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CONTENTS

OVERVIEW AND MACROECONOMIC ISSUES

KOREA'S NEAR-TERM ECONOMIC PROSPECTS AND CHALLENGES

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Introduction

Following several years of strong expansion, the Korean economy began losing momentum in the second half of 2008 in the wake of the stress engulfing the global financial system. Although the initial stages of the financial crisis directly affected mainly the United States and western Europe, the crisis became truly global during the course of 2008 as rising risk aversion among cross-border investors reduced capital flows and weakening demand adversely affected global trade. The more open economies, such as Korea's, were hit the hardest.

In the face of this sharp downturn, the Korean economy confronts a number of challenges in the short to medium term. Softening the impact of the global slowdown and restoring strong growth are the most important immediate tasks, and the Korean government's policy response in the financial, monetary, and fiscal areas has been comprehensive. Over the medium term, it will be important to pave the way for an even stronger and more dynamic financial sector, establish a sound and vibrant corporate sector (especially small- and medium-size enterprises [SMEs]), and resume fiscal consolidation, especially to meet the challenges stemming from a rapidly aging population.[1]

The rest of this paper elaborates further on these themes. The next section discusses macroeconomic and financial developments in 2008 and early 2009 and their implications for the near-term outlook. Given the importance of global developments for Korea, the subsequent section discusses the key risks and uncertainties surrounding the global economic outlook. The paper then discusses risks to the Korean economy that originate from domestic factors and the key challenges in managing the downturn. The final section concludes with some observations on prospects.

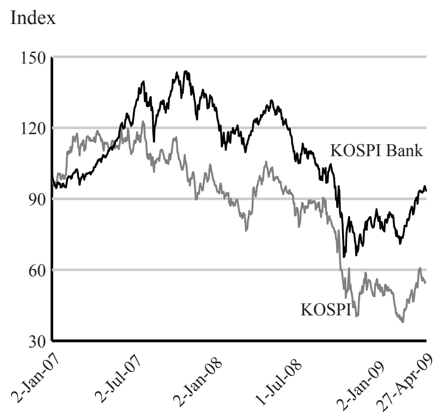
Korea's Current Economic Downturn

After peaking toward the end of 2007 and against the backdrop of a deteriorating external environment, Korea's growth moderated in the first three quarters of 2008 as private consumption and investment began to soften. Nevertheless, the Korean economy remained relatively resilient to the global economic downturn and the substantial stress in global financial markets. Indeed, exports held up relatively well, and the direct impact of the global financial crisis was minor given Korean banks' small exposure to subprime securities and structured instruments. At the same time, inflationary pressures rose as global commodity prices continued to trend up until midsummer 2008. Moreover, money and credit growth remained strong. In line with regional developments, however, the stock market declined (***Figure 1***), market volatility rose, credit spreads widened (***Figure 2***), and the exchange rate weakened.

The abrupt deterioration in global financial conditions in September 2008, in the wake of the collapse of Lehman Brothers, hit Korea particularly hard. As global deleveraging intensified, the liquidity of Korea's bond and equity markets allowed foreign investors to unwind their holdings more easily than in some less liquid markets. Investor attention also focused on some country-specific vulnerabilities, including domestic banks' exposure to wholesale

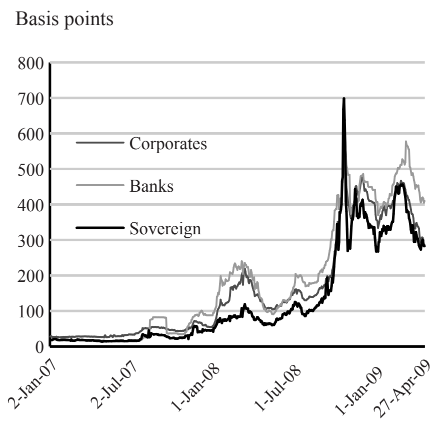
1. Jerald Schiff and Murtaza Syed, "The Graying of Korea: Addressing the Challenges of Aging," *Korea's Economy 2008* 24 (2008): 7–13.

Figure 1: **Stock Market Trends in Korea**
2 January 2007–27 April 2009



Sources: Bloomberg LP and CEIC Data Company Ltd.
Notes: 2 January 2007 = 100; KOSPI Bank refers to the index for banks included in the KOSPI index.

