



The Korean Economy in the Swirl of Global Crisis

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II. Current Recession of the Korean Economy

- 1. Collapse in Q4 2008**
- 2. Factors for the collapse in Q4 2008**

Until the 3rd quarter 2008 ...

❖ The Korean economy had maintained a reasonable pace of growth.

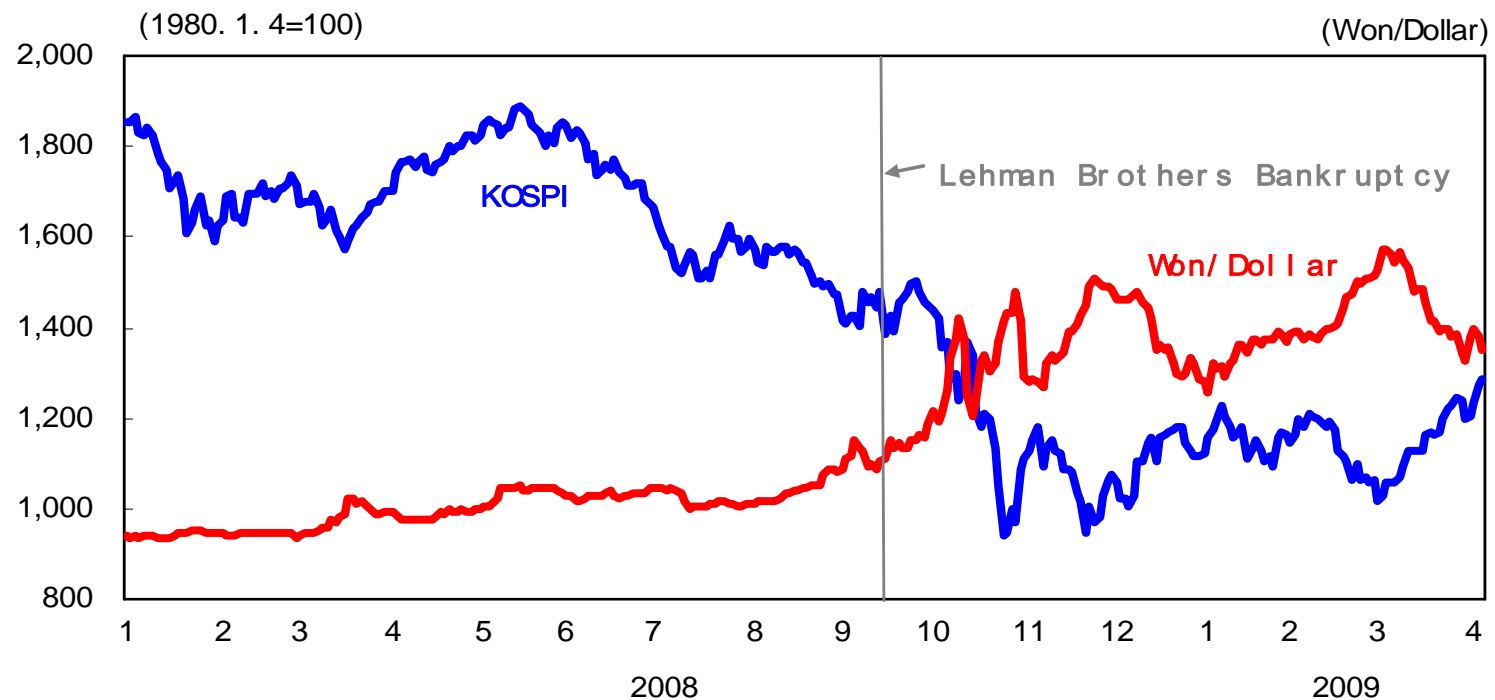
- Domestic demand had slowed mainly due to the soaring oil price, but exports had maintained a solid expansion.
 - The Q3's export growth increased 27 percent (year on year).

From September, however, ...

❖ Stock prices and currency value collapsed.

- Credit market became crunched, pressing domestic demand.

Stock Prices and the Won/Dollar Exchange Rate

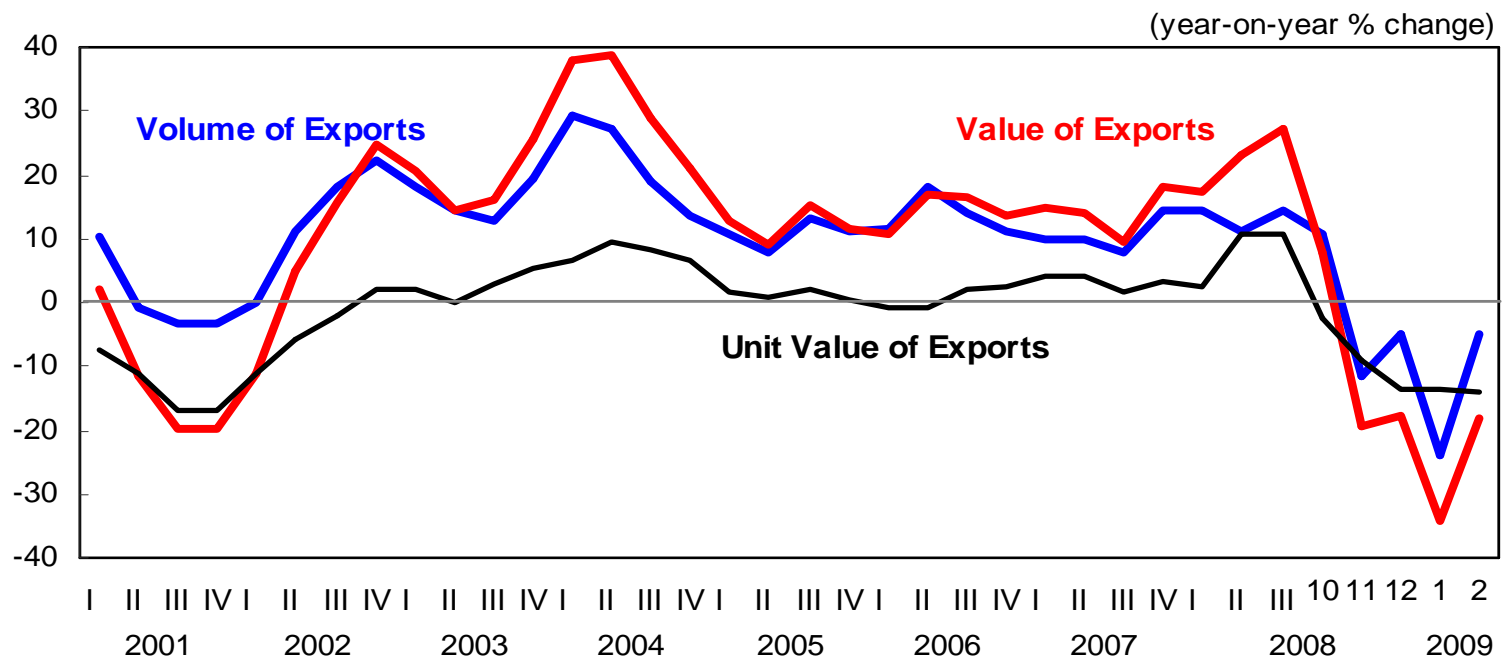


Particularly, export ...

❖ The export contraction speed was shocking.

27.6% in Sep. → 7.8%(-2.6%) in Oct. → -19.5%(-22.2%) in Nov.

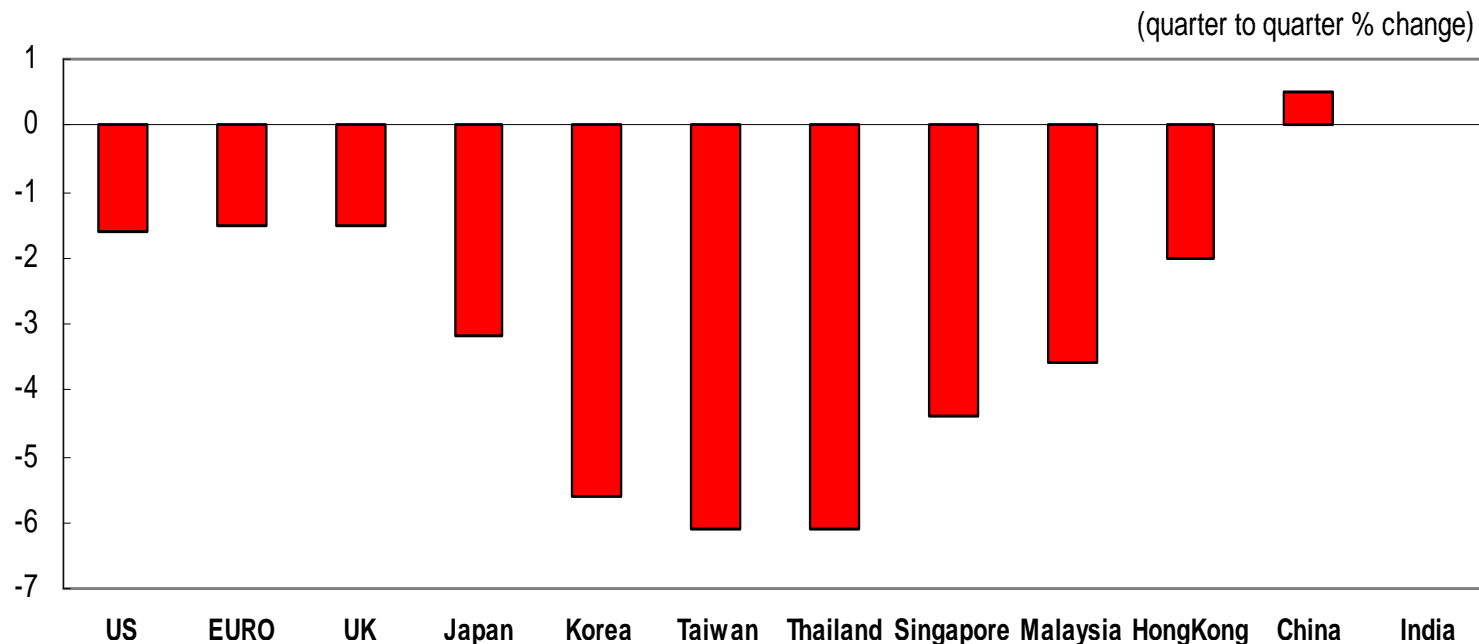
Export Growth Rate



Global Crisis in Q4 2008

❖ Has a devastating crisis broken out in Asia, spreading the adverse effects to other regions?

