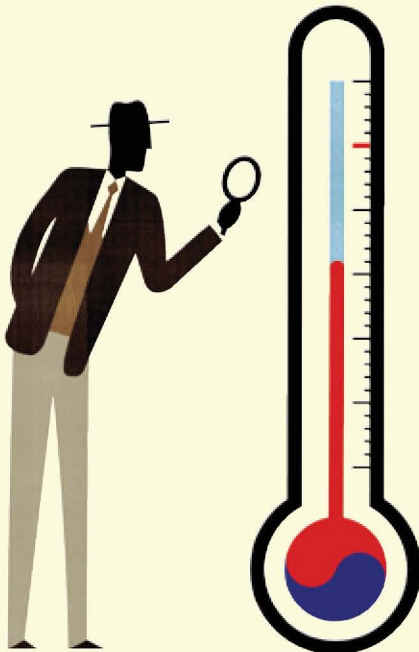


Low Possibility for a Repeat Crisis in Korea

JEONG Young-Sik



KOREA'S TROUBLED FINANCIAL MARKETS IN 2011

Korean financial markets have not escaped the extreme volatility stemming from the impact that the US and European sovereign debt worries are having on the global economy.

On October 4th the premium on Korea's Credit Default Swaps (CDS) reached 222.3 basis points, a more than 123.6-point spike from 98.7 basis points on July 5, while the won/dollar exchange rate surpassed the 1,200 mark during the intraday session. The next day, the bellwether Korea Composite Stock Price Index (KOSPI) plunged to 1,666 points as foreign investors unloaded their equity positions. Foreign financial institutions withdrew part of their lending money from Korea. The cost of borrowing money from overseas increased, temporarily halting major banks and companies' search for long-term foreign loans.

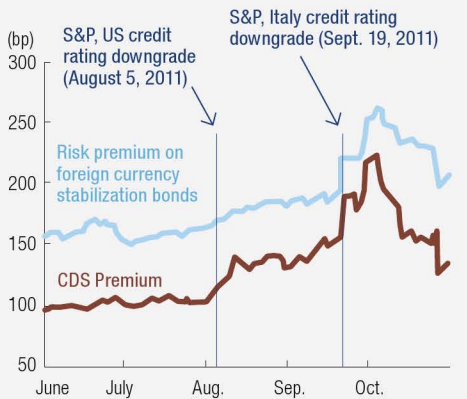
The spread between major banks' five-year foreign bonds and US government bonds soared to the 300-400 basis point range in early October from the 100-200 basis point range in late July 2011.¹ Due to the rising risk premium, some banks even postponed the issuance of foreign-currency bonds.² On the back of such unfavorable developments, worries are growing that the Korean economy could topple into another crisis.³

¹ Korea Development Bank: 168bp (late July 2011) 340bp (October 6, 2011) (up 172bp)
Woori Bank: 202bp (late July 2011) 425bp (October 6, 2011) (up 223bp)

² Hana Bank postponed the issuance of foreign bonds due to a rise in international interest rates. Hankyung (September 25, 2011). "Red light on for banks' dollar funding..... Risk premium on foreign currency denominated bonds rose by 1 percentage point in only 15 days."

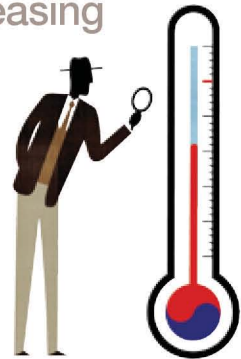
³ Morgan Stanley announced that Korea was the weakest among eight Asian countries (e.g., China, Malaysia and the Philippines) in terms of crisis response capabilities based on its coverage ratio for foreign borrowings and its loan to deposit ratio. Morgan Stanley (July 25, 2011). "Asia Credit Strategy. And if the Euro Debt Crisis Gets Worse."

