"THE BIGGER THEY ARE, THE HARDER THEY FALL": SOUTH KOREA IN GLOBAL ECONOMY

1. Introduction
This paper describes the economical and historical context of South Korea from the World War II to the recent global crisis, considering briefly the rapid growth of the country during the decades after the Korean war; the focus is on the two financial crises that hit the country: the first crisis during 1997-1998, and the second one in 2007-2008. It analyses sources and results, comparing the two different economical context.

2. South Korea in the past: economical context after the World War II
At the end of the World War II, the colonial government in the Korean peninsula was replaced by two separate regimes: a U.S. military government in the South and a Korean leadership guided by communist Russia in the North. This division brought interruption of trade with Japan and within Korea, and economic disorder.

The first South Korean government (1948) fulfilled a more egalitarian land reform, but then the Korean War broke out in 1950, damaging about a quarter of capital stock during three years.

After the war, the government tried to stimulate economic growth by promoting indigenous industrial firms and giving them privileges to buy foreign currencies and to borrow funds from banks at preferential rates.

Moreover, policymakers imposed a prohibition on manufacturing imports and tariff barriers, hoping that the protection would give national firms a possibility to improve productivity through learning-by-doing and importing advanced technologies. This policy was known as import-substitution industrialization (ISI).¹

Until 1960s, South Korea (hereafter Korea) represented a backward economy based on subsistence agriculture: its per capita income in 1961 was $82 (in 1960 prices), lower than Haiti, Ethiopia, Honduras, Perú and Yemen; the country relied on foreign aid for survival.

In twenty years the Korean's real per capita income more than tripled, placing the country in the top third of all middle-income countries.

By 1996 Korea appeared like the world's eleventh largest trading nation, with its 42 million of population and a per capita income of over US $10,000. It began to play active roles in global affairs by joining World Trade Organization (WTO) and the Organization of Economic Cooperation

¹ Economic History Association, available at eh.net/encyclopedia/the-economic-history-of-korea/ (15/05/2016).
and Development (OECD). In the quarter century following the early 1960s, the Korean per capita output increased at an unusually rapid rate of 7% per year, a performance paralleled only by Taiwan and two city-states, Singapore and Hong Kong. Since the end of 1970s, the rising trend in the Gini coefficient started to reverse. The capital accumulation was guided by an increasingly high savings rate due to a falling dependency ratio. The rapid growth was also aided by a collection of human capital, which started with the introduction of modern education under the Japanese rules. For poor countries, Korea is a model of growth, a better example to copy than China, too vast, and than Taiwan, Singapore and Hong Kong: all three are richer than Korea, but, they are, in different ways, exceptions: Singapore and Hong Kong are city states, while Taiwan's disputed sovereignty makes it sui generis. Korea has combined growth with democracy; for the past decades, the country has had a vibrant parliamentary system. It scores the same as Japan in the democracy tally kept by Freedom House. The country was stricken during the global financial crisis, but recovered faster than any other rich country. Between June 2008 and February 2009, Korea lost 1.2m jobs, and Korean open financial system made it vulnerable to the volatily in world markets. Some of the recovery depends on China: Korea exports more capital goods to China, relative to the size of its economy than anyone else, even Germany. Policymakers also introduced a public-works scheme that was mopping up over 2% of the labour force, by the introduction of an old-age pension and an earned-income tax credit. The Korean model had four features: a Stakhanovite workforce; powerful conglomerates; relatively weak smaller firms; and high social coesion. South Koreans rely on education and hard work: their reaction to the collapse of 2008 was to work harder still. During the 2009-2010 recovery, Korea had the second-largest increase in hours worked in manufacturing, after Taiwan. And the quality of labour has been even more important than the quantity: Korea spends a larger share of GDP on tertiary education than any rich country. Another basic characteristic is the economic model: total tax revenues are just 26% of GDP. Taxes

