

Rethinking the Causes of the Korean Currency Crisis of 1997

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Abstracts

This paper reviews two different camps regarding to the main causes of the Korean crisis of 1997. One camp (the fundamentalists) argued that the crisis reflected an unsustainable deterioration of the macroeconomic fundamentals. This camp argued that the fundamental weakness of the economic system inevitably gave rise to the currency crisis. The other camp (the instability theorists) emphasized the financial fragility in the international capital market, especially sudden shifts in market expectations and confidence as the main cause of crisis of 1997. This camp argued that the financial market, including the international capital market, is intrinsically unstable, and that this instability is the very cause of the currency crisis of 1997. Through empirical analysis and other evidence, the authors find that the fundamentalist argument lacks a solid base in explaining the cause of the Korean crisis, though weak macroeconomic fundamentals intensified the depth of the crisis in 1997. Empirical analysis based on Kaminsky and Reinhart (1996) produces results which are either unconvincing or which contradict that which can be expected from the fundamentalist argument. The authors have elaborated that the other important evidence supporting the fundamentalist argument, such as the debt/equity ratio and the nonperforming loan, could also not sufficiently account for the Korean case.

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I. Introduction

Almost 15 years have passed since the Korea had fallen into the debacle of the currency crisis. The Korean economy showed quick recovery from the crisis of 1997, but it again fell into the crisis in 2008. After the crisis of 1997, the Korean authority had taken various measures¹⁾ to recover from the crisis and to build a crisis-resilient economic system. However, international financial catastrophe due to the subprime crisis made all the efforts done by the Korean authority void in 2008. Furthermore, the world economy, including the Korean economy, has not recovered from the subprime crisis yet. This phenomenon casts doubts on the analysis of the Korean (Asian) crisis of 1997, and remedies taken from that analysis.

This paper deals with the analysis on the causes of the Korean currency crisis of 1997. Next section, we will review two different camps regarding possible causes of the crisis of 1997. Then, the paper traced the movements of the variables which are said to reflect the fundamentals of a national economy in the literature regarding the currency crisis following the analysis of Kaminsky and Reinhart (1997). Then this paper concludes with a summary and some policy implications.

II. Two Camps on the Causes of the Crisis

Papers on the Asian crisis can be largely divided into two different camps concerning possible causes. They are the 'fundamentalist' and

1) On the various measures, refer to Chopra et al. (2001), Lane et al. (1999), Shin eds. (2000), Coe and Kim eds. (2002), Independent Evaluation Office (2003), Kim (2007), and Lee et al. (2010).

the 'instability theorist'. One camp (Krugman, 1998;² Fischer, 1998; Corsetti et al., 1998) argues that the fundamental weakness of the economic system common to all affected countries inevitably gave rise to the currency crisis. This camp argues that the crisis reflected an unsustainable deterioration of the macroeconomic fundamentals. These problems of the economic system triggered the twin crisis of Asia while the overreaction of the international market made the situation of those countries even worse than expected by the initial conditions of the fundamentals. According to these scholars, the main cause behind the Asian crisis was the distorted investment decision by financial sector to domestic projects (mainly, real estate investment and, in Korea, overlending to *chaebol*) due to excessive government intervention. On this point Corsetti et al. (1998) describe as follows:

[w]hile in Korea most of the bad loans problem was concentrated in the manufacturing sector chaebols that had expanded capacity excessively, in other countries the overinvestment and overcapacity problem was concentrated in the real estate sector...

This camp suggested the debt/equity ratio for the chaebols compared to US firms as evidence of Korea's serious problem. But, it is much more reasonable to investigate the evolution of the debt/equity ratio as a result of the different socioeconomic environments than to just compare it with other countries. According to the argument by Wade and Veneroso (1998), high debt/equity ratio is an inevitable consequence of the high household saving and high corporate debt system, in conjunction with a bank-firm-state collaboration such mechanism has been an effective

2) Later, Krugman changed his argument. In a recent paper, he said, "[T]rue, the Asian crisis has settled some disputes...I was wrong; Maury Obstfeld was right..." (Krugman, 1999).

way of generating “patient” long-term investments. It is this very system which enabled those countries to achieve their prosperity before the crisis.³⁾

Corsetti et al. (1998) argue that large current account deficits, short-term foreign debt accumulation and excessive investment in risky and low profitable investments were common in the affected countries. Also typical were corporate bankruptcies, falling stock markets, very weak financial and banking institutions, and a large number of non-performing loans. Corsetti et al. (1998) argue that what triggered the 1997 crisis of Korea was neither the fall of the Won that came under severe attack only late October, nor the “financial panic” of investors that developed only in November and December, but a series of bankruptcies of chaebols.

