Emerging economies can learn a lot from how Korea faced down financial crises

Emerging economies can learn a lot from how the Republic of Korea faced down the financial crises of 1997 and 2008, and emerged from hard economic slowdown stronger than ever.

Painful macroeconomic and financial reforms plugged structural weaknesses and restored investor confidence, and have put Korea in a better position to weather similar shocks, offering lessons for emerging Asian economies.

In 1997, as the Asian contagion, which started in Thailand, hit Korea in its sweep, and the economy reeled as foreign investors pulled out capital meant for investments and trade.

By the fourth quarter of 1997, investors had withdrawn $26.1 billion from Korea's capital markets, equivalent to some 6 percent of the country's gross domestic product.

This is a reversal from previous years when foreign investors poured in $52.3 billion in capital from 1994 to 1996, three times the figure from 1990 to 1993.

The crisis came at a time when the Korean economy was already stressed by huge debts amassed by the chaebols—home-grown business conglomerates whose mantles covered steelmaking, shipbuilding, construction, and finance—as they sought to finance risky and unprofitable projects, largely unchecked because of weak government supervision.

The problem came to a head with Korea unable to defend the won, which came under attack along with other Asian currencies at the height of the 1997 crisis. This eventually forced the government to seek a $58-billion bailout from the International Monetary Fund in December 1997.

The Korean economy was again in crisis in 2008 in the wake of the housing debt disaster, which started in the United States.

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By the fourth quarter of 2008, foreign investors again withdrew from emerging markets, including Korea. Its capital account—which records transactions of purchase and sale of foreign assets and liabilities—had a deficit of $42.6 billion, or 20 percent of its annual GDP. Money was pouring out of the country.

Again, Korea focused on structural weaknesses in the economy and shored up macroeconomic and financial policy frameworks.

During the 1997 Asian financial crisis, Korea faced a heavily indebted corporate sector and an underdeveloped financial market with policies to develop both direct and indirect financial markets and an integrated supervisory framework.

At the onset, the reforms shut down troubled financial institutions, which had piled up bad debts.

The number of banks fell from 33 in 1998 to 19 at the end of 2004, while the number of merchant banks dropped from 30 to just 2.

The financial restructuring cost the government 160.5 trillion won. The government enforced measures to curb reckless lending, which had contributed to the chaebols amassing huge debts.

During the 2008 global financial crisis, the government injected capital into banks and arranged currency swaps to stabilize exchange rates and improve liquidity.

The Bank of Korea cut interest rates six times, from 5.25 percent in October 2008 to 2 percent in February 2009, providing additional liquidity of 28 trillion won, or 2.7 percent of GDP.

The government further shored up liquidity by creating a bank recapitalization fund with an endowment of 20 trillion won.

And it created a 10-trillion-won bond market stabilization fund to provide liquidity and established a 40-trillion-won corporate restructuring fund to solve the bad asset problem in financial institutions, while arranging a $100-billion payment guarantee for banks' short-term liabilities.

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These measures restored the stability of Korean financial markets, helping the economy recover.

Over the past two decades, Korea's authorities have improved the soundness and resilience of its financial markets and system because of these measures.

Although Korea is still vulnerable to external shocks, it is an open economy and the reforms have reduced the likelihood and potential impacts of future crises.

There is room for Korea to improve its financial markets and institutions, which are still less developed than those of advanced economies.

The World Economic Forum's latest global competitiveness report says Korea ranked 74th in financial market efficiency due to inadequate financial services, insufficient access to loans, and lack of support for venture startups. Korea should continue efforts to improve access to credit and develop a venture capital market.

It should continue to improve the transparency of financial institutions and build an effective supervisory and regulation system to avoid volatile capital flows as well as rapidly rising household debt and over-indebted firms.

The Korean experience has useful policy implications for emerging Asian economies, which are susceptible to external financial shocks.

Emerging Asian economies must strengthen their financial regulatory systems. One of the main causes of financial crises in emerging economies is inadequate financial regulation and supervision.

Reforms must promote effective incentives, improve the transparency and soundness of the financial institutions, and boost the prudential regulation and supervision of the financial sector.

Emerging Asian countries must build up a broad and consistent monetary and financial policy framework and develop tools that curb asset bubbles and volatile capital flows.

They should support financial market development and innovations, such as digital payment, transfer services, among others, and regulate them in a balanced manner.

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The global financial crisis highlighted the dangers of unrestrained, complex, and obscure modern finance.

Governments must stimulate and effectively manage innovations without stifling them by improving transparency and providing the right incentives to players.

Emerging Asian economies also need to promote regional and global financial cooperation.

Dealing with crises resulting from systematic failure and cross-border financial panic calls for cooperation among emerging economies.

They must, as a group, take on greater responsibility for developing global supervisory and regulatory structures by actively engaging in discussions at global meetings, such as the Group of Twenty, the Financial Stability Board, and the IMF.

Given their high vulnerability to cross-border capital flows, neighboring economies in the region, such as the ASEAN plus 3, must strengthen cooperation in financial supervision, surveillance, and regulatory issues to manage and prevent future crises.

Emerging Asian economies cannot afford to be complacent. They must gird themselves for any crisis that may come their way.

This episode was based on research done for ADBI by Jong-Wha Lee, a professor of economics and director of the Asiatic Research Institute at Korea University.

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