainly helped by resilient growth of consumption demand and export.

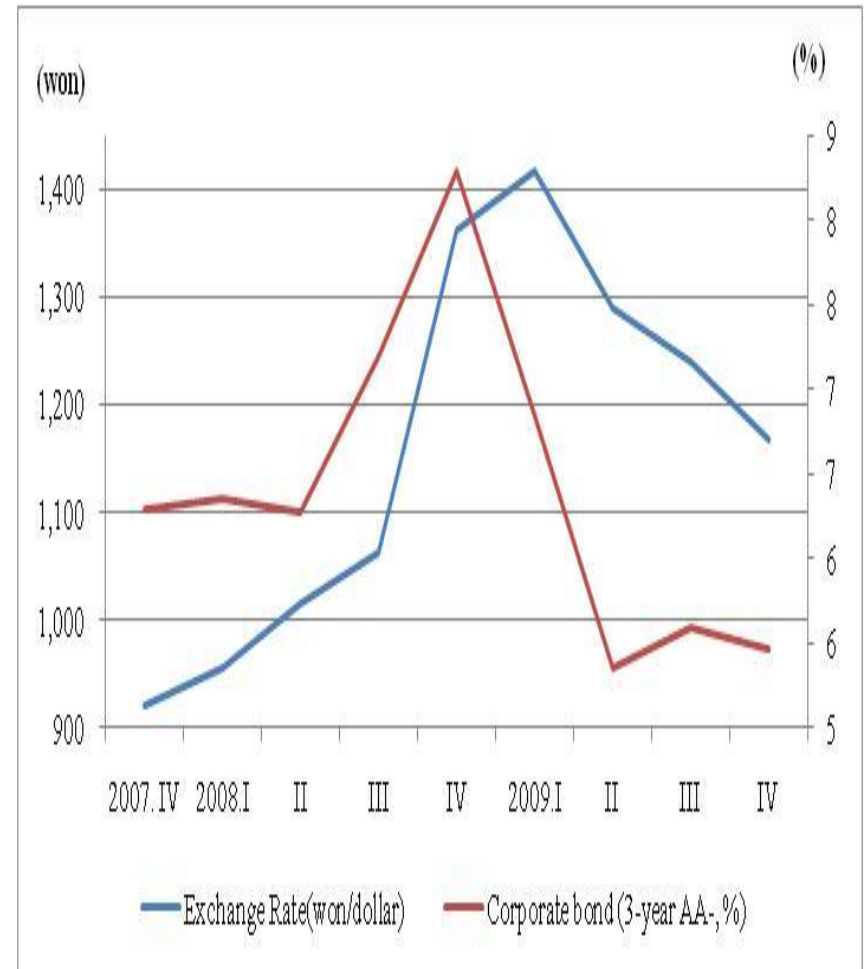
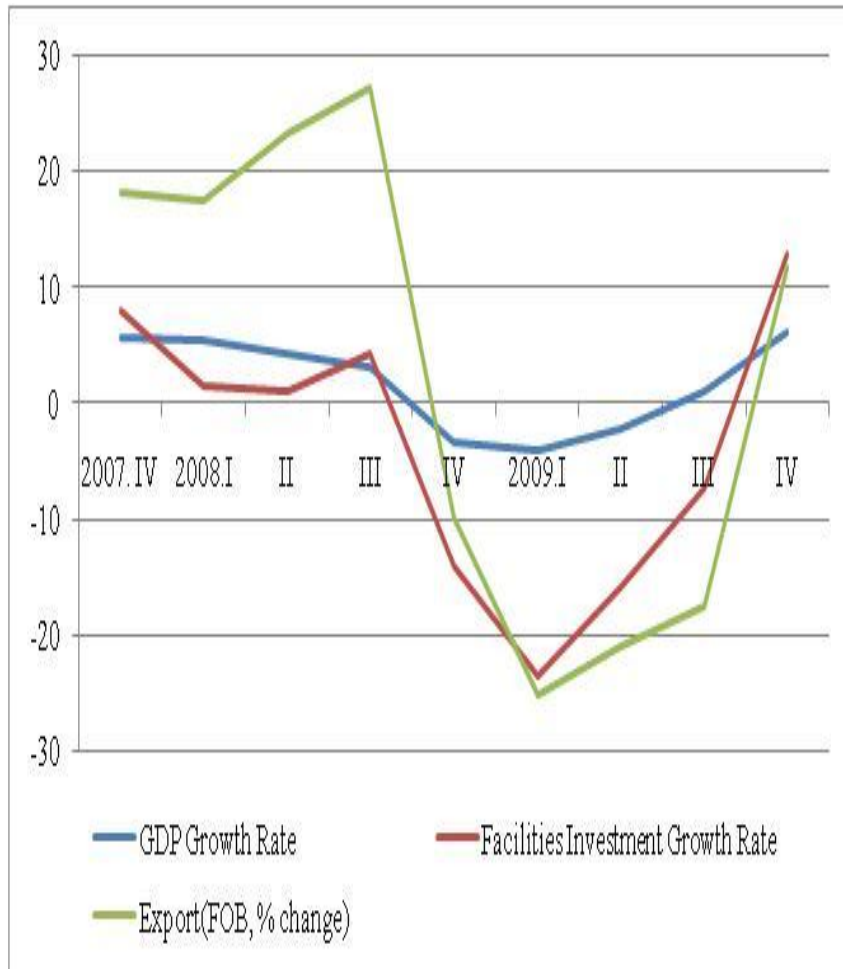
Table 2. Principal Economic Indicators of Korea

