KOREA: ECONOMIC OUTLOOK AND REFORMS FOR 2004

An Article
By Kenneth H. Kang
IMF Resident Representative in Seoul, Korea
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After several years of strong performance, the Korean economy suddenly slowed in 2003. On a quarter-on-quarter basis, GDP actually shifted into reverse, contracting by 1 percent during the first half of the year, as consumption declined sharply. Despite the impressive progress made over the past years, the slowdown was a reminder of the unfinished reform agenda facing Korea. Although growth appears to have resumed, it will be important for Korea to continue making progress in structural reform in order to realize its medium-term growth potential.

What were the factors behind the slowdown in 2003? First, Korea experienced a boom-bust in household credit. After the crisis, household credit, particularly credit card lending, expanded very rapidly, growing by almost 30 percent in 2002. Worried about the risks from this rapid credit expansion and rising credit card delinquencies, the government tightened lending standards and other prudential regulations. Credit card companies also responded to rising delinquencies by reducing their credit ceilings. As household lending slowed, so did private consumption which fell in the first half of 2003 and led the overall decline in GDP growth.

Second, the economy ran into several structural problems that have eroded business confidence and held back investment. Although Korea has made significant progress in restructuring since 1998, structural problems in the corporate and financial sectors still persist. The corporate sector remains dominated by the large *chaebol* whose corporate governance raises concerns in the market. Some large investment trust and credit card companies remain weak and are a source of financial distress. These structural weaknesses have left the economy vulnerable to shocks and held back growth.

As a result, the accounting scandal at SK Global in March 2003, the liquidity pressures at the credit card companies, and problems in the investment trust companies destabilized the financial markets and reduced investor's appetite for risk. Although prompt government action helped to stabilize the financial markets, investors remain cautious and have held back their funding for corporations, particularly for low-rated companies. Finally, labor strikes in the railway, trucking, banking and automobile sectors have also hurt business confidence and depressed investment, including from overseas.

However, we are now seeing signs that the economy is stabilizing and beginning to recover. In the 3rd quarter of 2003, the economy began to revive, with GDP increasing by 1.1 percent quarter-on-quarter, propelled by exports. In an encouraging sign, private consumption also expanded.

We are optimistic that a recovery is on its way in Korea. Recent data suggest that the economy is beginning to strengthen. Industrial production picked up strongly in December 2003; machinery imports—an important leading indicator for investment—have also increased, and business and confidence indicators have shown signs of improving.

Another reason we are optimistic is that growth in the rest of the world has also picked up. Third quarter GDP data for China, Japan, the United States, and Europe were better than expected and point to a continued strengthening of the global economy. For an open economy like Korea which still remains very dependent upon external demand, this is good news.

In addition, the government and the Bank of Korea have taken a number of steps to promote the recovery. The Bank of Korea has cut its target for the overnight call rate to an historic low of 3.75 percent to support the economy. Lower interest rates have helped reduce the debt service burdens for households, particularly those with large credit card debts, and reduced the cost of financing for corporations. The government has also passed two supplementary budgets, the most recent in October 2003 to address the worst typhoon damage in Korea's history.

On this basis, we are projecting growth to accelerate from 2½ percent in 2003 to 4¾ percent in 2004 (though this could be revised upwards in light of recent data). The recovery will initially be led by exports and then later be driven by consumption and investment. However, this recovery may not be the sharp "V"-shaped rebound as in previous recoveries. Large household debts, lingering problems with the credit card companies, and business uncertainty could weigh on private consumption and investment, holding back prospects for a vigorous recovery.

Of particular concern is the risks associated with household credit, especially credit card debt, which has increased significantly over the past years. Since 1999, household debt has roughly doubled while the official delinquency rate on credit card lending has risen from 6 percent in 2002 to 13½ percent in November 2003. Indeed, according to the FSS/FSC, if one includes rescheduled loans, the bad loan ratio for credit card loans would reach around 40 percent. As I mentioned earlier, the rising number of delinquent borrowers and structural problems in the financial sector have constrained growth in 2003.

