When it took economies on average more than a decade to regain their pre-depression per capita GDP, it will take time before per capita growth and employment reach pre-crisis levels. Reinhart and Rogoff show that in 10 of 15 severe post-World War II financial crises, unemployment did not return to pre-crisis levels even after a decade (and double-dip recessions occurred in 7 of the 15 crises). In short, meaningful recovery is likely some years away.

So what explains how South Korea, the world’s 15th largest economy, bucked this trend? Despite experiencing a deep and wrenching economic contraction in the fourth quarter of 2008, the Korean economy made a remarkable V-shaped recovery by the second half of 2010, notching an impressive 6.2 percent growth in 2010, which prompted the ever-cautious IMF to announce that “Korea’s rapid recovery from the global downturn has transitioned into a full-fledged expansion” (IMF 2011, 4). Although growth slowed in late 2011 due to an overall slowdown in the world economy, South Korea’s economy.

From Meltdown to Bounceback
How South Korea Weathered the 2008 Financial Crisis
By Shalendra D. Sharma

South Koreans remember the acute humiliation of the 1997-1998 Asian financial crisis, when the mighty export powerhouse was forced to go hat-in-hand for a bailout to the International Monetary Fund. Not so during the 2008 global financial crisis. Although hard hit, South Korea bounced back rapidly, while the US, Europe and Japan are still struggling. Lessons from the earlier crisis provided the foundations for recovery this time around, writes Shalendra D. Sharma.

THE GLOBAL FINANCIAL CRISIS of 2008, which was triggered in the world’s largest economy, the United States, left no country unscathed — although the severity and impact of the crisis varied widely from country to country. Four years later, many countries are still living with the adverse effects of the “Great Recession.” The world’s leading economies, including the US, Europe and Japan, have not fully recovered. The American economy continues to suffer low growth and high unemployment, while the eurozone is facing an existential crisis that could potentially lead to a break-up of the monetary union. According to a vast body of economic scholarship, this tepid recovery, if not stagnation, was to be expected in the wake of such a severe downturn.

In a path-breaking study published in 2009, “The Aftermath of Financial Crises,” Carmen M. Reinhart and Kenneth S. Rogoff claim that the periods following systemic financial crises are characterized by long, deep recessions with very low growth and high unemployment. Just as it was with the Great Depression of the 1930s, when it took economies on average more than a decade to regain their pre-depression per capita GDP, it will take time before per capita growth and employment reach pre-crisis levels. Reinhart and Rogoff show that in 10 of 15 severe post-World War II financial crises, unemployment did not return to pre-crisis levels even after a decade (and double-dip recessions occurred in 7 of the 15 crises). In short, meaningful recovery is likely some years away.

So what explains how South Korea, the world’s 15th largest economy, bucked this trend? Despite experiencing a deep and wrenching economic contraction in the fourth quarter of 2008, the Korean economy made a remarkable V-shaped recovery by the second half of 2010, notching an impressive 6.2 percent growth in 2010, which prompted the ever-cautious IMF to announce that “Korea’s rapid recovery from the global downturn has transitioned into a full-fledged expansion” (IMF 2011, 4). Although growth slowed in late 2011 due to an overall slowdown in the world economy, South Korea’s economy is
projected to have grown at around 4.5 percent in 2012. This is impressive given continued global economic uncertainty.

What explains South Korea’s phenomenal bounceback? It turns out to be more than the combination of revival and growth in external demand and expansionary fiscal and monetary policies. Often unacknowledged is the impact of wide-ranging structural and financial-sector reforms, some under IMF tutelage, that South Korea was forced to adopt in response to the Asian financial crisis of 1997-98. These reforms, including more effective regulation and supervision of financial institutions and better management of foreign exchange reserves, enhanced the Korean banking sector’s ability to absorb these shocks and recover quickly. The Korean experience vividly underscores that a healthy financial sector is the sine qua non of recovery in this age of rapid global economic integration. Without this, economies will not only be highly vulnerable to external shocks, but also measures to mitigate these shocks, including costly stimulus packages, will only be partially effective.

SOUTH KOREA’S STRUCTURAL REFORMS

Arguably, the singular reason why the South Korean economy succumbed so easily to the 1997 crisis was because of “crony capitalism” rooted in the ubiquitously corrupt relationship among the country’s chaebols, the banking sector and the state (Sharma 2003). It is also “crony” and “casino” capitalism in the US — vividly manifested in profligate bank lending, irresponsible borrowing, ineffective regulation and an incestuous relationship between Wall Street and Washington — that is widely seen as responsible for the subprime mortgage meltdown that triggered the latest global financial crisis (Johnson and Kwak 2010).

