INTERNATIONAL JOURNAL OF ADVANCE RESEARCH AND DEVELOPMENT

IJARnD

(Volume 3, Issue 1)
Available online at www.ijarnd.com

Financial Crisis in South Korea

Naveed M. Ashraf[1], Swayam Kumar[2]

[12]*Christ (Deemed to be University), Bengaluru, Karnataka*

ABSTRACT

The research study focuses on the simple idea of the 'funnel approach'. This approach looks at the effect/consequence of an occurrence towards a smaller group/entity etc. For this research study, the Asian Financial Market Crisis of 1997 is taken into consideration as the general phenomenon affecting the stakeholders and the citizens. For the specific aspect of this approach, South Korean economy is taken into account. Therefore, the idea of this research study is to portray how South Korea as a country and economy was affected by the 1997 crisis, and how eventually it took correctional measures to recover and be counted as one of the four Asian Tigers. Moreover, this research study looks at the involvement of various tools, statistics and reviews worldwide to show a clear distinction of South Korea in its past years during the crisis, in striking contrast to today, as a leading prototype economy for other economies all around the world. The objective of the study is to learn how a country in the face of adverse conditions, gets itself back to encounter and challenge global conditions considering the dynamic and competitive world today.

This study is also focused on furthering the idea of "The Ripple Effect", which is a spreading and unintentional effect because of an action took place or an action that would prospectively occur. This effect will discover the detailed reasons for the South Korean economy to drop considerably during the crisis years and the almost simultaneous manner in which it was on the path of recovery. There were a lot of countries such as Thailand, Indonesia, Philippines, Hong Kong, Malaysia and Singapore that were affected massively by the 1997 crisis. The most distinctive aspect to be noted here was that South Korea was the first and fastest country to recover and therefore, this research study is an ode to South Korean policy-making and crisis management.

Keywords: *Funnel, Ripple effect, Contagion, Conglomerate, Crony Capitalism.*

1. INTRODUCTION

The Asian financial crisis was a financial crisis that occurred in July 1997, leading to fear of a global economic meltdown because of a financial contagion. The start of the crisis began in Thailand due to the collapse of the Thai baht. The Thai Government was induced to devalue its currency in relation to the US dollar. This action, which was due to continuous months of speculation, had substantially depleted Thailand's official foreign exchange reserves. With this, began a deep financial crisis across most of East Asia. In the upcoming months, the entire region of East Asia started facing similar symptoms; weakening of the currency, equity and property markets. Moreover, this also led to payments and banking crisis.

Gradually, capital inflows reduced considerably and growth dropped sharply in the region. Commercial banks and financial institutions came under extreme pressure which caused the investment rates to plunge and simultaneously causing economies to enter deep recessions. With the unfolding of the crisis in the consequent years, the domestic credit growth and inefficient supervision had led to a build-up of financial leverage and bad loans. In addition to this, the domestic markets, which were over-heated economies at the time, and real estate markets were a burden and therefore, this added to the risks of foreign reliance, current account deficits leading to heavy external debt.

Moreover, since this was a time of extensive financial distress, there was heavy borrowing prevalent through currency pegs. Currency pegs are a good short-term idea to sustain the market, but in the long-term, (which was the actual case during this crisis), the corporations and firms realized a sharp rise in the local currency value of foreign debt, which quite obviously led to insolvency. This crisis portrayed how basic problems in the banking sector of an economy can lead to a withdrawal by foreign investors, which eventually leads to a loop of depreciation, recession and furthered banking and investment exhaustion. This could be termed as a financial contagion. This was the primary reason for the crisis to spread across East Asia at such a fast pace. This contagion occurred because of foreign creditors pulling back their investments from countries affected by the crisis having the same financial symptoms and conditions. In such adverse financial situations, foreign exchange pegging and intervention was just going to be an amplifying consequent, as some economies tried to deplete their official reserves and suffered even greater depreciations.

In relation to South Korea, the entire banking sector was functioning on non-performing loans. This was the period of time when there was a hurry to create conglomerates in response to the global competition. This hunger to becoming a conglomerate ultimately led to the failure of companies to ensure returns and profitability in South Korea. For example, in July 1997, Kia Motors, South Korea's third largest car maker pleaded for emergency loans.
South Korea's credit rating was lowered from A1 to A3 on 28th November 1997 and was further reduced to B2 on 11 December. This led to an almost immediate decline in the South Korean shares since the stock market had been bearish since over three months. The Seoul Stock Exchange dropped by 4% on 7th November, and on 8th November, it plunged by 8%, which is the biggest one-day drop to that date.

