Managing the Crisis |

South Korea Country Report

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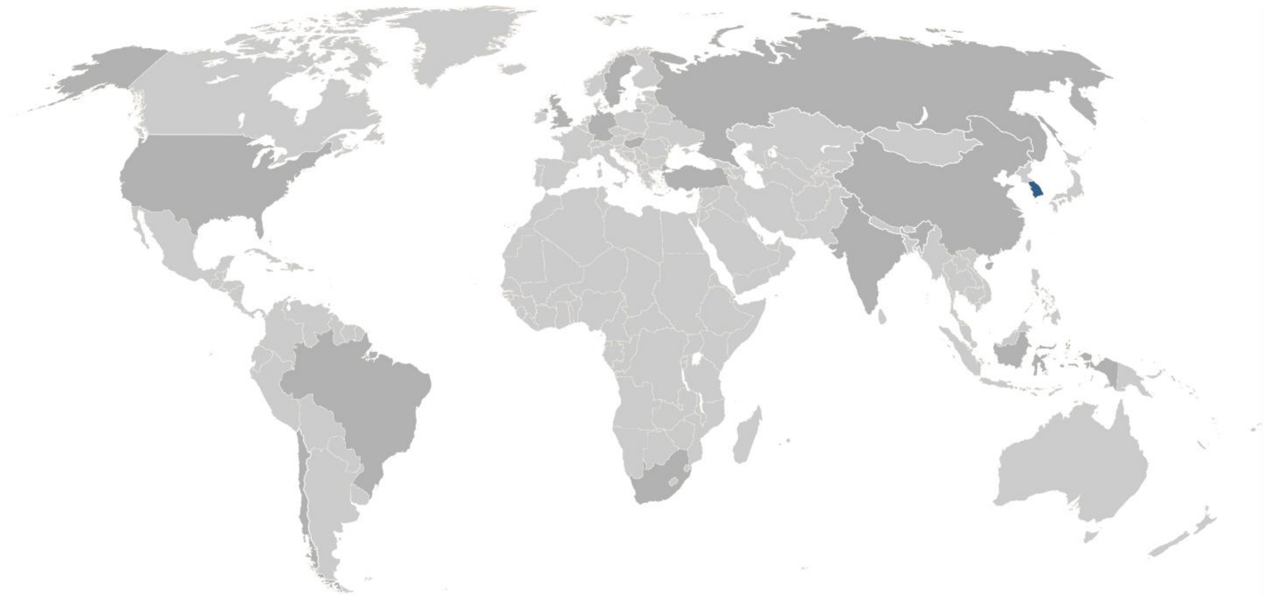

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1. Risk Exposure at the Outset of the Crisis

- What was the structure of demand (e.g., share of private/state consumption, gross capital formation, exports and imports in GDP/GNI)?
- To what extent was the economy exposed to macroeconomic imbalances (e.g., foreign debt, trade or fiscal imbalances)?
- Was/is the financial system primarily bank- or market-based?

Economic structure and macroeconomy

The Republic of Korea has been one of the most successful emerging economies in recent decades. Its GDP per capita in purchasing power parity (PPP) terms rose from less than 20 percent of the OECD average in 1970 to almost 70 percent in 2007. The share of the government sector has been quite low, with government consumption accounting for some 15 percent of GDP in 2008. Economic growth has typically been driven by strong private capital formation, which accounted for some 29 percent of GDP in 2008. Private investment has typically supported the export economy, as South Korea has been very open to international trade since the 1960s: Exports of goods accounted for some 45 percent of GDP in 2008, while commercial services added an additional eight percentage points. Imports (goods plus services) reached the equivalent of 57 percent of GDP.

Even before the global financial crisis erupted during the third quarter of 2008, South Korea was experiencing some macroeconomic problems. Though the economy expanded by 5 percent in 2007 and by 5.8 percent in the first quarter of 2008 (on a year-over-year basis), it has deteriorated since, reaching negative territory in the fourth quarter of 2008.[1] The value of imports had been increasing strongly since late 2007, driven by higher prices for raw materials and energy, on which South Korea is reliant. Accordingly, inflation had become an issue, with consumer prices rising 4.8 percent (year-over-year) in October 2008, well beyond the 2.5 percent to 3.5 percent target zone. Job growth, domestic consumption, investment and corporate profits were all negatively affected by these developments before the financial crisis set in. The won, South Korea's currency, had begun to depreciate well before September 2008, which only exacerbated existing problems.

South Korea's financial system is traditionally bank-based, and the government has found it easier to influence the economy through the banking system. Since the liberalization drive of the 1980s, and following the 1997 – 1998 crisis, government influence on the banking system has decreased sig-

[1] Asian Development Bank, "Asian Development Outlook 2009," chapter on South Korea, 172-176, http://www.adb.org/Documents/Books/ADO/2009/ado2009.pdf (accessed April 2009).

nificantly, while a bias in favor of bank-based financing remains. Small and medium-sized enterprises in particular rely on bank loans. In addition to the major commercial banks, a number of smaller banks and other non-bank financial institutions,[2] there are a number of specialized institutions more or less closely related to the state. The most important of these is the Korea Development Bank, which is often used in ventures of national importance. Compared to earlier decades, though, the role of the state has been much reduced, and primarily concerns regulation and supervision.

- What was the government's economic record (e.g., growth, unemployment rate, inflation and fiscal position) prior to the crisis?
- What was on the economic agenda prior to September 2008 (e.g., anti-inflation, efficiency-oriented, redistributive, supply vs. demand-side policies)?

Policy priorities prior to crisis

At the outbreak of the financial crisis in September 2008 (the Lehman Brothers insolvency), the new government under President Lee Myung-bak had not yet been in office even a year, as Lee was elected in December 2007 and took his oath in February 2008. Lee started as a pro-business president, but had to face a number of setbacks even during his first months in office. Some of his pet-project ideas, through which he hoped to strengthen economic growth, did not come off well. The vision of building a canal through the mountainous center of the peninsula, for instance, faced stiff opposition, and it did not help that the president tried to overcome opposition in the style of a "bulldozer," a working style that had given him his nickname in South Korea. In external economic affairs, the new government created problems as well. In part because of decisions to pursue a tougher approach to North Korea, several ideas aimed at strengthening economic ties could not move forward. A decision to re-admit beef imports from the United States, after an earlier import ban associated with the discovery of U.S. cases of bovine spongiform encephalopathy (BSE), led to strong domestic protests. However, the biggest macroeconomic concern in early 2008 was inflation due to rising prices for imported energy and other resources.

One important objective in President Lee's pro-business agenda prior to September 2008 was to "drastically improve the investment environment," through measures such as cutting taxes and making the country more attractive for foreign investors.[3] A second economic objective was to "sharply streamline regulations," a third to "create new jobs through green growth,"

[2] For a survey, see Bank of Korea, "Financial System in Korea," December 2008, http://www.asifma.org/initiatives/Korea/Financial-system-Korea-2008.pdf (accessed October 2009).
[3] All quotes cited in this paragraph are from the Office of the President's website, http://english.president.go.kr/government/goals/goals.php, accessed in June 2008 and again in September 2009.

and a fourth to "promote new growth engines and the service industry." More specifically, following the slogan "Economy First," Lee had promised a "Korea 747," another slogan translating into annual economic growth of seven percent, a per capita income of $40,000 and a rank of seventh among the major global economies in terms of economic output.[4] This lofty vision was regarded as unrealistic even by many sympathetic, observers when Lee took office. Nominally, the government also set some welfare and distribution-oriented goals such as better child care, the revival of underachieving regions, and the expansion of social services, but the administration's pro-growth priorities were clear.

- How stable was the executive branch in the years/months prior to September 2008 (e.g., credibility/legitimacy of leaders/parties in government, cabinet stability/reshuffles, parliamentary/electoral support)?
- How much room did fiscal conditions provide for a major stimulus (e.g., budget surpluses/deficits, conditions for issuing additional treasury bonds)?
- How much room was there for monetary policy initiatives (e.g., pre-crisis level of interest rates, required reserve ratios, flexibility of foreign exchange rate regime)?

Executive, fiscal & monetary capacities to respond to downturn

The president was elected with a comfortable 49 percent of the vote in late 2007, with his nearest competitor achieving 26 percent. The president's Grand National Party also achieved a majority in the parliamentary elections of April 2008, winning 153 of 299 seats. From this perspective, the Lee-led government was able to work with a stable majority. Nevertheless, Lee faced considerable opposition before the financial crisis set in. For instance, his full cabinet, including the prime minister, handed in letters of resignation in June 2008 after the scandal and major public protests following the re-admittance of U.S. beef imports. However, as Korean presidents serve only a single five-year term, Lee can act somewhat more freely on the political stage than can leaders in other countries who have to consider their re-election prospects.

Because South Korea has traditionally followed an extremely prudent policy with respect to government debt, it was able to make use of a deficit-financed stimulus package. In 2007, the share of central government debt to GDP was only 29 percent, one of the lowest values among OECD economies.[5]

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[4] Office of the President, http://english.mbplaza.net/default/main/ (accessed in June 2008); see also Jin Dae-woong, "New conservativism rises to power," The Korea Herald, December 21, 2007, http://www.koreaherald.co.kr/NEWKHSITE/data/html_dir/2007/12/21/200712210043.asp (accessed February 4, 2010).
[5] OECD , "Central Government Debt," http://stats.oecd.org/Index.aspx?datasetcode=GOV_DEBT (accessed September 2009).

In terms of monetary policy, the Bank of Korea had—at first glance—ample room to cut rates. The pre-crisis main interest rate of the Bank of Korea was 5.25 percent, a 7.5-year high. However, there were two concerns to consider. One was inflationary pressure, which made rate cuts less attractive. Consumer prices indeed continued to rise into the spring of 2009, for instance. A second concern was the exchange rate. Under the country's flexible rates—a major point of distinction with the 1997 crisis—there was concern that a rate cut might lead to an uncontrollable decline of the won as foreign investors left the country.

