Bendreff Desilus

Universidad Autónoma Metropolitana (Xochimilco) México

Economic performance of Mexico and South Korea after 2008 crisis

Normally, the economic performance of socialism and capitalism are usually seen as two models that generate in general growth and wealth in a society. However, the comparison between the economic policies of Mexico and South Korea is of great importance due to the economic history of the two countries shows how small the capitalist system, the policy responses to the financial and economic crisis of 2008 had very different results from lack of accompanying policy and the use of conventional or orthodox policies.

In every economic system, each nation has the right to choose policies that they feel necessary for better performance of their economies. So, the options for these policies depend heavily on institutions and specifically the leaders representing a class in society where they evolve. Based on this idea, (Djankov Simeon et al 2003) argues:

> Each capitalist economy has many public and private institutions. These institutions function to select political leaders, to secure property rights, to redistribute wealth, to resolve disputes, to govern firms, to allocate credit, etc. Political economy over the last two centuries, as well as recent empirical research, demonstrates that these institutions differ tremendously and systematically among countries. These differences and their consequences for economic performance are the subject of the new comparative economics.

From this perspective, one of the objectives of this paper is to analyze the extent of the economic policies of South Korea and Mexico in response to the 2008 financial crisis that began in the United States. I will demonstrate in this paper that the economic performance of both countries is due in part by the economic policies adopted by each government during the crisis, and on the other side by the lack of coordination of the institutions to carry out these policies.

To achieve the stated objective, the work has been divided in three sections, the first part we will focusing on the economic conditions of each one of the countries before to the 2008 crisis and at the same time we will be analyzing some of their most important macroeconomic variables . The second section focuses on the immediate effects of this economic imbalance in Mexico and South Korea. Finally, the last part of the work focuses on policies and strategies that each country uses to reduce the negative effects on their economies.

Both Mexico and South Korea have experienced a couple of very severe economic crises during the nineties. In the case of Mexico, the economic crisis of 1994-1995 was essentially caused by political and economic factors. This crisis shows that a capital inflow to developing countries

(the free flow of capital was the result of financial liberalization and trade liberalization during the beginning of the nineties) is a double-edged sword. On the one hand, the continuous inflow of foreign capital in the short term could help the country develop much faster. On the other hand, if foreign investors lost confidence in the economic and political stability of the country, the sudden departure of capital funds could produce a severe period of adjustment (see Bernanke, 2005, p.195).

The consequences of this were: in real terms, the trade deficit of the balance of payments of around $ 30 billion us, a 100% devaluation of the currency in 1995, a decrease of GDP almost -7%, one million of jobs lost, an increase in the inflation rate of 52%, external debt increased to 162 billion dollars, of which 50 were short-term (see Villarreal, 2005, p. 609).

There is no doubt that there are three fundamental elements that can explain the crisis of 1994-1995 known as the Mexican crisis

• The use of the real exchange rate as a tool to control the inflation.

• An incomplete economic policy as to strengthen the domestic economy by the transition of the import substitution model to the Export substitution model.

• The lack of institutions capable of regulating companies after being privatized.

Due to the role of Mexico in the US economic sphere, and also to find a way out of this crisis, the Clinton administration decided to lend Mexico an amount of about 50 billion dollars. Thanks to this financial support, Mexico could stabilize its economy in the late of the nineties. During this decade, South Korea also experienced one of its worst crises at that time. Like Mexico, the cause of the crisis that erupted in 1997 in South Korea had its origins mainly by endogenous factors.

The economic reality during the middle of the nineties was a mixture of the policies between the protection of the domestic market and international competition. It is noteworthy that the chaebol[1] had a financial structure that was not healthy by nature, this weakness being one of the causes of the crisis of 1997. The bankruptcy of these conglomerates was the first sign of economic weakness of South Korea. The solution required a structural transformation of both form and substance, because these clusters were experiencing old habits of corruption and monopolistic strategy.

