

Between Two Whales: Korea's Choice in the Post-Crisis Era*

2009. 8

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* The authors wish to thank Sumner LaCroix and Keun Lee for their comments on an earlier version of the paper.

SUMMARY

This paper examines the impact of the current global financial meltdown and China's rising power on the South Korean economy and South Korea's external relations with China and the U.S.

Main Argument

Since 1945 South Korea has had a close relationship with the U.S., who has both been the country's largest trade partner and guaranteed its security. This relationship has been changing, however, ever since China's emergence as a global economic power. As the Korean economy grows, it will inevitably become more closely linked with China through trade, investment, and production networks. How close these links become will depend on the economic relations that evolve between South Korea and the U.S. following the current crisis.

Policy Implications

- If the U.S. economy recovers quickly and does not grow protectionist, Washington's relationship with Seoul will remain strong.
- The U.S.–South Korean relationship will be strengthened if the Korea-U.S. Free Trade Agreement is ratified.
- A peaceful coexistence between the U.S. and China is the only way for South Korea to avoid being faced with the difficult choice of aligning with one or the other of these major powers.

The current financial and economic crisis that has emanated from the United States has had, and will continue to have, a serious impact on the economy of South Korea (Korea henceforth). Not only have the Korean financial markets been adversely affected by the failures of the U.S. financial system, but as the world economy has suffered a contraction of global demand, Korea's real economy has been forced into a recession—although there are now some signs of recovery since the early months of 2009. This chapter examines the impact of the current global financial meltdown and resultant economic recession both on Korea's economy and on the country's external relations with China and the United States.

Since liberation from Japanese colonial rule in 1945, Korea has had a close relationship with the United States, which has been Korea's largest trade partner and security guarantor. Yet this relationship has gradually been changing following China's emergence as a major global economic power and trading nation. As China develops further, the Korean economy will inevitably become more closely linked with the Chinese economy through trade, investment, and production networks, especially given the two countries' cultural and geographical proximity. How close they become will, however, depend on the economic relations that evolve between Korea and the United States. If the current crisis does not turn the United States toward protectionism, the Korean economy will remain closely linked with that of the United States, countering growing dependence on the Chinese economy. In sum, how the economic relationship between Korea and China evolves in the near future will depend critically on the impact that the current crisis has on the relationship between Korea and the United States.

The current crisis is thus expected to have a profound effect on Korea's relations with the United States and China. First, China has already surpassed the United States as Korea's most important trade partner, and the current crisis is likely to enhance China's supremacy as the country's trade partner unless the U.S. economy recovers within a few years. Second, the crisis will diminish whatever confidence that Korean policy elites may have had in the version of capitalism that has been practiced in the United States in the past few decades. Many of the economic reforms undertaken in Korea since the early 1980s and especially in the aftermath of the Asian crisis of 1997 were modeled, at least in theory, after the institutions in Anglo-American countries. This crisis may discredit some

of those institutions in the eyes of policy elites, causing them to rethink the attractiveness of those institutions as a model to emulate. In other words, the crisis may increase the economic interdependence between Korea and China while diminishing the value of the U.S. capitalist model and thus reduce U.S. influence on Korea's economic policymaking.

The chapter is organized as follows. The first section briefly examines some of the institutional reforms that Korea undertook in the aftermath of the 1997 crisis, arguing that it helped the Korean corporate and financial sectors better respond to the current crisis. The second section discusses the impact of the current crisis on Korea's financial and real sectors, as well as the impact of some of the government measures that have been adopted or proposed in response to the crisis, concluding that the current crisis is unlikely to have much impact on the country's political stability. The third section examines how China's rise over the past few decades has affected the Korean economy and how the current crisis may affect Seoul's economic relationship with Beijing. The fourth section concludes the chapter by overviewing the effect that the crisis has had on Korea's economic relations and strategic alignment with both the United States and China. Finally, it should be noted here that this chapter does not look into the possible effects of the current crisis on the Democratic People's Republic of Korea (DPRK, or North Korea). The North Korean economy is almost completely isolated from the rest of the world and is thus little affected by disruptions in the global export and financial markets.

The 1997 Asian Financial Crisis and Institutional Reform in Korea

Although the current crisis has clearly had an adverse impact on the Korean economy, other industrialized countries have been more severely affected. In particular, Korea appears to have suffered less than the United States and some European countries in terms of delinquency ratios, bankruptcies, and unemployment.¹

Korea's comparatively good performance may be due in part to the institutional reforms taken by the country in the aftermath of the 1997 crisis that led to changes in the financial structure of its corporations and in risk management of its banks. Large

¹ Federal Deposit Insurance Corporation (FDIC), *Quarterly Banking Profile*, First Quarter 2009; and International Monetary Fund (IMF), *World Economic Outlook: Crisis and Recovery* (Washington, D.C.: IMF, 2009), 65.

corporations managed to actually reduce their debt leverage ratios and improve their debt service capacity. It is not surprising then that the Korean economy has been able to withstand the current global crisis better than other industrialized economies.

Whether the post-crisis reforms—specifically, in macroeconomic policies, financial institutions, corporate governance, and labor market institutions—have had an overall salutary effect on the Korean economy is still being debated, as there are issues relating to the appropriateness of transplanted institutions to specific local conditions and the effectiveness of such reform.² Some have even argued that the severity of the current crisis in Korea is partly due to the “undisciplined” capital account liberalization that took place after 1997, which allowed Korean financial institutions to acquire large foreign currency liabilities and to invest heavily in foreign securities.³ One thing that is certain, however, is that corporations and financial institutions in Korea had undergone a series of reforms before the current crisis. How Korea has responded to the current crisis cannot be understood without first understanding these post-1997 reforms.

Corporate Sector Restructuring

The 1997 crisis prompted the Korean government to carry out a restructuring of the corporate sector, particularly *chaebols*, in order to restore the health and competitiveness of the economy.⁴ The reforms included various measures for promoting competitiveness and improving corporate governance, capital structure, and profitability. In particular, in order to improve the capital structure, the government required corporations to reduce

² Keun Lee and Chung H. Lee, “The Miracle to Crisis and the Mirage of the Postcrisis Reform in Korea: Assessment after Ten Years,” *Journal of Asian Economics* 19, no. 5–6 (November–December 2008): 425–37; and James Crotty and Kang-kook Lee, “The Effects of Neoliberal ‘Reforms’ on the Post-Crisis Korean Economy,” Political Economy Research Institute, Working Paper Series, no. 111, September 2005.

³ Yung Chul Park, “Global Economic Recession and East Asia: How Has Korea Managed the Crisis and What Has It Learned?” (mimeograph, Korea University, April 2009). Park argues that “undisciplined” liberalization led to large foreign currency liabilities in the banking sector, which jumped from \$83,429 million at the end of 2005 to \$194,045 million at the end of 2007.

⁴ A *chaebol* is a large, usually family-owned conglomerate in Korea. Examples include Hyundai and Samsung.

debt levels, strengthen their equity position, and eliminate chaebols' cross-subsidization of weaker affiliates.⁵

Recognizing a close link between the profitability of the corporate sector and the health of the financial sector, the government simultaneously pursued reforms in both areas. The restructuring of chaebols began, however, as a key element in the reform because insolvency of these conglomerates played a major part in the 1997 crisis and after that crisis the number of insolvent chaebols only increased. Out of 63 of the largest chaebols, 30 were forced to undergo some form of insolvency rehabilitation procedures—15 chaebols for in-court procedures and another 15 for informal workout programs.

Realizing the potentially serious negative impact that a massive wave of bankruptcies could cause, the government mobilized public funds to bring about the restructuring of the troubled firms. From 1998 to 2001, a total of 168 trillion won (25% of Korea's GDP in 2002) was mobilized, with a considerable portion being injected into the financial sector—both banks and non-banking financial institutions (NBFI). With these funds, the government cleaned up non-performing loans (NPL) through the Korea Asset Management Corporation (KAMCO) and strengthened the capital base of banks through the Korea Deposit Insurance Corporation (KDIC). In particular, KAMCO played a significant role in facilitating the rehabilitation of distressed chaebols, notably by reducing these businesses' level of debt: Between 1998 and 2002 KAMCO purchased NPLs valued at 48.3 trillion won (in book value) associated with the 30 troubled chaebols out of 63 largest chaebols for 17.4 trillion won.⁶ Once the government strengthened the soundness of the financial sector with public funds, financial institutions were in the position to implement creditor-led corporate restructuring, which began in 2001.

As part of the restructuring process, formal insolvency procedures were used in dealing with troubled chaebols.⁷ Informal workout programs, however, played a more

⁵ For a brief review of the post-crisis reform in Korea, see Chung H. Lee, "The Political Economy of Institutional Reform in Korea," *Journal of the Asia Pacific Economy* 10, no. 3 (August 2005): 257–77.

⁶ Joon-Kyung Kim, "Public Funds and Post-Crisis Corporate and Financial Restructuring in Korea," (paper presented at the symposium "International Forum on Non-performing Asset Fund," KAMCO, April 3, 2007)

⁷ The 1997 crisis prompted a number of changes in laws relating to corporate restructuring. The Corporate Reorganization Act was amended in 1998 and 1999 to improve insolvency laws with the following changes. First, an economic efficiency criterion was established, specifying the qualification for judicial insolvency procedures: the court now disqualifies a candidate firm whose going concern value is less

important role in restructuring and thus preventing corporate bankruptcies and restoring a rapid economic recovery. One such case involved Daewoo, the second-largest Korean business group at that time, which faced serious financial troubles and was technically insolvent by June 1999. Burdened with a massive non-performing debt of around \$72 billion, twelve affiliates of Daewoo entered into informal workout programs in August 1999. Implementing the workout programs was not easy, however, given that they involved a large number of domestic and foreign creditors with conflicting interests. Eventually, public funds were used in early 2000 to purchase \$3.9 billion of loans from more than three hundred foreign creditors.

Since the 1997 crisis, Korea's corporate sector has made significant progress in financial soundness and efficiency. The extreme high debt-equity ratios of over 500% in the years preceding the crisis were brought down to 200% by the end of 2000, and the intra-group debt guarantees of the 30 largest chaebols have also been reduced to a significant degree⁸ More importantly, many large-scale spin-offs have resulted in both the significant reduction in the number of poorly performing affiliates and the streamlining of financially weak chaebols.

To assess the degree of improvement in the corporate sector since the crisis, the present authors have examined the debt service capacity, operating profitability, and debt leverage of firms for 1991–2008 using the financial data for more than 18,000 externally audited firms. For the debt service capacity we have used the interest payment coverage ratio (IPCR)—the ratio of operating profits to interest expenses. This definition implies that the firms with an IPCR less than one are unable to even cover their interest payments, let alone the principal, with their current earnings. The IPCR for the entire group of sample firms has been rising since the crisis, albeit with some fluctuations (**Figure 1**). Reduction in debt, combined with lower interest rates, led to this upward trend. Another

than its liquidation value. Second, to speed up proceedings, time limits were introduced for the critical steps in the proceedings, including the decision to stay, the report of debts and equities, and the approval of a reorganization plan. In addition the Composition Act was amended in 1998 to prohibit large firms with complicated capital structures from [applying for](#) composition and thus prevent the abuse of the composition procedures. This appears to have had a salutary effect, as shown by the fact that the firms that entered both corporate reorganization and composition out-performed their 1997 counterparts. Joon-Kyung Kim, "Assessment of Progress in Corporate Restructuring in Korea since the 1997–98 Crisis," *Journal of Restructuring Finance* 1, no. 2 (September 2004): 289–310.

⁸ Fair Trade Commission.

feature relating to the IPCR is that the large firms have been improving their performance, albeit with some fluctuation, since the 1997 crisis, whereas small and medium-sized enterprises (SMEs) have been doing less well. Between 1997 and 2008 the IPCR of large firms rose from 1.3 to 4.3, more than a three-fold increase, while that of SMEs rose from 0.8 to 1.5, barely a two-fold increase.

There are at least a couple of reasons for the weaker debt service capacity of SMEs, one being these firms' stagnant profitability (**Figure 2**) and the other being their higher debt leverage than is the case for large firms (**Figure 3**). In particular, little improvement occurred in the operating profitability of SMEs compared to their pre-crisis performance.⁹ Large firms were, however, able to reduce debt leverage at a more rapid rate than SMEs: the ratio of total borrowings to total assets for large firms decreased from 49.9% in 1997 to 22.9% in 2008. Although initially decreasing after the crisis, the level of SME's debt leverage began to rebound in 2003 and reached 42.8% in 2008, almost the same level as before the crisis.

[INSERT FIGURES 1, 2, AND 3 ABOUT HERE]

In contrast to the considerable progress made in the restructuring of chaebols, there remain a vast number of financially weak firms in the SME group, as measured in IPCR. In 2008 the number of firms with an IPCR less than one was 7,470, accounting for 40.6% of the sample firms. Particularly worth noting is that the proportion of such firms was higher for SMEs than for large firms. Among the total number of troubled firms, 6,995 were SMEs, accounting for 42.6% of the total SMEs, whereas 515 were large firms, equivalent to 30.1% of the group. Though an IPCR of less than one for a single year may reflect only a short-term liquidity problem, a longer time horizon—for instance, three consecutive years—may point to severe credit risks and signal a “distressed” firm. In 2006–08, 2,662 firms recorded an IPCR of less than one for three consecutive years, accounting for 14.8% of the total sample firms. The amount of borrowings by these firms

⁹ Due to the global financial crisis in 2008, the operating profitability of large firms decreased substantially, from 6.7% in 2007 to 5.6% in 2008, whereas that of SMEs increased from 4.6% in 2007 to 4.7% in 2008. The increase in operating profitability for SMEs is mainly caused by the implementation of temporary changes in the accounting rule for non-listed SMEs: (1) applying the won-dollar exchange rate of June 30, 2008, instead of the traditional rate of December 31, 2008, to foreign currency-denominated assets and liabilities and (2) allowing a one-year deferment for reporting on losses that arise from holding derivatives with foreign exchange risk.

exceeded 101 trillion won, accounting for 17.3% of the total borrowings by all the sample firms.¹⁰

Restructuring of Financial Institutions

The 1997 financial crisis forced the government to carry out a number of reforms in the financial sector. These included the restructuring of financial institutions, liberalization of the financial intermediation industry, and reform of governance and regulatory institutions.

On the eve of the crisis, many banks in Korea were significantly undercapitalized, and the crisis only worsened the situation by further weakening their capital base. The government's top priority was to dispose of their NPLs and recapitalize the troubled banks. As a first step toward this end, the government set out to identify insolvent financial institutions and resolve their problems through either "purchase and assumption" or liquidation. By October 2006, 893 financial institutions had been either suspended or closed. A total of sixteen banks, twenty merchant banking corporations, fifteen securities companies, and twenty insurance companies were made to close through the mechanisms of either exits or mergers.

As mentioned above, the government created KAMCO and KDIC to clean up the NPLs and strengthen the banks' capital base. The funds expended by these corporations reached 168 trillion won, and the recovery ratio of total public funds was 55.7% as of February 2009. From inception through 2002, KAMCO purchased 111 trillion won of NPLs from financial institutions for 38.8 trillion won (an average of 36% of the face value) and so far has recovered 42.4 trillion won from the sale of the acquired NPLs, which amounts to 110% of the injected fiscal money.

As to be expected, the restructuring of the financial sector led to a drastic reduction in employment in that sector. By the end of 1999 the total employment in banks decreased from 128,503 employees on the eve of the crisis to slightly over 90,000—a

¹⁰ Joon-Kyung Kim, "Global Financial Crisis and the Direction for the Korean Economy" (paper presented at the symposium "What are the problems in Korea's Financial System?" Seoul National University Institute for Research in Finance and Economics, May 21, 2009).

significant drop of approximately 30%. Employment in that sector has since increased somewhat, yet still reached only about 100,000 in 2006.

The soundness of Korean banks improved markedly, thanks to the injection of public funds as well as strengthened prudential regulation and improved efficiency and internal risk management. Indeed, the BIS (Bank for International Settlement) ratio improved from 7.0% in 1997 to 12.3% in December 2007 while the NPL ratio decreased from 9.2% in 1999 to 0.6% in December 2007.

Liberalization of the Financial Intermediation Industry and the Capital Market

Another financial reform undertaken by the Korean government after the crisis was to fully open the financial intermediation industry by completely eliminating restrictions on foreign equity ownership. In August 1998 the Foreign Investment Promotion Act was enacted for the purpose of attracting FDI by fully liberalizing hostile mergers and acquisitions (M&A) by foreign investors. Foreign portfolio investments in the stock and bond as well as the short-term money markets were also completely liberalized. As a result, foreign investments in the financial intermediation industry steadily increased after 1999, with the total accumulated amount reaching \$26.4 billion by 2008. These liberalization measures have led to an increase in the share of foreign ownership in Korean banks and, in some cases, the acquisition by foreign investors. For example, Korea Exchange Bank was acquired by Lone Star in 2003, KorAm Bank by Citi Bank in 2004, and Korea First Bank by Standard Chartered Bank in 2005. One exception to this general trend is the Woori Financial Group, which is mostly government-owned.

The removal of restrictions on capital inflow was accompanied by the liberalization of foreign exchange transactions. In particular, the Foreign Exchange Management Law that had been maintained for over 50 years was abolished in 1999 and replaced with the Foreign Exchange Transaction Law. The old law constituted a positive list system in capital account transactions, which prohibited all capital account transactions that were not on the list. The new law introduced a negative list system that allows all capital account transactions except those on the list. Under the old law, foreign exchange transactions had to be accompanied with *bona fide* demand for foreign exchange, thereby preventing speculative transactions; under the new law, no such requirement is needed.

Beginning in 2006 the Korean economy continuously recorded surpluses in the current account, and the government encouraged capital outflows by, for instance, partly removing restrictions on overseas securities investment and real estate acquisition by individuals (**Table 1**). With these changes in laws and regulations relating to capital account transactions, Korea has now joined the ranks of the most advanced countries in the world in terms of the country's degree of capital market liberalization. In fact, Korea's liberalization index increased from 65.0 in 1997 to 85.1 in 2006, a level comparable to that of Japan or the United Kingdom.

