Choongsu Kim: Financial crises and policy responses – a Korean perspective

Speech by Mr Choongsu Kim, Governor of the Bank of Korea, at the Bank of Japan’s annual Tripartite Governors’ Meeting, Tokyo, 3 August 2010.

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1. Introduction

Honorable Governor Masaaki Shirakawa, Members of the Policy Board, Ladies and gentlemen,

It is a great pleasure for me to have this opportunity to share ideas with you today on the topic of financial crises and policy responses. The latest US financial crisis hit Asian countries hard as well, but they have shown remarkable resilience. And now Asia is regarded as the powerhouse for the growth of the global economy.

However, from this experience, we have come to realize that the interconnected global economy is highly vulnerable to various shocks. Therefore, the governments and the central banks of G20 countries are now working hard on designing a new financial architecture to prevent further crises and to support sustainable and balanced growth.

The topic of today’s speech is “Financial Crises and Policy Responses: A Korean Perspective.” In fact, I used to teach a graduate course titled “Economic Crisis Management” when I was a professor at a university in Korea. Since the 1997 Asian crisis, I have not been able to get the topic out of mind. I think many policymakers in emerging market countries have also had a similar obsession.

The plan of my exposition today is as follows. First, I will briefly talk about some theories regarding financial crisis and secondly I will review the history of financial crises with a special focus on the period since the 1980s. To understand the situation in which we are placed, it is helpful to look back and draw some implications from the past. Lastly, I will discuss the measures under discussion in the G20 to lower the probability of future crises and mitigate their impact on the world economy.

2. Economics of financial crisis

Leo Tolstoy opened Anna Karenina by asserting, “Happy families are all alike; every unhappy family is unhappy in its own way.” It seems this phrase also applies to financial crises. Each crisis may have its own causes and consequences. Even for a single crisis, there are many competitive diagnoses and policy prescriptions by researchers and policymakers. However, it is also true that there are some common elements to many financial crises. Understanding these common factors is critical for preventing a potential financial crisis from materializing.

Two key questions facing policymakers are how to reduce the risk of a financial crisis and how to cope with one when it does occur. Understanding the common elements of crises is

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related to the first question and can contribute to reducing the probability of financial crises even though it is not possible to escape them completely. The second question is related to identifying the amplification mechanisms behind a crisis. By doing this, we can check the spread of a crisis and contain the consequences once it has been triggered and a crisis erupts.

2.1 Causes of financial crises

There are several frameworks to explain the origins or causes of financial crises in economics. Even though there may be many ways to categorize them, I would like to classify them into two broad categories: the “fundamentalist view” and the “human nature view.”

The first view posits a financial crisis as a rational response of economic agents to exogenous events. Such external events include changes in fundamentals like the terms of trade or international financial market conditions which alter rational perceptions of agents as to future cash flows. Thereby, agents change their attitude toward risk, which is reflected in leverage limits, risk pricing, and asset prices. Moreover, according to this view, there is a fundamental intrinsic weakness within the financial system as Douglas Diamond and Philip Dybvig demonstrated. Banks provide liquidity services to the market and thus themselves take on large liquidity risks. Due to this inherent weakness, there are multiple equilibria: everyone should stay in if everyone else does, but everyone should pull out if everyone else does. So, a relatively small exogenous shock can move an economy from one equilibrium to another one and sometimes provoke a devastating crisis.

The second approach is based on the view that human nature is prone to irrationality. According to Hyman Minsky, the financial system itself has a tendency to generate economic instability through endogenous waves of euphoria and anxiety. Myopia and herd-like behavior rather than rational long-term calculations are common and they lead to endogenous cycles of manias and panics.

From the point of past experiences, both frameworks seem to help explain some causes of financial crises as these are not only driven by the extent of fundamental weakness even though agents are rational, but also by the illusion or myopia on the part of policymakers and investors that “this time is different.” However, the two approaches still leave some gap to be filled with other factors like incomplete regulation leading to incentive misalignments, global capital flows or global imbalances, and so on.