(2007 IV – 2009 IV)

		2007	2008				2009			
		Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP growth rate		5.7	5.5	4.3	3.1	-3.4	-4.2	-2.2	0.9	6.0
Private Consumption		4.7	4.0	2.3	1.4	-3.7	-4.4	-0.8	0.8	5.6
Facilities Investment		8.0	1.5	1.1	4.3	-14.0	-23.5	-15.9	-7.4	12.9
Production Index by Industry		10.9	10.9	8.9	5.6	-11.3	-15.5	-6.2	4.2	16.1
Manufacturing Capacity Operation Rate		105.5	98.9	102.7	95.1	90.6	80.7	94.3	97.5	100.2
Exchange Rate	won/dollar(average rate)	920.6	956.0	1,016.7	1,062.6	1,362.8	1,415.2	1,288.7	1,240.9	1,168.6
	yen/dollar(average rate)	113.1	105.3	104.5	107.5	96.2	93.8	97.4	93.6	89.8
Interest Rate	Corporate bond (3-year AA-, %)	6.3	6.4	6.3	7.2	8.3	6.9	5.4	5.6	5.5
	Treasury Bond (3-year, %)	5.6	5.2	5.3	5.9	4.7	3.6	3.9	4.3	4.3
Stock Price Index (KOSPI, average)		1,944.3	1,691.0	1,793.8	1,517.9	1,130.2	1,145.5	1,372.6	1,565.8	1,620.2
Export(billion dollars, FOB)		103.3	99.4	114.5	115.0	93.1	74.4	90.4	94.8	104.0
(% change)		18.2	17.4	23.1	27.0	-9.9	-25.2	-21.1	-17.6	11.7
Import(billion dollars, CIF)		100.6	106.1	114.8	122.9	91.5	71.4	74.0	84.8	92.9
(% change)		25.9	28.9	30.5	42.8	-9.0	-32.7	-35.6	-31.0	1.4
Current Account (billion dollars)		3.8	-4.9	-0.4	-8.3	7.8	8.6	13.1	10.4	10.6
Unemployment Rate		2.8	3.2	3.0	2.9	2.9	3.6	3.6	3.4	3.1
Unemployed Person(1,000persons)		690.0	759.0	726.0	708.0	709.0	853.0	877.0	830.0	755.0
Consumer Price Index (% change)		0.7	1.3	2.0	1.4	-0.3	0.7	1.0	0.5	0.2
International Reserves (billion dollars)		262.2	264.2	258.1	239.7	201.2	206.3	231.7	254.2	270.0
Total External Liabilities(a billion dollar)		383.2	414.7	423.8	426.1	377.9	365.2	378.6	397.5	

Sources: The Bank of Korea; Korea National Statistical Office ; Korea Customs Service

Figure 7. Principal Economic Indicators of Korea (2007 IV – 2009 IV)



Source: The Bank of Korea; Korea National Statistical Office, Korea Customs Service

4. Lessons from Two Financial Crises of Korea

- The key element to avoid financial disruption :
 - to maintain long-run equilibrium exchange rate
- The longer-run equilibrium exchange rate should be judged from the market-basket perspective.
- Analytical frameworks of Otsu and Pyo (2009) and Nam and Pyo (2009) :
 - Important to initiate and maintain constant macroeconomic stabilization programs to reduce macroeconomic volatility