[Insert Table 1_about here]

Foreign investments in the Korean equity market have also shown an upward trend since 1998 when ceiling restrictions on foreign ownership were abolished. Consequently, foreign investors' share of equities increased from 13% in 1996 and peaked at 42% in 2004 before falling to roughly 32% in 2007. During 2003–07, gross capital inflows to Korea averaged \$43.5 billion a year, led largely by foreign portfolio investments and foreign currency borrowings by financial institutions, which accounted for 50.1% and 45.3% of total capital inflows, respectively. In 2003–04, foreign investments in equity were greater than in debt securities, but in 2006–07 foreign investment in equity turned negative while investment in debt securities exploded. The share of FDI in total capital flows in 2003–07 was 15.5%.¹¹

Overall, the institutional reform undertaken by the Korean government in the aftermath of the 1997 crisis has put chaebols and financial institutions on more solid footing, helping them to better withstand the external shocks of a global financial meltdown and recession. One may debate the wisdom of the government's approach to liberalizing the capital account, but as far as the restructuring of large corporations and financial institutions is concerned, there appears to be little dispute about the appropriateness of the reform.

The Current Crisis's Economic Impact and Government Response

Impact on the Financial Sector

¹¹ "Economic Statistics System," Bank of Korea website, <http://ecos.bok.or.kr>.

The Korean financial market has suffered from the current crisis but not as severely as the financial markets in some countries. Stock prices certainly declined, with the KOSPI (Korea Composite Stock Price Index) falling by 40.7% between year-end 2007 and year-end 2008 and by 5.5% between year-end 2008 and February 2009. The decline was largely due to a surge in capital outflow, with a net outflow of \$46.2 billion between September and year-end 2008. This capital outflow was largely due to a massive withdrawal of foreign debt by financial institutions (**Figure 4**) and was a key factor in bringing about a rapid credit squeeze in the financial market. As a consequence, the won-dollar exchange rate fell, with the won depreciating by 40.8% between October 2007 and February 2009.

Since March 2009, stock prices and foreign exchange rates have gradually stabilized, due to the increased current account surplus as well as to the expansionary policy by central banks under the global policy coordination. The KOSPI increased by 28.8% between the end of February and the end of April 2009, and the won appreciated by 16.4% over the same period.

[INSERT FIGURE 4 ABOUT HERE]

Korea did not have as large a housing bubble as occurred in the United States.¹² During 1996–2007 housing prices in Korea rose only by an annual average of 3.6%, in contrast to an increase of 9.1% in the United States, and in 2008 prices in Korea rose by 3.1% versus the 16.8% drop in U.S. home prices (**Table 2**). Two factors accounted for this moderate increase in Korea: one was the deflationary effect of economic restructuring after the 1997 crisis (over the period of 1996–2000), and the other was the restrictive mortgage-loan regulations that the government introduced a few years before the current crisis.

[Insert Table 2 about here]

Until 1997, when the Korean Housing Bank (KHB) was privatized, a ceiling on the housing loan per household was typically set at less than 30% of the value of the property,

¹² Korea suffered from serious financial instability, however, due to credit card defaults in 2003 when there were 3.7 million credit defaulters (one-sixth of Korea's economically active population) with total household credit amounting to \$389.2 billion. See Hong-bum Kim and Chung H. Lee, "Financial Reform, Institutional Interdependency, and Supervisory Failure in Postcrisis Korea," *Journal of East Asian Studies* 6, no. 3 (September–December 2006): 409–31.

and loans were granted only for newly built houses. As the mortgage market became more market-based and competitive, however, and as more diverse financial products were introduced as a result of the post-crisis reform, housing loans increased, fueling a boom in the market. From 2001 to 2006 housing prices in Seoul rose on average by 11% per year.

In September 2002, to help control the bubble in the housing market, the government began tightening the loan-to-value (LTV) ratio on apartments in “speculative areas” priced over 600 million won. For banks and insurance companies, the ratio was set at the maximum of 60% on most housing loans but at a more restrictive 40%–60% on condominium apartments in the speculative areas. Some adjustments allowed for difference in the length of loan maturity and the value of the collateral. For non-bank financial institutions, such as mutual finance and savings banks, the ceiling was set at 50%–70%, with the difference depending on the type of housing and location. These ratios are more restrictive than in other OECD (Organisation for Economic Co-operation and Development) countries, where ratios generally range between 55% and 90% or in some cases between 80% and 115%.¹³

Beginning on August 30, 2005, a regulation on DTI (debt-to-income ratio, which is the principle and interest payments on total loan to income) was also introduced to reduce the default risk on housing loans. The government began to apply a 40% DTI ratio to borrowers who it suspected might use the loans to invest in apartments in the speculative area.

Measures such as LTV and DTI ratios had the effect of curbing the credit boom in mortgage loans and thus holding down the demand in the housing market. As of September 2008, the LTV ratio in Korea was 45.5%, a figure far lower than in the United States, where the ratio on subprime mortgages was 90% at the end of 2008.¹⁴

Since year-end 2006 the delinquency ratio of mortgage loans in Korea has remained low and was only 0.54% in April 2009. In contrast, the delinquency ratio for

¹³ Organisation for Economic Co-operation and Development (OECD), *OECD Economic Surveys: Korea 2007* (Paris: OECD, 2007), chap. 3.

¹⁴ After the collapse of Lehman Brothers in September 2008, the Korean government relaxed almost all restrictions on the housing market in fear of a rapid fall in housing prices. That action has led to a slight rebound in housing prices in certain areas since early March 2009.

SME loans, which had ranged from 1.0 to 1.8% during 2008, shot up to 2.59% in April 2009.¹⁵ These numbers suggest that the housing market in Korea is in a much healthier condition than that of the United States, although some financial institutions may still suffer a higher-than-average number of loan defaults given a general contraction in the real economy. So far, however, no bank has gone bankrupt in Korea.

Impact on the Real Sector

In spite of this relative stability in the financial market, the current global recession has brought about a severe contraction in Korea's exports, thus hurting Korea's real economy. As a matter of fact, Korea's monthly exports recorded an unprecedented decline from \$41.0 billion in July 2008 to \$25.5 billion in January 2009 (**Figure 5**). Between October 2008 and March 2009 exports to China, the United States, Japan, the European Union, and the rest of the world ("others") decreased by 24.4%, 15.4%, 22.6%, 25.0%, and 11.9%, respectively. The severity of these contractions is especially stark when compared with the high-growth rates in exports to these areas in the preceding seven years (**Table 3**). Beginning in March 2009, however, exports improved somewhat, though, with the exception of the shipbuilding industry, exports still remain weak overall.

[INSERT FIGURE 5 AND TABLE 3 ABOUT HERE]

As to be expected, this decline in exports has had a negative impact on Korea's manufacturing sector: the manufacturing production index fell significantly since November 2008 and its year-on-year growth rate recorded a 17% decrease between November 2008 and February 2009 (**Figure 6**). This negative impact was widely spread throughout the entire manufacturing sector, although the automobile industry appears to have suffered the most. Beginning in March, manufacturing production saw some improvement.

As indicated by the manufacturing production index, production activities have declined for large firms as well as for SMEs. Yet unlike during the 1997 crisis, when SMEs suffered more than large firms, the contraction in large firms has been more pronounced than that in SMEs (**Figure 7**). The severity of the impact of the current crisis

¹⁵ Financial Supervisory Service Delinquency Ratios for Loan Portfolios by Domestic Banks at the end of April, 2009 (May 27, 2009); http://www.fss.or.kr/kr/nws/nbd/bodobbs_1.jsp

on manufacturing can also be seen in the sharp decline in the capacity utilization index to 77 for January 2009, which is even lower than during the 1997 crisis (**Figure 8**). The capacity utilization index rose somewhat to 83.9 in February and further to 86.9 in March.

[INSERT FIGURES 6, 7, AND 8 ABOUT HERE]

Consumption-related indicators also show a continuing slowdown, particularly in durable goods, which suffered a 17.7% drop between November 2008 and January 2009, the largest dip since the 1997 crisis. In February and March 2009, sales of consumer durables fell by 9.4%. Equipment investment likewise decreased sharply during the same period (-22% YOY growth). The value of completed construction projects continued a sluggish pace between November 2008 and January 2009 (-3.4% YOY growth) but improved somewhat in February and March (8.4% YOY growth), owing to a massive increase in public sector spending.

The contraction in manufacturing has caused the unemployment rate to rise from 3.0% in January 2008 to 3.9% in February 2009. The number of new workers hired has continued to fall since December 2008, and in February this number fell by 0.6% (142,000 workers), the largest drop since the 1997 crisis (**Figure 9**). The nominal wage rate decreased by 2.1% in the fourth quarter of 2008, which is the first drop since the 1997 crisis. The impact was much greater for temporary/non-regular employees, whose wages declined by 9.0% as compared to the 1.7% drop in the wages of permanent/regular employees. This change has had the effect of increasing the wage gap between the two groups of workers, especially in large companies with more than 300 employees.

[INSERT FIGURE 9 ABOUT HERE]

Government Response

The Korean government has taken a number of comprehensive and preemptive measures designed to address the actual or potentially adverse impacts of the crisis. These measures are briefly discussed below, being cognizant that it is too early yet to tell whether these measures will be successful.

Foreign currency liquidity provision. The massive outflows of capital have exceeded those that occurred during the 1997 financial crisis; in response, the Korean government and the Bank of Korea have set aside \$55 billion for the October 2008–

February 2009 period in order to provide foreign currency liquidity (\$21 billion for trade finance and \$34 billion for liquidity provision). In addition, in October 2008 the government set up a three-year \$100 billion payment guarantee for foreign currency borrowing by domestic banks. During November and December 2008 Korea also made currency swap agreements of \$30 billion each with the United States, Japan, and China. As an additional measure for stabilizing the foreign exchange market, the government now grants to foreign investors an income tax exemption on interest from government bonds.

These measures have significantly alleviated the credit squeeze. Although the short-term external debts of domestic banks fell by \$46.7 billion in the fourth quarter of 2008, the term-loan rollover ratio increased to around 90% at the end of 2008 from 50%–60% in September (**Figure 10**). In March 2009 the rollover ratio further increased to 106%, mainly due to the current account surplus, which rebounded to \$3.68 billion from a deficit of \$1.64 billion in the previous month. The banks have secured enough funding to pay off the loans maturing in January and February of 2009 while obtaining roughly \$5 billion in long-term funds by issuing bonds and through private equity funds.¹⁶

[INSERT FIGURE 10 ABOUT HERE]

Policy rate cut and liquidity provision. To prevent the Lehman Brothers bankruptcy in September 2008 from resulting in a credit crunch, the Bank of Korea reduced the policy rate by 325 base points—from 5.25 to 2.0%. To assure liquidity the bank also pumped 23.3 trillion won into the banking system through a Repurchase Agreement (RP) (16.8 trillion won) and treasury bonds (1.7 trillion won) and the buyback of the Monetary Stabilization Bond (0.7 trillion won).¹⁷

Large-scale fiscal stimulus package. In response to the fall in aggregate demand, the Korean government has adopted expansionary fiscal measures. Specifically, the

¹⁶ Korea's foreign exchange reserves, down to \$200.5 billion in November 2008, increased to \$212.5 billion in April 2009, the sixth-largest in the world.

¹⁷ The Bank of Korea's cut in the policy rate has pulled down the short-term interest rate, but the expectation of fiscal pump priming (such as a large-scale supplementary budget) raised the treasury bond yield rate in February 2009, thereby widening the spread between short- and long-term interest rates. AA-corporate bond yields decreased whereas BBB-corporate bond yields increased to widen the credit spread, indicating that the Korean financial market is experiencing some degree of credit crunch.

government has earmarked 51.3 trillion won (5.7% of GDP) for a stimulus package, which includes investment in infrastructure, provision for the social safety net (16 trillion won), and a reduction in corporate and personal income tax rates (35.3 trillion won). The government may consider additional fiscal stimulus if economic conditions deteriorate further. In addition to spending on investments to strengthen the growth potential of the economy, the supplementary budget will focus on job creation, especially for low-income groups, the unemployed, SMEs, and the self-employed.

These expansionary fiscal measures may lead to a deterioration of fiscal balance and an increase in the national debt. The Korean economy is, however, unlikely to suffer much from these consequences of expansionary fiscal measures. The government has been running surpluses in the budget for the past several years, and the national debt is well below the average for the OECD countries (Figure 11).

[INSERT FIGURE 11 ABOUT HERE]

Enhanced support for SMEs. Government credit guarantees to SMEs through KODIT (Korea Credit Guarantee Fund) and KIBO (Korea Technology Credit Guarantee Fund) will increase to 62.6 trillion won at year-end 2009 from 48.9 trillion won at year-end 2008. An extension will be granted to credit guarantees maturing in 2009, which amount to 32.5 trillion won, and the criteria for credit guarantees will be relaxed. Moreover, the guarantees that have an upper limit of one-fourth or one-third of the sales revenue of a firm will be raised to one-half. In particular, the guarantees for exporting firms, “green-growth” firms, high tech firms, and start-up companies will increase from the current level of 85% to 100%. In addition, other SME loans maturing in 2009 will be rolled over.¹⁸

Since the global financial crisis began, the demand for SME loans has decreased while the credit risk has increased, creating a precipitous drop in the amount of SME loans made by the banks (in December 2008 alone the supply of SME loans decreased by 1.8 trillion won). After the implementation of the credit guarantee policy in January and February 2009, however, SME loans increased to 3.1 trillion won (**Figure 12**). Excluding

¹⁸ These measures may have the effect of keeping unviable “Zombie” firms alive, imposing a drag on rapid economic recovery. See Gonzalo Fernández de Córdoba and Timothy J. Kehoe, “The Current Financial Crisis: What Should We Learn from the Great Depression of the Twentieth Century,” Federal Reserve Bank of Minneapolis, Research Paper Staff Report, no. 421, February 2009.

the KDB loans, 97% of the increased SME loans by commercial banks were estimated to have been supported by credit guarantees.

[INSERT FIGURE 12 ABOUT HERE]

Enhancing the soundness of the banking system. The government is implementing various measures, including the Bank Recapitalization Fund, to expand the credit-supply capacity of banks. The fund will have 20 trillion won, of which 10 trillion will be from the Bank of Korea, 2 trillion from the Korea Development Bank, and 8 trillion from institutional and retail investors. The fund will purchase subordinated bonds, hybrid loans, and redeemable preferred stocks upon bank request. It will also provide support to commercial banks, the Industrial Bank of Korea, the NACF (National Agricultural Cooperative Federation), and NFFC (National Federation of Fisheries Cooperative) on a limited basis.

The government also plans to establish a corporate restructuring fund of 40 trillion won in KAMCO in order to purchase bad debts and support restructuring. This fund will conduct a role similar to the Non-performing Loan Resolution Fund, which was created during the 1997 financial crisis.¹⁹ As of year-end 2008, key soundness indicators of Korean banks, including the BIS ratio (12.2%), the NPL ratio (1.11%), and the coverage ratio (147.1%), are all in good standing.

Support for household loan/mortgage holders. Several measures have been introduced to lessen household burdens. They include guaranteeing collateral supplementation up to 100 million won for the depreciated value of housing, extending the maturity and grace period of mortgage loans up to ten years, and exempting the early repayment fees on the transfer from floating to fixed-rate loans.

Job sharing. In order to create new jobs and retain employment the government will spend 60% of its budget in the first half of 2009 and launch the Green New Deal Project, which will invest 50 trillion won for the purpose of securing future economic growth and employment.

¹⁹ From its inception up until the end of 2006, KAMCO purchased 111 trillion won (in book value) in non-performing assets from financial institutions for 38.8 trillion won. By the end of 2008, it recovered 42.4 trillion won from such sales, which is 110% of the injected fiscal money.

Youth unemployment is a serious problem in Korea and has spurred the government to initiate the Youth Internship Program in order to train unemployed youth for employment in an economy that is becoming more technologically sophisticated. The government also plans to revise labor laws and institutions to make the labor market more flexible and to promote job creation. Specifically, the government will offer tax credits and financial incentives to companies that are devising ways to bring about cooperation between labor and management for job-sharing and improved industrial relations. Also, to address the inequities between regular and non-regular workers, the government is revising the relevant labor laws and institutions—for example, by extending the employment of non-regular workers from two to four years.

Implications for Political Stability and Strategic Alignment

What effect the current economic crisis has on Korea's political stability will depend very much on whether the various measures currently being undertaken by the government will succeed in ameliorating the impact of the crisis. If the government succeeds in mitigating the credit and liquidity crunch, in moderating the demand fall and increases in unemployment with expansionary fiscal measures, and in providing an adequate social safety net to the more vulnerable groups in society, the economy will recover quickly. If this recovery occurs, there will be little danger of the current crisis weakening political support for the government and endangering the country's political stability.²⁰

An additional factor for the likelihood of the current crisis having little effect on political stability is that the crisis is seen to have its origin in the failures of the U.S.

²⁰ Since the 1997 crisis, Korea has experienced deterioration in income distribution as well as wealth distribution. According to the Korea National Statistics Office, the Gini coefficient for income distribution increased from 0.295 in 1998 to 0.325 in 2008. This increase was due to the restructuring in the corporate and financial sectors. According to an article by Joon-Kyung Kim, the Gini coefficient for total assets also increased from 0.60 in 2000 to 0.64 in 2006. The worsening of wealth distribution was mainly due to the fact that mortgage loans were relatively concentrated among the high-income class and that the price of real estate steadily increased during 2001–06, adding to the wealth of the well-off. Given this state of income and wealth distribution, unless the current social safety and income redistribution policy are strengthened, Korea may face social instability should the current crisis further deteriorate income distribution. See Joon-Kyung Kim, "Recent Changes in Korean Households' Indebtedness and Debt Service Capacity," Working Paper, no. 08-23, KDI School of Public Policy and Management, 2008.

financial system rather than in political corruption or “crony capitalism” in Korea itself, which some blamed for the 1997 crisis. Consequently, there is little or no demand—either domestically or from abroad—for institutional reform and thus no potential opposition from the entrenched domestic powers (e.g., chaebols and bureaucrats) that such reform may engender.

It is, of course, too early to tell how successful the macroeconomic and social safety net measures will prove. If, however, the Korean government does not succeed in solving the problems created by the crisis or at least in lessening the negative economic and social impacts, the government will need to devise and implement other measures, even including state ownership of some of the banks, as occurred in Sweden during that country’s financial crisis. There is historical precedent in Korea for such a government intervention: in the early 1960s the government nationalized the commercial banks and used them as an instrument in launching the Korean economy on the path of rapid economic growth.²¹ The Korean people may realize that the exigencies of the current crisis could call for such a pragmatic, less ideologically bound role of government.