Figure 2: **Credit Risk Premia in Korea**
Credit Default Swap Spreads
2 January 2007–27 April 2009



Sources: Bloomberg LP and International Monetary Fund staff calculations.

and external funding and the high leverage of households and the SME sector. The reduction in liquidity was felt acutely in domestic money markets, where spreads on corporate paper, for example, rose sharply. Moreover, external funding conditions tightened for banks rolling over their foreign exchange–denominated short-term debt. The stock market sell-off accelerated sharply, and the currency weakened substantially. Decisive policy actions by the Bank of Korea to inject liquidity into the financial system and other measures to support the banking and corporate sectors (see below) helped stabilize conditions by December 2008. However, financial markets have not fully normalized thus far.

With the global economy continuing to deteriorate, the demand for Korean exports began to weaken appreciably in the final quarter of 2008, and exports of goods and services fell 6.9 percent in real terms compared with the last quarter of 2007. As imports fell even further, however, external trade contributed positively to growth. Meanwhile, domestic demand continued to weaken in line with waning business and consumer confidence. As a result, the economy contracted by an annual 3.4 percent and a quarterly 5.1 percent (seasonally adjusted) in the final quarter, leading to full-year growth of 2.2 percent in 2008 compared with 5.1 percent in 2007 (***Figure 3***). There are, nonetheless, tentative signs that the deceleration in economic activity is moderating. Quarterly GDP growth (seasonally adjusted) turned marginally positive in the first quarter of 2009 (0.1 percent) according to preliminary official estimates, in part driven by strong fiscal support and the effects of the weaker exchange rate on exports and imports. At the same time, the rapid decline in imports also reflects waning domestic demand, and labor market conditions continue to worsen.

Against the background of weak domestic demand and declining exports, the International Monetary Fund forecast Korea's economy to contract by around 4 percent this year, in part reflecting the base effect associated with the substantial contraction in activity in the last quarter of 2008. A modest recovery in the global economy and an improvement in global financial conditions by 2010 could support a simultaneous recovery in Korea. Indeed, the authorities' strong macroeconomic policy response (see below) could raise growth in 2010 above that for the major advanced economies and other newly industrialized countries in Asia. Moreover, coupled with successful crisis policy implementation in the advanced economies, this could present an upside risk to the growth outlook. However, the unusually high uncertainty surrounding the global economic and financial conditions implies that projections for Korea are also subject to a substantial degree of uncertainty. The risks to the downside stem from both global conditions and country-specific circumstances, which are discussed in turn in the next two sections.

Risks and Uncertainties from the Global Environment

The global financial system remains under stress despite significant policy actions since the summer of 2007. As is well documented by now, the crisis has spread well beyond the U.S. subprime market, and has affected banks and a wide range of financial intermediaries. Moreover, the crisis has also spread to a broad range of financial assets, including corporate high-grade and high-yield bonds and large segments of the securitized financing sector. Policy interventions have included substantial provision of liquidity in many countries as well as support in the form of new capital, guarantees, and programs to deal with distressed assets. The policy responses have been effective in alleviating some of the extreme stress observed in September–October of 2008, but markets continue to remain under strain. Conditions have been further exacerbated by the financial stress linked directly to the deteriorating macroeconomic conditions.

The global outlook is likely to remain unfavorable for some time, and risks remain tilted to the downside. Of particular concern is the adverse feedback loop between deteriorating financial conditions and weaker economic activity. Arresting this spiral is a challenging task for policymakers, requiring the whole range of fiscal, monetary, and financial policies. At the same time, given the high level of uncertainty, there is a risk fiscal and monetary policies may prove less effective than hoped if rising precautionary savings lower fiscal multipliers and steps to ease funding costs fail to slow the pace of deleveraging. On the upside, however, strong policy implementation that is able to convince economic agents that economic and financial strains are being dealt with decisively could revive confidence.