2.2 Amplification mechanisms

When a crisis occurs, the loss of welfare is huge, compared with the size of the initial problem. For example, according to the estimation of the IMF, the losses on U.S. subprime loans and securities were estimated at about $250 billion as of October 2007. However, the expected cumulative losses in world output associated with the crisis for the years from 2008 to 2015 are forecast to run at $4,700 billion, about 20 times the initial subprime loss. Then, the following question is an obvious one: How could such a relatively limited event have effects of such magnitude on the national or world economy?

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To explain this phenomenon, I would like to adopt the explanation put forward by Frederic Mishkin (1999). Financial markets perform the essential function of channeling funds to the individuals or firms that have productive investment opportunities. However, relevant information is not free and not always creditworthy. The basic problems in the financial system are asymmetric information: adverse selection and moral hazard. To address these problems, various measures are created within the financial system: long-term customer relationships, credit line arrangements, collateral posting, etc.

However, shocks to the financial system make the adverse selection and moral hazard problems worse, and then credit tends to dry up, which is termed a “credit crunch.” The lack of credit leads individuals and firms to cut their spending, resulting in a contraction of economic activities. Four factors exacerbate asymmetric information problems, contributing to financial instability: the deterioration of financial sector balance sheets, rise of interest rates, increases in uncertainty, and the deterioration of non-financial sector balance sheets due to changes in asset prices.

This is why the government and the central bank intervene in financial markets promptly during a crisis. The central bank provides liquidity by acting as “the lender of last resort.” This helps the payment system work smoothly, and prevents the price of assets from dropping excessively. This, in turn, helps financial firms keep their balance sheets in better shape. The government injects public funds into banks for recapitalization and helps financial firms dispose of their non-performing assets by establishing special agents or bad banks. Sometimes, the government and the central bank engage in financial markets directly by taking over banks or buying commercial papers. Another important measure is enhancing transparency by disclosing key economic, financial and corporate sector information. All these measures alleviate the asymmetric information problem, helping prevent herd behavior.

So far, we talked about the causes and amplification mechanisms of crises. Bearing this theoretical understanding in mind, let us move on to the history of economic crises.

3. A short history of financial crises

Today, I would like to review four major financial crises that have taken place since 1980. These are the Latin American debt crisis of the 1980s, the Nordic Banking Crisis of the early 1990s, the Asian currency crisis of the late 1990s, and the latest US financial crisis in 2007. I chose them because they are most relevant for understanding the evolution of the global economy, although the choice may be somewhat arbitrary. I leave out the crisis which took place in Japan in the early 1990s and the long-term stagnation afterwards not only because I would not presume to venture in an area where your expertise is preeminent, but also it does not have great relevance to today’s topic. As we review each crisis, we will find common characteristics as well as its own particular features.

3.1 Latin America’s debt crisis of the 1980s

Let’s start by looking at the Latin American debt crisis of the 1980s. In the early 1980s, many Latin American countries found themselves in a situation where their foreign debt exceeded their earning power and they were not able to repay it.

Even though quite a few researchers tried to explain the crisis as a result of the economic development strategy of import substitution industrialization and heavy reliance on raw material exports, the direct causes were the two kinds of abnormalities. On the one hand, the

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governments and public sector typically took a large share of expenditures and investment in the economies, and thus the scale of the budget increased continuously. On the other hand, the governments were unable to collect the necessary taxes to pay for the increased spending.7

The consequence of this double problem was increased budget deficits, which in turn limited the capacity of the states to finance the deficit through raising debt. When the government could not resort to tax collection or further debt accumulation, printing money was the only option left, consequently resulting in hyper-inflation.

The evolution of the international financial environment at the time also played a role in the process. During the 1970s, oil prices skyrocketed and oil-exporting countries invested their money in international banks, which recycled a major portion of this as loans to Latin American governments. However, at the end of the 1970s, the US Fed led by Paul Volcker raised interest rates to curb inflation. As a result, interest rates in global financial markets rose and the world economy went into a deep recession. The debt obligations that should have been met by the Latin American countries increased dramatically and it became much harder for them to pay back their debts.