How will the current crisis affect Korea’s external relations and strategic alignments? According to Jonathan Pollack, Korea has three primary strategies: it can pursue a U.S.-centered, an autonomous, or a diversified (hedged) strategy.²² The first strategy was preferred and chosen by the current president Lee Myung-bak, the second by Park Chung-hee (1961–79) and Roh Moo-hyun (2003–08), and the third by Kim Dae-jung (1998–2003) and to a lesser extent by Roh Moo-hyun. This association of strategy with the incumbent of the presidential office seems to be determined by the political and strategic views of the president and the internal political alignments that led to his election to the presidency. There is, however, one geopolitical-economic change that has occurred in the past few decades that must be taken into account in discussing the direction of Korea’s strategic alignments in the near future: the emergence of China as a major economic power in the world and the effect on the Korean economy.

²¹ See Chung H. Lee, “The Government, Financial System, and Large Private Enterprises in the Economic Development of South Korea,” *World Development* 20, no. 2 (February 1992): 187–97.

²² Jonathan D. Pollack, “The Korean Peninsula in U.S. Strategy: Policy Issues for the Next President,” in *Strategic Asia 2008–09: Challenges and Choices*, ed. Ashley J. Tellis, Mercy Kuo, and Andrew Marble (Seattle: The National Bureau of Asian Research, 2008): 135–66.

Korea's strategic alignment depends, as Pollack has pointed out, on factors such as the ideology of political leaders, the strength of the economy and military, and historical relationships. To this list, this chapter adds the extent of economic integration or interdependence between Korea and its counterparts. Especially for an economy such as Korea's that depends heavily on external trade for economic growth, the choice of strategic alignment is critically dependent on how close economic relations are with the counterpart country. The following section shows that China has not only replaced the United States as Korea's biggest trade partner but has also incorporated Korea in region-wide production networks. This growing economic interdependence will challenge the long-standing close relationship between Korea and the United States. What effect the current crisis will have on this interdependence is thus a key determining factor in how Korea's relations with the United States may evolve in the near future.

Yet Another Variable: The Emergence of China

China's rapid economic growth since the late 1970s has brought the economies of China and Korea closer together through expanding bilateral trade and production networks while at the same time making the two states competitors for market share in the rest of the world.

In 1989, Korea exported to China \$437 million worth of merchandise and imported \$1.7 billion, while Korean merchandise exports to and imports from the United States amounted to \$20.6 billion and \$15.9 billion, respectively. By 2008, Korea's merchandise exports to and imports from China grew to \$91.4 and \$76.9 billion, respectively, while merchandise exports to and imports from the United States reached \$46.4 billion and \$38.4 billion, respectively. Thus, in less than twenty years China has surpassed the United States as Korea's largest trade partner. It has also become a major host country for Korea's overseas investment: in 2007 alone Korea invested \$5.3 billion in China and by year-end 2008 its total cumulative stock of investment in China stood at \$26.5 billion (compared to an investment of \$25.5 billion in the United States).

Competition

Although now Korea's major trade and investment partner, China has also become a major competitor in the realm of exports by gaining a comparative advantage in many manufacturing industries, especially those that are labor-intensive. China's gain of comparative advantage in such industries is seen by some observers in Korea to have put its economy in a position of being caught between two "neighboring whales": price-competitive China and technologically more-advanced Japan. Further complicating the economic relationship between the two states is the fact that Korea is now a major supplier of parts and components used in the manufacture of China's exports and thus indirectly benefits from the growth of these exports.

Over the past few decades China has successfully changed its export structure from low to more high tech products. In 1992, for instance, more than a half of China's manufacturing exports were low tech products such as textiles, apparel, and footwear, whereas the exports of medium-high and high tech products accounted for only 12.4% and 10.9%, respectively. By 2006, however, the share of low tech exports declined to 28.6% while the share of medium-high tech and high tech exports rose to 20.4% and 35.3%, respectively. The high tech product group, computers, office products, and radio, television, and -communication equipment increased the most in terms of export share between 1992 and 2006—from less than 6% in 1992 to 27% in 2006.²³

With China's export structure catching up to Korea's, a convergence would be expected in the two countries' export structure and increased competition in their export markets. To see how the two have fared in this competition, **Figure 13** compares the shares of imports from China and Korea for 1992 and 2007 in four markets— Japan, the United States, the EU, and the rest of the world. It is clear that China made significant gains in market share for all products in Japan and the United States, whereas Korea's share shrank in those markets.

[INSERT FIGURE 13 ABOUT HERE]

It is difficult to know how much of the loss in Korea's market share was due to the growth of exports from China and how much stemmed from cost increases in Korea and other factors unrelated to China's emergence. One thing that is certain, however, is that

²³ For a more detailed discussion, see Joon-Kyung Kim and Chung H. Lee, "Emergence of China and the Economy of South Korea," in *Korea Yearbook*, ed. Rüdiger Frank et al. (Leiden: Brill, 2008), 139–64.

while becoming a major competitor with Korea for world market share, China has also become an important destination for certain Korean exports. Although suffering a market loss to China in low and medium-low tech products, Korea has increased, between 1992 and 2006, its world market shares in high and medium-high tech products from 2.6% and 1.2% to 5.4% and 3.2%, respectively. This growth is partly due to an increase in Korean exports to China, as will be discussed below.

Complementary: Expanding Bilateral Trade

Although Korea competes with China in the rest of the world for market share for a number of products, its relationship with China has been complementary in that bilateral trade between the two countries has been growing at a rapid rate. In fact, China's share of Korean exports rose from 3.5% in 1992 to 19.5% in 2007 (see **Figure 14**), and this growth largely accounts for the increase in Korea's total exports over the past fifteen years. The increase is certainly phenomenal, but to confirm whether the bilateral trade has grown more rapidly than Korea's overall trade **Figure 15** shows the export- and import-intensity indices with respect to China for 1992–2007.²⁴

[INSERT FIGURES 14 AND 15 ABOUT HERE]

Not surprisingly, export intensity with respect to China rose from 1.6 to 4.3 during this period, whereas the import intensity remained almost the same, suggesting that Korea has become relatively more dependent on China for exports but not for imports. During the same period Korea's export intensity with respect to the United States fell from 1.7 to 0.9 while import intensity decreased from 1.9 to 1.2.

The various statistics presented so far point to a growing economic interdependence between Korea and China, the latter having surpassed the United States as Korea's largest trade partner and as a market for Korean exports. In addition, the nature of Korea's relationship with its primary trade partner has also changed: China has become closely linked with Korea through production networks. That is, interdependence between the two states is not only through trade linkages but is also based on networks that bring

²⁴ The export intensity of country A with respect to country B is the ratio of B's share of A's total exports to B's share of world total imports. An export intensity greater than one suggests that A is more closely tied with B in trade than the latter is with the rest of the world. The import intensity index is similarly calculated and has the same implication.

together production units across national boundaries. A sign of these networks is the trade in parts and components, which, as shown below, makes up much of the bilateral trade between Korea and China. Because these parts and components are used in the manufacture of goods exported from China, Korean exports are closely linked to China's exports to the rest of the world, especially to the United States. Thus, the Korean economy may appear to have become decoupled from the U.S. economy in that in terms of gross trade volume China has now replaced the United States as Korea's most important trade partner. In reality, though, this has not actually occurred. Korea remains indirectly linked with the United States through China because its exports of parts and components to China depend crucially on the latter's exports to the United States.²⁵ This situation may not last long, however, if China begins to domestically produce these parts and components or imports them from sources other than Korea. In that eventuality the Korean economy may truly become decoupled from the U.S. economy.

Trade in Parts and Cross-Border Production Networks between Korea and China

This section examines trade in parts and components, which is a good indicator of the extent of cross-border production networks. Such trade takes place either between separate production units that belong to the same firm or between two independent firms and is a consequence of the international fragmentation of production processes.²⁶

Table 4 reports the destinations and sources of parts trade for Korea in 1992 and 2006 for the industries in which much parts trade takes place. Between 1992 and 2006

²⁵ Joshua Aizenman and Yothin Jinjarak, "The US as the 'Demander of Last Resort' and Its Implications on China's Current Account," National Bureau of Economic Research, Working Paper, no. 14453, October 2008. Yung Chul Park and Kwanho Shin have claimed that East Asia has become decoupled from the U.S. economy due to the growth of East Asian trade with China. In comments published in the same journal, however, Prema-Chandra Athukorala has pointed out that intraregional trade with China is mostly in parts and components and that the bulk of China's exports are for extraregional markets. The decoupling is thus a statistical artifact. See Yung Chul Park and Kwanho Shin, "Economic Integration and Changes in the Business Cycle in East Asia: Is the Region Decoupling from the Rest of the World?" *Asian Economic Papers* 8, no.1 (Winter 2009): 107–40; and Prema-chandra Athukorala "Comments," in *Ibid.*, 141–45.

²⁶ Mitsuyo Ando and Fukinari Kimura, "The Formation of International Production and Distribution Networks in East Asia," National Bureau of Economic Research, Working Paper, no. 10167, December 2003.

exports to China of parts for computers and office products; radio, television, and communication equipment; precision, medical and optical instruments; and electrical machinery all increased from less than 2% to more than 30%. Even in motor vehicles and trailers the increase was from 0.9% in 1992 to 25.6% in 2006. This increase in parts trade is much greater than the increase in Korea's total exports to China from 3.5% to 21.3% during the same period and is a sign of the growing importance of parts exports from Korea to China. This trend is certainly an indication that China has become a major assembler of parts and components manufactured in Korea for many high and medium-high tech products and that Korea has become an indirect beneficiary of China's growing exports to world markets.

[INSERT TABLE 4 ABOUT HERE]

In 1992, Korea imported parts and components mostly from Japan, the United States, and Europe (a total of 82.1%) while importing only a miniscule amount (0.4%) from China. By 2006, however, imports from the former decreased to 51.8% while those from the latter increased to 19.2%. The most dramatic change took place in computers and office products; radio, television, and communication equipment; and electrical machinery. Their respective shares of imports from China increased from 2.7% to 58.0%, 1.1% to 38.6%, and 0.5% to 34.4%. The fact that these increases took place while the share of parts imports in those groups from Japan, the United States and the EU decreased is a sign both of growing cross-border production networks between China and Korea and of the growing relative importance of China for Korea's manufacturing sector.

It is clear that China has become Korea's major trade partner, importing many parts and components from Korea for the manufacture of its own exports and then supplying Korea with inexpensive consumer goods. Furthermore, the expansion of the economic relationship between Korea and China is more than a growth in the volume and variety of goods traded: numerous production networks now span the two countries, bringing them closer together. This expansion does not, however, mean that the Korean economy has become less dependent on the U.S. economy. To the contrary, the Korean economy remains closely linked with the latter not only indirectly through cross-border production networks with China but also directly through U.S.-Korean trade. Thus, the effect of the current crisis on the U.S. economy has a profound impact on the Korean economy. At the

same time, how Korea will react will depend on the effect of the crisis on China's economy, economic policy, and relationship with Korea.

The Effect of the Crisis on Korea's External Economic and Strategic Relations

What effect the current crisis will have on the realignment of Korea's external economic relations will depend on a number of factors. First, any effects will depend on the speed at which the U.S. economy recovers. The sooner and more quickly the United States recovers from the crisis, the less likely it is that there will be a long-lasting change in economic relations between Korea and its two major trading partners. Spending nearly \$600 billion for economic stimulus and growing at 8% (or 6.5%, as recently revised by the World Bank) in spite of the crisis, China's importance for the Korean economy will only grow, strengthening the country's status as Korea's biggest trade partner. The slower the recovery of the U.S. economy, however, the stronger will economic relations between Korea and China become.

Second, if the United States grows protectionist, Korea may have no option but to turn to China for market access. Because Beijing is changing its growth strategy from export orientation to domestic demand, China is thus potentially an expanding market for Korean exports. Korea's direct investment in China and the cross-border production networks that had been established before the crisis should be a positive factor in this expansion—especially if China's stimulus package boosts local demand for consumer durables such as television sets and home appliances.

Even if the United States does not turn protectionist in its overall trade policy stance, Washington may take certain specific measures that are likely to have an adverse effect on the U.S.-Korea economic relationship. One such measure would be the failure to ratify the Korea-U.S. Free Trade Agreement (FTA).²⁷ The ratification of the agreement is crucial for Korea because the FTA would have both a salutary effect on Korea-U.S.

²⁷ *Chosun Ilbo*, a South Korean newspaper, reported that Ron Kirk, the U.S. trade representative-designate, spoke out against the Korea-U.S. FTA in its present form. Korea already has an FTA with Chile and some of the ASEAN countries and is in the process of negotiating FTAs with Australia and the EU. See "FTA with Seoul Unacceptable, Says U.S. Nominee," *Chosun Ilbo*, March 11, 2009, http://english.chosun.com/site/data/html_dir/2009/03/11/2009031161001.html.

economic relations and a counterbalancing effect on Korea's increasing economic dependence on China.

If the United States either turns protectionist or grows slowly in the next few years, East Asian countries may search for a regional solution to ensure their own economic survival and prosperity. Such regionalization would mean that, given its size and economic strength, China would likely become the locomotive for the region's economic growth. If this were to occur, the East Asian economies could become more decoupled from the U.S. economy and more dependent on China.

One of the profound consequences of the 1997 crisis for Korea was that it brought about reforms leading to the adoption of many institutions of the Anglo-American capitalist tradition. Korea was pressured by the IMF to adopt its prescription of institutional reform. At the same time, having diagnosed some domestic policies and institutions as the cause of the crisis, Korea was a willing student of the tutorage offered by the multilateral organization.²⁸ This more recent crisis is a different situation, however, because the causes of the crisis are not seen as internal to Korea but as having originated in the United States, a paragon of free-market capitalism. The crisis has probably made many in Korea to question the wisdom of following the Anglo-American model as practiced in the past few decades with such a heedless emphasis on deregulation.

A fundamental change could take place in what Korea's policy elites regard as the appropriate role of government in a capitalist market economy. The current crisis and failure of the U.S. economy to recover quickly may lead both to the loss of credibility in certain features of Anglo-American free-market capitalism, especially those practiced in the past few decades, and to the strengthening of the effort to reinterpret East Asia's spectacular success in industrial development over the past 50 years. A successful reinterpretation of the development experiences of the East Asian countries will highlight common development strategies and lead to the establishment of a competing economic ideology.

The mainstream view of East Asia's economic development, which began in post-World War II Japan, continued in Korea and Taiwan in the 1960s, and finally spread to

²⁸ Chung H. Lee, ed., *Financial Liberalization and the Economic Crisis in Asia* (London: Routledge, 2003).

China since the late 1970s, is the “Washington consensus.” This consensus is basically the Anglo-American version of the capitalist market economy, promoting free trade and financial liberalization in addition to stable macroeconomic policies as a prescription for economic development. This view is being challenged by the “Beijing-Seoul-Tokyo consensus” (BeST consensus), which includes a greater role for government than that prescribed in the Washington consensus. According to the BeST consensus, East Asian governments have been actively engaged in creating and strengthening domestic enterprises, establishing pilot state agencies that coordinate and guide industrialization, and sequentially upgrading the leading sectors and activities to secure dynamic comparative advantage.²⁹ These are government activities that are proscribed in the Washington consensus, as they are presumed to lead to inefficiencies and rent-seeking. One likely consequence of the current crisis is increased credence to the BeST consensus and the way East Asian countries have managed their economies.

The current crisis may further increase the interdependence between the economies of Korea and China. If China is successful with its new policy of relying on domestic demand for economic growth, Korea will be well poised to find markets for its consumer durables in China. China may turn into a market of final destination for Korean exports rather than merely a way station for parts and components made in Korea, thereby making Korea more dependent on China for economic growth. This possible eventuality, however, may not be what Korea would like to see as its future, as this would put the country in a strategically subordinate position to China.³⁰ To hedge against this possibility, Korea will want to maintain strong economic and security ties with the United States. Ratification of the Korea-U.S. FTA would have the symbolic effect of affirming such ties.

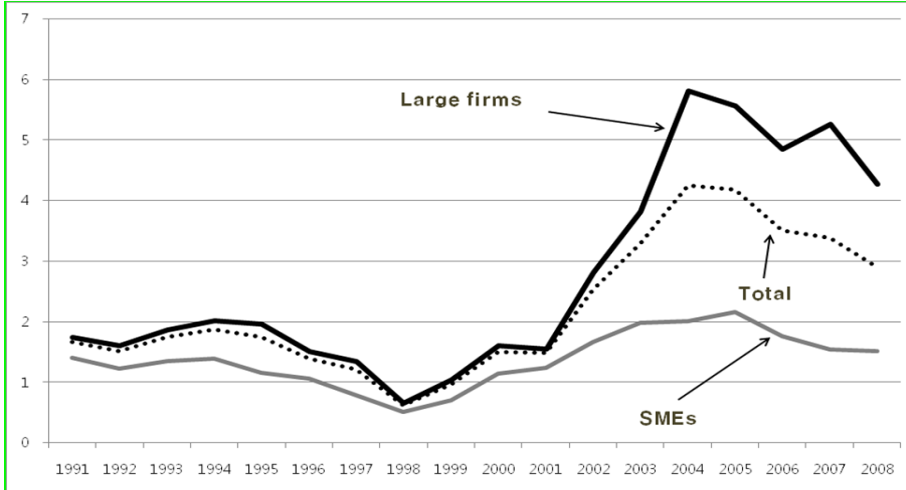
²⁹ Keun Lee and John A. Mathews, “From the Washington Consensus to the BeST Consensus: A New Path to Sustained Economic Growth?” Macquarie Graduate School of Management, Macquarie University, Working Paper, August 25, 2008.

³⁰ This would be a view of “realistists” in international relations, whereas “neoliberal institutionalists” would argue that close economic interdependence would mitigate the likelihood of political conflict. For a brief but succinct discussion of different theories on the relationship between economic interdependence and political relations in the context of Korea, see Scott Snyder, *China’s Rise and the Two Koreas* (Boulder: Lynn Rienner, 2009).

