



Korea-Kazakhstan Strategy Seminar

The Financial Crisis of Korea : Lessons for Kazakhstan

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C O N T E N T S



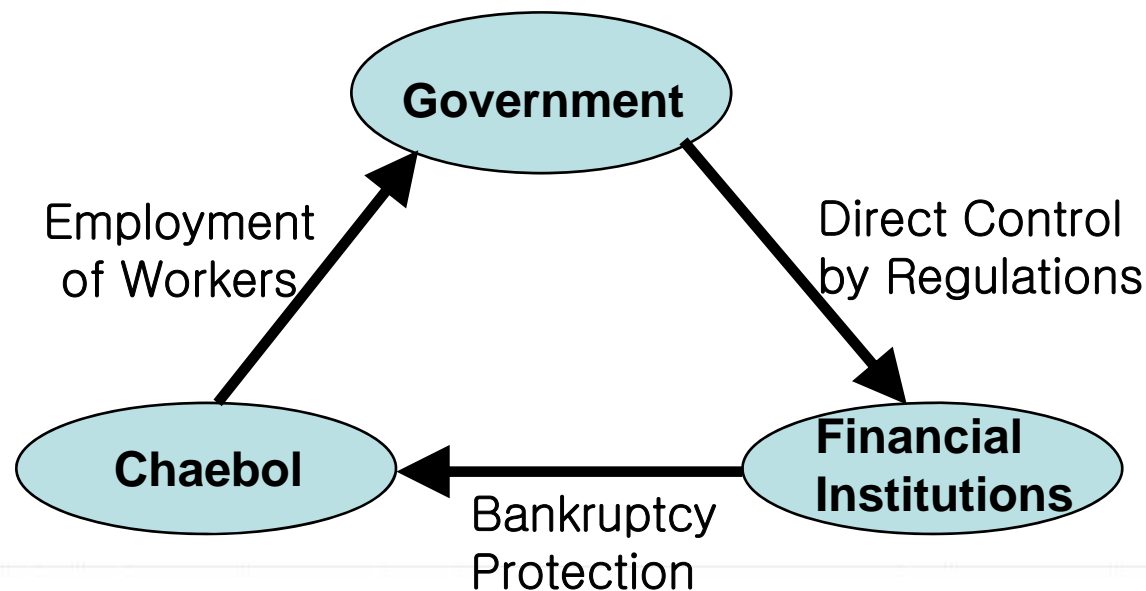
The Korean Economy before the Crisis
Policies during the Crisis
Lessons for Kazakhstan

Part-01 | **Korea before the Crisis**

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Moral Hazard Structure

- ❖ Triangular relationship among the government, large corporations (*chaebol*), and financial institutions.
 - There are no incentives to enhance capital efficiency, if firms do not have bankruptcy threat (“Too-Big-To-Fail”).



