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Assessing the Role of the IMF in South Korea during the Asian Financial Crisis

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Abstract

The role of the International Monetary Fund in the Asian Financial Crisis that occurred in 1997 serves as an important case study of how international financial institutions can influence the economic and political interactions of a nation. This paper will outline the polices implemented by the IMF in their recovery package for South Korea, as well as provide discussion of both the positive and negative results of these policies. A brief outline of what the IMF represents and how they were involved in the Crisis is followed by a critical discussion of the positive and negative implications for South Korean economics, public and financial policies as a result of the IMF's structural adjustment loans, such as its influence on employment, the housing market, domestic currency, loans and financial services. The paper concludes that while the IMF's actions did help foster growth, it did so at a significant cost to the quality of life for many in South Korea.

Keywords: IMF, South Korea, Asian Financial Crisis, structural adjustment policies

This essay will assess the role of the International Monetary Fund in the Asian Financial Crisis that occurred in 1997, particularly focusing on South Korea as an important case study of how international financial institutions can influence the economic and political interactions of a nation. This essay will attempt to outline the polices implemented by the IMF in their recovery package for South Korea, as well as provide discussion of both the positive and negative results of these policies.

Before discussing their functioning in the Asian Financial Crisis, this essay will briefly outline what the IMF represents and how they were involved in the Crisis.

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The International Monetary Fund was established along with the World Bank in 1944 at the end of the Second World War, with the aim of establishing a framework for international economic cooperation (IMF, 2013). The IMF has several functions, including providing loans and policy advice to its member countries facing economic difficulties. The Fund also maintains that it aims to aid developing countries achieve macroeconomic stability along with poverty reduction (IMF, 2013). The IMF provides financing on conditional terms, which involves implementation of structural reforms in its member countries (IMF, 2003), and South Korea during the Asian Financial Crisis will be discussed to illustrate this role further.

At the time of the financial crisis, East Asia was an important part of the world economy, making up 30 percent of the world GNP measured in purchasing power parity, and the crisis was an unforeseen occurrence (Bustelo, 1998, p.4). There is no unanimous agreement on the main cause of the crisis; rather it can be attributed to several reasons. Firstly, one of the main causes of the crisis is thought to be the rapid liberalisation of capital accounts, and it is important to note that it was institutions like the IMF that had encouraged East Asian countries to open their markets to foreign capital (Grozdev, 2010, p.1). The IMF had claimed that the liberalisation of capital accounts would diversify sources of funding, as well as speed up economic growth through allocation of funds to their most productive use (Grozdev, 2010, p.1). Before the Crisis, the East Asian economies were doing well in their own right, dubbed as “East Asian Miracles” in 1993 by the World Bank for their efforts. Many of the economies had saved and invested in various productions, directing their national savings to private export-oriented industries, and as a result did not need additional capital (Grozdev, 2010, p.1). Large current account deficits is also thought to have been another cause of the crisis, as fixing their exchange rates to the rapidly appreciating US dollar led to over-valued currencies in these countries, as well as a loss in investor confidence (Sangsubhan, 2008; Yap, 2009, p.14; Hutson and Kearney, 1999; p.402; Hale, 2011). The crisis was also attributed to currency mismatches, caused by borrowing between private banks and large nonfinancial companies as well as domestic companies borrowing from domestic banks that left banks and corporations vulnerable to exchange rate devaluations. Sudden outflows of capital led to a balance sheet crisis (Hale, 2011; Grozdev, 2010, p.2; Sangsubhan, 2008).

It is widely agreed upon that the Asian Financial Crisis was triggered in July 1997 in Thailand, when the government was forced to cut its exchange rate peg to the US dollar and float the baht (Bustelo, 1998, p.3; Yamazawa, 1998, p.333; Grozdev, 2010, p.1).