In the end, what will determine the future relationship between Korea and China will depend on the Sino-U.S. relationship, given that Beijing may have a long-term interest in seeing the growth of Chinese influence and a reduction of Washington's influence in Korea. According to China scholar Robert Sutter, China has been careful not to be seen as directly challenging the U.S. leadership in Korean affairs, and if the United States follows a "firm and effective policy toward China, avoiding challenge to core Chinese interests while making clear boundaries China should not cross," China is less likely to take a more assertive and disruptive stance in Asian affairs.³¹ The metaphor of Korea being positioned between the two whales of Japan and China may have been appropriate to Korea's economic situation a decade or two ago. In the sphere of strategic alignments that Korea will be faced with in the post-crisis era, however, the two whales are China and the United States. Only when these two behemoths co-exist in peaceful harmony will Korea not have to make a difficult choice between the two.

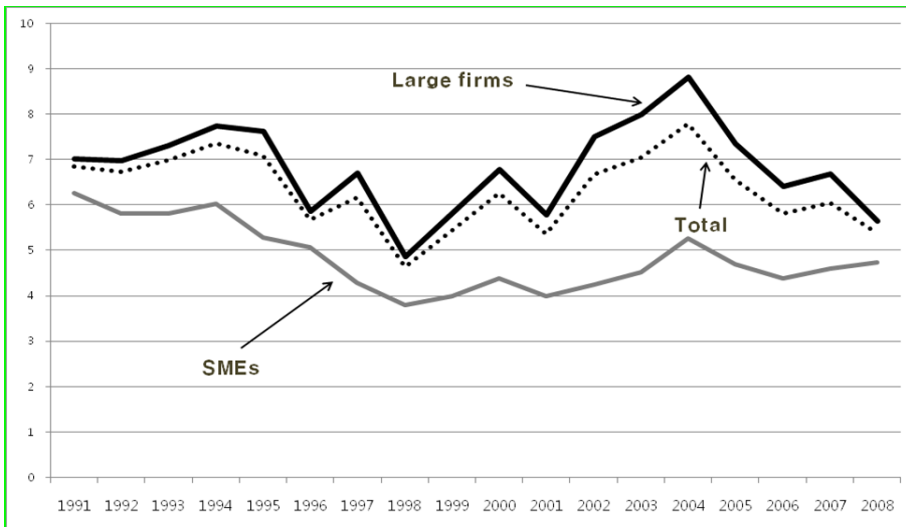
³¹ Robert G. Sutter, *China's Rise in Asia: Promises and Perils* (Lanham: Rowman and Littlefield, 2005), 6.

Figure 1 Interest payment coverage ratio (IPCR)



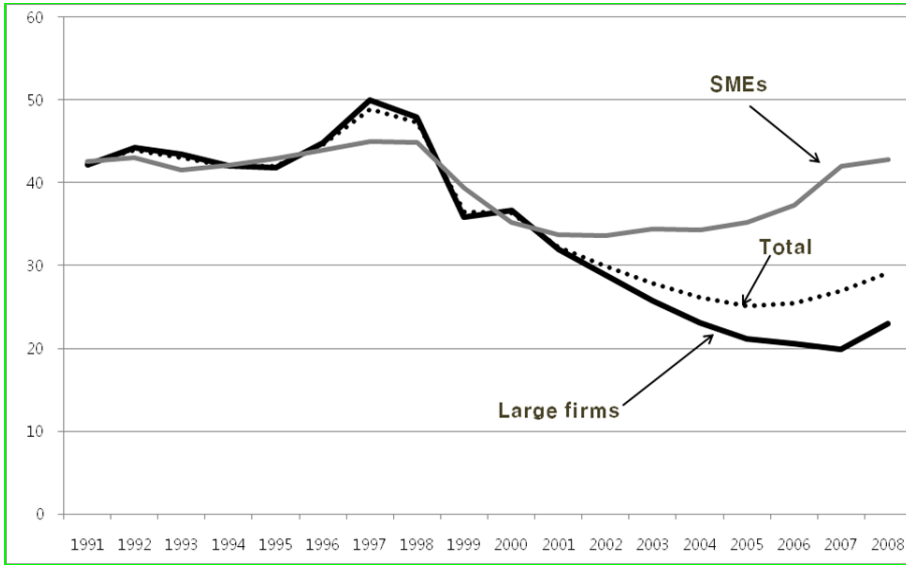
Data Source: Database from Korea Investors Service, Inc.
 Note: The ratios are a weighted average across firms.

Figure 2 Ratio of operating profits to total sales (%)



Data Source: Database from Korea Investors Service, Inc.
 Note: The ratios are a weighted average across firms.

Figure 3 Ratio of total borrowings to total assets (%)



Data Source: Database from Korea Investors Service, Inc.

Note: The ratios are a weighted average across firms.

Table 1 Key measures for capital account liberalization in Korea

Dates	Measures
Dec 1997	Full liberalization of corporate and government bond markets
Apr 1998	Establishment of foreign subsidiaries allowed
May 1998	Opening of all money market instruments (CP, CDs, RPs, etc.) Removal of ceilings on foreigners' stock market investment (with the exception of investment in some state-owned enterprises)
Apr 1999	First phase of foreign exchange liberalization: capital account transaction regulation changed from positive to negative list system
Jan 2001	Second phase of foreign exchange liberalization: abolishment of ceilings on overseas payments for overseas expenses for travel, stay, education, and emigration
Dec 2005	Abolition of capital transaction licensing system, replaced by an <i>ex post</i> reporting system
Jan, Mar 2006	Removal both of ceilings on outbound FDI by individuals (Jan) and of restrictions limiting the types and items of overseas securities investment by individuals (Mar)
May 2006	Early implementation of foreign exchange liberalization plan: (1) advancing schedule of plan from 2009 to 2011, and (2) allowing acquisition of overseas real estate up to \$1 million Reduction of tax rates from 25% to 14% on interest income from domestic bonds held by foreigners
Jan 2007	Raising of limit on acquisition of overseas real estate by Korean nationals for investment purposes from \$1 million to \$3 million
Dec 2007	(1) full completion of first phase of foreign exchange liberalization plan, as schedule, and (2) abolishment of reporting requirement for capital transactions up to \$50,000 and reduction of documents required for reporting

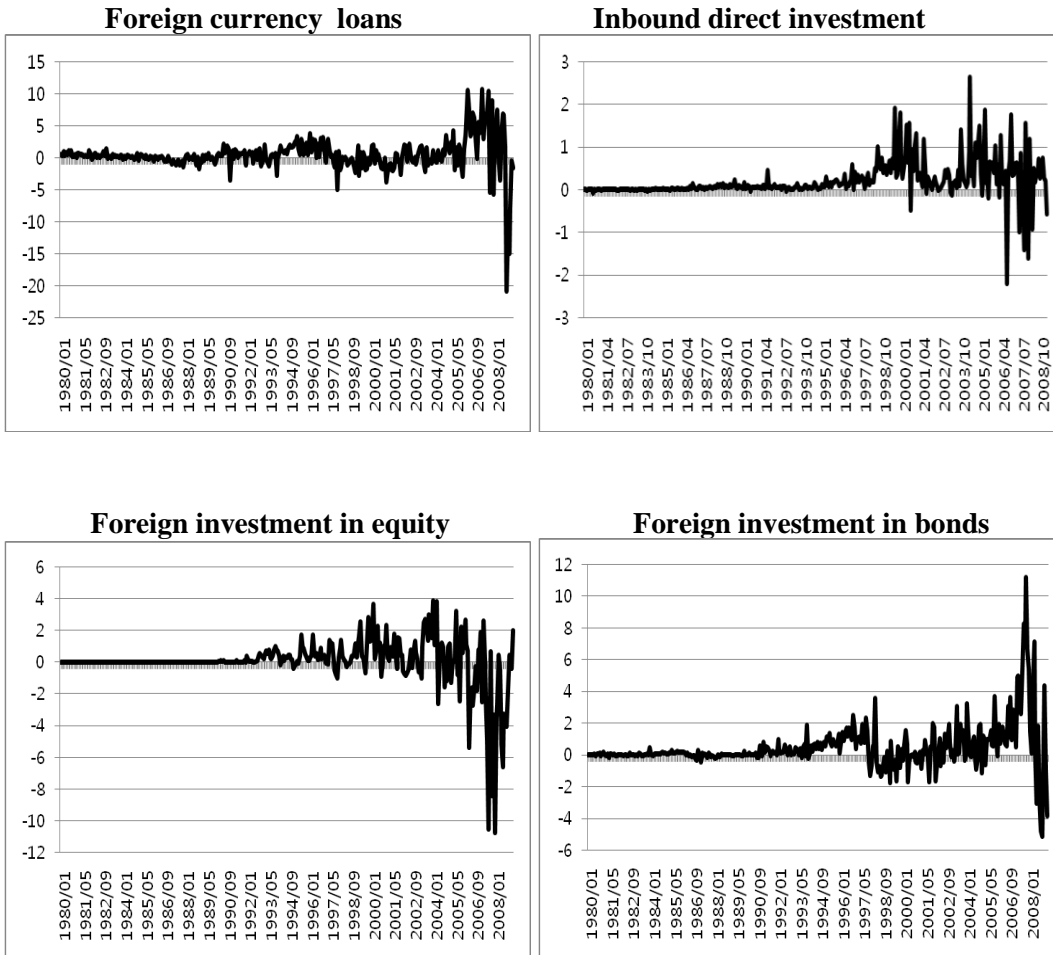
Source: Ministry of Strategy and Finance, cited from Kyungsoo Kim, Byoung-ki Kim, and Young Kyung Suh, "Opening to Capital Flows and Implications from Korea," Institute for Monetary and Economic Research, Bank of Korea, Working Paper, no. 363, February 2009.

Table 2 Change in housing prices

	YOY growth rate, 1996–2000 (%)	YOY growth rate, 2001–07 (%)	YOY growth rate, 1996–2007 (%)	YOY growth rate, 2008 (%)
United Kingdom	9.4	12.5	11.2	-6.7
Norway	11.3	8.1	9.4	-7.5
Spain	6.7	11.3	9.4	1.1
United States	7.0	10.7	9.1	-16.8
Sweden	7.5	8.9	8.3	3.0
Netherland	12.1	4.4	7.6	-0.3
Finland	9.9	5.8	7.5	1.2
Italy	1.4	8.3	5.4	2.6
Germany	-0.8	0.4	-0.1	1.4
Korea	-1.0	7.0	3.6	3.1

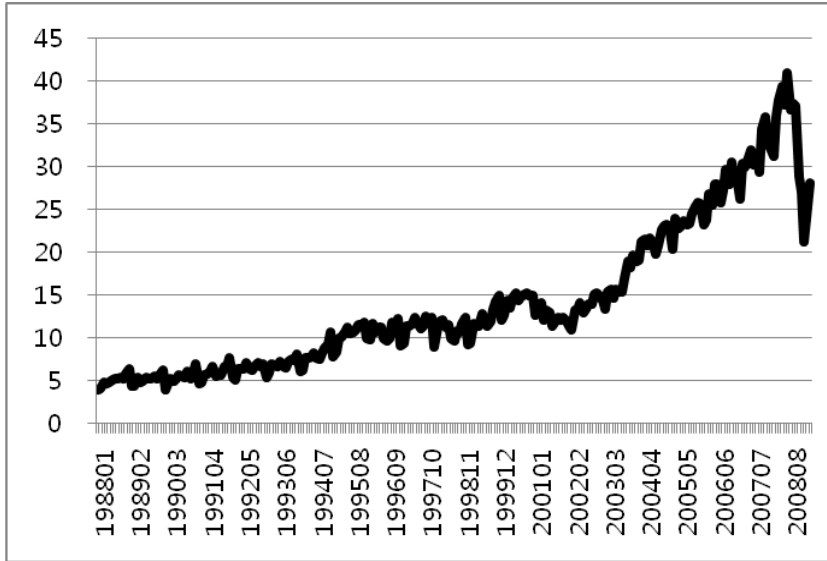
Source: Data for the European countries is derived from Financial Time European Housing Price Index, *Financial Times*, April 2009, http://www.ft.com/cms/s/0/4fda2cc8-525a-11dd-9ba7-000077b07658.html?nclick_check=1; for the United States, Case-Shiller Housing Price Index (Composite-10 cities), http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/0,0,0,0,0,0,0,0,1,1,0,0,0,0,0.html; and for Korea, Kookmin Bank, National Housing Price Survey http://land.kbstar.com/quics?asfilecode=5023&_nextPage=page=land&weblog=1_gnb_C0.

Figure 4 Capital inflows by category (unit: US\$ billion)



Source: Bank of Korea, Economic Statistics System, <http://ecos.bok.or.kr>.

Figure 5 Korea's exports (unit : US\$ billion)



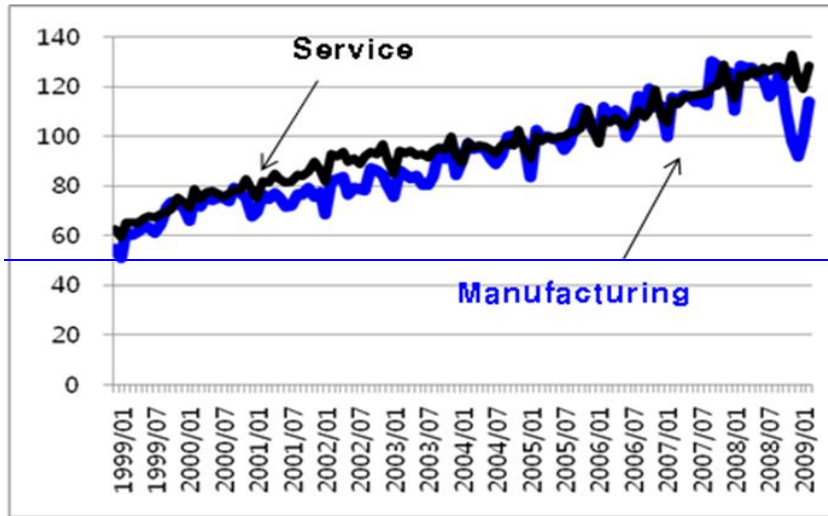
Source: The Korea International Trade Association,
http://stat.kita.net/top/state/n_submain_stat_kita.jsp?menuId=01&subUrl=n_default-test_kita.jsp?lang_gbn=kor^statid=kts&top_menu_id=db11&lang_gbn=kor

Table 3 Growth rate of Korea's monthly exports by destination (YOY growth, %)

	China	United States	Japan	EU	Others
Jan 2002 – Sep 2008	29.3	7.1	9.8	14.5	19.9
Oct 2008 – Mar 2009	-24.4	-15.4	-22.6	-25.0	-11.9

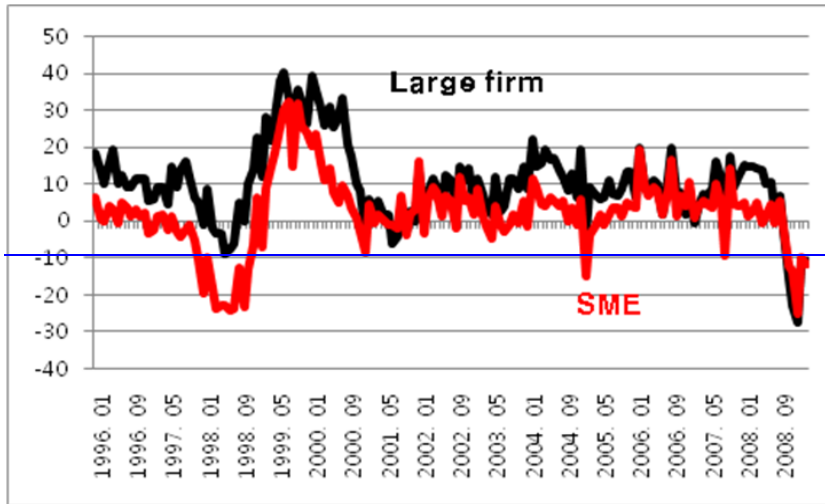
Source: The Korea International Trade Association
http://stat.kita.net/top/state/n_submain_stat_kita.jsp?menuId=01&subUrl=n_default-test_kita.jsp?lang_gbn=kor^statid=kts&top_menu_id=db11&lang_gbn=kor

Figure 6 Industrial and services production index (2005=100)



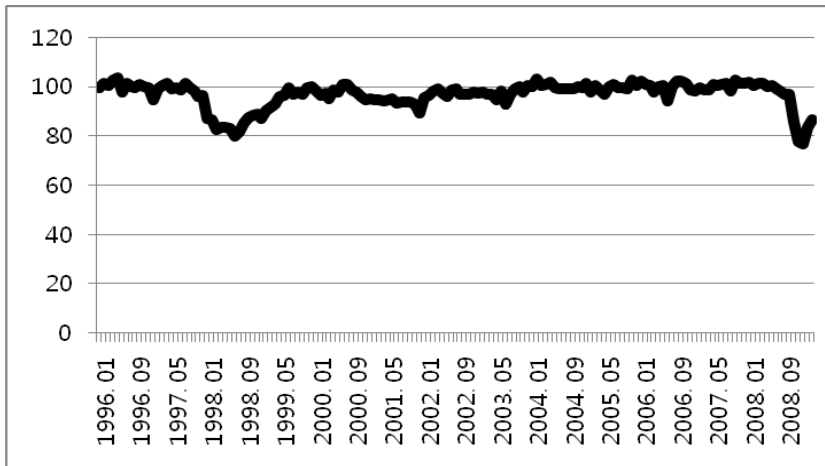
Source: Korea National Statistical Office, <http://www.kosis.kr/>

Figure 7 Growth rate of manufacturing production (YOY growth, %)



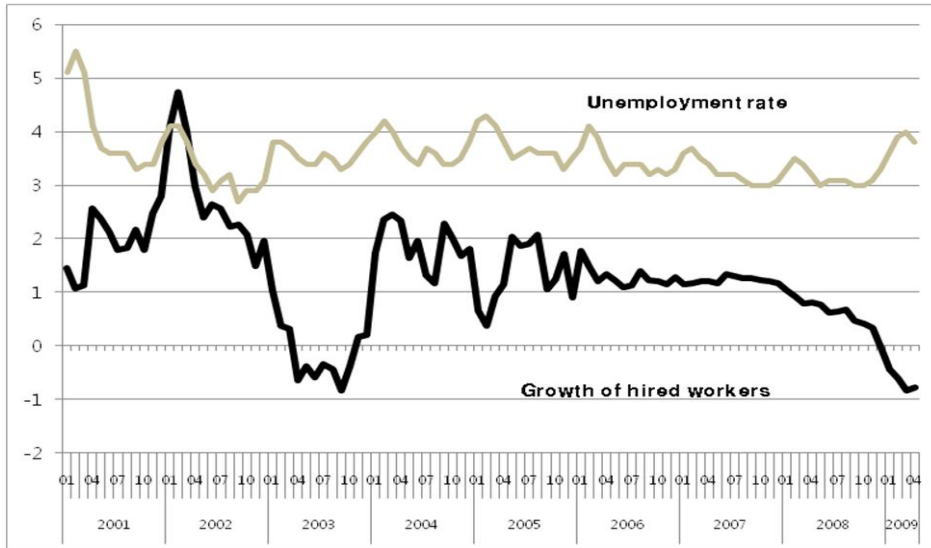
Source: Korea National Statistical Office, <http://www.kosis.kr/>

