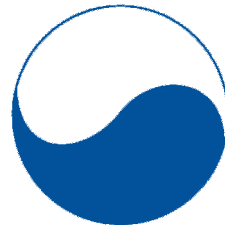

Korea's Economy 2005



a publication
of the
Korea Economic Institute
and the
Korea Institute of
International
Economic Policy

Volume 21

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NEW FRONTIERS OF FINANCIAL REFORM IN KOREA

by Kwon Jae-jung

Since the financial crisis of 1997, Korea has achieved many positive changes, ranging from stronger balance sheets for financial institutions to significant efficiency gains at the operational level. With respect to asset soundness of the financial service industry as a whole, nonperforming loans fell from 136 trillion *won* (about 20 percent of total loans) as of the end of June 1998 to 32 trillion *won* (about 3 percent of total) as of the end of June 2004. During the same period, the capital base of financial institutions also improved significantly. As a result of aggressive self-restructuring measures, including a drastic downsizing of the workforce and branch operations, the productivity of financial institutions sharply improved. Cleaned assets and enhanced productivity in turn improved financial institutions' profitability. The banking industry, for example, which has shown a relatively better performance since the 1997 crisis, also remained resilient in 2004 in spite of extremely sluggish domestic demand. In addition to financial-level and operational-level restructuring of financial institutions, the financial markets have enlarged on a solid basis and have improved their efficiencies.

Despite these significant changes, however, much work still remains ahead for Korea's financial system. This article reflects on what has transpired since the containment of the 1997 crisis and further discusses emerging issues. Prudence in lending policy exercised by financial institutions should be further improved. Although current problems are not likely to develop into systemic risk, corrective actions must be taken on problems emanating from excessive debts

carried by households and small and medium-size enterprises (SMEs). Funds flows should also be normalized by revitalizing the long-term capital market.

Prudence in Lending Policy

Because the financial crisis resulted primarily from lending institutions' imprudence in their lending policies, prudence in lending policies would be most important for the sound development of the financial industry.

A Granger causality test was used to ascertain with more precision the causal relationship between lending policy and rate of economic growth (*Table 1*). First, applying the test against the period running from 1980 to 1996, prior to the financial crisis, showed that the rate of growth in private loans was a causal factor in the rate of economic growth. We rejected the null hypothesis at a 5 percent level of significance but could not do so in the opposite direction. During this period, it was apparent that financial institutions' lending tended to encourage economic growth, and that numerous governmental financial policies supported this tendency.

For the 1997–2002 period, the test showed, conversely, that the economic growth rate caused the rate of growth in private loans. We were unable to reject the null hypothesis that the rate of growth in private loans at a 5 percent level of significance did not cause the economic growth rate. All in all, it might be said that, in the aftermath of the financial crisis,

Table 1: Granger Causality Test for GDP Growth and Credit Growth

Period	Null hypothesis	F-statistics (p-value)
1980–1996	GDP growth \neq > Credit growth	0.29 (0.59)
	GDP growth $< =$ Credit growth	4.24 (0.04)
1997–2002	GDP growth $=$ > Credit growth	10.58 (0.01)
	GDP growth $< \neq$ Credit growth	3.63 (0.07)
1980–2002	GDP growth \neq > Credit growth	2.74 (0.10)
	GDP growth $< \neq$ Credit growth	0.03 (0.87)

the tendency of the financial sector to aid the growth of the real economy significantly was reduced, and financial institutions' lending policies became more prudent.

It could be argued that the postcrisis boom-and-bust episode associated with the credit card business demonstrates Korean banks' inability to handle risk management properly. Although it would be difficult to deny this totally, it must be noted that numerous systemic changes and improvements have been made to prevent the recurrence of such problems. Since the financial crisis, the government, the regulators, and the banks together have made significant strides to reduce financial institutions' credit risks and improve their corporate governance.

Properties of Stability

The following section reviews the quality of the banks' loan assets in view of the financial system's stability.

Consumer Loans

The poor quality of Korean banks' assets in the aftermath of the crisis was aggravated by corporate loan delinquencies. It has also been adversely affected by the consumer loan delinquencies since 2002. The largest problem was caused by the spending behavior of people in lower-income brackets and by the younger generation. Cut off from financial access in the past, they began to use credit cards to spend beyond their incomes. If the refinanced claims are all delinquent and the asset-backed securities sold to divest the risk of delinquent credits are included, the amended delinquency ratio would exceed 40 percent. However, because there are now fewer newly delinquent accounts, the worst phase of the delinquency situation seems to be over.