Exposure to specific market and trade risks

- To what extent has the country been exposed to global financial market risks, particularly contagious/toxic financial instruments (e.g., open capital account, floating or pegged/fixed currency)?
- How important was/is the financial sector for the national economy? What was/is the extent of interdependence between the financial sector and real economy?
- To what extent was the economy integrated into regional/global trade flows? How dependent was the economy on foreign demand for manufactures and commodities?
- Did property, equity or other markets display excessive growth and a bubble-like situation prior to September 2008?
- In what condition was the banking sector (e.g., size/structure of banking sector, non-performing loans, capital adequacy ratios of major banks, if available)?

Due to its relatively open capital account (significantly more open than neighboring Japan's, for instance), there were major concerns in Korea in late 2008 that the country would suffer disproportionately from international investors retreating and liquidating Korean assets in order to fulfill their obligations elsewhere. The decline of the Korean stock market and the tumbling won provided ample evidence of this effect. At one stage in September/October 2008, Korean banks found it almost impossible to raise U.S. dollars in order to repay maturing foreign-currency loans.[6] Initially, Koreans observers felt rather safe, because of the significant accumulation of foreign exchange reserves ($240 billion by September 2009), and the relatively sound financial situation of Korean banks and enterprises as compared to 1997. However, due to the tightening of international liquidity, the government had to step in and promise a $30 billion infusion to support the banking system. By the end of October 2008, the foreign exchange reserves had been reduced to $212 billion, a decline of more than 10 percent in just a single month.[7]

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[6] Martin Fackler, "South Koreans Reliving Nightmare of Last Financial Crisis," New York Times (Business section), October 24, 2008, http://www.nytimes.com/2008/10/24/business/worldbusiness/24iht-24won.17217405.html?_r=1&scp=1&sq=South%20Koreans%20Reliving%20Nightmare%20of%20Last%20Financial%20Crisis&st=cse (accessed September 2009).

[7] Figures according to the IMF data series, "Time Series Data On International Reserves and Foreign Currency Liquidity Official Reserve Assets and Other Foreign Currency Assets" at http://www.imf.org/external/np/sta/ir/802P816.pdf (accessed September 2009).

How important was/is the financial sector for the national economy? How much interdependence was/is there between the financial sector and the real economy?

The competitive strength of the Korean economy is based on its manufacturing industry. The major business groups such as Samsung and LG, the so-called chaebol, do not include banks among their ranks. This is due to the fact that in former decades, banks were used extensively by the state to influence the direction of industrial change. This was sometimes done through nationalized banks, although these were later re-privatized. While it is unquestionable that banks, non-banks and the financial system in general represent an important foundation for the real economy to engage in business, compared to many other economies the relationships between the financial and real sector are not overly dense. This also holds for relations between the state and private business. When discussing economic development, the question is usually to what extent the interests of the major business groups, with their strong basis in manufacturing activities, are entwined with government. The financial system plays a comparatively less conspicuous role.

Since the 1960s, the South Korean economy (as one of the newly emerging East Asian economies) has been deeply integrated in regional and global trade flows. It is considered one of the premier examples of an outward-oriented development model. Being extremely resource-poor, the country’s “business model” consists of processing imported raw materials and intermediate goods, adding value and exporting the goods. China has become the major trading partner both with respect to exports and imports (respectively accounting for 21% and 16% of each in 2006, based on Korea International Trade Association (KITA) data), while other major trading partners include the United States and Japan. Korea is thus intimately linked to some of those economies that are (also) subject to the impact of the financial crisis and its consequences for real demand. South Korea is also deeply integrated with the world economy with respect to international investment.[8] At the end of 2007, it held $597 billion in assets abroad, compared to liabilities of $826 billion. With respect to foreign direct investment (FDI), Korea has recently made strong moves into China in order to tap its market and to use it as an export base for the world market; between 2004 and 2007, FDI assets increased from $7.5 billion to $23.7 billion. In this respect too, South Korea has become very dependent on the global market.

[8] Data based on Bank of Korea: International Investment Position at the end of 2008 (Preliminary), 20 February 2009, http://ecos.bok.or.kr/ (accessed September 20, 2009).

Speculative exuberance in the real estate sector has been a significant issue for Korean governments for many years. During 2005 – 2007, however, the former government, being concerned about bubble phenomena and uneven wealth distribution, took several countermeasures including the establishment of price ceilings on new apartments and an increase in capital gains taxes. As a consequence, residential construction declined and actually contributed to the weakness of domestic demand at the outbreak of the crisis.[9]

Compared to the situation of the late 1990s, and compared to many other countries, the Korean banking system seemed quite healthy at the outbreak of the financial crisis. Because of a real estate boom, Korea had previously introduced regulations on the loan-to-value ratio of mortgage loans, so excessive financing of inflated real estate prices could be avoided.[10] In June 2008, the capital adequacy ratio for Korea's commercial banks was 11.16 percent (based on Basel II standards), and thus seemed quite safe in comparison to other banks in the world.[11] However, a closer look reveals that some problems had begun to loom even among Korean banks. This holds in particular with respect to the liquidity ratio, which is defined as the ratio of current assets (with three months or less remaining to maturity) to current liabilities (also with three months or less remaining to maturity).[12] According to Korean financial regulations, this ratio should be above 100 percent for commercial banks. While for many years it had usually surpassed 110 percent, it dropped close to 100 percent in late 2007. Banks are reported to have tried "quick fixes" to overcome this situation, which led to severe problems when financing opportunities deteriorated seriously in 2008.

[9] OECD Economic Survey Korea 2008, p. 22.

[10] Hyun-Soo Park, "How to Ride Out the Financial Crisis," Samsung Economic Research Institute, http://www.seriworld.org/01/wldContV.html?&mn=A&mncd=0301&key=20090731000001&pubkey=20090731000001&seq=20090731000001&kdy=E5JjH5a6=&sectno=3, accessed in September 2009

[11] For an international comparison of the period 2004 to 2008, see Bank of Korea, "Financial Stability Report," October 2008, p. 73, http://eng.bok.or.kr/contents/total/eng/boardView.action, (accessed September 2009).

[12] Bank of Korea, "Financial Stability Report," October 2008, p. 73, http://eng.bok.or.kr/contents/total/eng/boardView.action (accessed September 2009).

- Did policymakers/executive agencies have any experience in handling financial crises? Did this experience play a role in the 2008-09 policy response?
- Were there independent regulatory institutions or prevention/response schemes in place to contain financial risks?
- Were there internal veto players (e.g., federalist powers, courts) or international obligations that thwarted swift action on the part of the government?
- Have executive powers been extended in times of crisis? Has this been based on formal or informal mechanisms?

Structural or policy advantages and disadvantages

In terms of previous experience, the obvious point of reference for the Korean government in late 2008 was the Asian financial crisis, which hit South Korea severely in late 1997. The legacy of this traumatic event can be discerned in several ways. Perhaps most evident are the lasting institutional effects, such as stronger financial regulation or the presence of a state-run organization to purchase toxic assets (Korean Asset Management Company (KAMCO); this will be described in more detail below). However, psychological effects were also strong, manifesting for instance in a strong national drive to avoid a similarly harmful situation at all costs.

Once the crisis hit, the Korean government employed the usual mechanisms at hand to contain financial risks. Given the traditional strength of the executive wing under the president of the republic, a series of weekly meetings headed by President Lee Myung-bak quickly became the central forum through which the government responded to the crisis. From January 2009 to September 17, 2009, 31 of these “Emergency Economic Meetings,” had been held.[13]

Government bodies were not blocked in their ability to act swiftly. Indeed, it may be considered one of the strengths of the South Korean system that the government can act speedily and decisively if backed by the “Blue House” (i.e., by the president). Of course, this can easily turn into a weakness as well. From this perspective, it is all the more surprising that the government has been criticized from various quarters for having acted too slowly—a critique voiced not only by opposition politicians, but also by a number of economists from Korea and from abroad.[14] The reason for any delay in decision-making is probably twofold: First, Korean observers were truly surprised how vulnerable the South Korean economy was in facing the financial crisis, despite large currency reserves and a rather sound banking system. Second, economic policy had to make a virtual about-face, from fighting inflation to countering a deep recession.

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[13] Na Jeong-ju, “Cabinet Asked to Pool Wisdom for Economic Revival,” Korea Times, January 8, 2009, http://www.koreatimes.co.kr/www/news/include/print.asp?newsIdx=37541 (accessed September 2009).
[14] Yoo Soh-jong, “Is the Lee administration on the right track?” The Korea Herald, March 4,2009.

The government was able to act rather freely to counter the crisis, without being slowed by formal mechanisms. There is a tradition of strong government leadership in Korea, and the domestic opposition—aside from some initial protest—acted with restraint. Consequently, the general sense of imminent economic danger, deepened by the memory of the 1997 – 1998 crisis, allowed the government to go ahead proactively.

- How strongly has the national economy been hit during the period under review? Where has it been hit most severely thus far (e.g., growth rate, production, trade, employment)?

Initial impact of economic downturn

South Korea was one of the G-20 economies hit hardest by the financial crisis. In the fourth quarter of 2008, the economy shrank 3.4 percent, compared to 4.3 percent in Japan (year-on-year). As of the end of October 2008, the won had depreciated by 24.5 percent compared to the beginning of the year, while by October 16, the stock market had dropped 31.4 percent.[15] Changes in the financial sector were soon reflected in the real economy.[16] Exports started to decline steeply in the last two months of 2008, and this continued well into 2009. Exports plunged by almost 34 percent in January 2009 (year-on-year) and by 17 percent in February. The current account balance turned negative in 2008, but will turn positive again for 2009. Private consumption, capital investment and construction investment decreased on a yearly basis in 2008, while capacity utilization ratio decreased to less than 65 percent around the turn of the year. As a consequence, GDP shrank in the final quarter of 2008, but due to higher growth in the first quarters, Korea still achieved 2.5 percent GDP growth for the whole of 2008. In terms of the labor market, the unemployment rate was contained at 3.2 percent in 2008. This is mainly due to the fact that the number of workers dropping out of the labor force surged during the downturn. In this context, it is noteworthy that the number of temporary workers has increased significantly in recent years, which offered a seemingly convenient buffer for regular employment adjustment. However, this implied that the welfare situation of those affected at the bottom of the labor force deteriorated seriously. This developed into a major social issue in 2009, which demanded a response even from a pro-market government like President Lee’s.