Figure 8 Manufacturing capacity utilization index (2005=100)



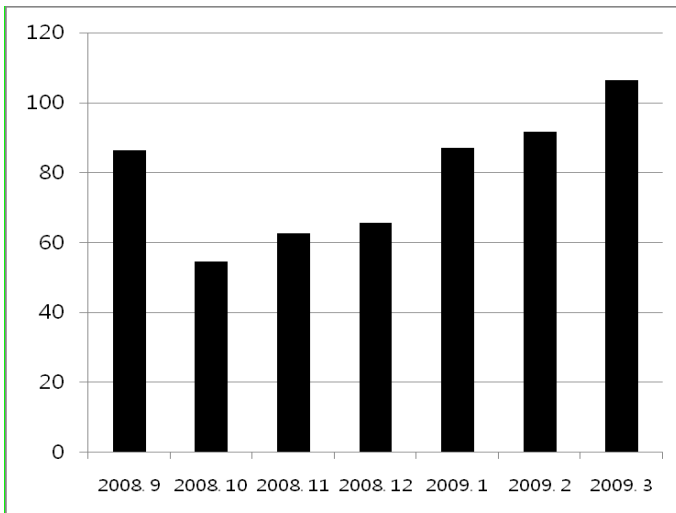
Source: Korea National Statistical Office, <http://www.kosis.kr/>

Figure 9 Rate of unemployment and YOY growth rate of hired workers (%)



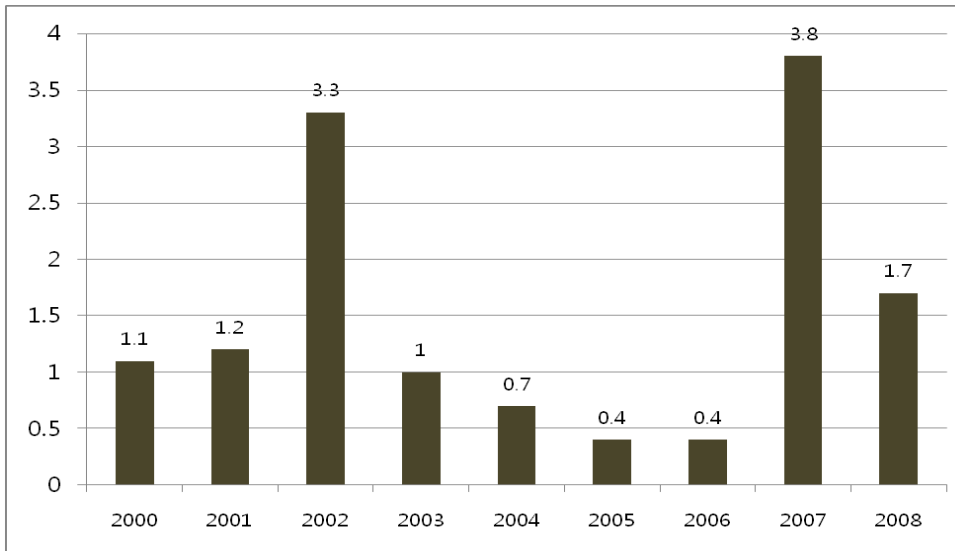
Source: Korea National Statistical Office, <http://www.kosis.kr/>

Figure 10 Short-term loan rollover ratio (%)



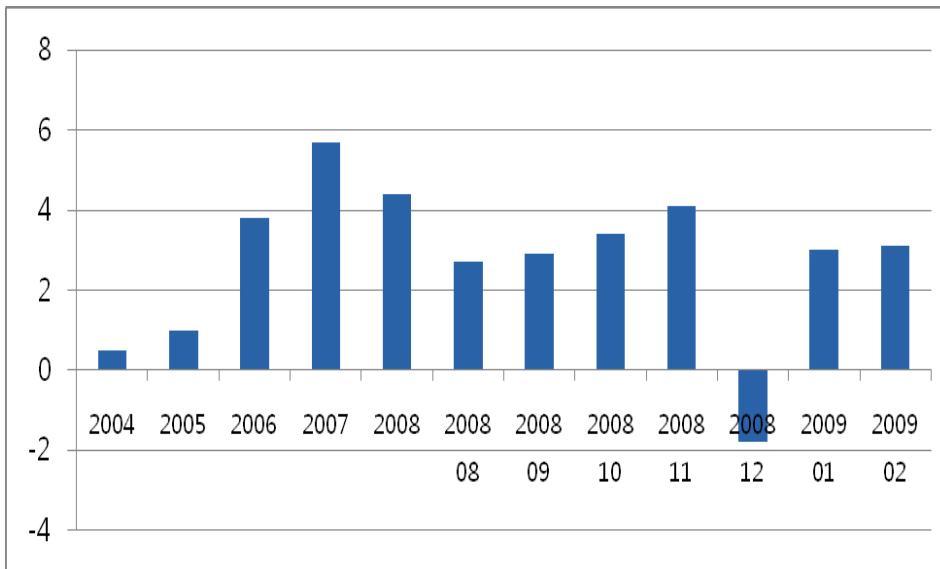
Source: Financial Supervisory Service.

Figure 11 Government surplus (% of GDP)



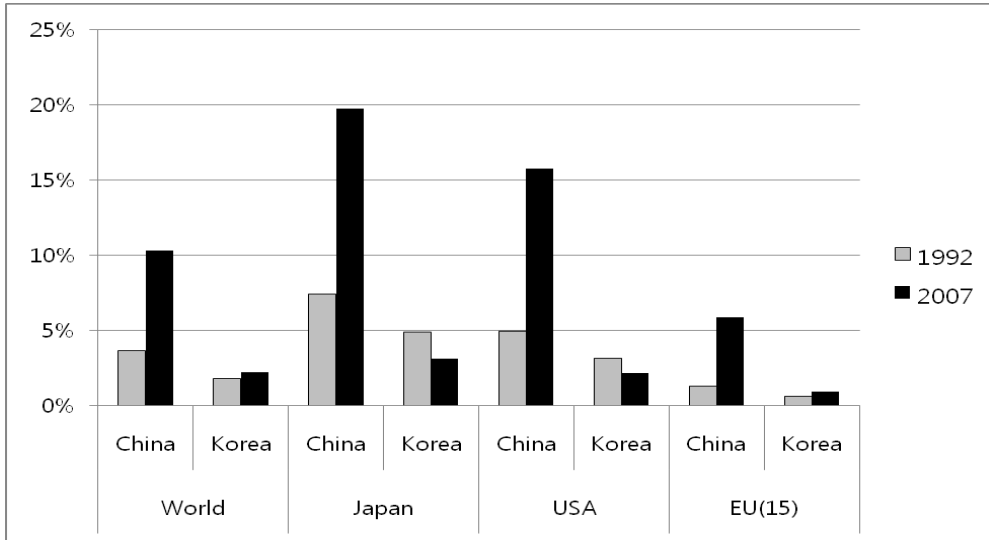
Source: Bank of Korea, <http://ecos.bok.or.kr/>. [

Figure 12 Monthly average of net increase in SME loans by banks (Trillion won)



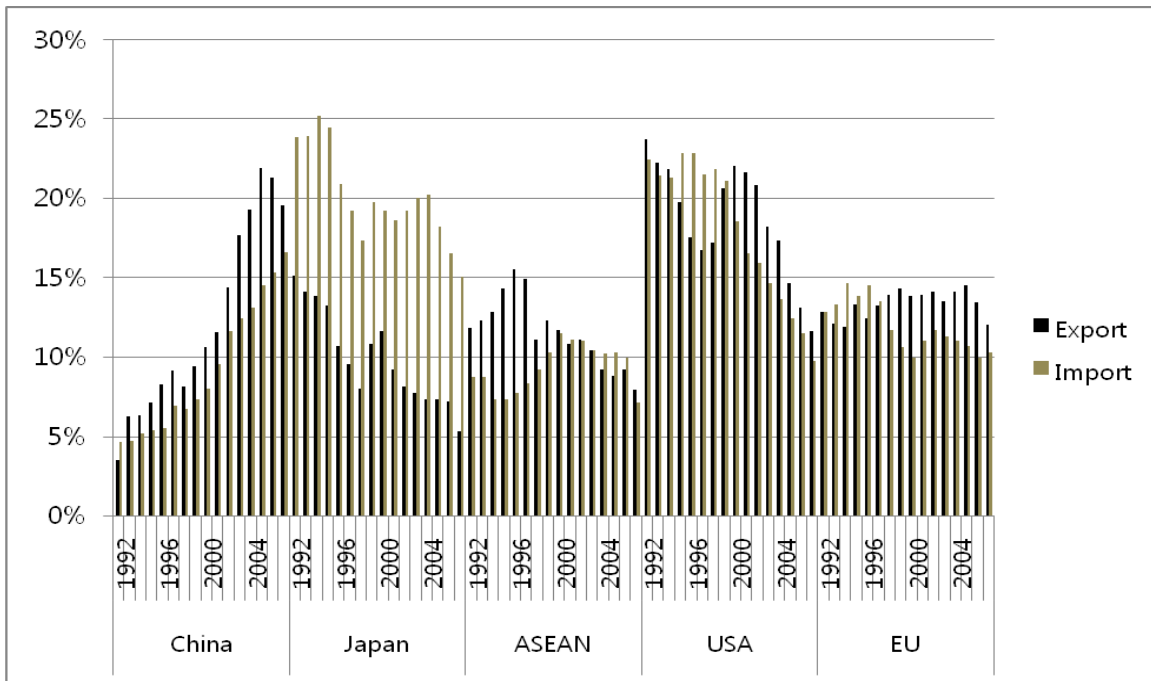
Source: Financial Supervisory Service, Actual results of SME loans.
<http://www.fss.or.kr>

Figure 13 Import share of China and Korea in major markets (%)



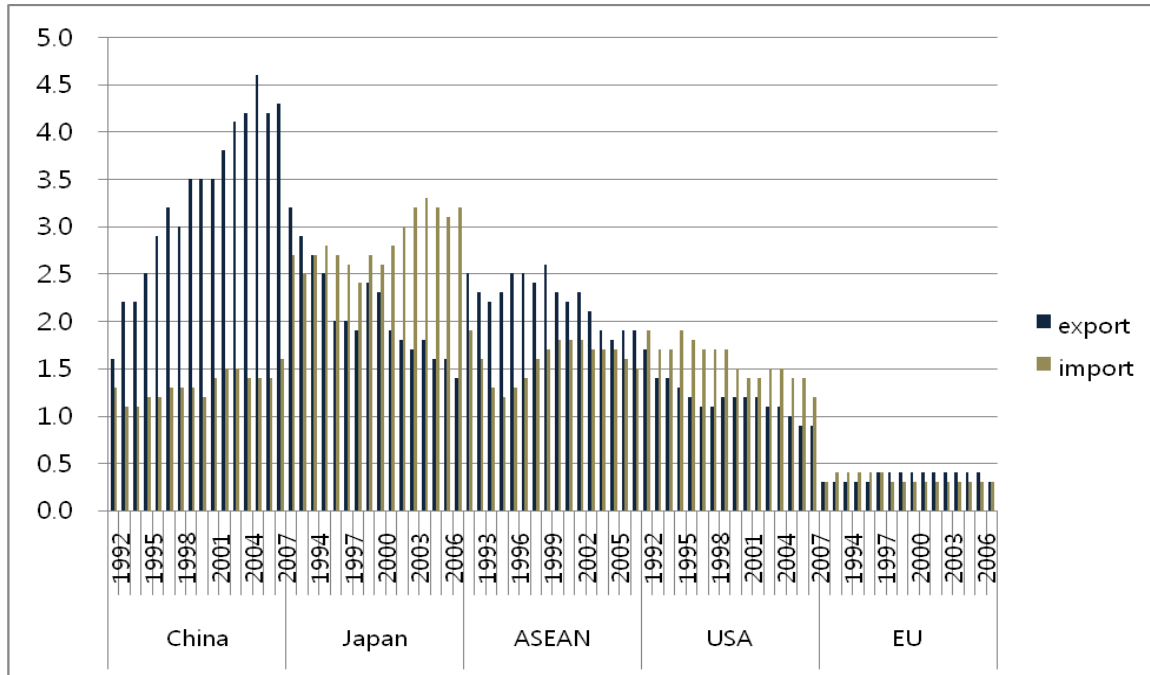
Source: UN Comtrade database, 2009, <http://comtrade.un.org>.

Figure 14 Direction of Trade as Share of Korea's Total Trade (%)



Source: UN Comtrade.

Figure 15 Korea's export and import intensity with trade partners




Source: UN Comtrade.

Table 4 Korea's trade in parts with major partners (%)

		China		Japan		ASEAN		United States		EU 15	
		1992	2006	1992	2006	1992	2006	1992	2006	1992	2006
Total Trade	Exports	3.5	21.3	15.1	7.2	11.8	9.2	23.7	13.1	12.8	13.4
	Imports	4.6	15.3	23.8	16.5	8.7	9.9	22.4	11.5	12.8	9.9
Total parts trade	Exports	0.9	30.0	10.5	6.5	21.4	12.0	31.4	12.3	12.7	7.1
	Imports	0.4	19.2	40.3	22.3	8.6	13.2	29.8	17.7	12.0	11.8
Parts for computers and office products	Exports	1.5	34.6	11.2	3.0	13.8	11.0	41.8	19.4	26.6	14.4
	Imports	2.7	58.0	46.5	10.3	3.0	9.5	34.0	6.7	3.7	2.9
Parts for radio, television, and communication equipment	Exports	1.0	35.6	17.4	1.7	14.0	5.4	22.1	5.6	16.9	4.1
	Imports	1.1	38.6	65.4	17.5	3.7	12.3	12.2	9.4	9.6	10.4
Parts for precision, medical, and optical instruments	Exports	0.9	82.2	18.4	4.2	4.0	1.3	58.8	3.8	9.0	1.9
	Imports	0.2	7.9	39.8	33.3	0.9	2.5	38.2	23.8	17.9	21.6
Parts for electrical machinery	Exports	1.8	48.5	16.8	6.4	11.4	6.0	19.6	10.2	13.8	5.0
	Imports	0.5	34.4	53.2	36.5	2.6	3.3	22.5	8.2	15.4	12.5
Parts for motor vehicles and trailers	Exports	0.9	25.6	20.2	4.6	5.8	2.9	27.9	25.3	18.2	7.3
	Imports	0.3	9.2	62.9	31.4	0.2	1.1	15.9	30.9	15.9	30.7
Parts for home appliances and machinery equipment	Exports	1.9	23.4	15.7	13.9	14.5	8.2	26.5	14.2	16.0	13.6
	Imports	0.4	11.6	39.4	31.4	1.1	1.6	16.0	13.6	22.9	28.1

Source: UN Comtrade



Between Two Whales: Korea's Choice in the Post-Crisis Era

Joon-Kyung Kim, KDI School of Public Policy and Management

Chung H. Lee, Univ. of Hawaii, Manoa

1. Introduction

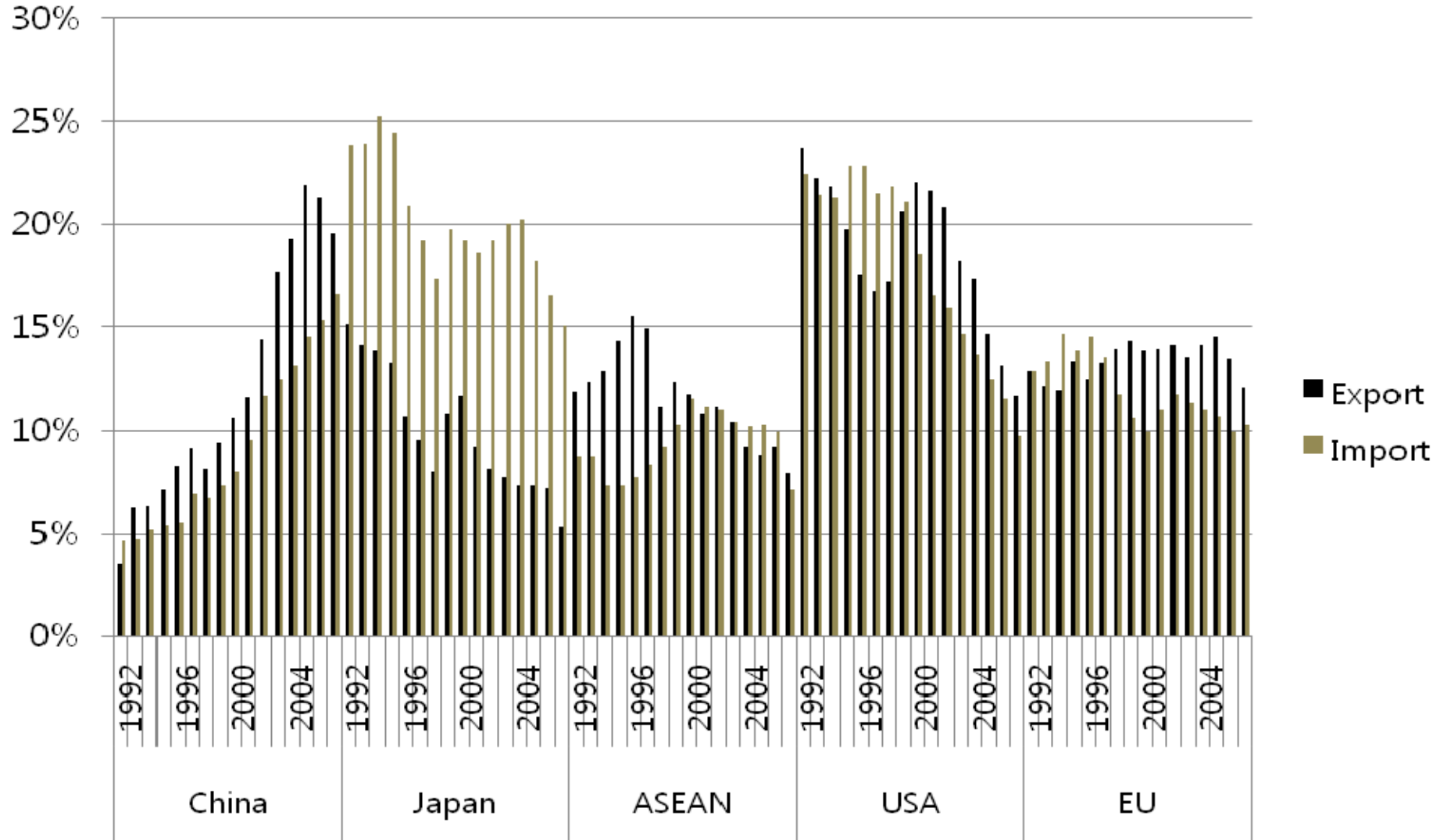
▶ Examine the impact of the global crisis on the Korean economy together with government's crisis management

- The global crisis has had an adverse impact on Korea, but **not as severely as** some other industrialized countries. Why?
- Why Korea was hit **hardest** in the early stage of the crisis contagion? **Great privileges of reserve currency countries**

▶ Korea's external relations, particularly with China and US in the future?