This saw major acquisitions take place; 1998; Hyundai Motors acquired Kia Motors, Samsung Motors' had a $5 billion venture, which was dissolved and finally, Daewoo Motors was acquired by the American car company General Motors (GM).

IMF provided US$57 billion as a correctional package. In reciprocation, South Korea was required to take correctional and restructuring measures. For example, the price ceiling on foreign investment prevalent in Korean companies was increased from 26 percent to 1oo percent. Also, the Korean government decided to start its reform program, through which 787 insolvent financial institutions had to be closed or merged before June 2003. The South Korean won, in this duration, had weakened from around 800 per USD to almost 1700 per USD.

Despite these factors and financial breakdown conditions, South Korea has adapted and tripled its per capita GDP in USD terms since the crisis. It resumed its role as the world's fastest- growing economy; per capita GDP has grown from $80 to almost $21,000 as of 2007. Despite certain advancements, the most important hit to South Korea was its national debt-to-GDP ratio, which had doubled from 13% to 30% due to the crisis.

2. REASONS

High levels of inflation, appreciation of the Korean WON and recession of the world economy were the primary reasons for the country to crumble and get caught in a crisis. In 1991, the Korean current account showed a deficit of $8.7 billion, 4 times more than the previous preceding years.

With respect to the relationship with government on its road to recovery, the government failed in two major policy areas: exchange rate policy and industrial policy. These policies primarily had a major impact on the Korean economy. The exchange rate policy failed due to the governments step to peg its currency WON to the US dollar. In 1997, when the US dollar had appreciated, WON appreciated too side by side leading to the WON being significantly over valued in the market. Governments promise of maintaining the fixed exchange rate made the business industry believe that the foreign exchange risk did not exist. Later on, when the WON was devalued, the business industry did not consider the likely potential increase in the domestic cost of the foreign debt. Due to its devaluation, South Korea found it difficult to repay its foreign debt, which led to the defaulting of Korean banks in meeting its loan obligations. The overvaluation of WON leading to more foreign borrowing and South Korea's industrial policy of crony capitalism of typically investing in terms of loans for all the uneconomic purposes was the reason for the crisis to arise. WON being overvalued was indicated fundamentally by the rapid declining of exports and imports.

The exchange rate had to dodge the strong selling pressure in 1997, which led to the WON devaluing up to 95% in relation to the U.S Dollar. This devaluation caused the disillusionment of the various borrowing firms and caused WON denominated loans to become uneconomic. With the government being well aware of the high levels by which the WON was overvalued, the government continued to intervene in its foreign exchange market by imposing a policy of setting a daily limit whereby trading had to come to a standstill if the WON would fall by more than 10%.

Furthermore, Korea lived with the expectation that IMF would bail out their creditors and this expectation came about due to the 1995 Mexican rescue and 1997 Thai bailout events where IMF played a crucial role. The IMF bailout certainly had a major impact on its citizens and economy. With this loan in hand by IMF, the country got rid of the overseas lenders and consequently shifted the burden of loan repayments and poor investments to the taxpayers residing in the country.

The government policy gave an incentive for the rapid increase in the number of financial institutions indulged in foreign currency denominated activities and this was quite significant with respect to merchant banks. The number of merchant banks rose from six to thirty in the span of just two years. A majority of these merchant banks were owned by chaebols, and they acted as mediators for chaebol investments. Financing mostly long-term projects could only be possible by the act of these merchant banks in raising Japanese funds from Hong Kong. Commercial banks as well indulged in borrowings from abroad to meet their short-term maturities competing with the merchant banks to maintain their business. This further bothered maturity and currency mismatches on the balance sheet of South Korea's financial and business sector. This fact was quite evident with 80% of South Korea's short-terms foreign debts being put into 70% of its long terms assets. Towards the end of 1997, the figured of its short term debt amounted to around $63.8 billion whilst it's foreign reserves being only $9.1 billion. This situation ultimately meant that it was impossible for the country to solve the problem of "double-mismatch" on its own.

