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[South Korea and a COVID-19 Financial Crisis: Part 2 – Tools and Cooperation](#)

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By **Kyle Ferrier**

Earlier this week [I covered major risks to the South Korean economy from a financial crisis caused by COVID-19](#). While South Korea is particularly susceptible to the worsening economic fallout from the pandemic, it is far from helpless. Rough experiences with past financial crises, namely the 1997-1998 Asian Financial Crisis, have led Seoul to build up resiliencies over the years to handle the next one. With another crisis seemingly on its way, this blog takes a look at some of the tools at Seoul's disposal to help mitigate the economic damage.

The Tools Available

Fiscal and monetary policy

South Korean President Moon Jae-in's economic policies have centered on government spending-led growth. Though this has resulted in [record government budgets](#), Moon's predecessors have given him plenty of fiscal space to work with. In 2016, the last year of the Park Geun-hye presidency, South Korean government spending was 32.3 percent of GDP, among the lowest in the OECD at the time. Under Moon, South Korean government spending [has surpassed 40 percent of GDP](#). IMF [Article IV country reports for South Korea](#) have consistently been supportive of Moon's expansionary fiscal policy to strengthen the social safety net and reduce inequality.

Even before COVID-19, the Bank of Korea (BOK) accommodated this government spending through its low rates. An [additional rate cut to the record level of 0.75%](#) resulting from an emergency meeting on March 16 has further provided room for Moon to maneuver his way out of a new crisis.

The Moon administration initially rolled out a stimulus package of [11.7 trillion won \(\\$9.5 billion\)](#) in early March to help the economy get through the pandemic, but has since raised the amount to [100 trillion won \(\\$80 billion\)](#) as growth prospects have weakened. With the higher money amount has come a wider scope. The first batch was largely directed toward small- and medium-sized companies, medical institutions, and child care facilities. As the extent of the potential damage has become clearer, Seoul plans to use the additional funds to further provide assistance to these groups as well as to stabilize financial markets by purchasing corporate debt at an elevated risk of default.

The worst of the economic turmoil, however, is likely ahead of us. It's difficult to predict how dire the situation will be, but there are already signs that additional stimulus will be necessary. The majority of the funds allocated so far have not been for the chaebol (though they will certainly stand to benefit the most from government purchases of corporate debt), and rightfully so. As major conglomerates not directly responsible for precipitating the crisis, they have been better equipped to weather the storm than SMEs. Yet, as global demand continues to deteriorate, [chaebols will also likely be seeking further assistance from Seoul](#). Because of their size the amounts will be substantial, and because of their structural importance the requests will be difficult to ignore.

As costly as it might be in the short-term, the government still has the fiscal space to help the chaebol, which would be worth it in the medium- to long-term. For Moon, who has sought to decrease South Korea's economic dependence on these conglomerates, this might seem like a politically difficult move. However, depending on the degree of their financial needs, it could also provide an opportunity for sweeping chaebol reform that Moon advocated on the campaign trail but has thus far proved elusive.

Currency reserves and International Cooperation

Perhaps the most significant lesson South Korea learned from the Asian and global financial crises has been the importance of access to emergency liquidity.

After the 1997-98 crisis, Korea's foreign exchange accumulation took off and, with the exception of the 2008 crisis, has continued to rise since. The country's [over \\$400 billion in foreign currency reserves ranks 9th in the world](#), behind India and ahead of Brazil.

Korea has also been active to supplement its access other sources of foreign exchange.

[South Korea added global financial safety nets to the G20 agenda in 2010](#), leading to the enhancement of the IMF's [Flexible Credit Line](#) and the establishment of the Precautionary Credit Line, which was [upgraded](#) a year later. The Lee Myung-bak administration additionally [proposed the creation of a global swap regime](#) at the same summit in Seoul – inspired by how the Fed's emergency bilateral currency swaps, including to Korea, helped to stem the spread of the 2008 crisis. However, this idea was ultimately shot down by the United States.

After opting not to access the Chiang Mai Initiative (CMI) during the 2008 crisis, [South Korea played a key role in its upgrade to the CMI Multilateralization \(CMIM\) in 2010](#). The CMIM is a regional financial arrangement among ASEAN+3 countries which allows members to swap local currencies for U.S. dollars to fend off a crisis. Its size today is \$240 billion, of which South Korea can draw on \$38 billion, but only \$11.52 billion without triggering IMF involvement.

Recent administrations have also been making efforts to negotiate bilateral swap agreements in currencies other than the U.S. dollar. Both swaps in reserve and local currencies offer access to emergency liquidity. However, while the main advantage of swaps in a reserve currency like the dollar is access to a more stable currency in a crisis and to be able to service dollar denominated debt, the key benefit of local currency swaps is boosting the use of these currencies, thereby cutting down on dollar dependency. The BOK now has local currency swaps with [Canada](#), [Switzerland](#), [Malaysia](#), [Australia](#), [Indonesia](#), [China](#), and [UAE](#).

Between its own reserves and other means, Seoul clearly has access to a large amount of foreign exchange, but is it enough?

When [Seoul took a \\$58.4 billion IMF loan in 1997](#) the country had \$63.8 billion in short-term external debt against its \$9.1 billion of usable foreign reserves. By the 2008 crisis, however, South Korea was in a much better position to cover its debt. In March that year the BOK had nearly \$265 billion in foreign reserves, but by the beginning of November it had drained over [\\$63 billion to support the won](#). What turned the tide was the [Fed's \\$30 billion swap deal with the BOK in late October](#) even though this amount was dwarfed by Korea's reserves. This highlights that not only are a country's resources important to allay market concerns during a crisis, but so too is international cooperation.

In response to COVID-19 so far, a [temporary swap line for \\$60 billion with the Federal Reserve](#) has been established and there has been no discernable impact to South Korea's foreign exchange reserves, both of which are promising. According to the latest available data from the BOK, there was a slight dip in reserves in February, but the holdings are still greater than any month last year. Figures from March could paint a less rosy picture, but the credit line with the Federal Reserve should be helping to shore up market confidence in the won.

What may prove to be the most useful measure for Seoul though is contributing to an effective global response. Ultimately, it is the areas where the Korean government has the least direct control that will have the most direct impact on the domestic economy. The G20 has been slow to react considering the speed at which the virus has spread, but is [now working on an action plan](#) to contain the disease and provide economic relief. Given South Korea's relative success in dealing with the virus, leadership roles in facilitating financial cooperation, and what is potentially at stake domestically from the mishandling of the virus elsewhere, Seoul should be just as engaged in working with other governments to resolve the crisis abroad as it is working to resolve the crisis at home.

Bottom Line

Integration with global markets has transformed South Korea into an advanced economy, but the flip side is that it is more susceptible to financial shocks. The strength of South Korean institutions has enabled successive administrations to identify major external risks and pursue policies to fend off and prepare for a COVID-19 financial crisis. However, to best help themselves, South Korea's leadership will need to actively work with others. This was true in past crises, but is especially noteworthy now given the epidemic underlying the current economic instability.

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