Consequently, in August 1982, Mexico declared that it would no longer be able to service its debt. And international commercial banks reduced new lending to Latin America significantly or halted it altogether. As much of the Latin American debt was short-term, a crisis followed when its rollover was refused. Sudden stops and massive capital outflows brought about a rapid depreciation of the Latin American currencies, thereby further raising the real interest rate. In terms of per capita real income, Latin America experienced negative growth of almost 9 percent between 1980 and 1985.

After the Latin American debt crisis, the so-called “Washington Consensus” emerged among economists and Washington, D.C.-based institutions such as the IMF and the World Bank. The term Washington Consensus was initially coined in 1989 by John Williamson, an economist of the Institute for International Economics, to describe a set of specific economic policy prescriptions that he considered constitute the “standard” reform package.8

Later, what was understood as the Washington Consensus came to include more market oriented policies such as capital account liberalization and was looked upon as a kind of ideology promoting free market economies. However, after the recent series of global financial crises, the Washington Consensus has been criticized by both policymakers and academics, and it no longer seems to have its past aura of “holy writ.”

3.2 The Nordic banking crisis of the early 1990s9

A second major international financial crisis we should look at is the Nordic banking crisis. During the late 1980s and early 1990s, nearly all major banks in the Nordic countries of Norway, Sweden, and Finland got into difficulties and made huge losses. And the governments of these countries had to provide public support to their banking systems.

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7 Cavallo, Domingo F., 2004, Lecture Notes for “Latin America and the Washington Consensus” delivered at Harvard University.

8 The consensus consists of ten recommendations: fiscal discipline, a redirection of public expenditure priorities, tax reform (to lower marginal rates and broaden the tax base), interest rate liberalization, a competitive exchange rate, trade liberalization, liberalization of inflows of foreign direct investment, privatization of state enterprises, deregulation (to abolish barriers to entry and exit), and secure property rights. (John Williamson, 2000, “What Should the World Bank Think about the Washington Consensus?,” The World Bank Research Observer, Vol. 15, No. 2).

The boom started with financial market deregulation, which led to an explosion of domestic bank credit. Following financial deregulation, competition between banks led to increased risk-taking. Another ingredient of the credit expansion was the freeing of international capital movements. A huge amount of capital flowed into the countries and a significant fraction of this was denominated in foreign currencies, but not hedged.

On the other hand, the rules and practices in prudential regulation and bank supervision were left unchanged in spite of the rapid deregulation. Meanwhile, social welfare policies distorted the market mechanism and prevented the efficient allocation of resources by placing a high priority on the housing and public sectors. The tax system also contributed to the credit boom. Full tax deductions for interest payments worked as an incentive to borrowers under a progressive tax system with high marginal rates.

On the side of real economy, strong external demand for the countries’ products and the positive terms of trade contributed to the domestic boom, rapidly pulling up real assets and stock prices. For example, the oil price surge in the early 1980s led to a boom in Norway, and the rise in the world market price of forest products contributed to the overheating of the Finish economy.

However, the overall run-up of the upswing finally ended with the bursting of asset prices and a huge loss to the banking system. The bust started with the turnaround of international economic conditions. The oil price fall in 1986 was a major negative shock to Norway. With the collapse of the Soviet Union, Finnish trade with Russia quickly decreased in 1991. Moreover, after German reunification, interest rates rose in Europe as a result of Germany’s combination of an expansive fiscal policy with a tighter monetary policy.

As a result, the three countries plunged into a deep recession for more than three years. Finland suffered an over 10 percent cumulative fall in GDP. The other two countries experienced a less severe loss but experienced three and four percent falls in their GDP.

One important feature to note about the Nordic banking crisis is that while the crisis was caused by excessive liberalization policies without due adjustments for social policies and regulation settings, it was overcome without resorting to the financial rescue packages of the IMF.

