BLACKSUMMIT FINANCIAL GROUP, INC
A Registered Investment Advisor
602 Steed Road, Suite 110, Ridgeland, MS 39157
601.714.1034 Office 601.714.1038 Fax
www.blacksummitfg.com

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South Korea: Choked by the Chaebol

Joel Charalambakis, Analyst

Introduction

The economies of Asia often garner substantial amounts of commentary for the tremendous growth path they have followed, their dynamism, and their increasing importance to the global economy. The nation of South Korea though tends to fly relatively under the radar compared to others in terms of the serious crossroads the country faces. China and Japan dominate discussions about the region for their sheer size and influence and the respective impediments each have. India (a nation we have previously covered) meanwhile is often looked upon as the next giant that could not only serve as a growth engine for the world economy but also influence the shape and infrastructure of the global system; commentary has grown increasingly bullish on India in the past several months.

South Korea has grown from a dormant economy to one of the richest countries in the world in the last half a century based upon a model that was popularized by its East Asian peers decades later: export based industrialism with capital directed by the state to national champions. The model provided stability and certainty to an economy coming off of a war and allowed for the development of brands that millions around the world recognize today, such as Samsung and Hyundai. The state-backed industrial export model elevated South Korea up the development ladder rapidly and served as a template for other countries from China in the 1970s to Vietnam today. It was the first country to go from being a recipient of OECD economic aid to being a contributor to the institution's aid programs.

There are signs however that the model is not providing South Korea the benefits that it once has. Its competitiveness in manufacturing has remained idle over the past ten years according to the Boston Consulting Group while other countries, such as the U.S. and Mexico, have improved their affordability over that time period.

In short, Korea stands at an interesting point in its economic story. It needs to make reforms along the lines commentators frequently associate with China but at a stage of economic development that parallels Japan. South Korea needs to reshape its identity and internal structure to provide a long-term growth model that can survive the country's ageing but it has limited space to maneuver. Its corporate titans, the driver of their growth historically, are burdened with debt and their own interests contrast that of the general Macroeconomy while households are leveraged as well. The public sector, one of the few globally with low debt levels, therefore may need to take the lead by instituting plans to rebalance the economy towards higher-value services and move away from the corporatist driven growth for a sustainable future and not just rely on a currency devaluation to solve its problems.

An Outdated Model

Coming out of the devastating Korean War South Korean GDP per capita was roughly $1,500 (in 2011 dollars). For some context, that is the current level of development for nations such as Mali and Sierra Leone. The authoritarian government listed economic development as a national priority, using state capital, tax subsidies and other favorable policies to guide the rise of national titans especially in the area of heavy industry. The result was the formation of the chaebol, massive corporations with stakes in every facet of the economy that sat in the control of the nation's wealthiest families. Today, the chaebols, about 60 in all, dominate economic activity and wealth in South Korea (Figure 1).

Figure 1: Chaebols and Their Share Within Korean DP, David Murillo and Yun-dal Sung

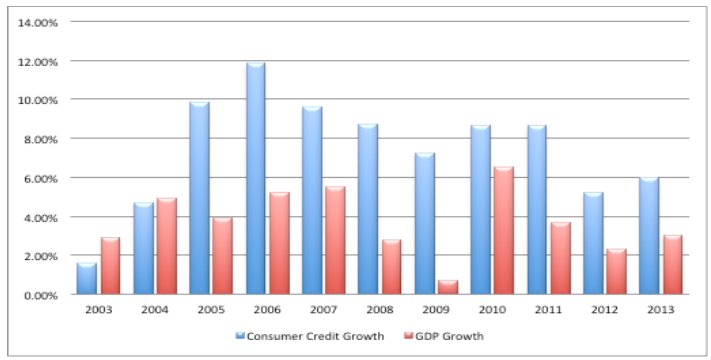
		2009	2010	2011
Asset / GDP	20 largest groups	75.3%	78.6%	85.2%
	5 largest groups	46.5%	49.9%	55.7%
Sales/ GDP	20 largest groups	75.3%	78.6%	85.2%
	5 largest groups	46.5%	49.9%	55.7%

The chaebols and the industrial expansion in South Korea promulgated wealth throughout the country for decades on the back of a strong export sector providing jobs, attracting capital, and maintaining healthy profits in the increasingly globalized marketplace. The country came to dominate in sectors such as shipping, mobile phones, electronics components, and others. The story maintains parallels with China's economic evolution of the past 30 years.

