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International Business

COMPETING IN THE GLOBAL MARKETPLACE

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INTERNATIONAL BUSINESS: COMPETING IN THE GLOBAL MARKETPLACE

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Anatomy of a Currency Crisis: The Collapse of the South Korean Won

In early 1997, South Korea could look back with pride on a 30-year "economic miracle" that had raised the country from the ranks of the poor and given it the world's eleventh-largest economy. By the end of 1997, the Korean currency, the won, had lost a staggering 67 percent of its value against the U.S. dollar, the South Korean economy lay in tatters, and the International Monetary Fund was overseeing a $55 billion rescue package. This sudden turn of events had its roots in investments made by South Korea's large industrial

conglomerates, or *chaebol*, during the 1990s, often at the bequest of politicians. In 1993, Kim Young-Sam, a populist politician, became president of South Korea. Mr. Kim took office during a mild recession and promised to boost economic growth by encouraging investment in export-oriented industries. He urged the *chaebol* to invest in new factories. South Korea enjoyed an investment-led economic boom in 1994–1995, but at a cost. The *chaebol*, always reliant on heavy borrowing, built up massive debts that were equivalent, on average, to four times their equity.

As the volume of investments ballooned during the 1990s, the quality of many of these investments declined significantly. The investments often were made on the basis of unrealistic projections about future demand conditions. This resulted in significant excess capacity and falling prices. An example is investments made by South Korean *chaebol* in semiconductor factories. Investments in such facilities surged in 1994 and 1995 when a temporary global shortage of dynamic random access memory chips (DRAMs) led to sharp price increases for this product. However, supply shortages had disappeared by 1996 and excess capacity was beginning to make itself felt, just as the South Koreans started to bring new DRAM factories on stream. The results were predictable; prices for DRAMs plunged and the earnings of South Korean DRAM manufacturers fell by 90 percent, which meant it was difficult for them to make scheduled payments on the debt they had acquired to build the extra capacity. The risk of corporate bankruptcy increased significantly, and not just in the semiconductor industry. South Korean companies were also investing heavily in a wide range of other industries, including automobiles and steel.

Matters were complicated further because much of the borrowing had been in U.S. dollars, as opposed to Korean won. This had seemed like a smart move at the time. The dollar/won exchange rate had been stable at around $1 = won 850. Interest rates on dollar borrowings were two to three percentage points lower than rates on borrowings in Korean won. Much of this borrowing was in the form of short-term, dollar-denominated debt that had to be paid back to the lending institution within one year. While the borrowing strategy seemed to make sense, it involved risk. If the won were to depreciate against the dollar, the size of the debt burden that South Korean companies would have to service would increase when measured in the local currency. Currency depreciation would raise borrowing costs, depress corporate earnings, and increase the risk of bankruptcy. This is exactly what happened.

By mid-1997, foreign investors had become alarmed at the rising debt levels of South Korean companies, particularly given the emergence of excess capacity and plunging prices in several areas where the companies had made huge investments, including semiconductors, automobiles, and steel. Given increasing speculation that many South Korean companies would not be able to service their debt payments, foreign investors began to withdraw their money from the Korean stock and bond markets. In the process, they sold Korean won and purchased U.S. dollars. The selling of won accelerated in mid-1997 when two of the smaller *chaebol* filed for bankruptcy, citing their inability to meet scheduled debt payments. The increased supply of won and the increased demand for U.S. dollars pushed down the price of won in dollar terms from around won 840 = $1 to won 900 = $1.

At this point, the South Korean central bank stepped into the foreign exchange market to try to keep the exchange rate above won 1,000 = $1. It used dollars that it held in reserve to purchase won. The idea was to try to push up the price of the won in dollar terms and restore investor confidence in the stability of the exchange rate. This action, however, did not address the underlying debt problem faced by South Korean companies. Against a backdrop of more corporate bankruptcies in South Korea, and the government's stated intentions to take some troubled companies into state ownership, Standard & Poor's, the U.S. credit rating agency, downgraded South Korea's sovereign debt. This caused the Korean stock market to plunge 5.5 percent, and the Korean won to fall to won 930 = $1. According to S&P, "The downgrade of . . . ratings reflects the escalating cost to the government of supporting the country's ailing corporate and financial sectors."

The S&P downgrade triggered a sharp sale of the Korean won. In an attempt to protect the won against what was fast becoming a classic bandwagon effect, the South Korean central bank raised short-term interest rates to over 12 percent, more than double the inflation rate. The bank also stepped up its intervention in the currency exchange markets, selling dollars and purchasing won in an attempt to keep the exchange rate above won 1,000 = $1. The main effect of this action, however, was to rapidly deplete South Korea's foreign exchange reserves. These stood at $30 billion on November 1, but fell to only $15 billion two weeks later. With its foreign exchange reserves almost exhausted, the South Korean central bank gave up its defense of the won November 17. Immediately, the price of won in dollars plunged to around won 1,500 = $1, effectively increasing by 60 to 70 percent the amount of won heavily indebted Korean companies had to pay to meet scheduled payments on their dollar-denominated debt. These losses, due to adverse changes in foreign exchange rates, depressed the profits of many firms. South Korean firms suffered foreign exchange losses of more than $15 billion in 1997.[1]

Case Discussion Questions

1. What role did the Korean government play in creating the 1997 crisis?
2. What role did Korean enterprises play in creating the 1997 crisis?
3. Why was the Korean central bank unable to stop the decline in the value of the won?
4. In late 1997, the IMF stepped in with a rescues package that included $55 billion in emergency loans to support the currency. These loans had the effect of stabilizing the won and over the next few years South Korean enjoyed a strong recovery. If the IMF had not stepped in, what might have occurred?

Sources

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