3 A measure of statistical dispersion intended to represent the income distribution of a nation's residents; it's the most commonly used measure of inequality.
4 A think tank in Washington D.C.
5 The Economist, What do you do when you reach the top?, available at www.economist.com/node/21538104 (19/05/2016).
are low on labour, to boost work and foreign investments. But, as a result, social spending is low, as well as public spending on family benefits.
Korea needs to increase taxes and social spending in order to reduce poverty and inequality, but the country is afraid because of the impact on jobs. In the 1990s, liberalization of capital account followed, with a consequent rapid accumulation of short-term external debts. This, with a highly leveraged corporate sector and the banking sector destabilized by the financial repression, provided the background to the contagion of crisis from Southeast Asia in 1997.
Korea's past strategy to improve growth led to dangerous structural distortions, like the syndromes of business concentration, stagnation of productivity, fragile corporate financial structure, corporate bankruptcies and weak interindustry linkage.
The Korean State failed to reform industrial and financial systems in preparation for global economic integration: this reason can be considered one of the major structural cause of crisis.

"The biggest they are, the harder they fall" describes exactly Korea's experiences during the Asian financial crisis (1997-1998), and those of many of the chaebol, the country industrial conglomerates. Korea was one of the country with the worst performance, and its International Monetary Fund (IMF)-led emergency bail-out programme costed around US $60 billion.
To its credit, Korea has also been one of the most responsible countries in implementing post-crisis economic and financial reforms. The country's financial sector is one of the region's strongest, combining greater openness with better regulation.
The crisis in this country was triggered by structural problems related to the high debt of its large enterprises with foreign creditors.
At the beginning of 1997, there were failures of Hanbo Steel and Sammi Steel, two of the largest conglomerates in the country. Western banks decided to interrupt their loans to Korean companies, limiting the vital inflow of capital and crippling the economy. The Korean stock market lost 4% of its value in one day (7 November 1997) and 7% the next day. On November 24 the requests of "structural reforms", formulated by the IMF for a loan, brought down the Korean securities by 7.2%. Samsung lost more than US $5 billion during the crisis, and Daewoo was absorbed by American group GM. The change went from 800 won per dollar to over 1800 (the devaluation came

6 Ibidem.
7 It's a South Korean form of business conglomerate. They are typically global multinationals and own numerous international enterprises, controlled by a chairman with power over all the operations.
to 110%).

Few scholars expected that the financial turmoil exploded in Thailand would so rapidly spread to a country like Korea, with an healthy macroeconomy and balanced budget, high savings, and a low inflation rate. Beneath the surface, the Korean crisis had been brewing for some time: the country's external balance started to worsen in late 1996. By mid-1997 Korea had a problem with its external debt which, as already noted, increased quickly as a result of cumulative trade deficits. It was simply a matter of time before investors would lose confidence in the Korean financial market and started to curtail investments funds from the country. Due to this, it wasn't able to maintain the value of the Korean won and it could not assure new funds from international markets. Foreign and domestic investors were scared about the continued depreciation of the won and fled the stock market, creating a vicious circle of downfall stock prices, pushing the value of the won down further.


Looking back, the main causes of the crisis can be attributed to structural factors, internal and external; the most important is the heritage of distortions and weakness from past industrial policy. More direct external causes can be the not favorable international situation after the mid-1990s, when the country's trade health was eroded.

Moreover, the microeconomic problems of low performance and profitability of domestic firms were evident: at the root of the crisis there was the clientelistic state-business relationship inherited from the past industrial policy.

The governments excessively relied on the chaebols for exports success, giving them privileged access to government-subsidized credit: due to the belief that they were too big to fall, they became too much ambitious in their investment decisions. External borrowing during the boom years of the early 1990s brought almost $100 billion (a third of GDP) of short-term debt. The presumption of implicit bailout policy by state promoted imprudent lending by bankers, according to chaebols' excess demand for credit, despite the rise in banks' nonperforming assets. As a result of Korea's highly centralized banking system, there were commonly political interventions on behalf of the chaebols.

This dangerous situation was exacerbated by external developments after the mid-1990s. Korea's export expansion went down from the annual growth rate of 33% in 1995 to 3% in 1996. This was due to the collapse of Korean export prices and the loss of the competitiveness resulting from the

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9 Ibidem.

10 Ibidem.
Chinese yuan depreciation in 1994, and the consequent depreciation against the US dollar to which the Korean won had been pegged.