Another factor that contributed to the Korean crisis was the failure of the South Korean financial liberalization 1993. The absence of mechanisms that could contribute to the inflow of capital to the majority of the population. Large conglomerates, for their appetites for investment capital, demanded huge short-term loans through the NBFIs (nonbank financial institutions) and were the

mismanagement of the financial resources which it caused the crisis of 1997-1998. The consequence of all these factors was a decline in GDP of -5.8% in 1998.

[1] A group Korean businessman who played a very important role in the strategy of industrialization and development of South Korea in the sixties and seventies, because it represented the organizational and knowledge base.

The global financial crisis that began in the United States in September 2008 with the collapse of Lehman Brothers had a major impact on the economy of many countries. Note that in the United States there was a negative growth of -0.3% in 2008 and -2.8% in 2009. The Mexican economy had repercussions due to the extreme dependence of respect to that country.

The negative impact of this crisis in developed countries and the developing countries represented a proof that the international financial market, under the new order of globalization, operated and continues to operate without rules. This reveals that there existed and there still exist difficulties when forecasting risk, as well as the lack of a regulatory framework for a better functioning of the international financial market.

Many experts mentioned several factors in the crisis of 2008 and its impact on the following year. However, I believe that the explanation of Raghuram G. Rajan (2011, p. 19) it is important in order to understand how Mexico was affected (infected) by this financial collapse, because he used the metaphor of "fractures" that were appreciated in the world's economy, saying that:

> A group of fractures derives from the tensions of national policy, especially in the United States. Almost all financial crises have political roots, which certainly differ in each case, but are political because these forces are necessary to overcome the checks and balances that have established the most industrialized countries to contain the financial exuberance. The second group of ''fractures'' emanating from trade imbalances among countries, which in turn result from previous growth patterns. The last group of fractures develops when the different types of contact financial systems to finance trade imbalances, particularly when transparent systems, based on contracts and equal in countries like the US and UK are financed by financial systems less transparent in the rest of the world.

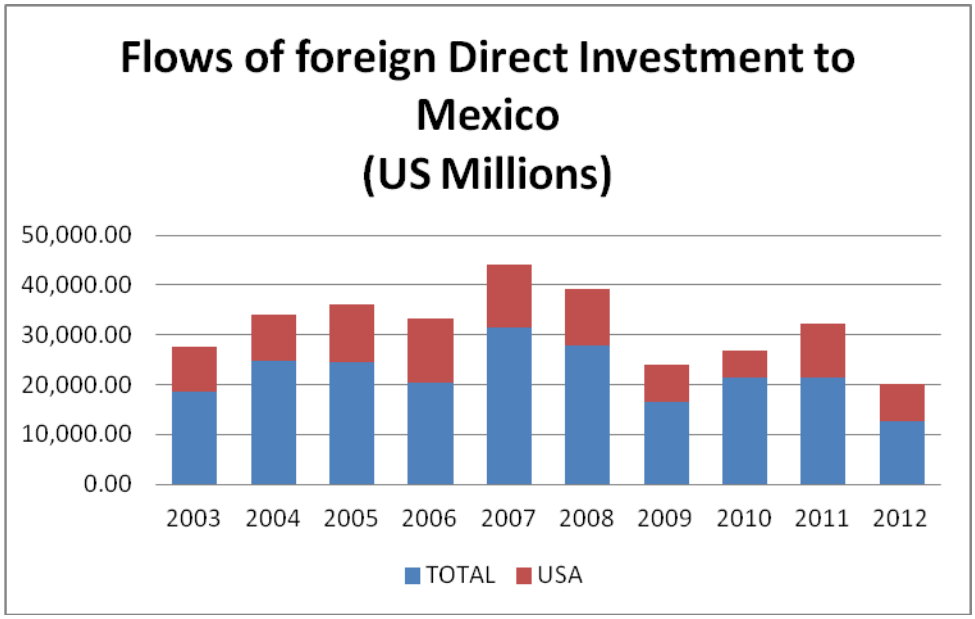
According to this statement, you can categorize Mexico in the second group of fractures, due to this commercial dependence of the Mexican economy with the United States. It is noteworthy that after the signing of NAFTA (1 January 1994) almost 80% of Mexico's foreign trade is directed towards the United States, as planned.

