

Ten Lessons Learned from the Korean Crisis

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The crisis has now passed in Korea. The excessive optimism of pre-crisis Asia gave way to what has now turned out to have been excessive pessimism in 1998. We have had a V-shaped recovery in Korea, as to some extent throughout developing Asia. The country has now, after two years, attained its pre-crisis level of production. This is just the length of time it took Mexico after December 1994. The same pattern as Mexico. Indeed, the timing and pattern of recovery has been remarkably similar to Mexico's, as my charts show.

- First, the trade balance turns from deficit to surplus, amazingly quickly – 1-3 months into the crisis.¹ Unfortunately, the cause is a fall in income and imports rather than an increase in exports. Nevertheless, reserves start to rise again.
- And the collapse of confidence in financial markets begins to reverse: interest rates and the exchange rate begin to ease 3-4 months into the crisis.
- The real economy is down for longer, but the steep rise in unemployment levels off at the eighth month, industrial production begins to rise again in the fourth quarter [Korean unemployment fell to 4.8 % in September 1999], and GDP reaches its pre-crisis level at the end of the second year. [After a decline in GDP of 5.8% in 1998, forecasts are about 9% for 1999.]

What are the lessons? I have ten. Some are old conventional wisdom, some are new conventional wisdom and some, I hope, are unconventional wisdom

1. Lawson's Fallacy is still a Fallacy. That is the claim that if a country has a strong fiscal position, so capital inflows are financing the private sector, then a big CA deficit is not a cause for concern. This belief came to grief in Chile in 1982, UK in 1992, Mexico in 1994, and now East Asia in 1997. Worse yet, the post-Mexico modification, also came to grief: namely, that if a country has not only strong public saving but also strong National Saving, so that the capital inflows are going to finance private investment rather than consumption (as in Mexico), then a big CA deficit is not a cause for concern.

2. The composition of capital inflows matters. Statistical studies of early-warning indicators. Short-term, dollar-denominated, banking flows especially risky, and FDI especially safe. Korea made a mistake by tilting in the wrong direction.

3. Foreign exchange reserves are important. Examples of Taiwan and China, vs.

¹ [K CA from a deficit of 23b in 1996 to a surplus of \$11 per quarter in the first half of 1998 >12% of GDP, \$41 b in all 98; now again easing to \$6 billion in 1999Q1. Est. \$25 b = 6% for all 99]

Thailand and Korea (where FX reserves had dwindled to about \$4 billion by late 1997).

4. Modern international financial markets are not perfectly efficient (though we are better off with them than without them). The magnitude of the recession seems disproportionate to the policy sins committed (though long-run growth probably higher as a result of open policies). Contagion also suggests imperfect efficiency. [The August 1998 spillover from Russia to Brazil and other markets suggests that pure financial contagion, unrelated to real economic fundamentals within the countries, is possible.]

5. Moral hazard at the international level (IMF bailouts) can't be the primary market failure, because that would imply too much private-sector money going to developing countries (whereas calculations based on the equalization of K/L ratios and rates of return say not enough money is going in the aggregate). **Moral hazard at the domestic level** instead was a primary problem in the East Asian case. Bank loans based on personal connections or government guidance rather than investments prospects for high returns, implicit government guarantees, empire-building, etc. I give equal weight to the flaws in the economic fundamentals, on the one hand, and to excessive swings in speculators' enthusiasm, on the other hand. I see no need to choose between blaming the countries and blaming the speculators.

6. IMF programs should sometimes involve structural conditionality in addition to macroeconomic conditionality. Any perceived or actual tendency to impose irrelevant conditions (e.g., US congressional trade priorities) as part of the Korea program is regrettable. Nonetheless, I view the IMF's evolution and expansion of scope to cover not just macroeconomics but also the structure of the financial system, in general, as appropriate "changing with the times" and not "bureaucratic mission-creep."