Growth Rates of Q4 2008 (Q-to-Q)

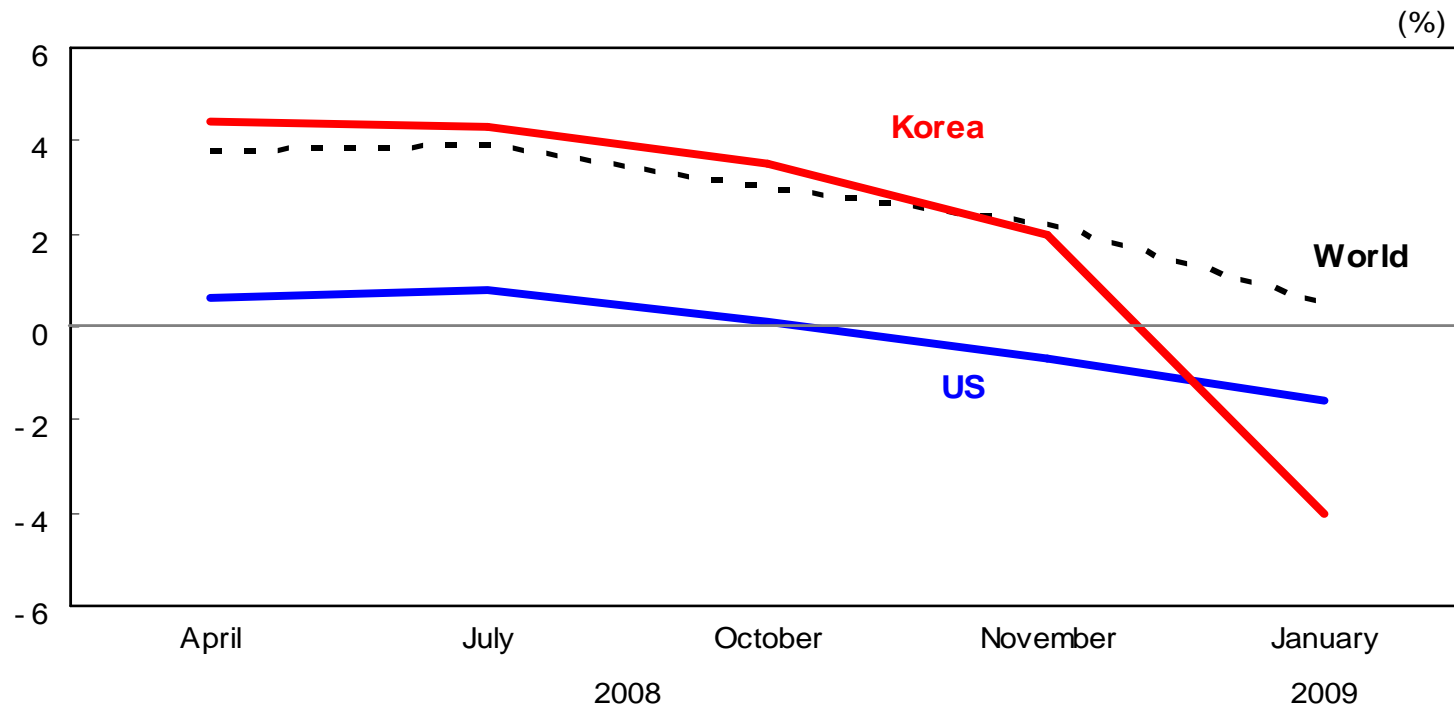


Note: For the countries (Taiwan, Thailand, Malaysia, Singapore, China and India) in which official quarter-to-quarter growth rates are not available, estimations were made by the formula, $\frac{Q4 - Q3}{Q3} = \frac{Q4 - Q3}{Q3} = \frac{Q4 - Q3}{Q3} = \frac{Q4 - Q3}{Q3}$, where $Q4$ is quarter-to-quarter growth rate, $Q3$ is year-on-year growth rate, and $Q3$ denotes the average quarterly growth rate of the past three years.

Revisions of IMF Forecasts on 2009

- ❖ The IMF drastically downgraded the forecasts of 2009 growth rates, particularly for Asia.

Revisions of IMF's Forecasts on 2009 Growth Rates



Issues to be discussed

❖ The worse-than-expected performance in Q4 2008 raised many issues.

- Why was Korea hit so severely by the global shock?
- Should this be interpreted as a signal for another crisis like the one that Korea underwent 10 years ago?
- How different are the policy responses this time from the previous crisis?
- What is the prospect of the Korean economy in relation with the global rebalancing process?



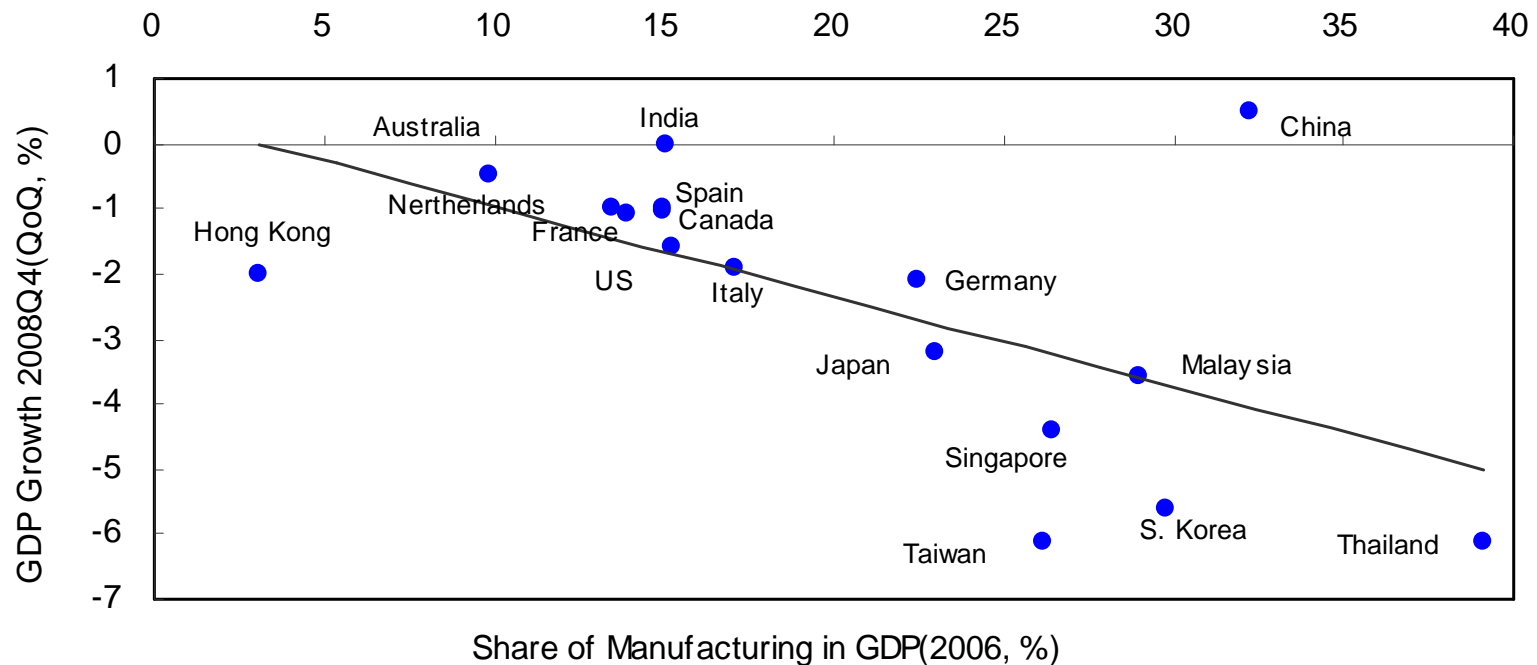
II. Current Recession of the Korean Economy

1. Collapse in Q4 2008
2. **Factors for the collapse in Q4 2008**

Factor #1: Heavy Dependence on Export

- ❖ Negative relationship between the Q4 growth rate and the share of manufacturing (Sommer).

Growth Rates in Q4 2008 and the Share of Manufacturing



More than a proportional response?

❖ How much of contraction in Korea's GDP is expected in response to the global contraction?

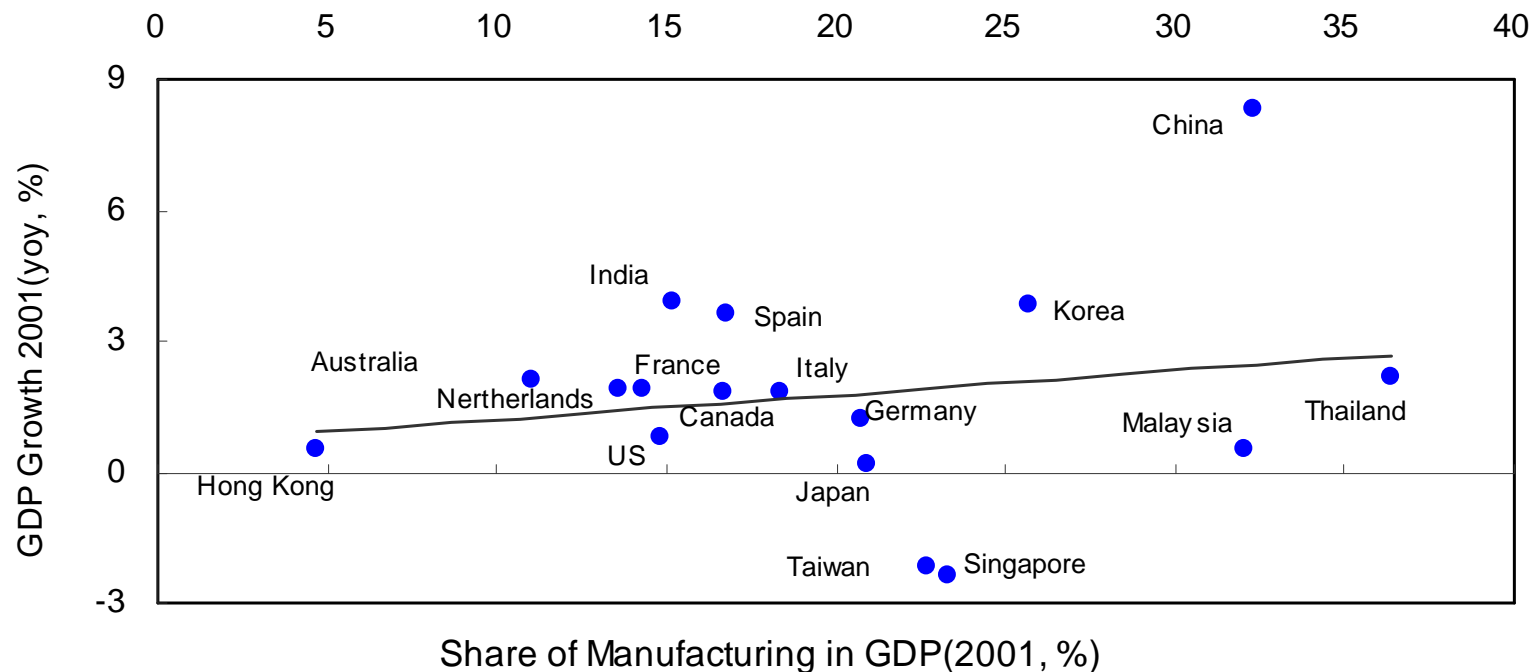
- 1% ↓ in G-7 → 0.4% ↓ in developing countries (IMF, 2002)
- 1% ↓ in world GDP → 0.8% ↓ in Korea (KDI internal report)
(1% ↓ in world GDP → 2~3% ↓ in export → 0.8% ↓ in GDP)

Why not in 2001?

