Challenges to Central Banking from Globalized Financial Systems

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The Role of Central Banks in Currency Crises

with

Special Reference to Korea's Experience in Recovering from the Currency Crisis

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Governor Blejer has given us a very clear and informative presentation of the causes of financial crises and the central bank's role and of Argentina's experience. I would like to supplement his remarks by talking about Korea's experience in recovering from its currency crisis and the role played by the Bank of Korea in this process.

I. General Discussion

I found myself nodding my head in sympathy with many of Governor Blejer's masterly analysis of the causes of financial crises and of countermeasures and policies to avoid them. In particular, I concur strongly with his point that for the prevention of financial crises the central bank should try to reduce macro-economic fluctuations by consistency in its conduct of monetary policy.

Of course, as the Governor pointed out, the central bank cannot prevent the outbreak of a crisis by its own efforts alone. There have been many instances where the fundamental cause of a foreign debt crisis in South American countries has been a large fiscal deficit. This is a problem of economic structure and it cannot be rectified by the will of the central bank. Nor is it so easy to solve the " too big to fail" problem, because it has been brought about by accumulated financial practices and involves complex political dimensions.

Although our discussion mainly centres around the internal problems of developing countries, I believe that we also need to consider the international capital supply aspect. To my mind, we ought also to discuss in greater depth the question of regulating speculative international capital flows, which have been cited as playing a walk-on role in financial crises by triggering their outbreak.

I would also concur with the principle of regulating the inducement of excessive short-term foreign debt as a means of avoiding financial crises. However, we have to consider that developing countries are burdened with heavy short-term foreign liabilities because they find it difficult to attract long-term funds at lower interest rates. In order to reduce their short-term foreign debt ratio, developing countries must strive to improve their creditworthiness. This requires them to maintain the soundness of financial structures and to be extremely rigorous in the choice of business projects to avoid duplicate investments. This said, efforts are also needed on the part of those countries that supply capital in order to bring about the smoother introduction of long-term capital to the developing countries.

Toward the end of 1997, around the time of Korea's financial crisis, even though the IMF provided standby funds, overseas banks proceeded to call in their loans more rapidly than before the provision of support. Such attitudes make it difficult for crises to be snuffed out at an early stage simply through the provision of bail-out funds from the IMF and other international financial organisations. Consequently, in order to deal with financial crises effectively at an early stage, the IMF's financial support should always be coordinated with private sector financial institutions.

II. Korea's Experience

1. Outbreak of the Currency Crisis

First, let me move on to say something about the origins of the Korean currency crisis. Up until 1996, the year prior to its outbreak, the macro-economic fundamentals in terms of GDP growth, employment, and price movements were comparatively favourable, and the country continued to run a budget surplus. The financial and foreign exchange markets were calm and a generally stable pattern prevailed as regards money supply growth, market interest rates and the exchange rate.

One black spot, though, was the current account position. The current account deficit had widened greatly from early 1996 as exports fell back sharply with the worsening of the terms of trade.

Principal Economic Indicators before the Currency Crisis

	1993	1994	1995	1996	1997
GDP growth rate(%)	5.5	8.3	8.9	6.8	5.0
Unemployment rate(%)	2.8	2.4	2.0	2.0	2.6
Growth rate of Consumer price rises(%)	4.8	6.3	4.5	4.9	4.4
Current account (billion dollars)	0.1	-3.9	-8.5	-23.0	-8.2
Consolidated fiscal surplus(billion dollars)	2.5	2.7	2.7	2.1	-4.0
M2 growth rate(%)[1)]	17.3	17.6	13.7	17.8	21.1
Corporate bond(3 years) yields(%)[2)]	12.6	12.9	13.8	11.9	13.4
Exchange rate(won/U$)[3)]	808.1	788.7	774.7	844.2	1,415.2

Notes : 1) Average growth rate in the last month of the period
2) AA- grade, annual average
3) Base rate, as of the end of year

The really major problem, however, was that the Korean economic fabric had become fragile as a result of the structural inefficiencies accumulated during the preceding thirty year period of concentrated rapid growth. These problems, though, did not come to light because of buoyant macro-economic conditions.

The situation as regards corporate governance was that, in many cases, one or two majority shareholders had grabbed the management rights and continued to focus on expansion financed by external borrowings rather than on profitability. Because the resources needed for their head-long expansion were raised through borrowings from financial institutions, the debt ratio of manufacturing companies reached 317% in 1996. This meant that, by and large, corporate financial structures were extremely fragile.

Trend of Debt Ratios in Manufacturing

Unit : %

	1993	1994	1995	1996	1997
Large Firms	273.5	282.9	268.3	301.6	390.0
Small & Medium Firms	388.1	394.2	380.6	387.4	418.4
Total	294.9	302.5	286.8	317.1	396.3

Blinded by the belief that corporate giants were too big to fail, credulous financial institutions recklessly continued to expand credit to big companies on a large-scale without regard for the commercial feasibility of their projects. In this environment, the financial supervisory authorities were in no position to be exacting in their supervision through the enforcement of prudential regulation.

Another problem was that, with the gradual expansion of foreign exchange liberalisation from the 1980s onwards, financial institutions and companies had increased the scale of their foreign borrowings. One of the most disturbing aspects of this was the deepening of the maturity-mismatch between foreign currency assets and liabilities at a number of financial institutions. Many of these relied on short-term foreign borrowings to extend long-term loans and purchase overseas bonds.

Trend of Long-term and Short-term Foreign Liabilities

(As of the end of year)

Unit : billion dollars

	1993	1994	1995	1996	1997
Long-term	24.7	43.5	55.6	70.2	95.7
Short-term	19.2	53.9	71.9	93.3	63.5
Total	43.9	97.4	127.5	163.5	159.2

Meanwhile, insolvent companies were not forced to exit the market in accord with market principles because of the problem of moral hazard and the inadequacy of bankruptcy legislation.