As is mentioned above, different socioeconomic settings may produce the high debt/equity ratio in Korea. The fact that Japan never suffered the same kind of crisis currently experienced in Korea, despite a corporate gearing ratio that was as high as that in Korea, shows that high corporate debt *per se* cannot be the cause of the currency crisis.⁴⁾ During its “high growth” period—that is, between 1955 and 1973—the debt/equity ratio of Japanese manufacturing was 320%, which was equivalent to the Korean figure of 338% between 1973 and 1996.⁵⁾ Even though a series of bankruptcies contributed to the difficulty in acquiring long-term foreign loans, the forex market was quite stable until October before the black hole effect undermined the ability of forex authority. With respect to the black hole effect, it is worth noting

3) Wade argues that the bank based systems are vulnerable to shock, and thus need some critical safety apparatus such as the bank-firm-state collaboration and a closed capital account (Wade, 1998).

4) Chang, H., Hong-Jae Park, and C. Yoo, 1998, “Interpreting the Korean Crisis,” *Cambridge Journal of Economics*, p. 744.

5) Refer to table 2 in the later part of this paper.

the following interview of one foreign exchange dealer at the Korea Foreign Exchange Bank. He said,

[A]s the Merchant banks sold the Won and bought the dollar in the domestic forex market in October, the exchange rate skyrocketed. Maybe they couldn't get the needed dollars in the international capital market. And, from that time, they got the nickname of the black hole.⁶⁾

At a breakfast meeting with CEOs of the Merchant Banks, the minister of MOFE said as follows:

In recent days, the Merchant Banks created the main problems in the forex market, by offering high borrowing rates in the international financial market and trying to get as much foreign exchange as they could in the domestic market, to solve the problems of mismatch between long-term lending and short-term borrowing, and the problems of wrong asset management in foreign countries.⁷⁾

There is strong evidence countering the view that the macroeconomic fundamentals were primary causes of the crisis in the case of Korea: Korean inflation rose to 5.5 percent in mid-1996, but in the months before the crisis had fallen to just over 4 percent. Its trade deficit—one of the “culprits” in many explanations of the crisis—had fallen steadily throughout 1997, essentially reaching balance in the months before the crisis and a small surplus in November.⁸⁾

6) Special Reporting Team 1998, *Hankookilbo*. According to an article of the *Joongang Ilbo*, one of the major Korean daily news papers, the merchant banks, by themselves, could not get the dollars from late September on, so that the Bank of Korea had to exhaust its reserve to support them (Nov. 26, 1997).

7) MOFE, Press Release, Oct. 1997.

8) Joseph Stiglitz, “Sound finance and sustainable development in Asia,” Keynote Address to the Asia Development Forum, Manila, the Philippines,

With respect to the problem of the low profitability, Chang et al. (1998) show that the ostensibly low corporate profitability is mainly due to high interest payments rather than to inefficiency. According to Chang et al. (1998), Korea's corporate profitability before interest payments, measured by the ratio of "operating income" to sales, has not been low compared to other countries. Over the 1973-96 period, this figure for Korea averaged at 7.4%, which is similar to that for the USA (7.7%) and Taiwan (7.3%) recorded in 1995.

[Table 1-1] An International Comparison of Corporate Profitability (%)

	Korea (1973- 1996)	Korea (1996)	Japan (1955- 1973)	Japan (1995)	Taiwan (1995)	USA (1995)
Operating Income/Sales	7.4	6.5	7.2*	3.3	7.3	7.7
Financial Expenses/Sales	5.5	5.8	3.4	1.3	2.2	n.a.
Ordinary Income/Sales	2.8	1.0	4.3	2.9	5.1	7.9
Total borrowing/Total assets	n.a.	47.7	n.a.	34.8	26.2	26.4
Debt/Equity	338.4	n.a.	320.7	n.a.	n.a.	n.a.

Source: Chang et al. 1998, p. 742.

Definitions:

Operating income = gross profit - selling and general administrative expenses.

Ordinary income = operating income + net non-operating income.

Note: * 1961-73.

