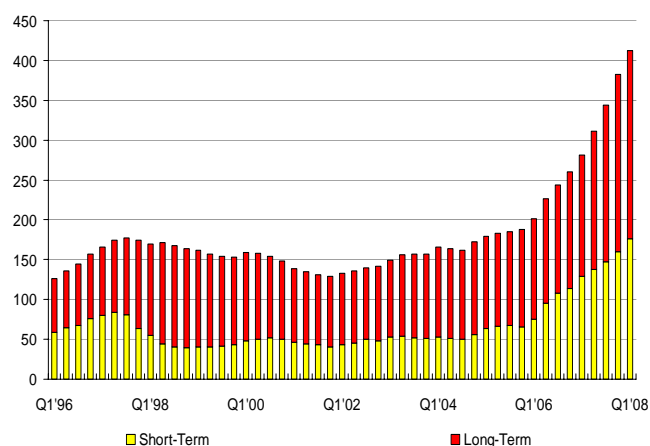


South Korea - external debt growing rapidly

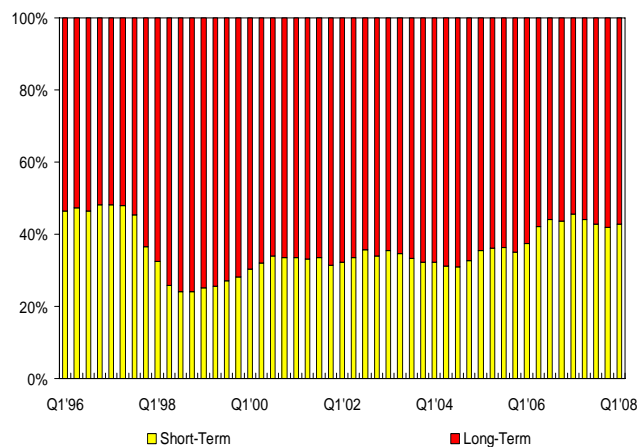
Key trends

- Foreign debt reached a record high US\$412.5 billion in Q1'08**, pushing up the debt to GDP ratio to 43.1%, from 30.8% in Q1'07. **Short-term debt is rising rapidly**. In Q1'08, it reached US\$178.5 billion, up more than 37% yoy and represented 42.8% of total gross debt. South Korea is now on the verge of becoming a net debtor country for the first time in eight years.
- Risks have risen, but a number of factors suggest that they are more manageable this time around**. South Korea has an ample foreign exchange reserves cushion, in stark contrast to the situation leading up to the 1997-98 financial crisis. Import coverage is strong and the growth in foreign debt has been mainly caused by foreign currency risk hedging activities of Korean exporters and Koreans investing in equity abroad, rather than aggressive company borrowing prior to the 1997-98 crisis that resulted in over-capacity, widespread bankruptcies and a sharp increase in bad loans. Fundamentals are also much stronger. The corporate sector has deleveraged significantly and is profitable. The banking sector is more healthy, with high levels of capitalisation and low non-performing assets.
- Overall, the situation in South Korea is different from that leading up to the 1997-98 crisis. However, **given the volatile state of world financial markets and the high possibility that financial instability will linger for some time, the rise in foreign indebtedness warrants monitoring**.

Foreign Debt by Maturity (US\$bn)



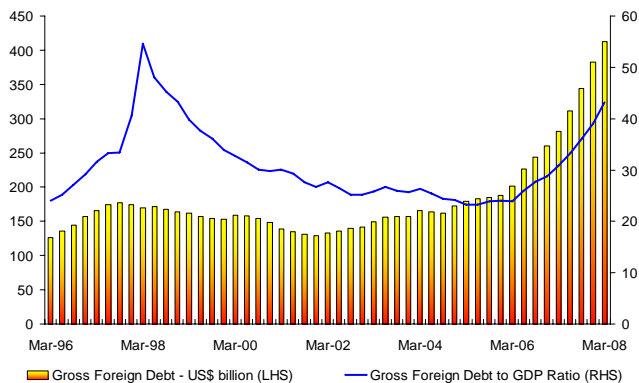
Foreign Debt by Maturity (% share)