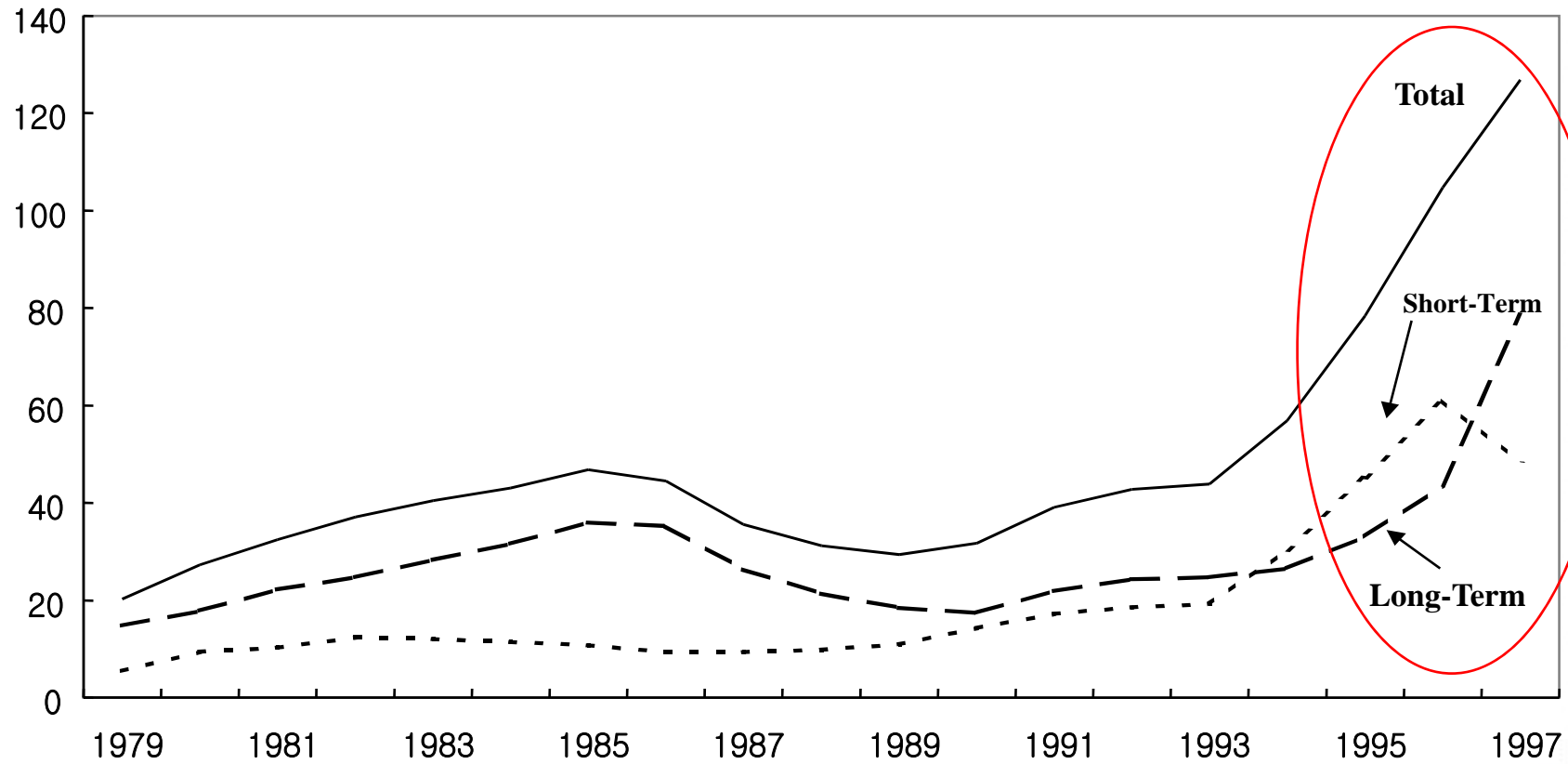
Financial Liberalization

- ❖ **Financial market was liberalized without establishing proper supervisory system to restrain the moral hazard problem in existence.**
 - Financial institutions (merchant bank corporations, in particular) rushed out to borrow “cheap capital” (low interest costs) abroad, and lent it to large corporations.
 - Under the moral hazard, both the large corporations and financial institutions had no reason to restrain the increase in borrowings.

