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Outlook 2013: Korea's Sovereign Credit Rating

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*Moderated by
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NIKITA DESAI: (Moderator)

Welcome to The Korea Society, and welcome to *Studio Korea*.

I'm delighted to welcome our guest, Senior Vice President and Asia-Pacific Manager Tom Byrne of Moody's Sovereign Risk Group. He is with us today to examine Korea's sovereign credit rating. Welcome, Tom.

TOM BYRNE:

Thank you. It's good to be back.

NIKITA DESAI:

Could you talk to us about Korea's government bond rating, which was upgraded from A1 to Aa3?

TOM BYRNE:

Certainly. We raised Korea's government bond rating in August of 2012, the second time we've raised their rating since the outbreak of the global financial crisis. When I think back, this is remarkable. During the global financial crisis, one of the few ratings I lost sleep over was that of Korea's. We maintained a stable outlook throughout the crisis. In hindsight, it was the right call, although there were some tense moments.

The bottom of this slide shows you the low point or nadir of Korea's sovereign bond rating, assigned in the late 1980s. It went all the way down to Ba1, one notch below the investment-grade threshold. This was during the depth of the Asian financial crisis. It was progressively raised to Aa3, which we consider to be a very high rating. The probability of default is essentially negligible over the medium term. Historically that's what Aa ratings have, whether they're sovereign or corporate.

The entries on this slide are in two colors, blue and black. I was often asked both internally and externally, before the upgrade, if a progressive government was elected (instead of the center-right Saenuri conservative government) would there be an impact on the rating? The entries in blue answer that question. We've upgraded Korea's rating under both progressive and conservative governments (the blue, highlighted lines represent the progressive governments). Shortly after Roh Moo-hyun was elected, there was a two-notch upgrade. In fact, Korea moved up five notches, which is pretty good, during the Kim Dae-jung and Roh Moo-hyun presidencies.

What that reflects is the strength of Korea's institutions, including the finance ministry in the years after the Asian financial crisis, an increase in regulations by the FSS, the FSC, and the BOK. These regulators, you could say, kept the economic ship going straight, and the political wins didn't blow the ship off course too much. Our assessment was that no matter who got elected, there wouldn't be any credit negative development.

NIKITA DESAI:

What are the key drivers behind this upgrade?

TOM BYRNE:

As this slide indicates, the primary driver was the strong fiscal fundamentals. The hallmark of the global financial crisis is that it has undermined the fiscal fundamentals of many countries, particularly the advanced countries. France is no longer Aaa. Spain is no longer Aaa. In fact, Spain is rated in the low investment-grade range. Approximately ten years ago, Ireland was deservedly rated Aaa. Indeed, there has been a big build-up of debt. We see the consequences of this every day in the US as the sequester increasingly comes into focus, along with all of the fiscal challenges.

A lot of debt has been added to these governments, along with the challenge of refinancing such debt. Selling debt in the market at an affordable interest rate is a big challenge for many of these countries. Because of the global reserve currency status, there is less build-up of debt in the US. At any rate, Korea's strong fiscal fundamentals were the primary driver, and I'll show you more slides about that later.

Another key driver is the high degree of economic resilience that we've seen. I should mention that there is currently a lot of pessimism in Korea over whether even a 2% growth rate can be sustained. The Bank of Korea has forecast 2.8% real GDP growth this year, and over 3% in 2014. The business community is pessimistic because of the weakness in the global economy, as Korea's economy is very linked to global economic prospects. That is the second driver.

Another key driver, and what kept me up at night during the fall of 2008, was the external exposure of the Korean banking system to the global markets. There were very high loan-to-deposit ratios, for example. They have all come down, now, partly because of better risk management by the banks. In addition, the banking system consolidated after the Asian financial crisis. There was also better regulation. I think the macro-prudential regulations have been effective in Korea, and they've helped reduce vulnerabilities to the unavailability of international credit. Lastly, we believe the geopolitical status quo is unchanged, despite the recent nuclear test and ballistic missile launch on the Korean Peninsula. Those are the key drivers.

