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Prevailing Uncertainties & Countervailing Policies in Korea's Economy in H2 2011*

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Abstract

The need is growing for preemptive government policies to countervail the rising tide of economic uncertainties in Korea and overseas. Some of the prevailing uncertainties overseas include global inflation, signs of an economic slowdown in the major developed countries, and the fiscal crisis in the euro zone. Domestically, sources of instability include rising prices, household debt, the distress in savings banks, and the heightened volatility of capital flows. To stabilize prices and address financial market uncertainties, the top priority of the economic policy agenda for the second-half of 2011 should be to maintain stability of all areas of the economy through gradual raising of interest rates, regulating liquidity and preventing financial institutions from engaging in excessive expansionary competition, and reorganizing distressed savings banks.

* *Opinions expressed are those of the author and do not necessarily reflect the official positions of the Korea Institute of Finance.*

As the first OECD member country to overcome the shock of the global financial crisis, Korea's economy has been a stalwart of stability as it grew by more than 4% after reaching a high of 7.5% in Q2 2010. But the need for preemptive government policies is growing more acute with internal and external economic uncertainties growing more pronounced recently. Developed economies, such as the United States, whose recovery appeared to be on track through sustained global inflation, have recently started to weaken and with the fiscal crisis in southern Europe that seemed benign is once again becoming the focal point, raising concerns over the possibility of a fresh outbreak in global financial uncertainty. Domestically, financial market uncertainties, triggered by the rising household debt problem and distress in savings banks, are lingering as prices have risen by more than 4% for several months in succession.

The need is growing for preemptive government policies to countervail the rising tide of economic uncertainties in Korea and overseas.

Global Economic Recovery Showing Signs of Stalling

Aided by the very active stimulus programs adopted by many countries around the world and the subsequent efforts to coordinate policies between them since the onset of the financial crisis, the global economy has been on a steady path to recovery from the crisis faster than it was expected. But compared to the continuing trend of sound growth in the emerging markets, the sustainability of recovery in the developed economies such as the US and UK is being questioned.

In the US, uncertainties are casting a cloud over the country's economic outlook as its Q1 2011 growth of 1.8% was much lower than the 3.1% in Q4 2010 and with the leading indicators also reversing trend to the downside. Particularly, the US has been unable to get a solid foothold on the road to recovery as the number of jobs added continues to be sluggish with

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unemployment hovering over 9% and the country's housing market also stalled after posting average home prices at their lowest level since March 2003 with new building permits, housing starts, and home sales all trending lower.

In the euro zone, the risk of an economic downturn is also growing as the fiscal crisis in the southern European countries reemerge after the recent downgrade in Greek sovereign debt. In Japan, too, Q1 2011 growth fell to a negative 3.5% with private investment and consumption pulling back after the earthquake. Considering the changes taking place in economic conditions, the IMF and the World Bank adjusted their expected growth for the world economy from 4.4% and 3.3% to 4.3% and 3.2%. Although some forecasts point to the likelihood of the world economy entering a double–dip recession that portends stagnation, there are signs that the world economy is in a soft–patch, going through a short transitional period of weakness.

Continued Global Inflation

The severity of sudden jumps in asset prices and price instability have become more frequent and more pronounced, but especially in the emerging countries where economic recovery has been strongest.

Asset price volatility has become more frequent and price instability more pronounced since the second–half of 2010 when the world economic recovery began in earnest, but this has been especially evident in the emerging countries where economic recovery has been strongest. Together with this, the main backdrop to global inflationary pressure has been the increase in global demand that followed on the back of the massive liquidity that was made available as part of the countermeasures taken against the crisis. While the emerging market–led economic recovery has led to an increase in commodity demand, and thereby prices, other factors have contributed to global price instability. This includes the political instability in the Middle East and Northern Africa that has been a factor in the rise in oil prices, but also grain and other commodities. The sharp uptrend in prices is expected to slow due to signs of an economic slowdown in the developed countries, the end of Q2, and the steps that countries started to take to combat price increases, but the effects will probably be limited.