Increase in External Debt

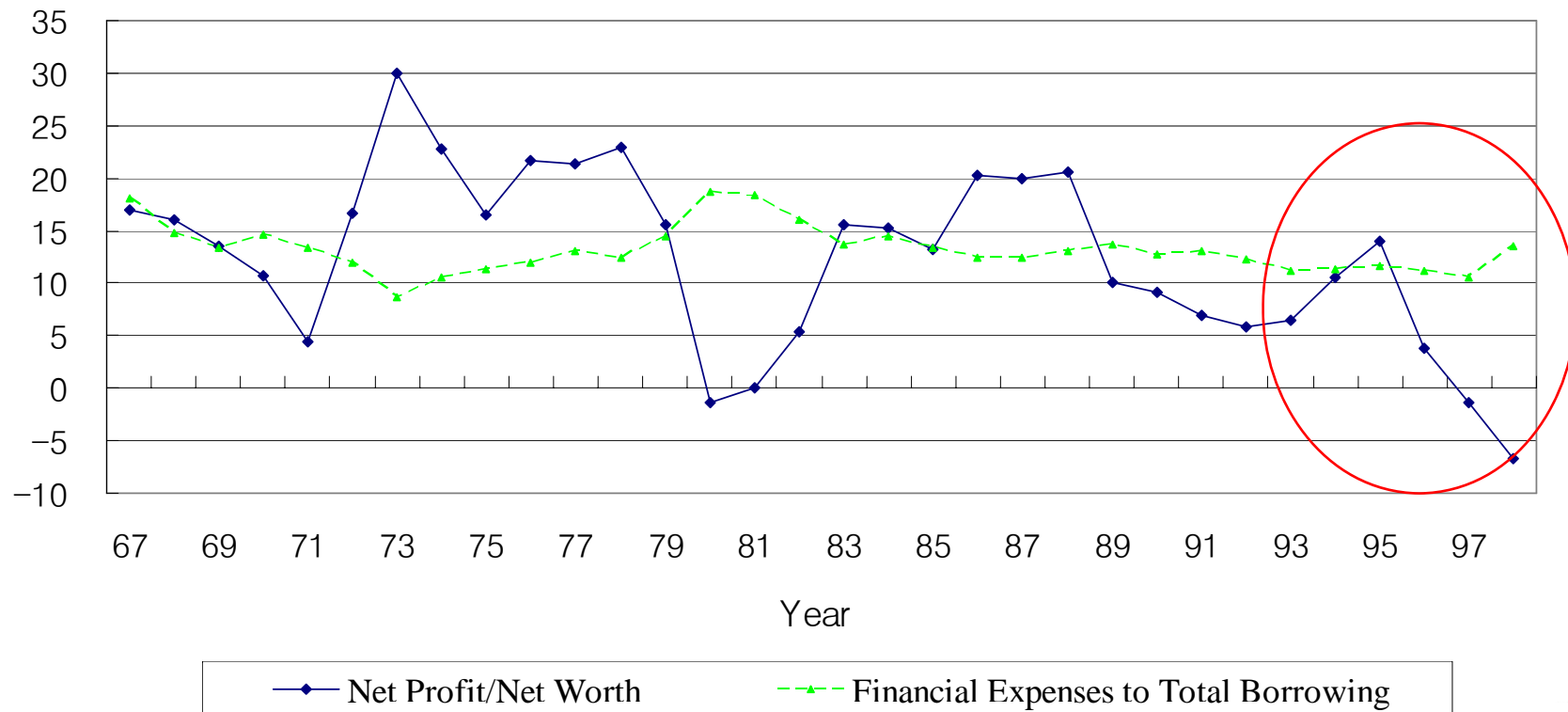
❖ Short-term debt was explosively increased.

(Bil. US\$)



Erosion of Capital Efficiency

❖ Corporate sector's profitability was rapidly eroded below the cost of capital (or interest rate).



Attempts to Rescue Non-viable Firms

- ❖ From January 1997, a series of chabol bankruptcies occurred.
- ❖ Being afraid of their adverse impacts to both labor and financial market, the government attempted to defer actual bankruptcies.
- ❖ This policy increased uncertainties to the financial market, and sent bad signals to the international investors regarding the government's will of restructuring.