External debt rising rapidly

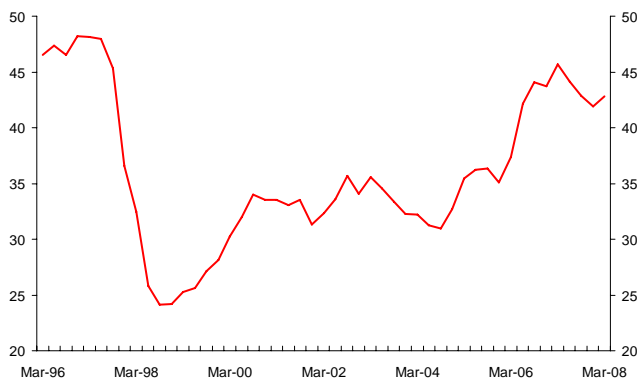
Gross external debt has been rising very rapidly recently, reaching a record high US\$412.5 billion in March 2008, up 7.9% qoq and more than 46% yoy. Consequently, the ratio of gross external debt to GDP jumped from 30.8% in March 2007 to 43.1% in March 2008 and is rapidly approaching the levels seen during the 1997-98 Asian financial crisis.

Chart 1: Foreign Debt



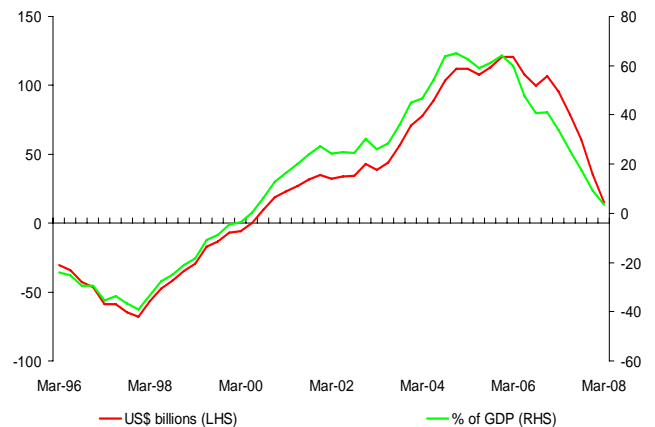
Short-term debt is also piling up a rapid pace, mainly due to exporters hedging their foreign currency risks and overseas equity investments by domestic investors. In March 2008, short-term debt reached US\$178.5 billion, up more than 37% yoy and represented 42.8% of total gross debt. This was slightly lower than the recent peak of 45.7% in March 2007, but still near the levels before the 1997-98 financial crisis.

Chart 2: Ratio of Short-Term Debt to Total Debt (%)



Rapidly growing foreign debt has put South Korea on the verge of becoming a net debtor country for the first time in eight years. Bank of Korea (BOK) data shows that net external credit reached US\$14.95 billion at the end of March 2008, down from US\$35.53 billion at end-2007 and a peak of US\$120.7 billion at end-2005.

Chart 3: Net Foreign Debt



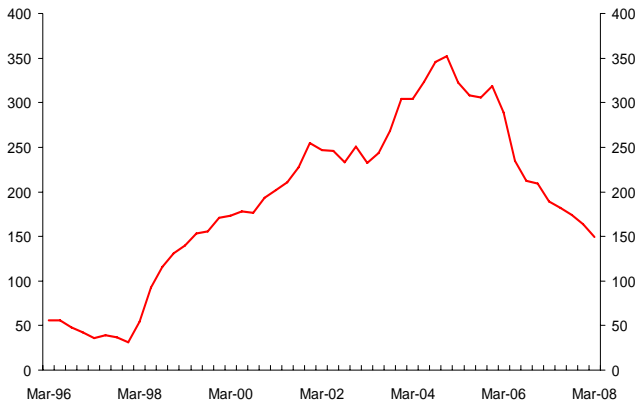
Crisis revisited?

The run up in South Korea's external indebtedness in recent years, especially the sharp jump in short-term external debt, has been flagged by some as a concern. Risks have indeed risen, especially the possibility of increased volatility or reversals of these flows. However, there are a number of factors suggesting that risks are more manageable this time around.