Looking at how various interest groups were affected by the financial crisis, it should first be noted that the exposure of the Korean financial system to toxic financial assets was small, so this has not become a major issue for

[15] Chang Jae-chul, “Global Financial Crisis and the Korean Economy,” Samsung Economic Research Institute, 29 October 2008, http://www.seriworld.org/ (accessed November 2009).
[16] ADB Asian Development Outlook, ibid .pp. 172- 176.

policy responses. However, banks and enterprises were seriously affected by the international liquidity crunch and by the steep drop in export markets. While the effects on groups such exporters and stock market investors were rather quickly cushioned by the eventual rebound of markets after early 2009, poor households continue to suffer due to the pressure on companies to remain competitive under extremely difficult circumstances. This has not been well reflected in official unemployment figures, which have not moved beyond the four percent range during the crisis. Indeed, regular employees of established companies enjoy rather attractive salaries and benefits. However, companies have had to compensate for these costly measures, and many less fortunate workers have had to accept badly paid irregular/temporary work, or have left the active work force altogether. As a result of Korea's still-incomplete social security system, levels of suffering and discontent have become quite considerable.

2. Agenda-Setting and Policy Formulation

- When did state organs (e.g., government, central bank) begin setting a crisis response agenda? How long did it take to adopt the first crisis measures?
- Who were the driving forces (e.g., government, central bank, foreign actors, media, trade unions, employers` associations) in getting stabilization/stimulus policies started?
- Were these measures launched as executive orders or parliamentary laws? How closely did constitutional bodies (e.g., executive, legislative, central bank) cooperate?
- What kind of role did sectoral or regional lobbies play in policy formulation?

Agility and credibility

As late as August 2008, Korea's central bank, the Bank of Korea, was still raising interest rates to fight inflationary pressure. Clearly, it was not until September 2008—when Lehman Brothers went bankrupt—that the government grasped the severity of the coming crisis. The first visible measure was the announcement of the Ministry of Finance on September 26, 2008 that it would inject $10 billion into the currency swap market to help domestic banks overcome their dollar funding shortages. A ban on short-selling stocks followed on September 30.[17] A first fiscal stimulus package was announced in early November 2008.[18]

[17] New York Times, "Chronology of Korean Responses to the Financial Crisis," October 19, 2008, http://www.nytimes.com/2008/10/19/business/worldbusiness/19iht-wonchrono.17073102.html (accessed September 2009).
[18] Bettina Wassener, "South Korea Earmarks $10.9 Billion to Aid Growth," New York Times, November 4, 2008,

The government and the formally independent Bank of Korea took the lead in formulating responses. Due to the fact that the major initial impacts included the strong depreciation of the won and the outflow of funds, both of which were associated with refinancing problems for private banks, the Bank of Korea was intimately involved with the unfolding events from the beginning.

Responses to the crisis included (and still include) a combination of government action and parliamentary laws. As usual in democracies, spending programs and tax measures in particular need parliamentary approval to become effective. The passage of laws was sometimes delayed, because even though the government party possesses a majority of seats, the opposition blocked voting procedures and even the entrance to parliamentary meeting rooms for some time.[19] Indeed, there is almost a tradition for the Korean opposition to act in such a way against a domineering government. However, the almost ritualistic opposition by minority parties and trade unions was less severe in this case than in other previous cases, probably because anxiety over the financial crisis was so great that there was some sense of a need for national unity. Indeed, in February 2009, there was an emergency meeting between labor and management groups, civic organizations, and the government; some common ground was sought here, although the more radical of the trade union groups, the Korean Confederation of Trade Unions, was critical of the results.[20]

Saving the Korean banks in late 2008 from their inability to honor dollar-denominated obligations was not generally seen as an unwarranted gift to this sector, but rather as a necessary defense against an unforeseeable shock from abroad. Arguably, the contents of the “Green New Deal” stimulus project, a major part of which has meant significant new business for the construction sector, could be seen as helping vested interests associated with the president, who is a former chairman of Hyundai Construction, a major company with links to one of the strongest business groups (chaebol).

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http://www.nytimes.com/2008/11/04/business/worldbusiness/04won.html?scp=1&sq=South%20Korea%20Earmarks%20%2410.9%20Billion%20to%20Aid%20Growth&st=cse (accessed November 20, 2009).

[19] Jens Herskovitz, “South Korean Reforms Stalled by Parliament Protest,” Reuters report of July 17, 2009, http://in.reuters.com/article/worldNews/idINIndia-41110220090717 (accessed November 20, 2009).

[20] Korean Confederation of Trade Unions (KCTU), “KCTU Statement Opposing the Grand Agreement to Overcome the Economic Crisis,” March 2009, http://kctu.org/277, (accessed September 2009).

- Did policymakers actively consult domestic and/or foreign experts outside of government?
- Did the government actively seek collaboration with other governments or international organizations?
- Did the government participate in multilaterally coordinated rescue efforts?
- Was the government curtailed in its response through IMF support programs?

Consultation with external experts and openness to international collaboration

It is difficult to evaluate the extent to which domestic or foreign expertise was solicited. Korean pride, particularly after the shameful experience of the 1997 – 1998 crisis, would probably prompt any such consultation, if indeed it did play a role, to be conducted in a confidential manner. However, the Republic of Korea is noted for the presence of highly qualified government-associated think tanks such as the Korea Development Institute and the Korea Institute for International Economic Policy, so at least on a technical level, the need for external consultation was probably not very significant.

In terms of international cooperation, the Bank of Korea successfully sought support in the form of currency swaps with its counterparts in the United States, Japan and China during late 2008.[21] In early March 2009, Korea tapped its $30 billion line with the U.S. Fed to lend some $16 billion to local banks. The other bilateral swap lines do not seem to have been used yet.[22]

President Lee Myung-bak eagerly participated in a trilateral summit with China and Japan on December 13, 2008, which had already been planned before the crisis. Concrete results in terms of jointly fighting the crisis are difficult to identify, however.[23] The government has also eagerly participated in the G-20 process, although it is again difficult to find instances of specific, fruitful interchange between Korea and the G-20 with respect to the financial crisis. The Republic of Korea will co-chair the G-20 in 2010, and hopes to raise its international profile accordingly. Active support of ASEAN+3 and the multilateralization of currency swaps under the Chiang Mai Initiative are also seen by the government as steps to strengthen the financial situation.

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[21] ADB, Asian Development Outlook 2009, p. 174.
[22] Nam In-Soo, “BOK: S Korea, Japan To Extend Bilateral FX Swap Line By 3 Months,” Dow Jones Newswire, October 16, 2009, http://www.nasdaq.com/aspx/stock-market-news-story.aspx?storyid=200910160215dowjonesdjonline000329&title=boks-koreajapan-to-extend-bilateral-fx-swap-line-by-3-months (accessed November 2009).
[23] Joint Press Conference by Prime Minister Taro Aso of Japan, Premier Wen Jiabao of the People's Republic of China, and President Lee Myung-bak of the Republic of Korea following the Japan-China-ROK Trilateral Summit Meeting, December 13, 2008, Provisional translation, http://www.kantei.go.jp/foreign/asospeech/2008/12/13kaiken_e.html (accessed September 2009).

Given the lingering memory of the 1997 – 1998 crisis, which is often called the "IMF crisis" in Korea, the government tried hard to pay back multilateral support as soon as possible after the Asian crisis had passed. In the following years, succeeding governments made sure they created—to the best of their abilities—economic conditions that would make it unnecessary to ask the IMF for support ever again. Approaching the IMF would thus be considered only as an ultimate recourse, and the country did not need to do so in 2008 – 2009.

3. Policy Content

- How large is the stimulus package as expressed as a percentage of GDP (including compensations to those hit particularly hard by the crisis through social/labor policies)?
- The stimulus is spread over a period of how many years?

Scope of stabilization and stimulus policies

According to the best available estimate, Korea's fiscal stimulus packages totaled about 3.6 percent of GDP in 2009; the effect in 2010 will still be 1.2 percent of GDP. This includes measures aimed at support for the self-employed and for low-income households, which make up about a third of the package and thus cannot be considered as negligible. Tax measures account for another percentage point of GDP; some part of this measure also includes a social component, as is explained under "social protection." [24]

Most stimulus measures were earmarked for effect in 2009, while an additional impact of some 1.2 percent of GDP is expected through tax measures, some of which are permanent. The most important expenditure measure, the "Green New Deal" announced in January 2009, covers a four-year period. According to estimates by HSBC Global Research, the whole program amounts to 3.5 percent of 2009 GDP (which, of course, depends on the size of the 2009 GDP). As for 2009 itself, HSBC expects the stimulus cost to be less than one percent of Korea's GDP.[25] It should be noted that some fiscal stimulus was also implemented in 2008; the OECD reckons this to have been in the range of one percent of 2008 GDP.[26]

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[24] Leif Lybecker Eskesen and Erik Lueth, Republic of Korea – Selected Issues, IMF Country Report 09/263 (2009): 10., http://www.imf.org/external/pubs/ft/scr/2009/cr09263.pdf (accessed September 2009).
[25] HSBC Global Research, "A Climate for Recovery. The Colour of Stimulus Goes Green," February 25, 2009, http://www.globaldashboard.org/wp-content/uploads/2009/HSBC_Green_New_Deal.pdf (accessed September 2009).
[26] OECD, "Report on the Strategic Response: Strategies for Aligning Stimulus Measures with Long-Term Growth. Meeting of the Council at Ministerial Level, 24-25 June 2009," June 17, 2009, C/MIN(2009)9/ANN2.

- How is stimulus spending distributed across sectors? How and to what extent is the financial sector supported (e.g., through loans, guarantees, capital injections)?
- Which industrial and structural policies (e.g. corporate tax cuts, subsidies, company bail-outs) can be observed?
- What kinds of measures target the expansion of public spending on infrastructure? Which ones are designed to sustain business and consumer spending?
- Are policies in support of businesses adequately targeted and delineated (e.g., at creating employment, supporting competitive firms)?

Targeting and coverage of policy tools

Somewhat more than a quarter of South Korea's stimulus measures consist of tax measures. These include changes in the personal income tax and the corporate income tax rates. The personal income tax changes contain some distributive elements, in the form of a bigger percentage reduction for lower-income taxpayers and an absolute per-person deduction element. The remaining 72 percent of the package (for 2009) is comprised of expenditure-related items; these include income support for low-income households, labor market-related measures, support for small and medium-sized enterprises, and investment measures.