Mexico's Exports: 2003-2011
(U.S.$ in billions)

MEXICO'S EXPORTS	2003	2004	2005	2006	2007	2008	2009	CHANGE 2008-2009	2010	2011
TO THE UNITED STATES	144.2	164.5	183.5	211.8	223.4	234.5	184.8	-21.19%	238.3	274.7
TOTAL EXPORTS	164.7	188.0	214.2	249.9	272.0	292.6	229.6	-21.5%	298.1	349.5

Secretariat of economy, Subsecretaría de Negociaciones Comerciales Internacionales, Mexico

US FDI in Mexico and exports from Mexico to the United States represented a major percentage in the growth rate of the country; we would expect that any change in the demand for goods and services in the United States had a positive or negative impact on the Mexican economy, because during that time exports accounted for over half of GDP



Secretariat of economy, *Dirección General de Inversión Extranjera, Mexico*

The decline in imports of goods and services in the United States was one of the consequences of the crisis, which directly affected Mexico, especially in the economic growth and the generation of employment. The negative impact of these imbalances was compared with the Mexican crisis of 1994-1995, due to the decline in GDP, which was -6.6% during this period. In this regard, Leon (. 2011, p 3) states that:

> In the case of Mexico, the crisis was caused by the decrease of imports from the United States, Mexico's main trading partner. Since late 2007, US imports from Mexico were hesitant, and the external sector came under stress. In 2007, the deficit in the current account of the United States was 8.4 billion dollars, but in 2008 almost doubled, reaching 15.9 million US dollars (ie, 1.46% of GDP).

We must also say that there were other factors that affected the Mexican economy in performance, for example, the decline in remittances of Mexican workers living abroad, especially in America, was 11%. Also it experienced a reduction in income from oil exports 50% and a significant decrease in the flow of tourists, this due to the outbreak of influenza A (H1N1).

The response of the government of Felipe Calderon was wrong from the perspective of monetary policy. The head of the Secretariat of Finance and Public Credit at the time, Agustin Carstens, said the slowing US economy would have a relatively minor effect on Mexican economy "(CNN Expansion 20/09/2011). However, the interest rate increased from 7.5% to 8.25% in August 2008 and had to wait until mid-2009 to reduce the interest rate to 4.25%, which is too late.

The response of the government of Felipe Calderon was wrong from the perspective of monetary policy. The head of the Secretariat of Finance and Public Credit at the time, Agustin Carstens, said the slowing US economy would have a relatively minor effect on Mexican economy "(CNN Expansion 09/20/2011). However, the interest rate increased from 7.5% to 8.25% in August 2008 and had to wait until mid-2009 when Mexican authorities decided to reduce the interest rate to 4.25%.

In times of crisis, reducing the interest rate long-term has positive effects on consumption and employment. To stimulate consumption and investment in production is advisable to reduce interest rates and thus discourage saving. The decision to increase the interest rate was attractive for investors and unfavorable for the economy as a whole.

> Interest rates in the long term are extremely important in economics. An interest rate to lower long-term increases the value of long-term assets such as stocks, bonds and housing, because dividends, interest payments and services offered by the house are discounted at a lower rate. Thus, the purchasing power of households increases and, consequently, spending. One type of low long-term interest, makes saving less attractive to families and consume more attractive, again contributing to the demand. Interest rates determine the long-term

> profitability of real investments: interest rate lower long term, they increase the present value of future assets, giving companies greater incentives to invest and also greater ability to borrow [Rajan , 2011, p. 135].

The fact that the authorities finally decided to reduce the interest rate is proof that the crisis was misdiagnosed, they think that the international reserves of the country could avoid large capital outflow and that the effect would be minimal or almost nonexistent, in the Mexican economy. The signal that the market needed in terms of monetary policy was late.

