

Korea's Economy

Korea's Economy 2009

Korea's Near-Term Economic Prospects and Challenges

Global Financial Crisis and the Korean Economy: Issues and Perspectives

The Impact of U.S. Financial and Economic Distress on South Korea

The Wall Street Panic and the Korean Economy

Economic Policy Reforms in the Lee Myung-bak Administration

Tax Reform in Korea

U.S.-Korea Economic Relations: View from Seoul

U.S.-Korea Economic Relations: A Washington Perspective

Engagement on the Margins: Capacity Building in North Korea

North Korea and International Financial Organizations: Political and Economic Barriers to Cooperation

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THE WALL STREET PANIC AND THE KOREAN ECONOMY

By Kim Dong-hwan

There may have been no one who anticipated the bankruptcy of Lehman Brothers, once one of the top five global investment banks. The shocking news reverberated through the Korean financial markets like a thunderclap. Subsequently, not a few Koreans suffered from the “September crisis,” when foreign investors were rumored to be on the verge of withdrawing capital from the local bond market en masse, especially in the second week of September 2008. Fear eventually led to a sense of an impending crisis, which, in turn, threw the financial market into a panic. Since then, the dollar has surged and stock prices have plummeted. In spite of the U.S. government’s \$700 billion bailout plan, international and domestic financial markets are in the midst of a deep fog. Although more than a decade has passed since the 1997 economic crisis in Korea, the acute pain of that crisis and the memories of hardship appear to have resurfaced. This paper examines the causes and lessons of the Wall Street panic, then discusses the problems at hand for the Korean economy.

Brief History of Investment Banks

According to encyclopedias such as Oxford and Britannica, U.S. investment banks are similar to the merchant banks of the United Kingdom, defined as institutions that underwrite large amounts of securities and then apportion and resell them to investors. The merchant banks have their origins in the acceptance of commercial notes issued by traders who immigrated to London from various European countries in the eighteenth century. Equipped with pioneering financial technology and vast amounts of information, they have wielded much power in the international financial market since at least the eighteenth and nineteenth centuries. Baring Brothers (now ING Group) and Rothschild were representative merchant banks that entered the U.S. financial markets in 1736 and 1837, respectively. In addition to dealing in and underwriting securities, they more recently began to provide deposit and loan services to wealthy clients as well as advise on and arrange mergers and acquisitions. Among these services,

principal investment for capital gain through self-financed or private equity funds has become one of their major businesses.

The era of the traditional merchant bank nearly ended after the capital market liberalization of 1986 (the so-called Big Bang), as many of them merged with global financial institutions based in the United States or continental Europe. Merchant banks had much influence on U.S. private banks. Global investment banks like Goldman Sachs, Lehman Brothers, and Morgan Stanley were launched out of New England private banks established by German Jewish immigrants to the United States in the early nineteenth century. They used the western railway construction boom as a stepping-stone for growth before becoming investment banks in earnest after the passage on 16 June 1933 of the Glass-Steagall Act (officially named the Banking Act of 1933), which established the “separation of banking and securities activities.” This had a strong impact on U.S. banking regulation, as private banks separated into commercial banks and investment banks, with deposits and loans being the main businesses of commercial banks, and the dealing in and underwriting of securities as activities of investment banks. It was the very reason that J. P. Morgan, a private bank until 1935, was divided into the commercial bank, J. P. Morgan, and the investment bank, Morgan Stanley.

In the 1960s, the U.S. stock market enjoyed a renaissance, and securities companies such as Merrill Lynch flourished, especially in the retail brokerage service area. The golden age did not last long, however, as many investment banks saw stable fee revenues eroded by the abolition of the fixed-rate brokerage commission system on 1 May 1975. In response, investment banks frenetically developed new high-risk and high-return business areas, such as financing of mergers and acquisitions and derivatives. Today, investment banks and securities companies are permitted to provide all financial services except for deposit and payment, as shown

in **Table 1**. One main change since the 1960s has been the provision of retail services for individual clients; previously their core businesses had been largely limited to wholesale services.

The 1987 Black Monday stock market crash was critical in precipitating major shifts in the U.S. capital markets. In the 1990s, megamergers among securities companies became prevalent, and a handful of giants began to dominate areas such as mergers and acquisitions and the junk bond market. At the beginning of the twenty-first century, however, many investment banks could not avoid the tide of restructuring and drastic decreases in sales. By and large, the restructuring can be explained by the Gramm-Leach-Bliley Act (GLB) in the United States and the decreases in sales caused by the collapse of the information technology (IT) bubble.