❖ Both 2001 and 2008 recessions were triggered by the asset bubble bust in the U.S.

- IT bubble bust (2001) vs. House price bubble bust (2008)

Growth Rates in 2001 and the Share of Manufacturing

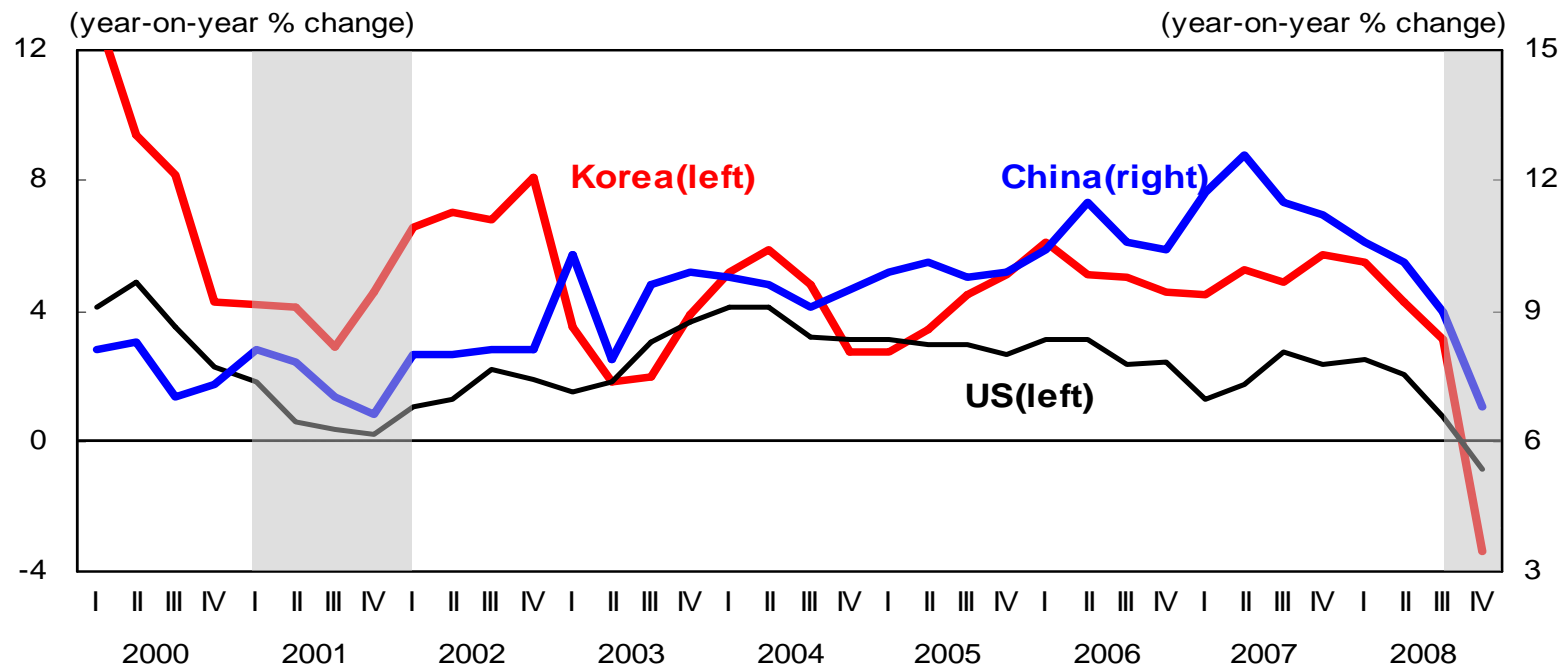


Factor #2: China

❖ China, the largest trading partner of Korea

- The sharp contraction of the Chinese economy in Q4 2008 was contrasting from its steady growth in 2001.
- In 2001, export (volume) of the U.S. ↓ by 5.4%, but China's export ↑ by 9.6%.

Growth Rates of Korea, China, and the U.S.

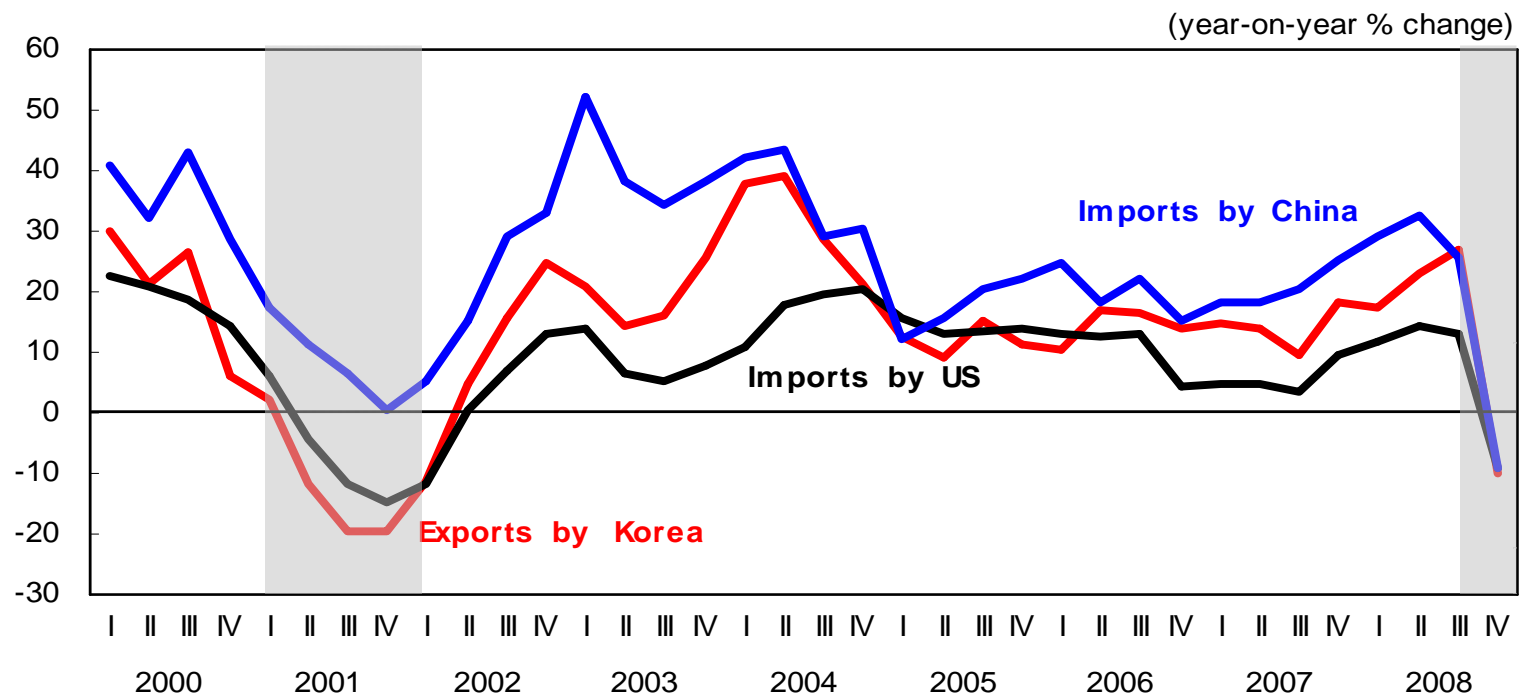


Overheating of China?

❖ The Chinese economy seems to have overheated before the current recession.

- A cause of the hysteric response this time?

