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# PROSPECTS FOR DEVELOPING KOREA'S FINANCIAL MARKET IN 2005

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## Financial Market Outlook in 2005

### *Bond Market*

Recently in Korea, the yield of a government bond with a three-year maturity fell to approximately 3 percent per annum. This historically low interest rate has been caused mainly by the sluggish economy since 2002 and the ample liquidity supplied by the Bank of Korea (BOK) as it tries to stimulate the economy. "Flight to quality," demonstrated by financial institutions, also played an important role in bringing about this new era of low interest rates. The BOK cut the target call rate by 50 basis points in November 2004, contrary to the general perception that the BOK would freeze the rate in order to preliminarily curb inflationary pressure caused by high oil prices.

In 2005, the Korean government will continue to take an accommodating stance in monetary policy as it has done for the past three years. The government will exert virtually every effort to revive the economy. As a result, liquidity will be sufficiently supplied, and large fiscal stimulus provisions (tax cuts of 2.5 trillion *won* and extra fiscal spending of 5.5 trillion *won*) will be arranged for 2005.

Although the flight to quality and sufficient liquidity supplied to financial intermediaries will make the demand for bonds exceed the supply of bonds, the government will increase the supply of government bonds. Nevertheless, the downward pressure on the interest rate will still be strong throughout the whole of 2005.

The interest rate will continue to stay low enough to make the real interest rate negative, a condition owing to the higher inflation pressure caused by high oil prices and prolonged recession. The rate of inflation will stay at a considerably high level because of high oil prices even though the aggregate demand is weak. Meanwhile, the nominal interest rate is expected to continue its downward trend because of the accommodating monetary stance and economic recession.

Judging from the factors affecting interest rates, we can expect that interest rates will fall again in 2005 (***Table 1***). The yield on a government bond is expected to stabilize at approximately 3 percent per annum. However, the degree to which the interest rate will fall will be small because of high inflationary pressure coming from high oil prices and the economic recovery, which is expected to come about in the second half of 2005.

***Table 1:*** **Interest Rates in Korea, 2003–2005**

| | 2003 | 2004 | | | | | 2005[a] |
|---|---|---|---|---|---|---|---|
| | | 1Q | 2Q | 3Q | 4Q | Annual | |
| End of period | 4.9 | 4.6 | 4.3 | 3.6 | 3.4 | 3.4 | 3.0 |
| Period average | 4.5 | 4.8 | 4.4 | 3.9 | 3.5 | 4.1 | 3.3 |

Source: Economic Statistics System (Seoul: Bank of Korea, various years), www.bok.or.kr/index.jsp.
a The interest rate for 2005 is a forecast.

### *Stock Market*

The stock market in Korea showed sharp fluctuations in 2004. High oil prices, the Federal Reserve Board's increases in the interest rate in the United States, and expectations for a slowdown of the Chinese economy eroded investors' confidence, thereby resulting in a depressed stock market during most of 2004. Late in the fourth quarter of 2004, however, stock prices began to increase thanks to the public's improved perception of the government's willingness to revive the economy. This trend continues even in early 2005 as indicators imply that domestic consumer demand is coming back from the dead. However, it may be too early to conclude that the stock market has regained its full power because facility investment is still showing a very modest pace of recovery. Stock prices in 2005 will depend on the degree of domestic aggregate demand and the degree to which exports can maintain their high pace. The current upward pace of the stock market may easily lose momentum if consumer demand falters owing to huge debt burdens, if exports fall because of a slowdown in the world's demand for information technology, or if the Chinese economy cools, unless there is a sufficient increase in domestic investment.

### *Foreign Exchange Market*

During 2004, the *won* underwent occasional episodes of temporary depreciation against the dollar when foreign investors took their money out of the Korean market, when the U.S. Federal Reserve Board was expected to raise the interest rate, and when the *yen* depreciated against the dollar. However, in general, the *won* continued to appreciate against the dollar throughout the whole of 2004. The main factor in the *won*'s appreciation was the large surplus in Korea's external balance.

The U.S. current account deficit is expected to continue to increase during 2005, which means that Korea's surplus with the United States will also increase and that an even stronger *won* will result. If consumer demands continue to rise without faltering and exports keep rising thanks to a growing demand for imports from economies such as China and India, it seems that there is virtually no policy tool able to curb the *won*'s appreciation against the dollar. The government's intervention in the foreign exchange market has its limit. The annual average for the *won*-dollar exchange rate will be approximately 950 during 2005.

## Financial Industry Outlook in 2005

### *Banking Industry*

The Korean banking industry has received a lot of support since the 1997–98 Asian crisis. Public funds injected by the government amounted to 86.8 trillion *won.* Unfortunately, the Korean banking industry is still inefficient compared with the world standard. Moody's competitiveness index in the banking area ranks Korea number 46 out of 61 countries. Nevertheless, Korea's banking industry has made progress (***Table 2***). Total assets of commercial banks are gradually increasing, from 697.2 trillion *won* in 2003 to 717.6 trillion *won* in the first quarter of 2004. Profitability is also improving, mainly from investment of profits from stocks and bonds. The banking industry is also becoming more stable and sound. The Bank for International Settlements ratio (a minimum capital/asset ratio) has been stabilized at approximately 10.5 percent since 2000.

