Foreign Capital Investment in Korea and Issues in Asian Capital Markets

Korea Institute of Finance

Ⅰ. Short History and Characteristics of Foreign Capital Investments into Korea

1. Emerging Countries and Foreign Capital

□ Korea is one of the emerging countries in the context of global investment.

□ Pros of foreign capital: economic growth, institutional advancement in the financial markets, etc.

□ Cons : potential risks from sudden outflows → possibly, systemic risk to domestic financial markets and overall economy

- ○ E.g. East Asian currency crisis in late 1990s, global financial crisis in 2008
- ○ Measures to control the risks in Korea: Macro-prudential Stability Levy(2011), leverage cap on bank FX derivatives positions(2010), tax rules associated with bond investments, etc.

2. After mid-2000s, Bond Investments rather than Stock

□ In 1990s, borrowing or direct investment → in the early 2000s, stocks → after mid-2000s, stable bond and volatile stock investment.

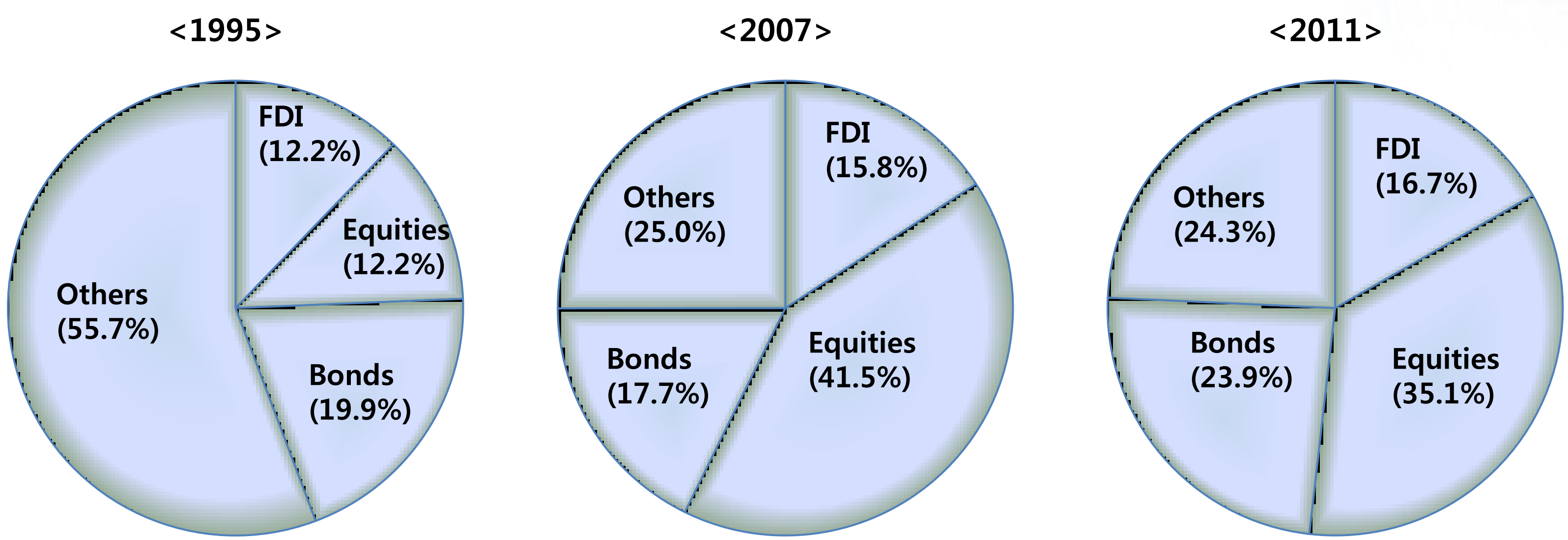
□ Before the entry into the OECD and 1997 Asian crisis, more than half of the total international liabilities were "other investments (mainly loans) "

□ After the opening of the capital markets, portfolio equity investments became the largest funding sources.

□ Since late 2000's, foreigners has increased their investments on Korean bonds (especially bonds issued by the government and the central bank)

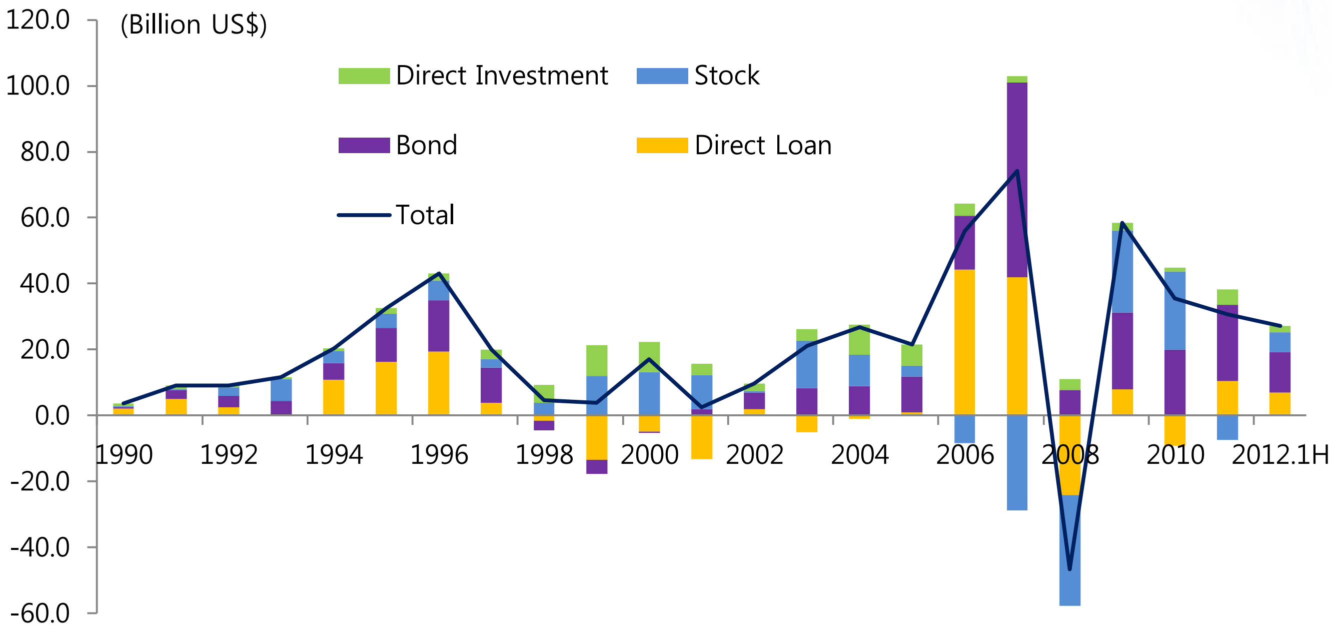
2. After mid-2000s, Bond Investments rather than Stock

