

South Korea and a COVID-19 Financial Crisis: Part 1 – The Risks

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By Kyle Ferrier

The world is on the precipice of another financial crisis, this time caused by a global pandemic. In the past several weeks financial markets have tumbled at a historic pace as the number of COVID-19 cases have exploded around the world. Although South Korea's response to contain the virus at home has been held up as an exemplar for other governments, it has not proven immune from the economic fallout. South Korea's key stock market index, the KOSPI, is seemingly poised to fall more in March than October 2008 at the height of the global financial crisis. The value of the Korean won has also fallen against the dollar, hitting a four-year low.

However, the worst of the economic turmoil is likely still ahead. International financial institutions, credit rating agencies, and major institutional investors alike are dramatically lowering expectations for global growth this year. The coming weeks and months will be crucial in determining just how bad the situation will be.

As a country that has been particularly impacted by financial crises in the past two decades, South Korea has made a lot of headway in protecting itself from the looming one, but significant risks remain.

The Risks

Internal

Among the most significant financial risks to the South Korean economy stemming from domestic factors is burgeoning household debt.

Last year, South Korean household debt reached 1.6 trillion won (\$1.26 billion) or nearly 94 percent of GDP, up 2.7 percent from 2018. This jump makes Korea the country with the fourth fastest household debt growth, after China, Hong Kong, and Norway. The overall debt-to-GDP ratio is also the seventh-largest in the world, though the governments ahead of Korea – Switzerland, Australia, Denmark, the Netherlands, Norway, and Canada – have

traditionally spent much more on social safety net programs. Additionally, Korean household debt has reached 186.1 percent of disposable income, much higher than the OECD average of 130.6 percent.

While household debt is not inherently bad as it can help jumpstart growth, too much of it can act as a drag on the economy and can greatly exacerbate or even precipitate a financial crisis – best demonstrated by the 2008 global financial crisis. Koreans have been spending more across a number of categories, but by far the biggest source of debt growth are mortgages.

The Moon government has tried to tackle the issue since taking office in 2017, but has recently stepped up its efforts. This includes the new drastic measures of limiting speculation by banning mortgage loans over 1.5 billion won (\$1.18 billion) and directly enforcing price caps on the sale of apartments in certain hot real estate markets.

However, with COVID-19 causing the volume of housing transactions to plummet by as much as 80 to 90 percent, the biggest risk now is not the accumulation of new debt, but the public's ability to service its sizeable existing obligations amid a worsening financial landscape. The latest official figures for South Korean consumer confidence show the largest drop since June 2015, during the Middle East Respiratory Syndrome (MERS) outbreak. The reality is likely much starker than the numbers suggest as they are based on a survey conducted in mid-February – before the number of cases took off in South Korea. Strong headwinds from the rest of the world in countries that have been less successful in curbing the virus stand to exacerbate the domestic situation.

External

South Korea's reliance on the global economy makes it particularly vulnerable to a slowdown in global growth. Among the world's 20 largest economies, South Korea is second only to Germany in terms of its export dependence, with exports representing 44 percent of GDP. At the onset of the epidemic major South Korean exporters were mostly impacted via delayed shipments of inputs from China, but as the disease has become a pandemic it is now not only affecting supply, but global demand, hitting major Korean exporters on both sides.

Perhaps a silver lining though is that investors are looking to buy more corporate debt in the search for higher yields, which can help major Korean firms weather a coming storm in the short-term. Whereas corporate debt amassed during the past few years of easy credit is seen to be a major risk elsewhere – particularly in the U.S. – it is a smaller part of overall debt in Korea. Still, there are challenges in the next few weeks and months with bonds due to mature amid struggling profits.

Another mitigating factor is that gross external debt is only about 28 percent of GDP. This figure tracks below the 30 percent in Taiwan, 83 percent in Japan, 96 percent in the United States, and almost 145 percent in Germany. Additionally, of South Korea's external debt, only about 30 percent is short-term, giving the country more leeway in tackling a COVID-19 crisis despite a falling won.

Nevertheless, that economic activity is concentrated in major South Korean conglomerates known as *chaebol* and that these firms are so dependent on international markets present a major structural challenge. The combined revenue from the ten largest chaebol represents about half of South Korean GDP. Samsung Electronics, for example, is South Korea's largest company by a wide margin, but of its 230.4 trillion won (\$186 billion) in sales last year, only 15 percent came from the domestic market. Some chaebols in the industries that have so far been most exposed to the effects of the virus, such as tourism and travel, are already struggling and others could soon follow as the pandemic worsens.

While the risks to the Korean economy are substantial, so too are the government's tools to prevent and manage the next financial crisis, which will be covered in a forthcoming post.

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