KOREA FEELS WALL STREET CRISIS ...AND REACTS

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Korea has once again been threatened by financial contagion that started in another country. In 1997, it began with Thai baht; this time, the trouble started on Wall Street. Since release of the October issue of Korea Insight, Korea's financial markets have come under heavy pressure. The government of Korea has repeatedly expressed confidence about the soundness of its economy and financial markets, and emphasized that it has sufficient foreign reserves to deal with current liquidity problems. President Lee Myung-bak assured the nation that Korea will never undergo another financial crisis and that the current situation is fundamentally different from 10 years ago. Despite such optimism, stock prices and the Korean won plunged sharply as the global financial crisis deepened. Foreign investors unloaded local shares at a record pace and took dollars out of the country as they began to doubt the health of the nation's financial system. Fear spread that the Korean economy could be entering into a deeper recession.

Growing Signs of Pessimism

Korean equity and currency markets went into near freefall during October as foreign investors reduced their exposure to assets deemed risky. They sold $34.7 billion worth of Korean stocks from the beginning of the year through mid-October. The Korea Composite Stock Price Index (KOSPI) fell below 1,000 points for the first time in more than three years. According to Daewoo Securities, Korea's stock market is the 6th hardest hit by the U.S.-led global financial crisis, declining 61.4% in value since last October. The loss of wealth from the plummeting stock prices has amounted to $47 billion so far this year and $18.6 billion during the first 3 weeks of October alone. Foreign investors sold Korean assets worth about $22.5 billion and took the proceeds out of the country.

Meanwhile, the Korean currency has weakened by almost 35% against the dollar so far this year, one of the world's largest depreciations in 2008. The won closed at a decade-low of 1,468 per dollar on October 28.

The news on the real economy was also of concern. The Bank of Korea announced that the nation's economy grew just 3.9% year-on-year during the third quarter, sharply down from 4.8% in the second quarter and 5.8% in the first quarter. It was the weakest growth since the 3.4% growth recorded in the second quarter of 2005. Consumers have tightened their belts as economic conditions at home and abroad have become dismal. Businesses have become reluctant to expand due to falling profits. Real exports registered year-on-year growth of just 1.8% in the third quarter, compared to 4.3% in the previous quarter. Weaker global demand will weigh on exports further next year.

Korea's current account deficit in September reached $1.2 billion, bringing its cumulative deficit for the year to $13.8 billion. On the strength of its strong export growth, Korea had been posting a current account surplus since the Asian financial crisis. But, for the first time in 10 years, it is expected to record a deficit this year of about $10 billion. Furthermore, Korea's foreign reserves have been declining for the past six months, the longest period of decline on record. Foreign reserves stood at $240 billion at the end of September, having shed a total of $22.6 billion during the first nine months. Press reports in early November indicated a further significant decline in October, to $212 billion at month-end. Earlier in the year, the authorities intervened in the market to prop up the won in an effort to reduce rising inflationary pressure caused by higher energy prices. Also, in September the authorities injected dollars into the market to ease a dollar shortage. As of the end of April, Korea had the world's sixth-largest foreign reserves.

The basic problem is a deepening dollar shortage caused by the global liquidity crisis. Korean banks rely heavily on overseas borrowing, but, with high demand for the greenback around the world, they have had trouble borrowing from foreign banks. Also, Korea's economy is largely dependent on dollar financing for international trade, but many foreign banks and companies are hoarding their dollars and hesitant to lend to each other. Reluctance of foreign banks to roll over existing loans to local banks has been forcing Korean banks to repay them in dollars. The Bank of Korea said that Woori Bank alone has had to repay as much as $280 million in a week. Analysts began to doubt Korean banks' ability to acquire dollars to pay maturing external liabilities. Also, Moody's Investors said that Korea is one of the few banking systems in Asia where domestic deposits are insufficient to fund debt and that the outlook for Korean banks' credit rating is the most negative in Asia. Standard & Poor's have placed seven Korean banks on the negative watch list.

Bailout Package and Policy Direction

Measures to Stabilize Financial Market: In an effort to stabilize the currency market and to help local banks overcome external funding difficulties, the government announced a comprehensive rescue package worth $130 billion. The plan calls for the government to guarantee as much as $100 billion in foreign debt of domestic banks for three years with respect to loans obtained from October 20 this year to June 30, 2009. Many countries have already implemented an inter-bank loan guarantee program since the credit crisis began. The Financial Supervisory Service said that Korean banks have $235 billion of external liabilities, with about $32.7 billion due to mature in the fourth quarter. To boost dollar liquidity, the authorities will inject $30 billion in dollars into local banks. This will be in addition to the $15 billion they injected into financial markets and smaller companies in September. Furthermore, Korea concluded a $30 billion currency swap deal with the U.S. Federal Reserve. A Bank of Korea official said that the swap deal, which expires in April 2009 unless renewed, will provide additional foreign currency resources if needed and will help improve foreigners' confidence in Korean markets.

Measures to Boost Real Economic Activity: For the first time in a decade, the government pledged to help the construction industry, which accounts for nearly 20% of the economy. It will spend $3.8 billion to buy land and unsold homes from builders suffering from falling housing demand and the credit crunch. The backlog of unsold homes reached the highest level in 10 years, and default by builders rose for the first time in five years. Some 29,000 workers have lost their jobs so far this year, while orders fell 7.6% in August from a year ago. The government also plans to ease some regulations on home loans and relax previously imposed restrictions on real estate transactions in areas designated as speculative zones. As a measure to control speculation, the government had tightened bank lending and real estate transactions beginning in 2006.

Many of the nation's small and medium enterprises (SMEs) are suffering from an extreme shortage of liquidity after the banks tightened credit standards amid the global credit crisis. The government said that it will extend $3.6 billion to prop up SMEs. Under the plan, the central bank will raise the ceiling on loans that banks can lend to SMEs at low interest rates from $4.76 billion to $6.23 billion, the first increase since October 2001. For SMEs struggling with their investment losses from "knock-in, knock-out (KIKO)" facilities, they would have an option to either extend maturities or take additional loans. The Financial Services Commission said that a total of 471 SMEs had KIKO facilities as of the end of August, and that their combined losses reached $1.03 billion.

The Bank of Korea slashed its key interest rate by 75 basis points to 4.25%, the biggest interest rate cut ever. The larger-than-expected reduction was a preemptive move to prevent a sharp decline of domestic demand and the overall economy. Officials said the lower interest rate would help ease the debt burden of SMEs and households. The central bank also reduced the interest rate on special discount loans for small businesses to 2.5% from 3.25%, and eased accounting rules for exporters. The central bank had cut its key rate by 25 basis points earlier this month, following concerted rate reductions by major central banks.

Korea has experienced two major crises in the past decade. The economy nearly collapsed during the 1997 Asian financial crisis. The credit card crisis in 2002 forced the government to spend billions of dollars to bail out credit card companies, and drove the nation into near recession. Korea was able to recover rapidly then because the global economy was healthy. The current situation is different and perhaps more serious, as most of the world appears to be entering into recession.