<Figure 1> Composition of Liabilities in Korea's International Investment Position



2. After mid-2000s, Bond Investments rather than Stock

<Figure 2> **Foreigners' Investments in Korea**



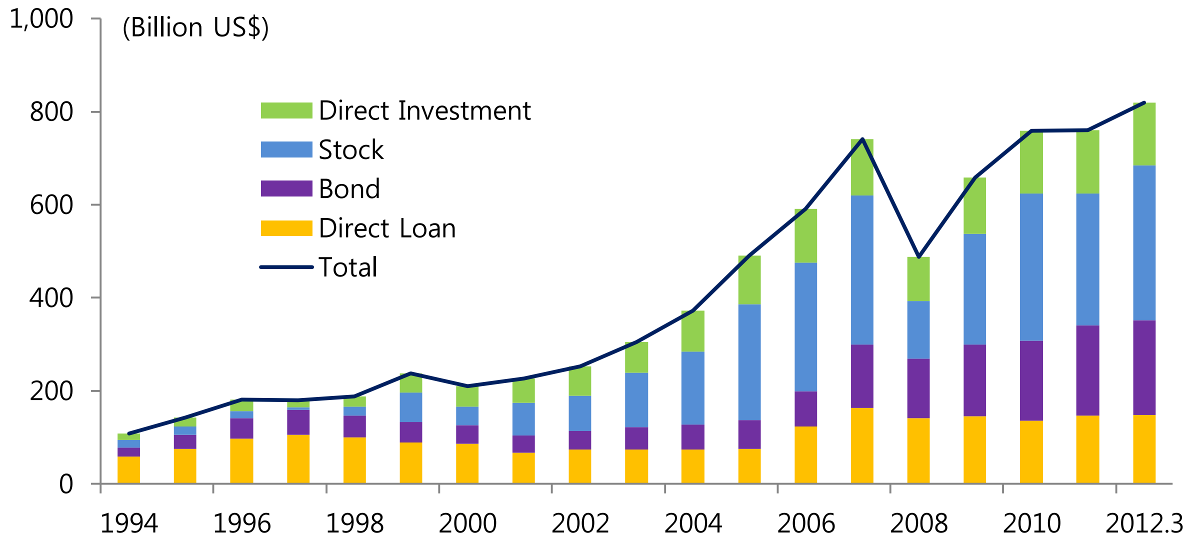
Footnotes : Balance of payments(BOP)
Source : The bank of Korea

3. Foreign Capital, Still on the Inflow Trend

□ After the East Asian currency crisis, foreign investment into Korea keeps increasing except for the recent global crisis.

- ○ Foreign capital outflows during the crisis bounced back to inflows very quickly.

<Figure 3> **Foreigners' Investments (Outstanding)**

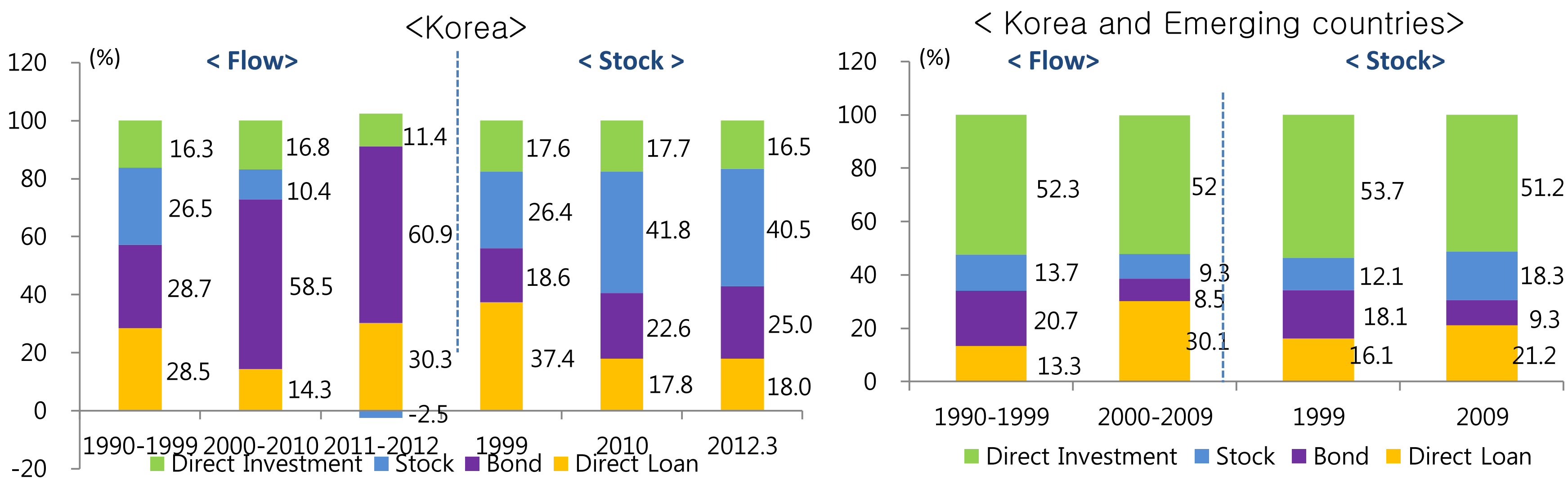


Footnotes : International Investment Position(IIP)
Source : The bank of Korea

4. Exposed to Sudden Withdrawal Risks

□ Foreign capital inflows composed mainly of borrowing, stock or bond investments rather than direct investment → vulnerable to sudden or unexpected outflows of foreign capital