After consumer-loan delinquencies spread to household credit and home equity loans, the banks were hit hard. Given the 269.1 trillion *won* of collateralized loans by banks and the 30.2 trillion *won* of lending by nonbanks (including those extended by savings banks and insurance companies) that comprise 21.2 per-

cent of the total assets within the financial industry as a whole at the end of June 2004, a steep depreciation of real estate property values may significantly affect the asset quality of the entire financial industry. According to the Bank of Korea, Korean households as of 2001 held approximately 83 percent of their assets in residential properties, including *chonse* deposits.¹ In effect, the shorter the maturity, the earlier the depreciation of real estate property values will take place. A deluge of available properties for sale will result, thereby fueling a far more aggressive depreciation of values and, hence, reducing debtors' ability to repay loans.

Rapid appreciation of real estate property values since 2000 has nonetheless been a global phenomenon caused by low interest rates. Moreover, given the continuation of low interest rates, any rapid depreciation of property values would be unwarranted. The 60 percent loan-to-value ratio the banks maintain is relatively respectable compared with ratios in advanced economies such as the United States and Europe. It is also unlikely that even a 20 percent depreciation would have any grave effect on the asset quality of financial businesses.

What is necessary, however, is extending the term of maturity because of the credit crunch potential arising from the concentration of short-term secured loans that mature in three years or less. If mortgagors roll over their mortgage loans rather than repay the principal, debtors' debt servicing capabilities would need to be improved. Although the banks are within reach of profitability on consumer loans, the level of exposure of nonbanks—especially mutual savings and credit cooperatives—to low-income-bracket customers will continue to affect their asset quality and profitability.

Loans to SMEs

Provided that there are valid prospects for banks' consumer loans, Korean banks' asset quality going forward would be based on their corporate exposure. Large corporate exposures have been reduced to 10 percent or less of Korean banks' total exposure. In

1. In Korea, most residential property is leased via the *chonse* system, which essentially gives the landlord a large deposit of 50–70 percent of the property's value. The deposit is returned to the tenant upon expiration of the lease.

spite of the reduction, however, they continue to be potentially detrimental to creditor banks, as shown by the recent SK Global case. More worrisome than the large corporate exposures are loans to SMEs.

Even in 2002, when the fast growth of consumer loans started to lose its momentum, loans to SMEs increased by 22.6 percent; this was followed by a 17.9 percent increase in 2003. Loans to SMEs thereby reached 45.4 percent of the entire loan portfolio, equivalent to 235 trillion *won*, within the banking sector at the end of 2003. In view of the continued slowdown of the national economy since 2002, the sudden growth of SME loans may place a heavy burden on the future asset quality of financial businesses. Statistically speaking, the delinquency ratio of SME loans seems to have followed the growth of Korea's gross domestic product with an apparent two-quarter lag. The recession under way since 2003 has the potential to contribute toward increasing the delinquency ratio of SME loans. While SME loans have increasingly been extended to nonmanufacturing businesses for domestic consumption, the continuing severe plight of domestic consumption could provide a basis for understanding that the SME loan situation is less propitious than what might be suggested by banks' financial statements.

Unlike credit card extensions of credit, however, approximately 50 percent of loans to SMEs are secured and the loan-to-value ratio remains at 45 percent. Loans extended to SMEs, whose cash flows and debt servicing capabilities are uncertain, would burden the banks on an incremental basis.² By the same token, Korean banks will continue to play a pivotal role in the corporate restructuring in progress.

Worthy of attention in connection with the restructuring of SMEs is the government's role in providing credit guarantees. Since the currency crisis, the scale of guarantees provided against bankruptcies has continued to grow even though the national economy has returned to its normal path. This essentially restricts an effective credit risk management in line with mar-

ket principles, further adversely affecting the restructuring of SMEs. It is also clear that evergreening the businesses having the least potential for survival via extending loan maturities and guarantees will only restrict competition and will result in greater losses being borne by financial institutions.

