



ECONOMIC VIEWPOINT

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Re-examining Korea's Crisis in a Post Sub-Prime World

The current turmoil in financial markets has exposed an important contrast in the way that economic observers view the concept of leveraging. Just about a decade ago, Korea suffered through its most severe financial crisis in its history when international credit markets froze up and a nation with an impeccable record of economic management was humbled by a massive liquidity crisis. While the proximate cause was financial contagion affecting an economy whose financial markets had been forced open without requisite regulation, many observers blamed the problem on the excessive leverage of Korean conglomerates, the fabled chaebol that produced Hyundai, Samsung and Lucky Goldstar. What made the chaebol infamous was in part their drive to enlarge and the financing methods used to achieve greater size—leveraging.

The generation of a large balance sheet with small amounts of equity is viewed differently by financial markets at various moments. For hedge funds, the key to leveraging is to risk small amounts of equity to make huge gains, betting that people will lend you funds to make these bets and that you will win many more times than you will lose. The sub-prime crisis and its aftermath show the perils of this financial strategy, and as is usual in deep financial crises with systemic spillover dangers, the government usually steps in and the taxpayers help bail out the excessive risk-takers.

Contrast this to the fate of many of Korea's chaebol, who were not leveraged twenty to one, as were many hedge funds that recently collapsed in the U.S. crisis, but by three to one in the typical case before the crisis deepened. When interest rates were forced to exorbitant rates by IMF programs that Joe Stiglitz rightly criticized, there was no solvent chaebol left in Korea. This was a natural consequence of 25 percent interest rates applied to highly leveraged firms faced with short term debts that could not be rolled over and slim profit margins. The consequence of this "excessive leveraging" was a massive retrenchment of Korean firms and a deep two year recession in Korea that left marked scars on the economy. In the end, Korea emerged stronger in terms of corporate financing and corporate governance, but with a black mark on its copybook.

Those managing the bailout went to great pains to point out the flaws of the Korean approach—using credit, admittedly some of it at publicly subsidized terms—to grow fast and capture export markets. Leverage allowed Korea to expand its exports at a pace that was unheard of in the postwar period and to penetrate OECD consumer markets in record time. Hence the prototypical American consumer now driving a Hyundai, watching TV on a Samsung plasma screen and talking on an LG cell phone. And as a corollary, we have witnessed the Korean worker made dramatic strides in standards of living in one generation.

One might have expected a louder hue and cry against hedge funds that were speculating in financial markets and obtaining credit at easy terms from lenders when the current crisis unraveled. Instead we have witnessed unprecedented liquidity being pumped into the markets at non-distress rates, essentially blurring the difference between illiquidity and insolvency. We have seen the world's central banks provide enormous amounts of credit to avoid larger scale collapse. What is not so clear is the real economic benefit that the speculating hedge funds were generating. At least in the case of Korea, there were real economic benefits to be generated, employment to be created, and international markets to be penetrated. This is not to absolve some chaebols of their misdeeds—pledging poor collateral, cross ownership among chaebol affiliates, use of cheap government credit and the like—yet there does seem to be a double standard in the way the international community is dealing with the current crisis caused by excessive and under-regulated leveraging and the way in which Korea was pilloried in the aftermath of the 1997 crisis.

The lack of adequate regulation in the case of Korea was attributed to its rapid economic development that outpaced the quality of supervision and the particular relationship between government and business that made it difficult for independent regulation to take root. In the case of the U.S. one would be hard pressed to make this argument. It might be worthwhile to look at the concept of leveraging for economic gain versus leveraging for financial gain. There are many cases where these objectives intersect, but not always. Long Term Capital and Kia Motors had leveraging in common, but very little else.

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