Now, I would like to put Korea's rating in perspective. Generally, Asia-Pacific performed very well during the post Lehman shock global financial crisis, as did Latin America. (In fact, Latin America performed a little better than Asia.) The sovereigns that were upgraded included Philippines, Indonesia, and China. Philippines, Korea and Indonesia were countries severely affected by the Asian financial crisis, and the policymakers learned their lesson. I think, to some extent, the politicians did as well as the regulators. So, the fundamentals have improved dramatically. In fact, Indonesia is now investment grade.

Two of them were downgraded. Vietnam was indirectly affected by global problems, but lacked cohesiveness in policymaking. Japan still hasn't recovered from the big bust of 1990. In addition, they had their own financial crisis in 1997 that coincided with the Asian financial crisis. Overall, Asia has done well, including Korea, which has been upgraded twice. Indonesia has also had multiple upgrades.

This slide helps put this in perspective. These are the sovereigns that are rated at the same level as Korea. We have corporate rated at the same level. There are also states in the US rated at the same or a similar level. I have just included the sovereigns here. The parentheses indicate where the rating was in 2009 when the global economy was in recession. As you can see, Korea has been upgraded twice, Chile was upgraded once one notch, and China was upgraded once one notch. Saudi Arabia was upgraded one notch, as well. Some smaller sovereigns who are quasi-sovereigns, like Macao, showed no change. Taiwan had no change. Belgium was downgraded and Japan was downgraded. That gives you some perspective as to where things are going globally.

NIKITA DESAI:

Doesn't Korea have a debt problem in the state-owned enterprise sector, Tom?

TOM BYRNE:

Yes, it does have a problem, but it's been managed well, so far. Now, I want to put this in global perspective by rating, because ratings assess the probability of default and the expected loss, should an entity default. In addition, this is an ordinal ranking of creditworthiness or strength of a credit profile. This table is from an IMF report, and you can see Korea's status from a global perspective. GRE is an acronym for government-related enterprise. These are the state-owned companies.

Since the global financial crisis, these Korean corporations have ramped up their debt. Some of this debt was part of a quasi-governmental, quasi-fiscal stimulus program. In another case, the debt was to alleviate inflation or mitigate inflationary pressures. For example, KEPCO was not allowed to raise tariffs, and therefore had to fund itself, instead of increasing revenue through debt issuance.

Korea's debt, as its share of GDP, is actually quite moderate. In fact, the countries with a higher amount of public sector debt (non-central government debt or non-general government debt) as a share of GDP tend to be rated higher than Korea. (You can't see that unless you have the handout.) The Middle Eastern countries are rated Aa2. Dubai doesn't have a public rating. The UAE rated higher, but they can manage the debt, and that's an important point. Our analysis looks at more than just debt stock (whether it's state-owned enterprise debt or general government debt, meaning central government and national government debt). We also take into consideration whether the debt can be managed, the refinancing risks are low, and whether the debt can be financed in a safe and prudent way.

I would also like to round out the perspective on state-enterprise debt, because that is not debt being financed by taxpayer revenue. It's off the balance sheet of the government. It is only put on the balance sheet when the state enterprises lose money or perform a public policy role. At that point, the government transfers resources, on a regular basis, to the state enterprise. Even though the debt has grown in Korea, (it's probably a bit higher, as these figures are from 2011), it has probably moved closer to those red bars relative to other countries.

However, the Korean government has never had to put debt onto its own balance sheet from state-owned enterprises. After the Asian financial crisis, it had to do that because of bank recapitalization exercises once bonds issued by KAMCO and KDIC started maturing. They went back on the government's balance sheet directly, and taxpayer revenue was going to service this debt. That hasn't been the case, yet, and we don't think it will happen with the state enterprises, as long as the economy continues performing well.

On this slide are two other aspects of Korean fundamentals that drove the rating. On the left panel is Asia-Pacific. On the right panel is Europe. The key fundamental here is the red bar. That's the increase in government debt since the global financial crisis. The bigger the bar, the weaker the credit fundamentals, or the more credit negative is the development. In addition, the entire length of the bar, whether red or blue, is a key fundamental.

When looking at these numbers, Asian governments have relatively low debt, except for Japan. We often talk about "Asia ex-Japan," and that's one of the reasons. Some countries have lower debt now than they did going into the crisis, including Indonesia, Philippines and India. Indonesia and Philippines, accordingly, were upgraded. Korea is just about the same with not much change. The countries that were severely downgraded in Europe either have the longest bar or the longest red segment on the bar. That's putting sovereign debt into a broad context. That's what's going on in Asia versus the geographical regions under the most economic and fiscal pressure.