The other crucial point of this camp's argument is that this private corporate sector profligacy was due to the moral hazard. That is, the high debt/equity system would not have been possible without the implicit and/or explicit guarantee provided by the government for the banks and chaebols.⁹⁾ They argue that this moral hazard problem resulted in reckless investment, such as high yield with high risk project, and which could not succeed.

March 12, 1998, pp. 8-9.

9) The irony about this argument is that before the crisis most main stream economist attributed those countries' great developments to the absence of policies promoting the moral hazard behavior.

They emphasized that to the extent that implicit guarantees led banks to engage in moral hazard lending, it represented a hidden government deficit (Krugman, 1999). However, between 1990 and 1996 alone, 3 of the 30 biggest chaebol went bankrupt in Korea. Furthermore, 6 went bankrupt in 1997. There were some cases where individual firms received government's help, but this involved a government-mediated take-over of the firm or the imposition of terms of enterprise re-structuring that severely restricted managerial autonomy (Chang et al., 1998). For these reasons, there may not have been incentives for the moral hazard. In addition, most chaebol investments were made in industries with stable returns, rather than in "high risk, high return" industries, thus contradicting the moral hazard argument of this camp. Radelet and Sachs (1998a) point out another problem with this argument. In their view, during the prelude to the crisis, all forms of investment in the emerging Asian economies were booming, including portfolio investment and real estate investment by foreigners, investments that clearly had no implicit guarantee.

The proponents of the other camp (Radelet and Sachs, 1998a, 1998b; Furman and Stiglitz, 1998; Taylor, 1998a, 1998b) emphasize the financial fragility in the international capital market, especially sudden shifts in market expectations and confidence as the main cause of the twin crisis. They argue that the financial market, including the international capital market, is intrinsically unstable, and that this instability is the very cause of the currency crisis of 1997. Their view can be well seen from the following quote from Stiglitz (1998b):

[S]mall open economies are like rowing boats on an open sea. One cannot predict when they might capsize; bad steering increases the chances of disaster and a leaky boat makes it inevitable. But their chances of being broadsided by a wave are significant no matter how

well they are steered and no matter how seaworthy they are.

They proposed the following evidence to support their view. First, the private capital flows to the five economies most affected by the Asian crisis fell from an inflow of \$ 93 billion in 1996 to an estimated outflow of \$ 12 billion in 1997.¹⁰⁾ The swing in one year of \$ 105 billion is equivalent to 11% of the combined GDP of the five countries.¹¹⁾ Second, the spread on a Korean Electric Power Company bond maturing in 2003 increased from about 30 basis points in the first half of 1997, to 230 basis points at the end of October, and to 700 basis points by the end of 1997 after the crisis intensified and the Korean sovereign rating was downgraded several notches. We can see from the IIF data that spreads of the Korean bond were below that of Mexico's before November. Third, indeed, elements that the other view emphasized, such as a high debt/equity ratio, a lack of transparency and weak financial system, were well known to investors during the periods when they were lending relatively cheaply to the East Asian countries. Fourth, there were no problems with macroeconomic fundamentals traditionally known as the causes of the currency crisis. The affected countries had high saving rates, robust government fiscal positions, low inflation, and low levels of external debt relative to other developing regions (Stiglitz, 1998b). Even though some macroeconomic fundamentals showed little weakness, the extent and depth of the crisis should not be attributed to the weakness of the macroeconomic fundamentals but rather the financial panic in a sound but underregulated system.

10) IIF, "Capital flows to Emerging Market Economies," 1998, p. 1.

11) This is worse than LA's in the 1980's. According to Wade, the swing between 1981 inflows and 1982 outflows in the three biggest debtor (Brazil, Mexico, Argentina) amount to 8% of their combined GDP (Wade, 1998).

III. Empirical Analysis on the Cause of the Korean crisis

To examine which approach is more plausible in explaining the Korean crisis, the authors traced the movements of the variables which are said to reflect the fundamentals of a national economy in the literature regarding the currency crisis. In their paper, "Leading indicators of currency crisis," Kaminsky, Linzondo and Reinhart (1997) provide a very good survey of the empirical literature on the currency crisis. According to their survey and other related literature, the following variables among the leading indicators of currency crisis account for the weak macroeconomic fundamentals: Real exchange rate, real wage, international reserve (in US dollars), exports (in US dollars), imports (in US dollars), M2 growth, the terms of trade (defined as the export price index over the import price index), an index of output, the ratio of current account to GDP, and the ratio of fiscal deficit to GDP.

