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The Korean Economic Crisis
What Can We Learn From It?

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Recent Developments

Just like many other crises, the Korean currency crisis came suddenly. In mid-November 1997, headlines in the Korean press consisted mostly of presidential election stories. At that time the presidential race was very close; the Grand National Party candidate, Lee Hoi-Chang, was making a dramatic comeback, while the National Congress for New Politics candidate, Kim Dae-jung, was making his best effort to maintain his narrow lead. Thus, when President Kim Young Sam announced on November 19 his decision to fire key economic policy-makers on the grounds of mismanaging the economy, most Koreans were surprised at the news and questioned the president's motivation. Two days later they were completely shocked to learn that the Korean government was asking the International Monetary Fund (IMF) for emergency standby loans because the Korean foreign reserve level was very low at $7.3 billion and most foreign financial institutions were unwilling to roll over their short-term loans to Korea.

Due to the urgency of the situation, the IMF loan was processed quickly and the Korean government had to accept virtually all the conditions of standby loans set by the IMF, including a rise in interest rates to a level as high as 30 percent per annum. Korean newspapers, which had until then paid little attention to economic issues, allocated most of their space to news of the currency crisis. The IMF became a household word, symbolizing economic difficulties and national disgrace. Because many Koreans felt that Korea had lost its economic sovereignty under the standby loan agreement, Korean newspapers designated December 3, when the agreement was reached between the Korean government and the IMF, the "day of national disgrace." Obviously, the Korean public was very angry with the Kim Young Sam government for having failed to prevent the crisis. Because of this, the currency crisis contributed greatly to the defeat of the ruling party in the presidential election held on December 18, despite the fact that the campaign theme of Lee Hoi-Chang, the ruling party candidate, was his independence of the incumbent president, Kim Young Sam.

To calm the currency market, the IMF and the Korean government announced on December 3 a loan package of $57 billion, consisting of $21 billion from the IMF, $10 billion from the World Bank, $4 billion from the Asian Development Bank, and the rest from bilateral sources such as Japan ($10 billion) and the United States ($5 billion). On December 5 the IMF board approved a standby loan of $21 billion to Korea, and the first installment of $5.5 billion was transferred to Korea the same day. Because the crisis occurred in the middle of the presidential election campaign, the IMF made a very unusual request for a written endorsement of the IMF program from the three major presidential candidates and got it. Even with these measures, however, the currency crisis continued; the exchange rate jumped from 900 won to 1,900 won per U.S. dollar, mainly due to uncertainties over the results of the presidential election.

The IMF-supported program, which followed the pattern of similar programs in other countries such as Thailand and Indonesia, consisted of the following far-reaching measures:

1. A more flexible exchange rate policy was immediately implemented as the limit on daily changes was eliminated.

2. Monetary policy was also tightened and the call rate was immediately raised from 12.5 percent to 21 percent.

3. The operation of fourteen insolvent merchant banks was suspended, two commercial banks were placed under supervision, and other financial institutions were requested to submit plans for capital restorations needed to meet the Basle standards.

4. Tightened fiscal measures amounting to about 1.5 percent of GDP were promised at the same time, including such measures as an increase in special excises and transportation taxes, widening the VAT and income tax base, and reductions in corporate support and capital investment expenditures.

5. The National Assembly passed a revised Bank of Korea act, which provides for the independence of the central bank, and a bill to consolidate supervision of all financial institutions.

6. In the corporate sector, improvements were promised regarding the transparency of balance sheets through the enforcement of independent external audits, full disclosure, and consolidated statements for conglomerates.

7. Measures to improve labor market flexibility, including enlarging the scope for layoffs, were incorporated in the subsequent revision of labor laws.

8. Finally, measures to liberalize capital account transactions and remove trade restrictions were recommended for early implementation.

As one can easily guess from its extensive coverage and depth, the IMF-supported program immediately had a drastic impact on the Korean economy. Although the IMF support helped restore the international financial community’s confidence in Korea, devaluation and high domestic interest rates have generated an unfortunate sequence of recession and high inflation. As banks became more reluctant to provide new loans to firms in order to meet their Basle requirements, the number of bankrupt firms jumped from one thousand to three thousand per month and the number of unemployed also increased sharply, from 0.5 million to 1.3 million. Consumer prices rose from an annual rate of 4.5 percent in 1997 to almost 20 percent during the first two months of 1998, reflecting the impact of the recent rapid depreciation of the Korean won (See Table 1).

Table 1. Recent Economic Trends in Korea

	Unemployed (per thousand persons)	Unemployment Rate	No. of Bankrupt Companies	Ratio of Bankruptcy (%)	Monthly Increase Rate of Consumer Prices
September 1997	469	2.2	1,235	0.31	0.5
October 1997	451	2.1	1,435	0.43	0.0
November 1997	574	2.6	1,469	0.38	0.1
December 1997	658	3.1	3,197	1.49	2.5
January 1998	934	4.5	3,323	0.53	2.4
February 1998	1,235	5.9	3,377	0.62	1.7