Support for the financial sector is not included in the measures listed above. The major finance-related measure has been the succession of base interest rate reductions, from 5.25 percent to 2.0 percent between October 2008 and February 2009.[27] Another important area of action was the encouragement of funds helping financial markets to overcome a credit crunch, for instance by broadening the definition of eligible collateral. The Bank of Korea also used quantitative easing: The aggregate credit ceiling was raised from KRW 6.5 trillion to KRW 9.0 trillion in order to increase banks' credit supply capacity. An additional measure was a support scheme for bank recapitalization, totaling up to KRW 20 trillion. Finally, as already mentioned, an important aspect of crisis management was the stabilization of foreign exchange and currency markets in the immediate post-Lehman phase. To this end, the Bank of Korea extended its existing swap agreements with the United States, China and Japan beyond their normal limits, and also in excess of those arranged through the Chiang Mai Initiative. With respect to the United States, a ceiling of $30 billion was announced on October 30, 2008, with an expiration date one year later. In addition, foreign currency liquidity was provided to financial institutions. The total volume represented by this program amounted to $50 billion, used mainly for short-term borrowing and trade-related finance. Finally, there was some easing of regulations concerning foreign currency loans. Behind the scenes, the Ministry of Finance is said to have urged foreign-exchange players "to curb their dollar purchases," but this was not done under an emergency order, as has sometimes been

[27] For the following, see Bank of Korea, "Policy Response to the Financial Turmoil," http://eng.bok.or.kr/user/util/print_pop_eng.jsp, (accessed September 2009).

claimed.[28]

Several measures can be understood as horizontal industrial support; most prominent among these is the previously mentioned corporate tax cut. Other measures can better be understood as vertical industrial policies, supporting specific parts of industry.[29] This holds for the support of small and medium-sized enterprises (SMEs), for example: Due to the dominance of the big conglomerate groups, the weakness of smaller companies, exacerbated by the financial crisis, has been a persistent problem for Korean governments over the years. As part of a tax deduction for investments, a more favorable rate is offered for investment in provincial areas, which indirectly represents support for SMEs. Support for specific industries includes help for the automobile industry in the form of a tax deduction of 30 percent, offered for a limited period to boost domestic sales of Korean automobiles. Under the Green New Deal, a special tax deduction is given to solar cell manufacturing plants. Finally, under the same program, the cleaning of Korea's four biggest rivers and the erection of flood defenses has meant a substantial boost for the construction sector.

The stimulus package's biggest measure boosting public infrastructure is the Green New Deal. This comprises nine major projects totaling $36 billion (spread over four years), including almost $6 billion to improve energy conservation in villages and schools, $7 billion on mass transit and railroads, and almost $11 billion on river restoration (see Table 1). Major elements of this package had already been contemplated before the crisis, and had been criticized as a support scheme for the construction industry, for which President Lee had worked for many years. After the crisis had set in, a major argument for the scheme became job creation: 960,000 positions are to be created within four years, with 140,000 of them coming in 2009.[30] Most of these jobs will be for manual labor, so the project can also be considered as social policy on behalf of the weak and potentially underemployed. This emphasis on low-skill labor has received considerable criticism, though.

Many observers doubt the sincerity of the whole project and some even talk of a "green bubble." In terms of CO2 reduction potential, however, scholars

[28] The Economist. "Paranoid Seclusions. A Prophet Without Honour in Seoul," January 15, 2009, http://www.economist.com/world/asia/displaystory.cfm?story_id=E1_TNJQSQJD (accessed September 2009).
[29] On the following, see Ministry of Strategy and Finance, "Realizing 2009 Policies: Action Plans by the MOSF," December 18, 2008. http://english.mofe.go.kr/news/pressrelease_view.php?sect=news_press&sn=6137, (accessed September 2009).
[30] Ministry of Strategy and Finance, "Briefing on the Green New Deal for Foreign Correspondents," January 19, 2009., http://www.korea.net/News/Issues/issueDetailView.asp?board_no=20045&menu_code=A (accessed September 2009).

at the Kiel Institute for World Economics argue that the 7.37 million tons to be saved is comparable in volume to the reductions of the much larger German economic stimulus program.[31]

Table 1: South Korea's Green New Deal

Project	Employment	$ (mn)
Energy efficiency		
Energy conservation (villages and schools)	170,702	5,841
Fuel-efficient vehicles	9,348	1800
Environmentally friendly living space	10,789	351
Mass transit and railroads	138,067	7,005
Energy efficiency sub-total	328,906	14,997
Low carbon power (clean energy)	4674	1800
Water and waste management		
River restoration	199,960	10,505
Forest restoration	133,630	1,754
Water resource-management (small and medium-sized dams)	16,132	684
Resource recycling (including fuel from waste)	16,196	675
National green information (GIS) infrastructure	3,120	270
Water sub-total	369,038	13,888
Total for the nine major projects	702,618	30,685
Total for the Green New Deal	960,000	36,280

Source: HSBC, 2009, p. 21 (based on South Korea Ministry of Finance and HSBC data)

As for consumer spending, the most important measures are the personal income tax reduction and the support for low-income households. Business benefits most from corporate tax reduction and from measures aimed at increasing the capital supply in the banking system, mentioned elsewhere.

The policies introduced in support of business make a reasonable effort not to focus on the "laggards," but rather to address substantial short- and longer-term issues of the Korean economy at large. For instance, the weakness of the small and medium-sized enterprise sector is well known, and support during the crisis is necessary to safeguard its survival. With respect to employment, the Green New Deal has been legitimated as a major instrument for the support of manual labor jobs (i.e., jobs for those most affected by the crisis). The government argues that 96 percent of the 960,000 jobs to be created through the four-year program are of this type (while high-tech and R&D jobs in the green sector are promoted instead through a longer-term government project focused on developing future core technologies and new

[31] Gernot Klepper, et al., "Konjunktur für den Klimaschutz? Klima- und Wachstumswirkungen weltweiter Konjunkturprogramme,", *Kieler Diskussionsbeiträge* Nr. 464 (April 2009): 19.

growth engines).[32] However, it is frequently argued that from a cost-benefit perspective, the significant funds spent on the program could more effectively be used elsewhere; the strong emphasis on construction work with dubious socioeconomic benefits is seen as a problematic bias to the program. Moreover, there are ecological concerns about the physical repercussions associated with the projects' size.

Development as an objective of stimulus policies

- Are stimulus measures influenced/limited by pre-crisis development strategies (e.g., industrial policies) or have novel/additional (e.g., environmental) policy objectives been inserted?
- Is the response to the crisis grounded in a broader developmental perspective (i.e., crisis as development opportunity) or predominantly short-term political constituency logic?
- Do stimulus policies address prevailing structural deficits and future growth potential?

The Green New Deal is the most imaginative part of the crisis rescue package. It is not totally new, though; rather, it represents an upgraded version of previous projects and plans.[33]

In parallel to the announcement of the Green New Deal in January 2009, the government announced its intention to support "new growth engines," represented by 17 specific industries including sustainable energy, information technologies, health care and tourism. Like the Green New Deal, the program is also designed to last four years, with 17 percent of KRW 6.3 trillion to be spent in 2009.[34] While this program is sometimes included in summaries of governmental responses to the global crisis, it seems more sensible to interpret it as part of the long-term concern by Korean governments to engage in sector-specific industrial policies, with the timing being rather coincidental.[35]

To some extent, the crisis response was driven by short-term necessities, at least as perceived by decision makers. This holds in particular for the finance-related parts of the program, which were issued in answer to the severe decline of the won, the rise in capital outflows and the lack of dollar funds available for refinancing.

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[32] Ministry of Strategy and Finance, "Briefing on the Green New Deal for Foreign Correspondents."
[33] See "Briefing on the New Green Deal.".
[34] Chung Myung-je, "Gov´t Finalizes Blueprint for 17 New Growth Engines," January 14, 2009, http://www.korea.net/news/news/newsView.asp?serial_no=20090114004, (accessed October 2009).
[35] OECD, "Report on the Strategic Response: Strategies for Aligning Stimulus Measures with Long-Term Growth," *Meeting of the Council at Ministerial Level*, 24-25 June 2009, June 17, 2009, C/MIN(2009)9/ANN2, p.16.

The Green New Deal is the most interesting part of the crisis response, because it combines a strong bias towards construction work, shrewdly justified by pointing to the creation of manual labor job opportunities, and by creating a lofty vision of a "Green Korea," addressing one of the accepted long-term challenges of Korea as an advanced, maturing economy. With respect to the international community, the Korean government was quite successful in stressing this latter aspect.[36] Indeed, Korea has the third-biggest green stimulus among major economies, with $31 billion devoted to green projects. While this is far behind China's $221 billion or the United States' $112 billion, in relative terms (as a percentage of total stimulus), it is even the largest at 81 percent, compared to the European Union's 59 percent (giving it second place) and China's 38 percent (third place).[37]

In the domestic political arena, however, critical voices have been more common. According to administration critics, after the Lee Myung-bak government received severe criticism during its first few months for its (over-) ambitious proposal to build a "Grand Canal" through mountainous South Korea, it used the "opportunity" provided by financial turmoil to repackage its construction plans as an antidepression New Deal, this time conveniently painted green.

The stimulus policies—particularly the Green New Deal, which accounts for 81 percent of the total, but only a minority of which represents 2009 spending—do indeed address some of the major developmental bottlenecks of the future Korean economy. The SME-related parts address a severe structural problem of the current economic system. However, it is questionable whether these measures are also effective (and efficient) from a longer term cost-benefit perspective. As noted elsewhere, the Green New Deal has been criticized on ecological grounds, and opposition parties argue that the river projects may even lead to water shortages in some parts of the country. As another example, support measures for vulnerable SMEs do not help to create a competitive economy, but preserve arguably unsustainable business models.

[36] UN News Service, "'Green' Stimulus Plans by Japan and Republic of Korea Hailed by UN Environment Chief," January 9, 2009, http://www.un.org/apps/news/story.asp?NewsID=29505&Cr=climate&Cr1=change# (accessed September 2009). For a rather uncritical appraisal, see OECD, "Green Growth: Overcoming the Crisis and Beyond," *Meeting of the Council at Ministerial Level*, June 24-25, 2009, C/MIN (2009)3, May 29, 2009.
[37] See HSBC, p. 3.