The instability theorist argument suggests that it may be difficult to find a tight relationship between economic fundamentals and crises, as sometimes crises may occur without a significant previous change in the fundamentals. Thus, if we cannot find any significant previous change in economic fundamentals, then we may support the instability theorist argument as opposed to that of the fundamentalists.

Following the method of Kaminsky and Reinhart (1996), the authors analyze the evolution of 10 macroeconomic variables around the time of the Korean crisis (18 months before and after the onset of the crisis) relative to their behavior in "tranquil" periods in the Korean economy, which is from 1992 to 1994. All the variables, with the exception of two variables regarding GDP, are available as monthly data. The other two variables are

available as quarterly data.

The analyzed results are illustrated in figures contained in the appendix. Figure 1 represents the behavior of the real exchange rate. The horizontal axis records the periods examined, beginning with January of the 1996 and ending with December of the 1998. The vertical axis illustrates the percentage differential between tranquil periods and crisis periods. For example, by the time the Korean crisis began as represented by the vertical line on July of 1997, the 12-month change in the real exchange rate was, on average, about 5.4 percent above the average during tranquil periods.¹²⁾

Most of the literature based on the fundamental problems, such as Dornbusch, Goldfajn and Valdés (1996), expect that the real exchange rate should be overvalued relative to its average level during tranquil times, in periods preceding the currency crash. However, Figure 1 shows that, on the contrary, the real exchange rate of Korea has been depreciating relative to its average tranquil time level. From the rapid and huge depreciation following the crisis, we can realize the severity of the Korean crisis.

Figure 2 illustrates the evolution of the M2. According to this figure, M2 displays only a small fluctuation just a little above the tranquil time average level leading up to the currency crisis. This result, like the previous one, is quite different from the typical fundamentalist argument characterizing one of weak economic fundamentals as a highly expansionary monetary policy.

Some papers on the Korean crisis from the fundamentalist viewpoint insist that export performance had been deteriorating while the import volume had increased before the Korean crisis. In their view, such conditions could be considered as the weak

12) Filtering the data by using the 12-month percentage change is for ensuring that the transformed variables are stationary, with well-defined moments, and free from seasonal effects. Kaminsky, Linzodo, and Reinhart 1997, p. 17.

economic fundamental problem. However, results obtained by the analysis do not confirm this argument. Figure 3 shows that, even though the export performance had deteriorated until late 1996, the first half of 1997 was marked by a recovering trend of export performance. In addition, Figure 4 shows that the imports volume had declined up to the time of the crisis.¹³⁾

Figure 5 shows the evolution of the terms of trade defined as the export price index over the import price index. Corsetti et al. (1998) stressed the role of the negative terms of trade shock in 1996 on the deteriorating economic conditions. We can see, however, as with the evolution of export performance, that the terms of trade had recovered during the first half of 1997. Furthermore, if we consider the fact that the price of semiconductors was abnormally high due to the strong demand force in the international market from 1993 to 1996, the real negative trend of the terms of trade might not seem so severe.

Figure 6 shows the evolution of the output. Here, the authors used the index of the manufacturing industry. The result contradicts Corsetti et al.'s argument (1998), that industrial production growth rates were way below previous level. The figure suggests that the industrial production growth rates were not quite different from the previous tranquil time period average. We can see the evolution of the level of wage in Figure 7. The result confirms that real wage growth was not the cause of the Korean crisis, showing the declining trend preceding the crisis.

Figure 8 shows the 12-month percentage change in the foreign exchange reserve, excluding gold of the Bank of Korea. Unlike other previous variables, the reserve had gradually deteriorated,

13) From Figure 3 and Figure 4, we can see that the huge gain in the current accounts after crisis is not due to the growth of the exports but due to the severe destruction of the imports.

even though during the first half of the 1997 it showed quite some recovery. However, the level of the 12-month change in international reserve is about 22.3 percent below the average of tranquil time, which is 17.7 percent. Comparing with the stylized 45 percent below the average during tranquil periods in Kaminsky and Reinhart (1996), the decline seems not to be quite severe.

Unlike previously examined 8 variables which describe the 12-month percentage change, the next two figures just show the evolution of interested variables in quarterly terms. Figure 9 shows the movement of the ratio of current accounts to GDP. As can be expected from Figure 3 and Figure 4, it shows a recovering trend up to the third quarter of 1997, after reaching the worst point in the first quarter of the 1997. Figure 10 shows the behavior of the ratio of fiscal deficit to GDP. From the figure, we can see that the budget deficit could not be the cause of the currency crisis, as in Latin American countries and Russia.

