KIEP Opinions

More External Financial Assets than Liabilities in Korean Private Sector: What It Tells Us

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Recently, Korea has seen a major change in terms of net external financial assets. Korea's net international investment position (NIIP) – defined as the difference between an economy's external financial assets and liabilities – is steadily recording a positive figure and continues to increase. Korea's NIIP turned positive in the third quarter of 2014 and has since increased to a positive $441.4 billion. Remarkably, Korea's NIIP in the private sector – excluding international reserves, which are government assets – turned positive at the end of 2018 for the first time. Now, Korea has become a positive NIIP country in the private sector as well. According to NIIP figures for 2019, Germany, Japan, Canada, and Saudi Arabia among G20 countries showed positive values in the private sector.

The growing positive value of the national NIIP, and the reversal of the private sector's NIIP to a positive value, have several important significances for the Korean economy. First, the risk of foreign exchange (FX) market instability and currency crisis has been reduced compared to when NIIP was negative. This is because structurally, it means that Korea can use its financial assets held overseas to offset a possible capital flight by foreign investors at the national level. In particular, the private sector's NIIP turning to positive implies that the role of Korean private funds in mitigating the financial market shocks, such as the exchange rate shock, has been greatly expanded, reducing the burden of policy authorities to intervene to stabilize the FX market. In fact, according to the KIEP Financial Stress Index (FSI), which was developed to measure financial stress levels in a single and continuous value, the Korean financial market was unstable in the first quarter of 2020 due to the pandemic of COVID-19, but the level of FSI did not exceed the threshold of financial crisis. The recent rise in the KIEP FSI index was found to be mainly due to unrest in the stock market, rather than the money market (funding market) or foreign exchange market. In terms of their contribution rate to the rise in KIEP FSI, the stock market was the highest at 52.3%, followed by the FX market at 29.0% and the money market at 18.7%. The recent financial instability has been markedly different from that Korea experienced during the Asian financial crisis in 1997 and the global financial crisis in 2008. In the past two crises, the KIEP FSI exceeded the financial crisis threshold, and in particular, the FX market contributed about 50% of the rise in FSI.

Second, in terms of financial risk management, the importance of external financial assets has increased significantly in line with their remarkable growth, especially in the private sector. Foreign financial assets increased by 2.8 times from $693.8 billion in 2010 to $1.94 trillion in 2020. In particular, foreign portfolio investment assets increased by 6.2 times from $112.2 billion in 2010 to $695.5 billion in 2020. And several financial risks have been exposed in the process of greatly increasing foreign financial assets. One is that distortion of the FX fund market, or FX swap market, is intensified due to the high rate of hedging foreign exchange risk when residents expand their overseas investment. In other words, as the swap rate was significantly lower than the difference in interest rates at home and abroad, investors' arbitrage transactions expanded, leading to an increase in short-term external debt. This indicates that, unlike the swap market, the expansion of overseas securities investment did not have a significant impact on the exchange rate (i.e. the foreign exchange market). The other is that the expansion of the issuance of equity-linked securities (ELS) in Korea has raised the risk of instability in the foreign exchange market and money market. Due to the plunge in stock indices following the COVID-19 shock, a problem arose in ELS with stock indices in major countries as an underlying asset. Korean securities firms with a large amount of self-hedging of ELS faced a large-scale margin requirement, resulting in a large-scale currency exchange (surge in foreign currency demand) after raising Korean won in the money market. During this process, the CP rate surged, the FX rate soared, and the FX swap rate sharply declined. Another risk is the insolvency of foreign alternative investment. Domestic financial companies have greatly increased their overseas alternative investments since the mid-2010s in order to achieve high returns. Korea's overseas alternative investment, for instance in real estate and infrastructure, stands at about $100 billion. However, as the profitability of overseas commercial real estate deteriorates due to the COVID-19 pandemic, the risk of insolvency increases for investment in the sector.

Lastly, the growing NIIP reflects how the globalization of Korean financial companies is progressing, and the conditions for internationalization of the Korean won are improving. As the overseas investment of domestic funds increased, the investment and management of foreign assets by domestic financial companies expanded, together with a significant increase in overseas expansion and business by these companies. The number of Korean financial companies located overseas increased significantly from 322 in 2009 to 407 in 2016 and 442 in September 2020. This is leading to a gradual rise in the Transnationality Index,[1] which shows the level of internationalization of financial companies. The increase in positive NIIP also suggests that the conditions for internationalization of the Korean won have improved compared to periods when NIIP was negative. Until now, concerns about foreign exchange speculation by non-residents and currency crisis have been one of the factors limiting the internationalization of the won, but these constraints have been alleviated due to the structural change in terms of NIIP. This is because the growing positive value of Korea's NIIP contributes to reducing the possibility of currency crisis.

As the increase in positive national NIIP and transition to positive NIIP in the private sector imply structural changes in the Korean economy, Korean policy authorities should prepare a financial policy direction in line with the structural changes. First, existing macroprudential measures for capital flows that have mainly focused on the management of foreign capital inflows need to be changed to expanded macroprudential policy measures that include risk management of the outflow of domestic funds. In addition, as Korea emerges as a creditor, it is highly likely to participate as one of the major players in debt treatment talks at the Paris Club, which Korea joined in 2016. Therefore the Korean government should consider preparing a debt restructuring strategy in advance that can be used at the Paris Club. It will also be necessary to strengthen the management of financial market risks that may arise through the capital market channel, such as expanding the issuance of ELS and expanding overseas alternative investment. Furthermore, the Korean government should strengthen the financial stability function of its external financial

[1] The Transnationality Index is calculated as the average of three ratios: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

assets, reducing volatility in the FX market (FX rate) while easing distortions in the FX fund market by lowering the excessive FX hedging ratio of domestic investors. These preparations will help Korea to weather global financial instability arising in the process of major countries normalizing their monetary policies in the future. In addition, the Korean government will be able to promote the globalization of Korean financial companies and the internationalization of Korean won in the process of expanding Korea's foreign investment. KIEP