- Regional integration between Korea and China through trade, investment and production networks.
- Effect of the crisis on Korea-China relations – will depend on 1) the **speed** of recovery of US economy and 2) economic relations that will evolve between Korea and the US.

<Annex 1> Direction of Korea's Trade as % of its total trade(1992-2007)





1. Introduction

2. Impact of Current Crisis on the Korean Economy

3. Government Response

**4. Emergence of China: Competition or
Complementary?**

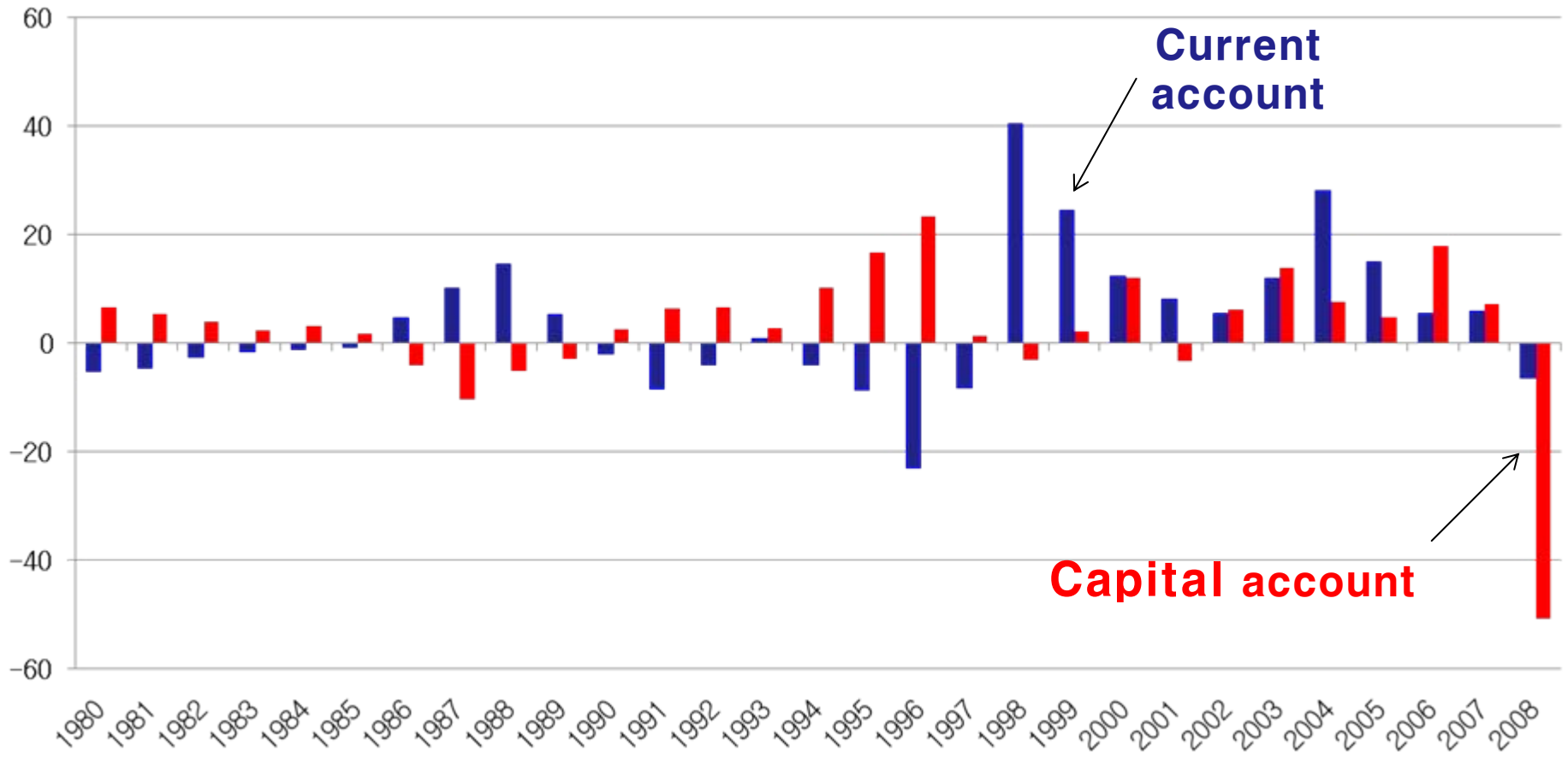
5. Effect of the Crisis on Korea's External Relations

2. Impact of the Current Crisis: Financial Sector (1/3)



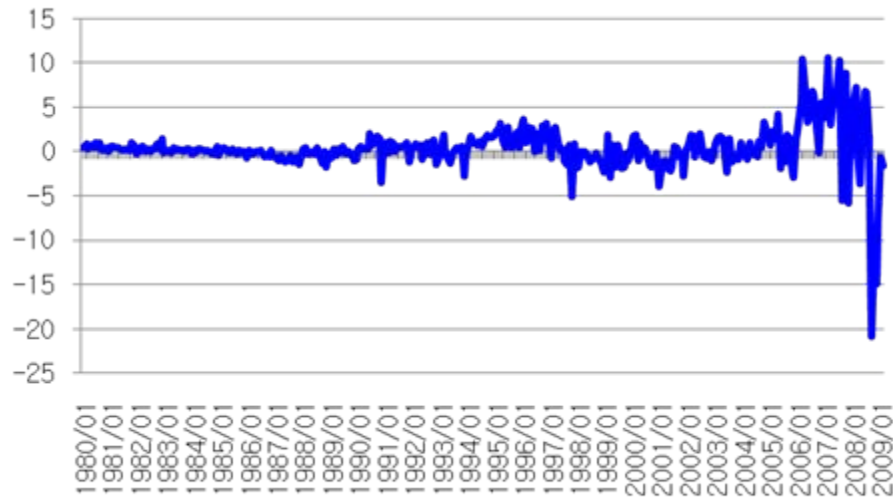
Net capital outflow amounted to \$46.2 billion between Sep. and yearend of 2008.

<Capital account and current account in Korea, \$billion>

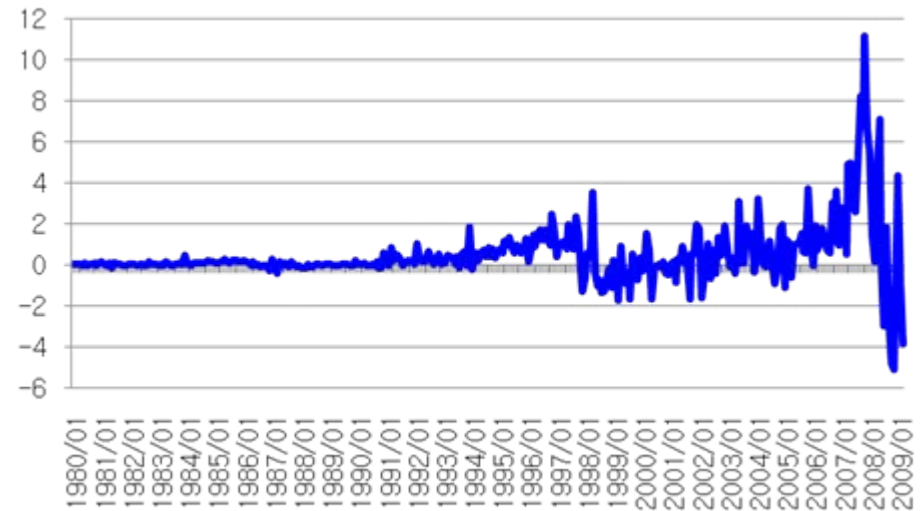


<Annex 1> Surge in capital outflow

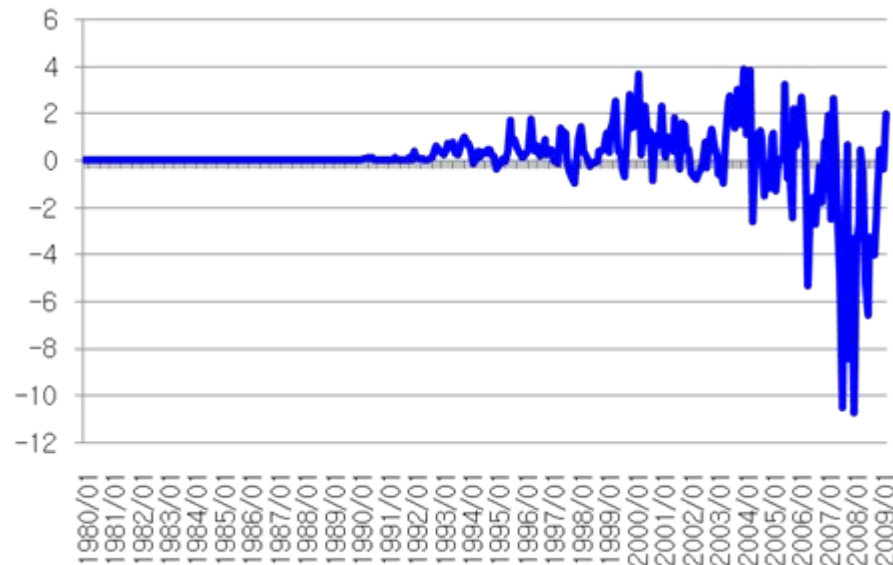
<Borrowing, \$ Million>



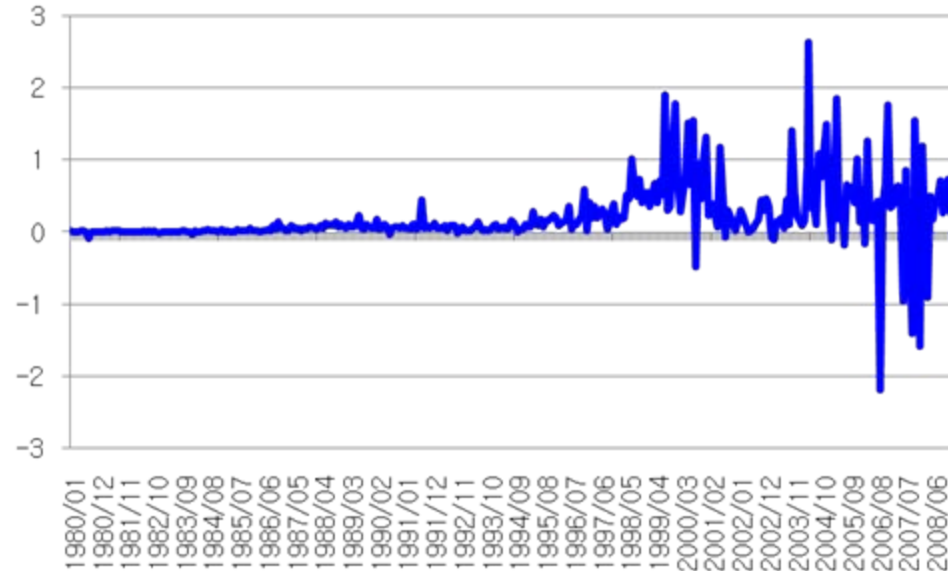
<Inbound Bond Investment>



<Inbound Equity Investment>



<Inbound FDI, \$ Million>



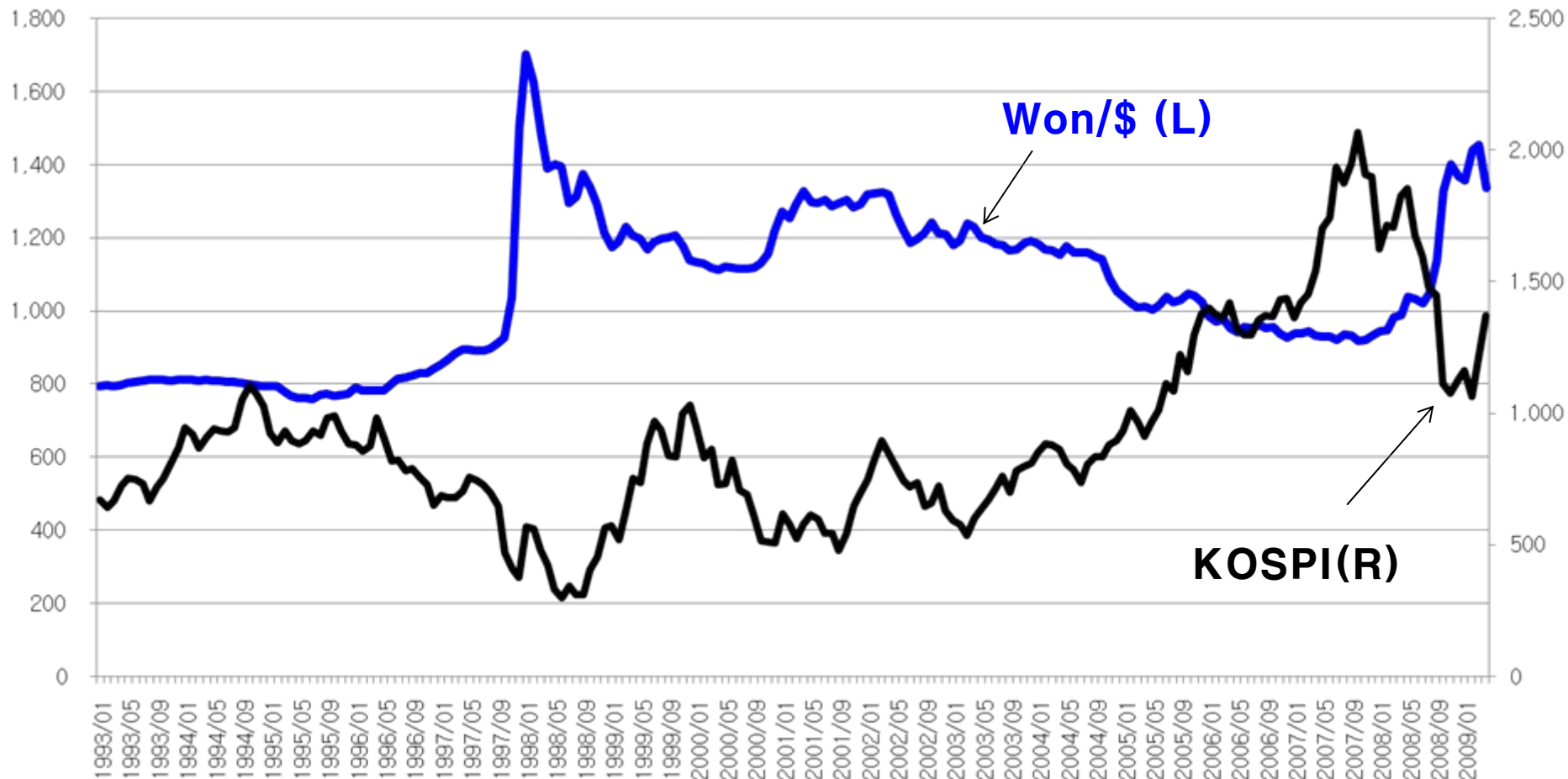
<Annex 2> Post-1997 Financial Crisis Capital Account Liberalization in Korea

- ▶ **Abolition of restriction on foreign equity ownership (98. 5)**
- ▶ **Abolition of all regulations on foreign purchases of debt securities (97. 12)**
- ▶ **Foreign Exchange Management Law (外換管理法) was replaced by Foreign Exchange Transaction Law (外換去來法) (99. 4)**
 - **Negative list system in capital account transactions**

2. Impact of the Current Crisis: Financial Sector (2/3)

KOSPI fell by 40.7% in 2008. Won/\$ exchange rate depreciated by 40% between 08.9-09.2

〈Stock price index and Won/\$ exchange rate 93.1 – 09.4〉



2. Impact of the Current Crisis: Financial Sector (3/3)

 **Moderate adjustment in Korea. Housing market in Korea is in a **much healthier** state than US**

<Housing price changes (Y-o-Y growth, % >

	1996-2000	2001-2007	1996-2007	2008
UK	9.4	12.5	11.2	-6.7
Norway	11.3	8.1	9.4	-7.5
Spain	6.7	11.3	9.4	1.1
US	7.0	10.7	9.1	-16.8
Sweden	7.5	8.9	8.3	3.0
Netherland	12.1	4.4	7.6	-0.3
Finland	9.9	5.8	7.5	1.2
Italy	1.4	8.3	5.4	2.6
Germany	-0.8	0.4	-0.1	1.4
Korea	-1.0	7.0	3.6	3.1

