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Research Report

Risks of Short-termism in Macro-prudential Policy Making: The Case of Household Debt in Korea

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Risks of Short-termism in Macro-prudential Policy Making: The Case of Household Debt in Korea

Youngil Kim, Fellow at KDI



* Based on Kim (2017).

Summary

- **Korea's household debt continues to be a major economic risk despite countermeasures, necessitating a thorough overhaul of the current macro-prudential management system.**
 - The debt expanded to 1,514 trillion won in 3Q 2018 from a decade ago (713 trillion won in 2008), considerably exceeding the income growth during the same period.
 - The rapid increase suggests that past policy measures have been ineffective in achieving a soft landing.
 - This study adopts a political economy perspective to determine the obstacles to past macro-prudential policies, which can be effective tools in terms of credit risk management, and suggests directions for improvement.

- **It was found that the more fixated policy makers are on the short-term gains in growth and employment, the less likely they are to seek macro-prudential policies for financial stability.**
 - Short election cycles can narrow the horizon of policy decisions, hence policy makers often pursue those with immediate outcomes to earn the public's favor—even if they entail negative fallouts.
 - The failure to implement suitable and timely macro-prudential policies will increase the probability of a credit boom-driven crisis and restrict the scope of mid- to long-term economic policies.

- **To improve the macro-prudential management system, its institutional basis needs to be consolidated to prevent the policy horizon from becoming narrower.**
 - An institutional mechanism should operate the macro-prudential management system in correspondence with the mid- to long-term preference of the national economy.
 - More practical measures should be considered and adopted which could strengthen public accountability and the operational independence of the macro-prudential management system.

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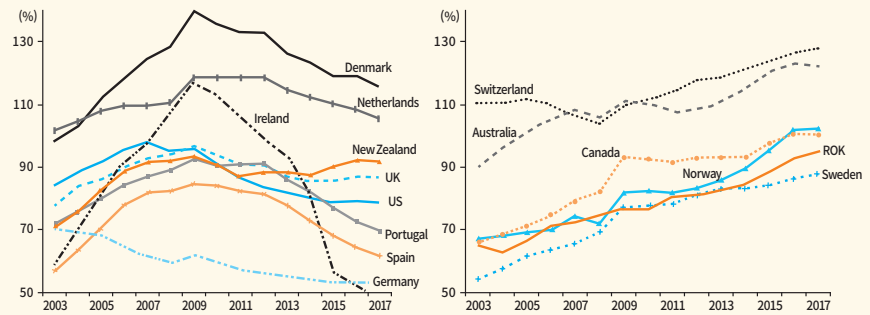
Issues

- **Household debt has long been a major threat to the Korean economy. Nevertheless, concerns over the issue have yet to be abated.**
 - Household debt has been one of the biggest risks to the Korean economy in terms of size, growth and quality for a relatively long time.
 - However, it continues to be a source of great concern.
 - The amount swelled from 713 trillion won in 2008 to 1,514 trillion won in 3Q 2018, far exceeding the income growth during the period.
 - While the majority of OECD countries underwent an adjustment following the global financial crisis, Korea and a few Nordic countries saw their household debt soar (Figure 1).

- * The risks are greater for Korea given its weaker pension system and social safety nets.
- Resolving household debt was designated as one of the Moon Administration’s ‘100 Policy Tasks.’

1 For instance, comprehensive measures for a soft landing of household debt (Jun. 2011), supplementary measures for the household debt in the non-banking financial sector (Feb. 2012), support to vulnerable households and the house-poor (2013), measures to expedite the reform of the household debt structure (Feb. 2014), new economic team’s economic policy direction (Jul. 2014), programs to improve the structure of household debt (Feb. 2015.2), household debt management directions and guidelines to improve credit approval procedure (Dec. 2015.12), household debt management plans (Aug. 25, 2016) and measures to consolidate the soundness in the non-banking financial sector (Mar. 2017). These measures indeed made positive contributions to enhancing the household debt structure and providing relief to vulnerable and marginal borrowers. But, aggregate household debt has increased so fast that concerns linger over the overall financial soundness of the household sector.

[Figure 1] Household Debt/GDP Ratio (%) in Major OECD Countries



Note: Left panel shows countries that underwent debt ratio adjustments pre- and post-global financial crisis while the right panel shows those whose ratio continued to increase.
Source: BIS Statistics Explorer.

- The risks from aggregate household debt have consistently grown despite warnings and government action. Accordingly, Korea’s current macro-prudential management system requires a fundamental reexamination.
 - The rapid trajectory of the debt increase indicates that preceding measures¹⁾ have been ineffectual.
- This study adopts a political economy perspective to discern the underlying flaws of Korea’s macro-prudential management system in terms of credit risk management and suggests a direction for improvement.