The difference has been in the official response to these systemic problems. In the midst of the Asian crisis, South Korean authorities, confronted with a debilitating and humiliating economic collapse that saw ordinary Koreans donating their valuables to the national coffers to help pay the national debt, embarked on a broad and ambitious path to radically clean up their economy. Unlike their American, European and Japanese counterparts, who were only too happy to kick the proverbial can down the road or buy time via massive stimulus spending, Korean authorities showed purpose and resolve to implement painful, yet necessary, reforms. In line with the recommendations of the 1997 Presidential Commission on Financial Reform, the Korean authorities promptly closed a number of problem banks and restructured 12 of the 32 largest banks through mergers, recapitalization and increased capital requirements. They strengthened the balance sheets of viable banks by providing them with much-needed liquidity so that they could restart lending; established the Financial Supervisory Commission (FSC) in 1998 and the Financial Supervisory Service (FSS) in 1999 to enhance prudent regulation; established the Korea Deposit Insurance Corporation (KDIC) in 1996 to insure bank deposits, including deposits in securities companies, insurance companies, merchant banks and savings banks to limit the problems arising from systemic risk; created a publicly funded corporation (the Korea Asset Management Corporation, KAMCO) to purchase non-performing loans; and enhanced the Bank of Korea’s financial and regulatory powers to improve transparency and oversight, and reduce political influence. Additional, swift adjustments in fiscal and monetary policies, including prudent depreciation of real exchange rates, helped boost recovery (Lee and Rhee 2007).

These reforms were accompanied by wide-ranging industrial restructuring designed to rein in the big conglomerates — in particular, reducing chaebol control over financial institutions and allocating them credit based on their performance. Chaebols that failed to measure up were deemed beyond repair — such as the once all-powerful Daewoo Group — were forced to undergo bankrupcy and restructuring. The dissolution of the Daewoo Group, South Korea’s fourth largest chaebol, was a stern warning to others that no company was “too big to fail.”

Finally, painful yet necessary labor market reforms were implemented to raise productivity and to make Korean exports more competitive. By tackling structural problems head on, rather than engaging in quick fixes, South Korea rebounded quickly to achieve rapid economic growth by late 1998. As outlined below, these measures also played a considerable role in preparing the country to weather the Great Recession of 2008 a decade later.

SURVIVING THE GLOBAL STORM

South Korea’s strong economic fundamentals left it well positioned to cope with the global economic turmoil that erupted in 2008 (Cho 2009). During the period 2005-2007, real GDP grew at 4.75 percent a year on average and the unemployment rate was at 3.5 percent. The current account was healthy and foreign reserves large enough to provide “self-insurance” against sudden stops and panicky de-leveraging. Second, the balance sheets of banks were strong because South Korean financial institutions were not heavily exposed to US mortgage debt and related securitized products. In 2008, Korean banks aggregated non-performing loan ratio was 0.8 percent, compared to 6.0 percent before the Asian financial crisis, and their Basel capital ratios were a respectable 11 percent, up from 7 percent in 1997. Third, the corporate sector was robust. The highly leveraged chaebols of the past were in much stronger financial shape. In 1997, the debt-to-equity ratio of the corporate sector was 426 percent, but in 2008, it stood at 131 percent (Jun-kyu 2010, 10). Fourth, apparently learning the bitter lessons from the Asian crisis, Seoul had built up huge reserves of dollars and euros, including restricting much of its borrowing in the domestic markets. For example, on the eve of the Asian crisis, South Korea’s foreign reserves amounted to only $8.4 billion, but by the end of 2007, they were a robust $260 billion (Park 2009, 1). Fifth, although the South Korean economy remains fundamentally export-dependent, its rapidly expanding intra-regional trade linkages with Asia provided it much greater protection. By diversifying its export markets over the course of a decade, its dependence on trade with the US and Europe declined. Clearly, by all key measures, the economic fundamentals of the Korean economy seemed sound in 2008 (IMF 2008; 2008a; World Bank 2008). Despite these obvious strengths, the spillover from the financial contagion proved more severe than anticipated. The Korean economy contracted by 5.1 percent in the last quarter of 2008 from the previous three months. The capital account recorded a deficit of $42.6 billion in the fourth quarter of 2008, equivalent to 20 percent of GDP. Thus, according to the IMF, South Korea’s was “among the sharpest contractions worldwide.” Why did South Korea experience such an unusually high degree of financial instability despite strong macroeconomic fundamentals, while other Asian economies with comparable fundamentals showed far greater resilience during the height of the financial turbulence? A key factor was Korea’s adoption of open capital account liberalization.