Possibility of a Fresh Outbreak in Global Financial Market Instability

The fiscal crisis in southern Europe, which appeared to have stabilized with the Greek bailout and the establishment of the EFSF in May and November of last year, is back to square one with the recent bailout of Portugal and the sovereign credit downgrade of Greece. With the finance ministers of the European Union announcing recently that a fifth round bailout of EUR120 billion would be withheld from Greece should the Hellenic Parliament fail to ratify bills on fiscal austerity and privatization, this crisis in southern Europe is uncertain as ever. Even if an additional bailout were to help avoid an immediate worst case scenario, the crisis has all the potential to resurface and spread at any time.

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Together with the foregoing, the US government's USD600 billion second quantitative easing program, which started last November to prevent a double-dip recession and deflation, is expected to end at the end of June. Should banks in the developed countries start to deleverage on the possibility of QE2 ending and because of the euro zone fiscal crisis, the impact on a small open economy like Korea can be significant.

Continued Price Instability in Korea's Economy

The Korean economy was the first among OECD member countries to overcome the global financial crisis and, with growth for 2011 forecast to be in the mid 4% range, remain on the solid path to recovery. But rising prices has become one of the biggest sources of instability with consumer price

Rising prices has become one of the biggest sources of instability for the Korean economy with consumer price increases exceeding 4% for five consecutive months this year.

increasing by more than 4% for five consecutive months this year. The continuing trend in rising prices can be explained by the jump in agricultural and fisheries prices earlier in the year and by the recent rise in international oil and commodities prices.

The trend of rising prices is expected to slow after the second-half of this year, as slowing world economic growth impacts rising oil and other commodity prices, but price instability will likely persist during the second-half as price hikes for public services that have been postponed kick in with price increases for private services and industrial products.

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Concerns of Financial Instability from Jump in Household Debt

Korea's household debt was KRW801.4 trillion as of the end of March 2011 after growing on an annual average of 12.7% from 2000-2010. This is far higher than the annual growth in GDP. Korea's disposable income-to-household debt ratio, which measures the ability of households to service debt, is approaching 150%, higher than the 130% of the US at the height of the sub-prime mortgage debacle. What's more, the seriousness of the household debt problem is highlighted by the fact that Korea's debt repayment ratio actually rose between the 2007 and 2009 crisis period from 136% to 143% when the US and UK saw the ratio fall from 136% and 172% to 126% and 168%. It is further expected that weaknesses will only become more aggravated when interest rates readjust, since those in the low-income brackets have mainly relied on financing loans through non-banks after the global financial crisis rather than through banks.

Household debt does not appear likely to aggrandize as systemic risk in the short-term.

When considering that the delinquency rate for household debt at banks is under 1% and that household debt is concentrated in high-income brackets than in low, the household debt problem does not appear likely to metastasize into

systemic risk, at least not in the near-term. But it is clear to see why household debt has become the biggest risk factor in Korea, not only because the biggest proportion of household debt is based on short-term floating-rate mortgage loans and structured for principal balloon repayment, but also because any deterioration in economic conditions, such as increase in interest rates, a fall in real estate prices, or instability in the international financial markets, can quickly lead to household insolvencies once a loss of confidence in non-banks spreads across the financial system.

Possibility of Sudden Inflows and Outflows of Capital

Much of the massive liquidity that was made available by a significant number of countries in order to overcome the crisis started to flow from 2009 into the relatively financially sound and growing emerging countries. But after migrating out of emerging markets for inflationary and international uncertainty reasons during Q1 this year, it flowed again into emerging markets in the latter part of March. In tandem with global capital flows, foreign capital inflows and outflows have been very volatile in the case of Korea also.

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With developed countries expected to maintain an easy monetary policy far into the foreseeable future and with growth in emerging economies expected to continue, Korea and other emerging countries can expect to see the trend in capital inflows continue. But sudden outflows from emerging countries are also possible after the second-half of 2011 through a flight to quality if interest rates rise in developed countries and over concerns of global inflation. Should volatility in international capital migration grow, an open economy like Korea could again face difficulties brought on by a lack of foreign currency liquidity.

Distress in Real Estate PF Loans & Restructuring of Savings Banks

Total PF loans of the financial sector stood at KRW66.5 trillion, including KRW 38.7 trillion held by banks and KRW 12.2 trillion by savings banks.