Thailand was facing bankruptcy due to major financial overextension and the burden of foreign debt after being unable to support its fixed exchange rate (Yamazawa, 1998, p.333). Floating the baht caused foreign debt in local currencies to become overshot and as investors began to lose interest this resulted in massive foreign private capital outflows. The effects were felt the most in Thailand, South Korea, Indonesia, Malaysia and the Philippines, one of the main impacts being on the US dollar exchange rate; all these countries experienced extreme rapid devaluation in their local currencies after maintaining a stable exchange rate throughout most of the 1990s, and this devaluation cost them overseas investment (Yamazawa, 1998, p.335; Grozdev, 2010, p.1; Hutson and Kearney, 1999; p.394). There were both economic and social issues that rose from this crisis, including mass unemployment, poverty and malnutrition (Bustelo, 1998, p.4).

The IMF estimated an increase in the number of people living in poverty: Thailand had an increase of around 7 million; Korea experienced over 5 million; and Indonesia had an overwhelming increase of almost 40 million people (Hutson and Kearney, 1999; p.400). The IMF was called upon for help by several countries, and created a US$40 billion recovery programme, featuring rescue packages with huge loans that involved currency, banking and financial system reforms, albeit with strict conditions (Hutson and Kearney, 1999; p.407; Grozdev, 2010, p.2; Yamazawa, 1998, p.333). This essay will go on to discuss the role of the IMF in the economic recovery of East Asia, with a particular focus on South Korea.

Before the crisis, South Korea enjoyed a robust economy with high savings, a low inflation rate and a balanced budget; by 1996 it was the world's largest producer of home appliances, the fifth largest car maker, the eleventh largest economy in the world and the third largest in Asia, and the twelfth largest exporter and trading country (Kim, 2000, p.6; Harvie and Pahlavani, 2009, p.2). However, it had also been facing issues with its external debt, with weak financial regulation and inadequate systems of corporate governance, and the crisis rapidly weakened its economy (Kim, 2000, p.6; Hayo and Shin, 2002, p.90).

South Korea suffered large declines in economic activity, along with a sharp increase in the amount of unemployed and homeless, after having averaged an annual GDP growth of 8.0 percent over the previous three decades (Kim, 2000, p.3).

The IMF offered South Korea a loan of US$58 billion, the largest loan package out of all the other East Asian countries, and the conditions required fundamental reforms of its largest economic sectors (Williamson, 2012; Hayo and Shin, 2002, p.90). The conditions outlined were typical of the IMF in terms of financial sector reforms, including fiscal tightening, capital account and trade liberalisation, as well as labour market reforms (Hayo and Shin, 2002, p.91). Kim (2000, p.12) suggests that the IMF offered such a large bailout loan because of their fear of South Korea's position as the world's eleventh largest economy threatening the international monetary system. The reforms that the IMF bailout package imposed upon South Korea resulted in an extreme transformation of its economic model (Corning, 2000, p.6). The IMF's recovery package was seen as an effort to make the South Korean economic system operate like a Western model; some of the specific conditions for the financial sector included establishing an independent central bank focusing on inflation control, and creating a supervisory institution to oversee all corporate and financial operations (Kim, 2000, p.13).

Existing financial institutions that were facing trouble were either shut down or recapitalised, and there was a removal of all restrictions on overseas borrowings by domestic firms (Kim, 2000, p.13). The IMF forced banks to adhere to Western standards of credit evaluation, limiting the loans available to the chabols for expansion (Corning, 2000, p.6). The chaebols were the most powerful economic institutions in South Korea which, at the time of the crisis in 1997, were burdened with high debt ratios (Hayo and Shin, 2002, p.90). The IMF intended to end the monopoly of chaebol in the Korean economy by lowering tariffs and raising import restrictions; this allowed for sectors such as the automobile industry to be exposed to imports and international competition (Corning, 2000, p.6).The IMF reform package also stipulated that the interest rate be raised, with the aim of stabilising the value of the Korean won through attracting foreign investment and also inducing Korean investors to keep their savings in domestic currency. Interest rates were raised from the pre-crisis rate of 12 percent to 27 percent by the end of 1997, and then elevated to 30 percent in early 1998 (Kim, 2000, p.13).

The IMF's polices not only transformed South Korea's economy; they also had a major social impact.

The South Korean economic model had been in existence for decades, with great success, and the reforms changed the way the population lived as workers and consumers (Corning, 2000, p.6).