Source: The Bank of Korea

Having won the election by a narrow margin, president-elect Kim Dae-jung moved quickly to restore international confidence in the Korean economy. Although during the campaign he mentioned the possibility of a renegotiation with the IMF, immediately after being elected Kim Dae-jung announced that he would comply fully with all the conditions the Kim Young Sam government agreed to with the IMF. He also participated in all the decision-making processes on crisis management and met most foreign dignitaries visiting Korea, including David Lipton, U.S. under secretary of the Treasury, Michel Camdessus, the managing director of the IMF, and well-known international investor George Soros. The president-elect formed the Emergency Economic Measures Committee, which supervised daily crisis management in consultation with the economic team of the Kim Young Sam government. Furthermore, he formed a tripartite committee of business, labor, and government from which consensus on the need for labor market flexibility was derived. The National Assembly was able to pass the pending reform bills on the financial sector and the labor market without much difficulty because opposition to these bills had been virtually eliminated due to the sense of urgency felt at the time by the general public. The first tangible outcome of these efforts was the agreement between the Korean government and international lenders on January 30, 1998, in New York to convert financial institutions' short-term debts of $24 billion into one- to three-year term debts at an average interest rate of 8.2 percent, i.e. LIBOR plus 2.50, with a guarantee by the Korean government. This agreement, although criticized by some for being too advantageous for foreign lenders, has contributed a great deal to stabilizing the exchange market and, to a lesser extent, domestic capital markets. The Korean Stock Price Index has recovered to a level of 550, slightly higher than the pre-crisis level, and the exchange rate of the Korean won against the U.S. dollar has gradually come down and in late April 1998 was around 1,400. Domestic interest rates, however, remain at around 18 percent, three times higher than the international level (See Figure 1).

Although recent developments have led to some optimism regarding the future of the Korean economy, uncertainties remain for the following reasons:

1. Unless the exchange rate and interest rates come down further in the near future, a vicious cycle of high inflation, high interest rates, and recession may become permanently embedded in the Korean economic structure.

2. The political leadership of the present regime may be challenged by discontent workers and citizens if the present rates of unemployment and inflation continue. The situation may worsen if the president is unable to obtain sufficient cooperation from the opposition party with the majority in the National Assembly.

3. Pressure for further market openings and eventual takeover of prominent Korean enterprises by foreign investors may provoke xenophobic sentiment among Koreans.

4. If the Japanese economy deteriorates to a level of crisis, Korea's recovery efforts will prove futile.

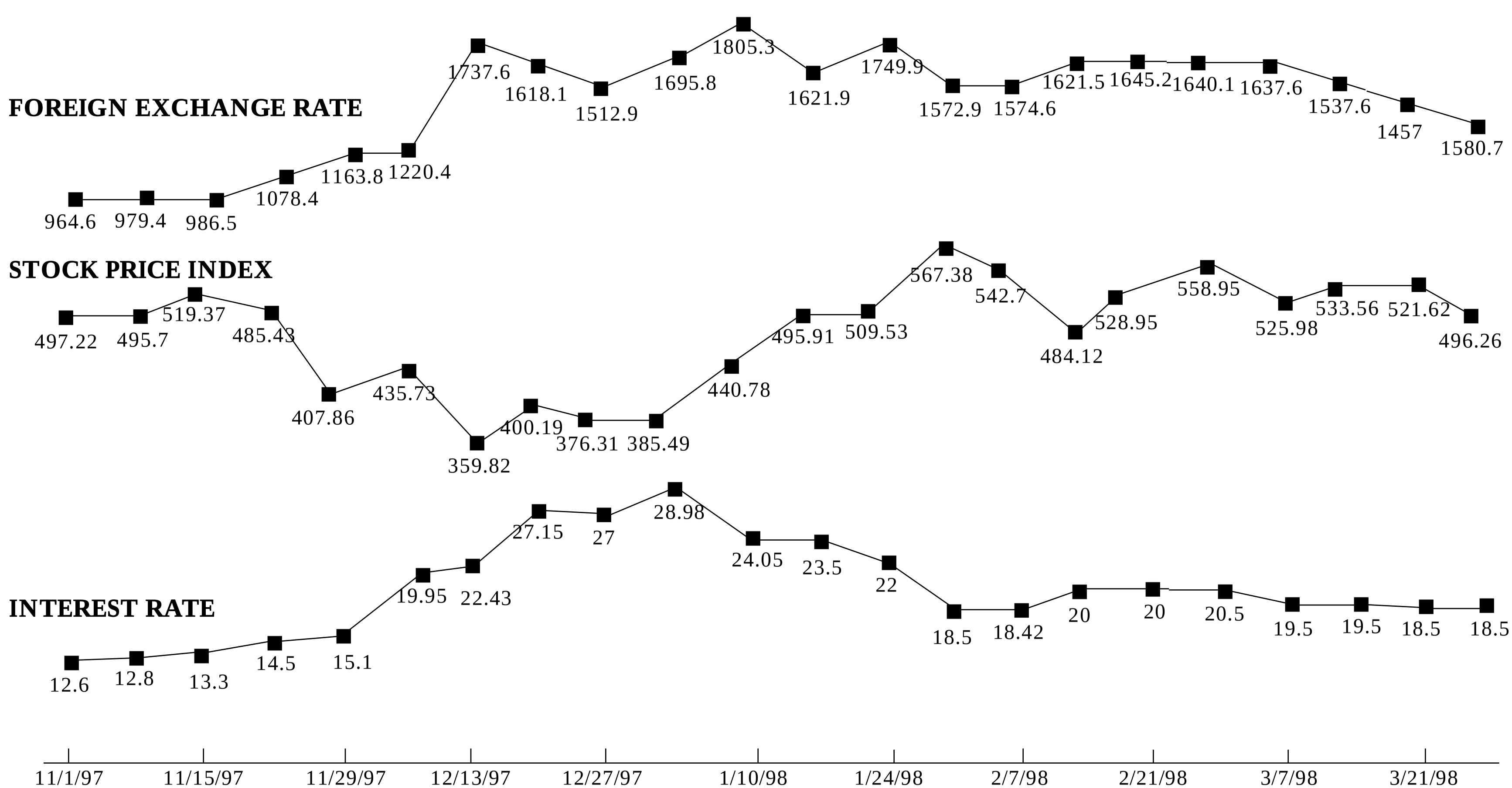
Clearly, it will take some time before we know for sure whether Korea has succeeded in overcoming the recent economic crisis. This paper will examine the following set of issues, which interest not only Korean policy-makers but the international development economics community as well:

