Comment on "The Financial Crisis in Korea and Its Lessons for Reform of the International Financial System," by Yung Chul Park

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Yung Chul Park's paper, like all his previous papers, is interesting, insightful, and thought-provoking. He addresses many difficult questions like "Why did the Asian financial crisis spread so widely and so fast?" and "Why was it so severe?", the questions which many of us here have been struggling to answer. He makes frequent references to the IMF-supported programme in Korea and raises some interesting and useful thoughts on a number of issues facing the international financial community, including the possibility of regulating international capital flows.

On my part, I would like to contribute to this discussion by addressing three questions: "Could the crisis have been prevented?"; "Could it have been better managed?"; and "What needs to be done to prevent another crisis?" I will offer my comments on some of the points Mr. Park makes and, in the process, touch on what the IMF has been trying to do in Korea. My main message here, not surprisingly, is a bit kinder to the IMF than Mr. Park is – the IMF programme in Korea had a rocky start and the initial stabilisation process took more time than had been expected but, after that initial phase, the programme has been doing well and the prospects for recovery in Korea are not bad, despite numerous difficulties the economy still faces.

So, let me start with the first question, "Could the crisis have been prevented?" My answer is "yes", on two conditions – namely (i) if a country had strong macroeconomic and structural fundamentals, and (ii) if it maintained flexible exchange rate and interest rate policies. I share Mr. Park's view that Korea could have avoided the crisis, if the authorities had dealt with all the structural weaknesses before they were uncovered by a cyclical slowdown of the economy. Market participants, then, could have differentiated Korea from countries like Indonesia and Thailand. Unfortunately, this was not the case in Korea in late 1997, and even if strong macro and structural fundamentals had been in place, that would not have been sufficient to prevent a crisis. In my view, strong fundamentals have to be

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accompanied by flexible policies on the exchange rate and, especially, interest rates. To keep markets functioning and to clear supply-demand imbalances, market prices – the exchange rate and interest rates – must be allowed to move freely and at times substantially. One mistake Korea – and Thailand and Indonesia – made at the initial stage of the present crisis was that they tried to deal with the imbalance through direct market intervention. Since no central bank could match the liquidity the market can mobilise, this strategy only aggravated the problem. The movements of the exchange rate and interest rates at this initial stage were too small, making the subsequent depreciation and interest rate increases much larger than otherwise required.

This was in sharp contrast to the experience of Hong Kong and the Philippines, both of which were perceived to have relatively strong fundamentals, but which nevertheless were subjected to a speculative attack at least once during last fall. At that time, market participants were so pessimistic about Asia and, as Mr. Park puts it, were behaving like a scared herd, that they were ready to move liquidity out of even those markets that were seen as having relatively strong fundamentals. Against this pressure, Hong Kong raised the overnight call money rate to 300% and the Philippines raised the rate to 200% for a few days in late October. Consequently, Hong Kong and the Philippines managed to prevent the initial exchange market turmoil from developing into a full-fledged crisis.

Let me now move to the second question: "Could the crisis have been better managed?" Here, I join Mr. Park in saying that the crisis could, and should, have been managed better, at least in the Korean context, but perhaps for different reasons. Instead of identifying these possible differences, however, I would like to present my own account of what happened in Korea. I will do so by dividing the Korean crisis into three periods – (i) the pre-IMF period between mid-November and December 4th (when the IMF Board approved the programme); (ii) the "initial" post-IMF period around Christmas; and (iii) the period since then.

Although the Korean economy had faced an increasing number of problems from the beginning of 1997, the crisis reached Korea only in mid-November. The subsequent three-week period – my pre-IMF period – was crucial in containing the crisis. In a way, the Korean authorities moved fast to address the situation. Following a change of Finance Minister, the IMF was contacted at the end of the first week, the programme was negotiated in the next two weeks and received approval on December 4th. To complete programme negotiations within such a short period required tremendous efforts, especially for the Korean authorities, who had to negotiate not only with the IMF mission, but among themselves to build consensus. However, in the meantime, policies were kept unchanged and no new

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measures were introduced to deal with the evolving situation. Most significantly, during the first week, the Bank of Korea tried to defend the rate through direct intervention, losing a large amount of reserves, then discontinuing the intervention without raising interest rates substantially, causing a sharp fall in the won exchange rate. Consequently, Korea lost the opportunity to contain the crisis at its very early stage.