Furthermore, although oil has reduced its participation in the composition of GDP, this product remained one of the most important sources of income of the country, along with tourism, remittances and FDI. Due to the slowing global economy, there was a considerable reduction in the price of oil. During the first half of 2008, oil prices experienced a decrease of 56% when comparing against previous period. For December 2008, the barrel of West Texas Intermediate (WTI) was priced at $ 39.95. This reduction in oil prices had a negative impact on the economy, regardless of whether the government had already taken out insurance in case of emergency.

Considering the consequences of the economic slowdown in the United States could have on the Mexican economy, the government of Felipe Calderon decided to implement some strategies for economic stimulus in order to revive the economy. The first strategy was a program to support the economy and jobs. The second strategy, which was announced in October 2008 was the construction of a refinery and a policy of financial support for SMEs. Finally, in January 2008, the authorities announced a third strategy called "National Agreement for Family Economy and Employment", whose aim was to encourage demand and thus reduce unemployment. The highlights of these stimulus packages according to Leon (. 2011, p 7) were:

> Between March 2008 and January 2009, the government issued three stimulus packages to deal with the effects of the Great Recession.9 As early as March 3, 2008, the Mexican government announced a program to support economic growth and employment (*Programa de Apoyo a la Economía y el Empleo*). This program provided provisional discounts on taxes to personal income, some reductions in specific services provided by the public sector, and scanty resources to reduce unemployment. The month before, President Felipe Calderón had announced the creation of a National Infrastructure Fund with an initial $4 U.S. billion dollars endowment, adding the possibility of reaching $27 U.S. billion dollars in the subsequent four years […] in October 2008 President Calderón announced the second stimulus package. Among other measures, the package foresaw the enlargement and more efficient exercise of public spending; the construction of a new refinery for the state oil company Petróleos Mexicanos (PEMEX), worth 1.2 billion U.S. dollars; the launch of a special program to support small and medium enterprises; and further steps in the road of deregulation and trade liberalization. [...] In January, 2009, Mexican government launched its third stimulus package, called “National Agreement to Support Family Economy and Employment” (*Acuerdo Nacional a favor de la Economía Familiar y el Empleo*). The main measures were a reduction of the cost of gas for domestic use, the freeze

of electricity and fuel prices, and credit disbursements of some 150 U.S. million dollars for industries hit by financial restrictions.

None of these strategies yielded positive results for the Mexican economy, this due to the lack of depth and accompanying policies for effective implementation. For example, in a recession, the government decided to increase VAT from 15 to 16%, and the Income Tax (ISR) from 28 to 30%. The result of these increases in tax rates was bad for economy as a whole; the unemployment rate increased from 3.97% in 2008 to 5.48% in 2009, and as a logical consequence, the rate was -4.7% of GDP (World Bank).

The behavior of economic variables in the Mexican economy during the crisis of 2008 is largely due to the decision of the Mexican authorities. Do not forget that during this time Mexico had large international reserves (about 96,000 million). However, the administration of Calderon decided to maintain the orthodox policies of the IMF with a fiscal deficit near zero, for fear of increasing inflation. Moreover, they did not apply any anti-cyclical policy. The slowdown of the Mexican economy was the lowest compared many Latin American countries, due to the application of a restrictive policy and the reduction in public spending amid one of the most severe crises of the century.

Percent Change in Real GDP for Selected Countries: 2007-2009

	2007	**2008**	**2009**
Argentina	8.7	6.8	0.9
Brazil	6.1	5.1	-0.2
Chile	4.6	3.7	-1.5
Mexico	3.5	1.5	-6.6

Data from the Economist Intelligence Unit online database

Moreover, the outbreak of the 2008 crisis also had a negative impact on the Korean economy. Although South Korea was operating in an acceptable manner in which he referred to economic growth, it was noted a slowdown in many of the factors before the crisis of 1997, especially in relation to GDP in the recent decades.

During the years before the 2008 crisis, the Korean economy had become vulnerable to external shocks. This caused the symptoms of the crisis were more severe than in other countries in the region. Do not forget that one of the recommendations of the IMF during the 1997 crisis was precisely the financial liberalization in order to attract foreign investments and the lack of protection. This liberalization allowed the entry of many resources on the capital account and

huge capital outflows in times of crisis. Moreover, exports played an important role in the composition of GDP; It was expected that any decrease in the demand for goods and services in the United States would have a negative effect on the Korean economy.

