

# 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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# GLOBAL FINANCIAL CRISIS AND THE KOREAN ECONOMY: ISSUES AND PERSPECTIVES

By Pyo Hak-kil

## Introduction

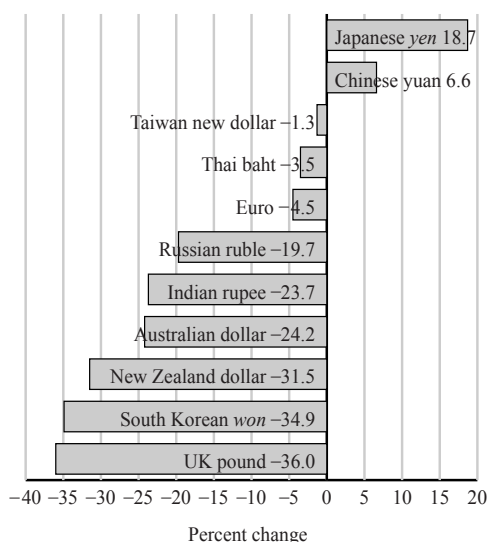
The year 2008 will be recorded in world history as a year in which the global capitalist system was threatened as a consequence of the U.S.-originated financial turmoil that began with the bankruptcy of Lehman Brothers on 15 September 2008. The impending worldwide recession is now often compared with the Great Depression that began in 1929. The repercussions of the financial turmoil from Wall Street have been quick and widespread around the globe, resulting in contraction in the real sector, rising unemployment, and a decrease in commodity prices including the price of oil. Emerging-market economies in particular are the hardest hit by the financial turmoil, with sharp reductions in stock prices and exchange rates.

The MSCI Emerging Markets Index<sup>1</sup> and Developed Markets Index (MSCI EAFE)<sup>2</sup> changed by -53.6 percent and -40.9 percent, respectively, between 31 December 2007 and 8 January 2009. The Emerging Markets Index includes the following indexes: Russia's RTS (-72.4 percent), China's Shanghai SE Composite (-64.3 percent), Hong Kong's Hang Seng (-48.2 percent), Korea's KOSPI (-36.4 percent), and Brazil's BOVESPA (-34.3 percent). The MSCI EAFE index includes Japan's NIKKEI (-42.0 percent), Germany's DAX30 (-39.5 percent), the U.S. Dow Jones Industrials (-34.1 percent), and the UK's FTSE100 (-30.2 percent).

The exchange rates of currencies of emerging-market economies during the same period have

depreciated significantly as foreign capital inflows abruptly changed to outflows as foreign investors started replenishing their liquidity and preferred to hold onto dollar-denominated assets to reduce risks of holding nondollar assets (*Figure 1*). Currencies include the South Korean won (-34.9 percent), the Indian rupee (-23.7 percent), the Russian ruble (-19.7 percent), the Thai baht (-3.5 percent), and the Taiwanese new dollar (-1.3 percent). The only exception to the depreciation trend was the appreciation of Chinese yuan (6.6 percent) and the Japanese

**Figure 1: Selected Nations' Currency Revaluation Rate Compared with the U.S. Dollar (zero)**  
31 December 2007–31 December 2008



Source: Thomson Reuters Datastream database.

1. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of June 2006 the MSCI Emerging Markets Index consisted of the following 25 emerging-market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

2. The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the United States & Canada. As of June 2007 the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

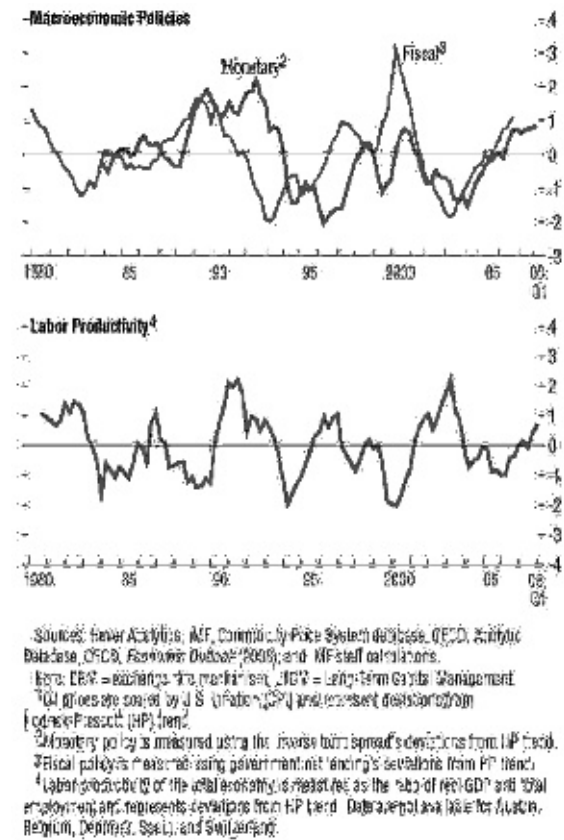
yen (18.7 percent). There was also a disparity between developed-market currencies: the UK pound (−36.0 percent) and the Japanese yen (18.7 percent). The question remains as to why the Korean *won* experienced the largest margin of depreciation among emerging-market currencies and why the KOSPI also fell by a substantial margin.