For the credit card companies, it would be important to take prompt and decisive steps to restore stability and health to the sector. We support the FSC/FSS' policy to have these companies sign memoranda of understanding outlining their plans for restructuring. These plans should contain realistic estimates of current and future losses and steps to raise new capital. Companies that fail to meet their prescribed targets should be subject to prompt corrective action, including court receivership.

In addition, credit card companies need to strengthen their risk management so that they can better differentiate between good and bad quality borrowers. Here, encouraging greater information sharing among credit bureaus and by providing more "positive" data on payment histories and income would also help credit card companies to assess their credit risk and eventually move to a revolving credit card system. This system, which is common in other OECD countries, would allow creditworthy borrowers who are experiencing temporary cash flow problems to have more time to pay their bills.

Now, let me turn to the state of the financial markets. Compared to five years ago, Korea's financial markets are much more open, dynamic, and competitive. As a result, corporations have more sources of financing and face greater discipline from the markets. In terms of financial institutions, Korea's banking system has been significantly strengthened, and the government has made considerable progress in its re-privatization efforts, including with its sales in December of its shares in Kookmin Bank. Foreign investment has also played an important role in transforming the sector and bringing in new technologies and skills.

However, as the events of 2003 have demonstrated, the financial markets, particularly the corporate bond market, remain vulnerable to shocks and prone to distress. To further develop Korea's financial markets, I would point to three important areas.

First is the restructuring of the nonbanking sector, in particular the investment trust companies. In order to have sound financial markets, an economy needs sound financial institutions. Here again, the government has made good progress by completing the sale of Hyundai Investment Trust & Securities and by announcing plans to sell off the remaining two large government-owned ITCs in 2004. Returning these institutions to the private sector will help to transform the investment trust sector and further develop the capital markets in Korea. This is important because Korea needs a sound asset management sector and well-functioning capital markets to support its transition to a service sector and knowledge-based economy. This, of course, would also help achieve the government's goal of transforming Korea into a regional financial hub.

The second important area is corporate governance. Research has shown that countries with sound corporate governance and strong investor protection have deep liquid capital markets. Improved corporate governance will also allow companies to access cheaper financing and reward investors with higher returns. That is why we support the government's bills to improve accounting and auditing standards and to introduce class action lawsuits which will help build investor confidence in Korea by strengthening shareholder rights and improving the transparency of its financial markets. We also welcome the FTC's three-year roadmap for corporate reform which aims to ease regulations on *chaebol* that improve their governance.

Another way to promote corporate governance in Korea would be to introduce a "comply or explain" system, as done in many other OECD countries, for the existing Code of Best Practices in Corporate Governance. This code, issued by the Korea Corporate Governance Service (KCGS), provides useful guidelines for Korean firms to strengthen their corporate governance practices in such areas as shareholder rights, board of directors, and audit systems. A “comply or explain” system would require firms to either comply with the code or explain on an article-by-article basis why they are not complying. Introducing such a system for a core set of guidelines would help investors to better identify and reward those firms which are practicing sound corporate governance.

The last area is further developing the corporate bond market. Korea has one of the largest corporate bond markets in Asia. However, the market remains vulnerable to shocks and temporary periods of paralysis, particularly for low-rated issuers. One way to improve the liquidity of these lower-quality assets would be to enhance the quantity and quality of information to the markets. Last year, the government announced measures to improve the accuracy of bond ratings, including by requiring them to publish information underlying their assessments. In addition, it would be useful to enhance competition by allowing foreign firms to enter the industry without joint venture partners.

Another way to strengthen the market would be provide liquid benchmarks for pricing credit risk. The government’s plan to issue more longer-dated treasury bonds and to establish a national housing agency to issue long-term mortgage loans are positive steps. It would also be important to remove any perception of an implicit guarantees from investing in corporate bonds. Guarantees, whether explicit or implicit through a promise of a bailout, distort the markets, promote reckless lending, and discourage the kind of careful credit assessment that is needed in Korea to stimulate bond market development.

To sum up, the economy is now beginning to recover, and the outlook for the rest of the world is improving. Although growth appears to have resumed, it will be important for Korea to continue its progress in structural reforms in order to strengthen its economy against adverse shocks and to keep it on a sustainable path for rapid growth.