1. The crisis came suddenly, when macroeconomic conditions in Korea were sound and somewhat improving. Thus, one wonders why and how Korea got into the recent crisis.

2. Given critiques of the adequacy of IMF-sponsored programs, what should the proper policy be for Korea and other countries in similar situations?

3. Korea has often been cited as a success story, even a miracle story, in the literature of development economics. Thus, the crisis leads us to ask, What happened to the Korean model of success?

Figure 1. Exchange Rate, Stock Price Index, and Interest Rate



Crisis Despite Sound Macroeconomic Management?

When a currency crisis hits a country, imprudent macroeconomic policies are usually cited as a main culprit. In Latin America, many of whose countries experienced an economic crisis during the last two decades, high levels of government deficits, inflation, and debt/GNP ratio appeared as the inevitable outcome of irresponsible macroeconomic management. In the case of Korea, however, there is no such evidence. As shown in Table 2, Korea's major economic indicators showed reasonably sound trends in recent years. For example, the rate of inflation stayed at 5 percent per annum, the government budget scored a slight surplus since 1993, and current account deficits, after a surge in 1996, dropped to U.S.$8.9 billion in 1997, a level less than 2 percent of GDP. Furthermore, the domestic savings rate remained at a very high level of 38 percent of GDP and foreign debts as a percentage of GDP were maintained at 25 percent in 1997, a level much lower than the 47 percent of Indonesia, 54 percent of the Philippines, and 46 percent of Thailand (See Table 3).

If one looks closely at these figures, however, it is possible to point out some weakness. For example, when the Japanese yen became weaker in late 1995, the Korean monetary authority adhered to a strong won policy despite market pressures for devaluation because they were very concerned about price stability. As a result, current account deficits surged to U.S.$ 23.7 billion in 1996. Nevertheless, this failure to fine-tune the exchange rate policy cannot be blamed for causing the currency crisis in late 1997, because the situation turned around in 1997 when the Japanese yen became strong again. As shown in Figure 2, the real exchange rate of the Korean won was maintained at a reasonable level at the time of the currency crisis in late 1997. Thus, one should look elsewhere for a villain in the crisis-making process.

Excessive Reliance on Short-term Foreign Borrowings

There is general consensus among economists that excessive reliance on short-term foreign borrowings was a main cause for the current currency crisis in Korea. As shown in Table 4, since 1993 there has been a surge in foreign borrowings, particularly short-term borrowings, amounting to almost 60 percent of the total foreign debt at the time of crisis in November 1997. A steady increase in current account deficits and an inflow of foreign capital due to capital liberalization measures and a huge gap between domestic and international interest rates were mainly responsible for the sudden rise in foreign debts in recent years. Particularly, current account deficits of U.S.$23.7 billion led to a corresponding surge in foreign debts. The recent increase in short-term borrowings is due to the fact that it is easier as well as cheaper to borrow in the short term, because lenders have the option not to roll over whenever they see more risks. Thus, many Korean firms and financial institutions preferred short-term borrowings and put them into long-term investments. When a crisis occurred in Thailand and Indonesia, foreign lenders suddenly decided not to roll over their short-term liabilities, paving the way for the currency crisis. It is rather surprising to note that the Korean government actually encouraged short-term borrowings by lowering mandatory requirement ratios of medium and long-term borrowings for financial institutions.

The Korean case and the experience of other countries have generated a debate over the usefulness of short-term capital flows in developing countries. For example, Lawrence

Table 2. Macro Indicators of Korea

	1992	1993	1994	1995	1996	1997
GDP Growth Rate (%)	5.1	5.8	8.6	8.9	7.1	5.9
CPI Increase (%)	6.3	4.8	6.2	4.5	4.9	4.5
Budget Balance (% of GDP)	-0.7	0.3	0.5	0.4	0.3	0.3
Current Account (% of GDP)	-1.5	0.1	-1.2	-2.0	-4.9	-2.0
Domestic Savings (% of GDP)	35.0	35.3	36.3	37.3	37.4	36.4