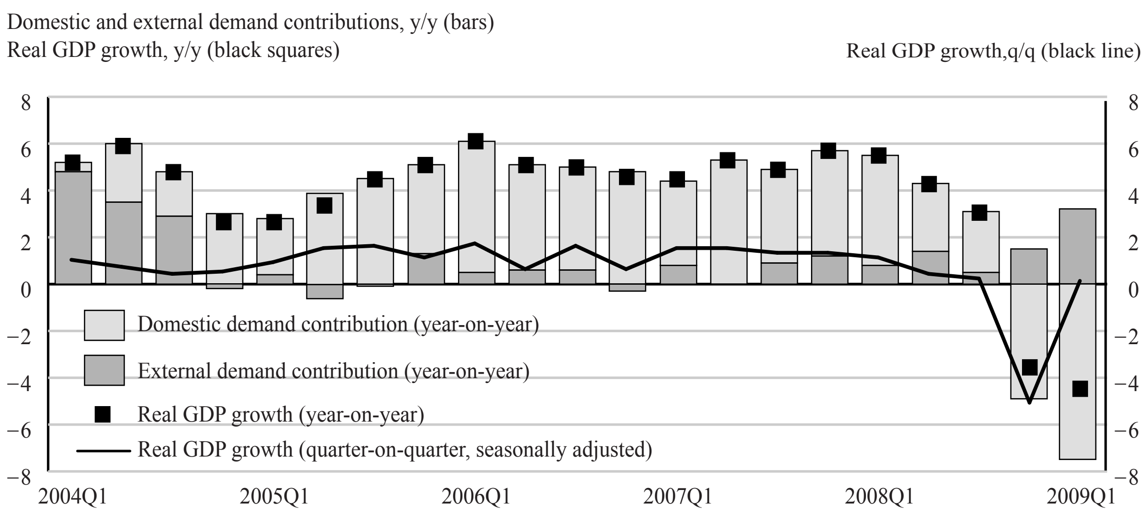
Given this, Korea's economy faces the possibility of further negative global spillovers through the financial and trade channels. Tighter global financial conditions imply that cross-border flows could remain under pressure for some time to come, raising the cost and reducing the availability of financing for banks and corporations. Moreover, slower global growth would have a direct negative impact on the demand for Korean exports.

Risks and Uncertainties from Domestic Sources

In addition to some of the global risks identified above, the Korean economy is also exposed to a number of vulnerabilities that originate from domestic factors.

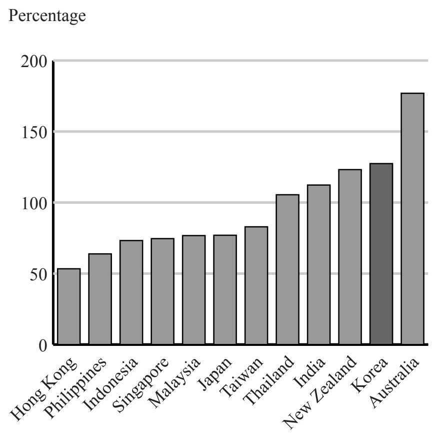
The financial system as a whole remains sound, with high capital cushions of 12 percent of risk-weighted assets at end-2008. However, Korean banks have

Figure 3: **Growth of Gross Domestic Product in Korea: Demand Contribution and Momentum, 2004–09 (Q1)**



Sources: CEIC Data Company, Ltd., and International Monetary Fund staff calculations.

Figure 4: **Bank Loan-to-Deposit Ratio in Selected Countries, January 2009**



Source: CEIC Data Company Ltd.

some of the highest loan-to-deposit ratios in the region, reflecting an ongoing shift away from bank deposits by households and a refocus of the banks' business model (***Figure 4***). These factors have, in turn, significantly increased the banking system's reliance on wholesale funding, which amounts to approximately 40 percent of total liabilities and includes foreign-sourced financing. Moreover, banks account for 75 percent of Korea's short-term external debt. As a result, concerns about banks' ability to roll over external debt obligations contributed to the elevated credit spreads on Korean banks following the September 2008 spike in market volatility. However, a large segment of short-term debt relates to foreign exchange hedging provided by banks to shipbuilders and other exporters, and this segment has offsetting foreign exchange receivables. Korean banks also have stringent liquidity requirements, implying a close maturity match between short-term *won* and foreign currency–denominated liabilities and assets. The nonperforming loan (NPL) ratio of banks remains very low, at around 1 percent. Although it has risen marginally recently, provisioning against NPLs appears broadly adequate so far.

The second key risk to the outlook is from the corporate sector, and from SMEs in particular. The SME sector has benefited from several years of strong credit growth and is economically important, as it accounts for close to 90 percent of employment and 50 percent of manufacturing output. However, the universe of SMEs spans a wide range of enterprises, from *chaebol* suppliers and shipbuilders for bulk cargo, to micro enterprises at the family level. According to the Bank of Korea, in 2007, well before the current turmoil began, some 44 percent of SMEs did not have sufficient earnings to cover interest payments; this has likely worsened although the majority of these SMEs are very small and make up only a minor share of bank lending. Nevertheless, given the depth of the projected downturn, distress in SMEs could potentially affect a large number of employees and increase the number of NPLs in the banking system.