The second period began with the approval of the Korean Programme on December 4th. The initial priority of this programme was to stabilise the exchange market through the restoration of market confidence. To that end, the programme entailed a number of specific measures: (i) demonstration of the authorities' strong will and commitment to structural reform and sound economic management, including defending the Korean currency through higher interest rates; (ii) demonstration of the central bank's ability to meet any contingency with its reserves. For this purpose, Korea received a large amount of resources from the Fund, as well as credit commitments for the second line defense from a number of industrial countries; and (iii) expectations of a rollover of short-term credits by foreign commercial banks.

In any event, things did not go as well as expected. Almost immediately after the programme was put in place, a public debate began as to whether the programme should be renegotiated in the heated political climate prior to the presidential election. Interest rates were raised, but only modestly compared to the prevailing market pressure. New short-term debts were "found" and market estimates of Korea's debt were revised upward almost every day, raising questions regarding the central bank's ability to meet payment obligations, even after its reserves had been enhanced with resources from the IMF. These developments did not help strengthen confidence, especially among foreign banks, who withdrew rather than rolled over credit during the first twenty days of December. Although a number of important actions such as capital account liberalisation and banking sector reform were introduced, the programme was not really in place. Consequently, Korea lost another crucial opportunity.

The third phase of Korea's adjustment began in the final weeks of December, when the situation started to improve. By that time, the then president-elect, Kim De Jung, had convinced the market that he was firmly behind the programme, and at the same time, policies were strengthened in many respects – including interest rates, which were raised to the highest level in many years in Korea. Debt data were finally revised and published, clarifying the uncertainties that had caused unnecessary confusion and fear. Discussion of a formal rollover of short-term debts began between the Korean authorities and foreign banks. The IMF had advanced its disbursement and made $2 billion available in late December, in addi-

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tion to the $9 billion it had already disbursed. The G-7 countries confirmed their commitments to provide resources for the second line of defense, if and when it was needed.

Based on these measures in late December, the won strengthened substantially from its trough on December 23rd and a measure of stability has now been established in the exchange market. The Korea authorities have since been working toward the second key objective of the programme, that is to establish a base for resuming strong growth. This is a difficult task but, as Mr. Park describes in his paper, the Korean authorities are forcefully implementing the needed measures and, like many others, I have every confidence that they will succeed.

Let me now turn to the last question: "What should be done to prevent another crisis?" In his conclusion, Mr. Park mentions the possibility of creating an international lender of last resort as well as a mechanism to regulate international investors and their activities. Mr. Park seems to favour creating such an institution and mechanism, but he recognises that this is not likely to be realised anytime soon. He argues that in the meantime, emerging market countries "should be allowed to throw some sand in the wheels of international finance," to safeguard themselves from the recurrence of financial crises.

In my view, the main problem with the argument for an international lender of last resort is that it comes too close to an argument for "an IMF with generous credit but with no conditionality". This is an argument put forward from time to time in Asia and elsewhere in the world. The presumption is that there is nothing wrong with the countries' policies and that all crises are externally induced. Hence, such a crisis should be dealt with without changing policies, or with minimal changes to the exchange rate and interest rate. However, this presumption does not usually hold. Policies, including the exchange rate, are often wrong and need to be adjusted. An international lender of last resort would create a moral hazard by prolonging wrong policies. Also, addressing a crisis by intervention only, or even mainly by intervention, is no longer technically feasible, given the recent expansion of cross-border capital flows.

This brings me to the subject of regulating certain types of capital flows. I believe that there is a growing consensus that the international financial community should monitor and collect information on large transactions and positions in exchange markets. I hope that the international community will be able to come up with and agree upon a mechanism to utilise this information in order to regulate excessive and abrupt movements of liquidity across borders. Here I share Mr. Park's wish, although, like him, I am not hopeful that we will get what we want anytime soon.

With regard to Mr. Park's suggestion of throwing some sand in the

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wheels of international finance, I would note that some emerging market countries have done this as a temporary measure, including requiring central bank deposits with no remuneration for all external short-term borrowing. At the same time, I would ask whether a country can effectively control these "speculative" capital flows while maintaining other flows intact. The question is at what cost? In my view, these considerations on balance, would not support Mr. Park's suggestion, especially in the Korean context.

Let me now conclude with my own suggestions, which I am afraid, are not exciting but which are, I believe, pragmatic. To avoid another crisis, it is important for countries to maintain strong macro and structural fundamentals, as well as efficient exchange and money markets, where both exchange rate and interest rates are allowed to move flexibly to address any supply-demand imbalances. At the regional and international level, this should be supported by a mechanism for effective mutual surveillance and a strong IMF, both in terms of policy advice and financial support.

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