- Has the stimulus included “buy national” clauses? Have import-restricting mechanisms been newly established or re-established?
- Has the country’s executive/central bank manipulated the exchange rate or intervened in the foreign exchange market (if so, in which direction)?
- Have there been measures to prop up export industries (e.g., tax rebates, direct export subsidies)?

National bias and protectionism

South Korea’s stimulus package has not included explicit “buy national” clauses. The independent Global Trade Alert (http://www.globaltradealert.org) has listed a number of possibly trade-restricting measures by South Korea in recent months, but with one exception they refer only minimally to the stimulus measures issued in response to the global crisis. The biggest measure mentioned refers to a $3 billion sale-and-leaseback scheme for ships on behalf of Korean shipping companies, run by the Korea Asset Management Corporation. This measure is accompanied by other instruments aimed at helping shipbuilders; these include loans and guarantees from the Export-Import Bank of Korea and the Korea Export Insurance Corporation.[38] Aside from these measures, the temporary tax reduction for purchase of a new car has a clearly domestic focus. Moreover, the Green New Deal, with its focus on the construction business, has an obvious bias in favor of domestic construction companies. In this context, it should be noted that Korean construction companies are strongly competitive internationally, and have been hurt by the impact of the global crisis on new major construction projects worldwide. While only Korean companies will be able to act as general contractors, western companies seem to be somewhat optimistic that they will be able to attract some business as subcontractors on public work programs.[39]

Finally, the strong impact of the global crisis on “innocent” Korea has rekindled a popular sense of unity. The advice by President Lee during the early days of the crisis to save dollars and return them to the banks, considered to be a rather naïve move by his critics, has supported such feelings—particularly as it resembled the call by an earlier government during the 1997 – 1998 crisis to sell gold jewelry to the domestic banks. However, a nationalistic “call of duty” has not in general been a substantial aspect of the government’s response to the crisis.

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[38] Germany Trade and Invest (R. F.), “Koreanische Regierung hilft in Not geratenen Werften und Reedereien,” *Datenbank Länder und Märkte*, September 4, 2009, http://www.gtai.de/DE/Content/Online-news/2009/17/medien/s1-koreanische-regierung-hilft-reederein.html (accessed September 2009).

[39] Personal communication from a senior representative of a Western chamber of commerce in Korea, October 2009.

Due to the strong decline of the Korean won in late 2008, associated with a significant withdrawal of funds held in Korea by foreign investors, the government felt compelled to defend the won. It did so not only by using its own foreign reserves (which were reduced by a tenth in October 2008 alone), but also by making use of extended swap agreements with the United States, China and Japan. The memory of the 1997 – 1998 crisis, during which the Korean won came under strong pressure that ignited the painful rescue and recovery process, probably persuaded the government to temporarily back the won. This time, the intervention was more successful, and the most critical months of global risk were weathered without a breakdown of Korea's financial system. However, the effectiveness of support in favor of the won remained unstable, as the won came under renewed pressure in February/March 2009.[40]
South Korea's crisis management programs contained no strong bias in favor of export industries. However, with respect to the support of the automobile industry and the construction industry explained above, it should be noted that both number among Korea's strongest export sectors, one in manufacturing and the other in services.

Social protection

- Which labor market policies have been enacted (e.g., unemployment benefits, rise in public-sector employment)?
- Which social policies have been included (e.g., expansion of support, additional investment in health and education system)?
- Which measures have been taken to support purchasing power (e.g., consumer checks, tax cuts, cash transfers)?

Since the crisis started, the Korean government has introduced several labor market-related policies, including the creation and expansion of a young adult internship program aimed at avoiding youth unemployment; increases in employment maintenance support; support for the reduction of working hours so as to contribute to job sharing; and wage support for job sharing including paid training leave.[41]

With respect to social policies, the following measures are included in the Korean government's crisis response: increases in support for the "newly poor" and for low-income households suffering from the slowdown; emergency relief aid and permanent rental housing support for low-income households; expansion in the range of the livelihood support program, so as to reduce program gaps; an increase in school expense support for low-income university students; support for the educational environment in elementary, secondary and preschool settings; and support for farmers and

[40] ADB, "Asian Development Outlook," 2009, p. 174.
[41] Ministry of Strategy and Finance, "2009 Economic Policy Directions," December 16, 2008, http://english.mofe.go.kr/news/pressrelease_view.php?sect=news_press&sn=6114, (accessed September 2009).

fishermen (in the form of working capital, guarantees and tariff rate quotas).[42]

As discussed briefly above, social policy measures encompass roughly a third of the total stimulus package, and thus represent considerably more than a minor supplement. Nevertheless, and quite expectedly, the political opposition has criticized the government for not doing enough on social issues. Particularly in recent months, the Lee administration has done a lot to prove its "compassionate" credentials. For instance, in August 2009, the government announced that it would reduce tax incentives for large firms and wealthy individuals again.[43]

In this struggle, the government faces limitations that a more "left-wing" government would have similar problems addressing. One issue is represented by the weaknesses in Korea's social security system, associated with the fact that Korea has only recently reached advanced economy status. Any kind of socially motivated measure taken by the government under such circumstances may look insufficient, because the challenges are so huge, particularly during a time of severe economic slowdown. The second critical restriction is the potential impact of any measure on the price competitiveness of Korean industry. Korea has reached a critical wage level, and its position is endangered by cheaper suppliers elsewhere (as well as by more advanced suppliers from the West). Implementing social policies that would ultimately make labor more costly could soon lead to a major upheaval in Korea's competitiveness, cutting off a swift recovery. From this perspective, the Lee government has so far done surprisingly well in finding flexible responses to the shifting economic, political and social challenges it has faced throughout the crisis.

The most significant anti-crisis measure aimed at supporting consumption is a permanent personal income tax cut, to be executed in two parts in 2009 and 2010. It encompasses a reduction of two percentage points across the board, from the original eight percent to 35 percent range to a six percent to 33 percent range. The lowest tax bracket was given the full two percentage points of relief in 2009. In addition, the maximum per-person deduction was raised.[44]

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[42] ibid. More specific information available at Ministry of Finance and Strategy, "KRW 6 trillion to Support Low-income Families," Press Release, March 13, 2009, http://www.mosf.go.kr/recover_eng/fiscal_3.html (accessed November 2009).

[43] Kim Yoon-mi, "Korea to Cut Tax Incentives for Large Firms," The Korea Herald, August 26, 2009.

[44] Leif Lybecker Eskesen and Erik Lueth, "Republic of Korea – Selected Issues," IMF Country Report No. 09/263, August 2009, p.10, http://www.imf.org/external/pubs/ft/scr/2009/cr09263.pdf (accessed September 2009).

The social policy measures mentioned above contain some de facto consumer support element. Specifically, low-income households can receive a cash stipend to give them some relief from soaring energy prices, which are a result of the won's depreciation.

4. Implementation

- Does the government actively communicate and justify the rationale/goals of its stimulus policies to the public?
- Over time, how has the public responded to the government's management of the crisis (e.g., consumption/investment trends, public opinion polls)?

Political communication

As is to be expected in a (young) democracy, the government does communicate its policies to the public. During the first weeks of the crisis, announcements were somewhat confused; however, due to the complex and unprecedented nature of the global economic crisis, this may not be surprising. It may be fair to add that policy communication with the domestic and international public has not yet reached the level of sophistication seen in some other advanced western economies. In some parts of a "critical" public, there is fairly widespread dissatisfaction with the government and its honesty in communicating policies, almost irrespective of the policy field.[45] Indeed, government figures agreed that communication of the crisis response had not been handled well in autumn 2008; as a consequence, a public relations firm was hired.[46]

In the summer of 2008, President Lee Myung-bak had reached an absolute low point in public approval, after the "honeymoon" phase following his election. Interestingly, during the months of the economic crisis, he was able to improve his public support, though approval ratings remained 30 percent below his earlier highs. At the least, the economic crisis did not harm him further; possibly there was some sense of national solidarity amidst international turmoil, although views are split on this interpretation. In more recent months, Lee's approval ratings have increased considerably. This is usually associated with some political factors (skillful handling of the funeral of the late President Kim Dae-jung, for example), but also with an improvement of the economic situation in general and Lee's "softer" approach toward the

[45] Critical websites include the following: http://www.gobada.co.kr, http://nocanal.org/bloglounge/
[46] The Economist, "Happy Travels. A Nasty Downturn, but Politics as Usual," November 20, 2008, http://www.economist.com/world/asia/displayStory.cfm?story_id=E1_TNGVNNTQ (accessed November 2009).

support of poor citizens affected by the crisis.[47]

This latter change of attitude followed a wave of public discontent in the late spring of 2009. An important rallying point was the death of former President Roh Moo-hyun by suicide, following investigations into his behavior during his presidency.[48] It was suggested that these investigations had been excessive (although some misconduct was evident among members of his immediate family). Public mourning over Roh by millions of citizens turned into anger against the Lee government and its alleged “coldness.” Public events were accompanied by the critical statements of thousands of professors, writers, civic groups and others, often following the partisan demarcations that are so typical of the Korean political system. The concrete concerns of politicians interested in their own political futures also played a role in this shift. The loss of a by-election in late April, while not immediately endangering the government party’s parliamentary majority, showed that the ruling party faced a dramatic decline in popularity, and that many parliamentarians would not survive the next general elections. This put additional pressure on President Lee, to which he succumbed in late June. While Lee has faced criticism from the left, his later policy shifts in particular have also received critical comments from conservatives and liberals. One issue has been Lee´s growing reliance on capable bureaucrats, particularly from the former Ministry of Finance (“Mofia”), which seems to run counter to his liberal roots.[49]

The government is now trying to find a way to govern without exacerbating political tensions on either side. For instance, in the summer of 2009, it tried to extend the period for which companies can use contracts for temporary labor from two to four years. This initiative was justified as part of the fight against unemployment (because those employed earlier with two year-contracts may soon face discharge), but it was also motivated by an urge to make the labor markets more flexible, a policy to be expected from a pro-market government. (As of this writing, this legislation has been blocked, partly because the expected negative impact of employee layoffs has not yet manifested itself).

