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Europe Could Learn From Korea's Experience

By Simon Johnson

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On the surface, at least, the situation in the euro zone today and South Korea in the fall of 1997 look very different. Both are cases of severe economic crisis, to be sure. But the euro zone's problems stem from high levels of government debt, while South Korea faced massive capital flight and a collapsing currency — and almost all of the debt was in the corporate sector.

Nevertheless, the euro zone could learn from the experience of South Korea, which came through its crisis more quickly than anyone expected, combining sensible reforms with a rapid recovery. The key to the South Korean turnaround was a large depreciation of the currency, the won. A depreciation of the euro seems to be one likely way that the euro zone will turn the corner.

Every crisis is different, but South Korea shared many features with other troubled emerging markets in the 1990s. Large, politically well-connected groups of companies — known as chaebol — expanded rapidly by taking on large amounts of cheap debt. Outside shareholders had little influence over the powerful individuals who ran the chaebol, and creditors lent money freely, assuming that the leading chaebol were too important for the government to allow them to go bankrupt.

Meanwhile, political factors played an important role in allowing debt to build up — creating vulnerabilities that could quickly become an economic crisis once investors became nervous. Even though South Korean state-owned banks nominally controlled the flow of capital, tight relationships between the private sector and the government meant that the chaebol felt they had little to fear.

In the fall of 1997, after crises battered Thailand and Indonesia, full-scale panic erupted in South Korea. As the currency depreciated, the corporate sector's foreign loans became more onerous — further exacerbating the panic. Early support offered by the International Monetary Fund did not stabilize the situation.

The euro zone today does not have a foreign-debt problem — all of the debt in question is in euros, and most of it is owed by European governments to their own countries' banks. But this is a toxic combination, as Greece and Italy have discovered. European debt dynamics are quite distinct from those in South Korea, but the problem in both instances could be considered insurmountable.

The obvious escape route leads through economic growth, which would reduce the debt-to-gross domestic product ratio and make interest payments look reasonable. But the standard ways to stimulate the European economy are not available: Fiscal policy is constrained by already-high debt levels; and the European Central Bank, fearing inflation, has kept a tight rein on monetary policy.

None of the other ideas on the European table, including various kinds of "structural reform," will provide fast growth in the short term. In September, Portugal planned to pursue a form of "internal devaluation," by cutting payroll taxes and increasing value added tax; this has now been shelved, presumably because it is politically unworkable.

A genuine devaluation, on the other hand, would work wonders for the real economy. The moribund Italian economy would spring to life if the euro fell 30 percent, adjusted for inflation. In 1997, South Korea's economy took a nosedive, and 1998 was still difficult, but GDP soared 11.1 percent in 1999.

How the euro would be able to depreciate, given that it is a floating currency with very little intervention — that is, the exchange rate is largely market determined — depends on monetary policy. If the ECB agreed to loosen monetary policy or provide enough "liquidity" to support various bailouts, investors would fear inflation, weakening the euro. On the other hand, if the ECB preferred to let major countries, such as Italy, default on their debts, this would likely weaken the euro even further, as investors feared a contagion of defaults.

While depreciation would never be euro-zone officials' stated policy, it currently looks like all roads lead in that direction.

Of course, currency depreciation is not a panacea. The South Korean situation also involved difficult steps, including a confrontation between the government and the largest chaebol, some of which had quite blatantly violated the law. After a series of showdowns, in which one company, Daewoo, threatened to default, and political forces rallied to its assistance, the government won; the hugely powerful Daewoo group underwent bankruptcy and restructuring. Overall, South Korea managed to curb its corporate sector's excessive power (which holds lessons for dealing with today's

mega-banks).

Similarly, Europe needs to fix its deeper structural problems. It needs a fiscal center — much as the United States needed a federal authority to tax in 1787. Indeed, the Europeans need the equivalent of the U.S. Constitutional Convention — and the difficult ratification debate that followed.

But some depreciation of the euro would provide a bridge to reach internal governance reform. And, like it or not, rising pressure on the euro is likely to force European officials to cross it.

Simon Johnson, a former chief economist of the IMF, is co-founder of a leading economics blog, BaselineScenario.com, a professor at MIT Sloan, a senior fellow at the Peterson Institute for International Economics, and co-author, with James Kwak, of "13 Bankers."

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