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# How much does excess debt contribute to currency crises? The case of Korea

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## Abstract

It is widely believed that seriously excess debt problems form a major cause of the 1997 Asian financial crisis. This paper investigates empirically the role of the debt problems using Korea's won/US\$ rate as the guinea pig. The problems are represented by two institutional variables in nonlinear equilibrium-correction models. The variables are found to exert positive feedback effects on Korea's won rate returns in three forms: disequilibrium in levels, short-run shocks, and explosive bubbles. However, the estimated effects are not so singly conspicuous as to serve as the predictor of a likely collapse in the won rate in late 1997. Excess debt is hence found to only constitute one of the many factors that brought about the 1997 won crisis. © 2001 Elsevier Science Inc. All rights reserved.

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## 1. Introduction

The 1997 East Asian financial crisis has led to rapidly mounting studies in currency volatilities and crises.<sup>1</sup> While theorists wrestle with feasible explanations for sudden currency crashes, empirical modelers delve extensively into data for possible crisis predictions.

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There are, however, still relatively few empirical works that try to verify or test certain theoretical explanations by using country-specific data information.

This paper presents such an attempt. It examines how much, from time-series data, we can identify and estimate the contribution of Korea's excess debt problems to the won crisis in the November of 1997. The choice of the subject stems from several considerations. Korea has long been recognized as a model of state-directed, export-led economy that has sustained rapid and continuous growth, and it is the strongest of the Asian economies which suffered currency crises during the 1997 financial turmoil. In fact, the macroeconomic management in Korea was considered generally sound by the international community and the country obtained its OECD membership shortly before the won collapsed. Indeed, there was little forewarning that the Korean currency would not be able to ride out the Asian financial crisis.

The won has been under close control by the Korean government until recent years. This is best seen from the macroeconomic models built by the Bank of Korea, e.g. BOK, 1993, in which the exchange-rate variable is assumed exogenous. The government exchange-rate intervention management has nevertheless undergone several phases of liberalization. Prior to 1980, the Korean won had been pegged to the U.S. dollars. During the 1980s, the won was fixed according to a certain weighted average formula centered around the U.S. dollars (Haggard et al., 1994; Chapter 9). In 1993, the government launched a 5-year programme of financial liberalization, in which the exchange rate was to float gradually via widening margins of its fixed fluctuation zones, see e.g., OECD surveys (1994; 1996). Unfortunately, the program was soon affected adversely by the slowdown of the economy since the late 1995 and brought eventually to a disastrous currency collapse in November 1997 (see Fig. 1), in the wake of financial turmoils in Malaysia, the Philippines, Thailand, and Indonesia.

It has been widely recognized that a series of bankruptcies of chaebols, i.e., large Korean conglomerates, in early 1997 seriously damaged foreign investors' confidence in the Korean economy and eventually exposed the won to severe speculative attacks in October 1997 (see footnote 1 for a chronology of the won crash). It is widely known that the bankruptcies were mainly caused by hefty debts due to cumulation of seriously underperforming investment projects that had been undertaken under weak banking supervision and strong state-directed development policies. The link between currency crises and cumulative debt-ridden investment projects thus serves as key evidence for a number of recent theories and diagnoses. For example, Stiglitz (1998) maintains that deregulated capital accounts combined with under-regulated domestic financial sector is a key weak point of the 1997 Asian financial crisis because it makes the national financial system very vulnerable to external shocks for an open economy, especially shocks from international capital markets (Radelet and Sachs, 1998). The underderegulation is further related to moral-hazard investment behaviour, e.g., see Krugman (1998), and linked with the soft-budget syndrome, which is believed to generate deteriorating economic fundamentals for transitional economies (Huang and Xu, 1999). These diagnoses suggest that the recent crisis was not entirely an unforeseeable burst of an explosive bubble fostered by widespread financial panic over external shocks, and that there are certain internal factors with disequilibrium potentials, which have contributed positively to the crisis.

Several recent empirical studies have actually made use of the diagnoses. For instance, Kaminsky et al. (1998) use banking crisis, money-to-reserve ratio, domestic credit-to-GDP

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