Figure 1 Korea's CDS and Risk Premiums on Foreign Currency Stabilization Bonds



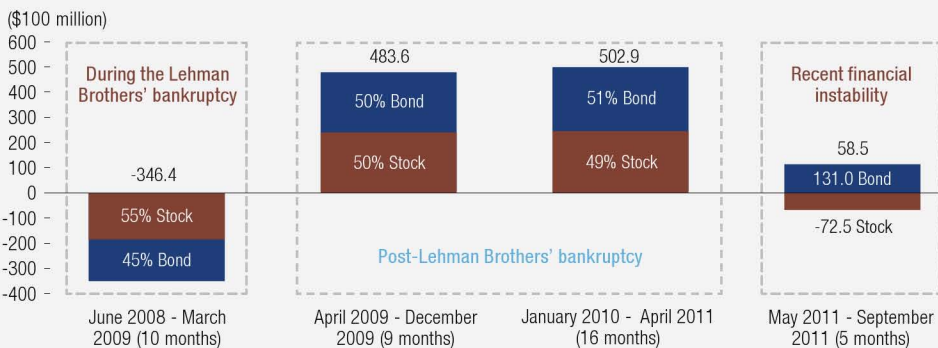
Source: Korea Center for International Finance; Bloomberg; Bank of Korea.

According to SERI's Financial Stress Index, Korea's financial markets entered the unstable range on increasing uncertainties.



According to SERI's Financial Stress Index,⁴ Korea's financial markets entered the unstable range (10.5-25.7) on increasing uncertainties. The index rose from 3.1 (the stable range) to 18.9 from July-September 2011 but remained comfortably below the crisis range (25.7-100) and far from the 56.6 level seen during the global financial crisis in October 2008. The biggest contrib-

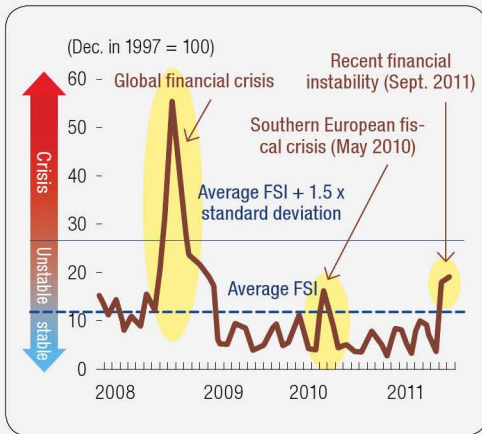
Figure 2 Trends in Foreign Capital Movement



Source: Korea Center for International Finance; Bloomberg; Bank of Korea.

⁴SERI Financial Stress Index, a comprehensive assessment of Korea's financial markets (financial intermediary, stock markets, foreign exchange markets), consists of eight sub-indices. The higher the index is, the higher the volatility in financial markets.

Figure 3 SERI's Financial Stress Index and Contribution Rate by Factor



Category	Foreign exchange market	Stock market	Financial intermediary market
Global financial crisis (June-Oct. 2008)	44.5%	33.2%	22.3%
Southern European fiscal crisis (Mar.-May 2010)	56.8%	39.3%	3.9%
Recent financial instability (July-Sept. 2011)	44.3%	49.1%	6.6%

Note: The contribution rate of each component= (change in each component/ change in FSI) X 100. This represents the contribution of each component to the increased amount (the sum total is 100).
 Source : Samsung Economic Research Institute.

utor to the recent rise in the index was the stock markets (49.1 percent) and the foreign exchange market (44.3 percent). The contribution rate of the financial intermediary markets was 6.6 percent, much lower than those for the stock and foreign exchange markets. It is not an exaggeration to say that Korea's financial instability is fostered by stock and foreign exchange market anxieties.

SLIM CHANCE FOR A 2008 RERUN

Since conditions both at home and abroad are better than those prevailing during the 2008 crisis, chances are slim that the Korean economy will face another crisis on the magnitude of the 2008 upheaval.

Externally, there is slim possibility that Europe's fiscal crisis will spiral into a global crisis. Though Europe's fiscal crisis will not be resolved in the short term, financial contagion is unlikely to overwhelm it as a whole, and the eurozone will not disintegrate. Accordingly, inves-

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Table 1 2011 vs. Pre-2008 Financial Crisis

Category		2011	2008
Foreign Exchange Soundness	Foreign currency reserves	\$311 billion (late October)	\$258.1 billion (late June)
	Proportion of short-term foreign debt	37.6 percent (late June)	48.2 percent (late June)
	Current account balance	\$12.2 billion (Jan.-Aug.)	\$680 million (1st half)
Bank Soundness	Loan-to-deposit ratio	98.4 percent (late July)	112.4 percent (late Aug.)
	BIS ratio	14.4 percent (late June)	11.4 percent (late June)
Measures to Secure Financial Stability		Ceiling lowered on financial firms' positions on currency forwards and levy on banks' foreign-exchange borrowings	Insufficient preventive measures

Source: Bank of Korea; Financial Supervisory Service.

tors' preference for safer assets will appear only on a limited scale, and Korea and emerging countries are unlikely to suffer from a large-scale foreign capital flight.