4. Lessons from Two Financial Crises of Korea

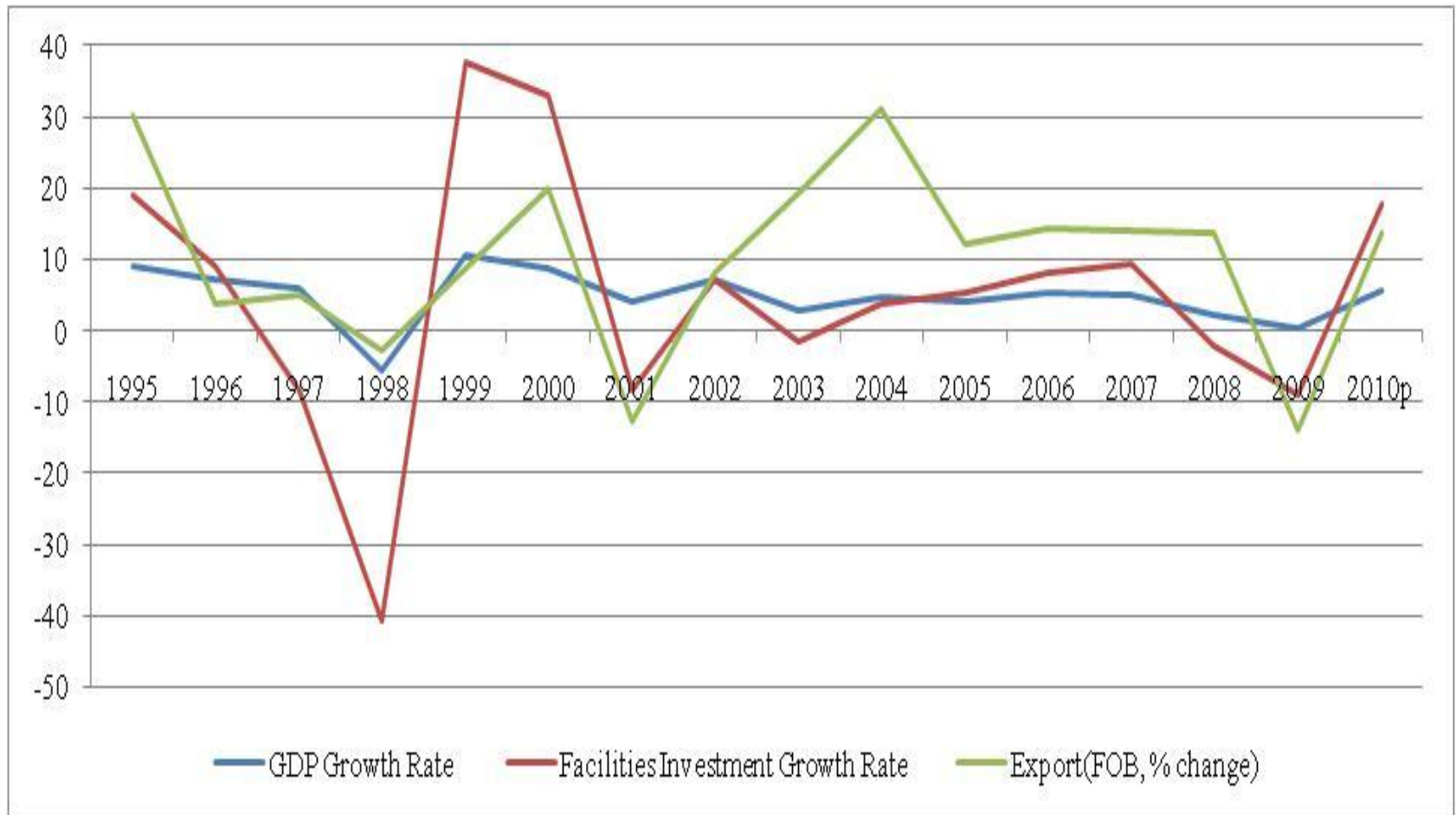
- Why the Korean economy has made a relatively faster recovery from the 2007 global financial crisis
 - 1) corporate and banking restructuring after the 1997 financial crisis has strengthened corporate earning capacity and reduced debt-equity ratios
 - 2) political stability after the regime change has helped in restoring investors' confidence