Lately however the model has begun to show its limits. Growth rates haven't recovered since the Asian Financial crisis, staying in a general downward trend. The crisis delinked some associations between the banking sector and its corporate champions in Korea. While the government took some support away from the chaebol the corporate giants still dominate the economic scene in the country.

Since that crisis of the 1990s growth has come from debt expansion, especially in the property markets. For nearly every year of the past decade consumer credit growth rates have outpaced GDP growth rates (Figure 2).

Figure 2: Consumer Credit (Blue) Grows Faster Than GDP (Red), Bank of Korea



As an in-depth analysis of the South Korean economy by McKinsey in 2013 demonstrated, manufacturing output grew consistently through the 2000s but thanks to outsourcing and productivity improvements at home there was not a concomitant rise in employment. The result was stagnation in wages and general decoupling between the corporate sector (which was driving growth via exports) and the real economy. According to Reuters, the chaebols only employ 5% of the labor force in South Korea. To try and keep up, South Korea's middle class had to turn to debt to afford the rising standard of living, particularly in the areas of housing and education. The result has been a steady climb in household debt to 164% of disposable income, well above the OECD average (Figure 3). But even this traditional statistic may not give the appropriate justice to the severity of the situation.

Figure 3: Household Debt As a Percent of Disposable Income, OECD

South Korea has tight regulations on homeowners when it comes to mortgages. To describe it simply, the mortgage value must stay within a certain range in relation to the value of the property. If not, homeowners are required to put up more principal. This policy, in an attempt to keep the mortgage sector in check (unlike the U.S.), raises the percentage of middle-income households in deficit from 25% to a staggering 55%. Regardless of these efforts household balance sheets are extremely tied to real estate assets where they make up 75% of assets, three times the U.S. while housing prices, as a multiple of income, are twice as expensive as American homes.

Herein lies the key problem for South Korea. The export-led model has been in place for too long and without a corresponding development of other sectors to rely on for growth. The frequently cited consensus with regards to China is to move the growth engine from an external one to a consumption driven economy. But as highlighted above (and due to other reasons) South Korean households cannot be turned to as the growth catalyst due to their current debt burdens. Moreover, over 90% of mortgages in South Korea are of a floating variety, meaning that if the Bank of Korea raises interest rates household cash flows will be further squeezed. It also doesn't help that the central bank's chief worry in their latest Financial Stability Report is the possibility that turbulence in global financial markets, led by a Federal Reserve rate increase, will push interest rates up and tighten monetary conditions at home.

Towards a New Model

Like in several other countries (Europe, China, India, Brazil, etc.) the Financial Crisis revealed the structural deficiencies in South Korea's growth model and the need to reform the economy in order to ensure sustainable growth going forward. There are reasons to be optimistic in the case of South Korea: it is a highly educated country, the infrastructure system is healthy, and the banking system is well capitalized per Basel's standard. In addition, as McKinsey's study points out, there are several reasonable efforts that could be taken to control housing prices, alleviate mortgage debt, and make education more economical (another huge source of debt) and worthwhile for the Korean people.

But what the McKinsey study and other analyses of South Korea lack is an exhaustive review over what to do about the chaebol, the anchor of South Korea's economic growth for over fifty years. McKinsey frequently complains about the lack of development in the service sector, the absence of an entrepreneurial culture, and weak small and medium enterprises (SMEs). Yet these soft spots in the Korean economy should be seen as the other side of chaebol coin; they have been unable to develop or be nurtured with the chaebol's entrenched interests. A recent survey by the Korean Economic Research Institute reported that 72.5% of respondents felt the government favored the corporate giants.

Despite the favor these conglomerates receive from investors it is becoming increasingly clear that time is running out for the chaebols. The sales growth rate continues to decline for these companies while maintaining one of the worst payout ratios in all of Asia. These large corporations have continued their policy of holding onto cash rather than investing in growth (equities have been flat for four years in South

Korea) or paying out dividends, agitating investors, in response to the sudden outflows they witnessed during the Asian Financial Crisis. The weariest indicator that Korea's old chaebol-centric model is outdated is the rapid buildup in debt these corporate goliaths have amassed (Figure 5). In a controversial report by the Korean Economic Reform Research Institute researchers revealed massive debt ratios among 20 of the largest chaebols and that half of all of them were not earning enough revenue to meet interest payments.