[47] Ser Myo-ja, Kim Jung-ha, “Lee’s Popularity Ratings Improve,” JoongAng Daily, September 14, 2009, http://joongangdaily.joins.com/article/view.asp?aid=2910033 (accessed September 2009).
[48] J.J. Hwang, “President Lee Gravitates to Political Center,” The Korea Herald, August 13, 2009.
[49] H.S. Lee, “MBnomics Turing Into Bureaucratism,” The Korea Times, October 19, 2009.

- How large has the time lag been between adoption and implementation of selected major stimulus components?
- What are the reasons for delay in implementation (e.g., legal barriers, insufficient capacities, corruption)?
- Have sectoral or regional interest groups influenced the workings of policy implementation in any way?

Modes and time frame of implementation

The government was aware of potential implementation problems in its response to the crisis, and earmarked 60 percent of the fiscal stimulus measures for 2009 for the first half of the fiscal year. Generally speaking, and at the risk of propagating a national stereotype, Korean actors are often considered to be fast in executing decisions—sometimes at the cost of careful reflection on possible side-effects. There is little doubt that program implementation has moved along quite successfully. To substantiate this claim, it should be noted that some 17 percent of all stimulus measures were executed by the end of 2008, one of the highest such proportions in the OECD area, according to an OECD appraisal in June 2009.[50]

The IMF has estimated the multiplier effects in Korea, using a general equilibrium model based on a multi-country setting and calibrated for Korean circumstances.[51] According to calculations with this model, multipliers in Korea are generally smaller than those of many other countries. For instance, first-year effects of a hypothetical government investment and consumption program totaling one percent of GDP would be an increase in growth of 0.8 percent of GDP (as compared to a scenario without any stimulus), while a temporary cut in personal income tax, also at one percent of GDP, would produce additional growth of just 0.1 percent to 0.15 percent of GDP. The relatively small size of these effects can be related to the openness of the economy and international leakage effects. If multipliers are calculated on the assumption of international coordination, they are significantly higher (for instance, consumption and investment expenditure totaling one percent of GDP would produce growth of around 1.3 percent of GDP).

From this perspective, the IMF authors give a positive evaluation of Korea's relatively large stimulus package, particularly given that the low government debt offers considerable leeway and that the Korean fiscal system has rather minimal automatic stabilizers.

[50] OECD, "Report on the Strategic Response: Strategies for Aligning Stimulus Measures with Long-Term Growth," *Meeting of the Council at Ministerial Level*, June 24-25, 2009; June 17, 2009, C/MIN(2009)9/ANN2, p. 7.
[51] Leif Lybecker Eskesen and Erik Lueth, "Republic of Korea – Selected Issues, IMF (approved by the Asia and Pacific Department)," July 23, 2009, http://www.imf.org/external/pubs/ft/scr/2009/cr09263.pdf (accessed September 2009).

In the Korean economics profession at large, views are of course more divided.[52] Many observers support the government, but some criticize the fiscal measures for having been taken somewhat late, after an initial period of uncertainty in late 2008. More broadly, my interpretation is that the stimulus measures have not been criticized so much on the basis of doubts as to their macroeconomic effectiveness, but rather on wider issues; these include concerns over the burden of debt service and efficiency considerations in terms of serving the country's longer-term needs (ecological considerations, human capital issues, overcoming social imbalances).

Regional or sectoral interests do not appear to have severely influenced implementation of the anti-crisis programs. Typically, the position of the executive is very strong in Korea, and the speed of decision-making and execution could conceivably make it difficult for program capture to play an important role.

- Beyond emergency stand-by programs with the IMF, has the government collaborated with other governments or international organizations in implementing its response to the crisis?

International or regional cooperation

As discussed above, the government, including the Bank of Korea, was overwhelmed by the swift deterioration of the financial sector during the critical months of late 2008. It realized that its links with the international financial community were not satisfactory.[53] To stabilize the financial markets (including gaining access to U.S. dollar loans and supporting the won), the Korean government sought cooperation with other leading economies, probably not only to gain concrete access to funds and swap credit lines, but also to signal its alignment with important financial players like the United States, Japan and China. Details of the various bilateral agreements are contained in Table 2.

Although the Ministry of Strategy and Finance announced that "reinforcing international coordination" would be one of its 10 "action plans" for 2009, there is little evidence that this cooperation went beyond faithful participation in multilateral frameworks such as the OECD, ASEAN+3, the G-20 and other similar groups.[54] South Korea is interested in playing a leading role in these processes, and is delighted to co-chair G-20 in 2010, for instance;

[52] For such views, see for instance Yoo Soh-jung, "Is the Lee administration on the Right Track?," The Korea Herald, March 4, 2009.
[53] The Economist, "Happy travels. A Nasty Downturn, but Politics as Usual," November 20, 2008.
[54] Ministry of Strategy and Finance, "Realizing 2009 Policies: Action Plans by the MOSF," December 18 2008, http://english.mosf.go.kr/news/pressrelease_view.php?sect=news_press&sn=6137 (accessed November 2009).

however, this posture is related to the broader strategic issue of feeling overshadowed by the two bigger economies of China and Japan, and is not caused by the current crisis.

Table 2: Currency swap arrangements between the Bank of Korea and other central banks

	U.S. Federal Reserve	People's Bank of China	Bank of Japan
Ceiling	$30 bn	CNY 1,800 bn KRW 38 trn	$20 bn
Date of announcement	Oct. 30, 2008	Dec. 12, 2008	Dec. 12, 2008
Expiry date	Oct. 30, 2009	3 years	Oct. 30, 2009

Source: The Bank of Korea´s Policy Response to Stabilize the Financial and Foreign Exchange Markets, p.12, http://www.korea.net/image/news/today/20090521002L.pdf (accessed September 2009).

5. Funding, Tax and Monetary Policies

- Has the government initiated tax reductions/incentive schemes?
- Have these been aimed at the private and/or the corporate, domestic or the foreign sectors?

Tax policies in support of stimulus/ stabilization

As described under "scope of stabilization and stimulus policies," reductions in both the corporate income tax and the personal income tax are important elements of the stimulus programs. They account for almost a third of stimulus volume in 2009. In comparison to other OECD countries, the size of Korea's personal income tax reduction is ranked fifth in relation to GDP.[55] Apart from these two major initiatives, there are some decidedly smaller measures, such as those aimed at boosting consumption.

[55] OECD, "Report on the Strategic Response: Strategies for Aligning Stimulus Measures with Long-Term Growth." *Meeting of the Council at Ministerial Level*, 24-25 June 2009, June 17, 2009, C/MIN(2009)9/ANN2, p. 9.

- What kind of policies did the central bank contribute to the national crisis response? Which unconventional measures were used to fight the crisis?
- If an independent national monetary policy is not feasible, were there substituting measures in the country's exchange rate policy?

Monetary and currency policies in support of stimulus/ stabilization

The most important policy contribution by the Bank of Korea was the decisive lowering of the base interest rate between October 9, 2008 and February 12, 2009. Given the fact that the base rate was still being raised as late as August 9, 2008, the activities of the bank cannot be considered as altogether positive.

Unconventional measures have been used, including quantitative easing to encourage the availability of bank capital to the ailing corporate sector. The danger of an excessive lengthening of the balance sheet has been limited, however, because the measure was to some extent cancelled out by the lending of currency reserves. Moreover, as the base rate is still well above zero, conventional monetary policy still works quite well, and the IMF assumes that the unwinding of the unconventional measures, already under way, can proceed quite smoothly.[56]

The late-2008 maneuvering aimed at ameliorating the banks' serious lack of U.S. dollars, necessary to refinance their exposure, involved some rather informal calibration with other financial players, which probably went somewhat beyond the established rules, although this is difficult to substantiate.

While South Korea's government did have some flexibility in terms of its national monetary policy, the necessary reduction in interest rates meant that the won's depreciation, due to an outflow of funds being used to fill gaps in balance sheets elsewhere, was accelerated. From this perspective, it is understandable that the Bank of Korea engaged in some major, costly defense of the value of the won. Interestingly, while the Asian Development Bank (ADB) joins the usual chorus of doubt as to whether this currency support was truly effective, it does not blame the Bank of Korea (or Korean government authorities) for having attempted this policy under the difficult circumstances. However, it reasons that Korea may have gone too far with its capital account liberalization in recent years.[57]

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[56] IMF, Staff Report for the 2009 Article IV Consultation, IMF Country Report No. 09/262, August 2009, p. 19 http://imf.org/external/pubs/ft/scr/2009/cr09262.pdf (accessed October 2009).
[57] ADB, "Asian Development Outlook 2009," p. 174.

- Relative to conditions at the outset of the crisis, does stimulus funding have a solid foundation in monetary policy or in bond/credit markets?
- Is the program part of the normal budget/integrated into the budgetary cycle, or is it financed primarily from sources outside of the formal budget?
- Is there cross-level burden-sharing between center and regions (e.g., debt issuance, fund transfers)?
- Is financial aid given to banks/companies/households in a discretionary way or based on well-defined formulas (e.g., conditionalities)?
- Did the government make credible commitments to terminate its expansionary fiscal and monetary policies under (what kind of) post-crisis conditions?

Credibility of funding mechanisms

Funding needs have not posed serious problems for Korean government authorities, either on the monetary or fiscal side. The weeks immediately following the Lehman Brothers collapse in September 2009 were the most critical period, but financial market conditions soon relaxed. By early 2009, risk premiums on government, prime corporate and bank bonds had fallen.[58] This was also reflected in the positive outlook expressed by leading international rating agencies during 2009. Moodys announced in a statement on September 16, 2009 that it would retain its A2 rating for Korea´s long-term foreign currency debt, a rating it has kept throughout the recent financial crisis.[59] Background factors for this more or less stable appraisal include the relatively low level of public debt in Korea, the country's significant foreign reserves and the comparatively sound situation of the Korean banking system, with capital-adequacy ratios above 12 and thus well beyond the recommended bottom level of seven.

The majority share of the crisis response program were undertaken as a part of the 2009 regular budget and a supplementary budget for 2009, announced in April 2009.[60] The final draft for the 2009 budget was decided in a cabinet meeting on September 30, 2008, so to some extent it could already serve as a reaction to the crisis. Adding a supplementary budget at a later stage during the fiscal year is not unusual, though the 2009 instance was more than twice the size of the supplementary budget passed in 1998, during the Asian financial crisis.