Growth of Exports by Korea and Imports by the U.S. and China

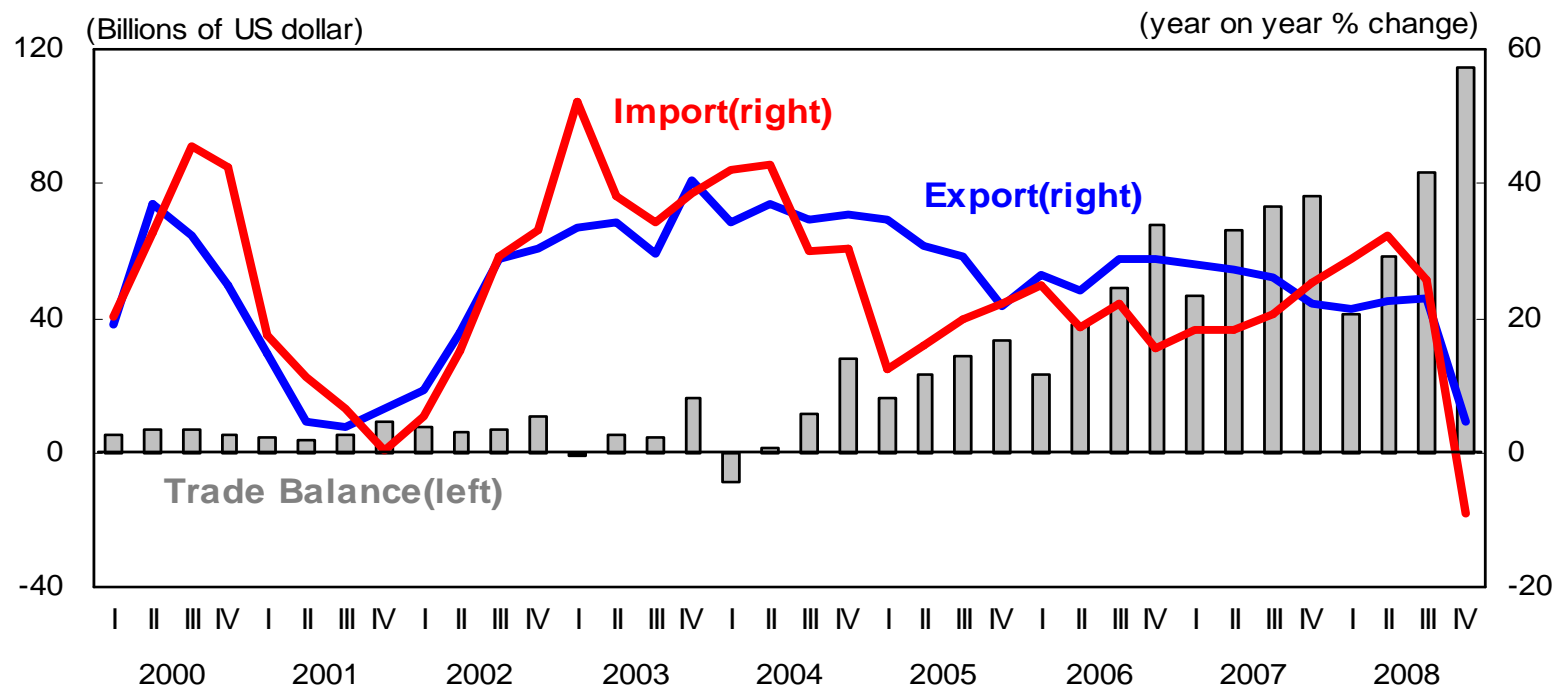


Expansion of China's trade surplus

❖ And China's import declined even more rapidly than its export, boosting trade surplus.

- Did domestic demand sectors contract more rapidly than export sectors?

Growth of Export and Import, and Trade Balance of China

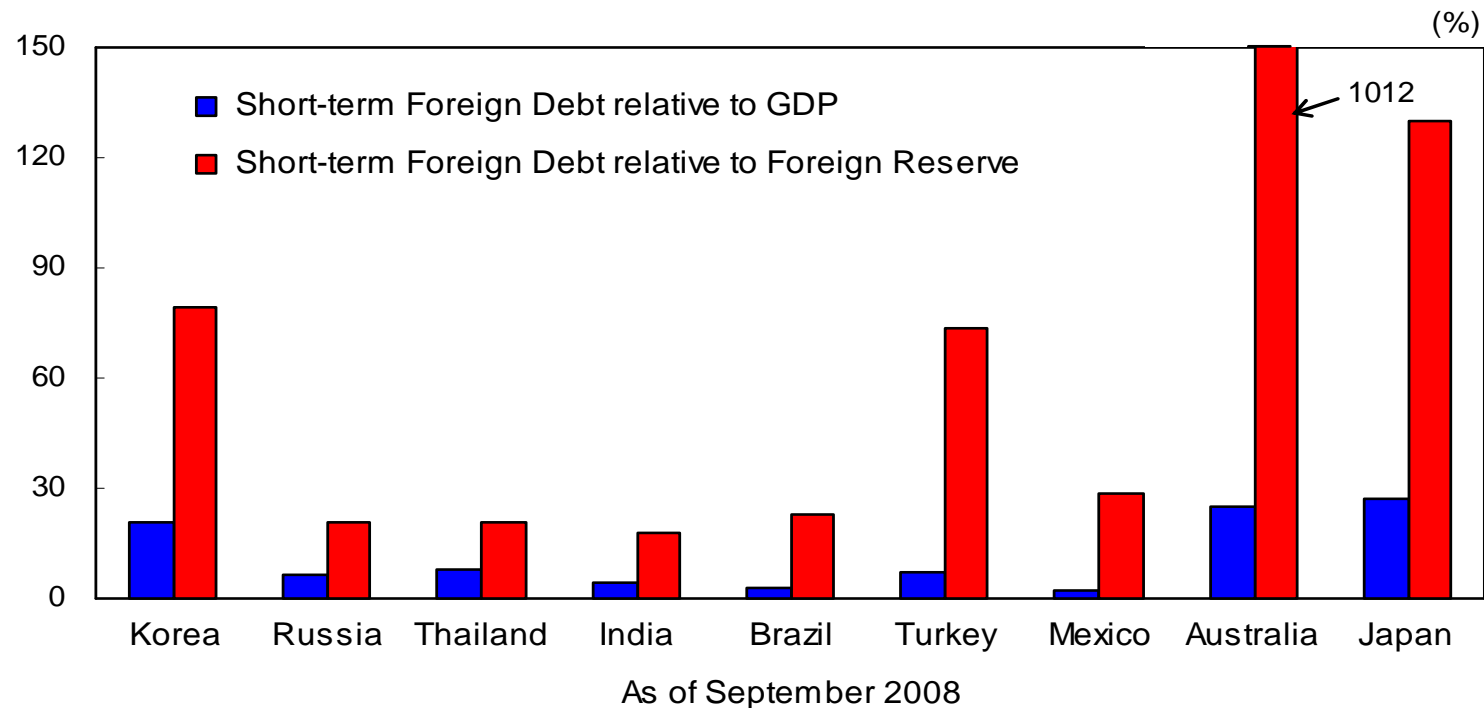


Factor #3: Massive capital withdrawal

❖ The relatively large exposure to short-term debt caused an abrupt capital outflow.

- The Korean won is not internationally “convertible”.

Short-term Foreign Debt relative to GDP or Foreign Reserve





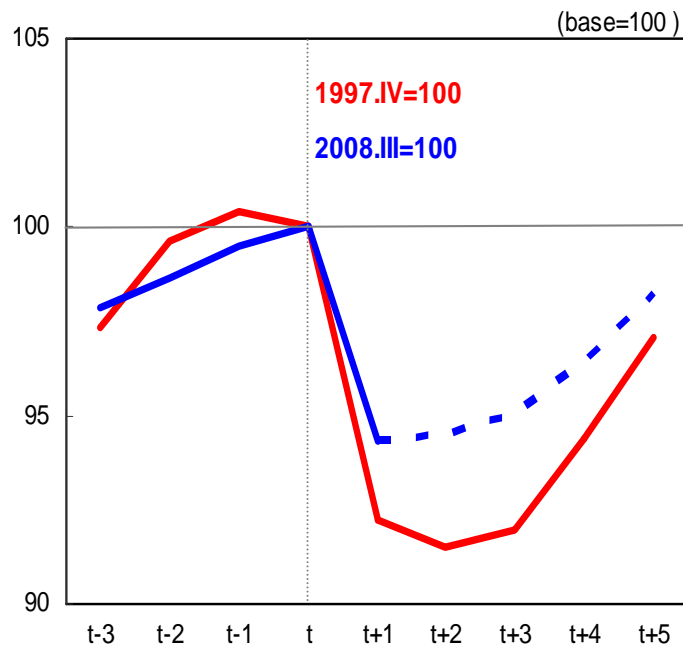
III. Comparison with the Currency Crisis Period

- 1. Major Macro-Economic indicator**
- 2. Structural Positions of the Economy**
- 3. Macro-Policy Reactions**

Similarities

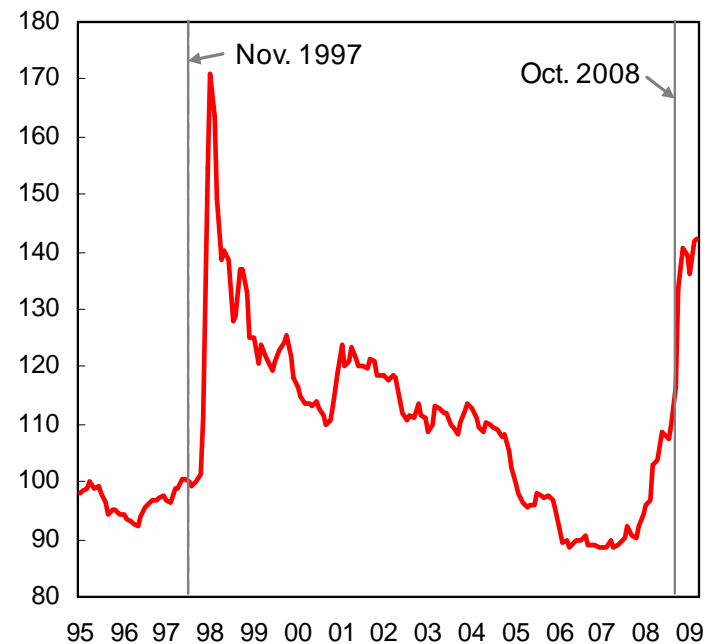
- ❖ In both periods, the growth rate & currency value collapsed simultaneously.

GDP (Index)



Note: Dotted line denotes author's projection.

REER

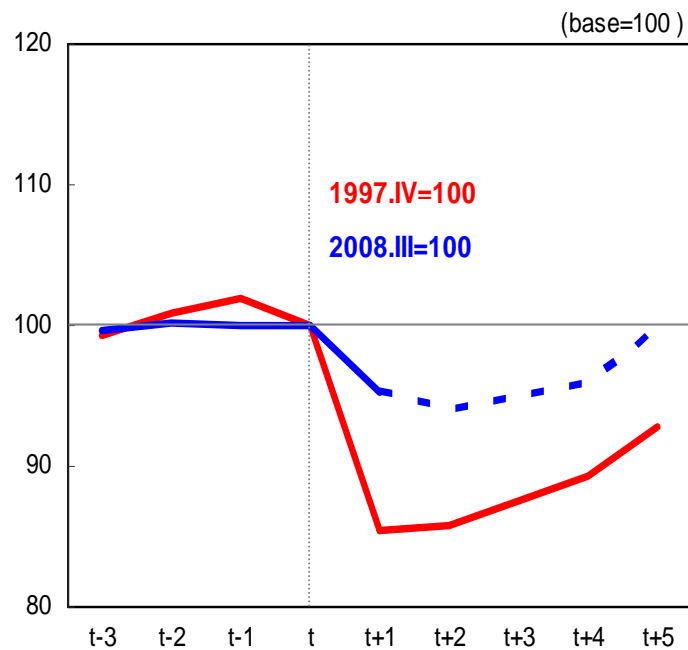


Differences

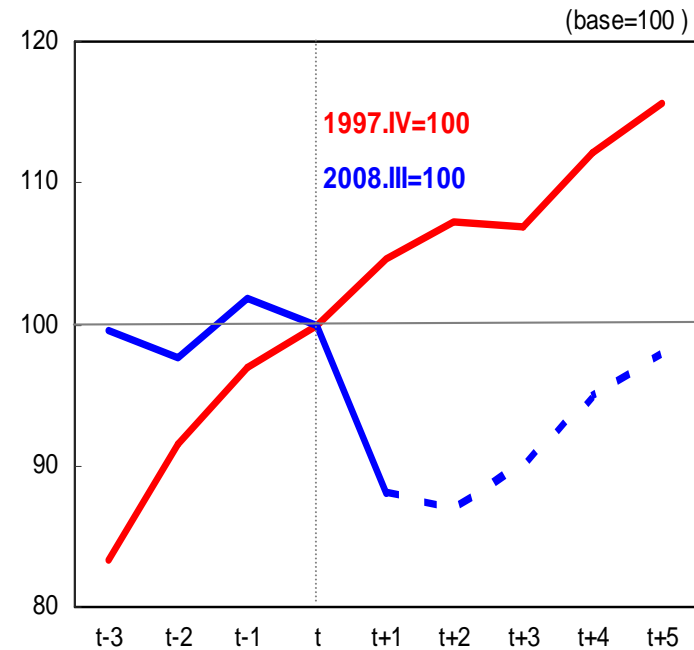
❖ Different responses of domestic demand & export