7. Involving the private sector in rescue packages is tricky (arm-twisted investors will pull their money out elsewhere), but it needs to be attempted. It is instructive to compare the unsuccessful December 4, 1997, IMF program in Korea, with the successful second try at the end of the month.

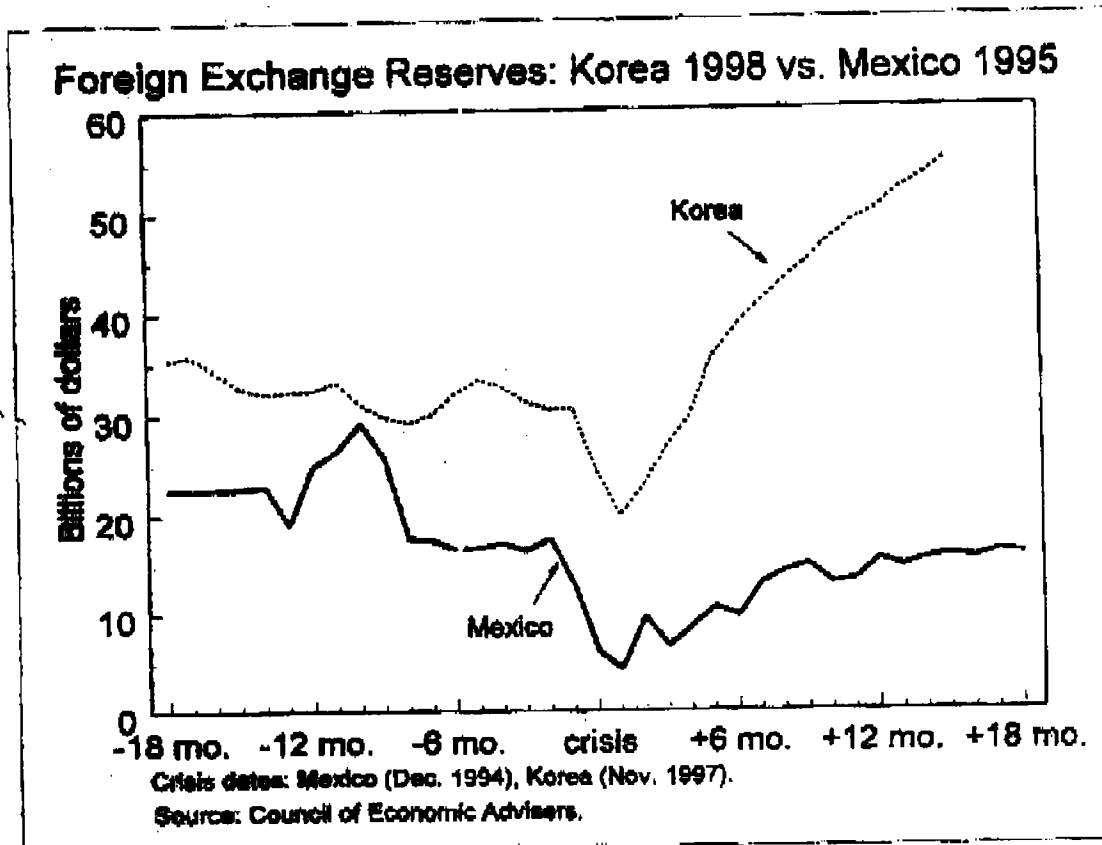
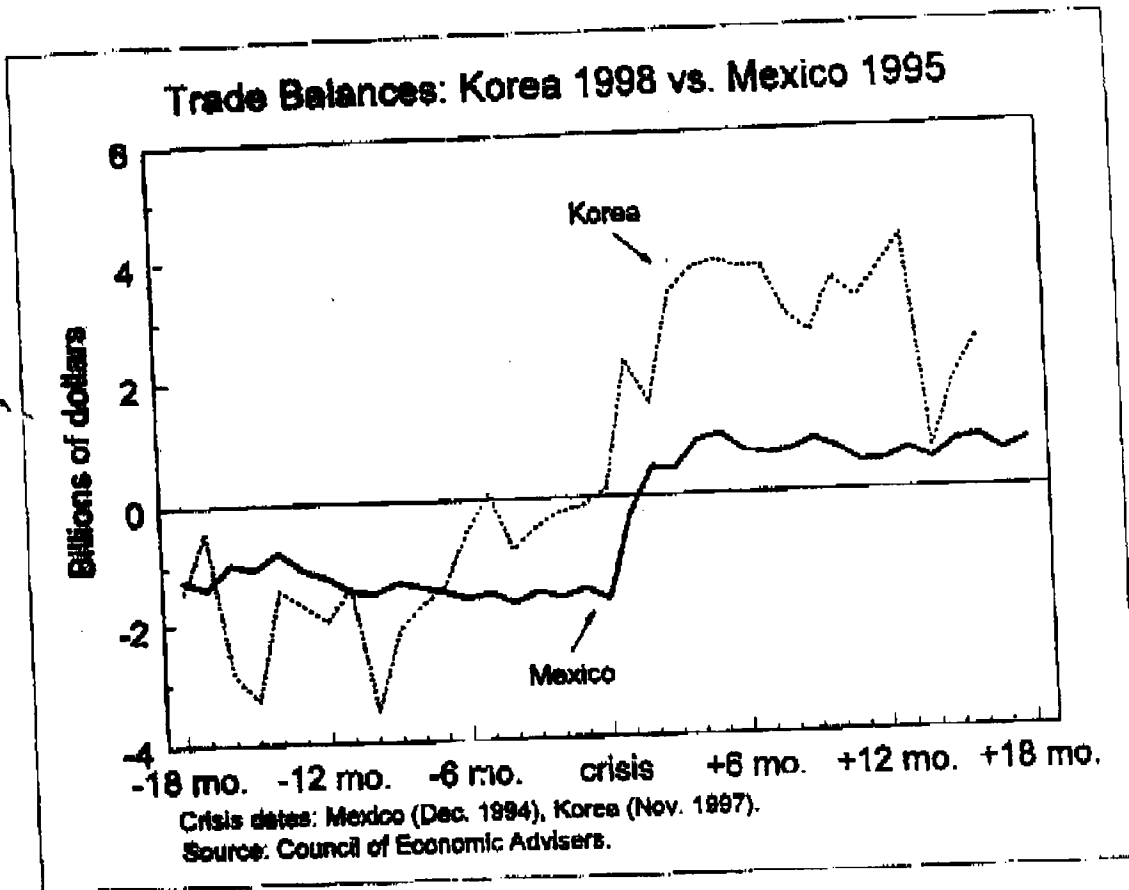
8. Keynesianism is alive and well in Asia. Fiscal expansion is expansionary in the short run, and fiscal contraction is contractionary.