As of the end of 2010, the financial sector held a total of KRW66.5 trillion in PF loans stood, including KRW38.7 trillion held by banks and KRW12.2 trillion by savings banks. Also as of the end of last year, the PF loan delinquency rate at banks and savings banks were high, each holding 4.25% and 25.14%. But when the distressed PF loans held by the most seriously affected savings banks are excluded, banks and other financial institutions have the capacity to address the troubled loans independently. Concerted efforts are being made to hasten the normalization of savings banks. For instance, financial authorities designated as insolvent 7 of the 8 savings banks that were forced to suspend operations due to PF loans. But because other savings banks could become insolvent in the second—half, a financial stabilization plan needs to be urgently adopted.

Direction of Future Countervailing Policies

With many internal and external uncertainties lurking in the second—half, the policy outlook is unclear, especially given the possibility for a flood of demands being made with the 2012 parliamentary and presidential elections on the horizon. An effort must be made for active policy—making to address the economic uncertainties in Korea lest external economic conditions take a turn for the worse and foreign investors cite Korean economic weaknesses to cause a revisit of the difficulties of the Asian currency crisis. In turn, the government needs to set preemptive countermeasures to address weaknesses in the Korean economy by basing second—half economic policies on stability.

Preemptive countermeasures should be set to address the weaknesses in the Korean economy by basing second-half economic policies on bringing about stability to each economic sector.

First, the policy of gradually raising interest rates needs to be maintained in order to stabilize prices, which is the highest priority on the Korean economy's policy agenda. An appropriate increase in interest rates will not only

have an impact on stabilizing prices, but it will also help resolve the household debt problem by discouraging demand for new loans. But with household debt already high, the size and timing of any interest rate increase should be weighed with gravity as any increase will go towards raising interest expenditures and kicking an already down real estate market. Together with this, there is the need to set appropriate amount and timing adjustments while implementing the scheduled increase in public services so it does not upset psychological inflation expectations.

There is particular need to come up with detailed contingency plans against financial company distress and the metastasis of that distress into systemic risk.

Second, there is the need for joint efforts between policy-makers, financial institutions, and borrowers to resolve the problem of high household debt levels, which is the most pressing policy issue for the Korean economy. More than anything else, borrowers must take it upon themselves to lower the risk of default by limiting their borrowings to within their ability to repay, and choosing long-term, fixed rate, and periodic principal repayment schedules when they do borrow.

Financial institutions too should recall the serious problems brought about by the unrestrained lending practices of the past and control their lending to rational manageable levels of risk. By using the stress tests that assumed the deterioration of pre-existing loans, there is particular need to come up with detailed contingency plans against financial company distress and the metastasis of that distress into systemic risk. Financial institutions also need to lower the risk borrower default by increasing long-term fixed rate loans and making improvements in extending the period of deferment. To provide borrowers with incentives to repay, there is also the need to consider differentiating the terms according to the character of each borrower, including rates specific to each financial institution, variations in maturities, and conditions for repayment.

There is need for joint effort between policy-makers, financial companies, and borrowers to resolve the household debt issue, the most pressing policy measure for the Korean economy.

Policy–makers need plans to stabilize prices and control demand for loans through interest rate adjustments, namely the appropriate pace and level of increase. To direct the household debt ratio lower, policy–makers should introduce a capital allocation policy to prevent excessive competition between financial institutions and help maintain appropriate loan book levels. And financial supervision should be strengthened to stave off any sudden jumps in distress by examining for risk on a loan by loan basis. Together with this, policy–makers should run their efforts in parallel with those that would raise income through greater economic activity and job creating. This would help improve the capacity of households to service debt. Supplementary policies that would prompt more activity in micro–finance is also needed to eschew hardship concentrating in the difficult segments among household borrowers.

Insolvent savings banks should be made to quickly exit the market through stringent re-organizations in order to resolve the biggest source of uncertainty in the financial markets today.

Lastly, insolvent savings banks should be made to quickly exit the market through stringent reorganizations to resolve the biggest source of uncertainty in the financial markets at the moment. Doing so will help recover depositor confidence in savings banks while bringing about the conditions for sound savings banks to resume normal operations. Especially important during the restructuring process is to strictly enforce loss sharing between shareholders, creditors and depositors alike and clearly hold accountable those who are responsible. As it was during the Asian currency crisis, it must be recalled that the forced exit of insolvent and troubled institutions through prompt restructuring is ultimately the least costly and fastest route to financial market normalization. Furthermore, reforms should be undertaken for savings banks to once again return to sound financial institutions by extending credit to ordinary citizens as they were originally intended to do.