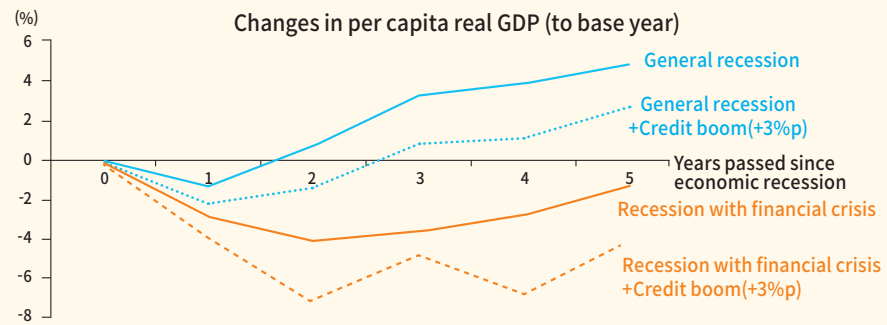
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The Credit Boom and Macroeconomic Instability

1 Refer to Reinhart and Rogoff (2009), Cecchetti, Mohanty and Zampolli (2011), Jorda, Schularick and Taylor (2013), King (1994), Mian and Sufi (2010), Dynan (2012).
2 Refer to IMF (2017), Lombardi et al. (2017).

- A financial crisis or economic recession will most likely ensue if the credit activities of economic agents (households, firms and government) experience a rapid increase or if they reach excessive levels, and the recovery will also be delayed.¹⁾
 - Past economic recessions in major advanced economies suggest that excessive growth or levels in private debt can lead to a deeper and more prolonged economic recession (Figure 2).
 - Extreme credit activities can weaken the resilience of households while the inefficient allocation of credit resources and growing risk-seeking negatively affect economic growth.²⁾

[Figure 2] Severity of Economic Recessions and the Recovery Period following Credit Booms in Major Economies



Note: The solid line represents the change in real GDP per capita to base year after an economic recession in cases where the private leverage ratio (credit/GDP) was at the average level before the recession. The dotted line represents the change in per capita real GDP to base year in cases where the private leverage ratio was higher (+3%p) than the average. This shows that compared to a 'general recession,' a 'recession with financial crisis' is more severe and the recovery is more delayed.

Source: Cited from Jorda, Schularick, and Taylor (2013), p.20.

■ **Korea has already experienced severe economic slumps due to excessive debt.**

- 1997–1998 Asian Financial Crisis: Improper management of external debt was blamed for the economic recession along with the enormous debt of large enterprises that contributed little to enhancing productivity.
- 2003–2004 Credit Card Crisis: Private consumption plummeted following a massive credit card lending boom among households.
- 2008–2009 Global Financial Crisis: Private consumption weakened significantly. Household debt was thought to be the main cause of the sluggish demand.³¹

3

Macro-prudential Policy Responses to the Credit Boom: Significance and Characteristics

- A credit boom can help to bolster domestic demand in the short-term but will undermine the soundness and resilience of economic agents and financial institutions in the mid- to long-term.
 - Excessive credit activity among firms and households was a major factor in dampening domestic demand during the Asian Financial and Credit Card Crises.
- The cyclical fluctuation in credit activities differs from that in the real economy, which is a monetary policy target, and requires a separate macro-prudential management system.
 - Credit activity tends to fluctuate within a longer cycle. Moreover, the two may stand at different stages.
 - The significance of a macro-prudential management system has grown since the global financial crisis as stabilizing the real economy can no longer guarantee macro-financial stability.

³ Kim and Hwang (2016) and Son and Choi (2015) state that heavily indebted households exhibit larger adjustments in household expenditure.

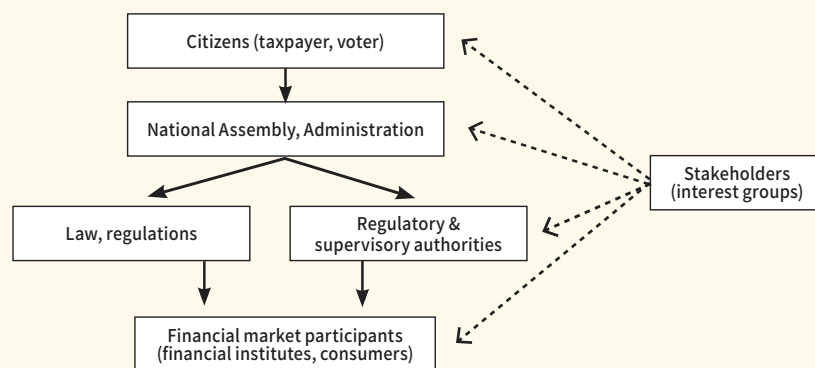
■ **Macro-prudential responses in times of a credit boom can effectively contain excessive credit activity (expansion, contraction) and help stabilize macroeconomic conditions in the mid- to long-term.**⁴