Due to the decline of external demands for Korean exports, Japanese economy started to deteriorate as well as a cyclical downturn in the Asian region. This was associated with a oversupply of manufactured goods in the regional and global stock market. For Korean industry, this provoked the syndromes of overinvestments, a stockpiled inventory, and stagnant productivity, that dissipated the strong profit positions of Korean firms in the previous years.

The directly contribution to the crisis was the poor governance of Yong-sam Kim's civilian state (1992-1997), considered like a regime legitimate to start political and economic reforms for a market-oriented democracy. But there were two aspects of policy failure: the premature decision to move toward financial liberalization by joining the OECD in 1996, and the lack of political will to undertake long and necessary structural changes.

In summary, this economical crisis didn't result so much from macroeconomic disorders as from the weakness in financial system and poor governance of the economy.

The explosion of the crisis in Southeast Asia was like a ignition that triggered a sparkle in the field of land mines waiting to be exploded. With right cautious and preventive measures, the crisis could have been avoided or at least the impact could have been moderated.

The Korean government agreed in December 1997 to a $58 billion bailout led by the IMF, scared about a possible default, that would pose a grave treath to the international monetary system; the first purpose of the bailout was to create a bridging finance to reduce current-account deficits, keeping inflation in check by restricting domestic demands. Specific adjustment measures were created: the introduction of a floating exchange rate system, a total liberalization of the capital market, and the abolition of the import source diversification system.

The programme stipulated macroeconomic target for monetary, fiscal and exchange rate policies. The IMF package tried to transforme the entire system more like a Western model: these reform measures wanted to overcome the banking, corporate, trade, and labour sectors as well as to reform the features of the economy that have been seen as impediments to growth (monopolies, trade barriers and non-transparent corporate practices).

The reform package included the establishment of an independent central bank with the primary function of containing inflation; the creation of a supervisory body with jurisdiction over all financial and corporate operations; eliminations of government-initiated loans; transparency in banking transactions and removal of all restrictions on foreign borrowings by domestical firms.

The most important element of the IMF's programme was the elevation of the interest rate, from the
pre-crisis rate of 12% to 27% by the end of 1997 and up to 30% in early 1998.\textsuperscript{11} The aim of this policy was to induce the investors to keep their savings in domestic currency and to attract foreign investments to stabilize the value of the Korean won. Korea made notable progress in overcoming the crisis in just a year, and the recovery of the economy continued until 1999. The economical rehabilitation was very quick, due to the fact that the crisis was a liquidity problem, and, more significantly, it was attributable to the good governance of the Kim Dae-jung\textsuperscript{12} administration.

The range of reforms and the speed with which they have been implemented don't have parallels in recent experiences of other emerging markets.

4. The last crisis

Korea’s experience with the last global crisis (2007-2008) has been less severe than the shock that economy faced during 1997-1998, but it has experienced significant spillover effects as a consequence of the crisis. Between August 2007 and November 2008, the won lost almost 50% of its value.

The real economy has fared relatively better through this episode, especially compared to the Asian crisis; as an export-oriented open economy, it has experienced slowdowns along with the rest of the world. However, net exports remained robust through the crisis, and GDP felt less than in 1997-1998.\textsuperscript{13}

Even if this crisis wasn't terrible like the previous one, Korea has been one of the Asian nations most severely hit. At the first glance, the country seemed better placed to resist thanks to its substantial cushion of official reserves, its improved policy framework, and its very limited exposure to toxic assets originating in Western banks.

With collapse of Lehman Brothers (15 September 2008), Korean won had depreciated by over 25\%, the largest fall among major Asian countries, excluding Turkey; the stock price collapsed by 27.2\% during the same period.\textsuperscript{14}

Korea's experiences during this crisis can be summarized in terms of the capital inflows problem: procyclicality\textsuperscript{15} generated by capital inflows has been a major cause of vulnerability for small open

\textsuperscript{11} Ibidem.
\textsuperscript{12} He was the 8th President of South Korea from 1998 to 2003, and the 2000 Nobel Peace Prize recipient.
\textsuperscript{15} In business cycle theory and finance, any economic quantity that is positively correlated with the overall state of the economy is said to be procyclical; any quantity that tends to increase in expansion and tend to decrease in recession is classified as procyclical. GDP is an example of a procyclical economic indicator.
economies as they can cause boom-bust cycles. Since the East Asian crisis, the Korean economy has progressed towards closer integration with global financial markets; its liberalized capital market has invited foreign capital inflows, but this has also enabled foreign investors to unwind their positions at the earliest signs of trouble.\textsuperscript{16}

Many South Koreans complained that their economy is vulnerable to Western market panic and destabilization because it is more transparent and open to foreign capital than those of neighboring Japan and China: Korea was particularly susceptible to global shocks since its financial and export sectors were opened.