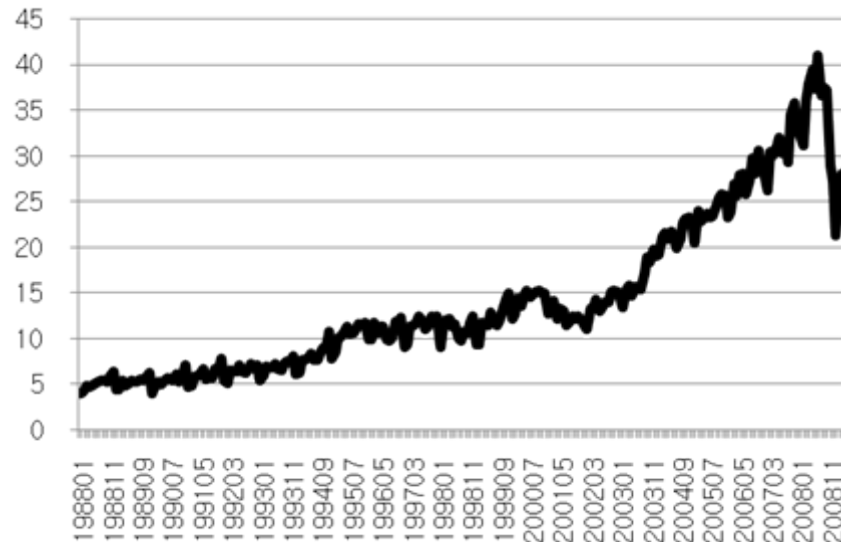
Source: European countries: Financial Time European Housing Price Index

US: Case-Shiller Housing Price Index (Composite-10 cities)

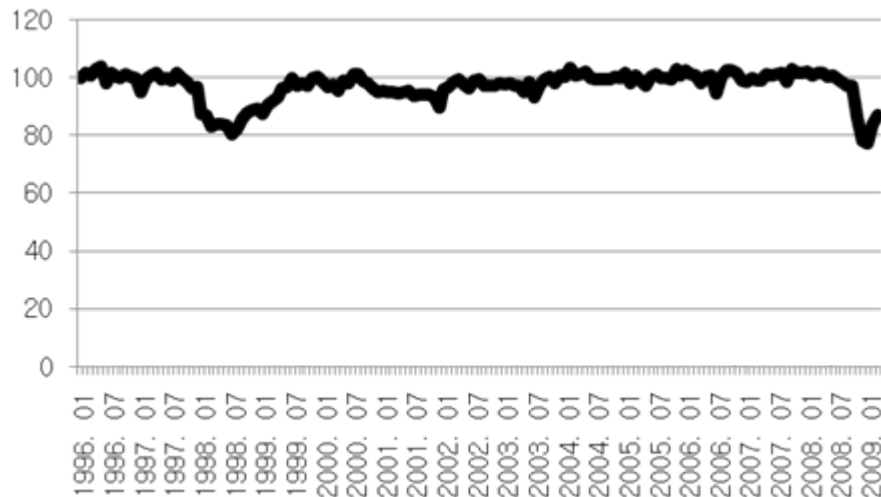
Korea: Kookmin Bank

2. Impact of the Crisis: Real sector

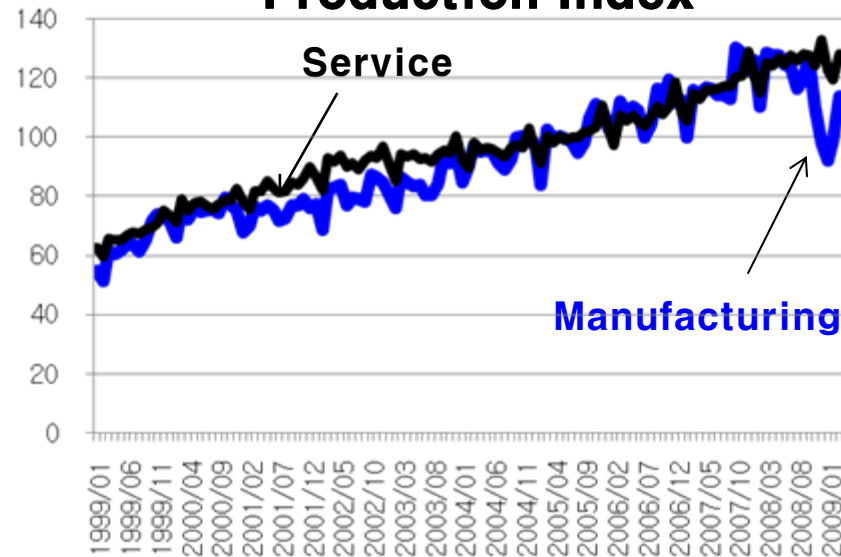
Export (billion \$ per month)



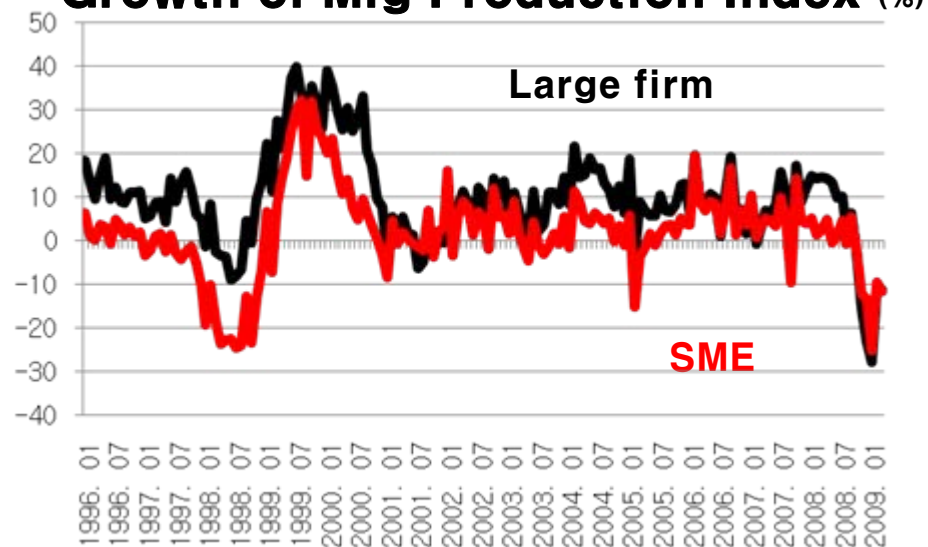
Mfg capacity utilization Index



Production Index

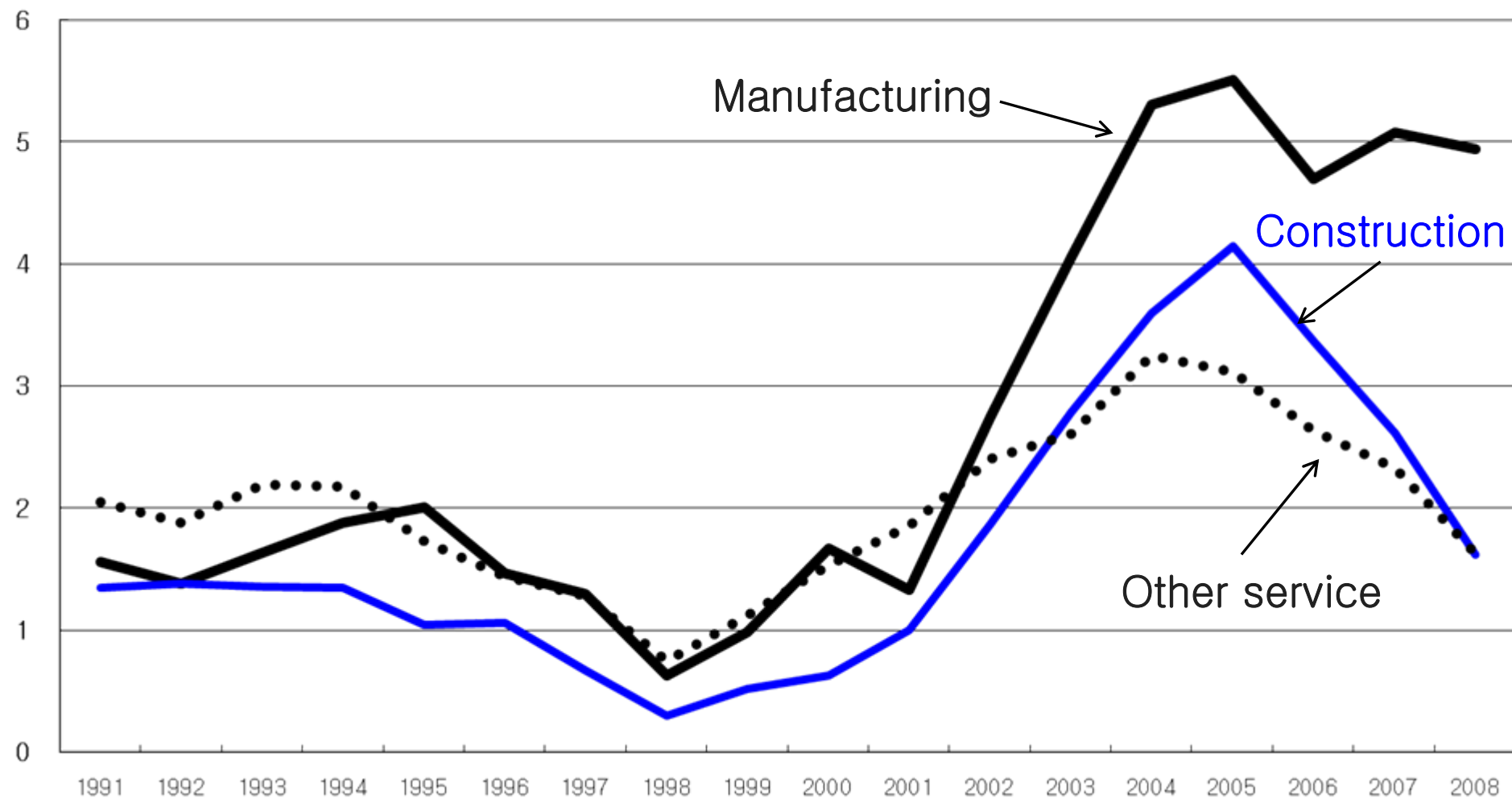


Growth of Mfg Production Index (%)



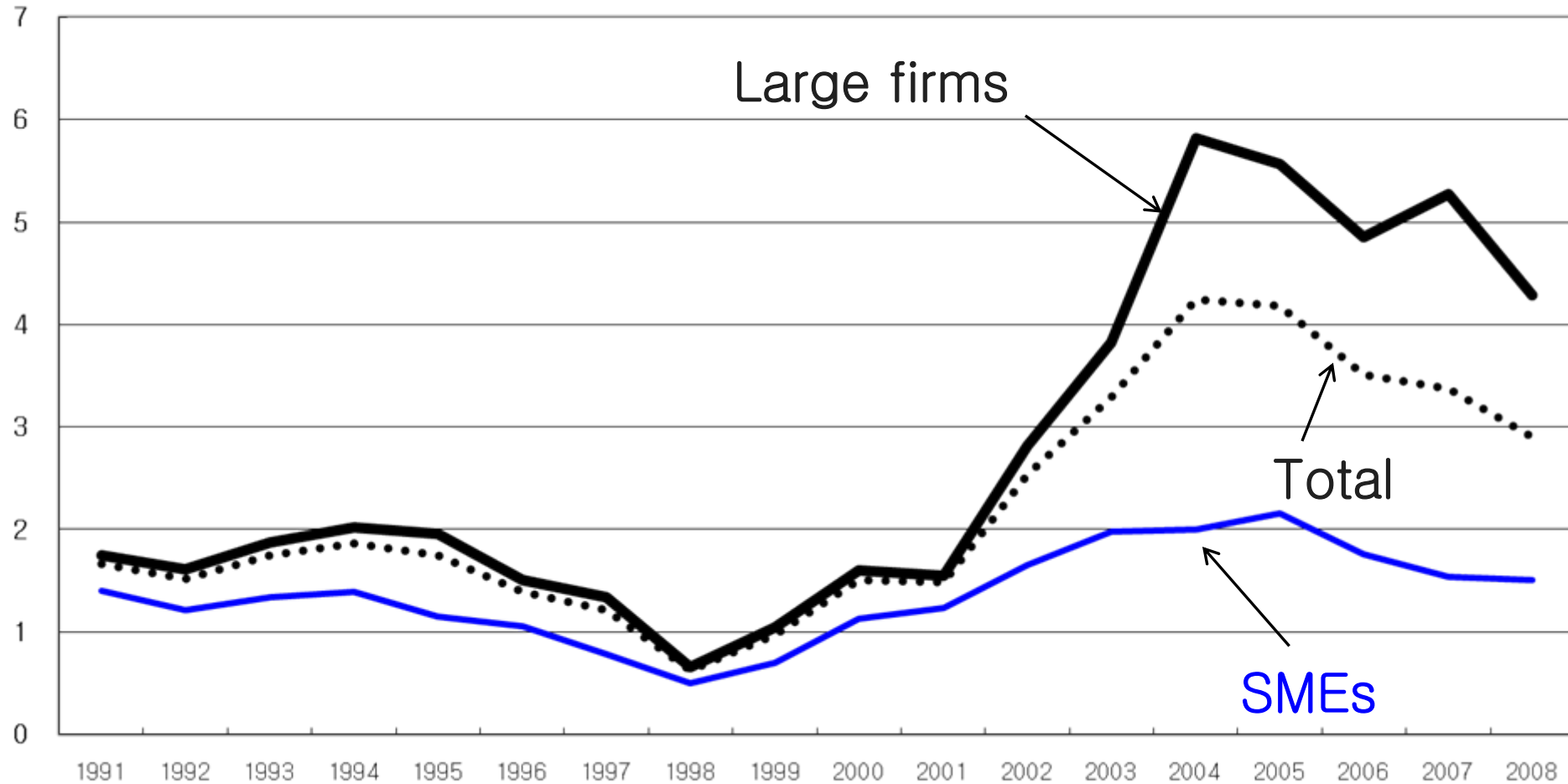
<Annex 4> Debt service capacity : by industry (1/2)

< Interest Payment Coverage Ratio (IPCR):
Operating Profits/Interest Costs >



<Annex 5> Debt service capacity : by firm size (2/2)

< Interest Payment Coverage Ratio (IPCR):
Operating Profits/Interest Costs >



<Annex 6> How did Korea recover from the 1997 crisis? (1/2)

KAMCO and KDIC were created to clean up the NPLs and strengthen the capital base of banks.

- A total of **168 trillion** won (25% of 2002 GDP) public funding was injected.

<Fiscal Support for Financial Restructuring (11/1997-11/2006)>

	KDIC and Others				KAMCO	Total
	Recapitalization	Capital Contribution	Deposit Repayment	Purchase of Assets	Purchase of NPLs	
Banks	34.0	13.9	0	14.4	24.6	86.9
NBFIs	29.5	4.6	30.3	2.9	11.8	79.1
MBCs	2.7	0.7	18.3	0.0	1.3	23.0
Insurance Companies	15.9	3.1	0.0	0.3	1.8	21.1
Securities and ITCs	10.9	0.3	0.01	1.9	8.5	21.6
MSBs	0.0	0.4	7.3	0.6	0.2	8.5
Credit Union	0.0	0.0	4.8	0.0	0.0	4.8
Others	0.0	0.0	0.0	0.0	2.4	2.4
Total	63.5	18.5	30.3	17.3	38.8	168.4

<Annex 6> How did Korea recover from the 1997 crisis? (2/2)



After the 1997 crisis, **30** out of 63 largest *chaebols*, were forced to undergo corporate restructuring.

- Formal rehabilitation procedures (Corporate Reorganization and Composition: **18** *chaebols*)
- Informal (out-of-court) workouts: **12** *chaebols* including **Daewoo**, the second largest *chaebol*



To facilitate *chaebol's* **deleveraging**, KAMCO purchased W48 trillion won of NPLs, paying for these assets W17 trillion won (an average **35%** at face value)

<Annex 8> KAMCO and Restructuring (de-leveraging) of *Chaebols*

< *Chaebols*' NPLs Purchased by KAMCO (billion won) >

		Book Value (A)	Actual Value (B)	B/A
Top 30 <i>Chaebols</i>	Daewoo	35,806	12,740	35.6%
	Kia	3,126	1,362	43.5%
	Ssangyong	742	221	29.8%
	Halla	410	55	13.4%
	Kohab	663	115	17.3%
	DongAh	879	248	28.2%
	Jinro	1,324	433	32.7%
	Hanil	645	522	80.9%
	Anam	27	4	14.8%
	Haitai	445	49	11.0%
	Shinho	118	44	37.3%
	Tongil	239	112	46.9%
	New Core	949	307	32.3%
	Dongkuk	288	45	15.6%
	Saehan	120	50	41.7%
	Kabeul	53	24	45.2%
Keopyong	158	92	58.2%	

< *Chaebols*' NPLs Purchased by KAMCO (billion won) > (continued)