Exports of goods and services (% of GDP)

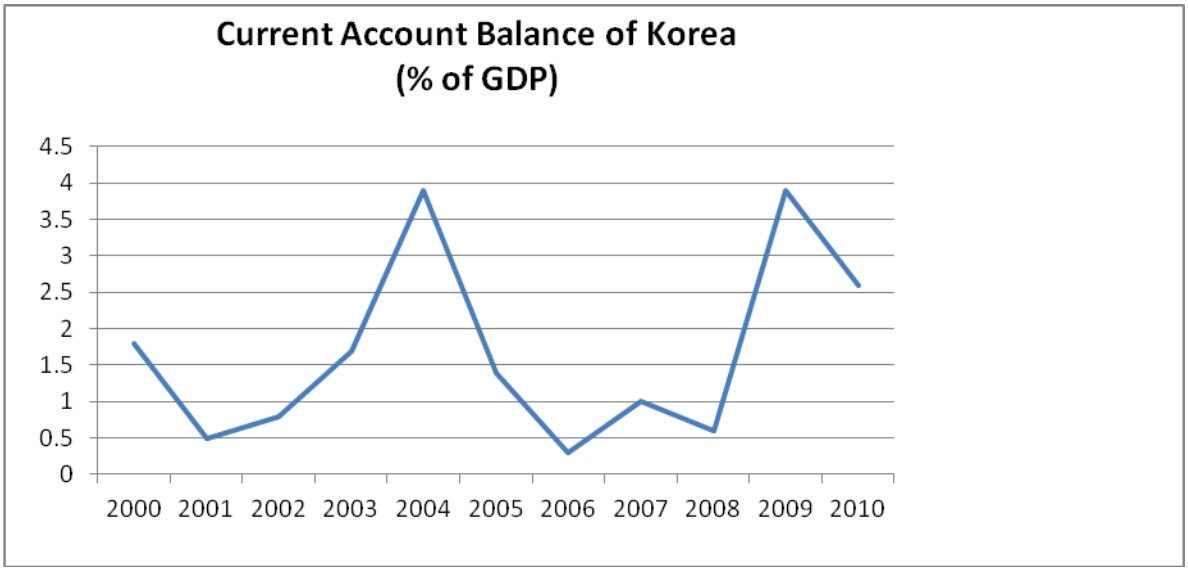
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Exports of goods and services(% of GDP)	35.0	32.7	30.8	32.7	38.3	36.8	37.2	39.2	50.0	47.5

World Bank, *2015*

Among the consequences of the crisis may be mentioned the decrease of the current account of the balance of payments, which went from 18 billion dollars in 2007 to 3 billion in 2008; the inflation rate experienced an increase of almost 100%, from 2.5% to 4.7% during that period; the unemployment rate increased slightly from 3.2% in 2008 to 3.6% in 2009, and a decline in international reserves of almost 20%.

Likewise, South Korea experienced a devaluation of its currency. The Korean Won had increased to 1,533 won per dollar, and real economic growth fell to just 2.1%.

The diversification of some of these variables, such as the exchange rate and inflation, were consciously modified by the monetary and fiscal policies that the South Korean government implemented to stimulate the economy. Anyway, as you can see in Figure 10, the balance of the current account had a decrease quite considerable at the end of 2008 to 0.6% decline.



Oecd 2015

During the years before the crisis, the Korean economy had already begun the search for other markets for export; however, the majority of sales abroad were destined for the United States, Japan and the European Union. On this point, Marchini (. 2009, p 11) argues:

Although Korea's exports have diversified in the last decade, both in terms of products and their destinations largely remain dependent, both directly and indirectly, in final demand goods advanced technology, and half of the large developed markets like the United States, European Union or Japan. Therefore, exports have begun to decline since July 2008 due to the weakening of the demand slumped in the last quarter at an annualized rate of 30% -higher than the 2001 crisis, in all markets, when falling demand for goods the severe contraction of trade credit was added. This "real" shock paralyzed the main engine of the Korean economy, and both private consumption and GDP have shrunk, the latter near 20% annualized pace in the last quarter of 2008.