To summarize, we cannot find any significant evidence supporting the fundamentalist argument that the Korean crisis resulted from the weak economic fundamentals. The analysis shows either unconvincing results or results which contradict the argument expected from the fundamentalists.

Table 2 shows some economic indicators which are important in understanding the economic condition of Korea. The GDP growth rate, the inflation rate, and the unemployment rate are quite impressive until 1996. Such conditions reflect the fact that Korea's economic success had been called a miracle. The debt/equity ratio was, however, quite high relative to that of the Anglo-American type of economy. Nonetheless, in reviewing the historical development of the Korean economy, the 333.5 percent debt/equity ratio of 1996 and that of 333 percent before crisis level of 1997, cannot be considered as different from the previous level.

[Table 2] Some Indicators of the Korean Economy

	GDP growth Rate (%)	Debt/Equity Ratio (%) ¹⁾	Inflation rate (%) ²⁾	Unemployment rate (%)
1990	9.5	297.1	8.5	2.4
1991	9.1	318.0	9.3	2.3
1992	5.1	325.1	6.3	2.4
1993	5.8	312.9	4.8	2.8
1994	8.6	308.1	6.2	2.4
1995	8.9	305.6	4.5	2.0
1996	7.1	335.6	4.9	2.0
1997	5.5	396.3(333)	4.5	2.6

Source: Bank of Korea, Economic Statistics Yearbook, various issues.

1) Debt ratio of 1997 is that of manufacturing industry, and others are all industry level. In the parenthesis is the debt ratio before crisis.

2) Inflation rate is the changes in consumer prices.

According to Corsetti et al. (1998), the high level of the nonperforming loan was an important element which contributed to the currency crisis. However, as seen in Table 3, the data do not confirm their argument. Rather, levels of the nonperforming loans in 1995 and 1996 were even smaller than those in previous years.

[Table 3] Nonperforming Loans

	Nonperforming Loan
1990	74,463 (7.5)
1991	83,140 (6.6)
1992	103,472 (6.7)
1993	120,892 (7.0)
1994	117,227 (5.6)
1995	124,893 (5.2)
1996	118,739 (4.1)
1997a	214,610 (6.8)

Source: The Bank of Korea

1) Nonperforming loans are in 100 million Korean won.

2) All items are measured at the end of the year, except 1997. The 1997 item (1997a) is measured at the end of September.

3) In the parenthesis, the numbers represent the percentage of the nonperforming loan to the total loan.

IV. Concluding Remarks

This paper reviews two different camps, which provided an explanation on the main causes of the Korean crisis of 1997. The first camp argued that the crisis reflected an unsustainable deterioration of the macroeconomic fundamentals. This fundamentalist argued that the fundamental weakness of the economic system inevitably gave rise to the currency crisis. The other camp emphasized the financial fragility in the international capital market, especially sudden shifts in market expectations and confidence as the main cause of crisis of 1997. This camp argued that the financial market, including the international capital market, is intrinsically unstable, and that this instability is the very cause of the currency crisis of 1997. Through empirical analysis and other evidence, the authors have demonstrated how the fundamentalist argument lacks a solid base in explaining the cause of the Korean crisis, though weak macroeconomic fundamentals intensified the depth of the crisis in 1997. Empirical analysis based on Kaminsky and Reinhart (1996) produces results which are either unconvincing or which contradict that which can be expected from the fundamentalist argument. The authors have elaborated that the other important evidence supporting the fundamentalist argument, such as the debt/equity ratio and the nonperforming loan, could also not sufficiently account for the Korean case.

Even though the financial liberalization, especially capital account liberalization was one of the main causes of the crisis according to the instabilist argument, the IMF and the Korean government have pursued even more extreme financial liberalization, especially capital account liberalization after the crisis (Kim, Kim, and Suh, 2009; Kim and Song, 2007). As a result of that pursuit, the potential risks due to destabilizing capital flows increased very

much. It forced the Korean economy fell into another serious financial crisis in 2008 (Lee et al., 2010), and to dangerous economic situation in 2011, as the global economy had gone through the economic turmoil. To prevent future crisis, sound regulation and supervision regarding to the international capital market is necessary. Furthermore, recent experiences, ongoing global economic debacles since 2007 demonstrate that international coordination must be needed in the era of globalization.

