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Global Credit Crunch Hitting Korea

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In the aftermath of the subprime mortgage debacle in the U.S., the credit crisis has continued in the global financial market, bringing repercussions for Korean financial firms and consumers as well. Since the crisis, Korean financial firms have had difficulties raising foreign funds. Even when they borrow only small amounts of foreign funds, they have to pay up to 50 basis points (1basis point=0.01 percentage point) above the average interest rate.

Kim In-joo, the chief of the global funding team at Korea Development Bank, said, "In the global money market these days, even leading investment banks like Citibank and Merrill Lynch can raise funds only when they propose additional interest of 30 to 40 bp. Although it maintains a higher credit rating than Korea's sovereign credit rating, KDB finds it very hard to raise more than US$500 million in foreign funds."

The Export-Import Bank of Korea raises more foreign funds than any other Korean bank. "We've so far managed to cope with the widened yield spreads" – the interest rates borrowers have to pay over Treasuries — its CEO Yang Cheon-sik said. "But if the trend continues, we'll have to increase the interest rates for domestic loans to make up for the loss." That would mean a blow to corporate profitability.

And still the sluggish housing market in the U.S., the cause of the subprime mortgage crisis and ensuing worldwide credit crisis, is showing signs of getting worse. Lee Geun-tae, a research fellow at the LG Economic Research Institute, predicted, "Falling housing prices in the U.S. will lead to sluggish consumption and investment and push down the U.S. economic growth rate to the 1 percent level in 2008. In that case, Korea's economy, which relies highly on the U.S. economy, will shrink and feel pressure."

In recent years, Korean financial firms have scrambled to increase project finance loans for property. Now many experts are saying that such loans are in great danger of turning into a Korean version of the subprime crisis. The domestic real estate business recession has dragged on, forcing financial companies to virtually suspend project finance loans. As a result, construction firms have had trouble raising funds, with many a small and medium-sized builder going bankrupt.

Many worry that the trend could spark a financial crisis, resulting in a domino effect in which the real estate business stays in recession, small and medium-sized construction companies go bankrupt, and large amounts of financial firms' insolvent bonds circulate. As of the end of June, project finance loans from domestic banks amounted to W69 trillion (US$1=W928), up W25 trillion year-on-year. For savings banks, project finance loans account for 29 percent (W12.5 trillion) of all their loans, their rate of overdue repayments a whopping 13 percent. Some are already talking about a savings banks crisis.

In the wake of the global credit crunch, overseas bond issuing has been all but suspended and securities firms have attracted more clients who would otherwise have deposited their money in banks. This trend has, in turn, led to a dearth of funds for commercial banks. So the banks are raising funds for most of their needs by issuing bank bonds and transferable certificates of deposit. But the drastic increase in the issuance of CDs has sent the CD interest rate, which plays the role as the standard rate for bank loans, soaring, and has forced households to pay more interest. As of Sept. 14, the CD interest rate had soared to 5.35 percent, up 0.72 percentage points year-on-year.

As of the end of August, domestic banks' housing mortgage loans were W218 trillion. Given that more than 95 percent of loans are at variable interest rates pegged to the CD interest rate, borrowers will have to pay an additional W1.5 trillion in interest per year due to the increase. Park Deok-bae, a researcher at the Hyundai Economic Research Institute, warned, "If the interest rate keeps rising, Korea could face a household liquidity crisis like the U.S." In other words Korea, too, could be trapped in a vicious cycle of rising interest rates, falling housing prices, household bankruptcies, insolvent household loans and a looming credit crisis.

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