Table 3 Principal Economic Indicators of Korea (1995-2009)

		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
GDP growth rate		8.9	7.2	5.8	-5.7	10.7	8.8	4	7.2	2.8	4.6	4	5.2	5.1	2.2	0.2
Private Consumption		10.3	7.3	4	-12.5	11.9	9.2	5.7	8.9	-0.4	0.3	4.6	4.7	5.1	0.9	0.2
Facilities Investment		18.9	9.1	-8.4	-40.6	37.5	32.9	-8.3	7.3	-1.5	3.8	5.3	8.2	9.3	-2	-8.9
Industrial Output		11.9	8.6	4.8	-6.4	24.7	16.8	0.5	8.0	5.6	10.3	6.4	8.4	6.9	3.0	-0.7
Manufacturing Capacity Operation Rate		80.7	80.4	78.9	67.8	76.3	78.1	74.9	77.9	77.9	80.1	79.7	80	80.1	77.2	74.1
Exchange Rate	won/dollar (average rate)	771.0	804.8	951.1	1,398.9	1,189.5	1,130.6	1,290.8	1,251.2	1,191.9	1,144.7	1,024.3	955.5	929.2	1,102.6	1,276.4
	yen/dollar (average rate)	94.0	108.8	121.0	130.8	113.8	107.8	121.5	125.2	115.9	108.1	110.3	116.3	117.8	103.3	93.6
Interest Rate	Corporate bond (3-year AA-, %)	13.8	11.9	13.4	15.1	8.9	9.4	7.1	6.6	5.4	4.7	4.7	5.2	5.7	7.0	5.8
	Treasury Bond (3-year, %)	13.4	11.8	12.3	12.9	7.7	8.3	5.7	5.8	4.6	4.1	4.3	4.8	5.2	5.3	4.0
Stock Price Index (KOSPI, average)		934.9	833.4	654.5	406.1	806.8	734.2	572.8	757.0	679.8	832.9	1,073.6	1,352.2	1,712.5	1,529.5	1,429.0
Export(billion dollars, FOB)		125.1	129.7	136.2	132.3	143.7	172.3	150.4	162.5	193.8	253.8	284.4	325.5	371.5	422.0	363.5
(% change)		30.3	3.7	5	-2.8	8.6	19.9	-12.7	8	19.3	31	12	14.4	14.1	13.6	-13.9
Import(billion dollars, CIF)		135.1	150.3	144.6	93.3	119.8	160.5	141.1	152.1	178.8	224.5	261.2	309.4	356.8	435.3	323.1
(% change)		32	11.3	-3.8	-35.5	28.4	34	-12.1	7.8	17.6	25.5	16.4	18.4	15.3	22	-25.8
Current Account (billion dollars)		-8.7	-23.1	-8.3	40.4	24.5	12.3	8.0	5.4	11.9	28.2	15.0	5.4	5.9	-5.8	42.7
Unemployment Rate		2.1	2.0	2.6	7.0	6.3	4.1	3.8	3.1	3.4	3.5	3.5	3.3	3.0	3.0	3.4
Unemployed Person (1,000persons)		430	435	568	1,490	1,374	913	845	708	777	813	833	783	733	725	829
Consumer Price Index (% change)		4.5	4.9	4.4	7.5	0.8	2.3	4.1	2.8	3.5	3.6	2.8	2.2	2.5	4.7	2.8
International Reserves (billion dollars)		32.7	33.2	20.4	52.0	74.1	96.2	102.8	121.4	155.4	199.1	210.4	239.0	262.2	201.2	270.0
Total External Liabilities (a billion dollar)		119.8	157.4	174.2	163.8	152.9	148.1	128.7	141.5	157.4	172.3	187.9	260.1	383.2	377.9	

Sources: The Bank of Korea; Korea National Statistical Office ; Korea Customs Service