The GLB Act of 1999 replaced the Glass-Steagall Act and dismantled the wall between commercial and investment banks, triggering a restructuring of the U.S. financial industry. Meanwhile, the burst-

ing of the IT bubble (sometimes called the dot-com bubble) after 2000 eliminated a great deal of the New Economy business for investment banks. The 2008 Wall Street panic seems to be another one of the inevitabilities of investment banks' history. In other words, panic follows as a natural consequence of profit-seeking financial capitalism. A stampede of hostile takeovers and hypercompetition in the development and sale of products such as financial derivatives are not of help to the real economy, and, in fact, they undermine financial stability and safety by making the economy a victim of frequent booms and busts, even if they have contributed to enhancing financial market efficiency by enlarging business areas of the financial institutions.

Causes of the Wall Street Panic

Basically, the Wall Street panic that followed the avalanche of subprime mortgage defaults resulted from the fact that nobody knew the scale of the risk from asset securitization. Three kinds of risk are involved in asset securitization: credit risk, liquidity

Table 1: Activities of Commercial Banks, Investment Banks, and Securities Companies in Korea

Activities	Types of banks		
	Commercial banks	Investment banks	Securities companies
Payments	✓		
Deposits	✓		
Loans to households and small firms (from deposits)	✓		
Loans to large firms (from deposits)	✓		
Loans to large firms (from borrowings)	✓	✓	
Financial and management strategy advisory	✓	✓	
Principal investment (merchant bank)		✓	
Underwriting		✓	✓
Dealing		✓	✓
Brokerage for institutional investors		✓	✓
Brokerage for individual investors			✓
Loans to individual investors (from borrowings)			✓

Source: Nishimura Nobukatsu, *Fund Business M&A Securitization Derivatives* (Tokyo: Nikkei BP, 2005).

risk, and structural risk. Investors assume the credit risk on an investment in a mortgage-backed security (MBS): the possibility that the price of the MBS will fall or that the interest and principal will fail to be paid, a situation caused by a fall in housing prices or in the underlying MBS asset. Liquidity risk over a temporary liquidity contraction or credit crunch in the money market is also assumed, especially when the price of short-term asset-backed securities (ABSs), such as asset-backed commercial paper, falls or the interest and principal of an ABS fails to be paid. Finally, structural risk is assumed by all participants in the asset securitization process: commercial banks, investment banks, credit-enhancing institutions such as Fannie Mae, Freddie Mac, and many monolines may take on a warranty liability or a surety in the process of handling products such as ABSs and MBSs that may subsequently be realized as a monetary loss. The problem is that it is hard to discern credit and liquidity risk, and structural risk tends to amplify capital market uncertainties even if the scale of the credit risk is relatively easy to ascertain. Furthermore, the easy monetary policy taken after the collapse of IT bubble has added more fuel to the fire, as pointed out by Kevin Rudd, the prime minister of Australia.

A direct cause of the bankruptcy of Lehman Brothers was investment losses incurred from the securitization of risky assets, such as subprime MBSs. A ticking time bomb remains, however, in the form of structural risk exposure to vast amounts of financial derivatives such as credit default swaps (CDSs). In fact, many investment banks, including Lehman Brothers, had made CDS contracts with originators—commercial banks and mortgage agencies—of mortgage loan securitization, on the condition that they would assume the losses incurred by securitization in place of receiving guaranteed fees from the originators. CDS losses from structural risk, however, might not show up on the books of both investment banks and commercial banks until the losses exceed a predetermined critical level and the underlying asset, for example, a mortgage loan, is subtracted from the balance sheet or ceases to be recognized as an asset of commercial banks. The structural risk would then develop into a liquidity risk and cause dysfunction in the payment system if large-scale losses are realized on mortgage loans owned by commercial banks. For these reasons,

commercial banks and investment banks have had an incentive to conceal or postpone structural risk and the losses realized from it, and the U.S. government eventually decided to spend more than \$700 billion to bail them out.

