The Korean Financial Crisis – Causes, Effects and Solutions

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The flaws of managed exchange rates and industry policy

Past large scale financial crises such as Mexico in 1995, have resulted from governments defaulting on debt repayments and consequently are widely classified in the economic literature as government failure. In contrast, the Asian financial crisis was a case of private borrowers being unable to repay loans and this has misled many commentators into declaring market failure. This article argues to the contrary, focusing on the government failure which caused the South Korean financial crisis. Adam Smith argued that governments are unable to manage the economy, a prediction confirmed by the Asian financial crisis. Peter Drucker (1989, p.56), citing Adam Smith's *Wealth of Nations* (1776), said

> He [Adam Smith] did not argue that government does a poor job running the economy. He argued that government, by its very nature, *cannot* run the economy, not even poorly. He did not, so to speak, agree that elephants are poorer flyers than swallows. He argued that government, being an elephant, can't fly at all.

The Korean financial crisis arose because of government failure in two major policy areas: exchange rate policy and industry policy. Collectively these government failures had adverse repercussions for the Korean economy. The exchange rate policy failure arose from the government's attempt to peg the Won to the US dollar. When the US dollar appreciated, so too did the Won which, in 1997, was judged by financial markets to be significantly overvalued. The government's implicit guarantee to maintain the fixed exchange rate misled business into believing that foreign exchange risk did not exist. Accordingly, business did not consider the potential increase in the domestic cost of foreign debt which occurred when the Won eventually devalued. As the Won lost value it became increasingly difficult to repay the foreign debt, which resulted in Korean banks and businesses defaulting on loan obligations.

Similarly, the government's industry policy, whereby it, financial institutions and business firms collectively made investment decisions on political rather than economic grounds, resulted in much investment being uneconomic. Accordingly, the Korean financial crisis was caused by the overvalued Won encouraging excessive foreign borrowing and the 'crony capitalism' industry policy investing the loans for uneconomic purposes.

In addition to examining the causes of the Korean financial crisis, the various solutions proposed by governments, central banks and the International Monetary Fund (IMF), and the effects of these government based interventions are analysed. The 1995 Mexican rescue and the 1997 Thai bailout created an expectation that the IMF would bail out South Korean creditors. This largely removed the incentive for lenders to accurately assess the risk of each loan at the time it was made and monitor its performance throughout the life of the loan.

The IMF bailout had adverse effects on South Korean citizens and their economy. With the IMF loan being used to repay foreign lenders, the Korean government let overseas lenders off the hook and shifted the burden of poor investments and loan repayments to its taxpayers. In addition, the IMF insistence on limiting economic growth and cutting government spending without permitting taxes to also be cut is a recipe for recession and rising unemployment.

Debt crisis due to government mismanagement of the exchange rate

Since the South Korean government fixed the Won to the US dollar, when the US dollar appreciated in 1997, it resulted in the Won also appreciating. Since the US dollar

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is a flexible exchange rate, its appreciation was due to millions of individual investors judging its value to have improved. In contrast, the Won appreciated simply because it was arbitrarily fixed to the US dollar. In fact, the underlying economic fundamentals of rapidly declining exports and rising imports indicated that the Won was overvalued. Consequently, the government-managed exchange rate came under strong selling pressure during 1997, resulting in the Won devaluing by up to 95 per cent against the US dollar. The devaluation caused the majority of Korea's foreign currency denominated loans to become uneconomic and borrowing firms to become insolvent.

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Even when it became evident that the Won was overvalued, the government continued to interfere in the foreign exchange market by setting a daily limit whereby trading was not permitted to continue if the Won fell by more than 10 per cent. During several days in December 1997, currency trading ground to a halt within the first few minutes of trade as the Won dropped by its permitted daily limit of 10 per cent. Not only did the government-imposed daily limit maintain an overvalued Won, it also precluded the currency exchange market from obtaining foreign currency.

At this time, short-term debt stood at $US100 billion and daily debt repayment was about $US1 billion. Foreign exchange dealers pointed out that foreign funds were not flowing and despite yields of 26 per cent on three year corporate bonds there were still no foreign buyers for the Won.

Only in the relatively rare situation that a firm's own exports were able to generate the foreign exchange needed to meet its foreign debt repayments could it avoid receivership from the non-payment of its foreign debt commitments as they fell due. Consequently, the government's interference in the Won market could have caused even the most viable firms to fail. If a similar policy had been adopted by other countries, including the US and Germany, then their economies would also have suffered from widespread bankruptcies and recessionary conditions.