Focus & Brief

July 11 – July 15

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☐ Policy Issue In Focus:

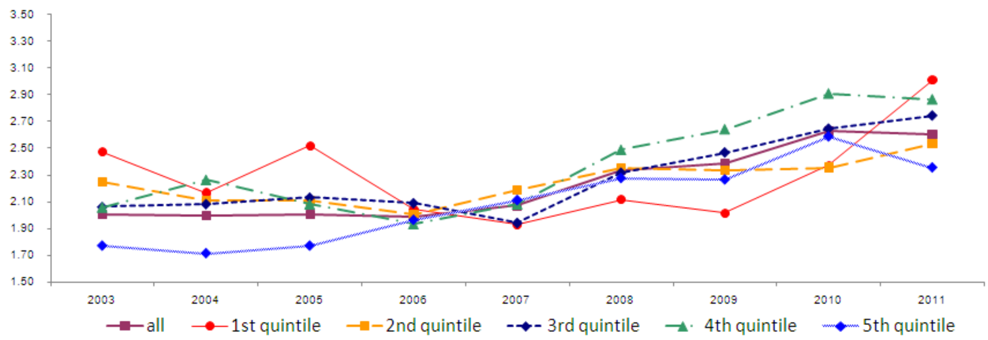
Trends in Household Interest Expenditures

(Hyoungsik Noh, *Research Fellow*)

■ **Overview:** Analyzed data from Statistics Korea Household Income & Expenditures shows household interest expenditure is trending continually higher. The rise in interest expenditures in 2010 appears to have mainly been a result of the increase in household loans from non-bank financial institutions. Closer monitoring of household borrowing costs is needed by supplementing the Interest Expenditures Index as borrowing costs were shown to be asymmetric with income brackets.

■ **Current Status:** According to Statistics Korea Household Income & Expenditures data, household interest expenditure is increasing. Interest expenditures, expressed as a ratio of disposable income against interest expenses, for all households stayed at 2.0% during 2003-2006 before starting to rise in 2007 until it hit 2.6% in 2010 and around the same level up to Q1 2011.

<Diagram> Interest Expenditures According to Income Brackets



(In quintiles, %)

Note: 2011 figures based on Q1 data

Source: Statistics Korea, Household Income & Expenditures

■ Interest expenditures continued to increase in 2009 and 2010 despite the fact that loan rates were falling during the two-year period, but this came about from the increase in disposable income slowing significantly in 2009 while interest costs rose sharply in 2010. As a result of a fall in market rates, interest expenditures either fell or rose only slightly for certain income brackets in 2009, which went to produce an average increase of 3.1% for all households for that year, but interest expenditures increased year-on-year for all households regardless of income bracket as the increase in disposable income fell sharply following the slowdown in the economy. In contrast, disposable income rose by 5.4% in 2010 along with the economic recovery, but interest expenditures rose for all households for the year as interest costs rose by 16.2%.

■ Household debt underwent a change in 2010 into one of high-cost structure, especially for the lower income brackets, as non-banks' share of the increase in household loans rose sharply and with it the application of loan rates higher than those of commercial banks. Of the KRW54.0 trillion increase in household loans in 2010, only 40.7% was made by commercial banks compared to 48.0% in 2009. In contrast, the proportion of household loans made by such non-banks as the National Credit Union, the Community Credit Cooperatives, and the specialized financial credit institutions grew markedly. With commercial banks focusing their household lending activities on mortgage loans, including mortgage-backed loans, interest rates impacted households more as demand for higher-cost unsecured loans concentrated in non-banks. Of the annual rate of increase in household loans by commercial banks, non-mortgage loans accounted for 9.5% in 2009 and 27.4% in 2010, much lower than the 64.0% in 2008. In contrast, non-mortgage household loans by non-commercial banks accounted for 63.8% in 2010, up sharply from 44.8% in 2008. This affected the 1st quintile the most with the average interest expenditure in 2010 rising to KRW23,000 from KRW18,000 in 2009 for an increase of 28.1% on year.