***Table 2:*** **Indicators for the Banking Industry in Korea, 2000–2004**

| | 2000 | 2001 | 2002 | 2003 | 2004[a] |
|---|---|---|---|---|---|
| Total assets[b] | 516.6 | 558.1 | 636.5 | 697.2 | 717.6 |
| BIS[c] (%) | 10.5 | 10.8 | 10.5 | 10.5 | 10.9 |
| BLR[d] (%) | 8.8 | 3.3 | 2.4 | 2.7 | 2.6 |

Source: Financial Statistics (Seoul: Financial Supervisory Service, various years), http://english.fss.or.kr/en/englishIndex.jsp.
a Through the second quarter of 2004
b *Won,* trillions
c Bank for International Settlements ratio
d Bad loan ratio.

In 2005, the growth rate of total assets will be slower as long as the economic recovery is delayed and the interest rate is low. The delayed recovery will make home loans and investments in stocks and bonds less profitable, and the low interest rate will reduce the inflow of funds into the banking sector, leading to slow growth of assets. However, the outlook for Korea's economic recovery is now a bit brighter than it was at the end of 2004, and Korea feels its banking sector will grow faster than earlier expected.

Profitability of the banking sector will also continue to show robust improvement in 2005. Asset growth will be somewhat limited because most financial institutions are running their businesses with extreme care in an effort to reduce the level of current and risk of newly generated bad loans. Fee revenues—a safe way to secure profits without exposing the bank to risk—are one of the main sources of growth for banks. The share of fee revenue out of total profits is expected to rise quickly during 2005. In 2005, the continuing decrease in credit card loans that began in 2003 will be another factor making for a healthier banking sector. Bancassurance,[1] which will be launched in April 2005, is also good news, suggesting a rise in profits of the banking sector.

1. Bancassurance refers to the business of insurance that is operated by banks.

***Securities Industry***

Profits dropped greatly in the securities company sector in 2004 because trading volume lost its growth momentum and competition became fierce among securities companies. Total sales for securities companies amounted to 3.58 trillion *won* in the first half of 2004, falling 5.35 percent compared with the same period in 2003 (***Table 3***). Net profits dropped much faster. They declined 63.7 percent between 2003 and 2004. All but two securities companies (19 out of a total of 21) recorded major losses in 2004. The gloomy

***Table 3:*** **Indicators for Securities Companies in Korea, 2004**

| | First half of 2004 *won,* trillions | *Growth rate* (%) |
|---|---|---|
| Total sales | 3.58 | –5.35 |
| Operating profits | 0.22 | –61.59 |
| Net profits | 0.19 | –63.66 |

Source: Financial Statistics (Seoul: Financial Supervisory Service, 2004), http://english.fss.or.kr/en/englishIndex.jsp.

performance of securities companies was mainly a result of the depressed economy; therefore, the outlook for the securities business in Korea does not look bright in 2005 unless there is a sufficient economic recovery.

Worse, securities companies do not have competitive advantages against banks. Banks are not regulated when they trade over-the-counter products, but securities companies face many restrictions. Equity-linked deposits provided by banks are protected by deposit insurance, while equity-linked securities provided by securities companies are not insured. Tax-exempt products and pension-fund products are open only to banks, not to securities companies.

There is, however, good news for securities companies. In 2005, securities companies will be permitted to trade cash management accounts (CMAs). Securities companies will be freer to invest customers' funds into many different investments such as commercial paper, certificates of deposit, and government bonds through the CMAs. Securities companies are currently selling money market funds (MMFs), which are similar to CMAs, but MMFs have been recording low profits. CMAs are expected to be a new, major profit source for securities companies.

Meanwhile, the government plans to reform regulations regarding the securities industry in order to upgrade Korean securities companies into big investment banks such as Goldman Sachs and Lehman Brothers. Falling profits in the Korean securities industry and in domestic securities companies are leading companies to develop many different sources of profits, just as done by large non-Korean securities companies. In other words, Korean securities companies are being asked to become larger and more specialized to survive.

***Insurance Industry***

**Life insurance.** The life insurance industry in 2005 is expected to experience a slowdown in its growth momentum because of tougher competition with banks and stagnating sales due to the delayed economic recovery. Therefore, total operating profits in the life insurance industry will be growing only modestly in 2005. As banks increase their bancassurance products, they will attract customers and may win a good share of the insurance market away from the insurance industry. This will be a major threat to the life insurance industry, bringing down the profit level of life insurance companies permanently even if the economy recovers. Thus, the possibility cannot be ignored that the life insurance industry could enter a long-term recession regardless of the macroeconomic environment.