■ Implosion vs. Explosion

Consumption (Index)



Export Volume (Index)

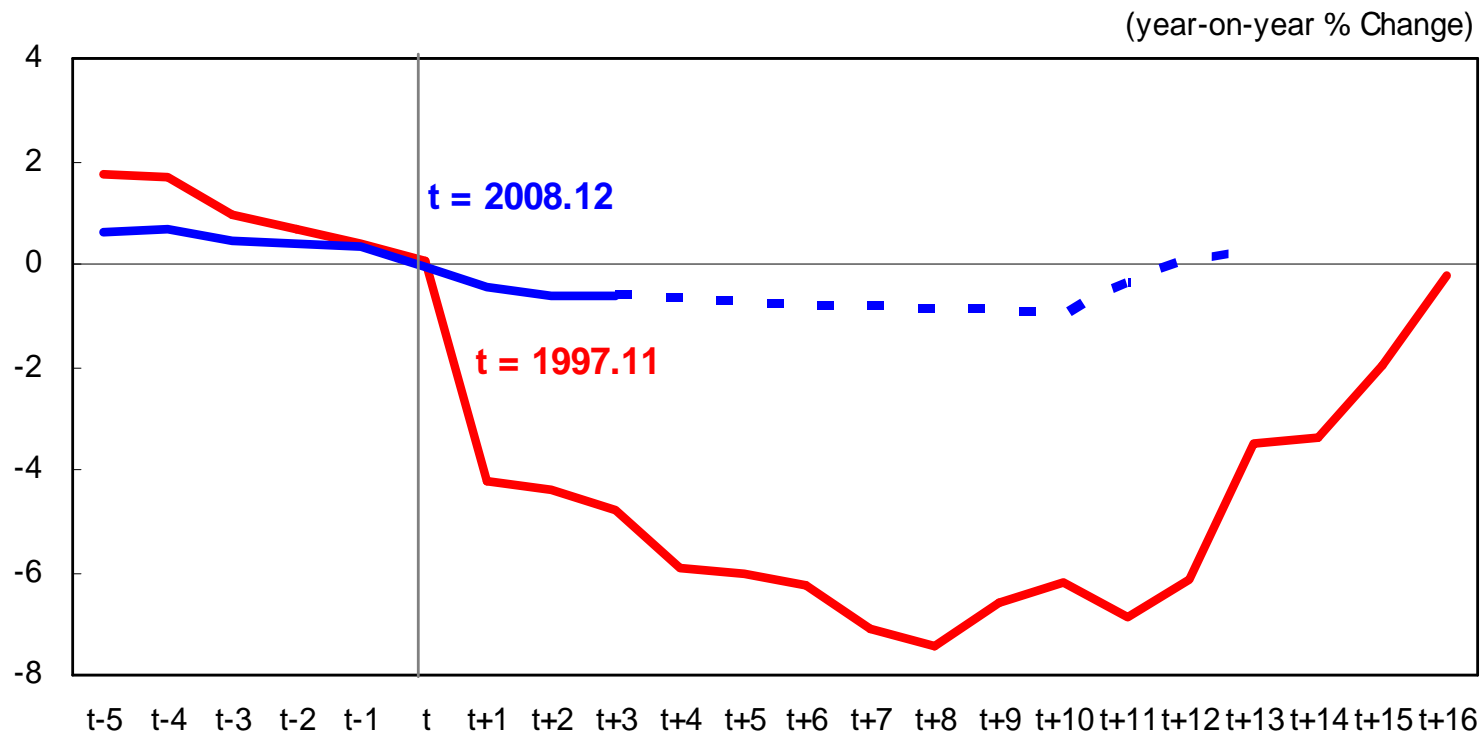


Note: Dotted line denotes author's projection.

Loss of Employment

❖ Far milder this time

Employment Growth



Note: Dotted line denotes author's projection.



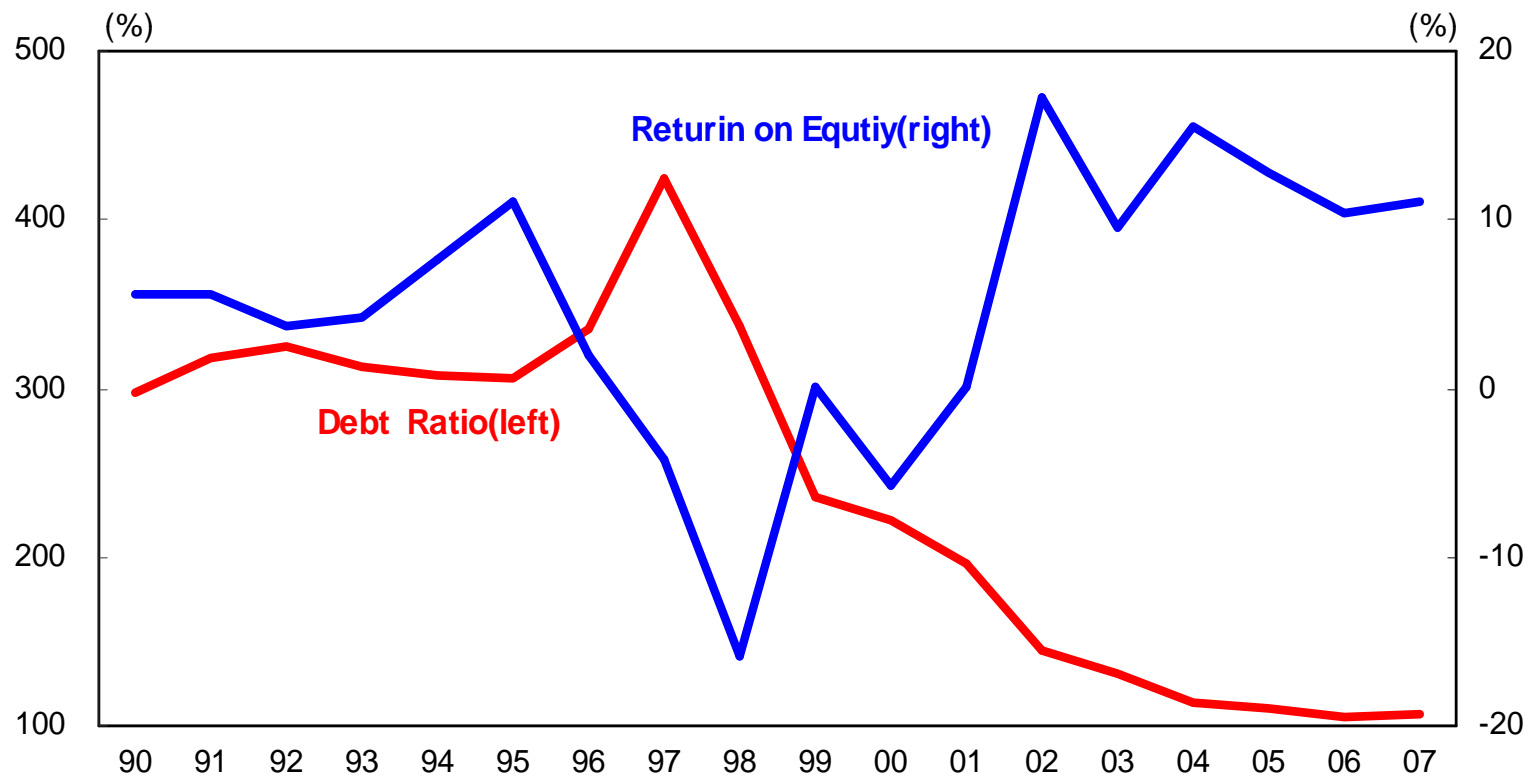
III. Comparison with the Currency Crisis Period

1. Major Macro-Economic indicator
2. **Structural Positions of the Economy**
3. Macro-Policy Reactions

Corporate Sector

❖ Financial positions were much improved.