Most importantly, South Korea has an ample foreign exchange reserves cushion, in stark contrast to the situation leading up to the 1997-98 financial crisis. We are, however, aware that the South Korea's international liquidity position has deteriorated as short-term debt has been rising rapidly. In March 2008, the ratio of foreign exchange reserves to short-term debt fell to 149.5% (the BOK says the situation is stable if this ratio is more than 100%), significantly above the 30% coverage level seen in December 2007, but it has

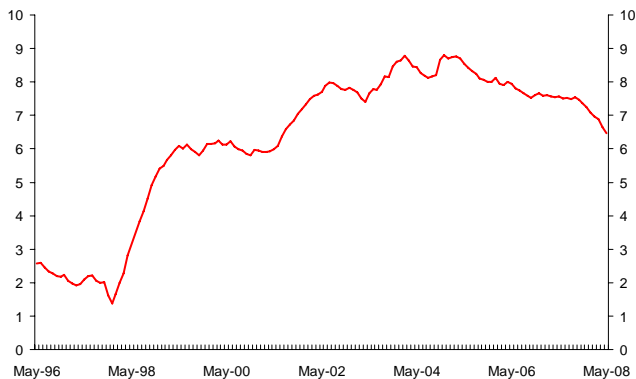
nonetheless fallen from almost 320% as recently as December 2005.

Chart 4: Foreign Reserves to Short-Term Debt Ratio (%)



Import coverage is also strong at around 6½ months of goods and services in May 2008 and more than double the conventional 3-month threshold - we recall that reserves were barely sufficient to finance a few weeks of imports during the height 1997-98 crisis. Again, however, import coverage has fallen from a recent peak of almost 9 months of coverage in 2005.

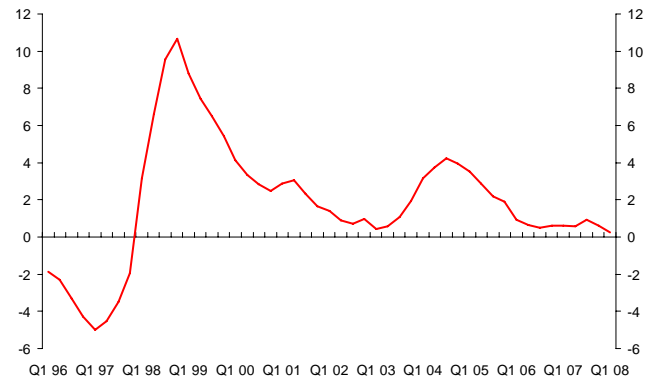
Chart 5: International Reserves (months of imports of goods and services)



Another salient point is that the current account deficit does not appear large enough to have a negative impact. In

the first five months of 2008, the current account posted a deficit of US\$7.2 billion, compared with a deficit of US\$2.9 billion in the same period last year as record high oil prices continued to push up the trade deficit. The June Consensus sees the current account deficit at US\$9.1 billion this year, which would still amount to less than 1% of GDP - during the 1997-98 crisis, this ratio climbed as high as 5% of GDP.

Chart 6: Current Account Balance (annual, % of GDP)

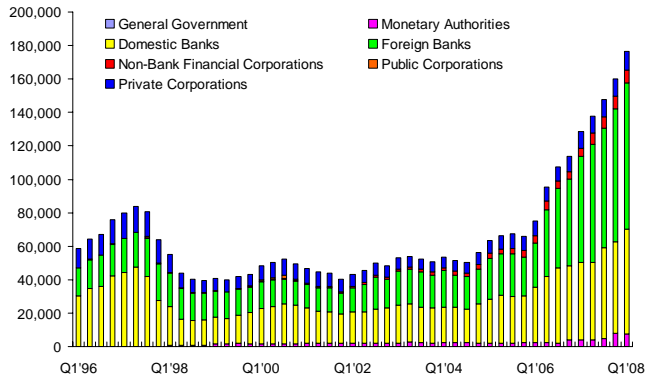


The growth in South Korea's foreign debt this time around has been mainly caused by large foreign currency risk hedging activities of Korean exporters and Koreans investing in equity abroad. This contrasts with the aggressive company borrowing prior to the 1997-98 crisis that resulted in over-capacity, widespread bankruptcies and a sharp increase in bad loans.