The Lehman Brothers bankruptcy and the subsequent panic in the global financial market has influenced the whole environment; the exchange rate depreciated from around 1100 won/dollar to over 1500 won/dollar, and foreign reserves declined from US $240 billion at the end of September 2008 to US $201 billion at the end of December.

Korea’s export also collapsed at an incredible pace. The year-on-year growth rate of export declined from 27.6\% in September to 7.8\% (-2.6\%, month-to-month) in October and further to -19.5\% (-22.3\%, month-to-month) in November.\textsuperscript{17}

The Korean economy began to recover from the second quarter of 2009. Also in trade sectors, some recovery signals of export demand were detected; the country achieved more than 8\% growth in just one year period until the first quarter of 2010.

This crisis and the previous one (1997-1998) looked alike: asset values and GDP collapsed simultaneously, though the recent crisis was less strong in terms of magnitude and duration: this time took 6 months, compared to 12 months of the precedent crisis, to restore the value of the currency.

The most important difference between the two crises can be found from the responses of aggregate demand components. During 1997-1998, domestic demand guided the collapse of GDP, while export demand continued to expand; in 2007-2008 period, it was the external demand that triggered the crisis, while the reduction in domestic demand was relatively mild.

This was due to the fact that the sources of crises were different: the recent crisis was mainly triggered by the explosion of foreign markets.

In summary, the two crisis appeared similar, but their sources and impact were quite diverse, and the foreign-driven crisis in 2008 ended up provoking less pain than the 1997-1998 crisis.\textsuperscript{18}

Financial market was the first channel that transmitted the global crisis; after the Lehman Brothers

\textsuperscript{16} Ibidem.
\textsuperscript{18} Ibidem.
bankruptcy, panicked financial institutions rushed out to secure liquidity from anywhere possible in the world. Due to no hard currency, Korea was swept into the strong current of global financial panic, and it experienced an abrupt and massive capital outflows.

Despite the crisis in asset markets, Korea's credit market was not greatly affected by the global crisis: no major banks were bailed out by the government and no symptoms of bank-runs were detected.

Usually, a currency crisis is transmitted into a banking crisis, a "twin crisis", through some channels: a reversal of foreign currency liquidity flow; a contraction of bank assets in public or private sector; a decrease in credit supply and a surge in default; a deterioration of bank's capital bases; and a vicious circle of credit crunch between banks and borrowers.

Korean economy in 2008 was equipped better than in 1997-1998; the amount of foreign reserves was large enough to cover the whole short-term foreign debt and banks also have better capacities to absorb shocks in 2008 than in 1997.

About policy reactions to the crisis, the most contrasting in 2008 to those in 1997 was the monetary policy. The policy interest rate was raised in 1997 to the level (almost 30%) above twice the pre-crisis rate (approximately 12%), but it was lowered to the level (2%) below half the pre-crisis rate (5.25%) in response to the recent crisis. In 2008, monetary easing was fundamental to protect domestic economy from the external storm, while the monetary tightening in 1997 aggravated the domestic banking crisis.

Moreover, it was important the way how the government approached to the foreign exchange market: in 1997, policymakers tried to control the foreign exchange market, unlike 2008 when the government let the exchange rate adjust to the shock instead of wasting foreign reserves. Korea could successfully recover this time, thanks to the relatively sound pre-crisis fundamentals achieved by the restructuring processes since the 1997-1998 crisis, along with consistent macro-policies. However, if the emergency policies are not normalized on time and necessary restructuring is delayed, the last success can become an ominous prelude to another crisis in the future.

19 Ibidem.
5. References


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