The Korean government's response to this external shock was quick, and the strategies used had a Keynesian character in order to increase consumption through demand and restore confidence to stem the outflow of capital. It should be mentioned that the 2008 crisis had a rather limited impact on the Korean economy compared to other countries.

One of the first counter-measures implemented by the Korean government to reduce the effect of the crisis was the use of monetary policy through the interest rate and exchange rate. The Korean authorities decided to use their reserves and fund to support businesses and, in general, the foreign trade sector due to the contraction of exports to the European and mainly Union. In addition, South Korea requested a credit line with the IMF and with other countries to ensure liquidity in the domestic market and thus to prevent capital flight. In this regard, Harun Alp (. 2001, p 6) states that:

> The korean authorities have implemented significant monetary and fiscal stimulus to stop the fall in confidence and support the real economy. Also, they established a fund preventive recapitalization of banks and a fund of bad assets to provide the banking system from the crisis and avoid a sudden deleveraging. In addition, the Korean government initiated a swap line with the Federal Reserve of the United States for about 35 billion dollars, as well as the facilities of a bilateral exchange with the People's Bank of China (of an amount of around 26 billion dollars) and the Bank of Japan for 20 billion dollars. To ensure adequate liquidity, the Bank of Korea (BOK, for its acronym in English) expanded the list of possible suppliers in their procurement operations eligible counterparties and collateral in repurchase operations and flexibility in the requirements of bank loans.

South Korea could avoid a paralysis in the credit market and at the same time it was able to further consolidate the financial market. The interest rate on short-term increased from 5.5% in 2008 to 2.63% in 2009; this interest rate cut led an increase in the market liquidity. From 2010, with the aim of controlling inflation, the Korean monetary authorities decided that the rate will increase slightly.

Interest rate and exchange rate of Korea

	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Interest rate in short term (%)	4.3	3.8	3.6	4.5	5.2	5.5	2.6	2.7
Exchange rate	1,192	1,145	1,024	955	929	1,102	1,277	1,156

oecd

However, rising oil prices and the decline in exports caused the reduction in GDP to -5.1% during the last quarter of 2008.

The increase in domestic demand during the crisis in South Korea was also a result of fiscal policy that the South Korean government launched in order to curb the negative impacts of the financial crisis. Reducing taxes and increasing government spending were two key elements of fiscal policy that the government undertook to stimulate the economy. In late 2008, the Korean Congress decided to increase the budget by 10% over the previous year, fearing the financial crisis could affect the economy. Other measures that were implemented may include support to families with low incomes and access to credit for SMEs. In this regard, Leon (. 2011, p 10) states the following:

> Since late October 2008, President Lee Myung-bak instructed his economic team to increase public expenditure and set tax cuts aimed at avoiding that the spread of financial crisis could affect the real economy. The same statement was made in December, when the president asked his economic team to support any public project that could be implemented immediately. At the same time, the National Assembly approved a generous budget of 207 U.S. billion dollars for 2009, which in real terms meant an increase of 10.6% over 2008. [...] Fearing that the multiplier effect pursued via the large budget could not to be accomplished, in April 24, 2009, the Minister of Finance and Strategy, Yoon Jeung-hyun, proposed to the National Assembly a supplementary amount of 20.7 U.S. billion dollars. The approval of these additional funds rounded up the largest South Korean budget in history.

Many countries implemented a couple of fiscal policies and counter-cyclical to reduce and even shield its economy from the financial crisis of 2008. Unlike the other countries, in the implementation of the fiscal stimulus package in Korea during this period was precisely the diversification of the government spending in almost all sectors of the Korean economy, quickly and at the right time.