Borrowing for hedging purposes has been especially pronounced among the foreign banks as they tend to have a larger share of the hedging market in South Korea. This is evident in the chart below, which breaks down short-term foreign debt by sector. It is clear that foreign banks have accounted for the lion's share of the recent increase in short-term foreign debt in South Korea. As a large share of their borrowing comes from their headquarters, the rollover risks involved in such operations would appear to be limited. Domestic banks have also increased their foreign currency borrowing in recent years, but their reliance on

foreign funding is reportedly limited to about 7% of their total funding.

Chart 7: Short-Term Debt by Borrower (US\$m)

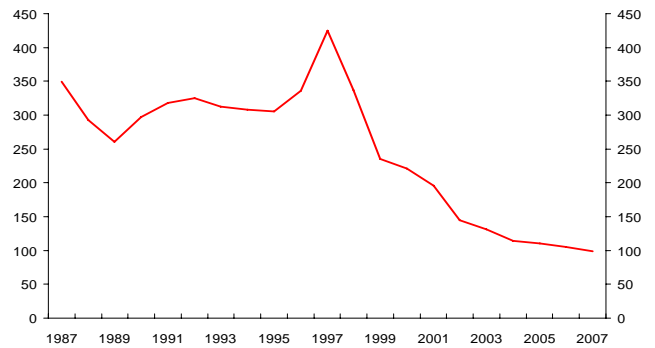


Fundamentals are also much stronger. The corporate sector has deleveraged significantly and is profitable. In its April 2008 Financial Stability Report, the BOK concluded that the capacity of the external sector to withstand external shocks remains sound - businesses have maintained their ratios of stockholders' equity to total assets at safe levels, profitability has generally improved and the current ratio (a measure of short-term solvency) remained stable.

Companies are also less indebted now, with the companies' debt ratio slightly below 100% at the end of 2007, compared with more than 425% at the end of 1997. The banking sector is more healthy, with high levels of capitalisation and low non-performing assets.

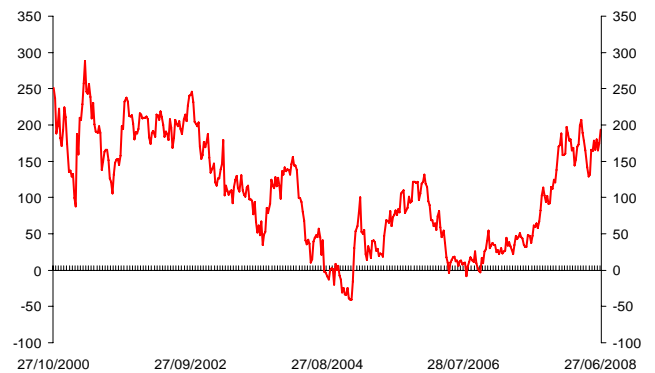
The BOK expects external debt growth to fall "sharply" this year. According to the BOK, hedging (especially by shipbuilders) is expected to decrease as order books slow (BOK sees orders falling to US\$95 billion this year, down from US\$101.5 billion in 2007), while overseas equity investment is expected to fall from US\$51 billion to US\$10 billion over the same period.

Chart 8: Companies' Debt Ratio (%)



Nevertheless, the authorities are concerned. In late-May, the Finance Ministry said that the government is reviewing measures to tackle the rapid growth of short-term debt. S&P also recently warned that South Korea's sovereign ratings could be hurt if external net borrowing continues to post a structural expansion, while a combination of global financial market instability, reduced risk appetite and the growing debt burden has seen the spread between comparable Korean and US 10-year Treasury bond yields rise to around 200 bps, from around 50 bps in July 2007.

Chart 9: Spreads: Korean & US 10-yr Treasury Bonds (bps)



Overall, the debt situation in Korea is different from that preceding the 1997-98 crisis. However, given the volatile state of world markets and the possibility that financial instability will linger for some time, the rise in foreign indebtedness in South Korea warrants close monitoring.

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