9. When a crisis hits an emerging market, there may be no combination of higher interest rates and/or lower currency that will satisfy international investors, and thereby meet the external financing constraint, without a recession. This is contrary to the textbook theory of targets and instruments. Perhaps the lines for internal balance and external balance don't intersect.

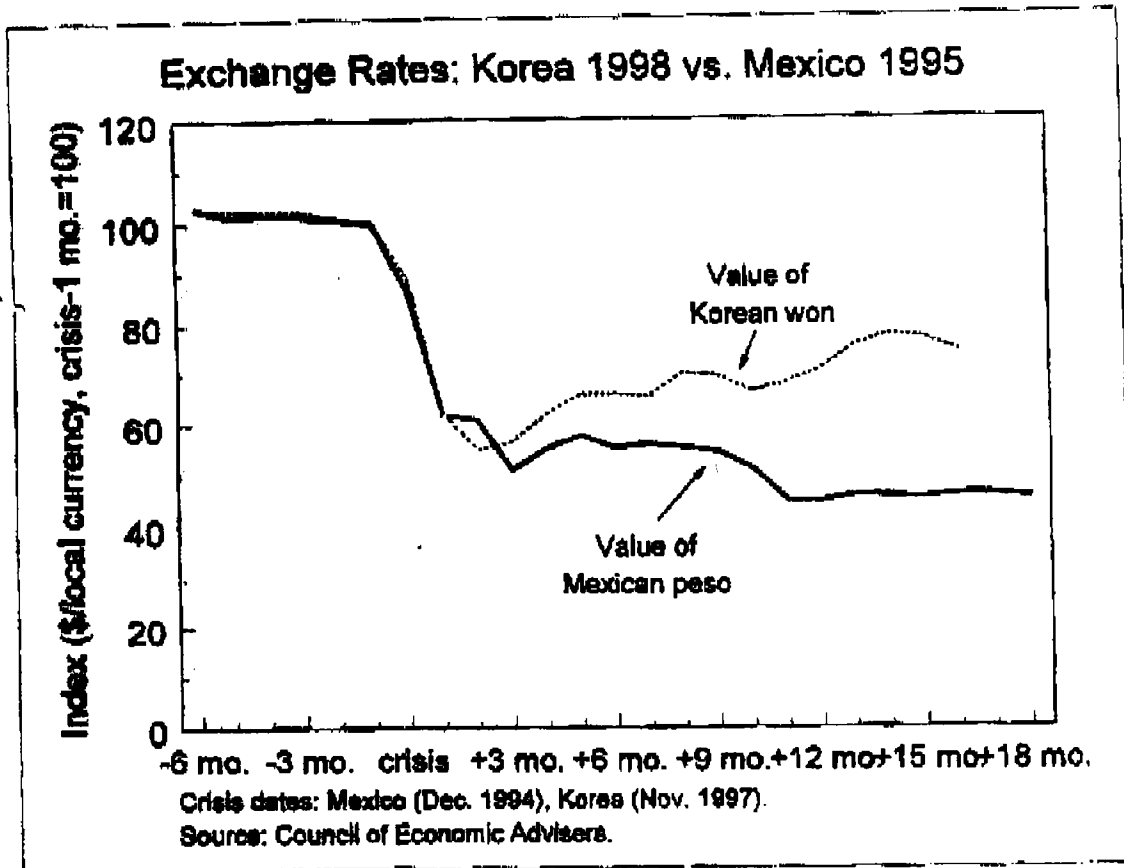
10. As of 1998, we thought we had learned that the one thing you can do to minimize the pain when inflows reverse is to try to devalue early enough (or else raise interest rates early enough – anything to adjust, rather than try to finance an ongoing deficit) -- that Mexico, Thailand and Korea made the mistake of waiting too long (until reserves ran low), so that by then there was no good way out. One variety of this hypothesis is the

newly-popular corners hypothesis: you should either adopt a rigid institutional fixed-rate commitment (Hong Kong and Argentina) or, if not prepared to do that, abandon the peg early.² On this basis, when Brazil in the Fall of 1998 delayed the seeming inevitable jettisoning of the real target, many thought this would be a repeat of the earlier mistakes, but in worse form because of the delay. Instead, when the devaluation finally came in January, Brazil's trade balance improved sharply and the output and employment did far better than neighboring Argentina.

² Even then we had a counter-example: Indonesia had widened the band right away in 1997, and yet that didn't save it. But one could argue that political instability would have done Indonesia in no matter what. Taiwan devalued promptly, and suffered less than the others.