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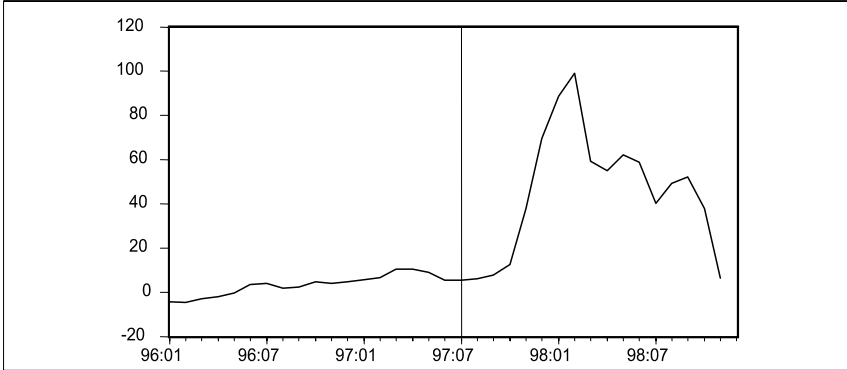
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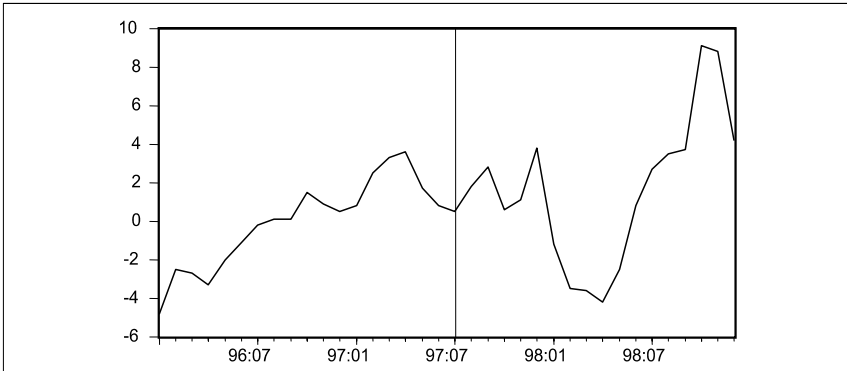
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[Appendix]

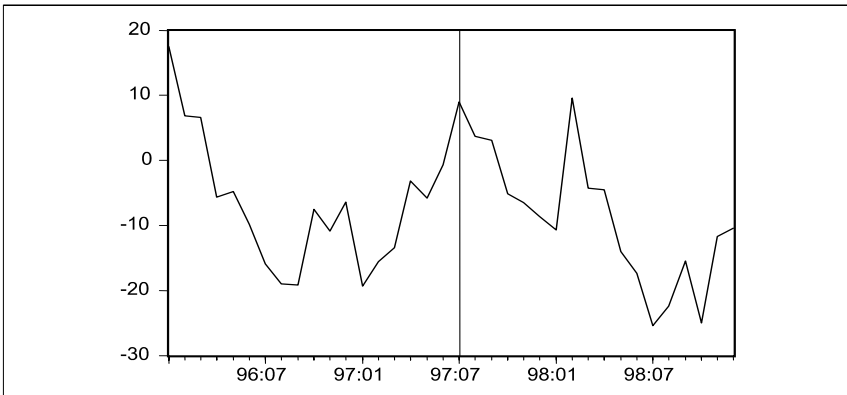
【Figure 1】 Change of Real Exchange Rates (%)



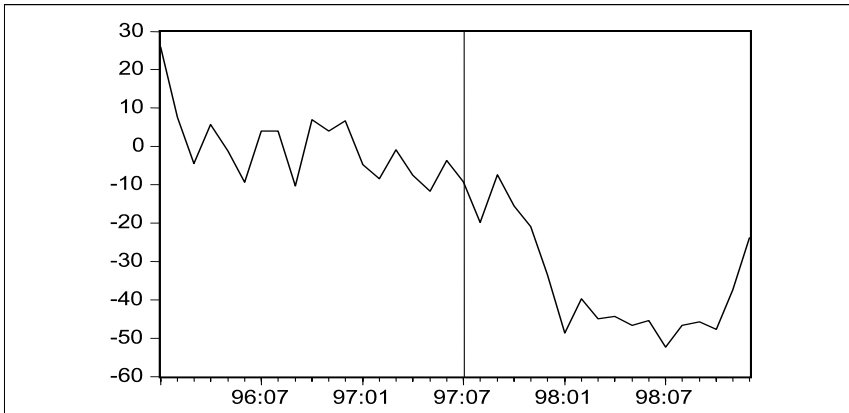
【Figure 2】 Change of M2 (%)