<Figure 4> Composition of Foreigners' Capital in Korea and Emerging Countries



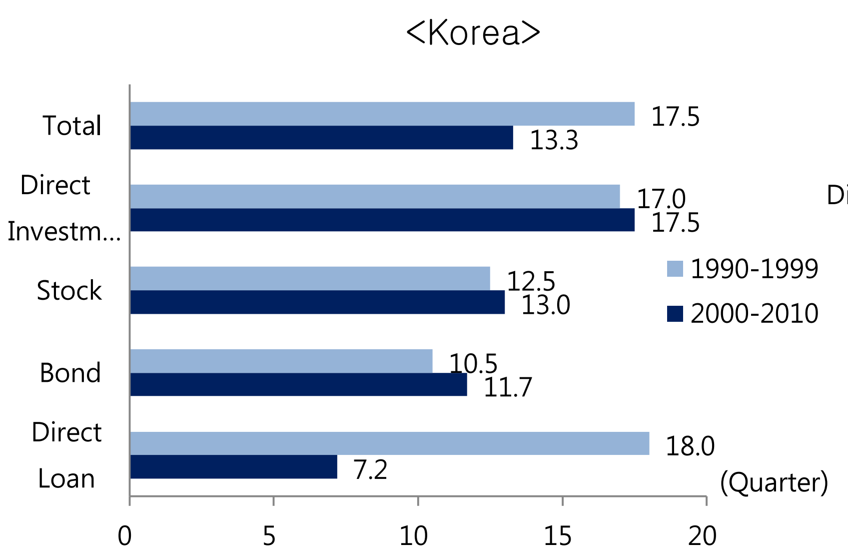
Footnotes : 1) The Korean flow data of 2011-2012 shows the sum of 2011 and the first half of 2012.
2) Emerging countries are 39 different nations of International Financial Statistics by IMF

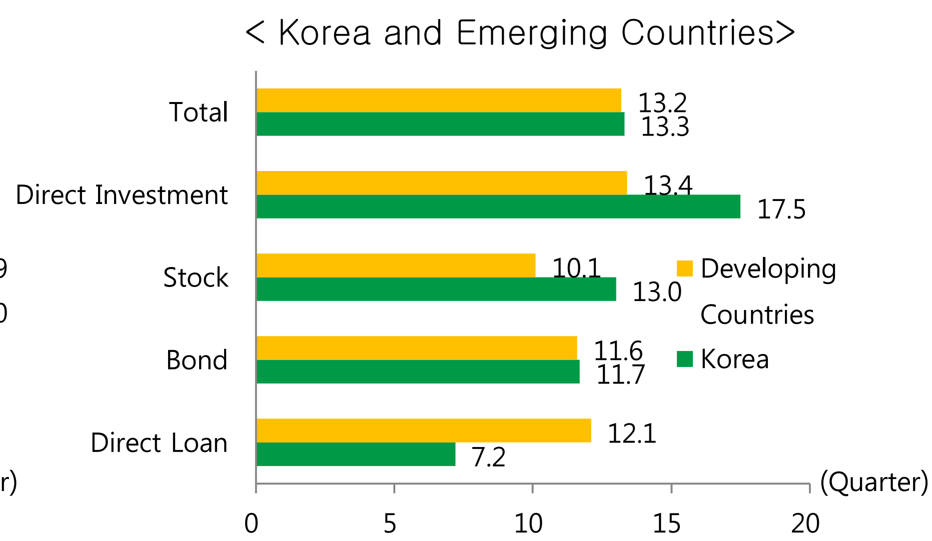
Source : The bank of Korea, 「The Movement of Korean Capital after Liberalization in Capital Market」 by Ha-il Park et al.(2012)

5. Shortened Persistency and Increased Variability of Overall Capital Inflows but Improved Stability of Bond Investment

☐ Overall persistency(average length of cycles) of foreign capital inflows shortened and variability(average amplitudes in cycles) increased → vulnerable to external shocks

<Figure 5> **Persistency of Foreign Capital Inflows**





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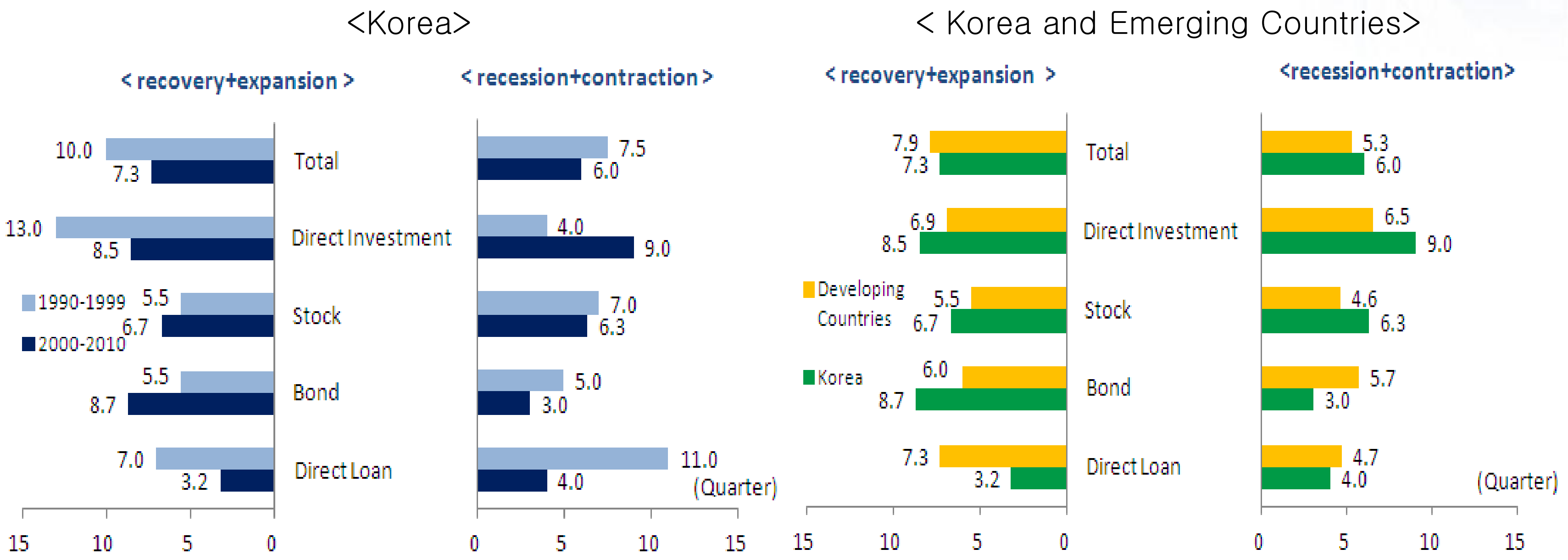
Source : 「The Movement of Korean Capital after Liberalization in Capital Market」 by Ha-il Park et al.(2012)