The South Korean governmental system is a centralized one, although the government wants to give more weight to viable economic regions in the

[58] Financial Services Commission, "Overview in the financial Stability Report (English translation)," No date (ca. spring 2009), www.fsc.go.kr/downManager?bbsid=BBS0117&no=61068 (accessed September 2009).
[59] Channels, "Moody's May Up Korea Sovereign Rtgs If Econ Improves," September 16, 2009, http://www.channelstv.com/newsdetails.php?news_id=14213 (accessed October 2009).
[60] More information available at Ministry of Strategy and Finance, "Supplementary Budget for Job Creation," April 28, 2009, http://english.mosf.go.kr/issues/policyissues/economic_view.php?sect=laws_policies&sn=6460 (accessed October 2009).

near future. The options for provinces or even municipalities for reacting to the crisis in terms of financing extra expenditures or making up for revenue shortfalls were very limited. From that perspective, the major issue for the national government was to help the regions through some kind of transfer. This is reflected in the supplementary budget mentioned above. Regional support is listed as one of five major focuses of the extra budget, and KRW 3 trillion out of a KRW 28.9 trillion total are earmarked for purchasing municipal bonds and facilitating infrastructure projects undertaken by provincial firms.[61]

Generally speaking, the government usually uses formulas to identify the beneficiaries of its programs. In its support schemes for low-income households, the usual demarcation point is defined in terms of income as a proportion of the minimum cost of living.[62] Crisis-management programs aimed at financial markets do spell out conditions for eligibility, but is difficult to ascertain whether such guidelines have been faithfully followed.[63] However, in the wake of the 1997 – 1998 crisis, the government has successfully tried to upgrade financial regulation and supervision in order to restore the sector's international reputation.

There were no clear exit conditions set by the Korean government in its crisis management programs. Some of the elements, including the tax measures, were considered permanent. Others, including the Green New Deal, the biggest fiscal stimulus project, have a clear timeframe. However, financial measures including the lowering of the base rate by the Bank of Korea or the financial support offered to banks and SMEs have not in general included clear criteria for conclusion.

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[61] ibid.

[62] Ministry of Strategy and Finance, "KRW 6 Trillion to Support Low-income Families," Press Release, 13 March 2009, http://www.mosf.go.kr/recover_eng/fiscal_3.html (accessed November 2009).

[63] For details, see Bank of Korea, "Expansion of Banks´ Credit Supply Capacity," no date, http://eng.bok.or.kr/user/util/print_pop_eng.jsp (accessed September 2009).

6. Feedback and Lesson-Drawing

- Have there been revisions or additions to the original policy packages or a sequence of distinct stimulus policies in response to unexpected new developments?

Policy feedback and adaptation

The recovery of the economy has taken place faster than originally expected. Even by the summer of 2009, for instance, the IMF had revised its growth projection for 2009 from -3 percent to -1.75 percent. This implies that Korea already has to consider exit options, arguably faster than is the case for many other OECD economies. The situation is quite complex, however. On the one hand, stock prices have already risen considerably, and even real estate prices are regaining ground in Seoul and its vicinity. Boosting the interest rate early may help avoid another asset bubble, but this may be premature for the real economy.[64] On the other hand, the rebound of the real economy may not only be threatened by a W-shaped recovery by the global economy at large, but it has also become more apparent that low-income households have suffered considerably from the impact of the crisis. President Lee has somewhat modified his earlier image as a “hard-hearted” liberalizer, shifting in June 2009 toward a softer approach that shows sympathy for the tough situation at the bottom of the socioeconomic pyramid.

Consequently, and given this dilemma, the mid-term outlook for policy direction in the second half of the 2009 fiscal year, issued in June 2009, was somewhat loose in drawing policy implications from the early months of crisis response. The gist was that authorities would carefully review and evaluate the current policies with respect to their effectiveness.[65] In a statement on August 9, 2009, following the regular Article IV consultations with the Republic of Korea, the IMF encouraged the Korean government to continue its efforts to support the economy.[66] At the same time, it identified some problems with the effectiveness of the measures, for instance that money borrowed by SMEs under the eased banking rules may not have gone into productive investment. As the Lee government has lately gained public approval by showing more concern for the relatively weaker parts of the economy, it will be difficult for it to find a suitable way between continued economic support on the one hand, and jointly avoiding an asset bubble and safeguarding allocative efficiency on the other.

[64] Kim Tae-gyu, “S. Korea Suffers ‘Exit Plan’ Dilemma,” Korea Times, September 3, 2009, http://www.koreatimes.co.kr/www/news/biz/2009/09/123_51191.html (accessed September 2009).
[65] Financial Services Commission, “Economic policy directions for second half of 2009,” June 26, 2009, http://www.korea.net/news/news/newsView.asp?serial_no=20090626005 (accessed September 2009).
[66] IMF, “IMF Presses Korea to Continue Rebalancing Economy,” August 9, 2009, http://www.imf.org/external/pubs/ft/survey/so/2009/car080909a.htm (accessed September 2009).

- Has major institutional reorganization/capacity-building been undertaken in financial supervision?
- Do we find new institutions that were not in place prior to the crisis (e.g., bad banks)?

Institutional restructuring

There has been no organizational change in financial supervision institutions or crisis management structures in the wake of the recent crisis. The "emergency economic meetings" chaired by the president are an ad-hoc device that likely will take on no longer-term role. The IMF has recently suggested the establishment of better coordination between financial supervisors, monetary policymakers and lender-of-last-resort facilities in Korea, possibly using the framework of a "financial stability council." However, the Korean side has argued in favor of a clear delineation of supervisory responsibilities, including the safeguarding of the Bank of Korea's independence.[67] Given the short track record of its formal independence, the ubiquity of interpersonal influences and doubts as to de facto independence, it might indeed be a problematic signal to subordinate the central bank to a new "council" that would probably be dominated by a representative of the president of the republic, or indeed by him personally.

The Korean government has set up a Bank Recapitalization Fund to support the recapitalization of banks by purchasing the subordinated bonds of banks, hybrid bonds and preferred stock. The fund is fed by capital from the Bank of Korea and the Korea Development Bank, a governmental policy bank, for a total of up to KRW 20 trillion (roughly $14 billion).[68] In the first quarter of 2009, eight banks drew a total of KRW 4 trillion. The fund has played a positive role in helping to raise the banks' capital adequacy ratio to almost 13 percent;[69] the availability of such funds has also indirectly helped some banks to regain access to international capital markets. There has also been some criticism, however, as capital from the fund has been linked to banks' offer of new credit lines or roll-overs for SMEs. This has contributed to the efficiency problems in supporting ailing SMEs. The government realizes the existence of such problems and wants to readjust the conditions for support.

[67] IMF, "Staff Report for the 2009 Article IV Consultation, IMF Country Report No. 09/262," August 2009, pp. 21-22, http://imf.org/external/pubs/ft/scr/2009/cr09262.pdf (accessed October 2009).
[68] Bank of Korea, "The Bank of Korea's Policy Response to Stabilize the Financial and Foreign Exchange Markets," no date, http://www.korea.net/image/news/today/20090521002L.pdf (accessed October 2009).
[69] IMF, "Staff Report for the 2009 Article IV Consultation, IMF Country Report No. 09/262," August 2009, p. 2,1 http://imf.org/external/pubs/ft/scr/2009/cr09262.pdf (accessed October 2009).

It should be noted that Korea already possesses an organization to buy up toxic assets, a remainder of the 1997 – 1998 crisis. The Korea Asset Management Corporation (KAMCO) has been able to raise some KRW 40 trillion to buy up non-performing loans and other troubled assets. Major private banks announced in August 2009 that they would set up their own "bad bank," able to purchase some KRW 5 trillion in troubled assets.[70] According to the Korea Federation of Banks, the motivation is to create a more transparent market, overcoming the monopoly role previously played by KAMCO. However, there are concerns that the mechanism would be used to set higher prices for the distressed assets, thus allowing the banks, which are currently facing a significant squeeze on their profitability, better sales prices for such assets.

7. Tentative Economic Impact

- What do major economic performance indicators tell us about the short-term effectiveness of the crisis response (e.g., growth rate, unemployment rate, industrial output, private consumption, consumer/producer confidence, inflation, exports, bank balance sheets, credit squeezes)?
- How has the political logic of crisis management (i.e., crisis as an opportunity to broaden political support) worked out for the major decision-makers so far? How has the reputation of major government leaders at the center of the crisis response evolved (e.g., based on polls, election results, backing within their political party)?

Economic and political effectiveness of the crisis response

The Korean economy has done quite well in recovering from the shockwave of the Lehman collapse in September 2008. According to the latest Bank of Korea figures for the third quarter of 2009, GDP increased 2.6 percent quarter-on-quarter, as compared to a median estimate by the Bloomberg survey of 1.9 percent. Even in the first quarter of 2009, some improvement could be seen. While the current account moved into negative territory in late 2008, it had returned to a surplus of 4.5 percent by the first quarter of 2009. Government consumption and construction investment rose by 3.75 percent and 5.25 percent (quarter-on-quarter) respectively, supported by the government stimulus measures, thus avoiding a technical recession (negative growth) in the first quarter of 2009.[71] This positive development was repeated in the

[70] Christian Oliver, "S Korea Set for Private Bad Bank," Financial Times online, August 20, 2009, http://www.ft.com/cms/s/0/cc78145a-8d93-11de-93df-00144feabdc0.html (accessed September 2009).
[71] IMF, "Staff Report for the 2009 Article IV Consultation, IMF Country Report No. 09/262," August 2009,, p. 7, http://imf.org/external/pubs/ft/scr/2009/cr09262.pdf (accessed October 2009).

second quarter:[72] GDP grew by 2.6 percent in comparison to the first quarter, while exports rose by almost 15 percent. Facilities investment showed a hefty 10.1 percent growth, certainly related to the earlier low levels, but also driven by government measures. Final government consumption registered an increase of 7.1 percent in the second quarter of 2009, as compared to one year earlier. This improvement from extremely low values has been hailed as a dramatic turnaround. The Korea Times, for instance, identified this as the fastest 2nd quarter income growth in 21 years.[73]

It is difficult to judge whether government measures or the rebounding global economy played a more decisive role in bringing about the surprising turnaround through the third quarter of 2009. Looking at economic performance during this quarter in comparison to the third quarter of 2008, it is evident that exports of goods and services actually increased by 0.9 percent, while imports decreased by 8.7 percent.[74] Korean export strength and the international recovery have thus been a major force in the recovery. This is in line with reports that major Korean exporters such as Hyundai Motor and Samsung Electronics are reporting "surging profits."[75] Government consumption has also increased significantly (by 4.9% in the third quarter of 2009, year over year), but given the relatively small share of the government sector, exports (combined with inventory changes) have been the stronger force, at least once the immediate financial shockwave in late 2008 was overcome, thanks to government initiatives.