Source: The Bank of Korea

Table 3. Comparisons of Major Indicators in the Troubled Countries

	Indonesia (1996)	Thailand (1996)	Mexico (1994)	Korea (Septemb-er 1997)
Foreign Debt (% of GDP)	47	46	35	25
Current Account (% of GDP)	-3.7	-7.7	-7.8	-4.1
Budget Balance (% of GDP)	-2.4	2.9	-0.7	0.3
Domestic Savings (% of GDP)	29	36	15	39
Foreign Reserve (% of short-term debt)	73	109	20	46
Foreign Reserves (import covered months)	4.4	6.6	1.0	2.4

Source: The Bank of Korea, The Economist *(August 24, 1996)*

Figure 2. Real Exchange Rates

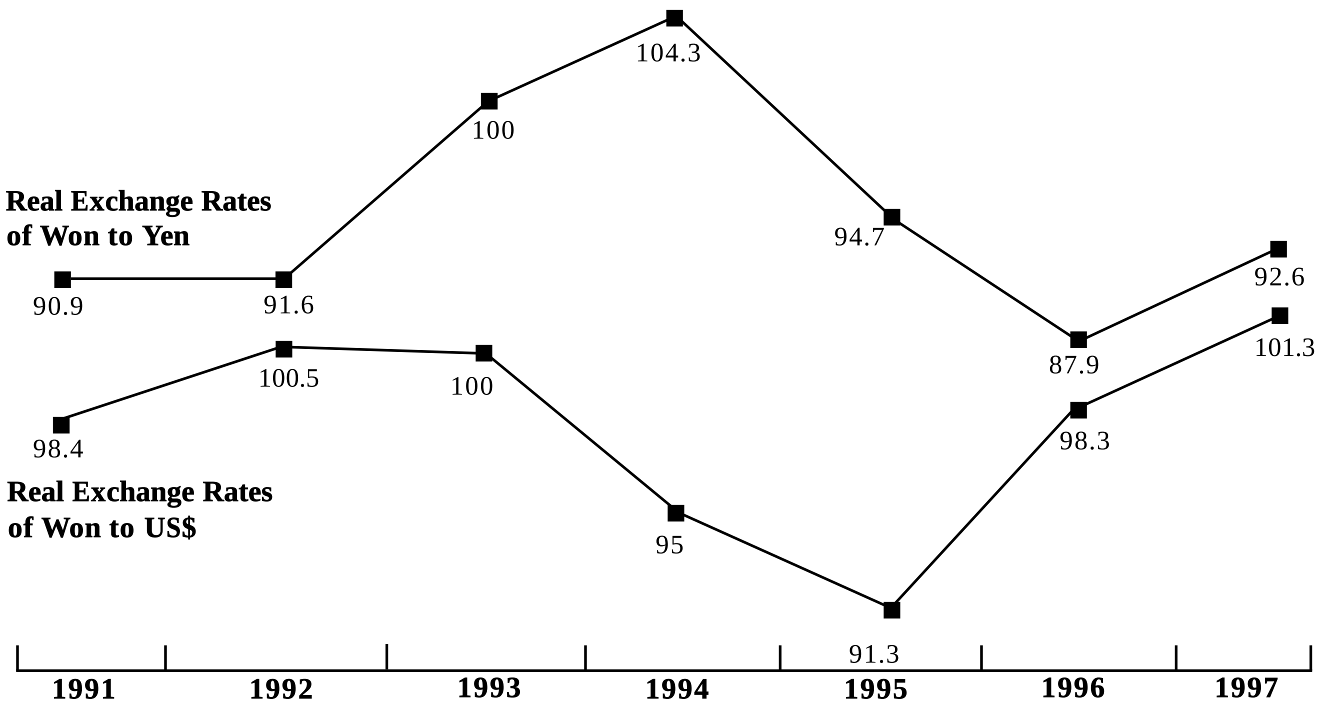


Table 4. Total External Liabilities (in billions)

	1993	1994	1995	1996	Nov. 1997	1997
Total External Debt	**43.9**	**56.9**	**78.4**	**104.7**	**161.8**	**154.4**
Mid & Long-Term External Debt	24.7	26.5	33.1	43.7	72.9	86.0
—Financial Institutions	13.0	13.9	19.6	27.7	53.2	50.4
—Private Enterprises	7.9	9.0	10.5	13.6	17.6	17.6
—Public Sector	3.8	3.6	3.0	2.4	2.0	18.0
Short-Term External Debt (as % of total)	19.2 (43.7)	30.4 (53.4)	45.3 (57.7)	61.0 (58.2)	88.9 (54.9)	68.4 (44.3)
—Financial Institutions	11.4	19.4	29.7	39.0	63.1	43.8
—Private & Non-Financial Sector	7.8	11.0	15.6	22.0	25.8	24.6

Source: The Bank of Korea

Summers, the U.S. deputy treasury secretary, argues that the emergence of modern financial markets is similar to the invention of the jet airplane. "We can go where we want to go much more quickly, we can get there more comfortably, more cheaply, and most of the time more safely, but the crashes, when they occur, are that much more spectacular."[1] On the other hand, Joseph Stiglitz, chief economist at the World Bank, depicts small open economies as rowboats on a wild and open sea. "Their chances of being broadsided by a wave are significant no matter how well they are steered and no matter how seaworthy they are."[2] Clearly, there is a need to place some restrictions on capital flows, particularly the most volatile and pernicious short-term ones. Chile's requirement that 30 percent of all non-equity capital entering Chile be deposited without interest at the central bank for one year has been named as a possible policy option. The extent to which short-term capital flows are destabilizing depends on the strength of the country's domestic financial system and the existence of effective supervision channels. Given the series of financial crises, it is important that such international financial institutions as the IMF and the World Bank devise an effective way of minimizing the destabilizing effects of short-term capital movements.

