INVESTMENT BOOM, FINANCIAL BUST

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From October to December of last year, Korea went from being the world's eleventh largest economy to one surviving on overnight loans from the international money markets. Between November 19, when Korea decided to approach the International Monetary Fund for a rescue, and December 24, the won fell more than 50 percent against the U.S. dollar, the stock price index tumbled from 498 to 350, and the short-term market rate of interest shot up to 40 percent a year.

Although the IMF made a huge rescue package available on December 3, Korean banks suddenly found themselves cut off from the international financial markets. During the last week of December, Korea was on the verge of defaulting on its foreign debts, a fate averted only by a last-minute emergency loan by the IMF and several G-7 countries.

Although Korean banks have been able to roll over some of their short-term debts and market sentiment seems once again to be turning in Korea's favor, Korea faces a long struggle in normalizing its ties to

the international financial markets.

BUILDUP TO THE CRISIS: INVESTMENT BOOM

From 1995 to the beginning of 1997, Korea's economic growth averaged almost 8 percent a year, peaking in 1996 at nearly 9 percent. The growth was fueled by exports and also by high investment by Korean firms. And though investment seemed exactly the right prescription for an economy coming out of a mild 1992–93 contraction, in the end it contributed heavily to Korea's financial and foreign exchange crisis.

From late 1992 to mid-1995, the appreciation of the Japanese yen sharply increased the export earnings of Japan's East Asian trade competitors, especially Korea, and spurred investment throughout the region. In the third quarter of 1995, the yen began its long slide against the dollar, slowing not only Korea's exports but its economy as a whole. Korean policymakers made no substantial adjustments in the won-dollar exchange rate, and the real effective (trade-adjusted) exchange rate appreciated for more than a year and then remained relatively stable until the financial crisis broke out.

The investment boom, however, continued as foreign capital surged into Korea with the easing of capital controls as part of a general financial opening. With domestic interest rates more than twice those in world financial markets, net foreign capital inflows during 1994–96 reached $52.3 billion, more than triple those for 1991–93. Much of the inflows, consisting of short-term liabilities of domestic financial institutions and firms, financed investment in Korea's major export-oriented industries: electronics, automobiles, iron and steel, shipbuilding,
and petrochemicals. Investment jumped to 38.2 percent of GDP in 1996 from about 35 percent in 1993.

Although the economy began to slow in the second half of 1996, the large industrial groups, or chaebols, habituated to competing for market share rather than for profits, were slow to adjust their production and investment. As inventories piled up, commercial banks became increasingly concerned about the chaebols' growing losses and accumulating debts and grew more selective in extending credit. Denied sufficient credit at commercial banks, the chaebols had to secure high-cost, short-term loans from merchant banks. They also turned to foreign financial institutions and markets to finance fixed investment as well as inventories. Foreign debts of domestic firms grew from $35.6 billion at the end of 1996 to $43.2 billion a year later. The liabilities of the foreign subsidiaries and branches of Korean firms were estimated to be more than $51 billion at the end of June 1997.

The chaebols, almost all family-owned and reluctant to issue equities for fear of diluting their management control, relied ever more heavily on borrowing. The average debt-equity ratio of the 30 largest chaebols was more than 380 percent in 1996, four times that of Taiwanese industry. The rapid corporate debt accumulation proved the Korean economy's greatest structural weakness.

BUILDUP TO THE CRISIS: FINANCIAL OPENING

Until the end of the 1980s, capital movements into and out of Korea had been tightly regulated to facilitate the government's industrial policy and minimize the destabilizing effects of short-term capital flows on the economy. But by the 1990s, the effectiveness of the interventionist regime had come into question within Korea, and the developed countries, led by the United States, were pressuring Korea to liberalize its financial sector. Financial market deregulation and market opening began in earnest in 1993 when a new government came to power.

Like many other financial market openings in emerging market economies, Korea's experience demonstrates that an improperly managed opening can easily lead to a boom-and-bust cycle during the transition. The opening in Korea drew in a surge of foreign capital, much of it short-term and speculative. As financial liberalization accelerated, domestic financial institutions were given greater freedom to manage their assets and liabilities, in particular to borrow from world financial markets. Korean financial institutions took imprudent risks investing in foreign securities with borrowed short-term funds, thus leaving Korea's economy vulnerable to the speculative currency attack and liquidity crisis that beset East Asia.