SME-related credit guarantees by the two government-owned credit guarantee funds³ grew from 17 trillion *won* in 1997 to approximately 50 trillion *won* by 2003. It is likely that the SMEs with lesser means of servicing their debts are surviving solely by relying on the renewal of the guarantees by their guarantors to extend their loan maturities. For the banks, because such guarantees provide loss coverage on the average of 85 percent for secured loans, maturity extension will not be a problem as long as the guarantees are properly obtained. These practices, however, result in reduced extension of guarantees and aid for startups. While Korea has a great deal of assistance in the form of guarantees for SMEs when compared with other advanced economies, its guarantees for startup business ventures are minimal. Thus, it would be a desirable policy to reduce guarantees for the SMEs and increase guarantees for startup ventures.

Short-Term Maturities of Assets and Liabilities

Since the second round of financial sector restructuring in Korea in 2000, the financial system's overall credit risk has declined, and its stability has been enhanced. Other concerns have surfaced, however. One concern is that market funds are taking on short-term investments, including bank deposits and money market funds of maturities of one year or less. As shown in *Figure 1*, the weight of short-term deposits compared with total liabilities has continued to grow, and recently the flow of funds has become unstable. Furthermore, the unstable flow of funds is the result of investors' seeking high returns from securities and real estate markets to a speculative extent. The greater weight of short-term deposits also translates into less efficient intermediation.

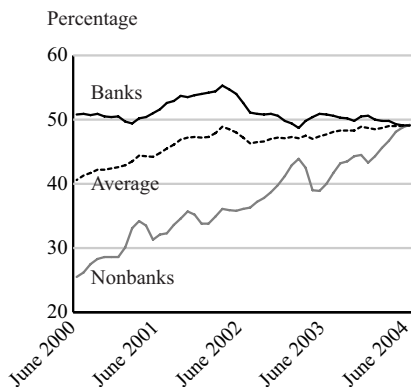
2. See the reports on corporate management periodically provided by the Bank of Korea in the Financial Statement Analysis section of the Bank's Web site, www.bok.or.kr/index.jsp.

3. These are the Korea Credit Guarantee Fund and the Korea Technology Credit Guarantee Fund.

One of the causes of this instability may be found in the declining yield rates from the perspective of funds supply. With the continuing economic slowdown since 2000, interest rates have remained at a low level. In this light, funds invested in long-term products were limited, making the short-term capital markets more attractive. On the other side of the equation, reduced demand in the long-term money market also was a factor. While the corporations' investment decisions were out of proportion to their ultimate goals—targeting expansion only by volume, so to speak—their recognition of the significance of healthy balance sheets since the 1997 crisis has resulted in their cutting back on their long-term borrowing. Furthermore, short-term borrowing has the benefit of a lower interest-payment burden than long-term borrowing, especially in today's low-interest-rate environment; the ease with which funding is readily available is an additional factor.⁴

At least for now, the attractiveness of short-term funds should continue for some time, provided that the supply of and demand for bonds and equities decline simultaneously. It would also be reasonable to conclude that the declining trend in interest rates will continue, together with persistent uncertainties in the performance of the economy and policies.

Figure 1: Percentage of Short-Term Deposits in Korean Financial Institutions, June 2000–June 2004



Source: Economic Statistics System (Seoul: Bank of Korea, various years), http://ecos.bok.or.kr/EIndex_en.html.

To be sure, shorter maturities of assets and liabilities held by financial institutions may well cause confusion within the financial markets by distressing stocks and real estate, making them vulnerable even small scale external shocks. In the real estate market, for example, false signals triggered by government policies may result in confusion, while the stock market would become dysfunctional and at a minimum invite speculative activities. With more than 42 percent of market capital owned by foreign investors in the Korea stock exchange, Korean individual and institutional investors alike are already concentrating on short-term trading.

Because of the shorter cycles experienced by the assets and liabilities of financial businesses, the liquidity risk within the financial system has been growing ever larger. Meanwhile, market participants continue to have an unsatisfactory level of recognition of the liquidity risk; hence, the infrastructures pertaining to accounting and credit valuation remain far less than required. Unfortunately, these risks are not yet reflected in the pricing of financial assets.