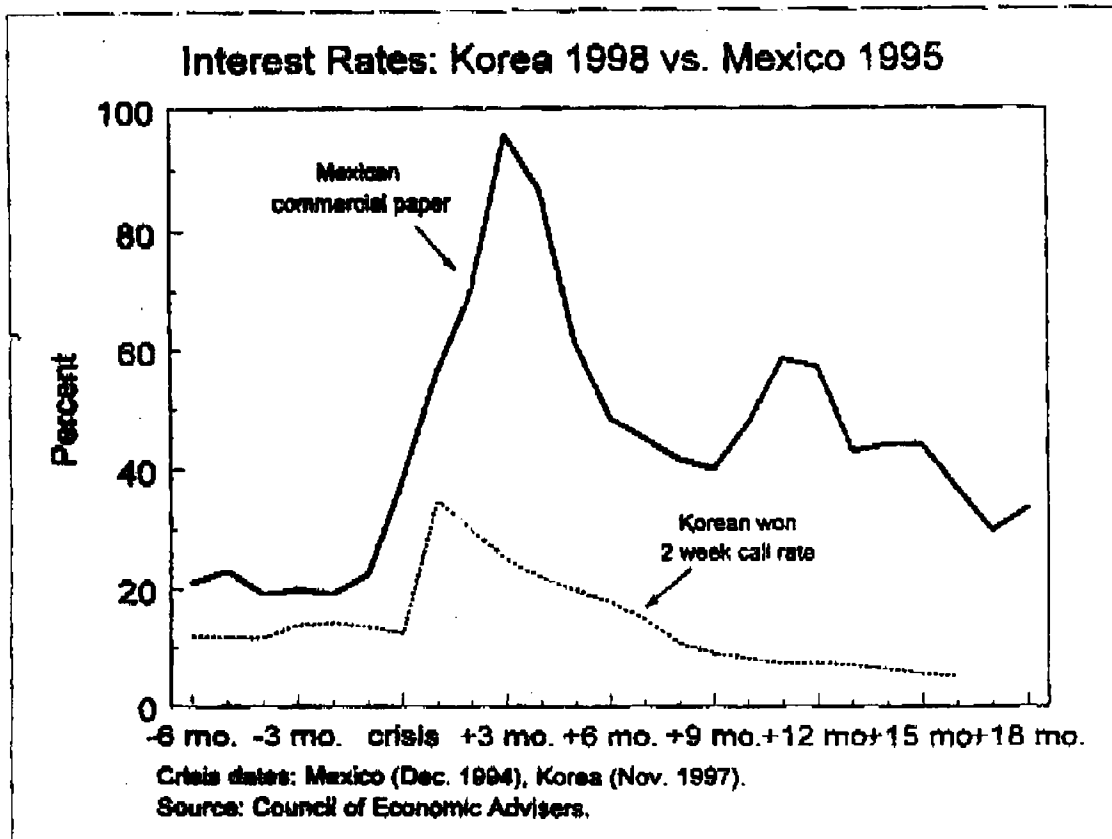
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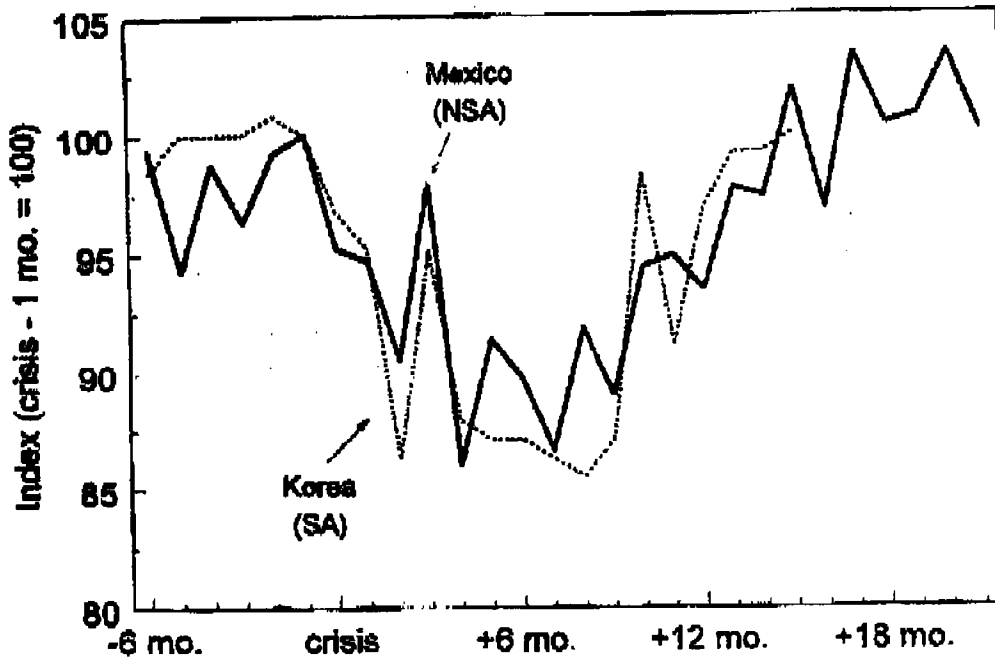
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Manufacturing Production: Korea 1998 vs. Mexico 1995