Figure 5: Dangerous Debt Levels, Economic Reform Research Institute

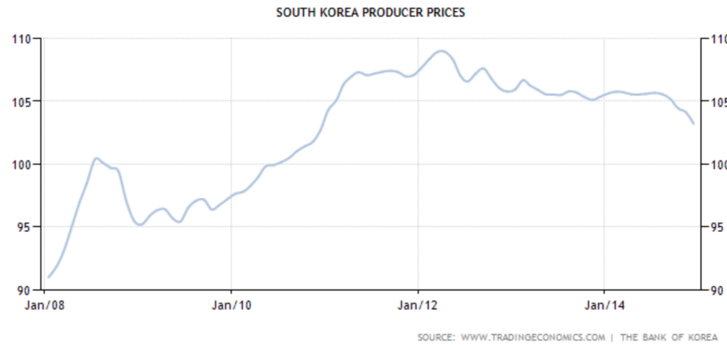
Chaebol at risk of insolvency

Group	Consolidated debt ratio	Consolidated interest earned ratio
Hyundai	895.4	−1.06
Hanjin	678.4	0.04
Doosan	405.4	0.89
Dongbu	397.5	0.3
Korea Gas Corporation	389.6	1.37
E-Land	369.9	1.86
Booyoung	326.5	10.48
Hyosung	311.5	0.82
GM Korea	307.4	−6.99
Halla	271.4	0.33
Hite Jinro	260.5	2.49
Hanjin Heavy Industries	256.1	0.26
Daewoo Shipbuilding and Marine Engineering	255.7	3.11
Homeplus	255.2	3.77
Hansol	250.5	1.02
Kolon	245.6	1.80
Hanhwa	227.4	1.15
Dongkuk Steel	227.2	−0.30
Daesung	220.1	0.57
LS	209.5	2.15

※Based on consolidated accounts as of 2012.

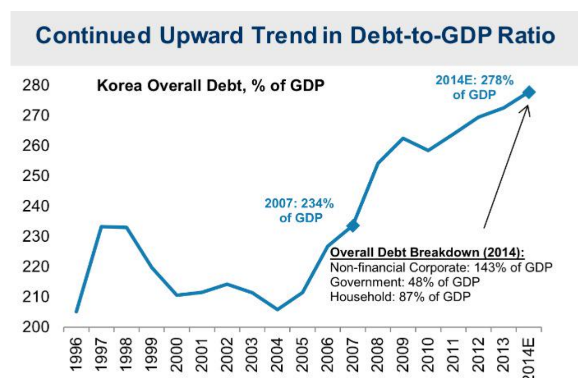
It is no surprise then, that growth has tapered off in recent years in South Korea and that the central bank has had to set its main monetary tools at some of their lowest levels ever, not only to support the property market for consumers but also to give easy credit to the corporate sector. As GavKal Capital pointed out with regards to China, a rising debt level and falling inflation are a massive incentive for devaluation. We cannot help but think the same sort of thing is in place for South Korea, especially since exports to China is equivalent to 10% of the country's GDP (Figure 6).

Figure 6: Falling Producer Prices in Korea



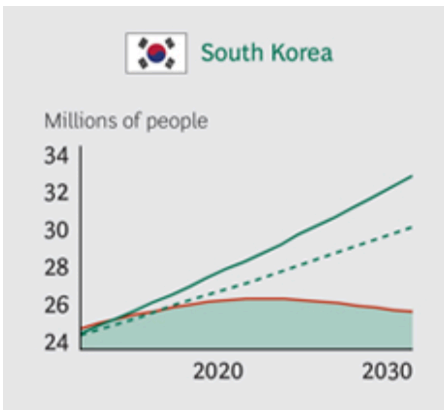
So with both a corporations and households heavily saddled where is South Korea to turn? The answer may be that the public sector has to step in because it is the only one that can (Figure 7).