Prudential supervision is the prime reason for the mismatch problems. Financial institutions followed accounting and disclosure standards different from the accepted International best practices with market-value not being practiced. With high chaebol dependence and due to weak financial supervision on bank financing, high rates of risk were concentrated on banks. The chaebol leverage was high for the following two reasons: They enjoyed preferential access to credit in the 1970s and 80s, and what allowed deductions on debt-related expenses was the nation's tax laws. The debt-equity ratio on an average reached around 400% in 1997 in the manufacturing sector which was double the average of OECD. It was certain that South Korea was suffering from a significant capital structure mismatches as well. Even after all these mismatches, Korea was still one of the few fastest growing economies with inflation about 5% a year and annual growth rate of about 7-9%. Its foreign debt to GDP ratio was less than 30% which was considered the lowest among other developing nations and less than most of the industrially advanced countries.

Summing up, there were three main reasons that triggered this crisis in South Korea. The first one was the movement of the US dollar. The second trigger was seen in 1997 when a series of domestic developments took place and the third trigger was a combination of domestic and international developments.

3. MEASURES

Role of IMF

IMF provided the country with a bail-out package of $58.4 billion on the 3rd of December 1997 from which a sum of $23.4 billion was kept aside as a second line of defense and the rest of the money to be used until 2000. South Korea decided to use $9.1 billion out of the package for the first 15 days. $9.1 billion was surely not sufficient for the country to cover its short term debt or for its foreign reserve assets.

Macroeconomic adjustment and structural reform were two part of the IMF program. The economic reforms included the elimination of trade barriers. Increased flexibility of exchange rates, closure of loss making financial institutions and chaebols, tightening of fiscal and monetary policy, etc.
It was expected that the funds would certainly not meet South Korean needs hence, on December 19, U.S persuades IMF into providing additional capital.

The Korean government was successfully able to convert $24 billion of short-term debt ratio into 1 to 3 years' maturity debt with guarantees from the government.

By the end of 1998, $60 billion was spent by the South Korean government in allocating funds solely for the financial sector and in doing so, it was able to recover 12 out of 32 largest banks in the country.
IMF allowance of having more flexibility in the economic policy allowed the newly elected President Dae-Jung-Kim to have a more Keynesian stance on the macroeconomic policy to trigger domestic demand.

Tighter Legal and Regulatory Infrastructure

Thirteen financial bills, including a bill to establish a consolidated financial supervisory authority, was implemented on December 29, 1997. Due to this legislation, On 1 April 1998, the Financial Supervisory Commission (FSC) was established and all other existing financial supervisory organs were merged into a consolidated Financial Supervisory Service (FSS) that acted as an administrative body for the FSC.

Reducing Moral Hazard

The government took adequate measures in reducing the moral hazards by improving efficiency and stability of the financial system. In this area, the most important institutional reform was the introduction of a partial deposit insurance. From January 2001, the government fixed the deposit insurance limit to $50 million WON per person per financial institution. This protection helped to introduce discipline in the market by providing the depositors with incentives to seek out healthy institutions.

4. CONCLUSION

Summarizing the South Korean crisis of 1997-1998, the crisis was triggered by different factors. Poor supervision and management of the financial sector liberalization led to a huge increase in short-term liabilities from abroad and an increase in the moral hazards. Investors lost confidence and their level of uncertainty rose due to external shocks such as Asian financial crisis that started in Thailand and the strengthening of the U.S dollar. The South Korean government failed in maintaining the fixed exchange rate as the country's official reserves exhausted leading to the fall in the value of their currency WON.

As the situation in the country's economy started getting worse day by day, the IMF intervened and provided a bailout package along with implanting tight fiscal and monetary policy. The currency was then stabilized but eventually, the increased interest rates led to the loss of confidence among the investors as the cost of capital increased. To combat this problem, South Korea took steps to cover their short-term debts and also acquired additional funding from the IMF with U.S influence. This gradually boosted the confidence in the market. The situation at hand was clearly a liquidity and currency crisis and not a BOP crisis. With concrete plans and strategies, South Korea managed to overcome this crisis like no other country.

5. REFERENCES

[1] https://www.imf.org/external/np/seminars/eng/2006/cpem/pdf/kihwan.pdf
[2]https://www.cis.org.au/app/uploads/2015/04/images/stories/policy-magazine/1999-autumn/1999-15-1-terry-black-susan-black.pdf
[3] https://www.imf.org/external/np/seminars/eng/2006/cpem/pdf/kihwan.pdf