Crisis dates: Mexico (Dec. 1994), Korea (Nov. 1997).

Source: Council of Economic Advisers.

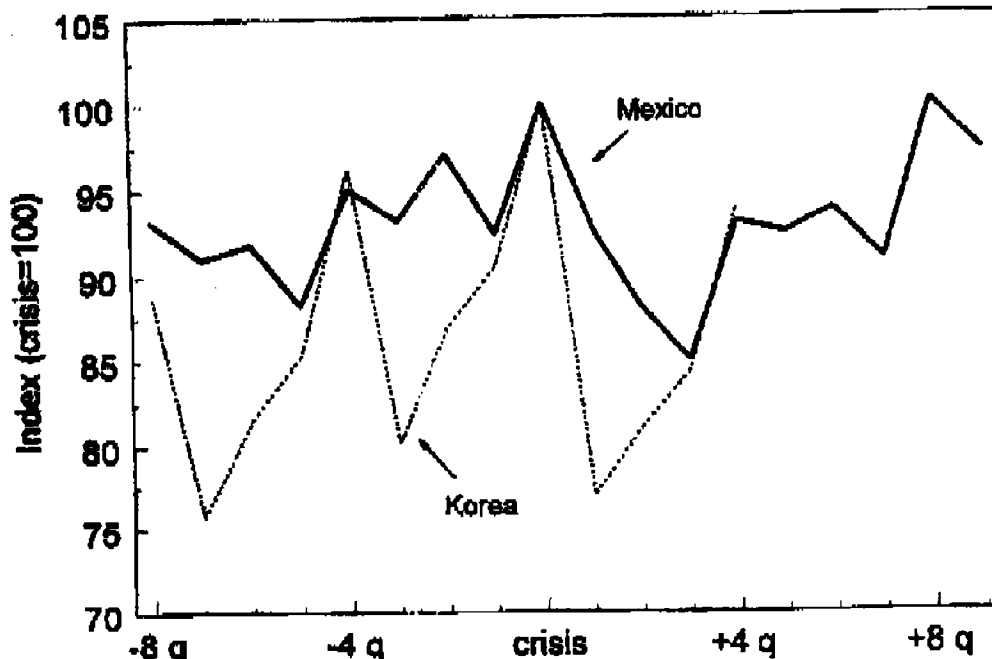
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Gross Domestic Product: Korea 1998 vs. Mexico 1995



