

Comments on Paper 10

Atish Ghosh

Chief, Systems Issues, RES, International Monetary Fund

I have enjoyed reading this well-written paper by Kyung-Mook Lim. The paper summarizes major developments in the financial structure of Korean non-financial firms and the macro-economic performance of the economy while making useful comparisons between the 1997 crisis and the recent global financial crisis. The formal regression analysis offers useful insight how the 1997 crisis changed the behavior of Korean firms and how the changed behavior paid off when the economy was hit by the global financial shock. In this respect, the paper is highly complementary to ours presented in this conference where corporate vulnerabilities were not covered for data related reasons. Albeit confined to Korea's experience, the conclusion of the paper appears compelling, and conforms well to our view of a crisis as the confluence of the underlying vulnerabilities and triggering events.

The paper highlights several important features that emerge from the data including the reduced debt equity ratio. Most striking are the sharp upward trend in retained earnings since 2004 (Figure 4) and the sudden jump in corporate debt between 2007 and 2008 (Figure 5). The former is in sharp contrast with the behavior of the cash holding ratio which peaks in 2004 and declines gradually afterwards (Figure 7). The increase in corporate debt in 2008 is the largest since 1980, resulting in an increase in the debt equity ratio by almost 50 percentage points. We suspect if the increase in the debt equity ratio in 2008 and the subsequent fall in 2009 largely reflects the balance sheet effects associated with the exchange rate depreciation (over 35 percent) and the fall in stock prices. In any case, these two facts warrant further explanation to better understand what had happened in Korea's corporate sector before entering into the global crisis.

The regression results reported in Table 4 suggest that the 1997 crisis was indeed a turning point in the behavior of non-financial firms of Korea. The crisis dummy remains highly significant even after controlling for other usual determinants of the debt equity ratio. However, the considered determinants of the debt equity ratio including the crisis dummy account for only 7 percent of the sample variation in the debt equity ratio. It would be interesting to see if the debt

equity ratio evolves differently between tradable and non-tradable sectors and if asset price movements have any bearing on the ratio. For example, the strong export performance may have allowed tradable sector firms to increase retained earnings and reduce the debt equity ratio while depreciated exchange rates have suppressed the profitability of non-tradable sector firms.

While the reduced debt equity ratio clearly indicates an improvement in the financial structure of non-financial firms, it does not necessarily mean that the “too-big-to-fail” hypothesis is no longer valid in Korea. What matters for the hypothesis is the real and financial externality that a large firm can impose on other firms and eventually on the entire economy, and not the financial soundness of the firm in question.

Finally, the paper raises an interesting and important point regarding the effect of corporate and financial reforms on real investment or, more broadly, the risk-taking behavior of firms. As shown in Figure 10, the investment ratio has fallen discretely during the crisis years and remained permanently below the pre-crisis level afterwards. The fact that the debt equity ratio has converged to a level way below the 200 percent guideline suggests that the observed reduction in the debt equity ratio must have been voluntary at least in the more recent years. Moreover, the real interest rate or the funding cost has been historically low over the past decade or so. These facts, together with the explanations put forth by the paper, suggest that the permanent decline in the investment ratio is most likely to be an optimal response of Korean firms to increased uncertainty (or renewed perception of existing uncertainty). In fact, the standard economic theory offers a plausible explanation consistent with this view. As is well known, after the 1997 crisis, Korea liberalized its capital account to a level comparable to advanced countries. The open capital account may have allowed greater diversification in the country’s asset portfolio, which was previously highly concentrated in domestic capital. If the national savings rate remains relatively stable, greater portfolio diversification would lead to a (permanent) fall in the investment ratio.

I will conclude my comments by suggesting possible extensions of the paper. First, the paper could usefully expand its analysis to other fundamentals of the corporate sector, including in particular FX liquidity or FX liabilities with short maturities. The debt equity ratio is an important indicator of financial soundness but may mask crucial weaknesses in the liquidity position. The cash holding ratio is informative in this respect, and seems to suggest that at least large firms might have been fairly well positioned in terms of FX liquidity on the eve of the

global crisis (although banks might not). Second, it would also be useful to see how the macroeconomic policies (including unconventional measures such as loan guarantees) interacted with improved fundamentals in preventing or limiting the consequences of the global financial shock and the subsequent wave of collapsing external demand.

Let me conclude by reiterating that I really enjoyed reading this paper, which fits very nicely into the overall themes of this conference.