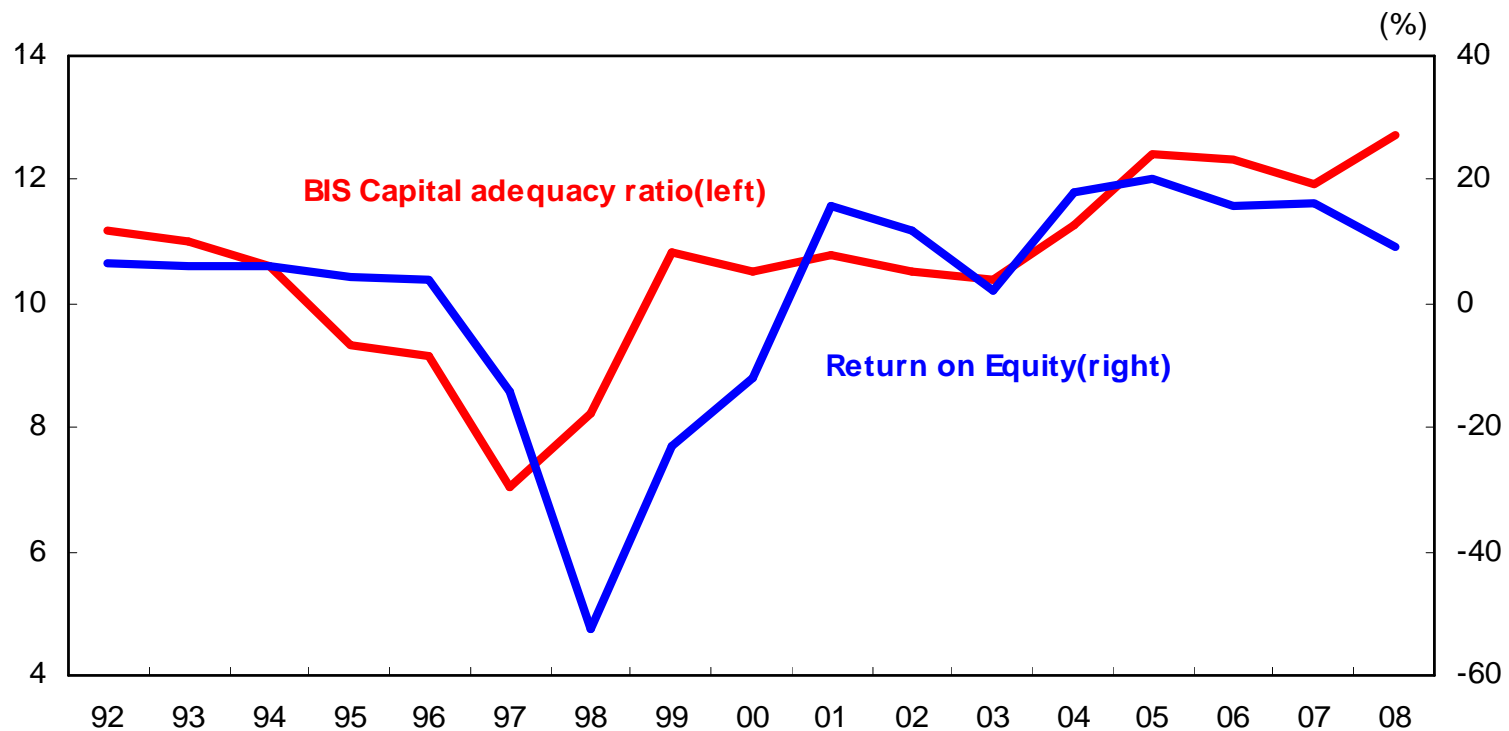
Debt-equity Ratio and Profitability of the Corporate Sector



Financial Institutions

❖ Capital adequacy and profitability were improved.

BIS Ratio and Profitability of the Banking Sector

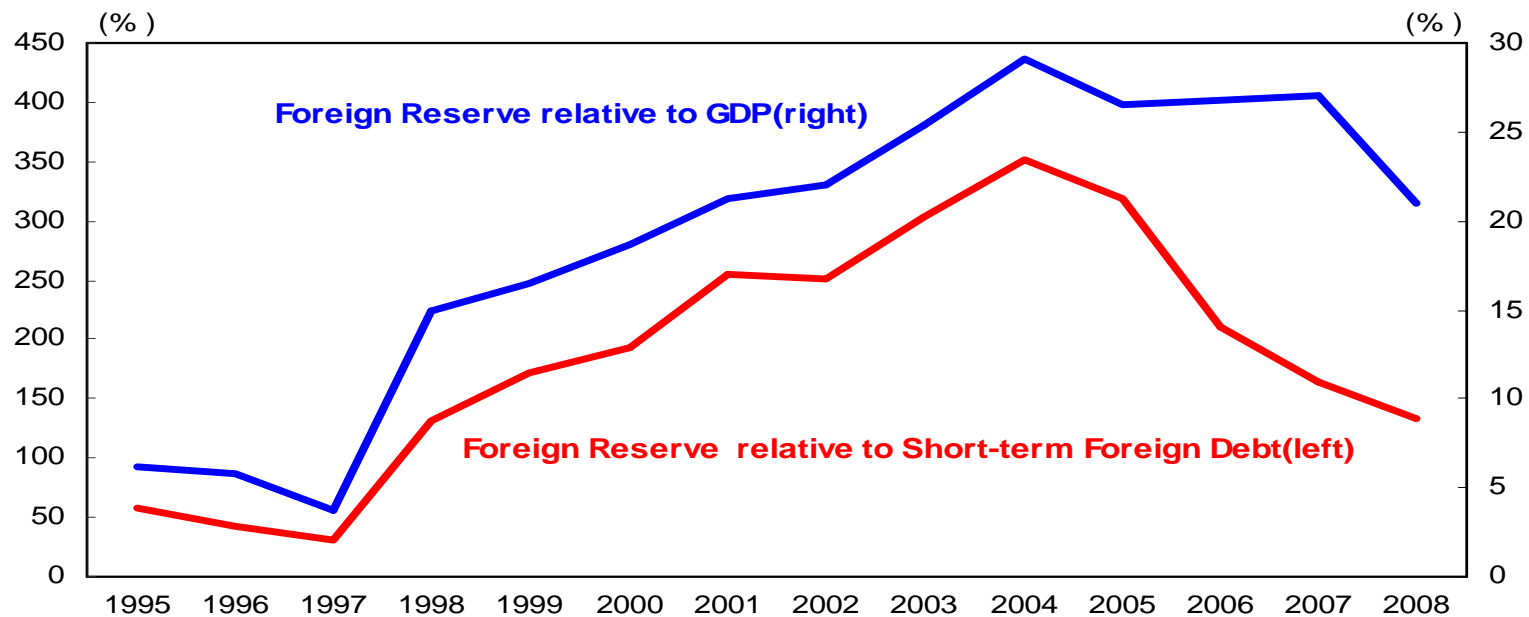


Foreign Reserve

❖ Foreign Reserves were increased.

- Yet, short-term foreign debts had increased more rapidly since 2005.

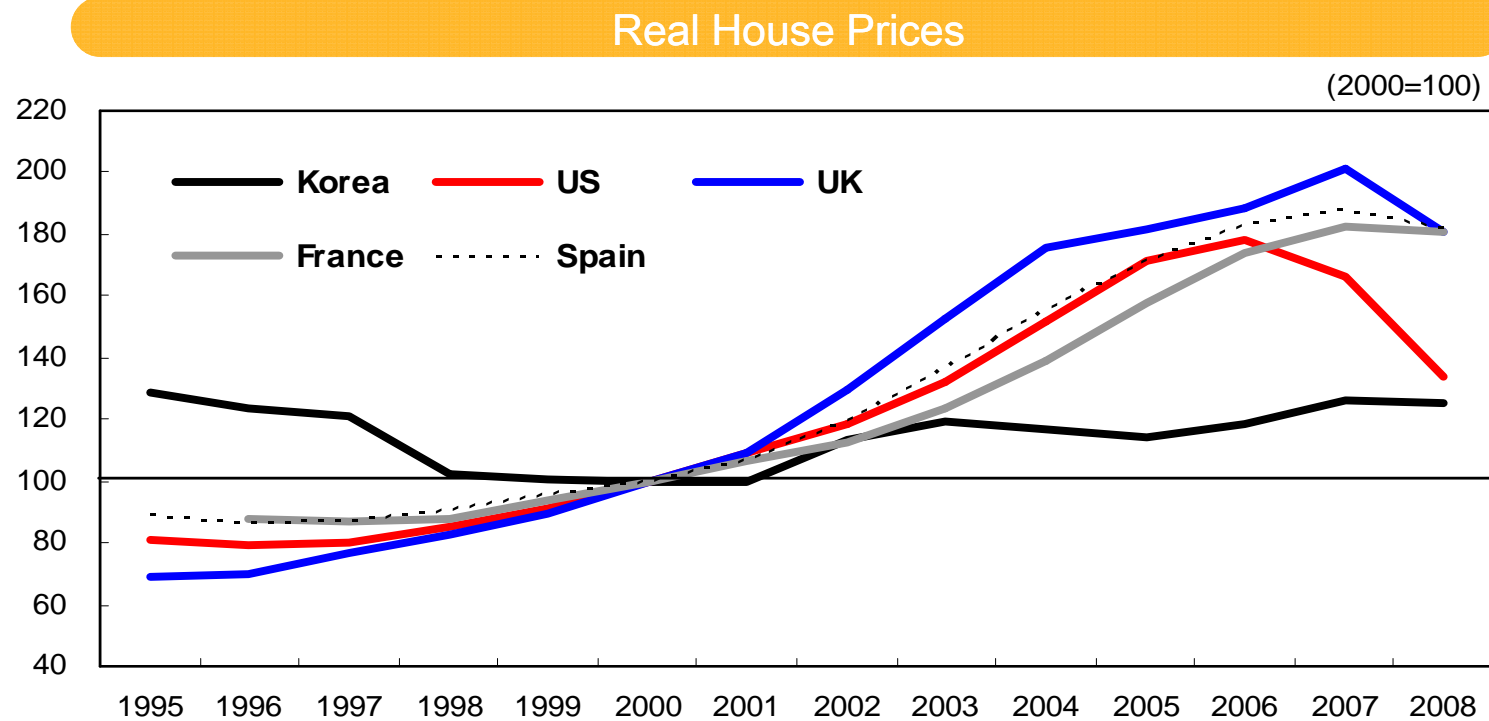
Foreign Reserves relative to GDP or short-term debt



Real House Prices

❖ Korea's economic conditions were believed to have become more fundamentally sound.

- For example, house price bubbles were far milder in Korea than in the U.S. and Europe.





III. Comparison with the Currency Crisis Period

1. Major Macro-Economic indicator
2. Structural Positions of the Economy
3. **Macro-Policy Reactions**

Exchange Rate Policy

❖ In 1997, attempts to defend the currency value through direct market interventions ...

- ended up with the depletion of foreign reserves.
- When the Korean government asked the IMF for a bail-out package, the remaining foreign reserve was below 10 billion US dollars.