Attempts to Defend the Currency Value

- ❖ **In July 1997, the Asian crisis broke out, further worsening the external credit conditions.**
 - Foreign investors began withdrawing their credit from Korea, and the won was faced with severe depreciation pressures.
- ❖ **Fearing the possibility that currency depreciation would speed up capital outflow, the government attempted to defend currency value.**
- ❖ **This policy only speeded up the depletion of foreign reserves.**

Part-02 | **Policies during the Crisis**



Dilemma for the Government

❖ Bail-out vs. Restructuring

- Blind bail-out could save employment and financial stability immediately, but would take an enormous (near-infinite) amount of tax-payers' money while deepening the structural moral hazard problem.
- Restructuring (or realizing the bankruptcies) could enhance capital efficiency eventually, but would drive the financial system into chaos immediately.
- Just delaying the action was the worst choice.

The Choice of the Korean Government

❖ Korea took the option in-between.

- The government announced to bail-out bank deposits to prevent the financial system from collapsing (bank-runs).
 - However, the government allowed the bankruptcies of non-viable financial institutions and large corporations (e.g. Daewoo) so that the relevant stake-holders (stock-holders, creditors, managers, and some workers) took their burdens.
- M&As, Workouts, Legal Management, Liquidations, ...

❖ Although a substantial amount of public money was injected, this policy provided a good ground for the early recovery while establishing disciplines in the financial market.

Restructuring of Financial Institutions

	Total No. of Institutions (end-1997) (A)	Type of Resolution					New Entry	Total No. of Institutions (end-2004)
		License Revoked	Merger	Others ¹⁾	Subtotal (B)	Ratio(%) (B/A)		
Banks	33	5	10	-	15	45.5	1	19
Merchant Bank Corporations	30	22	7	-	29	96.7	1	2
Securities Companies	36	5	4	3	12	33.3	18	42
Insurance Companies	50	10	6	3	19	38.0	19	50
Investment Trust Companies	30	6	2	-	8	26.7	25	47
Mutual Savings Banks	231	102	27	1	130	56.3	12	113
Credit Unions	1,666	2	108	499	609	36.6	9	1,066
Leasing Companies	25	10	2	1	13	52.0	6	18
Total	2,101	160	166	507	835	39.7	91	1,357