Internally, Korea's economic fundamentals (e.g., foreign exchange soundness and banks' financial health) have improved substantially since the 2008 crisis. For example, current account surpluses were posted for 19 consecutive months starting in March 2010. The proportion of short-term foreign debts to total foreign debts also declined from 48.2 percent in June 2008 to 37.6 percent in June 2011.

Foreign currency reserves are up substantially. They reached \$311 billion in October 2011, a \$110.5 billion increase above November 2008 (\$200.5 billion).

Bank soundness has improved as well. The loan to deposit ratio, an indicator for bank soundness, declined to 98.4 percent in July 2011 from 112.4 percent in August 2008. Reflecting improved fundamentals, Korea's sovereign credit rating was upgraded while those of European nations, the US, and Japan were downgraded.⁵

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Moreover, the international community (e.g., the International Monetary Fund) positively assessed⁶ the Korean economy as better than its 2008 state.

In addition, Korea's financial authorities are implementing a variety of measures to stabilize its financial markets and will take additional actions, if necessary. It has emphasized prudential measures for financial institutions and corporations by strengthening rules on banks' foreign currency liquidity ratios in 2009, and those on currency forward positions in 2010. The authorities also imposed taxes on foreigners' bond investments at the same rates as for domestic residents while introducing a levy on non-deposit foreign currency denominated liabilities held by banks, the so-called "bank levy," in 2011. These will be helpful in fortifying stability in the domestic financial markets by curbing surges in

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Table 2 Korea's Measures to Secure Financial Stability

Measures	Details
Prudential measures on financial institutions' foreign currency trading (announced in November 2009)	<ul style="list-style-type: none"> Regulations on foreign currency liquidity ratios were strengthened.
Controls on foreign capital movements (effectuated in October 2010)	<ul style="list-style-type: none"> Ceilings on currency forward positions were imposed in regard to financial firms' equity capital (40 percent for domestic financial firms and 200 percent for foreign bank branches). Banks were required to raise their mid- to long-term foreign-exchange borrowing from 90 percent to 100 percent of their mid- to long-term FX lending. Ceilings for currency forward transactions were lowered from no more than 125 percent to 100 percent of foreign currency denominated revenues. The use of foreign currency lending was restricted to overseas investment.
Taxes on foreign investors' bond yields (Imposed in January 2011)	<ul style="list-style-type: none"> A 14 percent tax was imposed on interest income and a 20 percent tax was imposed on capital gains earned by foreign investors on local bond investments.
Bank levy (Introduced in August 2011)	<ul style="list-style-type: none"> Banks were subject to a levy on their non-deposit foreign exchange liabilities (0.20 percent for liabilities maturing in less than one year, 0.10 percent for those maturing in less than three years, 0.05 percent for those maturing in less than five years and 0.02 percent for those maturing in five years or later).

Source: Ministry of Strategy and Finance ("Macro-prudential measures to lower capital flow volatility" June 13, 2010; "Government position on taxation on foreign investors' bond investments" November 18, 2010; and "Plans to introduce macro-prudential stability levy" December 19, 2010).

⁵ On November 7, 2011, international ratings agency Fitch announced that it would upgrade its outlook on Korea's sovereign debt from A+ (stable) to A+ (positive). Fitch had maintained the stable outlook (A+) on Korea since it raised its outlook for Korea to A+ in October 2005. Fitch Ratings (Nov. 7, 2011). Fitch Revises Korea's Outlook to Positive.

⁶ Subir Lall, division chief in the Asia and Pacific Department of the International Monetary Fund said "Korea will not face an international balance of payments crisis even if another global financial crisis arrives." <http://www.keia.org/embeddedvideo/near-term-outlook-korean-economy-imf-report>.