5. Shortened Persistency and Increased Variability of Overall Capital Inflows but Improved Stability of Bond Investment

<Figure 6> Persistency of Foreign Capital Inflows and Business Cycles



Footnotes : Emerging countries are 39 different nations of International Financial Statistics by IMF

Source : 「The Movement of Korean Capital after Liberalization in Capital Market」 by Ha-il Park et al.(2012)

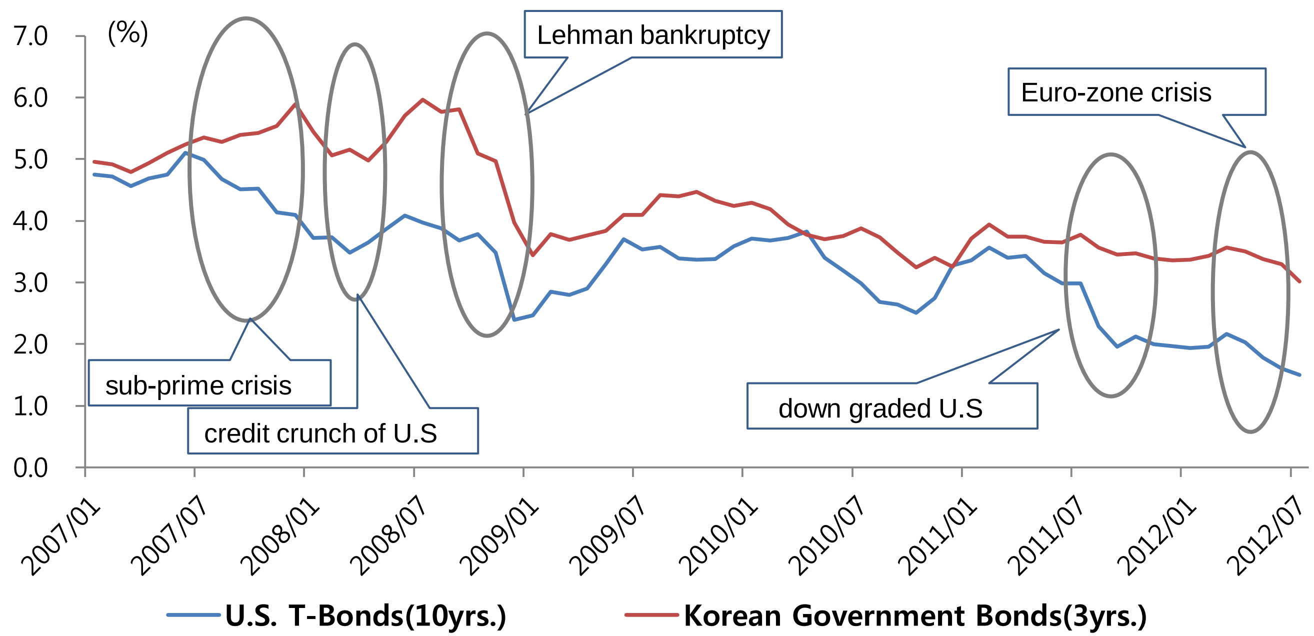
Ⅱ. Foreigners’ Bond Investment and Interconnectedness

1. Higher Correlation of U.S. T-Bonds and Korean Government Bonds after the Recent Crisis

<Table 1>Yield Correlation of U.S. T-BONDS(10yrs.) and Korean Government Bonds(3yrs.)

Yr. 2007 (sub-prime crisis)	Early half of yr. 2008 (credit crunch of U.S.)	Late half of yr. 2008 (Lehman bankruptcy)	Yr. 2011 (down graded U.S.)	Yr. 2012 (Euro-zone crisis)
-0.36	0.17	0.06	0.71	0.95

<Figure 7> U.S. T-Bonds(10yrs.) and Korean Government Bonds(3yrs.)

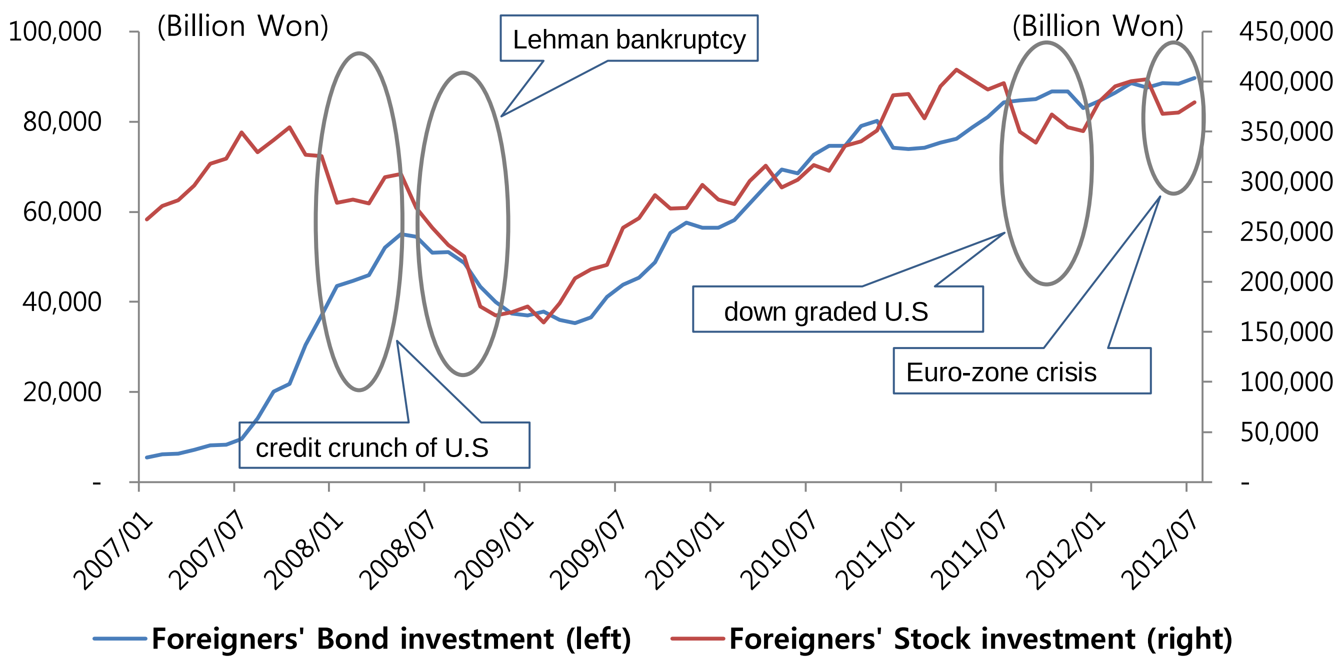


2. Foreigners' Appetite for Korean Bonds: Compared with Stocks

<Table 2> Correlation of Foreigners' Bond and Stock Investment

Early half of yr. 2008 (credit crunch of U.S.)	Late half of yr. 2008 (Lehman bankruptcy)	Yr. 2011 (down graded U.S.)	Yr. 2012 (Euro-zone crisis)
0.93	0.87	-0.53	-0.51

