

# The Impacts of Financial Market Instability on Real Economy\*

As the financial crisis caused by the U.S. subprime mortgage defaults spread to the global economy in the fourth quarter of 2008, it also had a great impact on the Korean financial markets. Deteriorating foreign currency supply and demand conditions following the flight of foreign investment funds and the worsening of foreign currency fundraising conditions, as well as domestic financial institutions' conservative lending practices resulted in plunges in local stock prices and the value of the won currency, and a credit crunch. As domestic demand, such as consumption and investment, as well as exports fell drastically, affected by the financial market instability, real economic activities weakened rapidly. For instance, the GDP growth rate (quarter-on-quarter) in the fourth quarter of 2008 hit a record low since the financial crisis in 1997-1998.

This paper conducts an empirical analysis of the impacts of the domestic financial market instability arising from the global financial crisis on the real economy, including private consumption, facilities & construction investment and exports & imports. Credit crunch index, the price earning ratio, the rate of appreciation of the exchange rate, stock price and exchange rate volatility are used for indicators of financial market instability. The analysis results show that most of the indicators, excluding stock price volatility, had a significant impact on the real sector of economy. This implies that the recession in the real economy during the period between the fourth quarter of last year and the first quarter of this year is heavily attributable to financial market instability. Meanwhile, the negative impact on the

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real economy diminished rapidly in the second quarter onwards, as the financial market instability abated.

Next, a possibility of the vicious circle of "financial market instability ↔ real economic recession" resulting from prolonged sluggishness of real economic activities due to unpredictable factors is examined with use of household, corporate and bank default-risk indexes. The analysis shows that the recession in the real economy may lead to an increase in dishonored assets at banks but may not cause credit crunch.

The serious instability in the Korean financial market resulting from the global financial crisis and consequent weakening of real economic activities are substantially attributable to the foreign exchange demand-supply structure vulnerable to de-leveraging by overseas financial institutions. In this respect, improvement in the foreign exchange demand-supply structure is necessary for the expansion of a stable foundation for the Korean financial market. To this end, efforts need to be made to improve foreign debt maturity structure, to keep the current account in black, and to attract foreign direct investment.