- Macro-prudential policy instruments include ① direct borrowing regulations e.g. LTV and DTI, ② regulations on the assets and debt of financial institutions e.g. restrictions on asset growth rate and reserve requirements, ③ regulations on the loss absorbing capacity of financial institutions (capital buffers, loan loss provisioning) and ④ taxation on specific assets (real estate properties) and debt.⁵
- Macro-prudential management can be undertaken by the financial policy and supervisory authorities, central bank and fiscal authority while the institutional structure, role sharing and coordination system of the macro-prudential management system may differ from country to country.
 - In Korea, the financial policy and supervisory authorities preside over the management of domestic macro-prudential policy instruments in collaboration and coordination with the central bank and fiscal authority.

■ **Due to the impact macro-prudential policies can have on credit activity and the real economy, there may be some heavy resistance during the implementation of such policies when they are most needed.**

- Macro-prudential policies are designed to resolve financial risks borne from a credit boom and as such, can restrict credit activity. Due to its impact on the real economy, there may be opposition and political resistance from stakeholders (Figure 3).
 - In particular, public support may be difficult to rally during a recession with low production and employment.
 - The policies' impact on the real estate market and the private sector's access to the credit market could generate significant hostility from stakeholders.
- Despite the benefits to social welfare, effective macro-prudential policies can be rejected by policy makers for policies that can generate growth and employment in the short-term.

[Figure 3] Design and Implementation of Regulatory and Supervisory Policies: Political Economy Perspective



Note: Regulatory and supervisory policies including macro-prudential measures are under the influence of general stakeholders associated with those in authority positions. The arrows show the direction of influence being exerted in the regulatory and supervisory process.

4 It was after the global financial crisis that macro-prudential policies were regarded as particularly important. They can be divided into two types according to the targeted risks; time-series risks e.g. increasing procyclicality in credit activities, or horizontal risks e.g. the systemic risk incurred by mutual linkage between financial institutions.

5 Refer to Claessens (2015).

4

Flaws of the Current Macro-prudential Management System: Political Economy Perspective

6 Besides environmental factors such as rushed opening of the foreign exchange market and exacerbating external economic conditions, there are domestic factors like structural weakness to be blamed for the crisis in 1997-1998: For instance, under the government-driven growth-priority initiative, financial institutions were loosely supervised for soundness and large enterprises were given an excessive supply of credit on the pretext of the “too big to fail” belief. The collapse of the credit card bubble in 2003-2004 was owed to the government policy that encouraged credit card use while easing financial regulations in the low interest rate environment after the 1997 crisis; the rapid default loan increase caused by overheated competition among credit card issuers despite their immature capability for personal credit risk assessment and the (yet) underdeveloped credit card industry and; the lukewarm response from supervisory authorities. Like this study, several preceding literatures have pointed out that the government’s domestic demand stimulus stance at that time overwhelmed the soundness regulation and supervision. Refer to Kim (2017) for further information on relevant studies and discussions.

■ **The fixation on performance, e.g. short-term growth, is evident in past cases of financial instability and credit rushes caused by an overheated credit market.**

- Some have criticized policy makers for prioritizing short-term growth and domestic demand while failing to take timely action against the spread of macro-financial risks during both the Asian Financial and Credit Card Crises.⁶⁾
- Voices have also been raised about the fact that, even during the rapid expansion of household credit from 2H 2014, policy makers set aside macro-prudential policies that would contain the risks of household debt and instead, pushed stimulus policies to bolster domestic demand in response to the slowing growth.
 - During this time, household debt was cited as a major risk factor to Korea’s financial system.
 - * According to the ‘System Risk Survey,’ conducted by the Bank of Korea to examine financial-market participants’ perceptions of risk, household debt has been listed as a major risk factor in every survey.
 - Nevertheless, due to concerns about an economic slowdown, policy markers have concentrated on bolstering domestic demand using all available policy instruments including conventional stabilization means such as monetary and fiscal policies as well as housing and financial policies.⁷⁾

■ **When the policy stance for short-term economic growth collides with that for the mid- to long-term improvement of social welfare, the political structure has a tendency to lean towards policies that can generate gains in the short run due to the sensitivity of election outcomes.**

- Short election cycles and the strong desire to be elected are conducive to developing a predilection for short-term gains during the decision-making process, narrowing the policy horizon (Box 1).
- Even if financial instability is expected in the mid- to long-term, the possibility grows for stimulus packages, e.g. financial easing measures that deliver immediate, tangible results, when the real economy slows down e.g. GDP.