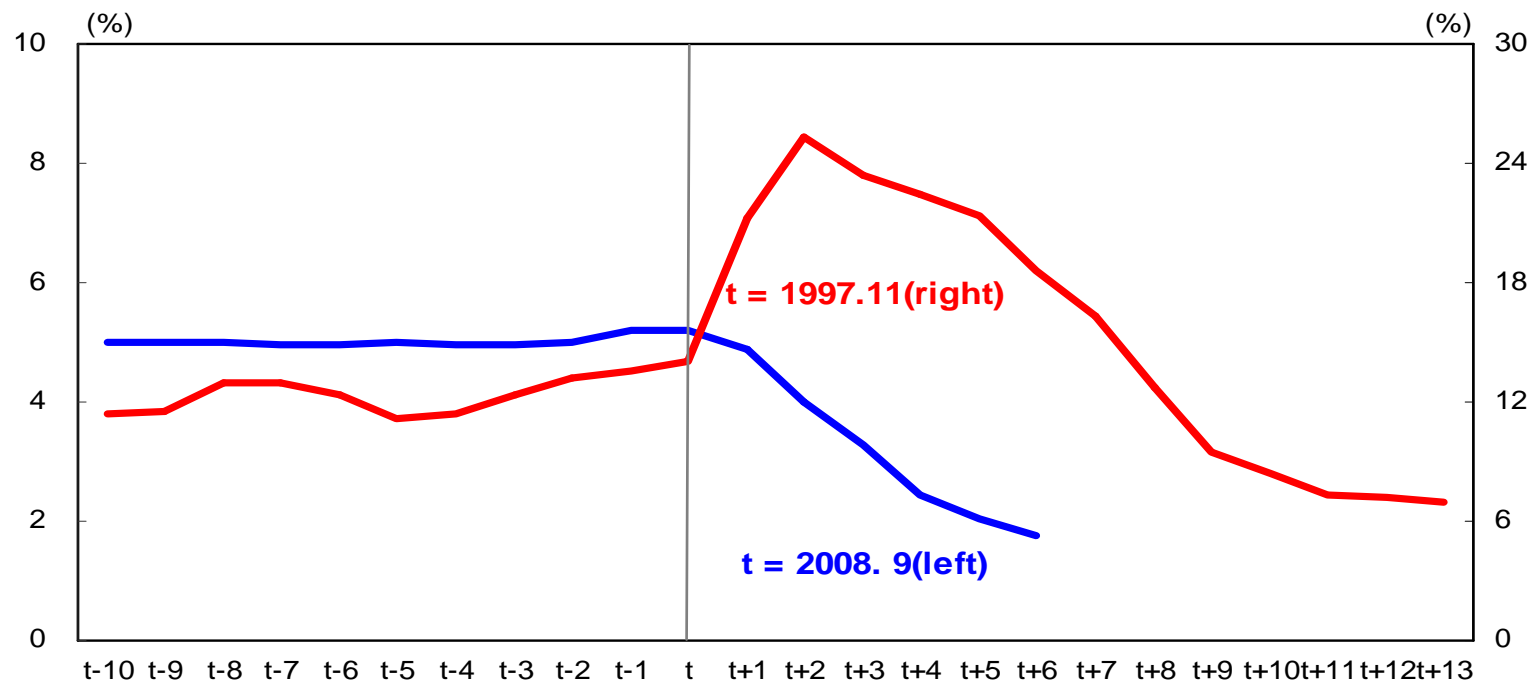
❖ This time, the exchange rate was let float.

- The gov't tried to secure overall foreign currency liquidity by negotiating currency swaps with the U.S., Japan and China.

Monetary Policy

❖ This time, the policy interest rate target was swiftly lowered.

Interest rate target and overnight interbank call rate



Fiscal Policy

❖ In both periods, expansionary fiscal stances were assumed.

❖ But, the processes were different.

- In past, the IMF revised its recommendation toward budget deficit:
 - 0.8% of GDP on Feb 1998, → ... → ... →
 - finally 5% of GDP in 8th agreement on Oct 1998.
- This time, the Korean government promptly announced fiscal expansion in November 2008, and further in March 2009.



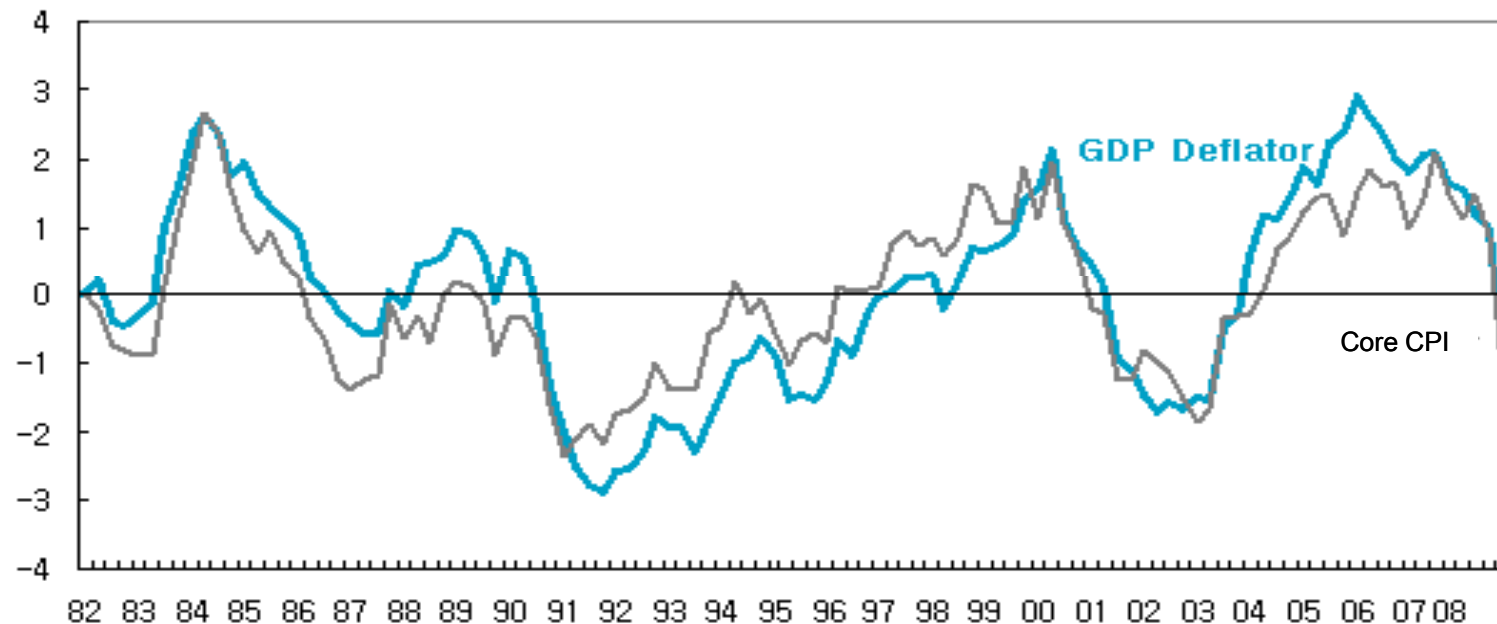
IV. Prospect of the Korean Economy

- 1. Short-term Prospect**
- 2. Domestic demand vs. Export, or
Service vs. Manufacturing**

#1. Correction of Global Overheating

- ❖ Until Q3 2008, the U.S. economy had appeared to need “soft-landing” rather than a “recovery.”
- Hadn't the world been enjoying an unsustainable boom? (Overheated U.S. consumption and Asia's export)

Aggregate Demand Pressures of the U.S.



#2. Collapse of China's Import: A factor for Asia

❖ Global rebalancing, centering on China, is yet to realize.

- What happened in Q4 2008 may have been the correction of global overheating.

❖ Asian economies should benefit more than other regions from the recovery of China's import.

- The global rebalancing scenario must imply a relatively faster recovery of China's domestic demand (hence import) than that in the U.S.

#3. Capital Withdrawal: A Korea-specific factor

❖ Drastic capital withdrawal pressures are likely to be eased.

- The size of short-term foreign debt withdrawal:

\$23 billion (Oct.) → \$12 billion (Nov.) → \$6 billion (Dec.)

- Short-term foreign debt remaining at the end of last year was approximately 150 US billion dollars.

#4. Korea's Macro-Policy Reactions

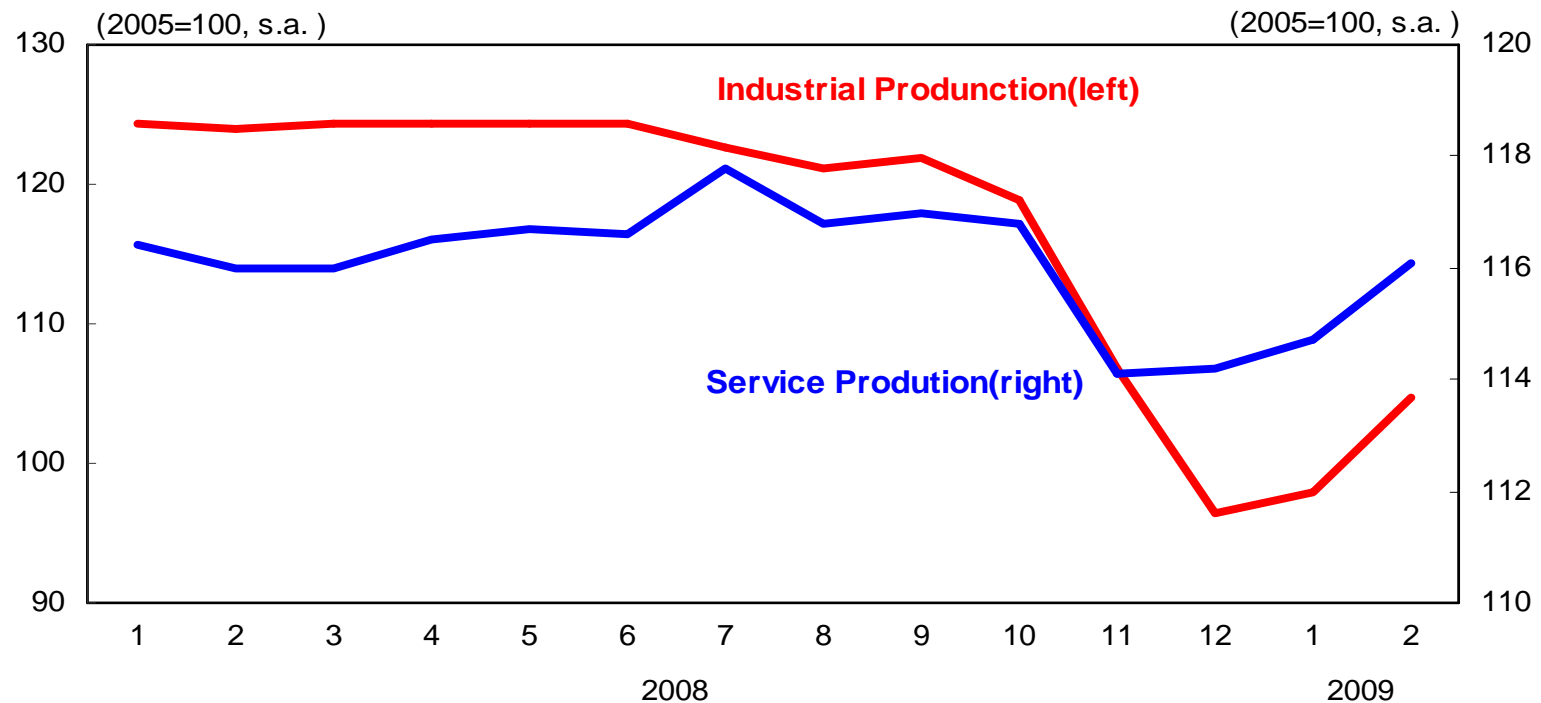
❖ All of the Korea's macro-policy measures are consistently aligned for boosting demand.

