Credit crunch impacts on South Korea

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The global credit crunch associated with the US subprime collapse is impacting on South Korea where incoming President Lee Myung-bak has been forced to deal with a looming credit card crisis and revise his predictions for economic growth downwards.

During his campaign in last month's election, Lee, the candidate of the right-wing Grand National Party (GNP), sought to galvanise support by promising to the revive the economy with his "747" plan—7 percent annual growth, per capita income of $40,000 and South Korea to become the world's 7th largest economy. In his New Year address on Monday, Lee reset his growth target to 6 percent.

Even this figure is optimistic. Economist Chun Chong-woo of Standard Chartered Bank told the *Financial Times*: "It will be difficult to achieve a 6 percent growth, given the US subprime turmoil. Korea's export growth is expected to slow to single digit this year as the US economy is likely to enter recession in the first half." The estimated growth for last year was just 4.8 percent.

South Korea's banks and insurers are believed to have only limited direct exposure to subprime mortgage loans in the US—estimated at about $850 million. However, the associated tightening of international credit markets and general financial instability is having an impact on the South Korean financial system.

Spurred on by the cheap credit policy initiated by the US Federal Reserve, South Korea, like many other countries, has been experiencing rapid growth in real estate and stock market speculation and in consumer debt in recent years. Aggressive lending by South Korean banks to small and medium firms last year left them unprepared for the sudden tightening of global credit markets last year.

The impact of the credit squeeze has been higher interest rates for small business and for millions of consumers with credit card debt. In the course of the election campaign, Lee, who is due to be inaugurated on February 25, promised an $11 billion bail-out plan to help 7.2 million troubled credit card debtors—one in every seven South Koreans. While the pledge was a populist pitch to voters, its real purpose is to shore up the banking system, which faces a wave of credit card defaults.

South Korea's last credit card bubble emerged in the wake of the Asian financial crisis in 1997-98. Consumer credit was made easily available to boost domestic spending. Amid growing financial hardship, many had no choice but to resort to credit. Credit cards surged to 105 million in 2002—up from 42 million in 1998—in a country of 50 million people. The bubble burst in 2004, when the number of defaulters skyrocketted by 41 percent to 3.7 million. Such was the distress that some committed suicide. The previous government of President Roh Moo-hyun was compelled to intervene to write off the debt of about one million people.

Credit card usage continued unabated, however. Last year witnessed a record high in credit card spending of 254.8 trillion won ($272.1 billion)—up 15 percent from 2006. Every economically active South Korean has on average four credit cards—as compared to five in the US. Although South Korea ranked just 34th in the world in per capita income in 2005, it was fifth in terms of per capita credit card spending. The country's six largest credit card companies, mainly related to South Korean conglomerates, reported a profit of 2.2 trillion won in 2006, compared to losses of 7.7 trillion won in 2003.

The danger of widespread credit card defaults is connected to the tight conditions in international credit markets. A recent study by JPMorgan noted that Korean commercial banks are heavily exposed, with a loan-to-deposit ratio of 130 percent—compared with the 60-80 percent in the rest of Asia. Deposits have continued to fall as money has moved into more profitable non-banking sectors such as the rising stock market. At the same time, the ability of the banks to raise funds has been hit by the sharply increased cost of inter-bank funding produced by the subprime crisis.

The problems confronting South Korean banks have been exacerbated by new government restrictions on overseas borrowing. As a result, banks, which are traditionally buyers of bonds, have resorted to issuing bonds to cover their rapid increase in loans. Last week for example, South Korea's largest lender, the Woori Bank, announced a new bond issue worth $300 million denominated in the Malaysian ringit. But the tight credit conditions are also reflected in a sluggish global demand for bonds, which is driving up interest rates. In the past two months, the average rate on the three-year treasury bonds in South Korea has surged by 0.38 percent to 5.89 percent. The result for South Korean consumers and small businesses is higher interest rates and greater financial burdens.

A Hyundai Research Institute study published on December 17 warned: "The instability in the bond market is a concern as it could lead to the Korean version of the subprime mortgage crisis... Many households will suffer a credit crunch if interest rates continue to rise and that is also the worst case scenario for banks and construction industry."

More broadly, the *Financial Times* warned: "Has the global credit crunch, having largely bypassed Asia, turned up in South Korea? With banks scrambling to secure funding and the three-month interbank rate at three-year highs, Korea's financial system is displaying some eerily similar signs of stress."

The Bank of Korea (BOK), the country's central bank, confronts a similar dilemma to that of the US Federal Reserve. Rising inflation indicates that the bank should lift interest rates even as signs of an economic downturn point to the need to cut rates. The BOK kept its interest rate at 5 percent in January, already a six-year high, even though the consumer price index in December jumped by 3.6 percent—above the BOK's target range of 2.5-3.5 percent.

Despite president-elect Lee's plans for 6 percent growth, the BOK is forecasting a slowdown to 4.7 percent for this year—compared to 4.8 percent last year. The main factors are an expected weakening of global demand for Asian exports and continuing high oil prices. The prospect of a US recession will also impact on Japan and China, which are major South Korean trading partners. South Korea experienced a significant export slowdown last month, recording its first monthly trade deficit since 2003. Foreign investment decreased last year for the third consecutive year to $10.5 billion—a fall of 6.5 percent from 2006.

Lee, who was formerly head of Hyundai's construction division, has proposed a series of measures to boost economic growth. In reality, he is preparing to shift the burdens of the growing economic crisis onto the working class. His party, the GNP, has been highly critical of the outgoing Roh administration's welfare spending. Lee has indicated he will slash public spending and privatise state assets in order to fund massive tax cuts worth 20 trillion won to encourage business investment. He plans to sell off government stakes in four large groups—Hyundai Engineering, Daewoo Shipbuilding, Hynix Semiconductor and Daewoo International—for an estimated $38 billion.

South Korea's official unemployment rate is currently just over 3 percent—among the lowest in the world. However, the undermining of the system of life-long employment over the past 15 years has led to a rapid growth of more poorly paid temporary and part-time jobs in line with corporate demands for a more "flexible" labour market. Official data shows a steady decline of full-time jobs in South Korea. In 2006, nearly 9 percent of employees worked for 30 hours or less per week—up from 7 percent five years earlier and just 4 percent 10 years ago.

Sections of voters, hostile to the impact of the Roh administration's free-market reforms, swung back to the GNP in the presidential election for the first time in 15 years hoping that Lee would improve their economic position. All the signs, however, point to a further economic slowdown, greater financial instability, increasing hardship for millions of South Koreans and a sharp political backlash against Lee.