The Bankruptcy of Hanbo Group and Its Damaging Impacts

The next immediate cause of the crisis in Korea was the bankruptcy of the Hanbo Group in January 1997. Hanbo, which started as a construction company, invested heavily in steel operations relying mainly on borrowings from Korean banks. While Hanbo was making a huge capital investment in steel, the world steel industry went into recession. A combination of large debt and recession drove Hanbo to the brink of bankruptcy as early as mid-1996, but creditors tried to save Hanbo through a series of emergency loans. By the time Hanbo filed for bankruptcy in early January 1997, its debt amounted to 5 trillion won.

Given the Hanbo Group's involvement in a bribery case in 1989–91, many suspected that political lobbying activities by Hanbo chairman Chung Tae-Soo were the main reason Korean banks gave Hanbo Steel such a huge line of credit. After President Kim Young Sam ordered the public procurator's office to investigate the Hanbo case, a political scandal erupted. In the investigation process more than a dozen influential politicians from both the ruling and opposition parties were implicated in bribery and influence peddling; even the incumbent president's son, Kim Hyun Chul, was arrested on these grounds. President Kim's authority was seriously tarnished in the process, resulting in ineffective political leadership in a period when strong leadership was required to cope with an emerging currency crisis.

The Hanbo scandal also destroyed the myth in Korea that large conglomerates could never be brought down. Financial institutions were in fact hostages to their large loan commitments. Rumors of financial difficulties caused merchant banks to recover their loans to other conglomerates. A series of bankruptcy cases followed Hanbo: Sammi in March, Jinro in April, and Daenong in May. Then came Kia in July. Kia, the seventh largest conglomerate in Korea, is one of the major automobile producers, with a good international reputation. Thus, when Kia declared bankruptcy in July 1997, the crisis was further worsened. The indecisiveness of the Korean government, also an outcome of the Hanbo scandal, aggravated the problem. The economic team insisted that the market mechanism be

[1] Lawrence Summers, "Of take-offs and tempests," *The Economist*, 14 March 1998.

[2] Joseph Stiglitz, "Boots, Planes, and Capital Flows," *The Financial Times*, 25 March 1998.

relied on to solve the Kia problem, while the management and labor unions of Kia blamed the economic team for instigating a conspiracy to turn Kia over to the Samsung Group. Three months went by before the government made a decision to place Kia in receivership and turn it into a state-owned enterprise by converting government loans into equity. But enough damage had been done. In October foreign banks started to call in loans and stop rolling them over.

The most damaging aspect of the Hanbo scandal was that it vividly revealed many weaknesses of the Korean economic system to the international financial community, such as excessive reliance on bank borrowing by conglomerates, political collusion between conglomerates and politicians, lack of transparency in business accounts, and ineffective bank supervisory mechanisms. Altogether eleven conglomerates failed in 1997. These corporate failures were a result of the tendency by these firms to diversify their businesses recklessly with borrowed funds, thus resulting in high debt/equity ratios (See Table 5). As their financial accounts were nontransparent, their performance was not actively monitored by the market. Furthermore, many of the conglomerate firms were protected from competition through effective political lobbying and restrictions on mergers and acquisitions. Korea lacked an effective corporate governance system. The problem was worsened by the backward banking sector, which tended to make its lending decisions on the basis of two factors, collateral and favoritism and outside pressures. This was an outcome of many years of government-directed banking. The Korean government had tried to change this practice but failed to achieve any tangible results due to ineffective political leadership and resistance by interest groups.

Table 5. Financial Status of Bankrupt Companies (1996)

	Sales	Debt	Capital	Ratio (%)
Hanbo*	332	4,246	224	1,895
Sammi	1,492	2,593	-77	—
Jinro	1,482	3,895	45	8,655
Daenong	1,365	1,833	-75	—
Kia	12,098	11,890	2,271	523
Total/Average of 30 Major Companies	355,618	271,692	69,898	388

* as of June 1996

Source: The Bank of Korea

Deterioration in the Competitive Position of Korea

If the fundamentals of the economy had remained sound, as in the case of Singapore and Taiwan, a few mistakes by policy-makers would not have led Korea to a crisis. The competitive position of the Korean economy has gradually deteriorated during the last ten years, as indicated by a steady rise in current account deficits and external debts. To tell this part of the story, we have to go back to 1987 and the beginning of the rapid democratization process that began with the June 29 declaration of democratization by Roh Tae Woo, the chairman of the ruling party who became president of Korea in 1988. The declaration triggered serious labor unrest and nominal wages jumped at rates far exceeding gains in labor productivity. For example, during the period 1985–95 unit labor cost in manufacturing increased by 46.0 percent in Korea, while the corresponding figures were 22.1 percent in Japan, 25.1 percent in Taiwan, and 4.4 percent in the United States (See Table 6). The situation became worse because other Asian countries such as China, Thailand, Malaysia, and Indonesia adopted an export-oriented economic strategy and became very successful in their endeavors. In a way, Korea was sandwiched between the developed countries, with their superior technological base, and the newly industrializing countries, with their very low wages.