Table 3 Foreign Investment in Korea (As of late October 2011)

(Unit: \$100 million, percent)

	Holder	Amount	(Percentage)
Stocks	Total	10,760	100.0
	Foreigners	3,310	30.8
	European	1,010	9.4
Bonds	Total	10,700	100.0
	Foreigners	780	7.3
	European	230	2.1

Table 4 Foreign Claims and Other Potential Exposures in Korea (As of late June 2011)

(Unit: \$100 million, percent)

Sector	Total	European	(Percentage)
Total	3,495	1,873	54
Public	913	429	47
Banks	913	550	60
Non-banks	1,666	891	54
Others	3	3	100

Note: 1. Figures for stocks (KOSPI and KOSDAQ) and (listed) bonds are from the end of October, 2011; figures for exposure are from the end of June; "Banks" exclude foreign banks and their Korea branches. Source: Financial Supervisory Service "Foreign Investments in Domestic Securities in October 2011," November 3, 2011; Bank of International Settlements.

short-term overseas debts and foreign capital inflows. Korea increased its currency swap arrangement with Japan to \$70 billion and that with China to \$56 billion last October. It also paved the way for a swap deal with the US by agreeing to cooperate for currency stability. These will aid in lowering the potential for a repeat of the financial crisis.

In the future, Korea may intermittently suffer financial distress, if not a crisis, because its high dependence on trade and its weak financial structure have left the country vulnerable to external shocks. In 2010, Korea came 14th⁷ out of 33 OECD member countries surveyed in terms of financial liberalization, and 8th (at 87.9 percent) among the 34-nation OECD in terms of share of trade (on a customs cleared basis) in gross domestic product. The presence of large amounts of foreign capital in Korea and a high percentage of foreign investors in the domestic markets increases financial market volatility. Branches of foreign banks accounted for 53.0 percent of all foreign exchange transactions in

the second quarter of this year. Foreigners held 30.8 percent of Korea's market capitalization as of October 2011, higher than the 13.6 percent in the US, and the 26.7 percent in Japan. From August to September, foreigners enacted a net outflow of 7.2 trillion from the country's stock market and a net inflow of 100 billion into the bond market, while European investors enacted net outflows of 4.4 trillion and 3.2 trillion out of the stock and bond markets, respectively.

Given all of these factors, a repetition of the 2008 financial crisis is unlikely in Korea, but intermittent financial distress will be unavoidable. **SO**

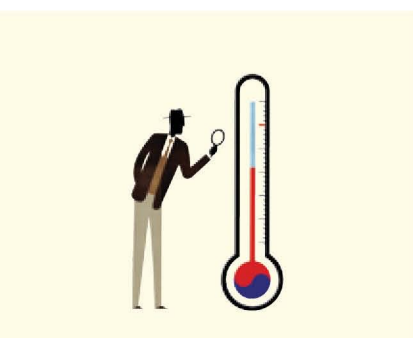
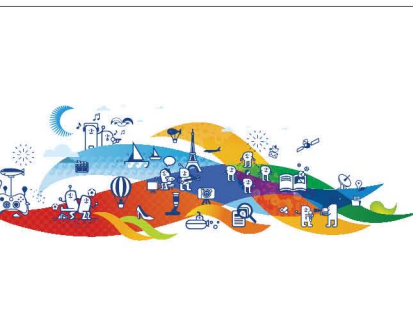
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Keywords

Financial crisis, Credit Default Swaps (CDS), foreign investment, sovereign credit rating

⁷ OECD (2010). "OECD Code of Liberalisation of Capital Movements".

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084 bada Makes Waves

CHOI Eunjeong

The smartphone revolution has till now come mostly in three flavors: iOS, Android, and Blackberry. Samsung Electronics' bada powered smartphones, however, are making a major dent in the market. Samsung's bada phones are gaining ground on their accessible interface, familiar development environment, competitive prices, and wide app selection.

094 Flying High at the Incheon Airport

LEE Ahn-Jae

Incheon Airport has become a traveler's favorite, and has been named the World's Best Airport for six years in a row. Meticulous attention to customer service and employee satisfaction, as well as innovations in producing revenue streams have made the airport a role model to benchmark. Incheon now consults other airports on the techniques that have made it a success.

108 Japan's Persistent Deflation

Kaoru Hosono

Prices in Japan have been undergoing consistent deflation for more than 15 years. Various theories have been proposed to account for this phenomenon, including monetary policy, and liquidity and deflation traps. Japan can begin to address its deflation by allowing more inflation, preventing asset bubbles, and pursuing structural reforms.

115 Korea's Financial Stability in 2012

JEONG Young-Sik

Sovereign debt turmoil in Europe and the US is unnerving investors, but a repeat of the 2008 global financial crisis is only a remote possibility. Korea's financial system and economic structure is in better shape but remains vulnerable to external shocks. Possible countermeasures include controls on foreign capital movement, prudential measures on foreign currency trading, and taxes on foreign investors' bond yields.

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