3.3 The Asian currency crisis of the late 1990s

Now let’s move on to the familiar Asian currency crisis of the late 1990s. East and South Asia had been widely acclaimed as successful models for economic development by international institutions including the IMF and the World Bank. Outward-oriented growth, high savings and investment ratio, low inflation and strong fiscal positions were mentioned as the key elements in the successful development strategy. Each country experienced high GDP growth rates of 8 to 12 percent in the late 1980s and early 1990s. How then did these countries fall prey to such severe financial distress?

The causes of the debacle are many and disputed. Huge capital inflows played a crucial role in the development of internal imbalances in the countries before the crisis. Capital inflows relative to GDP were very high in all affected countries for the pre-crisis period, ranging from 5 percent to 14 percent of GDP. Moreover, the ratio of short-term debt denominated in foreign currencies was quite high compared to central banks’ foreign reserves. The ratio of short-term debt to total foreign debt of the affected countries exceeded 50 percent.10

As foreign capital poured into the Asian countries, lending booms emerged in all these countries before the crisis. If the capital inflows and lending booms had enhanced the

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productivity and competitiveness of the economies, there might not have been a crisis. However, many of the loans were misallocated and eventually turned sour. Before the crisis, nonperforming loans exceeded 10 percent of total bank lending in those countries. The other aspect of capital inflows was the current account deficit. For example, Thailand, Indonesia, and Korea ran current account deficits of 8.0, 3.4, and 5.0 percent of GDP, respectively, in 1996.

The crisis started in Thailand with the collapse of the Thai baht. The crisis spread quickly around the region. Indonesia and South Korea were particularly hard hit. Hong Kong, Malaysia, Laos and the Philippines were hurt by the slump, and the rest of the region also suffered from a loss of demand and confidence.

The Asian financial crisis showed the weakness of an emerging economy against the volatile international capital markets. Together with inflows of foreign capital, overconfidence or excessive optimism created credit booms in the economies. Ironically, they were “victims of their own economic success.” The input-dependent development strategy, which had worked very well up until then, itself contributed to the crisis.

After the crisis, Asian countries introduced various measures to tackle the weaknesses that had led to the crisis. First of all, they enlarged the scale of their foreign reserve accumulation as the first line of defense. They also shifted to a free floating exchange rate system to contain the excessive capital flows. The other measures included making financial surveillance and regulation efficient; improving the functioning of the market by breaking the links between businesses, banks and the government; and enhancing transparency by enforcing the duty of disclosure of key financial or corporate sector information.

Controversy has raged over the IMF prescription for the affected countries. For example, the IMF was criticized as acting in Southeast Asia and Korea in much the same way as it had in the transitional economies of Eastern Europe. In short, the main criticism was that the same prescription was applied for different symptoms. Especially, in the case of Korea, interest rates were raised excessively in response to the foreign currency shortage, which resulted in a severe domestic credit crunch. However, I think that most of the measures during the crisis were inevitable to a certain extent and can be regarded as having erred more in their degree of severity rather than in their primary purpose.

### 3.4 The latest US financial crisis

The final example of a major crisis we will review is the latest US financial crisis. Even though it is not yet clear whether the crisis has ended or not, it is certain that it will have a profound impact not only on our economies but also on our economic thought. There is even a saying that we face not only an economic crisis but also a crisis in economics. As you are of course all too well aware of the evolution of the US financial crisis, I will be brief on the crisis itself, instead focusing on the mechanism of propagation to emerging economies.

The trigger for the crisis was the decline in housing prices in the United States. But, in the run-up to it, three elements had been working to bring about a major global crisis. The first element was credit expansion and asset price increase. During the first half of this decade, a benign environment of low inflation, low interest rates and sustained growth led people to have an optimistic attitude with regard to their economies. Some people enjoyed consumption in excess of their income level for too long a period of time. The second

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ingredient was the securitization of financial assets and the interconnectedness between financial institutions both within and across countries. Basically, securitization should improve risk allocation and helps absorb shocks. However, in fact, it brought opacity with increasing complexity, and a large degree of uncertainty about the value of the securities because their evaluation became much more difficult. And the third ingredient was the increase in leverage. Financial institutions financed their portfolio with more and more external debt, thus increasing the rate of return on capital. Underestimation of risk, moral hazard and poor supervision were the factors underlying this.