[Box 1] Realistic Election-sensitive Political Structure and Narrowing of the Policy Horizon

■ **The election-sensitive political structure may be a factor behind the preference towards short-term gains:**

- In Korea, politically significant elections are held every 1-2 yrs (Table 1).
- Previous governments presented new goals for employment and GDP growth which were never fulfilled.
- Short election cycles and overly ambitious growth targets can incite policy makers to make decisions based on short-term performance.

<Table 1> Major Election Timetable

Year	00	01	02	03	04	05	06	07	08	09	10	11	12	13	14	15	16	17	18
Presidential elections			○					○					○					○	
Legislative elections	○				○				○				○					○	
Local elections			○				○				○			○					○

Source: Historical data on elections extracted from the National Election Commission’s election statistics system.

7 In the new economic task force's policy direction announced in July 2014, concerns were addressed about the possibility of Korea following in the path of Japan's 'Lost Two Decades.' To prevent this, they called for a seismic shift in policy direction, presenting the '41 Trillion won+ Policy Package' to stimulate domestic demand. The package includes policies related to the housing market (easing housing regulations and regulations on reconstruction and redevelopment, increasing housing demand, etc.) and financial risk management (mitigating LTV-DTI regulations in the banking and insurance sectors) in addition to expansionary macroeconomic policies.

■ It is theoretically confirmed that the more policy makers prefer short-term outcomes, the less likely they are to adopt macro-prudential policies and the worse social welfare will become (Box 2).⁸⁾

[Box 2] Conditions for the Preference for Short-term Outcomes and Selection of Macro-prudential Policies

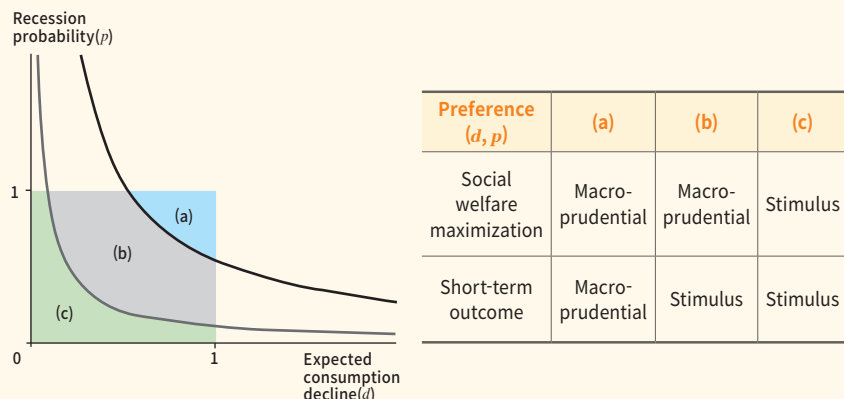
■ In this theoretical discussion, a comparison was made of the effects of stimulus policies, which entail credit overheating, and macro-prudential policies, designed to achieve mid-to long-term financial stability.

- (Basic assumption) Stimulus policies are likely to boost current spending but also curtail future spending while macro-prudential policies enhance the sustainability of consumption by reducing the possibility of a decline in future consumption.
- Policy makers choose between stimulus or macro-prudential policies, taking into account the probability of economic recessions incurred by credit overheating ($0 \leq p \leq 1$) and the expected decline in consumption ($0 \leq d \leq 1$).
- Policy makers maximize the present value of the expected utility flows as follows:
 - $\text{Max} \{U(\text{current spending}) + (1-\text{discount rate}) E[U(\text{future spending})]\}$
 - * Here, $U(\cdot)$ denotes the utility function and $E[\cdot]$ the expected value operator.
 - If there are no preferences for short-term outcomes, a social discount rate would be applied as the discount rate would provide the corresponding social welfare.
 - If there is a preference, the discount rate would be higher than the social discount rate.

■ Policy makers who prefer short-term gains will only adopt macro-prudential policies when both the likelihood of an economic recession and resulting decline in consumption is extremely high (Fig. 4 (a)). Additionally, policy makers will adopt stimulus policies that contribute little to social welfare even if social welfare-enhancing policies are available (Figure 3 (b)).

- Those in favor of maximizing social welfare are likely to choose macro-prudential policies in the likelihood of an economic recession and plunging consumption (Fig. 4 (a)+(b)), leading to large gains in social welfare.
- However, there are cases in which stimulus policies can provide more social welfare if the probability of an economic recession (p) and consumption decline (d) is sufficiently small (Figure 4 (c)).