At this time the Won currency market had ceased to operate for four consecutive days with no sellers of US dollars for Won. Despite the severe shortage of foreign currency, the government squandered its first tranche of nearly $US6 billion from the IMF in a futile attempt to maintain the overvalued Won by exchanging precious foreign currency for Won. Finally the government realised that the overvalued Won was unsustainable and it was floated in mid-December 1997.

The government's mismanagement of the Won's exchange rate was a major cause of Korea's bad loans. When the Won was floated, it caused the Won cost for the repayment of overseas debt to significantly increase. This debt became much larger than the original borrowing due to the inevitable devaluation of the overvalued Won.

For example, if the government-determined exchange rate was 1000 Won/US$ but the true market value was 1500 Won/US$, a firm wishing to invest 1 billion Won would borrow $US1 million at the managed exchange rate. The overvalued exchange rate caused firms to borrow more US$ than they would have if the Won had been floated, since at the market rate 1 billion Won would have been equivalent to a smaller $US670 000 loan. When the Won inevitably fell to the market value of 1500 Won/US$, the $US1 million debt became a far larger 1.5 billion Won repayment. Due to government intervention, the firm borrowed 1 billion Won but had to repay 1.5 billion Won. It is likely that the 50 per cent increase in debt would have rendered most firms' investments unprofitable since very few projects can sustain an increase in costs of this magnitude.

Had the Won been floated several years earlier, the firm would have borrowed 1 billion Won, which would have equalled $US670 000. When the loan was due for repayment several years later, under a floating exchange rate the firm would have been required to pay

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approximately $US670 000 at a cost of 1 billion Won. At any point in time, a floating exchange rate represents the market's best estimate of its value and consequently a large depreciation is unlikely. However, borrowers can protect against this risk by a forward exchange contract to 'lock in' a repayment rate equal to the rate at the time of borrowing. Consequently, under a floating exchange rate it is likely that the amount borrowed would be close to the amount repaid.

Foreign exchange risk

The government's management of the Won's exchange rate misled business into believing that foreign exchange risk did not exist. Consequently, business did not consider the risk of the Won devaluing and thereby significantly increasing the domestic repayment value of the foreign debt. Despite the widespread belief that foreign exchange risk does not exist under fixed exchange rate regimes, it is not possible for any country, no matter how large, to have foreign currency reserves sufficient to indefinitely maintain an overvalued fixed exchange rate. With any overvalued asset, the asset owner will rationally choose to sell it to earn a profit. Similarly, investors chose to exchange the overvalued won for foreign currency. This resulted in the Korean central bank's reserves of foreign currency being depleted to the point that maintaining the overvalued Won was unsustainable. The only choices then were the cessation of all foreign transactions or devaluation.

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The government's implicit guarantee of the managed exchange rate deterred foreign exchange risk protection such as hedging. Had borrowers taken into account the ultimate devaluation of the Won, which significantly increased the domestic repayment cost of borrowing overseas funds, much investment would have been recognized as unprofitable and hence South Korea's bad loan problem could have been avoided.

Corporate collapses due to excessive interest rates

A consequence of the government's attempt to maintain the overvalued exchange rate was that Korean interest rates became cripplingly high. In early December 1997 prior to the floating of the Won, the benchmark three year corporate bond yield reached 26 percent, the highest in 15 years. While domestic interest rates were extremely high, the overvalued Won caused the effective yield to foreigners to be much lower. In addition, the exchange rate risk of a devaluation of the Won required even higher domestic interest rates to persuade foreigners to supply foreign currency. Had the government not pegged the Won but allowed it to float several years earlier, then interest rates would not have reached this excessive level. Since the overvalued Won significantly increased the cost to foreigners lending or investing in Korea, then interest rates had to rise to very high levels in order to attract funds from foreigners. The higher interest rates resulting from the government's exchange rate policy imposed an intolerable burden on corporate Korea, causing a string of corporate collapses.

Domestic moral hazard

It is possible, due to Korean business practices, that even if the exchange rate for the Won had been determined by market forces some years earlier, and hence not have become overvalued, the Korean financial crisis may still have occurred. A major cause of the crisis was the government requiring loans to be made on political rather than economic grounds, and consequently much investment was unable to generate cash flows to meet debt repayment requirements.