President Lee Myung-bak and his party have done surprisingly well throughout the crisis. As described above, he reached his lowest (personal) approval ratings before the outbreak of the crisis in the summer of 2008, and has improved since. In recent months, his popularity has risen significantly, following a shift in policy to show more compassion to citizens in distress. Of course, the perceived improvement in economic conditions has helped him in this respect. It is more doubtful whether the government party, the Grand National Party, can profit significantly from this change of mood.

Having presented this rather positive evaluation, it should be stressed that the last year has not been an altogether smooth ride for Lee. For instance, he replaced his former finance minister, Kang Man-soo, and in September

[72] Bank of Korea, "Gross National Income: the 2nd Quarter of 2009 (preliminary)," September 3, 2009, http://www.korea.net/image/news/today/20090903005L.pdf (accessed September 2009).
[73] Lee Hyo-sik, "Second-Quarter Income Growth Fastest in 21 Years," The Korea Times, September 3, 2009, http://www.koreatimes.co.kr/www/news/nation/2009/09/123_51233.html (accessed October 2009).
[74] Bank of Korea, "Real Gross Domestic Product: The 3rd Quarter of 2009 (Advance)," October 26, 2009, http://ecos.bok.or.kr/EIndex_en.jsp (accessed October 2009).
[75] Kim Seyoon, "South Korean Economy Expands at Fastest Pace in Seven Years," Bloomberg News, October 26, 2009, http://www.bloomberg.com/apps/news?pid=20601068&sid=atQTF.sdEVa4 (accessed November 2009).

2009, a new prime minister was installed. This figure, Seoul National University economics professor Chung Un-chan, holds social-democratic inclinations, at least as far as that term can meaningfully be applied to Korean politics. Such (frequent) changes in cabinet positions are not a new phenomenon, however, but are rather a normal feature of the South Korean presidential system of democracy. Apart from these issues, the opposition has severely criticized the government on several occasions, in some instances leading to fistfights in the main parliament chamber, and there has also been some labor unrest, including strikes held to protest layoffs.[76] Nevertheless, considering the usually confrontational, sometimes even violent nature of Korean politics, and in view of the severity of the economic downturn, the government has done surprisingly well. It has been helped by the fact that no major elections are imminent.

- Is there early evidence that the structure of the economy will change (e.g., greater role of the state, changes in sectoral shares in GDP)?
- Could old structural imbalances be aggravated? Can we already identify new structural imbalances? Have previously existing imbalances been tackled?

Structural distortions

There are no indications that the country's economic structure will change due to the financial crisis and its consequences. While the fiscal deficit is expected to be in the range of 2.75 percent in 2009, there is no evidence that the government sector will grow in the future. South Korea has a history of extreme fiscal prudence, and the government has already announced that it wants to present a medium-term fiscal consolidation plan in October 2009, even though it will still continue to support the economy with fiscal means in the short term. The early announcement of a consolidation plan is probably influenced by public sensitivity about the fiscal deficit. Several governmental programs have been met by doubts about the practicality of providing for the costs, even by the informed public. These concerns seem to be exaggerated. The IMF expects Korea's public debt to peak at 47 percent of GDP in 2011, which is hardly alarming, and even seems to offer sufficient leeway in case of further economic emergencies.[77]

While there is no evidence that the economic structure will significantly change due to the crisis, there is rather some concern that existing structural imbalances are being preserved, and potentially even aggravated. As is well known, there is a worldwide debate centering on structural imbalances that do not seem sustainable over the long term. Some economies have registered

[76] For a recent example, see Jung Yeon-Je, "S Korean Strikers End Auto Plant Sit-in: Company," AFP report, August 5, 2009,
http://www.google.com/hostednews/afp/article/ALeqM5gaYe8rPANfbMXzPnHKPA_E3BLVjw
(accessed September 2009).
[77] IMF, "Staff Report for the 2009 Article IV Consultation, IMF Country Report No. 09/262," August 2009,, p. 16, http://imf.org/external/pubs/ft/scr/2009/cr09262.pdf
(accessed October 2009).

large trade surpluses and capital account outflows, while others have the opposite characteristics. South Korea clearly belongs to the former camp, with a considerable trade surplus, a strong export sector, a structural capital-account deficit and large, growing foreign reserves that keep the currency relatively low and could thus work as an additional mechanism to reinforce imbalances in the balance of payments. Due to the nature of the monetary and fiscal responses to the crisis, the characteristics of the production sector have remained untouched. As described above, the weakness of the SME sector has been a persistent issue for the South Korean economy. Due to various support schemes for distressed SMEs, many have been able to survive the crisis, although they should have been undergoing severe restructuring. According to government screening since June 2009, of 861 SMEs evaluated, 77 have been found to need restructuring and 36 were found to be unviable.[78] For political reasons, it is questionable whether a competitiveness-based restructuring is feasible for the time being.

The usual recommendation for export-reliant economies is to strengthen their domestic economy further. It is difficult to achieve this in the case of Korean domestic consumption, as household debt is very high by international standards. On the supply side, the Korean government announced a program in May 2009 to strengthen the service economy, focusing in many cases on non-tradables.[79] In particular, the government plans to support education, content industries, IT services, design, consulting, medical services, employment agencies, logistics services, broadcasting and communication. Due to the crisis, this project may receive a strong boost from the state. However, the goal is to avoid creating a new layer of basically inefficient companies. For that reason, the opening of the services sector to domestic and foreign competition will play an important role. It remains to be seen whether new free trade agreements with the United States and the European Union are allowed to play a constructive role in this respect, given the still-difficult circumstances of a vulnerable economic recovery.

[78] ibid., p. 23.
[79] Ministry of Strategy and Finance, “Gov't announces Plans to Boost Service Industries,” May 8, 2009, http://www.korea.net/News/news/newsView.asp?serial_no=20090508014&part=101&SearchDay=(accessed October 2009).

8. Concluding Remarks

The major results of this report on the response of the Republic of Korea to the 2008 – 2009 global economic crisis can be summarized as follows:

- The Korean economy was in fairly good condition when it entered the crisis in late 2008. A high level of foreign reserves and reasonably high capital-adequacy ratios of major banks meant that Korean actors were not deeply concerned until the crisis actually set in.
- Seen in hindsight, some problems had already begun to appear before September 2008: Job growth, domestic consumption, investment and corporate profits had already been negatively affected by higher raw material and energy prices. The government faced an inflation problem, and in the financial sector, the exposure to short-term liabilities had increased.
- Unexpectedly, Korea was hit very hard by the aftereffects of the Lehman Brothers collapse. On the one hand, investors withdrew funds from Korea to patch problems elsewhere, the stock market and the won fell substantially, and new dollar funds seemed at some points almost impossible to obtain; on the other hand, for the real economy, the large exposure of the Korean market to the world market implied an extremely fierce decline in export demand.
- The very first reaction of the government, particularly with respect to monetary and financial issues, was rather insecure, but it did manage to stabilize the flow of funds by the end of 2008. Fiscal measures were better prepared, involved a major stimulus (compared to many other OECD economies), and were executed in a rather timely manner.
- The government profited from several factors. Among these: the administrative system is strictly top-down, so decisions can be quickly made and executed; no elections were forthcoming; the president was safe in his position and had a majority in parliament; the reaction of the opposition and of the trade unions, while certainly not tame, may have been somewhat muted by the sense of national crisis; and finally, Korea enjoyed low levels of public debt and had interest rates well above zero, so fiscal deficit spending as well as monetary policy could be expected to work reasonably well.
- Institutional mechanisms were quite able to handle all issues. An asset management organization to purchase toxic assets has already been in place since the 1997 – 1998 crisis. The only new organiza-

tion is a Recapitalization Fund, used to help banks to recapitalize.

- The fiscal measures implemented comprise some strategic development aspects. This holds in particular for the so-called Green New Deal. It is not primarily, or at least not only an ecological development program, but has a strong employment-creation effect and particularly helps the construction sector, the industry President Lee worked in before entering politics. There are concerns about the environmental impact of the gigantic construction plans.
- The crisis response has not helped to overcome some of the major structural weaknesses of the economy, but seems rather to have contributed to them. In particular, the various support measures for small and medium-sized enterprises have helped this weak sector of the economy to survive, but have prolonged problems of long-term business viability. As the once-staunchly pro-market president announced in mid-summer 2009 that he would give more consideration to the poor and the weak in the future, there are concerns that these problems, while recognized, will be approached only half-heartedly.
- The government may have begun to reconsider its outward-oriented development model. For instance, it started a program in May 2009 to promote the service sector, and particularly domestic economy-oriented activities. It remains to be seen whether a competitive domestic economy can be developed. This depends to some extent on opening it to foreign competition, which could result from recent free trade agreements with the United States and the European Union. Another concern is domestic demand: Due to the significant levels of household debt, it will be difficult to replace foreign with domestic demand in the near future. Korea´s recovery from the current crisis may yet depend on the sustained rebound of the world market.

Study Context

The Bertelsmann Stiftung has a long tradition of assessing the quality of governance and devising evidence-based policy strategies for decision makers.

The **Transformation Index (BTI)** monitors political management, democratic quality and economic development around the world. The BTI encompasses all 128 developing nations and countries in transition that have a population of more than two million inhabitants, and have not yet attained fully consolidated democracy and a developed market economy.

The **Sustainable Governance Indicators (SGI)** offer a complementary focus on the OECD member states. The SGI evaluate the sustainability of political action in 15 different policy fields (from economy, labor, and education to environment, research and development), the quality of democracy and questions of strategic management capability in each of the 31 OECD countries.

The study *Managing the Crisis* is a joint initiative of the two projects.

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