U.S. financial authorities were not able to discern the credit or liquidity risk, and thus they failed to prevent the diffusion of the former into the latter. They also have been accused of being too lax in addressing structural risk. These government or supervisory failures seem to be an indirect cause of the Wall Street panic. Sitting on their hands while allowing excessive wealth building through the leveraged finance and asset securitization that formed the source of the calamity, these authorities helped facilitate the crisis.

Wealth building through leveraged finance utilizes various present and future assets and debt to produce a reciprocal leverage effect and generate abundant and continuous liquidity and credit in the money market. This differs from a more typical secured loan, in which the debt created is levered by collateral made up of present assets. For example, a person obtains a mortgage loan (personal debt) from a commercial bank levered by the house itself (personal asset), then the commercial bank issues an MBS (commercial bank's debt) to an investment bank levered by, that is, securitized by, the mortgage loan (commercial bank's asset). The investment bank then sells a collateralized debt obligation (investment bank's debt) to other investors levered by a pool of MBSs (investment bank's asset). Leveraged finance, a combination of *zaitech*-type loans (*zai* is Japanese for "wealth") and abnormal asset securitization, heated up the U.S. housing and stock markets in the 2000s. *Zaitech*-type loans, in fact, were notorious for aggravating the Japanese asset bubble in the latter half of the 1980s. Not a few scholars and journalists warned that excessively leveraged financing might cause an asset bubble and another "lost decade," in which a burst bubble would render all the assets and debt involved in leveraged financing unhealthy and would plunge the U.S. economy into a long-term slump.

Second, abnormal asset securitization is a method in which originators do not transfer the property rights of underlying assets—such as mortgage loans—to

special-purpose vehicles; instead the originators make use of financial derivatives such as CDSs. It is abnormal in the sense that the two major principles of asset securitization—the “true sale” principle and the “bankruptcy remote” principle—are violated and also that it exposes financial institutions and investors to structural risk. Originators such as commercial banks, for example, stand to be harmed not only from unhealthy asset soundness but also from being responsible for redemption of the MBSs and for legal flaws, especially when the mortgage loans become nonperforming. This is mainly caused by the fact that they did not comply with the true sale principle and kept the mortgage loans on their balance sheets. Investment banks and credit-enhancing institutions incur losses from warranty liabilities and sureties imposed on CDS contracts or collateralized debt obligation contracts. Hence, many general investors are exposed to the risk of bankruptcies of commercial banks or investment banks.

Discussion on the Future of Financial Capitalism

Since the 1980s, a surge in the prominence of neoliberal financial capitalism has overhauled the industry and broken down the walls of tradition. On the one hand, this surge has promoted the development of financial technology and facilitated the ample provision of financial products and services to consumers. It has created a series of megatrends such as consolidation, universal or one-stop banking, and securitization, by which economies of scale and scope and the intermediary function of the capital markets were enhanced. On the other hand, it has not only undermined the safety of the payment system and the credibility of the capital markets by fostering bubbles, but it has also threatened the economic sovereignty and national wealth of smaller, developing countries.

It is also true that not a few defects accompanied the megatrends, contrary to theoretical expectations. The trend of consolidation among financial institutions has, because of less competition, entailed a scale diseconomy of bulky organizations. Consolidation has also imperiled many small- to medium-size financial companies. The trend of universal banking has been abused as a rationale for financial consolidation, bequeathing unfortunate scope disec-

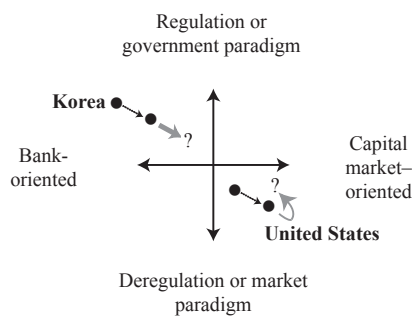
onomies, which flattened preexisting firewalls and induced overcompetition among core businesses and financial institutions. The trend of securitization has also resulted in too much attention on investment banks and away from the traditional function of commercial banks. The capital markets became a place of speculation aimed at realizing short-term gains, thereby losing their intrinsic financial intermediation function. Some of the same investment banks once touted as the flower of capitalism have been closed, and some are proclaiming that financial capitalism as we know it is coming to an end.

