Comments on Paper 2

Sumner J. La Croix

Professor, Department of Economics, University of Hawaii

Professor Cho has provided us with a very stimulating paper that addresses an interesting topic for academic economists and a critical topic for Korean policy makers: Why has the Korean economy emerged from the recent global financial crisis in so much better economic and financial shape than it did from the (1998-2000) Asian Financial Crisis? Professor Cho argues that the rapid recovery of Korea's stock market and its exports—both of which sharply declined during the recent global financial crisis—was primarily due to changes in a few key economic policies carried out during the 2000s decade and the restructuring of its banking industry in the aftermath of the Asian Financial Crisis. The reforms of 2000s decade reduced exposure of the Korean economy to the externally generated shocks of the recent crisis and allowed for a rapid depreciation of the won to facilitate adjustment to a large decline in foreign demand for Korean export goods.

Professor Cho's analysis posits a strong linkage between an improvement in the policy choices of the Korean government during the recent crisis and the surprisingly strong performance of Korea's economy in light of the severity of the crisis in many developed countries. At the center of this improvement is the decision taken during the 2000s decade to switch exchange rate to a flexible rate regime. When the Korean economy was hit by sharp and unexpected declines in demand for its exports in the second half of 2008 and the first quarter of 2009, Professor Cho argues that the fall in the value of the won contributed to a strong turn around in export performance in the second half of 2009 and first half of 2010. Cho finds that Korea's accumulation of substantial foreign exchange reserves during the 2000s decade was important even in the context of a flexible exchange rate regime, as it allowed the government to respond more credibly to the large capital outflows from Korea after the Lehman Brothers bankruptcy in September 2008. Professor Cho argues that a high ratio of short-term foreign debt to GDP had triggered the capital flows and that the combination of a currency swap with the United States and a government guarantee of the short-term debt was sufficient to stop the

outflows. Since the government's foreign exchange reserves exceeded the short-term foreign debt, the government's guarantee was more credible. Lurking in the background of this story is, of course, the ability of Korea's banks and corporations to service these debts. And, as is well known, the Korean banking industry was in excellent financial health when the recent crisis unfolded, as the Korean government had, in the immediate aftermath of the 1998-2000 crisis, carried out a long, costly, and mistake-ridden reorganization and restructuring of major banks in addition to reforms in the areas of bank regulation and supervision. as well as the regulations governing bank activities and supervisory oversight. Also important to the service of the short-term debt was that a decline in leverage of large- and medium-size chaebols left them less harshly exposed to liquidity problems in global markets than in 1998/1999.

Professor Cho also commends the government's timely enactment of a fiscal stimulus program in Fall 2008 that relied on a combination of tax cuts and increases in government spending. In addition, monetary policy, freed of supporting a fixed exchange rate provided reductions in short-term interest rates and contingent policies to be implemented in the event that Korean firms had difficulties rolling over short-term financial assets.

There are, however, a few other factors that are mentioned only briefly in Professor Cho's paper, perhaps because they can mostly be categorized, following Sherlock Holmes, as "Dogs that DID NOT bark in the night," i.e., factors that contributed substantially to the generation and propagation of shocks in the U.S. and U.K. economies during the recent financial crisis and that were not present to any substantial degree in Korea's financial markets.

First, Korean banks had very limited direct exposure to collateralized securities backed by sub-prime mortgage securities issued by U.S. banks. This absence of substantial holdings of these toxic assets meant that private and public resources did not have to be devoted to valuing the assets or to develop strategies to unwind them or to understand how the risks from one bank's holdings might be propagated through the banking network to other banks, depositors, or loan recipients. While the Korean Government established a small fund to provide financing for banks with these securities, only $5 million was actually used. Thus, the government was saved the enormously costly and divisive job of bailing out banks.

Second, Korea did not have a substantial shadow banking sector, i.e., financial firms that intermediated funds much like banks but not within the umbrella of firms subject to regulation and supervision of their activities. There were no large investment banks like Goldman Sachs,

Lehman Brothers, or Merrill Lynch that were making medium-and long-term leveraged investments with funds raised by issuing short-term financial instruments. Another segment of the shadow banking sector—unregulated hedge funds—had only a small direct presence in Korea. Strict regulations imposed on on-shore hedge funds forced most hedge fund investing in Korean assets to move off-shore—to Hong Kong, Singapore, Tokyo--to take advantage of less restrictive regulations imposed by these money centers.

Finally, Professor Cho also briefly notes that Korea's housing prices appreciated very modestly during the 2000s decade. (This was due in part to sharp increases in the tax on housing capital gains and restrictions on the ratio of mortgage payments to family income.) And without a bubble in housing prices, it's hard for consumers to become convinced that rapid housing increases would be the new norm or to borrow excessively against temporarily high housing prices. Of course, interventions to control market prices can also yield deadweight losses, and large increases in the price of homes in emerging economies happen.