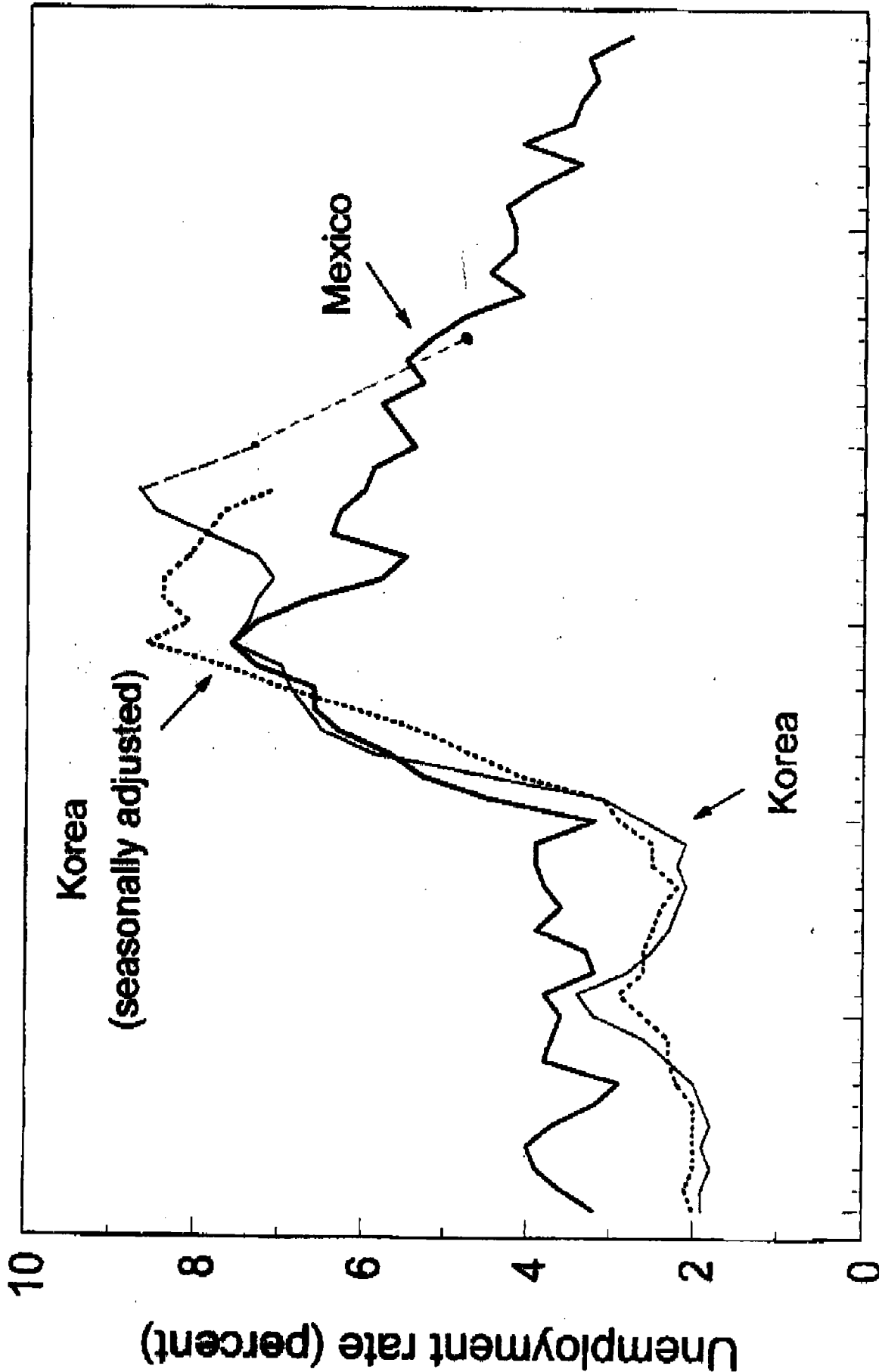
Crisis dates: Mexico (Dec. 1994); Korea (Nov. 1997).

Source: Council of Economic Advisers.

Gross Domestic Product:

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Unemployment Rates: Korea 1998 vs. Mexico 1995



-18 mo. -9 mo. crisis +9 mo. +18 mo. +27 mo. +36 mo.
 Crisis dates: Mexico (Dec. 1994), Korea (Nov 1997).
 Source: Council of Economic Advisers.