It can be said that the IMF's high interest rate policy did succeed in stabilising the currency market by restraining the outflow of domestic capital, however this has been at the cost of a major income disparity between the rich and poor population (Kim, 2000, p.13). The interest policy also did not achieve its goal of increasing foreign investment; rather it reduced foreign investors' confidence in the economy as there was a concern that high interest rates could bankrupt South Korea's corporate sector (Kim, 2000, p.13). One other major criticism of this policy is that it triggered a stagflation, where there was growing levels of unemployment amongst consumer price inflation (Kim, 2000, p.14).

For the Korean government, it was difficult to abandon their macroeconomic model that had brought them success for so long, however many resigned themselves to the notion that accepting the conditions of the IMF bailout was the best path to recovery (Corning, 2000, p.6; Hayo and Shin, 2002; p.89; Williamson, 2012). Hayo's and Shin's (2002, p.89) study of Koreans' reactions to the IMF intervention in the crisis suggests that while many of the people were critical of some of the reforms, especially the decline in income, overall there was an agreement that this had helped the recovery for the long-term. However, it is important to note that opinions on the IMF will vary from who was badly affected in the crisis and who was not, for example Koreans who had to pay a mortgage towards a house or flat were significantly more critical of the IMF's fiscal austerity policies, which increased interest rates on mortgages (Hayo and Shin, 2002; p.94).

The IMF has faced many criticisms of its approach to the crisis in East Asia, particularly the appropriateness of their policies. While South Korea may have recovered fairly quickly compared to the other East Asian economies, it came at a huge expense with mass unemployment and major structural reforms. IMF's monetary and fiscal policies were based on the premise that only free markets provide efficient economies, and government intervention would not be necessary (Grozdev, 2010, p.1), and the Fund held the view that the crisis was caused by flaws in the East Asian countries' own macroeconomic fundamentals (Yap, 1999, p.10).

Yet, in spite of the IMF laying blame for the crisis on the East Asian economies, several studies (Yap, 1999, p.10; Busetlo, 1998, p.5; Grozdev, 2010, p.1; Kim, 2000, p.6; Harvie and Pahlavani, 2009, p.2) suggest that their macroeconomic fundamentals were adequate before the crisis began.

Also it is important to remember that the IMF had pushed the East Asian countries towards opening their markets, and it was found that this rapid capital liberalisation was not an appropriate route towards economic growth (Grozdev, 2010, p.3). Some of the East Asian governments had budget surpluses and foreign exchange reserves which they could have used to stimulate the demand in their economy and boost recovery; however the IMF opposed government intervention in the economy (Grozdev, 2010, p.2).

One of the IMF's policies that was largely criticised was their policy of fiscal austerity, which reduces the amount of borrowing the government can partake in; reasoning that it would raise the money required to pay back the IMF as well as other foreign lenders (Grozdev, 2010, p.2). The IMF also pushed for monetary contraction in many countries, which decreased the quantity of money in circulation and increased interest rates. Higher interest rates were expected to reverse capital outflows and also garner overseas investment. The IMF's monetary and fiscal tightening was also imposed in the interest of preventing further currency depreciation, but it instead caused high real interest rates, which in turn raised the interest costs of private firms, limiting their access to credit by discouraging investor confidence (Yap, 1999, p.10). Had the IMF not enforced policies that raised interest rates, it may have not exacerbated the impact of the financial crisis through economic contraction and collapsing tax revenues (Yap, 1999, p.15; Grozdev, 2010, p.3).

In conclusion, this essay has attempted to evaluate the role of the International Monetary Fund in South Korea during the Asian Financial Crisis. The discussion concludes that while the IMF's recovery package for South Korea may have provided several benefits and facilitated its recovery, it came at a large social cost including loss of income and unemployment for its people. While economic growth may be a positive force for a nation, it is not always a true indicator of quality of life. In particular, the difficulties faced by the other East Asian countries under the recovery packages' strict conditions illustrate the flaws in the IMF's strategies. The IMF has acknowledged its own failings in the Asian Financial Crisis (IMF, 2013), indicating that it is aiming to improve its own functioning as a financial institution in order to reach its goals.

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