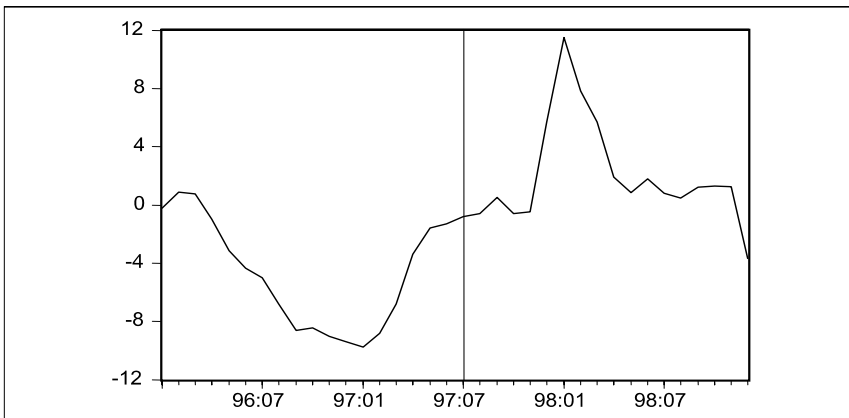
【Figure 3】 Change of Export (%)



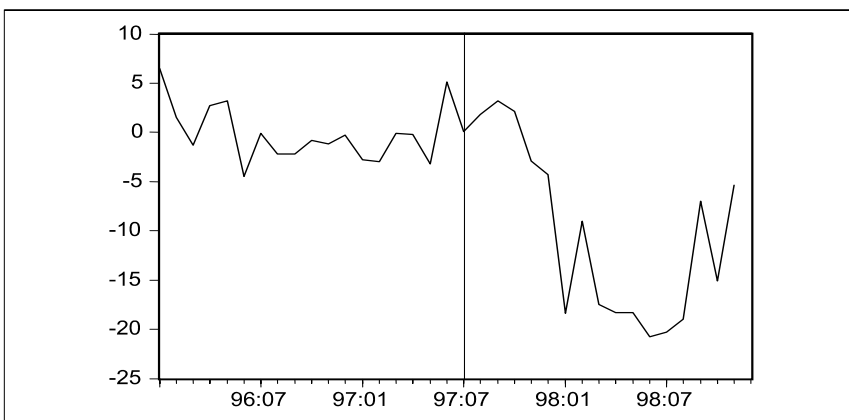
【Figure 4】 Change of Imports (%)



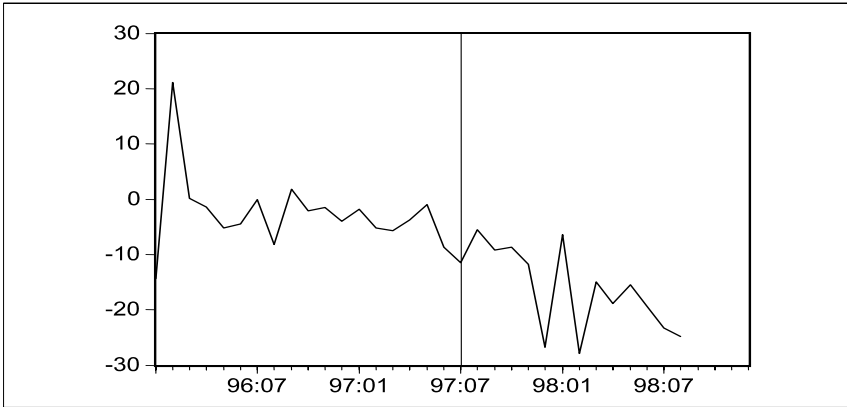
【Figure 5】 Change of the Terms of Trade (%)