Unlike every other major economy in Asia, South Korea placed almost no restrictions on the purchase and sale of domestic equities by for-
The Difference a Decade Makes

Structural and financial-sector reforms in response to the Asian financial crisis of 1997-98 were significant in South Korea’s resilience in 2008.

Korean banks’ aggregate non-performing loan ratio:
- **6%** in 1997
- **0.8%** in 2008

Korean banks’ Basel capital ratios
- **7%** in 1997
- **11%** in 2008

South Korean corporate sector debt-to-equity ratio:
- **426%** in 1997
- **131%** in 2008

Kang (2009, 4-5) notes that “The Korean financial markets have also been heavily hit by foreign investors’ retreating from their portfolio investment to Korea. In 2008 more than $50 billion of investment flowed outward from Korea. This massive withdrawal occurred in every type of foreign investment: foreign direct investment (FDI), portfolio investment, financial derivatives, and in the category of other investments. In 2008, $225 billion was withdrawn from the Korean financial markets.”

South Korea is the world’s fifth-largest oil importer.
handssets, they later declined due to apprehensions about the US economic slowdown. Indeed, the country's broadest measure of trade (the current account) recorded an annual deficit for the first time in a decade, meaning Korea was spending more on goods, services and investments from overseas than it was selling abroad.

RESPONSE TO THE CRISIS

The South Korean government, including the Bank of Korea, responded aggressively to the crisis through diverse policy instruments. With the onset of the crisis, and especially following the collapse of Lehman Brothers in September 2008, Seoul implemented a fiscal stimulus package equivalent to 1.2 percent of its GDP, totaling some $11 billion. In March 2009, the government announced a 28.9 trillion won supplementary budget (equal to around 3 percent of GDP) to boost the domestic economy. The government's two fiscal packages, including the original budget and supplementary budget, totaled 3.6 percent of GDP — one of the largest fiscal expansions among G-20 countries (IMF 2009a). Moreover, the Korean authorities created a 20 trillion won Bank Recapitalization Fund to help banks to shore up their capital base by purchasing their subordinated bonds, hybrid bonds and preferred stocks. Further, in October 2008, the government announced that it would guarantee banks' external liabilities up to a total of $100 billion (OECD 2008). In order to encourage flows of funds into the money and bond markets, which were reeling under the credit crunch, the central bank widened the scope of eligible securities and eligible financial institution counterparts for its open market operations and provided liquidity (of up to 5 trillion won) to support financial institutions subscribing to its “Bond Market Stabilization Fund.” Last, but not least, to facilitate the supply of credit through banks, the Bank of Korea not only raised its Aggregate Credit Ceiling (from 2.5 trillion won in November 2008 to 9.0 trillion in March 2009), and paid banks interest on their required reserve deposits, it also helped the banking sector build its capital base in order to give banks’ an incentive to lend to businesses, especially small and medium enterprises.

As cross-border lending became tight, especially during the period September-December 2008, Korean banks faced serious difficulty in rolling over their external debt. This forced the central bank to step in with foreign exchange swaps to alleviate the funding pressures and to stabilize the won. Specifically, the central bank put aside $55 billion in foreign exchange reserves to provide as swaps or loans to banks and trade-related businesses (Alp, Elekgad and Lall 2011). In addition, the Bank of Korea entered into swap arrangements with the central banks of its major trading partners. It concluded some $30 billion bilateral swap arrangements with the US Federal Reserve on October 30, 2008; and on December 12, 2008, it entered into a 180 billion yuan/38 trillion won swap arrangement with the Bank of China, in addition to expanding the ceiling of an existing currency arrangement with the Bank of Japan from $3 billion to $20 billion. Finally, the central bank provided foreign currency liquidity totaling some $26.6 billion to domestic financial institutions experiencing difficulties raising foreign capital, and introduced a $10 billion in “Foreign Currency Loans Secured by Export Bills Purchased” in late 2008 to provide financing to domestic small and medium enterprises (OECD 2008).

Cumulatively, these measures helped to limit the impact on Korea’s real economy, in addition to helping the country maintain its international credibility. Government actions brought a measure of stability to the foreign exchange market, especially in late 2008 and early 2009. Indeed, the rollover of external liabilities of South Korean banks improved substantially by end-January 2009. Also, as Alp, Elekgad and Lall (2011, 2), pointed out, the Bank of Korea’s proactive monetary policy — allowing the exchange rate to depreciate as capital flowed out of the country and cutting the policy rate by 325 basis points — reduced the depth of the economic contraction. They correctly note, “Were it not for an inflation-targeting framework underpinned by a flexible exchange rate regime… the actual outcome of a -2.1 percent contraction, the outturn would have been -2.9 percent if the BoK [Bank of Korea] had not implemented countercyclical and discretionary interest rate cuts. Furthermore, had a fixed exchange rate regime been in place... output would have contracted by -7.5 percent… In other words, exchange rate flexibility and the interest rate cuts implemented by the BoK helped substantially soften the impact of the global financial crisis on the Korean economy.”