The excessive involvement of the government in Korea's banking industry, whereby banks frequently made loans on a political rather than commercially prudent basis, created a moral hazard problem. Banks operated on the implicit assumption that if they made loans in accordance with the government's wishes then the government would rescue them if the loans became bad. This expectation led to a self-fulfilling prophecy. The greater the involvement of the government, the bigger the moral hazard problem whereby lending decisions did not reflect commercial risks.

The big conglomerates (Chaebols) received political favours from the government which resulted in preferential treatment from the banks. At best the government involvement was an inappropriate industry policy attempting to pick winners, but the absence of arms length commercial analysis resulted in bad loans when the economic downturn hit South Korea. During 1997 seven conglomerates either went bankrupt or obtained bank protection. To the extent corruption existed, the likelihood of bad loans was even greater.

'Greed is good'

Korea Inc consisted of strong relationships between politicians, bureaucrats, banks and Chaebols. It was based on government instruction to the banks to lend to Chaebols. This industrial policy of managed capitalism, first employed by Japan, was said to be the strength of the Asian tigers including Korea. It was claimed to be superior to the self-interest of the market. Instead of business decisions reflecting greed, the public was misled into believing the government's wise men would make decisions for the best interests of society. However, self-interest prevails in both markets and governments, but governments bestow enormous power and thereby provide the opportunity for corruption. In contrast, in competitive markets the power of individual firms is minor and therefore the opportunity for corruption is trivial. By replacing the market with government decisionmaking, crony capitalism involving interdependent relationships between government, business and the financial sector was established. Based on kickbacks and other payoffs, political corruption thereby spread to financial markets.

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If the government had not been involved with business, particularly the Chaebols, then businesses would have been motivated to incur loans only if they were convinced that the cash flows from investments would be sufficient to repay the debt. The combined effect of government directed lending and investment, and the government's interference in the Won's exchange rate largely caused Korea's financial crisis.

The undesirability of government-funded bailouts

In addition to the government causing Korea's financial crisis, the government's solution of accepting the International Monetary Fund bailout was contrary to the interest of Korean citizens. When private firms takeover or invest in banks, other financial institutions and business firms, they are risking their own (shareholders') funds and they suffer the consequences of poor investment decisions. Consequently, they are motivated to ensure that the return on investment is appropriate given the risk. The ultimate market sanction for poor management is their replacement and the firm itself may be liquidated or subject to takeover. Given the severe repercussions of poor investment decisions, management have strong incentives to ensure that private sector bailouts are worthwhile. Consequently, market incentives are such as to ensure an optimal allocation of society's scarce resources.

In contrast, there are three major undesirable consequences which result from government-funded bailouts by organisations such as the IMF, World Bank and Asian Development Bank. These are the removal of market discipline; the nationalisation of private debt; and the strings attached to bailouts.

Removal of market discipline

When a government-funded bailout occurs, it removes lenders' motivation to monitor the activities of borrowers. Monitoring is desirable because it pressures borrowers to efficiently manage the investment in order to service the loan. Government-funded bailouts replace market discipline with government officials who lack the survival incentives of the market since their job security is not tied to the performance of the loan.

Prior to the involvement of the IMF, the loan problem was constrained to Korean borrowers and international lenders.

> The IMF involvement in the Thai crisis resulted in the strengthening of expectations of further IMF bailouts. Consequently, the IMF created a strong contagion effect whereby having rescued the Thai creditors, it greatly increased the expectation that the creditors of other countries would also be rescued. This occurred with South Korea, Indonesia and more recently Russia and Brazil. (Black and Black 1999)

The lenders consisted of overseas banks who supplied finance to Korean financial institutions which largely on-lent to private firms. Private borrowers then invested in highly risky ventures including property development. In the absence of government-funded bailouts, the usual recourse available to lenders when borrowers default is to take possession of the security supporting the loan. The lender can either sell the asset or appoint a receiver/manager to operate the asset, for example collection of rental income in the case of property. Loan contracts thereby motivate both borrowers and lenders to monitor the performance of the loan, since potentially large costs can be incurred in the event of default. Default results in lenders either becoming the asset manager or arranging for a new owner to substitute for the borrower. This market determined outcome results in the replacement of inefficient borrowers with superior, competitively chosen owners/managers. This potential ex-post settling-up provides both borrowers and lenders with strong incentives to accurately assess the risk of each loan at the time it is made, and monitor its performance throughout the life of the loan. Hence, the government-funded bailout destroys this optimal market-determined monitoring process by allowing inefficient management to continue managing the investment.