Primary examples would include the investors' trading patterns, their pricing processes, and the credit rating agencies' capability to evaluate card issuers' debts, which were apparent within the process by which credit card bubbles were formed. Given the insufficiency of client information, credit card issuers should have strengthened their credit risk management against the rapid growth of cash advances and unsecured credit card loans. It is a discipline that they could have exercised but have left unexercised to date. For issuers seeking fast expansion of their businesses without due diligence regarding their clients' creditworthiness, risk premiums corresponding to liquidity and credit risks should have been required.

It is also important to understand that the growth of liquidity risk and insufficient recognition are not limited to credit card issuers or financial companies more broadly. Notwithstanding the lower debt ratios attained by corporations, improvements to their financial structures and short-term indebtedness have been achieved only to a limited extent. Although the average debt

4. It is also noteworthy that corporate use of short-term instruments like commercial paper to repay corporate bonds provided part of the cause.

ratio of domestic companies as of the end of 2003 came to 123.4 percent, compared with 154.8 percent for U.S. companies, the proportion of short-term debt averaged 54.8 percent, considerably higher than the 17.0 percent for U.S. companies. This appears to be mostly caused by the preference for short-term capital because of the persistent gap between short-term and long-term interest rates as well as the uncertainties many companies face in raising long-term capital in the debt and equity markets because of market volatility.

Growing Dependence on the Banking Industry

Given that Korea's industrial structures are device oriented,⁵ the financial system needs to be developed with the focus on capital markets rather than on banks. Korean businesses in the past may be said to have relied upon banks for long-term investment financing, thereby causing increased maturity mismatches and systemic risks. To resolve these problems, it would be desirable to increase the weight of corporate financing through the direct financing market, as is conventional in other advanced economies.

To achieve more stable corporate funding and capital markets, Korea needs to further develop its market for long-term corporate bonds. A shallow corporate bond market indicates structural weaknesses of the market. In advanced economies such as the United States but not in Korea, the stock and bond markets mutually complement each other. Thus, Korea has not efficiently absorbed shocks, such as credit events, that may arise domestically and abroad; this inability has resulted in capital being pushed in a single direction and a significant increase in the scale of variance in the pricing of all types of financial assets.

Although long-term investors and short-term traders should coexist, financial businesses such as securities companies and investment trust companies have been sensitive to short-term capital gains. National pension funds are probably the single best example of the long-term bond investor; however, it is likely that the base for the demand for corporate bonds will grow if the weight of pension funds and insurance is greater

within the market for long-term investments. In addition, successful introduction of derivative products would help resolve maturity mismatches and manage interest rate variances, among other risks.

Conclusion: Future Tasks

Despite great changes in Korea's financial industry and markets, much work still remains to be done for Korea's financial industry to be globally competitive. Continued efforts must be made on the issues that remain despite the restructuring initiatives undertaken to date. Efforts need to be made in respect of mutual savings banks and credit cooperatives, and corrective actions must be taken on structural problems such as excessive debts carried by households and SMEs.

For financial businesses to enhance their competitiveness, sound competition structures need to be in place, and mechanisms that prevent the proper exercise of the financial market's dynamics need to be removed. Policymakers should work on implementing more effective and streamlined regulations that eliminate obstacles that may dampen market dynamics; they should also fully support sound competition among financial institutions. Furthermore, supervisory incentives need to be reformed to help continue the restructuring efforts of financial businesses at the operational level, such as risk management and corporate governance improvements.

Capital markets must also be further vitalized and their infrastructures enhanced to introduce market-centric virtuous patterns of cash flows. To improve market participants' confidence, systemic reforms to corporate accounting must continue, as well as enhancement of disclosure systems to ensure that information is sufficient and delivered in a timely manner to the investors. Meanwhile, other systemic improvements are needed to provide a basis for institutional investors' growth on both qualitative and quantitative bases.

Another important task is to detect and preempt potential risks that can arise from ever-changing market environments. Continuous monitoring and early-warning systems make it possible to detect problems ear-

5. Korea's important products—ships, semiconductors, automobiles—depend on equipment and devices.

lier and take measures in advance, thereby reducing contagion and restructuring costs. It is imperative that risk-based supervision focusing on financial businesses' risk management capability be in place. Developments are also necessary to improve methods and procedures of supervision and examination, thereby creating market-friendly customs and practices. In addition, preparation by and collaboration among regulators and financial businesses are required in order to meet successfully the challenges of the new Bank for International Settlements agreements and compliance requirements within the next couple of years.

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