<Figure 8> Foreigners' Bond and Stock Investment

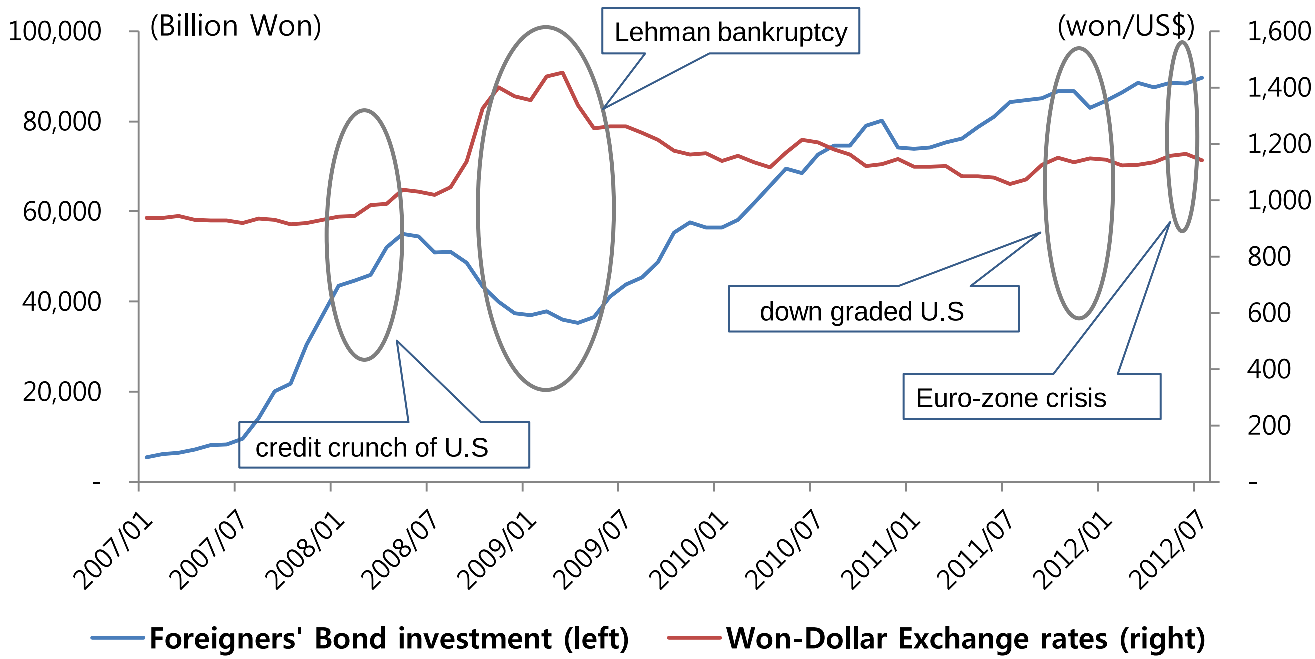


3. Positive Correlation of FX Rates and Bond Investments

<Table 3> Correlation of Won-Dollar Exchange rates and Foreigners' Bond Investments

Early half of yr. 2008 (credit crunch of U.S.)	Late half of yr. 2008 (Lehman bankruptcy)	Yr. 2011 (down graded U.S.)	Yr. 2012 (Euro-zone crisis)
-0.33	-0.74	0.49	0.05