Around the end of 2006, US housing prices stopped rising and started declining rather steadily. Many marginal mortgages, especially subprimes, fell into default. And the shock reverberated through the securities markets and financial institutions. As asset prices dropped greatly, financial institutions needed to improve their capital ratio, to satisfy either investors or regulatory requirements. To do this, they deleveraged by selling part of their assets or reducing their lending.

Through the deleveraging of financial institutions in the advanced countries, emerging market countries eventually started to get affected by the crisis that had originated from the former. Right after the financial crisis, it looked as if emerging markets might be shielded from the crisis. But things changed dramatically after Lehman’s collapse in the fall of 2008. In the process of deleveraging, banks in advanced countries started to drastically reduce their exposure to emerging markets, closing credit lines and repatriating funds. The situation was similar to the Asian crisis of the 1990s.

Since the eruption of the latest U.S. financial crisis, much work for establishing remedial and preemptive measures has been going on, both in each country and internationally, ranging from the examination of the rules governing credit rating agencies to constraints on executive compensation, to new rules for evaluating assets on balance sheets, to the introduction of new regulatory capital ratios and so on.

Here, I will not go into details of policy responses after the US financial crisis because these topics are now under discussion at the meetings of the G20, FSB, BIS, etc., and they are too specific to be discussed here and now. Instead, I would like to move on and touch upon the global financial safety net, which is one of the most important agenda items for the G20 Seoul Summit.

4. Global financial safety net (GFSN)

We learn more when something goes wrong than when everything hums along smoothly. We have become more knowledgeable about the global economy through a series of crises. As the global economy has become more integrated, crises have also evolved in their scope of influence and propagation mechanism. In the Latin American debt crisis and the Nordic banking crisis, the influence was more or less restricted within the territorial boundaries. Even though we name these crises by their region, contagion was not a big issue. However, since the Asian currency crisis, contagion has come to be understood as a key factor threatening the stability of the global economy.

4.1 Principles of the GFSN

During the recent crisis, the affected emerging market countries responded through domestic policy actions by allowing exchange rates to depreciate, and by making use of accumulated reserves to help cushion the impact of the shock. But this was often only partially effective. In a number of cases, countries also needed to rely on external cooperation, including central bank swap lines, precautionary finance from the IMF in the form of the newly developed Flexible Credit Line (FCL) or traditional IMF lending through a series of Stand-By
Arrangements (SBAs). These measures played a crucial role as a “fire break,” limiting the impact of the crisis and its further feedback.

Based on these experiences, the G20 has recognized increasing capital volatility as a serious future risk to the global economy. And, as a part of its efforts to pursue sustainable growth, it has agreed to develop ways to assist countries to deal with such problems. Notably, the Korean government has put forward the strengthening of the global financial safety net (GFSN) as a major item on the agenda for the G20 Seoul Summit to be held this November.

From past experience, we find the GFSN should be constructed under the four principles: certainty, sufficiency, stigma-free, and minimizing moral hazard. These principles are important because a truly effective GFSN must work as a forward-looking crisis prevention mechanism rather than a crisis resolution mechanism. When countries are in need, they have to be assured of access to funds and the amount available has to be sufficient to cover problems. And eliminating or reducing the stigma effect is also very important to enable countries in need to access the resource. If not, an application to the GFSN may create more problems than it solves, and the GFSN will become useless.

Minimizing the moral hazard problem is also challenging, but must be dealt with in order to have a workable GFSN. When I emphasized the importance of the GFSN in the annual international conference of the Bank of Korea this June, some participants raised the moral hazard problem. I fully understand their concerns. Instead of giving up a system because of a moral hazard problem, however, we should design the system to minimize it efficiently. In fact, we have various insurance schemes in our daily lives even though they are not immune to such problem. A GFSN can cope with it by extending funds only to countries with a strong track record and sound macroeconomic policies. In this way, it gives countries an incentive to keep the macroeconomy sound, bringing a virtuous cycle for the global economy.