Major fiscal stimulus measures after the Global Financial Crisis

The main fiscal stimulus measures	Quantity (trillion won)
2008 supplementary budget (September 2008)	4.6
Infrastructure spending of the local government	1.0
Support for the stabilization of utility bills	1.3
Support to farmers, fishermen and small and medium businesses	0.6
compulsory expenditure	0.7

Investment in development funds and other resources	1.0
Tax reform of 2008 (December 2008)	-29.6
Tax cuts in 2008-2010	-29.6
Revised Budget 2009 (December 2008)	10.7
Supporting local SMEs, small business owners, farmers and fishermen	3.4
Increase in social spending projects	4.6
Support for the welfare of low-income people	1.0
Measures to tackle youth unemployment	0.3
Financial support for local governments and others	1.4
2009 supplementary budget (April 2009)	28.4
Support for the welfare of low-income people	4.2
Conservation and job creation	3.5
Support for small businesses, exporters and freelancers	4.5
Investment in research and development	2.3
Spending on local governments and others	2.7
Coverage of loss of income	11.2
Tax reform of 2009 (December 2009)	8.3
Increase of the revenue from the termination of the exemption and tax reduction in 2010	8.3

Hur and Kim, 2012, p. 400.

The amount of resources used in the fiscal stimulus package was the largest in the history of South Korea. It is estimated that around 59.8 trillion Won (accounting for 5.1% of South Korea's GDP in 2010) were used in support of the implementation of this policy, which was distributed as follows:

- 30.5 trillion (Won) in government spending.

- 29.3 trillion (Won) in tax exemptions and reductions.

According to official sources, monetary and fiscal policy that the government launched stimulus package as South Korea was the largest after Saudi Arabia and South Africa.

We must not forget to mention the work of Hur and Kim (2012, p. 408). After analyzing some indicators such as the fiscal impulse (FI: Fiscal Impulse and FIS: Fiscal Stance) and the fiscal position to assess the effectiveness of the expansionary fiscal policy applied by the South Korean government, they came to the following conclusion:

> The GDP growth increases when the fiscal stance is expansionary, and vice versa. One thing that should be noted is that the size of coefficient is lager when including the GFC periods, which implies the expansionary fiscal stance during the GFC (Global Finance Crisis) was quite effective for the Korean economy to rebound from the recession. This finding can be explained by timing and size of fiscal stimulus package. The government quickly switched fiscal stance right after the GFC by implementing supplementary budget, revising budget for 2009, and reforming tax system. Especially, tax reform in 2008 was an anticipated action for the Korean economy to rebound, though it was not intended. As a result, the government could allocate massive fiscal stimulus expenditure in the end of 2008 and the first half of 2009

The economic stimulus package as a strategy of anti-cyclical policy, helped South Korea to significantly reduce a negative impact of the crisis, and at the same time, avoids the decrease of the demand and its direct effect -the unemployment could affect the GDP. Under this mechanism, the South Korean economy could continue to grow in the years that follow the GFC.

References:

- Alp H., Elekdag, S. y Lal S., 2011. *Did Korean monetary policy help soften the impact of the global financial crisis of 2008–09?* IMF Working Paper, 12/5

- Bernanke Ben, S., y Abel Andrew, B., 2005. *Macroeconomics.* 5ª ed. Canadá: Pearson Education.

- Jose Luis Leon Manriques, 2011 : "The global crisis of 2008 in South Korea and Mexico: The role of internal market and regional trade''

- Marchini, G., 2009. Financiera global: Costos vs. beneficios de la apertura financiera. *México y la Cuenca del Pacifico*, Vol. 12, Núm. 36.

- Rajan Raghuram, G., 2011. *Grietas del sistema*. España: Deusto.

- Seok-Kyun Hur and Seong-Tae Kim: ''Fiscal Policies of Korea through the Global Financial Crisis'' Korea and the World Economy, Vol. 13, No. 3 (December 2012)

- Simeon Djankov, 2003: ''The new comparative economics'', Journal of Comparative Economics

www.worldbank.com
www.oecd.com
www.se.gov.mx
www.cnn
www.eiu.com