<Figure 9> Won-Dollar Exchange rates and Foreigners' Bond Investments

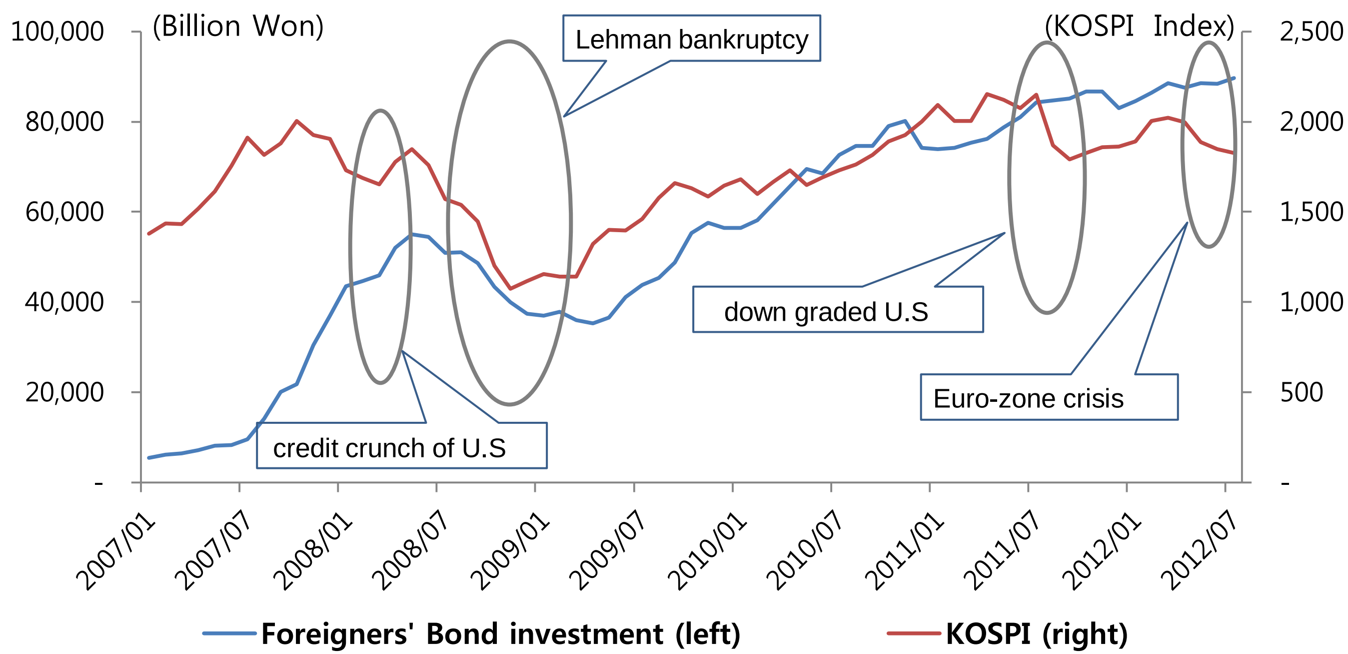


4. Negative Correlation of Stock Markets and Foreigners Bond Investment

<Table 4> Correlation of KOSPI and Foreigners' Bond Investment

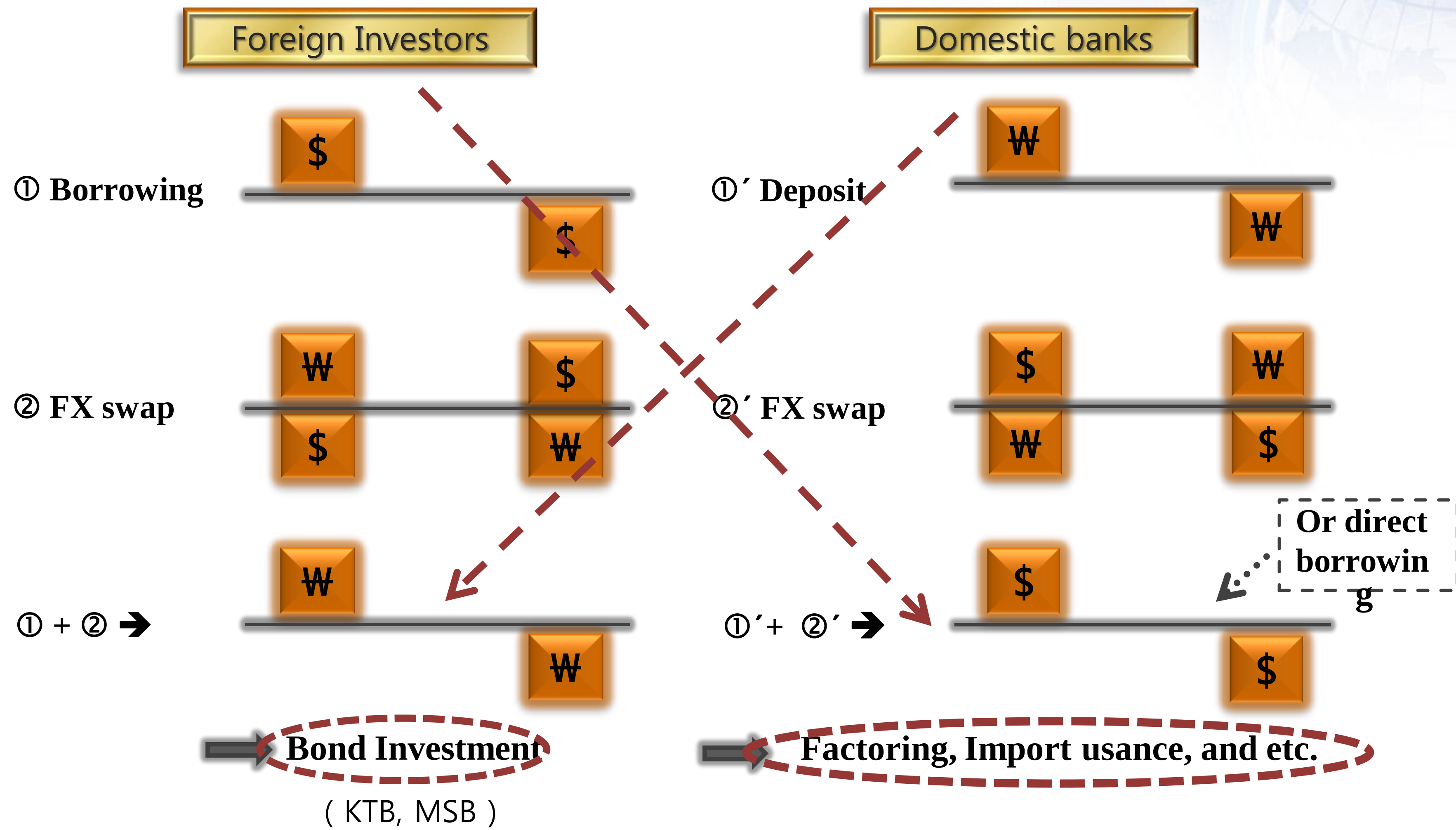
Early half of yr. 2008 (credit crunch of U.S.)	Late half of yr. 2008 (Lehman bankruptcy)	Yr. 2011 (down graded U.S.)	Yr. 2012 (Euro-zone crisis)
0.92	0.85	-0.58	-0.54

<Figure 10> KOSPI and Foreigners' Bond Investment



5. Always Not Good News: Interconnectedness of Bond Investment

<Figure 11> Foreigners' Bond Investment and Flows of Borrowed Foreign Funds



Ⅲ. Regional Changes of Funding Sources

1. Currency Denomination of International Liabilities

□ In general, international liabilities are believed to be systemically riskier because they are denominated by foreign currencies.

□ After the full opening of domestic equity market after 1997 Asian crisis, reliance on US dollar has reduced from 45.1% in 2002 to 32.3% in 2011.

□ Korean won denominated international liabilities increased from 47.6% in 2002 to 58.2% in 2011 while other currencies' shares did not change much.

