A NEW WAVE OF THE CURRENCY CRISIS

by Doo-Yong Yang

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Worries over a new wave of financial turmoil in next several months are widely spreading, generating a sense of crisis. The grounds for these worries are coming from every direction. Since the currency crisis erupted last December, the Korean economy has been hurt badly, showing the lack of a sound economic structure as well as a suitable locomotive for sustainable growth. On the other hand, the financial market turmoil has affected the product market by reducing the level of production and investment, causing an unprecedented number of lay-offs. In line with this, rumors of a second crisis have been developing due to internal and external factors, which could act as a deathblow to the stumbling Korean economy.

Gloomy Future in Terms of Foreign and Domestic Debt

Since last December, Korea has experienced extremely difficult liquidity constraints on foreign currencies, mostly the U.S. dollar. Even though the rescue funds from the IMF provided a little breathing room, this has not been enough to calm down the foreign exchange market. The central bank is using up most of the funds to shore up its foreign currency reserves and support rickety financial institutions. However, of the total $153 billion in foreign debt, private companies owe $42 billion — $25 billion of which is due to mature in one year or less. In addition, despite the successful conclusion of the negotiations in New York regarding the nation's external loan payments, companies are facing the pressing need to pay off their own foreign debts. Since the Korean currency, the won, is not traded internationally, most private companies have to obtain foreign currencies in the domestic market. That is a main obstacle for the stabilization of the foreign currency market in Korea.

The current situation of domestic debts is no less gloomier than that of the foreign debts. Won-denominated corporate debt exceeds $200 billion. Domestic banks have determined that there is little prospect of collecting on about $15 billion in short-term loans coming due around March. Moreover, the Bank of Korea announced that non-performing loans totaled $6.09 billion at the end of last year, which is 2.7% of all loans. That figure includes loans without collateral, on which payments are at least six month overdue. Some have argued that using a stricter definition of non-performing loans — those on which payments are at least three months late — would cause this figure to reach at least $30 billion, or between 15% to 20% of total loans. In addition, domestic banks are refraining from supplying funds to domestic firms to meet the requirement by the Bank for International Settlements (BIS) regarding capital adequacy ratios. This in turn is serving as a huge bottleneck for companies' cash management, particularly to highly leveraged firms.

Negative Foreign Factors As Well

At the same time, there are several foreign factors which are disturbing or hindering the healing process of the Korean economy. First, the tension between Indonesia and the IMF (or the Clinton administration) may result in domestic financial turmoil in Korea once again. According to government figures, Korean financial institutions have invested around $5.5 billion in Indonesia. If a moratorium is officially declared in Indonesia, the financial institutions would have no choice but to collect their domestic loans or go bankrupt.

Second, the Chinese economy is showing sluggish economic growth mainly due to an export crunch and investment slowdown. As a result of this, the Chinese yuan is likely to depreciate, which will cause another round of competitive currency depreciations in East Asia, including the Southeast Asian countries, Hong Kong, and Korea. The yuan has appreciated by 25% in real terms against the currencies of China's trading partners since last July. If competitive depreciation starts once again, it will aggravate the burden of foreign debt in Korea as well as in the Southeast Asian countries, which will prolong the current crisis in the region. It will also create a serious trade conflict between Asia and other regions, particularly Western countries.

Third, the Japanese economy is still in a recession. Since the collapse of its stock and real-estate markets seven years ago, Japan has suffered from stagnation. This year, if everything goes well, Japan will show near zero growth. In addition, Japan's financial fallout does not seem likely to clear out in the near future. Bad loans at Japanese banks are estimated to total $620 billion, which equal to 15% of Japan's GDP.

Asia, especially Korea, is basing its recovery on export-led growth. Greater devaluation and recession translate into readily available and competitive exports. The worse off Japan is, the more difficult it will be for Asia's larger economies to get back on track. Asia needs to resume its growth one way or the other. The sicker Japan is, the more depreciated the Asian currencies will have to be and the more Asia and Japan will compete in running huge trade surpluses against Europe and the U.S.. In this sense, a trade war is a real possibility. This is the reason why the U.S. and European leaders want a prosperous Japan, stimulating domestic demand by huge tax cuts and expansion of the government budget.

On a Brighter Note

To solve the problem of the short-term foreign debt, the Korean government and international creditors reached an agreement in late January on a plan to lengthen the maturities of $24 billion in the short-term debt of local financial institutions. Thanks to the smooth rollover of banks' short-term debt, the worst seems to have passed. The rollover rate of Korean banks' short-term debts has improved significantly from around 60 percent in December to 85% in January, and higher to 90% in February. Domestic corporates' rollover rate of short-term debts also reached 70 to 80% in February, relieving much of the worries that Korea may face a new wave of crisis. At the same time, a growing number of Japanese banks, whose lending to Korea accounts for 25 to 30% of the total debt, are joining the New York agreement for the restructuring of Korea's short-term foreign debts, showing more than a 90% rollover rate. If this restructuring scheme is successfully accomplished, it is expected that the domestic foreign currency market will regain its stability, and the won should stabilize at the 1400 to 1500 won/dollar level by the end of the first half of this year.

The next question is then: can the Korean economy be revitalized enough to pay off a substantial portion of the total foreign debt and continue its previous growth. The answer to

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