[Figure 4] Conditions for the Implementation of Macro-prudential Policies Based on the Degree of Preference for Short-term Outcomes



Note: The figure shows the expected consumption decline (d) and probability of recession(p) in three cases (a), (b) and (c) depending on their size. The table demonstrates policy methods chosen by those favoring either social welfare maximization or short-term outcomes in respective cases in (d, p). In (a) and (c), the same policy methods are chosen regardless of the preference type while this is not so in (b).

8 Refer to Kim (2017).

5

Directions to Improve the Macro-prudential Management System

9 Examples of quantitative indicators to assess macrofinancial vulnerability include the Basel gap, systemic risk indicators, and stress test results, etc. They can be used to operate relevant rules but because not all data can be reflected in indicators, minimum discretionary judgment is inevitable, of course based on the mechanism to ensure accountability and independence in the policy-making process. The deferred compensation system for senior decision makers is designed to defer a part of the yearly bonus for later payment based on the long-term evaluation of their performance, given the fact that the effect of policies cannot be properly assessed in the short run. Other ongoing discussions are based on the reform of institutions and their organizational structures as a way to strengthen public accountability and independence of the financial regulatory and supervisory framework. Refer to Kim (2017) for further details.

- **The above discussions imply that the more policy makers prefer short-term outcomes, the less likely they are to adopt macro-prudential policies to enhance social welfare.**
 - It will become more difficult to implement social welfare-oriented measures, particularly macro-prudential policies for the mid- to long-term, if the preference for short-term gains is heavily reflected in the policy decision-making process.
 - An expansionary government stance, in terms of fiscal and monetary measures to bolster domestic demand, would make it difficult to adopt substantial macro-prudential policies to contain the macro-financial risks.

- **The tendency to concentrate on short-term outcomes must be prevented in order to improve the macro-prudential management system.**
 - Institutional mechanisms should be established to operate the macro-prudential management system in a manner that corresponds to the mid- and long-term preferences of the national economy.
 - Macro-prudential management systems in major advanced countries emphasize accountability to the public (sovereigns and taxpayers) and a guarantee of operational independence to enable this (Box 3).
 - Macro-prudential policies in major advanced economies prioritize financial stability and, at the same time, support government projects for growth and employment in ways that do not impede financial stability.

[Box 3] Implications from the Operation of Macro-prudential Management Systems in Major Countries

- **Countries with the central bank in charge of key macro-prudential policies, e.g. the UK and Eurozone countries, have deterred the preference for short-term gains from the political process, based on institutional independence.**
 - Given their specialized analytical skills and the low probability of collusive ties with former employees seeking post-retirement job opportunities, the central bank is expected to make policy decisions for macroeconomic soundness in a competent and independent manner.
 - However, without fully securing independence, there are concerns that the independence of monetary policies, an essential function of the central bank, may be compromised.

- **Countries with regulatory and supervisory agencies in charge of core macro-prudential policies (Australia, Canada, etc.) have contributed to the mid- to long-term financial stability by strengthening the openness and transparency of the policy-making process.**
 - This study suggests the following measures to consider in order to strengthen the accountability and operational independence of the institutions that implement macro-prudential policies.⁹⁾

- The vulnerability of the financial system should be judged on more rule-based grounds, using quantitative indicators to the fullest extent, and any discretionary judgment should be accepted only in inevitable cases.
 - Some argue that judgement and policy enforcement should be separated as this would contribute to enhancing the checks and balances among the competent authorities.
 - In addition, like major countries, the policy decision-making process should be made transparent through meeting minutes. And submissions of the grounds for decisions should be mandated to ensure a higher level of accountability.
 - Others demand a legally guaranteed tenure for decision makers, or an even longer tenure if necessary, along with measures to strengthen the responsibility of regulatory and supervisory authorities in terms of legal accountability.
 - For top decision makers, a deferred compensation system may encourage them to concentrate on the mid- to long-term policy outcomes.
 - Specialized monitoring mechanisms or an ombudsman system can be adopted to monitor the competent authorities to increase their accountability.
- In addition, there is a need to further systematize the collaboration and coordination between the competent institutions with regards to the implementation of macro-prudential policies.¹⁰⁾

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¹⁰ To make the most of information and analysis capabilities required to implement macro-prudential policies, it is necessary to develop a system that enables effective collaboration and coordination between competent authorities. Also, to implement macro-prudential policies more effectively, the implementation needs to be supported by collaboration and coordination with monetary policies.