- The depreciated currency value helps the profitability of exporters and relieve the deflation pressures from abroad.
- The drastic interest rate cut to an unprecedented level (2%) will relieve the burdens of debt-ridden households and firms as well as the downward pressures in asset prices.
- The supplementary budget will also help alleviate the declining trend of domestic demand.

Recent economic indicators

- ❖ Both service and industrial production indexes began to increase (m-to-m).

Service and Industrial Production

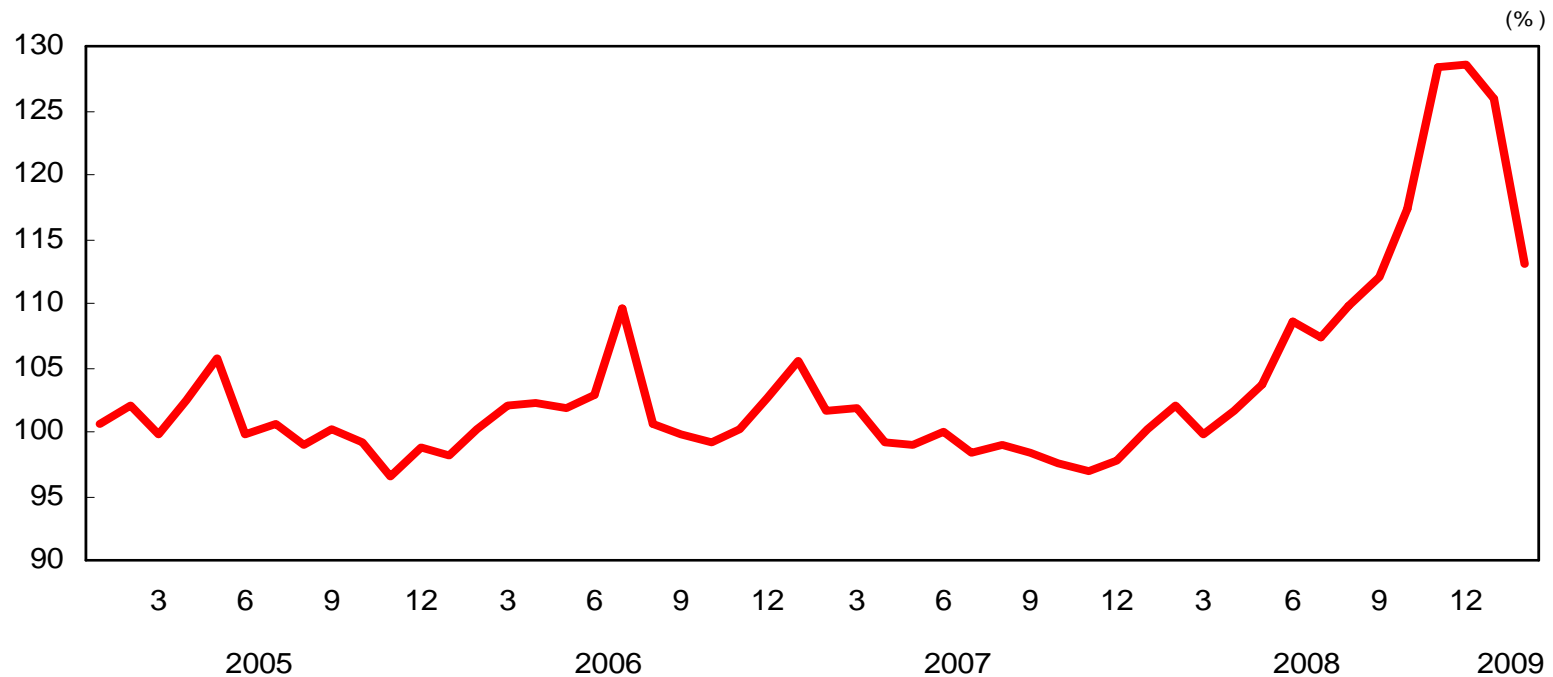


Industrial sector

❖ Inventory has been declining very rapidly.

- This implies that industrial production has been adjusted promptly to the abrupt contraction in (export) demand.

Inventory to Shipment Ratio





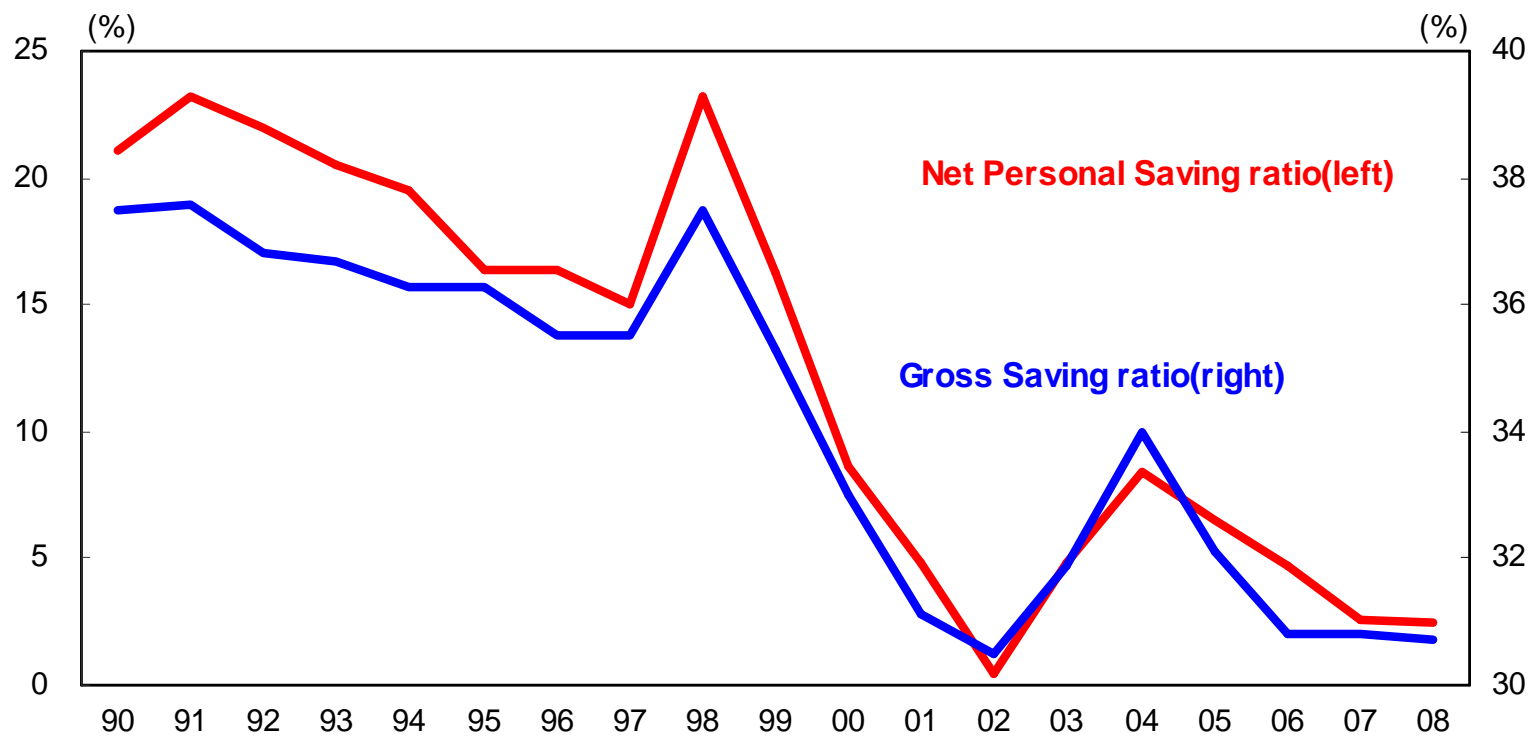
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Boosting Domestic Demand in Korea?

- ❖ Current account has been around balance and savings rates have been declining.

Figure 22. Saving Rate, Aggregate and Household



Boosting Service Sector Productivities

❖ Korea needs to boost service production, which is mostly spent domestically.

- The productivity of Korea's service sector relative to that in manufacturing sector is notoriously low. (OECD, 2004)

❖ This supply-side approach yields different implications from the demand-side approach.

- It has no implication on the current account sustainability.
- Recommended policy measures are different.
- Reforms of entry and exit barriers, mandatory licensing, policy discriminations in favor of manufacturing, ...



V. Conclusion (Lessons)

Lesson #1: Global Overheating

❖ Keep the macroeconomy from getting overheated.

- Why couldn't we do it this time?

- Too much attention to the "global imbalance"?

(Bashing China, instead of watching their own internal problems)

- Too much attention on inflation only, as opposed to real economic activities or asset prices?

Lesson #2: Sound Fundamentals

❖ Maintain sound structural fundamentals.

- The size of shocks vs. the magnitude of impacts in Korea.
 - Shocks: Thai Baht crisis (1997) vs. Lehman Brothers bankruptcy (2008)
 - Impacts: Implosion vs. Explosion
- Pay more attention to short-term capital flows, particularly in emerging countries.
 - Emerging countries' currencies are not accepted during crisis periods.
 - Streamlining prudential regulations
 - > Accumulating foreign reserves
 - > Capital controls

Lesson #3: International Coordination

❖ Strengthen efforts for international cooperation.

- Economic environment is getting more and more internationally dependent.
 - Currency swap was a leading example.
 - More coordination is needed in many areas (macroeconomic policies, financial information sharing, bankruptcy laws,...)

Lesson #4: Financial Market Reform

❖ Many lessons from the Korea's restructuring.

- Many bold policies under the dictatorship of IMF
 - Korean gov't required drastic restructuring in return for the injection of public money.
- ➔ May need another paper.

A wireframe globe on a stand is positioned on the left side of the image. The background is a gradient of blue and white, with a large, faint, stylized letter 'A' visible. The text 'Thank you' is centered in the lower half of the image.

Thank you