What does this all mean looking forward five years from now? What is the trajectory of the debt burden and the amount of debt as a share of GDP? Well, if everything goes well, (meaning there's no more global or domestic shocks), Korea is looking pretty good. It is in between Australia, Sweden and China. Australia is at stable Aaa. Sweden is at stable Aaa (one of the few stable Aaa's in Europe). It looks pretty good. Then we have Belgium, a Aa3, with a negative outlook. Canada is a stable Aaa sovereign, even though the banks are feeling some pressures now. Korea is a Aa3 with a stable outlook.

That rounds out the whole picture. When we talk about public sector debt, you have to first look at it from a central government perspective, and then see the implications—whether this debt would wind up on the central government's balance sheet. This has implications for taxpayers, because some of their money will go to service that debt.

NIKITA DESAI:

Many countries today are facing stronger austerity measures, such as cutting government spending and raising taxes. Why isn't Korea facing the same problem?

TOM BYRNE:

Korea has a very prudent fiscal policy, regardless of whether the government has been conservative or progressive. Korea has been running surpluses, once you include the net receipts from social security and exclude the very small deficits. In fact, the Lee Myung-bak government had a goal of getting rid of even those deficits over the medium term. Korea is that little blue bar on the right. This is the summation of past budget deficits that need to be financed (the debt has to be rolled over) along with the current year's budget deficit.

Korea's budget deficit is less than 2% of GDP. It's a remarkably low level. Asia is in generally good shape. China comes in at a little less than 10%. Malaysia is in good shape. Indonesia is in good shape. For the countries that have faced a lot of rating pressures, the gross financing needs are very high, usually more than 20% of GDP. Greece has been reduced somewhat because the debt has been restructured. I believe this chart is the best reflection of Korea's fiscal fundamentals—the budget debt discipline in that country.

NIKITA DESAI:

Has it always been like that?

TOM BYRNE:

It's been like that for a long time. Korea got into trouble with the so-called contingent liabilities, where banks and corporations borrowed too much. That was certainly the case before the Asian financial crisis. The corporations were highly leveraged. The Daewoo Group was one of the biggest bankruptcies at the time. When they went under, they dragged the banks down with them during the Asian financial crisis. Now, the Korean corporate sector is fairly well deleveraged. Its debt-to-equity ratios and interest coverage ratios are close to international norms. There's not a lot of leverage lurking out there that could destabilize the system. The banks are in much better shape, being better capitalized. There has been a restructuring of not only the corporate sector, but also the banking sector.

I don't think Korea had much of a choice when it allowed bonds to default. This was the process of creative destruction in Korea, and it was done so that future resources wouldn't be used inefficiently to keep barely viable companies going. Those companies were forced to fold up, and I think that's a big lesson. Korea didn't follow the example of Japan that, after its 1990 crisis, had so-called zombie companies that were heavily indebted, yet rolling over their loans with the banking system.

On this slide, the highest negative numbers represent faster growth relative to the interest rate that a country pays on its debt. The top countries are Indonesia, China, India (despite all its other problems) and Korea. This is a projected rate of growth through 2017, over the medium term, by the IMF. Were they to be a bit optimistic, then that negative number would shrink. Germany is at the break-even point. Spain is under a lot of pressure with interest costs greater than nominal GDP growth. As nominal GDP growth is closely correlated with revenue growth, Spain is under a lot of pressure because it can't grow fast enough.

That's not the case in Korea, as long as Korea snaps out of its current doldrums in terms of growth. Korea looks better on a number of indicators, just comparing it with some of the Aaa's. One of the interesting indicators is the column on the right, nonresident holding (the so-called external government debt). This could either be in foreign currency, or in the case of Korea, KTBs.

This was a big Achilles' heel for peripheral European countries going into the crisis. You had foreign banks holding government debt. It didn't matter that the debt was in Euros. Once those banks were in trouble, they deleveraged. They bailed out. They wouldn't refinance. They rolled over the government debt loans. Korea is very low in this regard. The foreign currency component is extremely low, and most of that 14% is KTBs. That's a very safe and prudent level (you can see China is even lower). Its rating is positive with the deep domestic capital market. It also reflects a high savings rate.