Third, Korean households' indebtedness has increased faster than income in recent years. It is relatively high, at nearly 70 percent of GDP, and in most cases the interest rate is adjustable. This makes household balance sheets sensitive to credit and income shocks. Moreover, the rollover of mortgage loans and expiration of grace periods on newer amortizing loans could pose challenges in a tighter credit environment. Further to this, household balance sheets face risks associated with rising unemployment and downside risks to housing prices. That being said, housing prices did not rise nearly as much as elsewhere in the region, partly because the housing market started softening back in early 2007. Households also benefit from relatively low mortgage loan-to-value ratios of less than 50 percent, and mortgage delinquency ratios remain low at around 0.7 percent, even though they have been edging up recently.

Finally, an adverse feedback loop between the financial sector and the real economy could reinforce these risks. With banks directly impacted by the current downturn through investment losses, tighter funding conditions, and a more uncertain economic environment, they may well tighten lending standards and scale back credit to corporations and households. This will aggravate conditions for the corporate sector, in particular SMEs, and households already affected by the economic downturn. In turn, this could feed back to banks through a deterioration in asset quality and capitalization, leading to a further pullback in credit, and so on. Although bank lending to the private sector still grew annually by around 10 percent in March, the growth rate has declined significantly in recent months, especially for lending to SMEs.

Challenges of Managing the Downturn

To cushion the impact from the negative global economic spillovers and lessen the adverse feedback loop between the financial and real sectors, policy action should be comprehensive and focus on safeguarding the stability of the financial system, containing the vulnerability of the corporate sector, and supporting domestic demand.

In managing the downturn, financial sector policies should broadly focus on two objectives, containment and resolution:

- Following the collapse of Lehman Brothers in the fall of 2008, domestic and foreign exchange liquidity tightened for banks with large wholesale financing requirements, and foreign investors retrenched from even liquid money markets, including Korea's. The immediate objective of policymakers was to contain the fallout from the crisis and forestall widespread panic. To this effect, the Korean authorities took a number of key steps: the Bank of Korea bolstered liquidity by injecting both *won* and U.S. dollar liquidity in the markets; liquidity facilities were expanded; and swap facilities, each worth close to $30 billion, were set up with the U.S. Federal Reserve, the Bank of Japan, and the Bank of China. Further to this, the Korean authorities extended deposit insurance to cover foreign exchange deposits, and the government guaranteed domestic banks' external debt incurred between 20 October 2008 and end-2009 (for a period of five years and up to $100 billion).

- Korean authorities have also taken a number of steps to support resolution of distressed assets and recapitalization of financial institutions. The state-run Korean Asset Management Corporation (KAMCO) has been charged with buying up NPLs, including from savings banks, and, as recently announced, will manage a 40 trillion *won* fund set up to purchase distressed corporate bonds and assets from financial institutions. A recapitalization fund of 20 trillion *won* has also been established, allowing banks to boost their capital in exchange for hybrid bonds, subordinated bonds, and preferred shares. In addition to these measures, it will be important to continue close monitoring of financial institutions, undertake enhanced stress-testing exercises to identify vulnerable institutions, and ensure that the contingency framework is calibrated to deal with any further stress to the system, including through a comprehensive prompt-corrective action and resolution framework.

The current economic downturn and vulnerabilities in the Korean corporate sector, in particular the SME sector, call for steps to reduce the near-term risks of an adverse feedback loop between rising corporate bankruptcies and tightened bank lending. To relieve near-term pressures on SMEs, the authorities have focused on securing continued availability of credit, including by encouraging banks to roll over all SME debt maturing in 2009 (approximately 160 trillion *won*), expanding government guarantees through government agencies, and boosting SME lending through state-owned banks. Liquidity in the domestic corporate bond and equity markets has also been supported through a number of initiatives, including bans on short selling of stocks, stepped-up investments in the local bond markets by the National Pension Fund and Korea Investment Corporation, and plans to abolish withholding taxes for foreigners on interest earned on local bonds.