4.2 Current issues related to the GFSN

To be more specific, let me briefly introduce some instruments of the GFSN which are currently under discussion. No single facility can meet the various needs of countries because each country confronts a different situation. A GFSN should be a tightly-woven multi-layered network of facilities with their respective strengths. The GFSN could have three layers: bilateral, regional and global.

An example of the bilateral layer is the swap lines between the central banks. The network of swap lines was highly effective during the last financial crisis. The swap between the BOJ and the BOK, which contributed greatly to stabilizing the Korean capital market, serves a good example of a successful bilateral swap. However, the flexible nature of these swap lines generates a significant degree of uncertainty for potential recipient countries because it is at the discretion of the issuing central banks.

The second layer is regional financial safety nets. Regional arrangements in Europe were established quite rapidly in response to the developments in Eastern Europe during the 2008–9 crisis and the more recent euro area financial distress. In the Asian region, the Chiang Mai Initiative (CMI) of the ASEAN plus three countries has expanded into the Chiang Mai Initiative Multilateralisation (CMIM). We need to find the most effective way in which the IMF and the regional arrangements can mesh together through, for example, coordinated surveillance or co-financing.

Lastly, various liquidity provision facilities of the IMF make up the global level layer in the GFSN. The Flexible Credit Line (FCL) of the IMF was a critical part of the toolkit in the response to the latest crisis. This is a precautionary finance facility based on pre-qualification criteria. However, some countries feel the current FCL is not enough in view of the critical GFSN principles I mentioned. There are concerns about certainty, sufficiency, and the stigma-effect. Including the improvement of the FCL, a Global Stabilization Mechanism
(GSM) is now under discussion. The GSM is a comprehensive liquidity-supporting framework which will be activated by the resolution of the Executive Board in the event of a systemic crisis. The GSM will allow qualified systemically important countries access to various types of liquidity line such as the FCL and the Short-term Liquidity Line (SSL).

5. Concluding remarks

In Korea, the Asian crisis is also commonly referred to as the IMF crisis. This term may indicate the fact that the IMF played a major role in resolving the crisis. But the term also reflects the bitter emotion felt by the Korean people. In a sense, such emotion has some reasonable grounds in that the pain might have been much less acute if there had been an adequate GFSN at the time of the Asian crisis.

The U.S. financial crisis highlighted the risk of sudden reversals of capital flows in emerging market countries. In the past, these sudden reversals were typically associated with the problems of emerging market countries such as mismanagement of macroeconomic policies and a weak financial regulatory system. This time, many of the economies affected by contagion had strong policy frameworks in place. In this sense, the crisis hit “innocent” bystanders through financial and trade channels.

Now we are working hard to fix the system in the hope that the next crisis can be prevented by minimizing systemic risks. However, crises are still likely to happen in the future. It seems quite natural to think that, even if jurisdictional systemic risks are somehow controlled for, “global” systemic risks will emerge as a source of future financial crises due to the ever-stronger trend toward the inter-connectedness of the world economy.

It remains true that strong national economic and financial policy frameworks provide the first and most important line of defense for countries facing external shocks. But these are not enough in a globalized world. The GFSN will help cushion the impact of a crisis and limit its further propagation.

And there is another issue I would like to raise. The current crisis was caused by systemic malfunctions within the advanced economies, coupled with contagion effects on the emerging economies. As the current crisis is to be overcome, we may well find that the income gaps between the low income countries and the rest of the world have widened during the course of the crisis. International social instability as well as international financial instability will be an issue that must be dealt with soon to avoid a new type of crisis. This is one of the compelling reasons that we are putting a very high priority on “development” issues at the upcoming G20 meeting in Seoul.

What then should be the role of central bankers in preventing and managing future financial crises? With the limited policy instruments available, central bankers should establish closer networking among themselves for active information sharing to cope with the ever-increasing cross-border transmission of domestic policy actions.

I think there is much more that the Tripartite Governors’ meeting and our three central banks should be doing together in the future than they have in the past. For heightened prosperity and stability, let us go forward together hand in hand. In this way, I believe, our three countries can also contribute immensely to the global economy.

Thank you for listening.