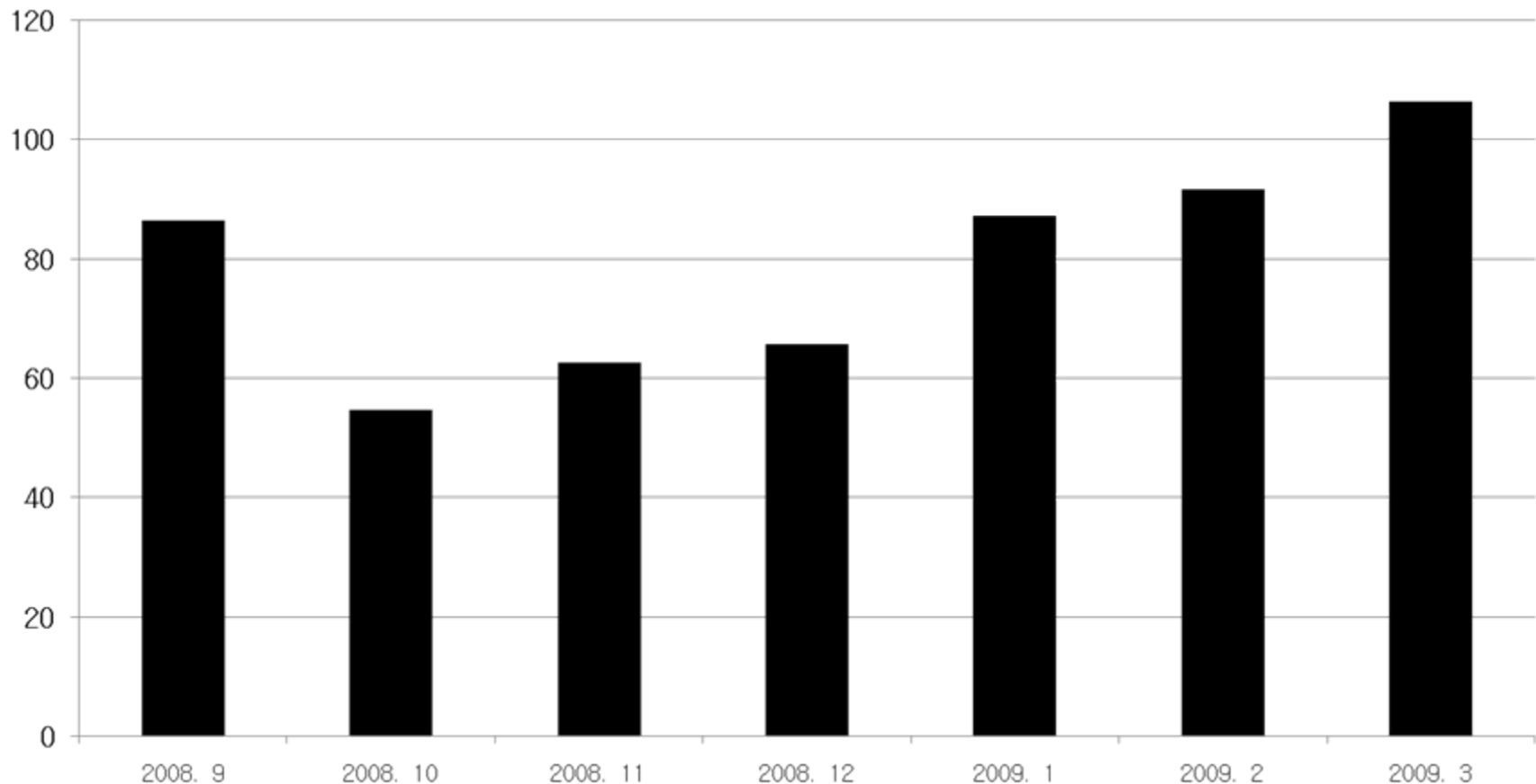
		Book Value (A)	Actual Value (B)	B/A
Top 31-63 <i>Chaebols</i>	Byuksan	87	54	62.1%
	Daenong	403	145	36.0%
	Woobang	367	71	19.3%
	Soosan Heavy	51	29	56.9%
	Kangwon Industry	42	28	66.7%
	Chungkoo	382	134	35.1%
	Sepoong	2.4	1.3	54.2%
	Bosung	465	151	32.5%
	Jindo	175	26	14.9%
	Shinwon	3.5	3.0	85.7%
	Nasan	170	91	53.5%
	Keukdong	328	190	57.9%
	Daedong	368	158	42.9%
	Total (30 <i>chaebols</i>)	48,827	17,401	35.6%

3.1 Government Response: Foreign currency liquidity provision (1/2)

- ▶ \$55 billion of **foreign currency liquidity** (\$21 bil. for trade finance and \$34 bil. for liquidity) was provided to the banks in Oct 08–Feb 2009.
- ▶ The government set up a 3-year \$100 billion **payment guarantee** for foreign currency borrowings by **domestic banks**
- ▶ **Currency swap agreements** of \$30 billion each with the US (2008. 11), Japan and China (2008.12).

3.1 Government Response: Foreign currency liquidity provision (2/2)

<Short-term Foreign Loan Rollover ratio, %>

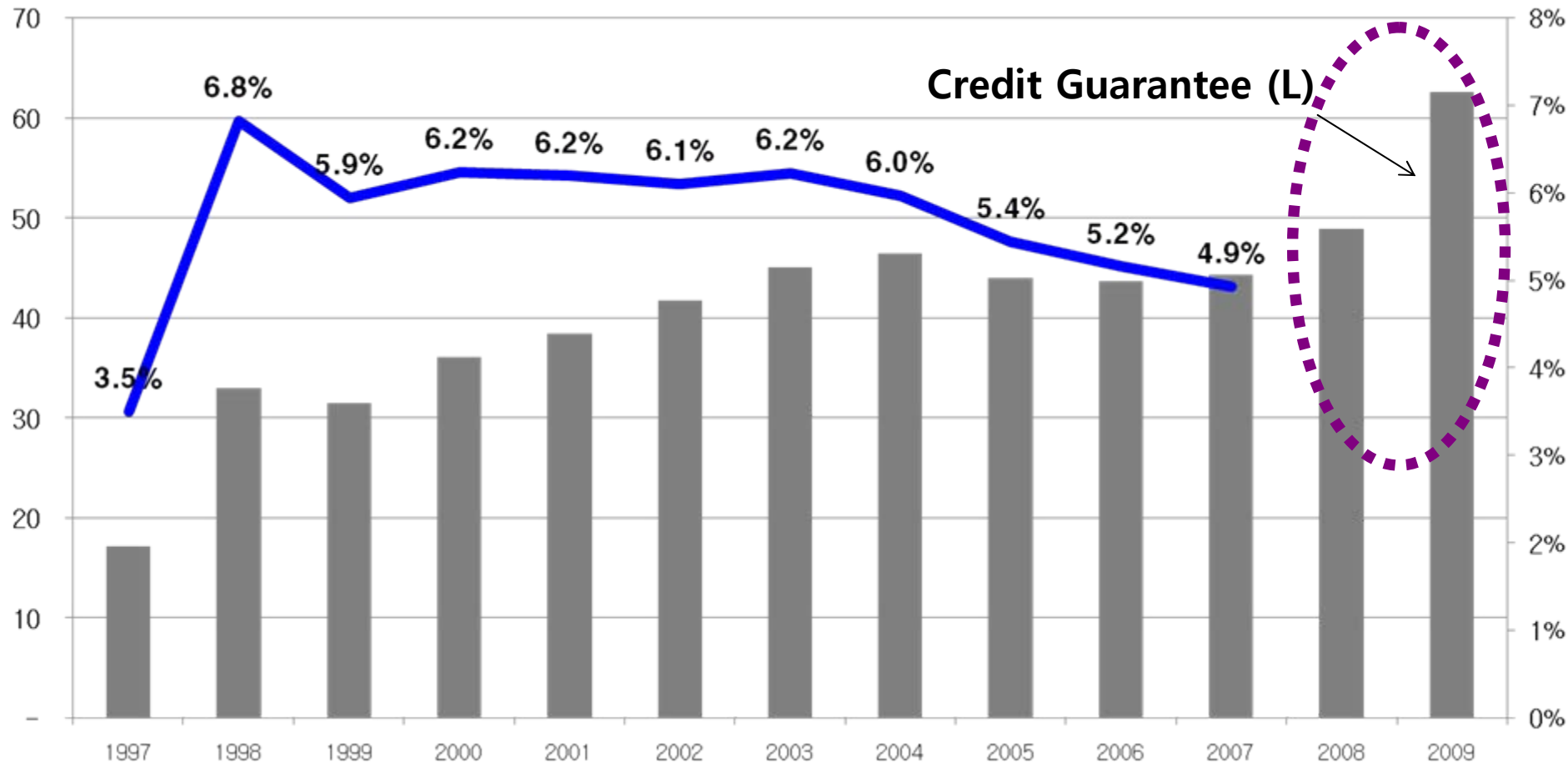


3.3 Government response: Enhanced support for SMEs (1/2)



Government's credit guarantee for SMEs will be increased to 62.6 trillion won in 2009.

Credit Guarantee (trillion won, % of GDP)

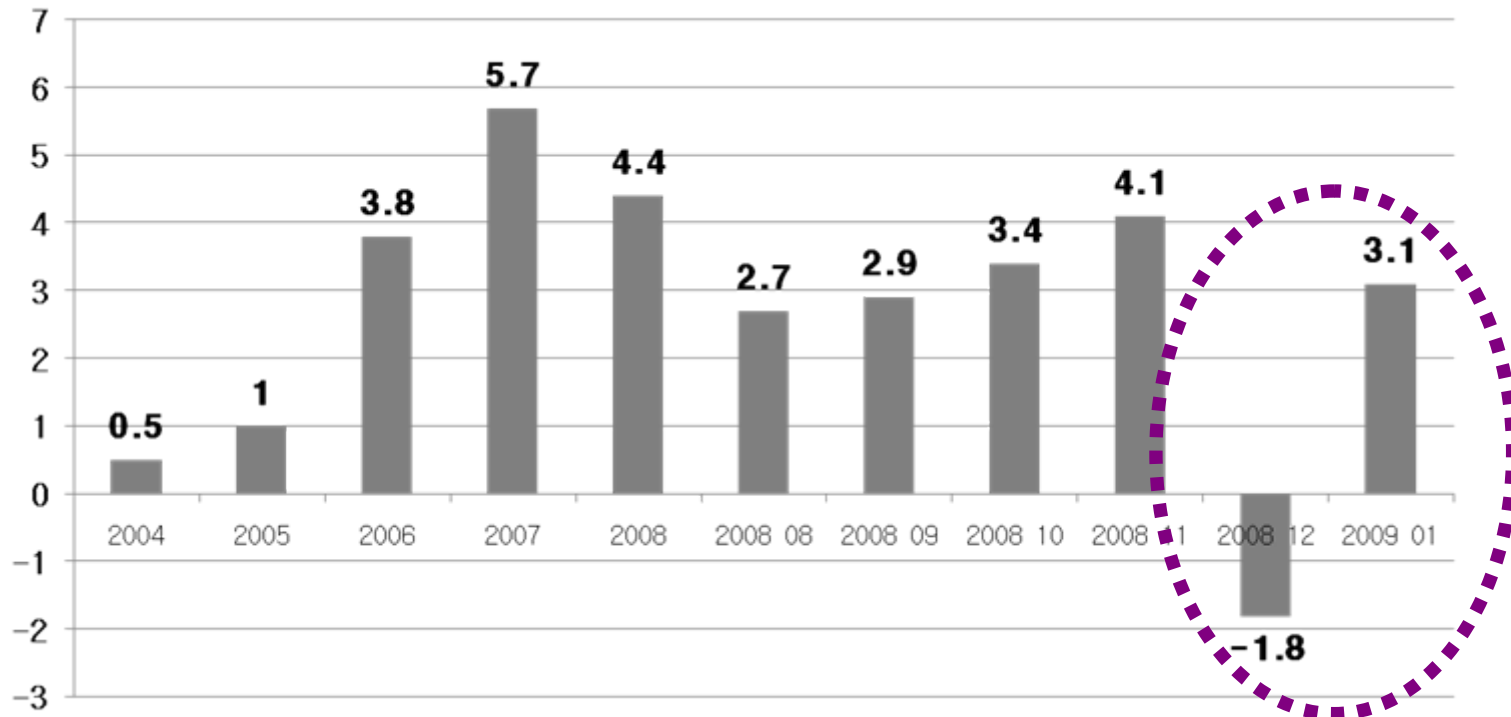


3.3 Government response: Enhanced support for SMEs (2/2)



SME loans (declined in Dec 2008), surged to 3.1 trillion won in Jan 2009, thanks to the credit guarantee policy.

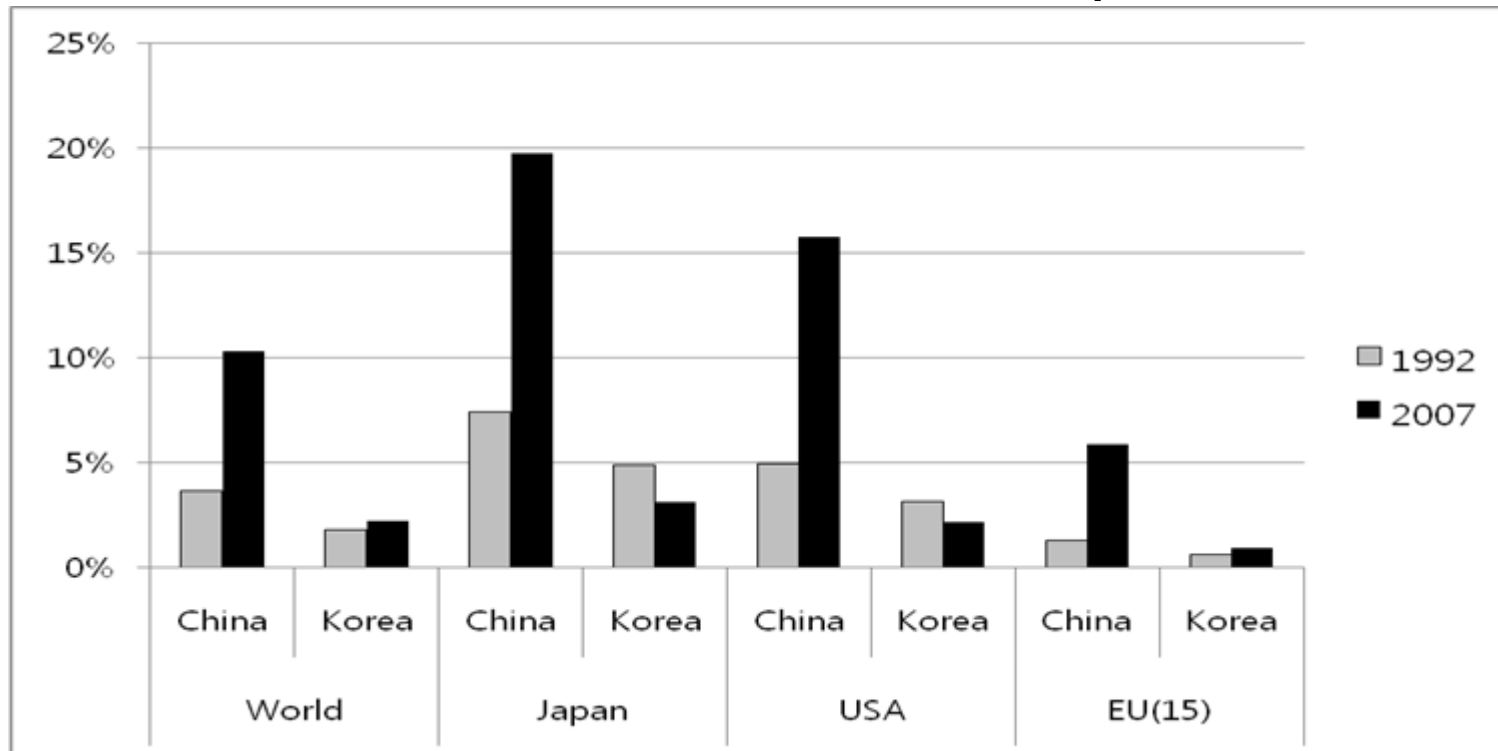
SME Loans by banks (monthly avg, trillion won)



4. China effect (1/2): competition or complementary?

Emergence of China has made China and Korea **competitive** with each other: they are rivals for market share in the rest of the world

Market Shares of China and Korea in Global Market
(Total Exports)

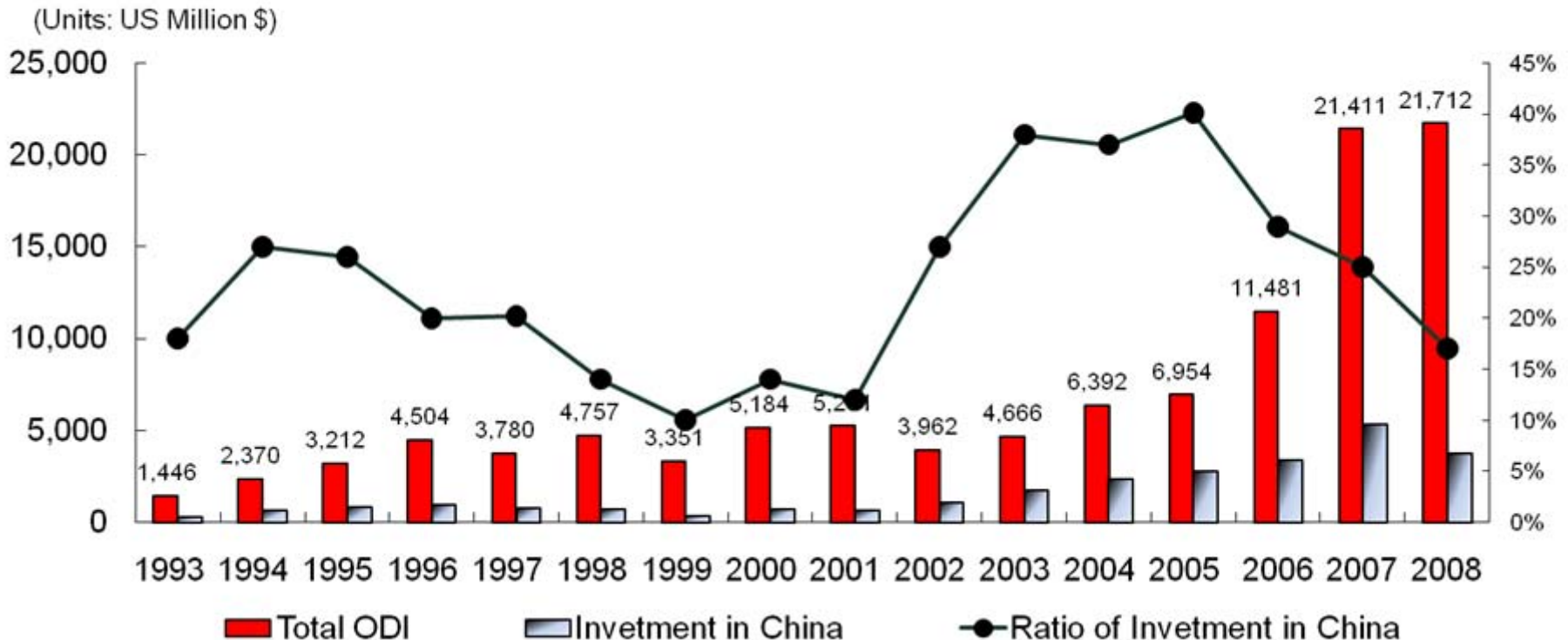


4. China effect (2/2): competition or complementary?


China and Korea are complementary : closely linked through expanding **bilateral trade** and **production networks**.


- Since 2002, China has become Korea's largest **investment partner** and **have now bypassed** the U.S.

Direct Investment in China in Korea' s Total FDI



5. Effect of the Crisis on Korea's External Economic Relations

 As Chinese economy grows, the Korean economy will inevitably become more closely linked with China through trade, investment, and production networks.

 However, how close they become will depend on the relations that will evolve between Korea and US following the crisis.

- If the US economy recovers quickly, its relationship with Korea will remain strong and Korea will not become overly dependent on the Chinese economy.
- If Korea-US FTA is ratified, the relationship between Korea and US will be strengthened.
 - * If the US turns protectionist Korea may have no option but to turn to China for its markets, which is changing growth strategy from export orientation to domestic demand.