Nevertheless, given the depth of the crisis, government actions, regardless how ambitious, could not limit all fallout. Despite valiant efforts, between June and October 2008, South Korea’s foreign exchange reserves fell by $46 billion and the won continued to depreciate, falling by about 26 percent in trade-weighted terms between July and November of 2008. As Park and Song (2011, 7) note, “the nominal exchange rate, which had
remained below 1,000 won per US dollar during the first quarter of 2008, began a sharp depreciation in April to reach a high of 1,513 won to the US dollar on November 24. Among the East Asian currencies, the Korean won lost most in value vis-à-vis the US dollar that year. Clearly, given the large volume of bonds held by foreigners, especially the large volume coming up for renewal in the first quarter of 2009, the swap arrangements failed to convince markets about Korea’s ability to service its foreign debt. Thus, although the Korean government’s policy measures helped to soften the negative impact of the crisis, they came at a heavy cost.

LESSONS AND CHALLENGES
Chastened by the 1997-1998 Asian financial crisis, South Korea’s wide-ranging structural and financial sector reforms enabled it to absorb the shocks and to recover far more quickly from the 2008 global crisis than most countries. Yet, as an open export-dependent economy, the country remains highly vulnerable to the potentially destabilizing effects of volatile international capital flows. This explains why accumulating, if not hoarding, foreign currency reserves is seen as an effective “self-insurance” strategy — the first line of defense against externally induced volatility.

No doubt, during the 2008 crisis, countries with sufficient reserves avoided sharp drops in output and consumption. South Korea’s large foreign currency reserves enabled it to stabilize the domestic market by intervening directly in the foreign exchange market, to supply desperately needed dollars to financial institutions and to establish the $30 billion swap-line with the US.

Of course, holding huge reserves is not cost-free for the domestic economy. It also exacerbates the problem of macroeconomic imbalances and the resultant “global savings glut” that US Federal Reserve Board Chairman Ben Bernanke identified as culprit number one in the global crisis. However, what constitutes an adequate level of reserves always varies greatly from country to country, because financial crises impact countries differently. Some experience panicked withdrawal of foreign capital by both foreigners and domestic residents, while others experience a sharp loss of export income. Arguably, given South Korea’s strong economic fundamentals and sound macro-prudential regulations, it could manage with much lower levels of reserves — but that is something that Seoul, in co-operation with international institutions, will have to work out.

Although experience suggests that an economy such as South Korea’s — which is export dependent and has an open capital account — can best protect itself from external shocks by having a flexible exchange rate and continually deepening its foreign exchange markets, the reality is more complex. Although South Korea officially maintains a market-determined exchange rate, the authorities intervened extensively to smooth volatility during the crisis. Excessive intervention, of course, should not become a habit. Korea will be better off by maintaining greater exchange rate flexibility. In the end, strong macroeconomic fundamentals are the best protection against the vagaries of global capitalism.

The road out of the Asian financial crisis — robust growth and demand in the advanced economies — is now filled with many potholes. With the US, Japan and Western Europe reeling from massive de-leveraging, volatile equity prices, high debt burdens, tight credit markets and weakened consumer demand, excessive reliance on external demand is fraught with dangers. Like China, South Korea must decisively rebalance its economy towards domestic demand to reduce its vulnerability to external shocks. However, as the preceding discussion has shown, given that Korean households are already burdened with high levels of debt, and have very low savings, rebalancing in Korea will not be as straightforward as in China. Rather, boosting the incomes of lower income households is a prerequisite for boosting domestic demand. How to do this efficiently is an important challenge for South Korean policymakers.

Finally, the prolonged global economic slowdown, weakening global demand and higher trade barriers in both advanced and emerging market economies will remain a challenge for Korea. Despite achieving double-digit growth in 2010 and 2011, Korea’s exports experienced negative growth in 2012. To overcome these challenges, Korean companies must strengthen their export competitiveness, and Seoul must continue to advance free-trade agreements with its trading partners.

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This is a separate from the existing currency swap already entered into under the Chiang Mai Initiative, set up as a set of bilateral currency swap lines after the 1997-98 financial crisis. Specifically, the initiative was designed to prevent the kind of sudden run on financial assets that wreaked havoc on Asian economies in the late 1990s.