### Imbalance between Real Sector and Financial Sector

Even though subprime mortgages in the United States had begun to surface as a potentially serious issue beginning in the second half of 2007, the financial turmoil manifested itself only later through a series of incidents such as the failure of Bear Stearns and the financial troubles of Freddie Mac during the first half of 2008. The bankruptcy of Lehman Brothers followed on 15 September 2008, an event that preceded the bailout request by the three largest U.S. automobile manufacturers, the takeover of Merrill Lynch by Bank of America, and subsequent reports of huge losses by Bank of America and Citigroup.

A question has emerged about the fundamental cause of this financial malaise and impending global recession. There can be multiple causes and explanations, but the cumulative imbalance between the real sector and the financial sector seems to have formed a core of the real cause. According to the International Monetary Fund (IMF; see *Figure 2* excerpted from *World Economic Outlook*, October 2008, figure b4.3, p. 135), labor productivity of the economies of a group of advanced countries, measured as the ratio of real GDP and total employment and representing deviations from Hodrick-Prescott trend, shows a sharp decline during 2003–06 after the information technology boom started to slow. During the same period, however, both monetary and fiscal policies were excessively expansionary. The lower interest rate policy, in particular, fueled asset markets, driving up prices of houses and stocks (*Figure 3*) and ultimately commodity prices, including the oil price. As the asset price bubble continued to build, the financial industries in the United States started creating derivative after derivative, which fell outside of reserve regulations.

**Figure 2: IMF Graphs of Systemic Events Showing Financial Stress, 1980–2008**



In short, there was a continuing speculative bubble in both the housing and financial sectors, which was not supported by a real income gain. Like the Asian financial crisis of 1997, the cumulative imbalance between the real sector and the financial sector awakened investors to the fact that they might not get back their expected returns. The imbalance between the two sectors is characterized by the wage gap between the two sectors. How the financial industries could have afforded such a high wage scale for their professional employees for such a prolonged period of time is still an open question, especially when there was no real value-added and marginal productivity gain. It seems to boil down to the question of corporate governance and supervision over secondary banking, which implies a system failure like the 1997 crises in Indonesia, South Korea, and Brazil.

When the systems failed in 1997, Indonesia, South Korea, and Brazil went through IMF-mandated

structural reform programs. But, in the case of the U.S. system, the IMF is not the source of a bailout; instead, the U.S. Congress is the ultimate source. It is an irony that, although the IMF conducts an annual consultation with the U.S. government and the Federal Reserve Board, it seems to have failed to detect the U.S. financial crisis in advance—as it had failed to detect the Asian financial crisis.

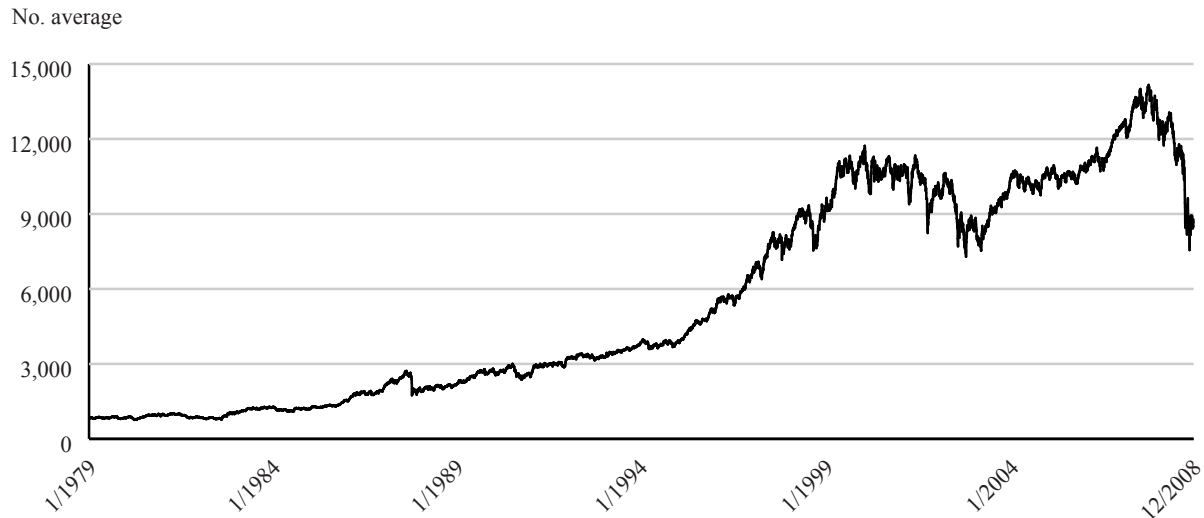
### What Has Gone Wrong with the Won and the KOSPI?