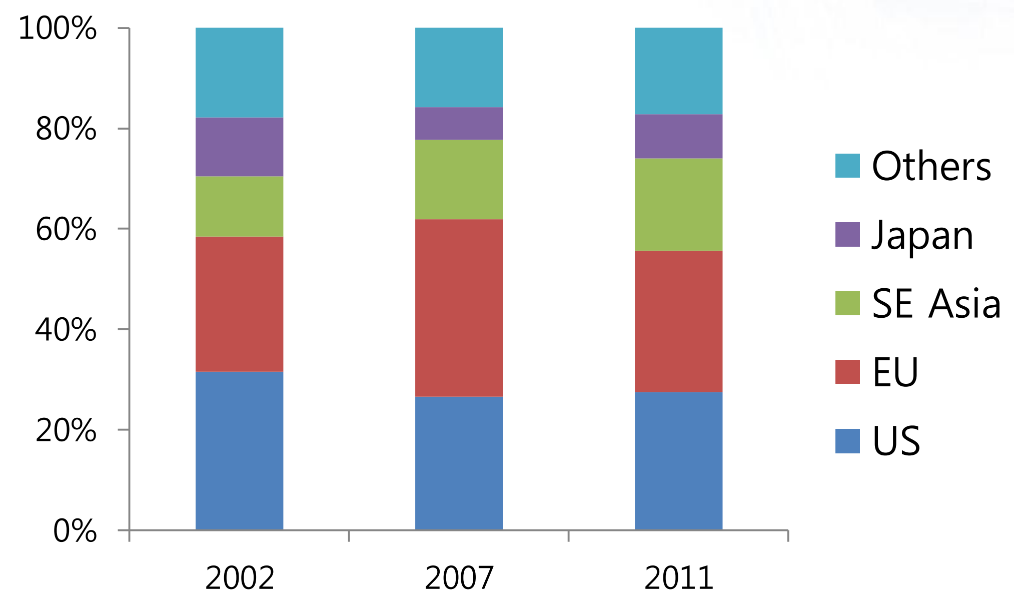
□ FDI and most of portfolio investments are Korean won denominated.

- ○ FDI is 16.7% of total international liabilities and portfolio equity and bond investment are 59% of the total.

2. Regional Changes in Funding Sources

- □ During 2000's, the EU countries had become the largest funding source to Korea, surpassing US.
- □ EU countries acted as intermediaries which borrow dollar funds from US and supplies them to other regions in the world.
- □ Due to large deleveraging by EU financial institutions after global financial crisis, EU countries' share has been reduced.

<Figure 12> Regional Changes in Funding Sources



2. Regional Changes in Funding Sources

☐ **(Equity)** Regions of portfolio equity investment by foreigners have not changed much during 2000's.

☐ **(Debt)** US and South East Asian countries have taken over the reduced share of the EU countries.

- ○ EU: 35.3%(2002)→ 54.6%(2007) →26.2%(2011)
- ○ US: 41.6%(2002)→ 15.1%(2007) →24.4%(2011)
- ○ SE Asia: 8.6%(2002)→ 17.0%(2007) →28.0%(2011)

☐ **(Other Investment)** US and Japan filled the gap made by the decreased share of the EU countries.

- ○ EU: 18.4%(2002)→ 23.2%(2007) →15.5%(2011)
- ○ US: 14.8%(2002)→ 9.4%(2007) →13.1%(2011)
- ○ Japan: 10.9%(2002)→ 6.5%(2007) →12.6%(2011)

Ⅳ. Recent Asian Capital Markets

1. From Equity to Bond

□ Changes of Asian investment banking: Asia debt fees overtake equity.

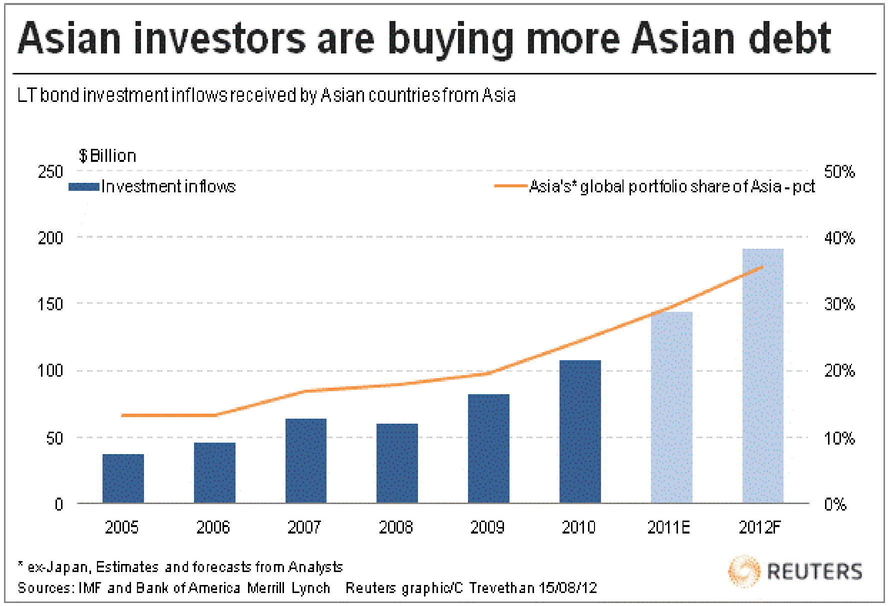
- ○ At the end of August in 2012, fees from bond deals are about double the typical proportion in the pre-crisis years.
- ○ The bond percentage is 26%, the highest on record and the syndicated loans are 14% and equity fees are just 36% nearing a historic low.

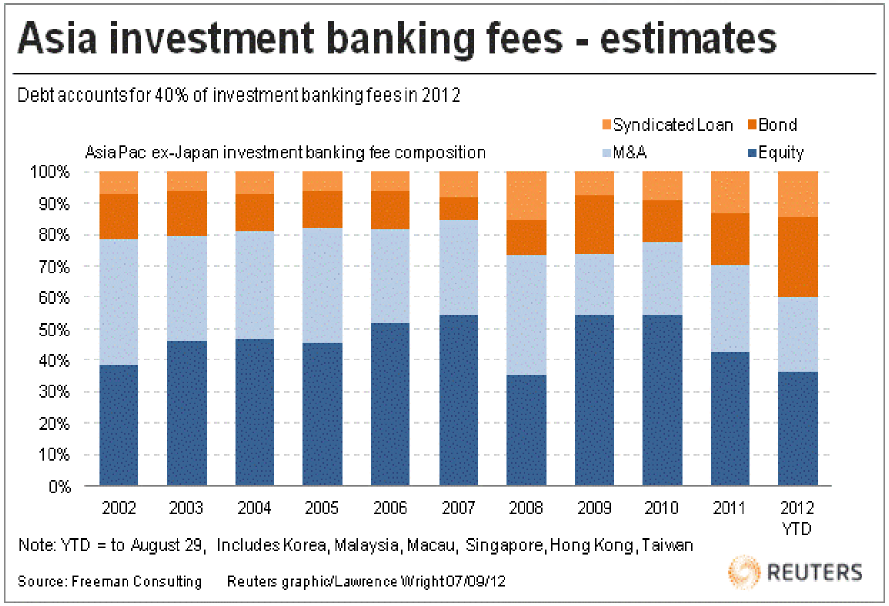
□ IPO drought in Hong Kong

- ○ $26.81 billion from IPO in 2009 → $57 billion in 2010 → $36 billion in 2011
- ○ Because the wave of huge state-backed Chinese listings is over and equity markets are in a worldwide slump.
- ○ However, attention to some deals elsewhere in the Asia, such as Malaysia and Japan