1) Includes dissolution and asset transfers to bridge institutions

Dilemma for the Central Bank

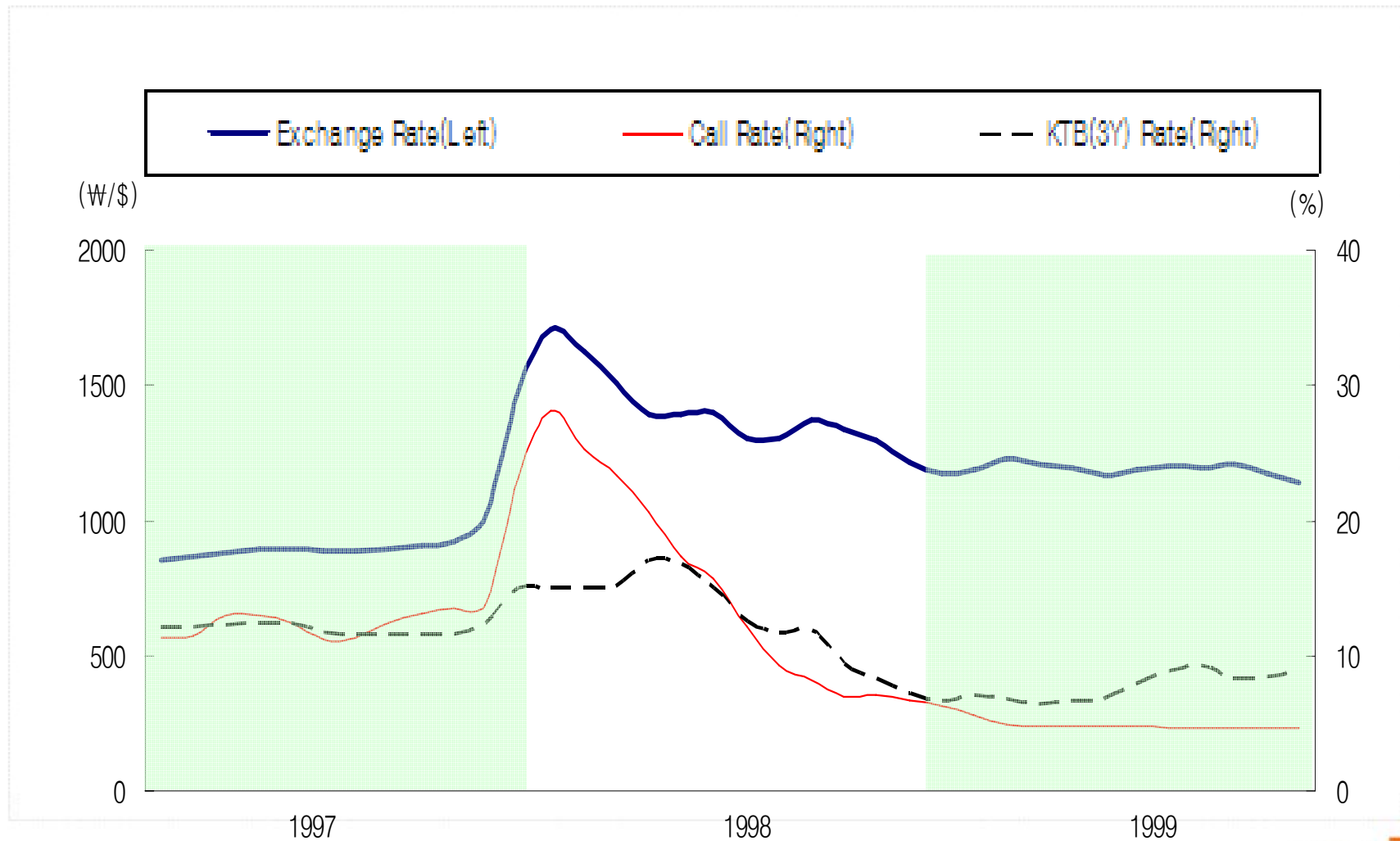
❖ Internal vs. External Stability

- A loose monetary policy could help alleviate domestic financial instability, but would accelerate capital outflow, worsening the currency crisis.
- A tight monetary policy could help stabilize the exchange rate, but would further destabilize domestic financial market, deepening economic recession.

The Choice of the Bank of Korea

- ❖ **The BOK (or IMF) chose the external stability first, and the internal stability later as the foreign exchange market was stabilized.**
 - The BOK substantially raised the interest rate for both foreign- and domestic-currency-denominated loans.
 - As the official foreign reserves were restored and the exchange rate became stabilized, BOK gradually lowered the interest rate.
- ❖ **This pattern of interest rate policy seems inevitable in the country that cannot print hard currency.**
 - The BOK can always avoid bankruptcy in domestic currency at the expense of inflation, but it could go bankrupt in foreign currency.

Interest Rate Policy



Part-03

Lessons for Kazakhstan

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Preventing Crisis is the Best Policy

- ❖ **Establish self-discipline in the financial market.**
 - Moral hazard is the root cause of reckless investment.
- ❖ **Strengthen financial supervision.**
 - This is particularly important when the financial market is deregulated.
- ❖ **Watch out asset price bubbles.**
 - It is extremely difficult to judge *ex ante* whether asset price hikes are due to the improvement of fundamentals or not.
 - However, it is advisable to discourage rapid asset price increases accompanied with a rapid accumulation of debt.

Preventing Crisis is the Best Policy

❖ **Maintain sound macroeconomic policies.**

- Do not be over-ambitious about growth, and suppress inflation pre-emptively. (inflation comes after over-heating)
- Maintain fiscal soundness. (the last resort that can rescue the economy without deepening the crisis.)

❖ **Maintain exchange rate flexibility.**

- Once the capital market is opened, it is impossible to maintain both the exchange rate stability and interest rate stability.
- Maintaining (nominal) exchange rate stability accelerates capital inflow when economic conditions are good, while accelerating capital outflow when economic conditions deteriorate.