The Korean economy during the first two quarters of 2008 maintained a resilient growth of real GDP with rates of 5.8 percent and 4.8 percent, which is roughly in the range of potential GDP growth rates, as shown in **Table 1**. Even though domestic demand was sluggish—with consumption at 3.4 percent and 2.3 percent and investment at 1.4 percent and 0.7 percent—Korea showed strong export performance (17.4 percent and 23.1 percent on an FOB customs clearance basis). In the third quarter, however, although investment (rising to 4.7 percent) and exports (27.0 percent) improved as the price of oil went down, consumption (which grew at a rate of only 1.1 percent) slowed as the global financial crisis

became apparent and a recession was impending. These developments made Korea's third and the fourth quarter GDP growth rate (3.8 percent and -3.4 percent respectively) slower than the previous two quarters.

In fact, at the beginning of October 2008, after the collapse of Lehman Brothers, the Korean financial market was put into a panic as the *won* depreciated from 1,187 *won* per dollar in early October to 1,467.8 *won* on 28 October and then further, to 1,513 *won* on 24 November. The average monthly stock price index fell from the peak month of May 2008 (1,846.8), to October 2008 (1,201.7), and then to November 2008 (1,073.9) (**Figure 4**). Samsung Economic Research Institute (SERI) attributed the changes mainly to massive foreign capital outflows from stock and bond investments. Even though Korea ranks number 27 among 30 OECD countries in terms of financial market openness measured by the ratio of foreign investment inflow and nominal GDP, it ranks number 3 in terms of the weight in stock investment (39.0 percent) and number 6 in terms of weight in securities investment, including bonds (55.7 percent).<sup>3</sup>

**Figure 3: Dow Jones Industrial Average, January 1979–December 2008**



Source: Dow Jones and author's records

3. "CEO Information," Samsung Economic Research Institute, 24 December 2008.

**Table 1: Korea's Principal Economic Indicators, 2007–08**

Indicators		2007	2008			
			Q1	Q2	Q3	Q4
GDP growth rate		5.0	5.8	4.8	3.8	-3.4
Private consumption		4.5	3.4	2.3	1.1	-4.4
Facilities investment		7.6	1.4	0.7	4.7	-14.0
Manufacturing output		6.9	10.9	8.9	5.6	-11.3p
Average capacity utilization rate		80.1	80.8	80.4	78.3	69.1p
Exchange rate	Won/dollar (average rate)	929.2	956.0	1,016.7	1,062.6	1,362.8
	Yen/dollar (average rate)	789.8	909.4	972.7	988.8	1,421.4
Interest rate	Corporate bond (3-year, AA-, %)	5.7	6.4	6.3	7.2	8.3
	Treasury bond (3-year, %)	5.2	5.2	5.3	5.9	4.7
Stock price index (KOSPI, average)		1,714.2	1,692.0	1,794.5	1,504.9	1,136.4
Exports (in billions of dollars, FOB)		371.5	99.4	114.5	115.0	93.1
Percentage change		14.1	17.4	23.1	27.0	-9.9
Imports (in billions of dollars, CIF)		356.8	106.0	114.8	123.0	91.5
Percentage change		15.3	28.9	30.5	43.0	-9.0
Current account (in billions of dollars)		5.9	-5.2	-0.1	-8.6	7.5
Unemployment rate		3.2	3.4	3.1	3.1	3.1
Unemployed persons (per 10,000 persons)		78.3	80.1	76.7	75.2	75.7
Consumer price index (percentage change)		2.5	1.3	2.0	1.4	-0.3
International reserves (in billions of dollars)		262.2	264.2	258.1	239.7	201.2
Total external liabilities (in billions of dollars)		383.2	415.8	421.7	425.5	380.5

Sources: Bank of Korea; Korea National Statistical Office; Korea Customs Service.