Figure 7: Public Sector Debt Much Healthier Than Rest of Country, SoberLook



Critics warn that a sharp disruption of the chaebol's position within the Korean economy can be destructive. They are essentially the membrane of the country and their corporate governance, based on bloodlines, make them extremely resistant to external criticism; they want their brands to survive for generations and thus think in time horizons that are often inconsistent with investors. But the long term puts South Korea in a more intransigent position: by 2040 they will be the second oldest country in the world trailing only Japan according to Boston Consulting Group (Figure 8). South Korea already has the worst productivity rates in the developed world according to the OECD, stemming from a lack of competition, as cited by McKinsey, and a deficiency of investment by the chaebol. This trend of diverging productivity and dependency ratios poses long-term risks.

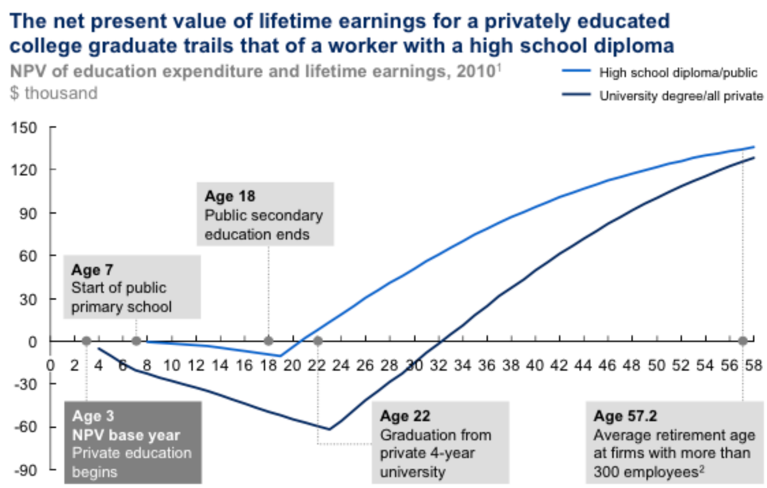
<u>Figure 8: Shortage of Labor Supply (Red) Compared to Demand Trends (Green), Boston Consulting Group</u>



South Korea desperately needs to find new sources of growth and it will most likely require reform of its institutions but also public capital to get the effort started. As McKinsey finds, the service sector is underdeveloped and financial services are particularly substandard in South Korea compared to other nations at its stage of development. In healthcare, primary care is weak, leading to waste as the sick spend too much time searching for the right treatment or specialist, while preventive care is also underdeveloped and offers substantial employment potential in the rapidly ageing country. The development of new industries will need a concurrent effort in relinquishing the stranglehold the chaebols have over much of the country: subsidies, preferential tax treatment, and favorable regulations need to be shifted towards small and medium sized businesses while continuing to unwind the cross-holding structure that allows chaebols to control vast amounts of industry and capital.

South Korea must also take action to relieve the burdens of its squeezed middle class. Loan-to-value ratios need to be eased further than recent efforts, mortgages should be stretched out to include 30-year options and converted to fixed-rates like much of the developed world, and vocational training should become a national theme. South Koreans take great pride in education but the Net Present Value of an expensive college degree has fallen below that of simply working through studies (Figure 9).

<u>Figure 9: A College Degree Is Not the Value It Once Was, McKinsey</u>



Conclusion

Much of economic development theory involves first finding a catalyst for economic growth, something that can carry the country and attract capital. It is often the most difficult step to climbing out of poverty. From there the hope is that the country's institutions and leaders can nurture the development of other industries high up the value chain, expand employment opportunities and become more balanced. It is an approach that comes off logical but has been exceedingly difficult to execute for various reasons (political, social, economic, etc.), requiring exceptional judgment, foresight and discipline, qualities that are difficult to embrace when times are good.

Now that it seems the low-hanging fruit has been picked however South Korea finds itself with limited options that it can turn to for growth. It's extremely sensitive to the well-being of the manufacturing base which is capital intensive and does not offer wide benefits among people as well as it used to. Other parts of the economy are small in scale, are burdened with debt and experience low levels of productivity, which hold down wage growth. Unlike many other nations in the developed world though its public sector maintains a healthy balance sheet. Korea's leadership has shown in its history its ability to foster growth but lacked the foresight for secondary steps once the economy began expanding. As the country ages it should correct that process and offer reforms that will regenerate growth in a fuller capacity.