Under these circumstances Korea should have made more efforts to upgrade its economic structure through investments in technology and human resource development and deregulation reforms in the government and financial sector. Furthermore, Korean firms should have been more careful in large investment decisions, while making more efforts to improve productivity. Due to the deterioration of Korea's competitive position in the world market, many investment projects became unprofitable and the financial position of many Korean firms gradually deteriorated, thus setting the stage for the current crisis.

Table 6. Comparisons of Manufacturing Unit Labor Cost

	Korea	Taiwan	Japan	USA	Canada	France
1985	100	100	100	100	100	100
1990	134	118	115	100	98	107
1995	146	125	122	104	103	112

Source: Samsung Economic Research Institute (SERI)

Crisis in Thailand and Indonesia

The currency crises in Thailand and Indonesia, which occurred in August and October 1997, respectively, generated a panic in the international financial community with regard to their operations in Asia. The Korean won as well as the Hong Kong dollar and the New Taiwan Dollar began to feel pressure in early October (See Figure 3). Instead of letting the won float, the Korean government tried to defend it by spending approximately U.S.$15.1 billion in October and November. Korea's liquid foreign reserve, which was $22.4 billion in early October, dropped to a paltry $7.3 billion. While Hong Kong and Taiwan were able to defend their currencies with their large reserves, Korea failed to defend the won. With its reserve depleted and no prospects for new borrowings, Korea had to ask for an IMF bailout on November 21. Thus, the crises in Thailand and Indonesia had a direct bearing on the recent developments in Korea.