Note: Some data for the fourth quarter (Q4) of 2008 are preliminary estimates.

In 2008 (prior to 22 December), foreign investors in the Korean securities market are reported to have recorded net sales of 43.2 trillion *won* out of total holdings of 176.2 trillion *won*. As a consequence, foreign investors' share of Korea's stock market declined from 42 percent in 2004 to 29.4 percent in November 2008. During the period of 2 January 2008–12 December 2008, the net sales of foreign investors' stocks in seven Asian economies (Korea, Japan, India, Taiwan, Thailand, Indonesia, and the Philippines) were \$102 billion, of which the largest

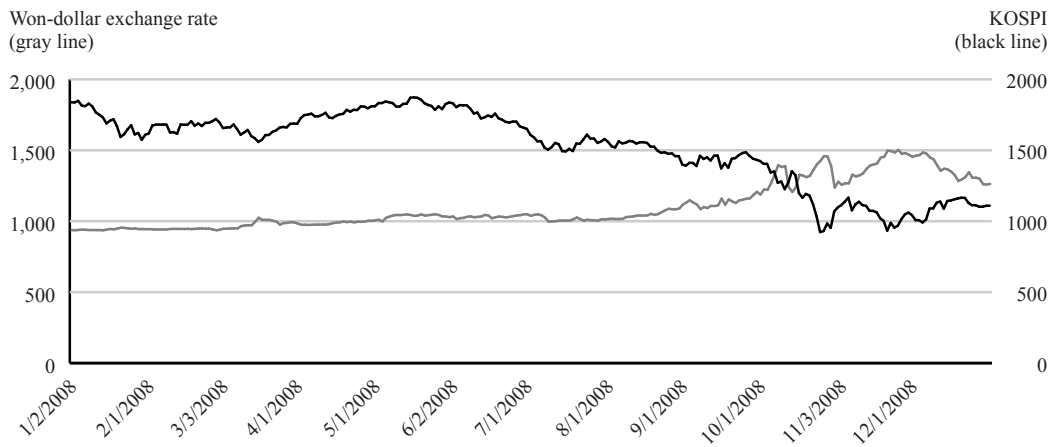
proportion was the net sales that took place in the Korean market, which amounted to \$34 billion.

The SERI report<sup>4</sup> points out that dollar-denominated transactions in Korea's foreign exchange market amounted to 98 percent (\$40.4 billion) of Korea's total foreign exchange transactions (\$41.4 billion) during the third quarter of 2008. This lack of decoupling from the dollar has made both the *won* and Korea's stock market index very volatile at a time of U.S.-originated financial distress, as shown

4. Ibid.



**Figure 4: Won-Dollar Exchange Rate and Korean Stock Market Index (KOSPI)  
1 January 2008–31 December 2008**



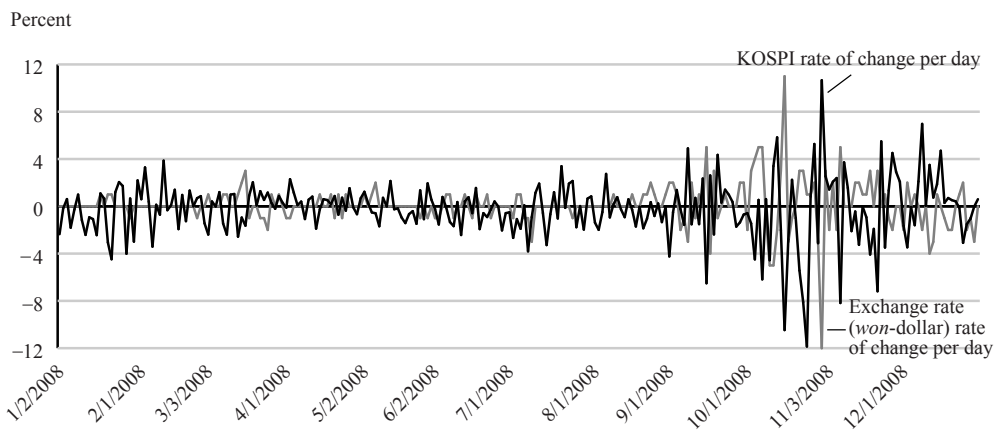
Source: Thomson Reuters Datastream database; Korea stock exchange.

