South Korea: Debt in the time of Covid*

C.P. Chandrasekhar

South Korea, long lauded as a "model" for developing countries looking to transit to developed status, had lost some of its sheen after the 1997 Southeast Asian financial crisis. Yet, the return of stability after the crisis and the global success of its conglomerates (like Samsung and LG) has kept the country in the limelight. More recently, South Korea has been included among countries that managed the Covid-19 pandemic well. Though the test positivity rate for the country rose from below 1 per cent in early October to 2.5 per cent at the end of the first week of November, the figure is well below the WHO's acceptable level of 5 per cent. South Korea also successfully handled the aftermath of a few super-spreader events. That provides evidence of a strong public health system and buttresses the view that besides success with growth, South Korea has also considerably improved its social sectors like education and health.

But lurking beneath this creditable performance are signs of a brewing crisis that the pandemic has intensified. The country sits on a mountain of private debt, both corporate and household, especially the latter. Household debt, which shot past a record 1,600 trillion won last year, galloped to reach 1,637.3 trillion won at the end of the second quarter of this year. According to data collated by the Bank of Korea, overall private debt which was already at a peak of 201 per cent of GDP at the end of the first quarter of 2020 rose 5.2 percentage points to 206.2 per cent over the second quarter ending June. Households taking on "retail loans" were major contributors to this trend. Starting at around 80 per cent in 2014, the household debt to GDP ratio went past 90 per cent in 2018 and touched 96 per cent in the first quarter of 2020, almost equal to the level it stood at in the US at the time of the 2008 crisis. Based on figures till March 2020, the Institute for International Finance had identified South Korea as the country reporting the highest level of household debt relative to the size of the economy among a set of 39 countries it assessed. And, according to the Bank of International Settlements, South Korea's household debt to gross domestic product ratio rose at the fastest pace in a set of 43 countries in 2019.

This growth has accelerated because of the adverse economic effects of the Covid-19 pandemic, with the government ramping up credit provision to address financial difficulties. With GDP shrinking and debt rising the debt to. GDP figure is expected to go past the 100 per cent mark in 2020. Household debt rose by 25.9 trillion won ($21.8 billion) over April to June, as compared to 11.1 trillion won during January to March. The trend seems to be persisting. Between May and August, housing-related loans to households reportedly rose by 15.4 trillion won and other loans to households by 17.8 trillion won, reflecting increases that were higher by 81.2 per cent and 93.3 per cent respectively than the increases in the same period last year.

These increases are troubling because South Korea was already among the top ten countries globally in terms of the ratio of household debt to household disposable income, which captures the burden of debt. The larger that ratio, the higher the share of current income that would have to be set aside for servicing debt, failing which the debtor would turn defaulter. According to a study by the secretariat of the Organisation for Economic Cooperation and Development, the debt to disposable income ratio of households of only 7 rich countries exceeded that of South Korea, which rose 30 per centage points from 2010 to 2019 to reach 184 per cent. All seven countries (Denmark, Norway, the Netherlands, Switzerland, Australia, Sweden and Luxembourg) were significantly richer than South Korea in terms of per capita GDP.

The extended surge in South Korean household debt has been the result of three different factors. The first is that, well before the Covid-19 crisis, rich and middle class households had begun availing of loans kept cheap by the government ever since the 1997 financial crisis with the aim of spurring private demand. A part of that credit went to finance debt-fuelled consumption spending—as illustrated by the high volume of credit card debt in South Korea. But a significant part went into investments (including speculative ones) in housing and stock markets. In fact, the government has favoured borrowing by households for housing investments. As far back as 2014, the then South Korean government announced what came to be known as the "July 24 measures," which included raising the loan-to-value ratio for housing loans from 50 per cent to 70 per cent and hiking the ceiling on debt-to-income ratios from 50 per cent to 60 per cent. That began a spiral in mortgage loans, which pushed up housing prices, raising mortgage debt levels even further.

The second is that South Korea has encouraged a culture of borrowing even by low income households. A 2008 paper by Kyuil Chung of the Bank of Korea had reported that the lowest fifth of income earners in Korea (the bottom 20 per cent) were net dissavers, recording negative savings rates because they were borrowing to cover their expenditures. The savings rate of this lower income group was -8 per cent in 1998, and -15 per cent in 1999, after the 1997 financial crisis. It then recovered to -10 per cent over the next three years only to begin deteriorating again to -17 per cent in 2004. As Kyuil put it: "the number of households living from hand to mouth seems to have risen rapidly since the crisis and can be estimated to account for over 20% of Korean households." Household debt has been fuelled by easy access to credit cards. A feature of debt dependence in South Korea is the high level of credit card spending, which is placed at 40 per cent of the country's GDP, compared with 18 per cent in the United States. Credit card receivables are also high, and so are defaults on credit card debt. Even before the pandemic there had been an increase in the number of those defaulting on their card payments because of slow growth and increases in the cost of living.

The third factor is that these trends have only intensified after the onset of the pandemic, when the need for emergency funds would have increased significantly, and the availability of credit would have increased because of government policy. Across the world, one fallout of the Covid-19 pandemic has been a sharp increase in debt both public and private. Governments that find their revenues shrinking as GDP contracts, are required to spend more to address the health emergency, provide support to distressed households and firms and stimulate the economy. Public debt inevitably rises. Firms and households that find revenues and incomes shrinking or vanishing, turn to credit as a means of staying afloat, partly encouraged by special schemes devised for the purpose. So private debt also climbs. Interestingly, much of the focus of attention globally has been on public debt, as fiscal conservatives warn against too much reliance on debt financed government expenditure as an antidote to the economic crisis triggered by the pandemic.

However, the real problem in a country like South Korea may be private borrowing, which the financial system that advocates fiscal conservatism encourages. In fact, a significant part of borrowing by private agents is from non-bank financial companies such as brokerages wanting to profit from the demand for credit and willing to accept securities as collateral. According to the Bank of Korea, over April to June 2020, the outstanding balance of securities-backed loans rose by 7.9 trillion won ($6.7 billion) to 29.9 trillion won. With both the probability of debt default and a collapse in security prices likely to result from any economic shock, this is a high-risk strategy that increases systemic vulnerability.

At the moment, the risk of default is rising, as debt levels have soared and recovery, even if visible, is likely to be slow given global conditions and South Korea's dependence on external markets. Fears that the system may implode are being expressed in various circles. South Korea may have been successful in handling the pandemic. But the after effects of the virus may set off a debt crisis that the government may find difficult to resolve.

*** This article was originally published in the Frontline Print edition: December 4, 2020.**