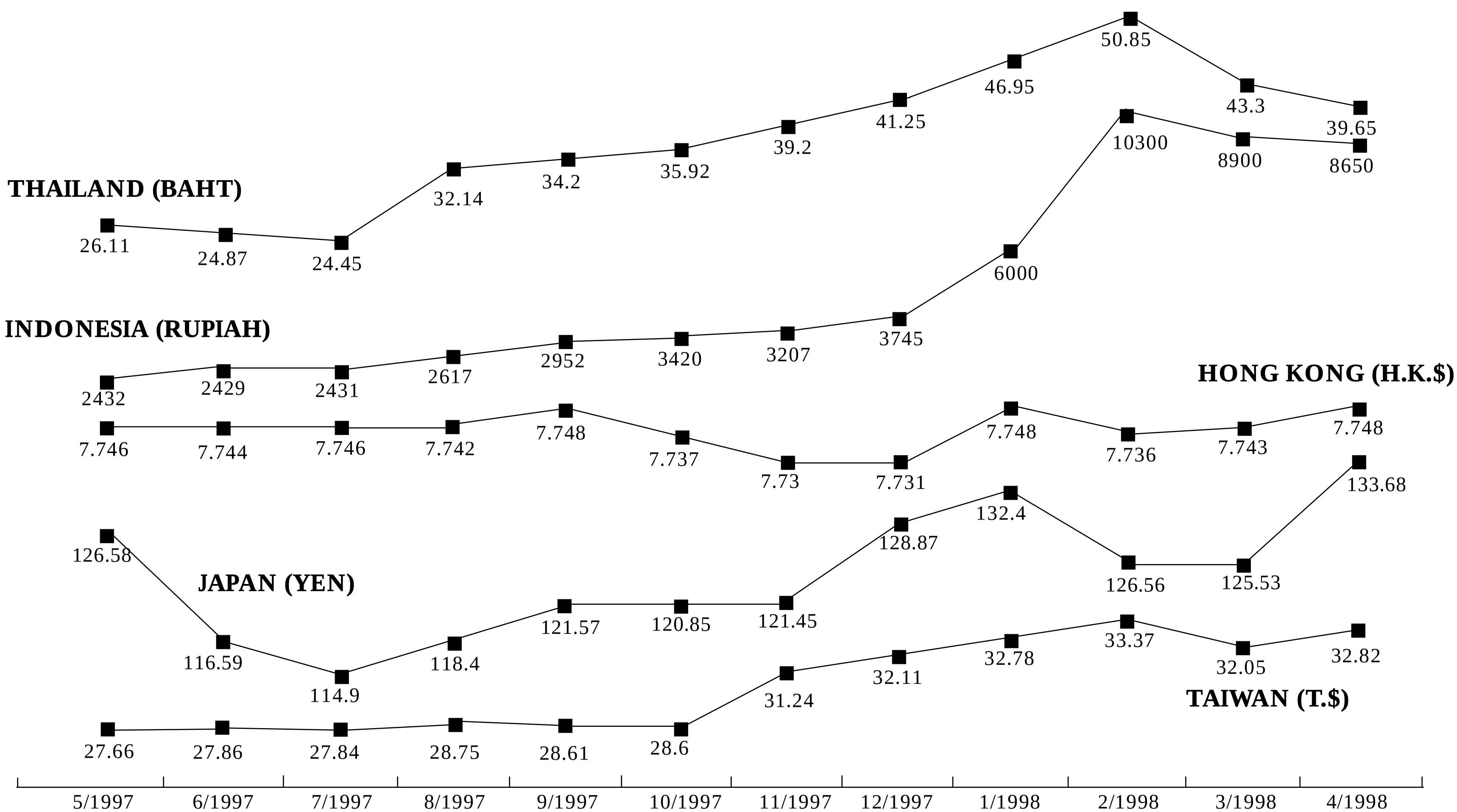
Critiques of the IMF Program

Due to the urgency of the currency crisis, the IMF program was imposed on Korea without much public discussion on the adequacy of its content. Although Koreans are hesitant to criticize the IMF program in public for fear of giving the international financial community the impression that Korea is not keeping its word with the IMF, a number of American professors including Jeffrey Sachs and Martin Feldstein of Harvard University recently have openly criticized the IMF program for Korea. Feldstein argued that Korea was "a case of temporary illiquidity rather than fundamental insolvency"; thus, "what Korea needed was coordinated action by creditor banks to restructure its short-term debts, lengthening their maturity and providing additional temporary credits to help meet the interest obligations.... Although many of the structural reforms that the IMF included in its early-December program for Korea would probably improve the long-term performance of the Korean economy, they are not needed for Korea to gain access to capital markets."[3] Harsh macroeconomic policy adjustments are under heavy attack in these critiques. Korea's macroeconomic fundamentals are sound, according to Sachs: "the budget is in balance, inflation is low, the savings rate is high, and the economy is poised for export growth."[4] Thus, there is no need for such tight monetary and fiscal measures.

The combination of rapid currency depreciation, draconian monetary measures, and tight fiscal policies unnecessarily generated more market panic and increased the possibility of bankruptcy even for healthy firms. For example, out of the thirty-four listed companies that went bankrupt since the IMF program was implemented in December 1997, twenty-three were making a profit but were brought down due to a temporary cash shortage. The average ratio of profits per sales for bankrupt firms was –2.9 percent during the pre-IMF period of January–November 1997 but improved to 1.3 percent during the post-IMF period. The Kyemong Group, a well-known publishing company, recently went bankrupt; the group was making profits at a rate of 12 percent per sales, much higher than the corresponding rate of 1.4 percent for all manufacturing firms in Korea. These statistics clearly suggest that many

[3] Martin Feldstein, "Refocusing the IMF," *Foreign Affairs* 77, no. 2 (March/April, 1998).
[4] Jeffrey D. Sachs, "The IMF Is a Power unto Itself," *The Financial Times*, 11 December 1997; and "The Wrong Medicine for Asia," *New York Times*, 3 November 1997.

Figure 3. Exchange Rate of Asian Countries



more healthy firms will go bankrupt in Korea if the current trend of credit tightening and high interest rates continues.

The IMF defends its position by stating that sufficient increase in interest rates is needed particularly at the outset to stabilize the exchange rate and restructure the corporate sector.[5] Furthermore, fiscal austerity is needed to absorb the costs of financial restructuring and reduce the current account deficit. Although the IMF position of tight monetary policy at the outset of crisis can be justified, the recent Korean experience clearly suggests that it should be relaxed and returned to a normal level as soon as the situation in the foreign exchange market improves. The Korean won has come down from as high as 1,900 to 1,400 won per U.S. dollar, and thus now is the time to relax the monetary policy and lower interest rates. Otherwise, bankruptcies of healthy firms will fundamentally weaken the Korean industrial base and it will take many years to rebuild the industrial and entrepreneurial base of Korea. Furthermore, it is very difficult to justify fiscal austerity in the present Korean situation where unemployment is rising rapidly while the current account is in surplus and the government budget is in balance.

Urgent Policy Issues

Since most short-term debts have been converted into one- to three-year-term debts, the most urgent issue at present is stabilization of the Korean won and interest rates. The IMF position on the exchange rate is to let it move freely according to market forces. Under normal conditions, this is an appropriate policy. But after experiencing a shock recently, market forces are moving slowly toward a new equilibrium. If the transition period is overly prolonged, many firms will go bankrupt and the economic and social costs of the currency crisis will be unbearable. Thus, there is an urgent need for intervention in the foreign exchange market. For example, a “multinational Korean won stabilization fund” can be established in order to maintain an orderly foreign exchange market in Korea. The objective is not to peg the exchange rate at a fixed parity but to smooth the price changes as well as to reduce the variance. The fund can be financed by the Korean central bank and major Asian economies including Japan and China. Stabilizing the Korean won will enable export and import as well as other foreign-exchange-related activities to return to normal levels and allow the interest-rate risk premium on Korean won-dominated loans to shrink rapidly to a more reasonable level. Since exchange rate stabilization was the foremost objective of the founding fathers of the IMF, this fund and its activities should be viewed as complementary to the IMF program in Korea.

Bad loans by Korean commercial banks and merchant banks were estimated at about 50 trillion won, or 17 percent of the total lending outstanding, as of December 1997. As more firms go bankrupt every day, these figures are rising rapidly. With a burden of this magnitude, Korean financial institutions cannot be expected to properly play the role of financial intermediary unless the government provides them with some extra help. A “bad loan consolidation fund” of 20 trillion won was set up to buy up bad loans from financial institutions but its operation needs to be accelerated and expanded. Furthermore, the capital base of many banks should be raised through equity issues and budgetary supports, while

[5] Stanley Fisher, *The Asian Crisis: A View From the IMF*. Address at the Midwinter Conference of the Bankers’ Association for Foreign Trade, Washington, D.C., 22 January 1998.

more active mergers and acquisitions operations are encouraged through the revision of related legislation and government measures. In addition to these short-term measures, the program to restructure the Korean financial sector, as agreed with the IMF, needs to be implemented as soon as possible.