NIKITA DESAI:

This issue of “economic democracy” was front and center in the South Korean presidential campaign. How is this likely to be manifested in President-elect Park's administration?

TOM BYRNE:

I struggle conceptually with the term "economic democracy." There's a lot of topical interest in income inequality these days—the need to redistribute wealth in order to create a fair economy. Democracy is a noun. If you're talking about one man, one woman, one vote in the economic sphere, that implies that everyone should have equal income; and, in an extreme case, that's one notion of economic democracy. An economic democracy could also be a government—as Lincoln said, "of the people, by the people, for the people." That means the government has to be accountable, and since we're talking about the economy, that means the economic institutions have to be accountable, whether they're government institutions or private sector institutions.

In the case of Korea, I believe this applies to the chaebŏl. My reading of Park Geun-hye and the Saenuri-dang's version of economic democracy is more towards the former; where they want to make the chaebŏl accountable. I also expect there will be additional spending on social welfare. That is in the cards, anyway. Korea's share of the GDP among OECD countries in Western Europe and North America (and Japan) is low. (Singapore is not a member of the OECD, but has high income). The other countries spend a lot more on social welfare (pensions, healthcare, unemployment insurance, etc.) than Korea does.

Even in the early years of the Lee Myung-bak government, the finance minister was talking about increasing spending on social welfare. I expect there will be increased spending on social welfare, but I don't think they'll go to the extreme of, say, raising marginal tax rates on corporations or individuals as, say, the French or US have done. Rather, I think it will just be more social welfare spending, along with the accountability issue that the chaebŏls be treated equally before the law.

I believe the best way to get income to the workers and laborers in Korea is to have low inflation, because income is a tax on the middle and lower middle classes—on those who do not have a lot of assets. It's also important to keep employment up or unemployment low. Inflation is only at 1.5% in Korea, so there is really no tax on the poor. Unemployment in the second half of last year is really low compared to the US. In the second half of last year, it was around 2.9%. The Bank of Korea expects it go up to a little above 3%. I think it's been around 3.3% in 2013. The US unemployment rate is currently at 7.9%. Spain is above 20%. Youth unemployment in Spain is at something like 50%.

Korea doesn't have this problem. So, if you're talking about democracy in the sense of initiative and the ability of a person to maximize his potential, then that's another feature where Korea stands out globally. There's less of an urgent need to redistribute income.

NIKITA DESAI:

Lastly, two weeks ago North Korea conducted its third nuclear test. Isn't geopolitical risk a major constraint on South Korea's sovereign credit rating?

TOM BYRNE:

Yes, it is. We have a methodology we created as a guide for the rating. This methodology takes into account four different factors. One factor is a government's financial strength. The fourth factor is event risk. This does not drive the rating, even though it's very influential. In the event risk category, we include political event risk. The levels go from very low to very high, and Korea is right in the middle along with countries in the Middle East such as the United Arab Emirates and Saudi Arabia, and the state of Qatar. The risk for those areas is Iran. South Korea's risk, of course, is North Korea, and that figures negatively in their rating. Most sovereigns rated in the Aa are either very low or low in terms of event risk. Political risk is generally very low, and sometimes financial risk is low.

Although North Korea is considered a credit negative factor, North Korea's provocations and militaristic policies have not undermined the economic and financial fundamentals of South Korea. The short-term effects of provocations by North Korea are usually transitory (even within a day) and the exchange rate and stock market tend to wear off any negative effects. Over the long run, I don't think North Korea has done anything to deter investment in the economy. In terms of the external debt of the government (14.4%), Korean KTBs yield more than US treasures. That creates a demand for these by foreign investors, and the Korean government doesn't want too heavy of an exposure to foreigners holding KTBs. They have put macroprudential restrictions on foreigners holding KTBs. They reimposed the withholding tax.

So, despite the North Korean risks, foreigners want to buy Korean government debt—more than the Korean government wants to sell to them. This reflects that a status quo exists, and I believe the status quo is primarily underpinned by the robust US-ROK military alliance. The former US ambassador to Korea, Kathy Stevens, is a friend from my Peace Corps days. I remember hearing her say that the alliance has never been as robust. It went through a shaky period in the beginning of the Roh Moo-hyun government, but in the history of the alliance, it's never been as robust. Having this alliance on the Peninsula is a big deterrent to North Korea.

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