in **Figure 5**. The report estimates the correlation coefficient between the *won*-dollar exchange rate and the KOSPI in 2008 was the highest in history (–0.89), followed by 2007 (–0.76) and 2003 (–0.48). In short, the strong co-movement between the depreciating *won* and Korea’s declining stock prices observed during the final quarter of 2008 and the excessive volatility in the foreign exchange market and stock market imply the absence of decoupling of the Korean markets from the U.S. markets and the Korean market’s overexposure to foreign portfolio investment. The foreign press and ratings agencies have voiced concern over Korea’s ability to service short-term debt. The *Financial Times* (28 November

2008) pointed out that South Korea’s external debt swelled to \$425.1 billion, an increase of \$4.4 billion in the second quarter of 2008. Short-term debt grew \$12.9 billion, to \$189.4 billion; while long-term debt declined by \$8.5 billion, to \$235.7 billion. The press and ratings agencies also pointed out that South Korea’s loan-to-deposit ratio of 140 percent in the banking sector is also seen as problematic, outstripping other countries in the region.

The Korean government announced a \$130 billion bailout fund in October 2008, but Fitch downgraded its outlook on Korea from “stable” to “negative” in November 2008. In addition, Fitch released the

**Figure 5: Change per Day of Won-Dollar Exchange Rate and Change per Day of Korean Stock Market Index (KOSPI), 1 January 2008–31 December 2008, percentage**



Source: Thomson Reuters Datastream database; Korea stock exchange.

result of its “stress test” and estimated on 12 March 2009 that Korean lenders may suffer a combination of additional losses amounting to 42 trillion *won* by the end of 2010 on account of their high-risk loans and exposure to foreign currency assets.

Korea’s Financial Services Commission (FSC) disputed the Fitch result, saying, “Unlike banks in major developed countries, Korean lenders are able to boost their capital bases through common share offerings and have their own capacity to raise capital.” FSC announced the creation of a 40 trillion *won* Finance Stability Fund as a contingency plan and a backup measure to the bank recapitalization fund of the 20 trillion *won* (\$13.5 billion) fund it plans to use soon. As shown in Table 1, Korea’s total external liabilities have been reduced from \$425.5 billion (2008 Q3) to \$380.5 billion (2008 Q4). At the same time, the current account balance improved from a deficit of \$–8.6 billion (2008 Q3) to a surplus of \$7.5 billion (2008 Q4). Therefore, the concerns by the *Financial Times* and Fitch are not fully warranted. The Korean government, however, should pay due attention to the deleveraging costs of commercial banks and their relatively high loan-deposit ratios.

### **New Economic Policy Agenda**

Entering 2009, both industrial nations and emerging-market economies have been engaging themselves in producing stimulus policy packages, including the \$700 billion relief fund in the United States. The Korean government is also planning to lay out a series of economic recovery policies to protect the economy from further downturns and to preserve the potential for a sustainable growth. Even though the Korean government had planned for real GDP growth in 2009 of 2 percent, the Korea Development Institute on 22 January 2009 released its new forecast of 0.7 percent.

As the world will be full of stimulus policies, there will be a beggar-thy-neighbor threat and a risk of a competitive depreciation war as each country promotes its exports. For example, the bailout attempt by the U.S. government on GM and other

automakers will inevitably induce protectionism in automobile imports and will delay the worldwide recovery through trade divergence rather than trade creation. We all know that the consequence of such policy games in the end is hyperinflation. Therefore, it matters which economy puts forward more sustainable and competition-enhancing policy packages. The new economic policy agenda that should be pursued by a newly appointed economic policy team in Korea calls for a careful reexamination of economic stimulus packages in order to determine which policy is likely to enhance real productivity. According to the Conference Board, labor productivity in South Korea in terms of GDP per hour (in U.S. dollars) in 2007 was estimated to be \$23.50; this compares with the United States (\$52.10) and Japan (\$37.10). Therefore, as their relative percentages compared with the United States (100) show, both South Korea (45) and Japan (71) need to increase their real productivity.<sup>5</sup>

In this respect, the success or failure of each country’s stimulus packages will depend on the contents and the quality of such policy packages. The criteria will be whether and how much the net results of stimulus policy packages have been productivity enhancing.

For policies such as corporate restructuring, the judgment must rest on whether there is a chance for productivity-enhancing business activity. Instead of ready-made policy packages, such as across-the-board employment cuts and populist-style mass development projects, a more prudent research and development program, educational improvements, and expansion of on-the-job training programs would help to restore growth potential and preserve social networks. The recent news that China is planning to invest in the renovation and improvement of its vast educational facilities as part of its domestic stimulus packages deserves our special attention.

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5. Bart van Ark, “Performance 2008: Productivity, Employment, and Growth in the World’s Economies” (New York, Conference Board, 2008).







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