Yet each country’s financial market development and regulatory scheme differs. The ratio of capital market assets to gross domestic product in Korea, for example, is at most half of that of the United States. The share of investment banking business for Korean securities companies was only 5 percent in 2005, far lower than the 45 percent for U.S. securities companies in the same year. In 1997, Korean households held just 27.0 percent of their wealth in the form of financial assets, versus 68.4 percent in the United States in 2000. Moreover, the government of Korea has maintained a strict financial regulatory regime, under which abnormal asset securitization via financial derivatives has not been permitted. Finally, major investment banks still do not exist in Korea, even though investment banking has been recognized and established as a business unit following the post-1997 International Monetary Fund-coordinated financial consolidation and capital market liberalization. In light of these facts, views on the hypothesis of “the end of financial capitalism” may vary. In the case of Korea, the hypothesis could be said to go too far; but the United States, having adopted a relatively extreme capital market-oriented financial system, may consider shifting the existing financial regulatory regime toward a more bank-oriented one (*Figure 1*). In a sense, the Wall Street panic could give a second-mover advantage to Korea, which had in fact been pursuing an Anglo-American market-oriented financial system since 1997. The reason is as follows.

The Wall Street panic has the attributes of a winner’s curse in that the United States may have paid too high a cost to become the champion of the market-oriented financial system. A return to a bank-oriented financial system may be inevitable

since the U.S. capital markets are being pushed to the limit by the panic. The transformation of Goldman Sachs and Morgan Stanley into bank holding companies suggests a full-blown emergence of a CIB model in which commercial banks (CB) and investment banks (IB) are combined under a holding company.¹ Such a model would mark the arrival of a new financial architecture designed to address the intrinsic limitations of investment banks with regard to financing and supervision.

Figure 1: Evolution of Financial Systems and Financial Regulation



Source: Author's concept.

Note: Using comparative institutional analysis, Joseph Stiglitz, Masahiko Aoki, and others have shown that the economic system and regulatory regime of each country can be interpreted as a path- or history-dependent equilibrium. Hence, problems may arise if a country with a bank-oriented financial system attempts to shift to a market-oriented one, or vice versa.

By contrast, Korea, which is still under a bank-oriented financial system, does not need to follow the same track. Nonetheless, it should try to maintain aspects of a market-oriented financial system and a bank-oriented financial system, as both have merits and demerits. A market-oriented financial system functions best under perfect market conditions. Such conditions never truly exist in practice, however, since market failures such as monopoly or asymmetric information are always present. These imperfections are the very reason government regulates the market. Historically, the bank-oriented financial system has flourished under an active

regulatory regime and from long-term relationships between banks and firms. A bank-oriented financial system complements the market-oriented system in a real world where perfect market conditions are not always satisfied. Afterward, Korean banks should play a major role in the capital market and make use of the CIB model that will enable both the long-term cooperative function of the bank-oriented financial system and the short-term competitive function of the market-oriented financial system.

Future Tasks for the Korean Economy

The present economic circumstances in Korea are not as serious as during the 1997 crisis, when almost every economic indicator hit bottom and many major corporations went bankrupt. The Bank for International Settlements ratio for commercial banks was about 11 percent in 2008, in contrast with 7 percent in 1997, while foreign currency reserves stood at more than \$200 billion in 2008, approximately 10 times as high as in 1997. The global credit crunch, however, has developed into a full-blown crisis of trust and led to a period of deflation. Moreover, no one can be sure that a rush of latent market liquidity would not incite further problems, even though the present liquidity crunch is much bemoaned.

During the 1997 crisis, ex post microeconomic structural reform was necessary in order to improve the governance structure of insolvent firms. Now it is time to adopt preemptive macroeconomic structural reforms, which are urgently needed to prevent surviving firms from falling into insolvency. Considerable fluctuations in asset prices, exchange rates, and short-term financial market liquidity are inevitable until the Wall Street panic subsides. Hence, it is unnecessary for Korea to fluctuate between hopes and fears, even though there are wild daily fluctuations in asset prices, exchange rates, and market liquidity. It is crucial that the Korean government protect domestic and foreign depositors and investors and reinforce financial supervisory and regulatory systems to minimize the toll that the external financial turmoil aggravated by the Wall Street panic has on the domestic economy.