Nationalisation of private debt

The IMF loan can be described as a bailout since it results in private lenders and borrowers avoiding incurring the costs of their loan decisions. With the IMF loan being used to repay foreign lenders, the Korean government has let overseas lenders off the hook and shifted the burden of poor investments and loan repayments to its citizens. From the viewpoint of its citizens, turning down the IMF loan and leaving the loan problem with overseas lenders and Korean borrowers is superior.

Transferring private debt to government debt imposes the IMF repayment obligations onto taxpayers. Although taxpayers did not share in the high returns earned during boom periods, they are being forced to participate in the losses. When the IMF loans fall due, the South Korean citizens will face a rising tax burden which will have a contractionary effect on the economy. These higher taxes, which can be expected to continue for many years into the future, are effectively a 'sleeper', ignored by Korean decision makers.

Strings attached to the IMF 'solution'

Typically, IMF loans have strings attached in the form of fiscal and other constraints on the economy. This standard formula may have been appropriate in the case of Mexico because the crisis was caused by government budgetary deficits. However, this 'one size fits all' formula is inappropriate for Thailand, Indonesia and Korea because their financial crisis is not fiscal but one of uneconomic private sector loans.

Further, the IMF insisted on Korea's economic growth being only 2·5 per cent in 1998, the lowest economic expansion in 18 years, and rejected the Finance Minister's request for almost 5 per cent growth. Eventually Korea agreed to set its GDP growth rate at 3 per cent which motivated some of Korea's largest firms to restructure in response to the drastically reduced growth rate. The government predicted that unemployment would rise from 2·4 per cent to 7 per cent as a consequence. The IMF insistence on cutting government spending without permitting taxes to also be cut is a recipe for a recession and rising unemployment. It will also cause the failure of loans which could have been serviced if the economy had not been forced to contract. It is instructive that a Heritage Foundation study shows that half of the 89 developing countries which borrowed from the IMF between 1965 and 1995 are not better off today.

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Moral hazard of IMF bailouts

From the viewpoint of overseas investors and creditors, such as the large international banks, the IMF loans to Korea are highly desirable as they result in them avoiding losses from bad loans to Korean banks and businesses. The expectation of such a bailout created a moral hazard problem, whereby overseas lenders were not motivated to ensure that loans were made only for commercially viable investment. Ironically, proponents of the IMF bailout, including US Treasury Secretary Robert Rubin and IMF managing director Michel Camdessus, agree that having investors lose money if they make poor decisions is an important incentive to ensure that markets work effectively. It is likely that the earlier IMF bailout of Mexican creditors caused some uneconomic high risk lending to Asian countries, including Korea. The IMF bailout of Korea's overseas creditors only reinforces moral hazard behaviour by removing the downside risk of investment. In the absence of IMF bailouts, lenders have an incentive, at the time of deciding whether or not to grant the loan, to ensure that the potential investment is able to generate sufficient cashflows to fully service the loan.

The way forward

Korea has a choice – continue to receive IMF funds which will bail out overseas lenders/investors and thereby shift the burden of those loans which financed uneconomic investments to citizens of Korea, who then become responsible for the repayment of the IMF loans, or refuse to accept anymore IMF money.

If Korea does not incur any further IMF debt, then foreign creditors would not be 'let off the hook'. Instead they would cause insolvent Korean businesses, including some Chaebols to default on their overseas loans. Whilst the overseas creditors would be unlikely to receive full repayment of their debts, they would become the owner of those businesses. They could either operate these businesses as owners, in an effort to make them profitable and thereby able to repay their loans, or they could sell them to new owners. Either way the ultimate owners would have strong incentives to operate the businesses efficiently. No longer would government interference in these businesses result in poor decisions and inefficiency. To allow this to happen, the government must repeal its foreign ownership restrictions and thereby allow worldwide competition for the ownership and management of its businesses to occur. Failure to do so will result in 'business as usual' and the burden of the inefficiency of Korean businesses will be borne by Korean citizens.

The only way to prevent further government failure in the South Korean financial market is to remove the government from the market place. Just as elephants cannot fly, not even badly, the government cannot manage exchange rates or the economy, or 'pick winners'.

Conclusion

This article argues that the cause of the Korean financial crisis was twofold: the fixing of the Won to the US dollar and political interference in lending decisions. The solution requires the floating of the Won without any government attempts to interfere in its value either directly by buying and selling the Won or indirectly through interest rate policy, particularly high interest rates to prop up the Won's value. In addition, the government's industry policy needs to change to a hands off policy whereby private firms are motivated to invest and obtain finance on commercial grounds so that it is economically beneficial. *Policy*

References

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