This period proved to be just the calm before the storm. From early 1997, a number of large companies collapsed and, under the impact of the currency crises in several Southeast Asian countries, symptoms of an impending banking and currency crisis began to appear.

Several banks and a number of merchant banks involved in transactions with these ailing companies suffered a run on deposits, and there was a sharp contraction in roll-overs of maturing foreign debt. Whereas the rollover ratio of commercial banks' foreign borrowings stood at the 100% level in the first half of 1997, by December that year it had dramatically shrunk to just 32%.

Under the widening impact of the Southeast Asian currency crisis, Korea's soverign credit standing was falling rapidly and pressures for a devaluation of the currency mounted swiftly.

As it became more difficult to roll over maturing foreign debt, the level of foreign exchange reserves began to fall steeply from early October 1997. Finally by December 1997, even after Korea had received 5.6 billion in SDRs from the IMF, foreign financial institutions were calling in their loans indiscriminately and there was a huge outflow of foreign investment funds. In this situation, foreign exchange reserves shrank to a level sufficient only to meet 28% of average monthly current payments, standing at just 3.9 billion dollars.

This was accompanied by a massive devaluation. The Korean won fell from 901 per dollar in October to change hands at 1,965 won per dollar on Christmas Eve 1997.

To add to our woes, several ailing financial institutions ran short of settlement funds owing to the deepening run on deposits. We were by now looking at the possibility of a breakdown of the financial system as a whole.

2. The Policy Response of the Bank of Korea

Following the outbreak of the currency crisis, the Bank of Korea devised various monetary policy options in order to respond appropriately at each stage of the change in the macro-economic environment.

At the initial stage of the currency crisis, the emphasis of monetary policy was placed upon securing the stability of the foreign exchange and financial markets. Stressing exchange rate stability and the stemming of capital outflow, the Bank put in place a high interest rate policy, raising call market rates to a range of 20 to 30% from the level a little above 10% around which they had previously moved.

Because financial institutions faced a liquidity crisis amidst the financial market credit squeeze in the course of structural adjustment, the Bank supported them with emergency funds to the tune of 4.9 billion dollars between November 1997 and March 1998.

The government experienced difficulties in raising the funds required for structural adjustment of the financial sector all at once. Accordingly between November 1997 and March 1998, the Bank agreed to purchase through direct subscription of Deposit Insurance Fund Bonds and Non- performing Asset Management Fund Bonds to a total value of 5.9 billion dollars.

Thanks to the combined impact of the Bank of Korea's high interest rate policy, the government's steps to promote the inducement of foreign capital and the negotiation of agreements with the international financial community to extend the maturities of loans, stability gradually returned to the foreign exchange market from early April 1998, with the Korean won regaining much of its lost ground.

While this process had been underway, however, GDP growth had turned deeply negative under the impact of the currency crisis and the pursuit of severe austerity policies. The economic difficulties were greatly exacerbated by the widespread collapse of small and medium enterprises and the massive increase in unemployment.

Through consultation with the IMF, the Bank of Korea was able to shift the first priority of monetary policy from stabilisation of the foreign exchange market to preventing an overly deep contraction of business activity. On the foundation provided by the stability of the foreign exchange market, it repeatedly lowered its policy rate target, bringing it down to the level of 4.75% in April 1999. As a result, market interest rates saw a corresponding progressive reduction.

In spite of its efforts, a credit crunch developed in the bank lending market. This was generated by the uncertainties surrounding structural adjustment and concerns over the credit risk of companies in an environment characterised from early 1998 onwards by high interest rates and a rapidly deepening economic recession.

In a move to encourage an expansion of bank lending to small and medium enterprises, along with the lowering of interest rates, the Bank of Korea expanded its credit facility through which support is provided to small and medium enterprises. It also supplied liquidity flexibly when financial market instability emerged during the course of structural adjustment.

III. Concluding Remarks

There are many differences between the causes of the financial crises in Argentina and Korea and in their political, economic and social conditions, so that Korea's experience in overcoming the currency crisis may not be of great help in this case. Several elements in the process of its policy response may, nevertheless, be useful as a point of reference.

In the controversy concerning financial crises, the most important point is to identify accurately where the causes lie. I say this because, once we have accurately grasped the reasons for a crisis, we are in a better position to get the upper hand over it and we can then derive useful lessons for preventing a future crisis.

In the case of Korea, I think that an earlier recognition of the structural fragility of the Korean economy would have permitted a timely correction so as to ward off the country's financial crisis. Additionally if we had promptly adopted the appropriate macro-economic and exchange rate policies when faced with the deterioration of the current account in the mid-1990s, we might still have avoided the currency crisis.

In the process of structural adjustment to cope with a crisis, it is very important to set up objective principles that the majority of people can accept so that all economic actors are prepared to endure the hardships brought about by restructuring and bear their share of the burden. It also calls for leadership that is prepared to press ahead boldly with the structural adjustment programme.

Monetary and fiscal policies need to be operated flexibly according to the state of the economy, so as to reinforce the basis for economic stability at an early stage. A greater or lesser degree of public hardship caused by the low growth inevitably accompanies this process. Great efforts are needed to secure the confidence of the markets both at home and abroad through the bold pursuit of structural reforms in every sector of the economy that are designed to raise economic competitiveness over the medium and long term.

Finally, regarding the central bank's role in a currency crisis, much depends on whether the central bank possesses those powers and functions necessary for attaining financial stability. In this respect, although the Bank of Korea greatly contributed to resolving the banking crisis through flexible monetary policy and its role as lender of last resort, it could not play a leading role because it was stripped of its supervisory powers shortly after the outbreak of crisis.