1. CIB is used here as an abbreviated acronym for the combination of commercial banks (CB) and investment banks (IB).

Bolster Supervision of Financial Derivatives Transactions

Financial derivatives have been abused as a tool of speculation, even though they are a good means for hedging risk. They have also been situated in a supervisory blind spot, mainly since they are off balance sheet. Financial authorities should bolster supervision of derivatives transactions to encourage risk hedging. Specifically, authorities should monitor each type of the financial institutions' risk exposure from various off-balance-sheet transactions and ascertain whether accountability, suitability, and the know-your-customer rule, among others, are being appropriately applied. They should strengthen the payment system and macroprudential supervision to ensure that the credit and structural risks accompanying asset securitization are not transmitted to the overall liquidity risk; otherwise, the Bank of Korea should assume the liquidity risk as a lender of last resort. Authorities should also monitor the compliance officers of financial institutions so that abnormal asset securitization, violating the true sale and bankruptcy remote principles, is not done.

Preemptive Macroeconomic Structural Reform

Preemptive macroeconomic structural reform (PMSR) should be based on the following three principles. First, it should recover market trust by alleviating the credit crunch epidemic. The Korean economy could face catastrophe from a collapse of trust if previously healthy firms fall into a liquidity crisis that results in mass bankruptcies. Creditor banks should draw up prompt workout plans for firms that have fallen into a temporary liquidity crisis, and financial authorities should make the existing procyclical supervisory rules, like Basel II, more flexible and countercyclical. Loans to firms that have filed for preworkout or reorganization procedures should be given preferential treatment in the asset classification and loss provisions.

Second, PMSR should counter deflationary pressure by unhinging the supply-side bottleneck for Korea, which has struggled to find new growth drivers since the 1997 crisis. Without such drivers, supply capacity has always been limited. Now that the financial crisis is spreading to the real economy, the supply curve should be shifted to the right to

boost both gross national product and employment. Specifically, the government should (1) foster employment-inducing high-tech industries through small- and medium-size enterprises, (2) increase the productivity of the service industry, and (3) prepare outplacement measures for the surplus of workers in the service industry. In general, the supply-side bottleneck is found in the high-risk and public sectors, where active loans, investments, and guarantees by state-owned financial institutions or development financial institutions are needed. These include the development of regional and social overhead capital and human capital, protection of the environment, outplacement, relief from natural disasters and the economic depression, full-blown restructuring of industries and firms, and relief for credit delinquents from the public sector. Fostering innovative entrepreneurs and future growth engines such as the biotechnology and nanotechnology industries, developing an alternative energy industry and an aerospace industry, building inter-Korean economic cooperation, and promoting the evaluation and commercialization of venture technology all fall under the high-risk sector.

Third, PMSR should involve a bailout plan that combines flexible monetary policy with resolute corporate restructuring measures. An inflationary monetary policy will be unavoidable in order to cope with the present credit crunch, but excessive money issuance and hesitant corporate restructuring would render the Korean economy unable to cope with hyperinflation or a bubble in case excess latent liquidity gushes into the market. In these circumstances, repurchase agreements are a convenient and dynamic anti-inflationary measure that can rein in such excessive liquidity. Debt-equity swaps, debt-debt swaps, debtor-in-possession financing, and loan covenants with remuneration contingent on success are good corporate restructuring measures for promising firms that have fallen into a temporary liquidity crisis. Firms that have fallen into a solvency crisis should be liquidated according to the unified bankruptcy law.

Alleviate Uncertainty via Regulatory Change

A series of deregulatory policies, including a separation between banking and commerce, should be carefully implemented so that the efficiency, fair-

ness, and stability of the financial markets are not disturbed. The reasons are as follows. First, anonymous financial consumers stand to be harmed if the efficiency of the financial markets is damaged by market failures. Second, specific financial consumers also stand to be harmed if the integrity of the financial markets is damaged by a few interested parties or stakeholders who seek rents unfairly. Third, the economic foundations would collapse if impaired financial market stability results in negative externalities for or a contagion effect toward the payment system and the real economy.

In particular, the “negative system” has been a symbol of deregulation since the Capital Markets Consolidation Act was enacted in Korea. It is hoped that a negative system will raise the efficiency of the financial markets although such deregulation may in fact create negative momentum by breaking away from the tradition of the Glass-Steagall Act and overheating competition among financial institutions for enlarging core businesses. Moreover, certain business areas may be abruptly prohibited or restricted in the process of deregulation, which might become a nuisance disturbing the financial markets. To minimize such regulatory uncertainty, the government should apply the Capital Markets Consolidation Act as narrowly as possible and not apply it, for example, when investment banks want to participate in the payment system.

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