Unemployment has become the most serious social issue in Korea, as the number of unemployed is expected to reach 1.5 million in May this year. Economic recovery through the stabilization of the exchange rate and interest rates is the most effective way of dealing with the unemployment problem. Nevertheless, social and political pressures on the government for a special effort are mounting, since the prospects for an early recovery appear rather dim. The Korean government is contemplating several measures, such as early implementation of public works projects, improvements in the public employment insurance scheme, and activation of construction activities through deregulation. Since there may be a trade-off between structural adjustment efforts and unemployment concerns, the Korean government should be very careful in selecting proper policy measures for tackling the current unemployment problem. In this respect rather drastic deregulation measures in the construction and retailing sectors are highly recommended.

Outlook for the Korean Economy

There is clearly a new sense of optimism regarding the future of the Korean economy both domestically and internationally, as indicated by rising stock prices and an upward trend of the Korean won. More pain in terms of rising unemployment and inflation are waiting for most Koreans in the coming months, however, perhaps for one or two years. An important issue in this respect is whether Korea can withstand the political difficulties arising from these short-term pains. Militant labor union leaders are threatening policy-makers with possible nationwide labor strikes, although it will not be easy for them to carry them out because a sense of urgency makes most Koreans think that labor problems will aggravate the current crisis. Various vested interest groups may try to impede early implementation of reform measures. In this respect, political parties, both the ruling party and the opposition, should stand firm against any temptation to ease reform efforts. Again, a sense of urgency may make this possible.

As indicated earlier, there is a need for the IMF to be more flexible in its policy stance, particularly concerning monetary and fiscal policies. Since some criticisms of the IMF program have sound theoretical justifications as well as political realism, there is a good chance that the IMF will agree to ease its stance on monetary and fiscal policy in the near future. One potential trouble spot is the worsening economic prospects of Japan. If the Japanese situation reaches a crisis level, many of the painful efforts made by Korea may turn out to be futile.

As most reform measures recommended for overcoming the currency crisis will improve the efficiency of the Korean economy in the long run, they can be considered bitter medicines for Korea. If Korea succeeds in implementing these measures, the current crisis will turn out to be a blessing for the Korean economy from a longer-term perspective.

Lessons from the Korean Crisis

A number of lessons can be drawn from the Korean currency crisis. The first lesson is the importance of a well-functioning financial sector and an effective financial supervisory apparatus. The financial sector has often been described as a burden for the healthy development of the real sector in Korea. The recent experience proved that it is not just a burden but a poison that can cause a crisis for the whole economy. Thus, this is a golden opportunity to make a fundamental improvement in this area. The next lesson has to do with more prudent opening of capital accounts. Just like Mexico, Korea opened capital accounts easily without a proper supervisory scheme after joining the OECD in October 1996. Furthermore, through the Korean experience one can appreciate the importance of more timely and accurate data as well as more transparent financial transactions. If policy-makers in both the Korean government and the international financial institutions had known the facts on short-term capital flows in and out of Korea, the crisis could have been averted.

Several aspects of the Korean economic development strategy which were very successful in the past became major sources of serious trouble in the current episode. The first is the Korean strategy of borrowing heavily from abroad to finance domestic investment projects and the tendency of Korean firms to rely on borrowed capital to finance their ambitious investment requirements. This strategy worked well in the past when Korea maintained an edge in its competitive position in the world market but failed badly as its competitive position deteriorated and the rate of return declined accordingly. Korea should have adopted a more conservative strategy of making more efforts toward structural adjustment and aiming for a slower economic growth rate.

Table 7. Korean Economic Outlook (1998)

	Korea Development Institute	Samsung Economic Research Institute		L.G. Economic Research	KLB* Economic Research
		Under an austere IMF program	Under a flexible IMF program		
Economic Growth Rate	-1.0	-3.0	2.5	-1.3	-1.0
Private Consumption	-4.6	-1.1	0.9	-4.0	-0.5
Fixed Investment	-33.6	-24.5	-13.6	—	—
Unemployment Rate	—	6.2	5.0	5.7	5.6
Consumer Price Index	8.9	7.5	8.2	7.0	10.2
Current Balance	259	62	-18	100	43

* Korea Long-Term Credit Bank

Government officials in economic ministries, particularly the Ministry of Finance and Economy, and *chaebol*, Korean conglomerates, are often cited as main actors in the Korean economic miracle. They are now blamed for leading the country to the current crisis, however. The National Assembly will hold public hearings on the currency crisis to determine who in the economic ministries should be responsible for such gross errors in policy judgment. There is also a growing demand for drastic reforms of the business behavior of Korean conglomerates. The champions of the Korean miracle, proud of their past performance, became arrogant and thus made their decisions without due consideration of the drastically changing domestic and external environments. Like dinosaurs, they became extinct after failing to adjust to a changed environment.

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Sang-Mok Suh received his Ph.D. in economics from Stanford University. He has worked at the World Bank and served as the vice president of the Korea Development Institute (KDI) and senior counselor to the United Nations High-Level Advisory Board on Sustainable Development. He was elected to the National Assembly in Korea and served as Minister of Health. He is now in his third term in the National Assembly.

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