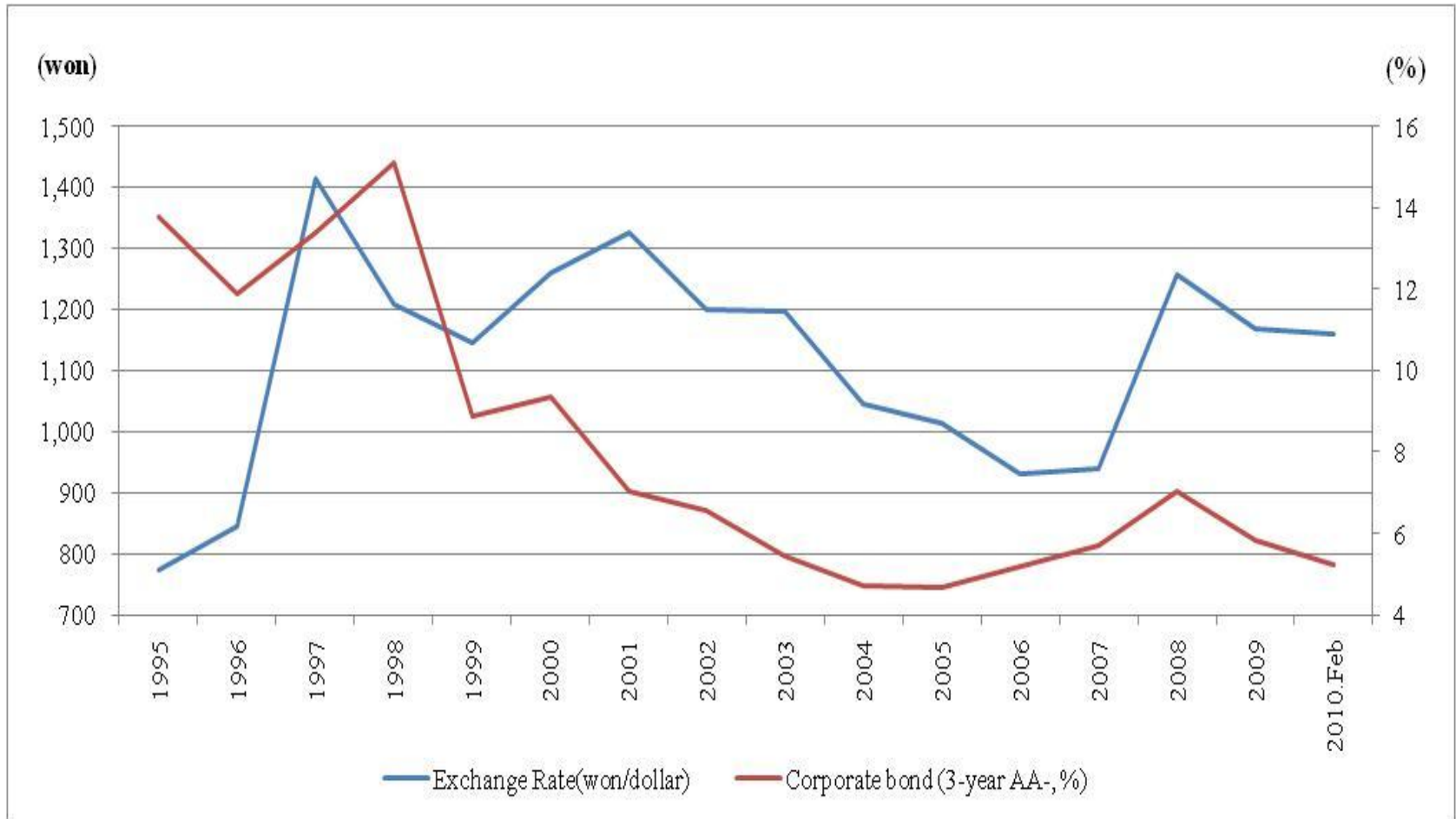
Figure 8. Growth Rates of GDP, Investment and Exports: Korea (1995-2009)



Note: p - preliminary

Sources: The Bank of Korea ; Korea National Statistical Office ; Korea Customs Service; Korea Development Institute

Figure 9. Exchange Rate and Corporate Bond Rate: Korea (1995-2009)



Sources: The Bank of Korea ; Korea National Statistical Office ; Korea Customs Service; Korea Development Institute

4. Lessons from Two Financial Crises of Korea

- A beggar-thy-neighbor threat and a risk of a competitive depreciation war as each country promotes its exports.

ex) the bailout attempt by the U.S government on GM and other automakers

- The new economic policy agenda :
a careful reexamination of economic stimulus packages in order to determine which policy is likely to enhance real productivity

4. Lessons from Two Financial Crises of Korea

- The success or failure of each country's stimulus packages will depend on the contents and the quality of such policy packages.
- A more prudent research and development program, educational improvements, and expansion of on-the-job training programs would help to restore growth potential and preserve social networks.

Thank you.