Macroeconomic policies are needed to support domestic demand and reinforce the efforts undertaken to stabilize the financial system and corporate sector. The authorities have been very proactive on this front. The Bank of Korea has eased monetary policy aggressively, lowering policy rates by 325 basis points to 2 percent since October of 2008. Further to this, fiscal policy has been loosened with the introduction of a fiscal stimulus package worth around 2.1 percent of GDP as part of the 2009 budget. Cuts in income taxes and investment tax credits account for around half of the package, and the expenditure measures focus mostly on infrastructure and SME support. It will be important, however, to supplement these with additional fiscal policy stimulus to cushion the slowdown, and the relatively low public debt ratio at 34 percent of GDP allows for this. Indeed, the government has already proposed a supplementary budget focusing on new spending measures worth around 1.7 percent of GDP, including outlays to support low-income families and SMEs, and additional infrastructure spending. The concentration on expenditure measures is welcome, as these are generally found to have the largest impact on demand, especially outlays on infrastructure and targeted transfers to liquidity-constrained households and businesses. Temporary investment tax credits can also be relatively effective. Although income tax cuts tend to have smaller multipliers, they can often be implemented quickly and will also serve to support economic growth when the recovery is under way. With inflation expectations under control, there may be some scope for further monetary easing through rate cuts and quantitative measures to boost liquidity should downside risks come to the fore. Interest rates are already low, however, and monetary policy effectiveness may be somewhat constrained by weakening bank balance sheets.

It is crucial that current policy actions be consistent with Korea's long-term economic objectives:

- It will be important for the financial sector to come out of this as sound, efficient, and dynamic. In turn, this requires steps to limit moral hazard and facilitate exit strategies from large-scale public interventions, including to ensure a smooth transition back to full private intermediation in dislocated markets. Lower leverage and a somewhat smaller financial sector seem inevitable, and current actions should not impede necessary restructuring of the system as a whole. As in other countries, it is also important to now revisit the regulatory and supervisory framework to reflect lessons learned from the current crisis, including giving consideration to counter-cyclical capital adequacy ratios.

- Strong efforts to restructure the corporate sector, especially the weak SME sector, are essential to allow for a faster recovery and higher potential growth over the medium term. To help facilitate this, the government has pursued financial institution–led restructuring, promoted market-based efforts to set up a corporate restructuring fund, introduced tax exemptions to facilitate restructuring, and announced the establishment of the 40-trillion-*won* KAMCO-managed fund mentioned earlier. The authorities' efforts could be further strengthened if a more differentiated approach to SME restructuring was followed, given the varied nature of these companies. Such an approach could involve a bank-led restructuring for small and medium-sized SMEs to capitalize on banks' often in-depth knowledge of the debtor's business, and a market-based solution for large SMEs, able to attract strategic investors such as private equity firms, venture capitalists, or distressed-asset funds.

- While temporary fiscal stimulus is key for cushioning the slowdown and bringing about a faster recovery, it is crucial that the government remain mindful of the long-term fiscal pressures associated with aging and the need to resume fiscal consolidation over the medium term.[2] Moreover, signaling continued commitment to fiscal prudence will help bolster the effectiveness of current stimulus efforts by safeguarding fiscal credibility. Preparing a medium-term fiscal consolidation plan consistent with long-term sustainability and presenting it to the public would be important in this regard.

Conclusion

This year and next will be challenging for Korea's economy. The outlook for the global economy and financial system is surrounded by a high level of uncertainty, and a worse-than-expected outcome is possible with implications for Korea's globally integrated economy. Risks from domestic sources are also present and could be reinforced through an adverse feedback loop between the financial sector and real economy. Compared with the Asian crisis of the late 1990s, the Korean economy faces these challenges from a position of relative strength: foreign exchange reserves are high, the financial sector is generally sound, and larger corporations have deleveraged and are less vulnerable to foreign exchange risk than in the past. Moreover, the Korean government has taken decisive and timely steps to address the fallout from the crisis through proactive and mutually reinforcing financial sector and macroeconomic policies. Korean policymakers have also demonstrated readiness to take further measures as needed. Although there is considerable uncertainty about when the global recovery will take place, the strong fundamentals and policy steps taken so far

2. Ibid.

have positioned Korea well for a solid recovery when the global tide turns. Indeed, the flexibility and resilience of the economy could enable Korea to be among the first countries to bounce back from the current downturn.

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