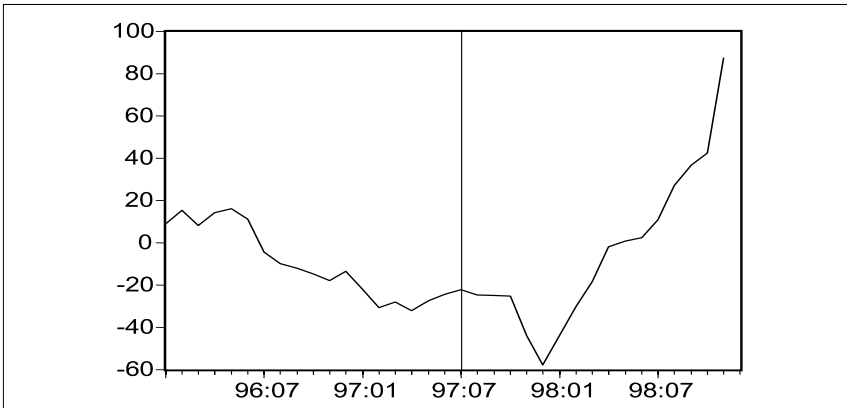
【Figure 6】 Change of an Output Index (%)



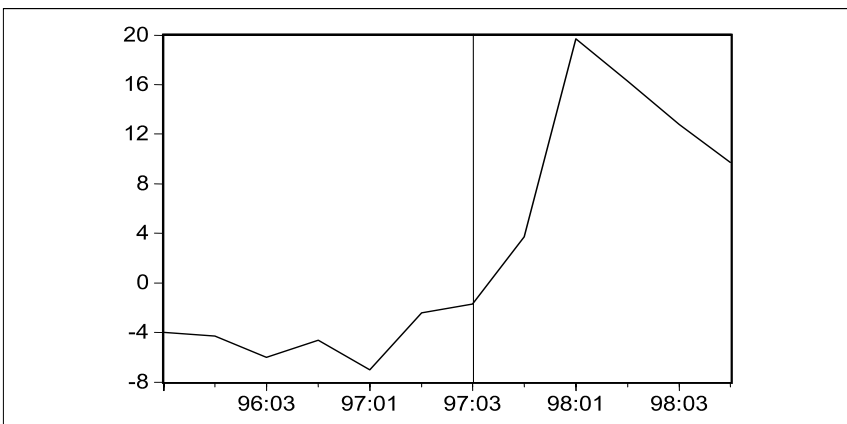
【Figure 7】 Change of Wage Index (%)



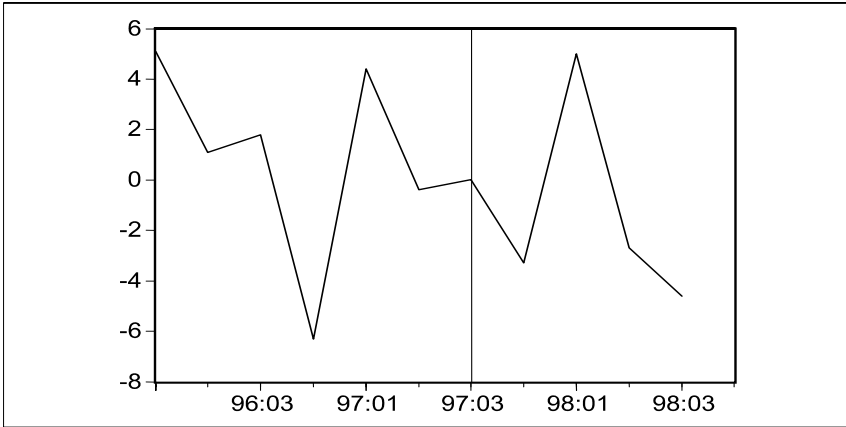
【Figure 8】 Change of International Reserves (%)



【Figure 9】 Current Account/GDP (%)



【Figure 10】 Budget Deficit/GDP (%)



1997년 한국 외환위기의 원인에 대한 재검토

김진일* · 장덕주**

논문초록

본고는 1997년의 한국 외환위기의 원인에 대한 두 가지 주장, 악화된 거시 경제의 기초 여건이 문제였다는 주장과 국제 자본 시장에서의 금융 불안정성이 문제였다는 주장에 대해 살펴본다. Kaminsky와 Reinhart (1996)의 분석에 따라 거시 경제의 기초여건을 반영하는 변수들의 위기 이전 움직임을 보았을 때 별다른 문제점을 발견할 수 없었다는 사실은 비록 악화된 거시 경제의 기초 여건들이 위기를 심화시켰지만, 그 자체로는 위기의 근본적인 원인으로 작동하지 않았음을 보이고 있다.

주제분류 : B030604

핵심 주제어 : 외환위기, 거시 경제의 기초 여건, 내재적 금융 불안정성

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