Comments on Paper 4

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Professors Lee and Song ask what are the channels through which the international financial crisis that started in the U.S. real estate market reached Korean shores. They start by noting that the crisis, following the Lehman Brothers collapse in September 1998, manifested itself in large capital outflows, a contraction in the availability of foreign exchange credit, and a large contraction in exports and production.

How did these adverse impacts in Korea originate from the U.S. financial crisis? Professors Lee and Song focus on financial spill-over, and we hope that in future work they will elaborate on whether and how this financial contraction spilled over into the real (production) economy. The first, and maybe most important observation Professors Lee and Song make is that the largest credit contraction was experienced in short-term borrowing by domestic deposit-taking institutions (figure 3).

The comparison the authors make between the most recent crisis and the previous crisis to hit Korea in 1997-8 is especially enlightening. The authors note that the fundamentals before the most recent episode were much stronger than in the summer of 1997, though exactly how to measure this remains an open question. These stronger fundamentals at the onset of the crisis may explain why the most recent crisis manifested as a much lower external pressure as measured by the Aizenman and Hutchison index (another paper in this volume). Table 1 shows the Aizenman-Hutchison index for Korea for the current crisis and compares it to the same index applied to the previous episode (calculations by the author from IFS data).

Table 1: EMP Aizenman-Hutchison Index for Korea

	EMP Index	Δ XR	Δ FX Reserves
1997 M6 - 1997 M12	131.1	90.0	41.1
2008 M8 - 2009 M2	70.3	51.6	18.7

By this metric, the previous Korean crisis was experienced twice as severely than the current one. In both cases, however, there was a dramatic increase in short-term lending prior to the crisis (in the latter case, starting from 2006). By the third quarter of 2008 (when the crisis began), the short-term debt to reserves ratio for Korea was 79%, and some observers interpreted that as a vulnerability. The authors, however, hint that these worries may have been misplaced – but are reluctant to refer to this as a self-fulfilling concern.

Following the 1997-8 crisis, there was much disagreement between the first- and second-generation interpreters of financial crises, with the former identifying the crisis with mis-aligned fundamentals (deficits and crony capitalism were frequently mentioned) and the latter with multiple equilibria and self-fulfilling scenarios (herd panic leading to a sudden stop, or, more rarely, a conspiracy of international speculators). In the current context, we can then ask what are the implications of the authors' findings on similar disagreements about the current crisis. Did Korea indeed have fundamental imbalances, or was this a completely external crisis that hit Korea without any fundamental justification?

What led to this pre-crisis credit boom is also a topic that is worth exploring. We know from this paper that much of it had to do with foreign exchange hedging done by exporting (and importing) Korean firms. However, what was unique about the 2006-2008 period that led to this extraordinary boom in credit is still not thoroughly explained. At least in the U.S., the origins of this crisis clearly lie in a credit boom that produced a real-estate bubble. Is this the case for Korea as well?