Nevertheless, crisis occurs everywhere.

❖ The basic evolution processes are similar.

	Korea	Kazakhstan
Main Cause	Structural moral hazard	Optimism about house prices
Magnifying Factor	Capital market opening (low financing costs without exchange rate risks)	Capital market opening (low financing costs without exchange rate risks)
Shock	Asian crisis	Sub-prime mortgage crisis
Policy Rooms	Sound government budget Shallow foreign reserve liquidity Long track record of low inflation	Sound government budget Good foreign reserve liquidity Short history of stabilization

To cope with crisis: Resource Mobilization

❖ Take early and bold actions.

- Delaying the necessary restructuring during a crisis period is very likely to increase bad assets at an exponential pace.

❖ Mobilize a sufficient amount of (non-inflationary) resources to clean up bad assets in the financial market.

- This is important to preserve the market confidence about the financial system.
- The resources should be mobilized by the government (i.e. fiscal money) rather than by the central bank in order to exclude the possibility of hyper-inflation or currency crisis.

To cope with crisis: Restructuring Strategy

❖ Do not attempt to rescue across the board.

- Attempt to rescue everyone is likely to exacerbate moral hazard problem very rapidly, which can aggravate a partial crisis into a national crisis.
- “Divide-and-rule” policy (distinguishing viable from non-viable institutions) according to certain criteria may be necessary.

❖ Protect depositors’ money to reduce “system risk,” but penalize those who made reckless investment.

- This is effective for establishing market disciplines and sharing the restructuring burden, while maintaining the minimum level of financial stability.

To cope with crisis: Monetary Policy

❖ **Maintain consistent monetary policy.**

- Taking an easy monetary policy stance while defending the currency value is the classic example of inconsistent policy.

❖ **Adhere to the declared “inflation targeting.”**

- The market’s suspicion that the central bank attempts to overcome the crisis by generating inflation can be very dangerous for the confidence about the currency value and the overall financial system.
- Yet, the inflation targeting can allow for the monetary policy room to the degree of alleviating the deflationary pressures that can be possibly generated by drastic restructuring.

To cope with crisis: Exchange Rate Policy

- ❖ **Allow exchange rate flexibility and be cautious about foreign exchange market intervention.**
 - Attempting to defend currency value while the economic fundamentals have not been improved is like combating against global capital market.
 - It can provide opportunities for speculators to take their money out of country without much loss, which may accelerate capital outflow.
 - If the foreign exchange liquidity is dried up as a result of the attempt to defend the currency value, it will become a critical factor to confine the monetary policy flexibility.

Korean Case: Foreign Reserve and Monetary Policy

- ❖ **During the crisis, the BOK provided troubled commercial banks with foreign exchange liquidity at an extremely generous interest rate of LIBOR.**
 - Commercial banks were given no incentives to restructure, continuing to deplete the (usable) foreign reserves of the BOK.
- ❖ **One of the first actions by the IMF was to charge penalty interest rates on these commercial banks .**
 - 4%p above LIBOR (12/3/97) → 7%p above LIBOR (12/27/97)
→ 10%p above LIBOR (12/27/97)
 - All of sudden, those troubled commercial banks began rapidly redeeming their borrowings somehow, substantially contributing to the early recovery of the official foreign reserves.

Korean Case: Foreign Reserve and Monetary Policy

- ❖ **Until the foreign reserves were recovered, however, it was inevitable to maintain high interest rate policy in domestic financial market.**
 - Otherwise, those commercial banks (as well as other troubled firms) would have borrowed cheap money in the domestic financial market, and rushed to the foreign exchange market to convert it into foreign currency to redeem their foreign debts.
 - This would have substantially added depreciation pressures.
- ❖ **This high interest rate policy significantly deepened the recession and made the Korea's restructuring process far more painful.**