Korea's financial institutions had no expertise in credit analysis, risk management, and due diligence. They also had little experience in foreign exchange and securities trading and international banking in general. Nor did the supervisory authorities, pressured to overhaul the regulatory system to make it more compatible with a liberalized system, monitor international financial activities as they should have. They eliminated and relaxed many controls, but failed to replace them with a new system of prudential regulation to safeguard the stability and soundness of financial institutions.

Total capital flows (in and out) rose from less

than 30 percent of GDP during 1991–93 to 47 percent during 1994–96. Of net inflows amounting to $52.3 billion, 62 percent were short-term borrowings with maturities of less than one year. Although foreigners' equity investments increased somewhat, the biggest increases were in trade credit (more than sevenfold), bank borrowings (elevenfold), and borrowing of Korean branches of foreign banks from their home offices (more than sevenfold). The share of commercial banks' external short-term indebtedness in total external liabilities jumped to 79 percent in 1994 from less than 65 percent in 1993.

The supervisory authorities did nothing to correct the prevalence of short-term external financing.. Nurtured in the tradition of direct control, they had neither the resources nor the experience to maintain the overall soundness and profitability of financial institutions. Long relegated to the role of supporting manufacturing industries under the control of the government, banks and other financial institutions had become accustomed to accommodating the credit needs of the industrial conglomerates without necessarily checking their credit-worthiness.

THE CRISIS IN FULL FORCE

The investment boom supported by foreign credit could not last long, and the government was powerless to come to the rescue when corporate bankruptcies began to soar, along with the volume of nonperforming loans at financial institutions.

The first major casualty was the Hanbo group. The nation's fourteenth largest chaebol was placed in court receivership early in 1997. A subsequent investigation revealed ties between politicians and the iron and steel group on a scale that shocked the Korean people and foreign investors alike. Indeed, the pervasiveness of corruption discovered in Korea this past year has been central to foreign institutional investors' loss of confidence in the government and the economy in general.

By the first week of September six chaebols, including the Kia Group, the nation's eighth largest, had been placed under a workout plan or become insolvent. The government, having lost the confidence of the public, became a lame duck. With the next presidential election scheduled in December, the administration was powerless to restore stability to financial markets. Foreign investors began withdrawing funds in early September.

The government's handling of exchange rate policy did not help. The won had been under strong pressure since early 1997. Time after time the government declared its intent to defend the won at a certain level, only to be forced to retreat. When the won-dollar rate approached the psychologically important level of 1,000, the government intervened heavily in the market and then suddenly gave up.

Between June and November, the Bank of Korea's reserve holdings fell by $10 billion, and it sold $12.2 billion in the spot market and made forward sales amounting to $7 billion to defend the won. By the end of November the bank held $7 billion in usable reserves.

Toward the end of October, policymakers and market participants alike realized that the situation was getting out of control. Foreign investors fled the stock market, and Korean banks were increasingly unable to roll over their short-term financial loans. To avoid default they turned to the Bank of Korea for liquidity or resorted to the foreign overnight loan markets. Finally, on November 19, the government announced reforms regarding nonperforming loans; it also widened the exchange rate fluctuation band. But with the sense of panic rising by the day, the market hardly noticed.

On November 23, the government announced its decision to approach the IMF. Ten days later, the IMF agreed to provide $21 billion over three years. It also secured commitments totaling $36 billion from the World Bank, the Asian Development Bank, the United States, and 12 other countries as a second line of defense. In return the IMF required reforms often linked with such rescue packages—tight money policy, a fiscal surplus, sweeping financial reform, and further liberalization of the financial markets. It also demanded more flexible labor markets and restructuring of the chaebols.

The rescue, however, did little to allay fears and stabilize the financial markets. Many observers doubted that Korea would be able to comply with the structural reforms mandated by the IMF. They feared that the tight monetary and fiscal policies would depress economic activity and undermine Korea's ability to service its foreign debt, thus defeating the purpose of the IMF. The rollover rate at commercial rates fell to about 10 percent, market interest rates shot up to 40 percent, and the won continued to fall, reaching 1,995 to the dollar on December 23.