1. From Equity to Bond

<Figure 13>





2. And from Loan to Bond

- In Q1 2012, Asian companies and banks raised a record amount in the bond market while the loan market went in the other direction.

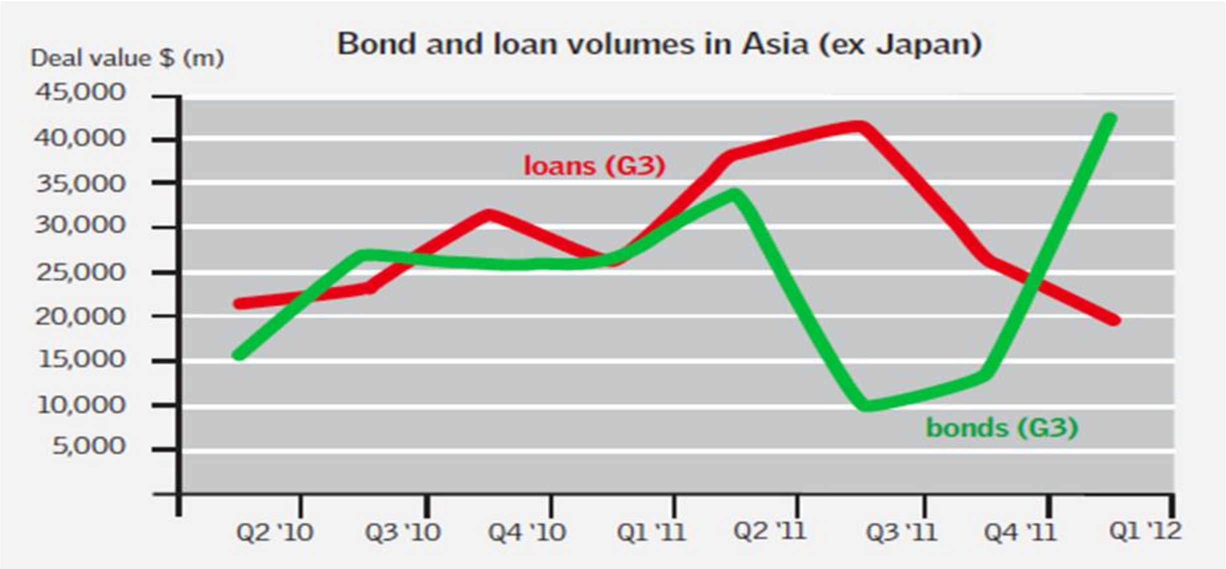
- Borrowers in Asia (except Japan) raised $42.3 billion, more than 60% above that for Q1 2011. (for only those deals sold in dollars, euro or yen)
  - Global funds are becoming increasingly interested in Asian debt as their investments in European and US markets prove more volatile than expected.
  - The rise of China is dragging up expectations or other countries.
  - Relatively attractive pricing on offer compared with record-low yields of advanced countries.

2. And from Loan to Bond

☐ Asian loan volumes were $20.0 billion in Q1 2012, 23% lower than Q1 2011. (again, using dollar, euro and yen volumes)

- ○ Banks preparing for Basel III are being forced to be more careful with their lending.
- ○ Some European banks scaled back their lending in emerging market due to their big problems at home.

<Figure 14>



3. An Exception: Increase of Japanese Lending

- ☐ The increase in the share of Japan in other invests can be explained partly by more aggressive foreign lending strategy by major Japanese banks.
  - ○ Pessimistic growth forecast and extremely low domestic interest rates have led major Japanese banks to expand their foreign business.

- ☐ The three largest Japanese banks increased their project financing and syndicated loans abroad, especially loans to Asia.
  - ○ MUFG: USD 192.8 billions(2010.3)→ USD 255.3 billions (2011.9)
  - ○ SMFG: USD 90 billions(2010.3)→ USD 128 billions (2011.9)
  - ○ Mizuho: USD 77.2 billions(2010.3)→ USD 113.5 billions (2011.9)

<Table 5> **Major Japanese Banks' Foreign Loans**

(unit: USD billions)

		MUFG		SMFG		MIZUHO		Sum	
		2010.3	2011.9	2010.3	2011.9	2010.3	2011.9	2010.3	2011.9
Total		192.8	255.3	90.0	128.0	77.2	113.5	360.0	496.8
	Europe	47.4	58.6	34.0	40.0	25.5	26.4	106.9	125.0
	US	39.8	46.9	25.0	38.0	24.6	33.8	89.4	118.7
	Asia	56.0	89.9	31.0	50.0	27.1	53.3	114.1	193.2

3. An Exception: Increase of Japanese Lending

- □ Japanese banks have also advanced in trade financing in Asian Pacific region.
  - ○ The three major Japanese banks increased their share rapidly from 8.7% in the first half of 2011 to 14.5% in the first half of 2012.
  - ○ In particular, Mitsubishi-Tokyo UFJ Bank (MUFG) jumped up to the top in H1 of 2012 from 9th in H1 of 2011.

<Table 6> Rankings in Asia-Pacific Trade Financing in H1 of 2012

Rank[1)]	Bank	Nationality	Share(%)[2)]
1(9)	MUFG	Japan	6.5
2(2)	HSBC	U.K.	5.8
3(14)	MIZUHO	Japan	4.3
4(19)	Bank of China	China	4.0
5(8)	SMFG	Japan	3.7

Note: 1) Figures in ( ) are rankings in the H1 of 2011
2) Shares are the proportion of the total trade financing in Asian Pacific region.
Sources: Dealogic