

OP-ED ON THE KOREA HERALD

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THE RISE IN KOREA'S SHORT-TERM EXTERNAL DEBT AND WHAT IT MEANS

In recent months, the run-up in Korea's short-term external debt has been flagged by some as a concern. True, this rise in debt could present some risks—notably the possibility of increased volatility or reversals of these flows—and so must be monitored closely. At the same time, however, these concerns should not be exaggerated, given that both the size of the debt and the causes of the increased borrowing suggest the risks to be manageable.

Sensitivities to the buildup in short-term debt in Korea are understandable. For it was excessive short-term external debt that was the epicenter of the financial crisis a decade ago. However, the situation today is very different. Prior to the 1997 crisis, short-term debt flows were mostly lent on a longer-term basis to overleveraged and unprofitable large corporates that operated under the aura of being “too big to fail”. These loans were given by domestic banks that lacked the ability and incentives to assess the risks involved in such lending under a fixed exchange rate system and weak financial supervisory oversight.

After a decade, Korea's fundamentals have improved dramatically. The corporate sector has deleveraged significantly and is profitable. The banking sector is healthy with high levels of capitalization and low levels of non-performing assets. Financial supervision has been strengthened significantly. And Korea operates under a flexible exchange rate system, which encourages corporates, banks, and individuals to better assess the risks of their financial actions and provides a cushion against external shocks. On top of this, Korea has built up substantial international foreign currency reserves which can act as a buffer against shocks.

How large is Korea's external debt?

External debt has indeed risen rapidly. Korea's total external liabilities increased by \$152 billion since 2007 to \$412 billion or nearly 40 percent of GDP in the first quarter of 2008 (from around 30 percent at end-2006). More than a third of this increase—\$62 billion—has been in the form of short-term borrowing.

Despite this increase, the outstanding amounts of external debt are still not unusually large when compared to the country's export earnings or international reserves, or when compared to other countries in the region. Korea's gross foreign currency reserves cover more than 100 percent of its payment obligations, including current account payments, as well as all

maturing debt obligations, although this coverage has declined since 2006 (Figure 1). In light of these sound fundamentals, Korea's sovereign rating is solid and its external debt remains in line with countries with similar credit ratings.

However, it is not only the size of flows that matters in ascertaining risks, but also the nature of these flows and how they are used.

What lies behind the recent increase in external debt?

The recent build up in short-term external debt is mainly attributable to foreign currency risk hedging activities of Korean exporters and Koreans investing in equity abroad. Typically, exporters—particularly shipbuilders—and domestic investors in foreign equities sell expected dollar receipts forward to domestic banks and foreign bank branches (FBB) in Korea, which then borrow dollars abroad to match their own currency exposure, thereby creating a capital inflow and adding to short-term external debt (Figure 2). Hedging of risks by exporters reflects their increased awareness of financial risks in the global marketplace and would help buffer their earnings against exchange rate shocks. The banks who engage them in these operations are also required by the supervisors to limit their risks associated with such flows.

This use of the external short-term debt appears to limit the likelihood of quick reversals. In particular, this type of borrowing has been particularly pronounced for FBBs, contributing to about 60 percent of the increase in short term debt in 2007, as they tend to have a larger share of the hedging market in Korea (Figure 3). To the extent a large portion of their borrowing comes from their headquarters the rollover risk involved in such operations would be limited, as their parent banks would likely not be willing to risk their international reputations by cutting off funding to their own branches. Also this type of borrowing is not subject to the same counterparty risk that has hampered the operation of the interbank markets globally. However, considering the heightened liquidity risks in global markets even for large international banks, close monitoring and cooperation with parent supervisors would need to continue, especially if the sources of funding were to shift from parents to third parties.

In addition, ship orders and Korean equity investments abroad via asset management companies have grown rapidly in recent years, suggesting a possible “stock-adjustment” element to these hedging related debt flows. These may moderate in the period ahead once desired hedging ratios have been reached. At the same time, reduced forward selling could result from a slowing in both the growth in ship exports and in equity investment abroad by Korean residents in the context of the global slowdown and financial market volatility.

But external borrowing has not been limited to FBBs. Domestic banks have also increased their foreign currency borrowing from abroad since 2006, although their reliance on external funding remains limited at about 7 percent of their total funding. This borrowing was partly

used to finance their foreign currency lending to small and medium enterprises (SMEs). This lending takes up only about 2 percent of banks' total lending portfolio and the substandard loans to SMEs remain low at 1.13 percent of total SME loans at end-March, 2008. But this should not distract the vigilance of bank risk managers and supervisors alike. With a slowdown in growth, the sustained high growth rate of bank lending to SMEs should be watched closely to ensure the credit quality of loans does not deteriorate.

What should be done about this?

While rising rapidly since 2006, Korea's short term external debt remains moderate in comparison to its export earnings or international reserves. The nature of these flows also limits the risks of rapid reversals, which could be disruptive. In the period ahead, these developments should be monitored closely. While it is tempting to impose explicit limits on borrowing, such limits have often proved ineffective elsewhere and could even increase financial sector vulnerabilities and adversely affect confidence. Korean authorities are focusing appropriately on further developing financial markets and strengthening financial supervision, consistent with Korea's ambitions to become a regional financial hub. Their efforts will help ensure that large capital inflows and outflows can be intermediated without posing undue risks to the economy.

Figure 1

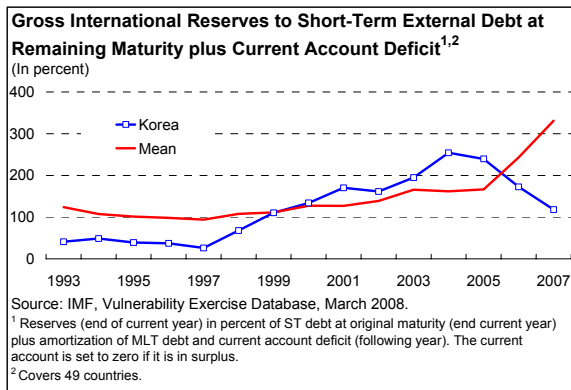


Figure 2

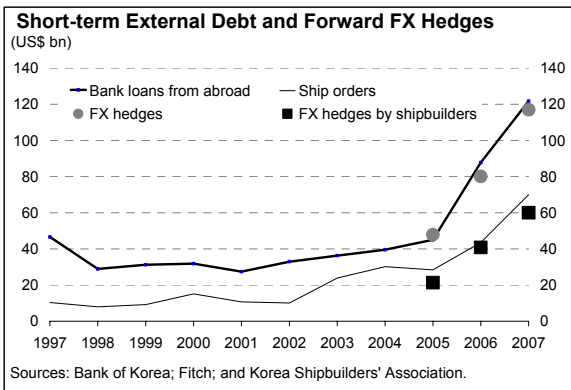


Figure 3