As rumors began to circulate among foreign investors that Korea might have to declare a debt moratorium, on Christmas Eve the IMF and the G-7 countries came up with a $10 billion emergency

financing program, drawing $8 billion from the second line of defense. The new package turned market sentiment around by demonstrating the resolve of the IMF and G-7 to rescue Korea. It represented a new watershed, with the IMF clearly serving as lender of last resort in the East Asian financial crisis.

CONTAGION

Despite the numerous mistakes made by Korean policymakers, regulators, bankers, and businesses, Korea's economic fundamentals were sound. In many respects Korea looked quite different from the other Southeast Asian economies experiencing crisis in 1997. During 1991–96 it ran a budget surplus. Monetary expansion was moderate. The savings rate was one of the highest in the world. Capital inflows, which totaled no more than 2.7 percent of GDP, were primarily channeled to the nonmanufacturing sector for its fixed investments.

What suddenly gave foreign investors such grave doubts about the prospects of the Korean economy? Journalistic accounts suggest that these investors, increasingly concerned about structural weaknesses that made Korea highly risky for portfolio investment and bank lending, finally got fed up and left. Certainly, foreign investors had long complained of the lack of transparency in corporate management in Korea, questioned the reliability of balance sheets and income statements of large corporations and banks, and warned of the risks in the cross-ownership and cross-debt guarantees between the affiliates of Korea's major conglomerates.

But these problems had never made them contemplate a sudden withdrawal from Korea before Southeast Asia's currency crisis erupted. In fact, well into November, according to a survey by the Korea Development Institute, many foreign investors were "optimistic" about the future of Korea's economy. Only two weeks later would they become negative and leave all at once, taking their money out of investments almost regardless of whether they were good or bad.

It appears that Korea was affected by the contagion of the Southeast Asian crisis. In particular, the Hong Kong stock market crash in the third week of October helped trigger the exodus of foreign banks and institutional investors from Korea. Before July 1997, changes in the Hong Kong stock index had little effect on movements of Korea's index. Afterward, the two moved together, with the causal effects clearly running from Hong Kong to Korea.

After the Hong Kong crash, the Korean economy suddenly looked vulnerable to foreign investors, and a stampede ensued. The close presidential race in Korea, with the election scheduled for December, cast doubt as to the prospects for economic reform and accelerated the flight of foreign investors.

MANAGING FINANCIAL CRISES

Korea faces a difficult future. During 1998, fixed investment is expected to fall more than 30 percent, consumption 10 percent. Aggregate demand will likely fall more than 5 percent, despite an expected 7 percent rise in exports. Annual inflation will soar to about 10 percent, while the jobless rate will probably exceed 5 percent. Recent forecasts suggest that it will take Korea at least two years to recover.

The Korean government bears much responsibility for the Korean crisis. Policymakers tinkered with essential economic reforms for far too long, thereby deepening foreign investors' distrust. Furthermore, in 1997 they paid too little attention to the sharp deterioration in various liquidity indicators and to the complaints of foreign investors about secretive management of corporations and financial institutions or the reliability of the published statistics on banking and foreign reserve holdings. They also tried to defend the won for too long by maintaining a managed floating system, thereby costing the Bank of Korea substantial reserves.

At the same time, increasingly evident deficiencies of the international financial markets, including herd behavior and information problems on the part of investors, exacerbated the crisis and worsened its damage.

The East Asian crisis has shown that in an integrated financial world, financial crises can be contagious and pose systemic risk. But most of the measures proposed so far for preventing and better managing such crises—creating an international lender of last resort, restructuring the IMF for regulating global institutional investors, harmonizing rules and enforcement efforts at a regional or global level—are not likely to be realized any time soon. Given this reality, and in view of the severity of the ongoing financial crisis in East Asia, the international financial community should seriously reconsider the demands it is making on emerging market economies to open their financial markets. Until the international financial community is willing and able to safeguard these countries from the recurrence of devastating financial crises, it should be prepared to tolerate the sand they throw into the wheels of international finance. ■