One special feature of the life insurance industry is that companies based in foreign countries are taking over an increasing share of the Korean life insurance market. In the first half of 2004, foreign companies recorded a steep growth of 35 percent per annum, and their market share increased to 12.1 percent (***Table 4***). Also in the first half of 2004, the 23 life insurance companies listed in Table 4 earned insurance fees totaling 38.1 trillion *won,* an 8.4 percent increase compared with the same period in 2003. Twelve domestic life insurance companies earned 33.5 trillion *won;* this was a 4.3 percent increase year on year. In contrast, life insurance companies home-based in foreign countries earned 4.5 trillion *won,* which grew 35.5 percent compared with the previous year.

In 2001, the market share of foreign-based life insurance companies was only about 8 percent. It was 16.5 percent in the first half of 2004, rising from 13.2 percent in 2003 and 10.0 percent in 2002. In contrast, the three big domestic life insurance companies (Samsung, Daehan, and Kyobo) earned 17.1 trillion *won* and grew only 2.5 percent compared with the previous year. Market shares of the big three Korean life insurers dropped below 70 percent in 2004. If Met Life from the United States successfully takes over SK life insurance, the foreign-company market share would increase to 20.0 percent in 2005. The foreign market share could well rise to more than 20 percent sooner or later if the current growth momentum continues. Foreign life insurance companies are competitive in the area of new sales channels such as bancassurance, home shopping, and telemarketing. They are also competitive in the traditional sales channels, thanks to their expertise in this industry. Therefore, their robust growth trend will continue for the time being in Korea.

***Table 4:*** **Indicators for Life Insurance Companies in Korea, FY 2004**

| Domestic companies | | |
|---|---|---|
| **Company** | **Total fees, Apr–Sept 2004 *won,* trillions** | **Market share (%)** |
| Samsung | 8.51 | 22.4 |
| Dongyang | 7.24 | 19.0 |
| Shinhan | 7.02 | 18.4 |
| Daehan | 4.61 | 12.1 |
| Kyobo | 3.97 | 10.4 |
| Heunguk | 0.65 | 1.7 |
| SK | 0.61 | 1.6 |
| Kumho | 0.44 | 1.2 |
| Dongbu | 0.17 | 0.4 |
| Green Cross | 0.16 | 0.4 |
| Lucky | 0.11 | 0.3 |
| KB | 0.03 | 0.1 |
| **Subtotal, Domestic** | **33.52** | **88.0** |
| **Foreign companies** | | |
| ING | 1.14 | 3.0 |
| New York | 0.50 | 1.3 |
| Met Life | 0.45 | 1.2 |
| Prudential | 0.42 | 1.1 |
| SH&C | 0.10 | 0.3 |
| HANA | 0.09 | 0.2 |
| Lina | 0.09 | 0.2 |
| PCA | 0.08 | 0.2 |
| Allianz | 0.98 | 2.6 |
| AIG | 0.70 | 1.8 |
| CARDIF | 0.002 | 0.0 |
| **Subtotal, Foreign** | **4.552** | **12.0** |
| **Total** | **38.07** | **100** |

Source: Statistics (Seoul: Korea Life Insurance Association, various dates), www.klia.or.kr/eng/index.asp.

**Non-life insurance.** The delayed economic recovery in Korea and a slowdown in the auto insurance business will also slow the growth of the non-life insurance industry in 2005. The second phase of bancassurance and the fast-growing online auto insurance companies, especially, are expected to bring about the reform of the non-life insurance market during 2005.

In fact, net profits of non–life insurance companies increased greatly in 2004. During the first half of 2004, the 10 non–life insurance companies in Korea recorded net profits of 0.36 trillion *won,* an increase from 0.27 trillion *won* the year before, growing 35.9 percent. This large increase in profits was possible because companies were able to reduce their operating losses. During the first half of 2004, non-life insurance companies recorded operating losses of 0.22 trillion *won* compared with operating losses of 0.38 trillion *won* in 2003. Thus, operating losses decreased 42.4 percent. At the same time, the companies made large profits by investing their assets wisely in the financial markets. Profit generated from financial investment was 0.75 trillion *won,* big enough to cover up operating losses.

Online auto insurance companies are gradually gaining a greater market share. For the period between April 2004 and October 2004, fee revenue collected by auto insurance companies was 5.0 trillion *won.* Online auto insurance companies collected fees totaling 0.33 trillion *won* out of this total, resulting in a higher market share of 6.6 percent for online auto insurance companies. This market share is 1.9 percent higher than it was in 2003. Online auto insurance companies are able to offer insurance at a price roughly 15 percent lower than prices offered by traditional companies. Therefore, the demand for online insurance will continue to rise, and the market share of online auto insurance will exceed 10 percent in 2005.

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