■ **Conclusion:** There is a need to closely monitor the changes in borrowing costs of households according to income brackets as the implementation of the household debt policy could affect the income brackets asymmetrically in the short-term. The strengthening of the LTD regulation on commercial banks could give rise to a structural change of household debt to one of high-cost by increasing non-bank household loans, something that could disproportionately affect low income brackets. While it is meaningful to monitor interest expenditures by using the Household Income & Expenditures data, there is also the need to include principal repayments in the Household Income & Expenditures data enabling a calculation of service ratio, which measures the cost of principal and interest repayments against disposable income. Furthermore, the remaining principal and average interest rate for each loan that is broken down in consistence with the repayment method can be sued to estimate the macroeconomic debt service ratio and used as supplementary data to debt service ratio calculated using

Household Income & Expenditures data. There also seems to be a need to consider developing comprehensive debt indices, such as the financial obligations ratio that the US Federal Reserve Board publishes quarterly together with the debt service ratio estimates.

☐ Policy & Industry News Briefs: July 11 – July 15

■ BOK Leaves Base Rate Unchanged

The Monetary Policy Committee of the Bank of Korea left the Base Rate unchanged at 3.25% on July 14. Among the reasons cited were economic weaknesses in Korea and overseas, concerns over increasing interest expenditures of households and companies, and easing inflationary pressures following three rounds of interest rate hikes this year. The Committee took particular consideration of the increased possibility of the fiscal crisis in the euro zone metastasizing from the periphery into the heart of Europe, such as Italy, as well as the economic downturn in the Unites States and the chance of a hard landing in China. Although sources of price instability still linger, the BOK is expected to continue being cautious on raising the rate for the time being given the Korean government's efforts to drive forward with countermeasures.

■ Strengthened Regulations on Credit Card Companies Announced

On July 7, the FSS strengthened regulations on credit card companies to prevent competition from overheating and to quell any jump in household debt. The regulations stipulate a percentage cap on growth in regards to credit card loans, the maximum chargable amount, minimum standards for issuance, and marketing costs. In setting the percentage growth on card loans and maximum chargable amount, the annual average growth of disposable income for the last five years was taken into consideration and capped at 5%. This will come into effect from the second-half of this year. A percentage growth rate of under 3% was set for new credit card issues to prevent

competition between card companies from overheating. And approximately 12% is expected to be set for marketing cost over total income increases.

■ June's Employment Figures Best in 11 Months

According to the Ministry of Strategy & Finance, the number of people who were employed in June rose by 472,000 from a year earlier, the biggest jump since July 2010. Much of the job gains came from increased demand for labor in the manufacturing and service sectors on the back of the economic recovery and favorable outlook for exports. The national unemployment rate fell 2bp on year to 3.3% at the end of June with the rate for the 15-29 age group dropping 7bp to 7.6% over the same period. The percentage of employed started climbing from January this year to reach 62.4% in June, the highest since 62.5% recorded in June 2008.

☐ Market Indicators: July 11- July 15

		2010 Avg.	June Avg.	July 11	July 12	July 13	July 14	July 15
Interest Rates (%)	Call Rate (1d)	1.97	3.19	3.26	3.26	3.26	3.27	-
	C D rate (100 million won)	2.63	3.53	3.59	3.59	3.59	3.59	3.59
	Industrial Finance Bond	3.38	3.70	3.79	3.73	3.74	3.74	3.73
	Corporate bonds (3yr, unsecured·AA-)	5.81	4.11	4.52	4.42	4.42	4.42	4.40
	Koran Treasurys (3yr)	4.04	3.65	3.81	3.71	3.71	3.70	3.68
	Nat'l. Housing Bonds (5yr)	5.10	4.39	4.21	4.10	4.10	4.09	4.06
KOSPI & Trade Value (KRW 100 mil.)	KOSPI (1January1980 =100)	1,764.99	2,078.98	2,157.16	2,109.73	2,129.64	2,130.07	2,145.20
	Trading Value	56,077	66,660	56,122	62,419	65,637	81,914	60,084
	Investment Balance	136,858	155,689	170,963	174,467	176,235	176,235	-
	Foreigner Net Purchases	859	-681	10,948	-38,555	-19,559	-5,090	-13,531
FX Rates	Won/Dollar	1,276.18	1,081.03	1,057.80	1,066.50	1,060.60	1,058.40	1,058.10
	Won/Yen	1,363.83	1,343.35	1,334.93	1,341.34	1,348.85	1,338.22	1,337.84
	Won/Euro	1,773.65	1,555.72	1,478.38	1,493.63	1,509.45	1,499.65	1,499.22

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