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A Theme Park Crisis Is Wrecking South Korea's Bond Market

A provincial default has destroyed local government credibility.

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Imagine the turmoil if a newly elected president of the United States announced that the U.S. government would no longer honor any outstanding Treasury bills because most of them were issued under his profligate predecessor. That's essentially what Kim Jin-tae, the governor of South Korea's Gangwon province, did. In doing so, Kim sparked a nationwide credit crisis that is spreading internationally, in the most farcical and unnecessary economic self-destruction this side of Liz Truss.

Enhancing the absurdity is the origin of the crisis: Legoland Korea, a theme park based on the familiar brick toys. Gangwon, a sparsely populated, mountainous region east of Seoul, had tried since 2010 to build a Legoland near the resort town of Chuncheon. After years of delay caused by a discovery of ancient artifacts in the construction site and allegations of bribery and kickbacks, the theme park finally opened on May 5.

To construct Legoland Korea, the Gangwon provincial government established a special purpose entity called Gangwon Jungdo Development Corp. (GJC), owned 44 percent by the province and 22.5 percent by Merlin Entertainments, the British company that owns the rights to Legoland. To fund the construction, GJC, through a subsidiary, issued bonds worth 205 billion won (about $150 million). The bonds were backed by the GJC-owned real estate for the theme park and its surrounding area, as well as a guarantee from the Gangwon provincial government, then led by liberal Gov. Choi Moon-soon. Korea Investors Service, the South Korean affiliate of Moody's, gave the GJC bonds an A1 rating, the highest rating available for corporate bonds.

But Legoland Korea struggled out of the gate, too far from Seoul and too expensive for what was on offer, and it did not generate enough revenue to honor the bonds. Also, as South Korea's real estate market softened, the value of the real estate backing the bonds began falling below the amount of the debt. As the first due date for the bonds was approaching on Sept. 29, GJC was in talks to extend the deadline with BNK Securities, the underwriter for the bonds. Negotiating for such an extension is a tense affair but a relatively common one. GJC was close to buying itself a three- or four-month reprieve, by prepaying BNK four months' worth of interest that it would additionally owe by extending the due date.

Then came the disaster. Out of the blue, on Sept. 28, Gangwon's newly elected conservative governor, Kim Jin-tae, announced that he would not honor the government's guarantee. Instead, GJC would enter into bankruptcy, meaning that creditors would receive pennies on the dollar. BNK Securities declared a default on the GJC bonds and sought assurances that Gangwon would pay back the 205 billion won, but the government gave only a vague promise that it would honor the guarantee without giving a specific date. By mid-October, the GJC bonds were downgraded to junk status.

Kim's declaration was brutally unnecessary. He claimed that he was trying to reduce the debt left behind by his liberal predecessor who, according to Kim, irresponsibly embarked on a white elephant project in Legoland Korea. But Gangwon's decade-long pursuit of building a Legoland had always been a bipartisan affair, linked more to a hope of revitalizing the province than to any political faction. As a legislator representing Chuncheon, Kim was a vocal advocate for the theme park, claiming in 2014 that he would "jump into the Soyang River" along the city if South Korea's Cultural Heritage Administration blocked the project because of the ancient artifacts discovered at the construction site. Nor was the bond amount anything excessive. Gangwon's annual budget is over 17.7 trillion won (about $13 billion), in which a debt of 205 billion won is but a line item. Nor was the provincial government being asked to pay the entire 205 billion won in one shot; it only had to assist GJC in paying the extra interest it would have incurred for extending the bonds' due date.

By itself, extending the due date for the bonds would have cost Gangwon a bit, but it would have stayed contained. Kim's move, however, has shattered trust in government bonds. In the South Korean bond market, a local government guarantee was previously enough to ensure a bond got the highest rating, approaching the safety of South Korea's national government bond. By withdrawing Gangwon's guarantee, Kim demonstrated that a local government's guarantee could evaporate for a purely political reason.

This would be a reckless move under any circumstances but nearly suicidal in the current economy. In order to curb inflation, the U.S. Federal Reserve has been aggressively raising the benchmark interest rate to remove liquidity from the market. The Bank of Korea, South Korea's central bank, had to follow suit to prevent a rush of capital flight from South Korea to the United States. The result is a financial market starved of capital, with companies struggling to keep up with the sudden jump in the interest rate. Kim's declaration all but threw a match into the dry winter forest that was the South Korean bond market.

Immediately, South Korea's local government projects ground to a halt. As Gangwon did, South Korea's local governments issue bonds with their guarantees attached to them in order to build infrastructure, public housing, and other large-scale projects. But Gangwon's default made those guarantees worthless overnight. On Oct. 27, reports emerged that Incheon Housing and City Development Corp., a publicly owned company responsible for urban renewal for South Korea's third-largest city, had abandoned a plan to issue bonds for affordable housing construction, as it expected no buyers. Out of the 60 billion won (about $44 million) worth of bonds issued by Gwacheon Urban Corp. (GUC) for public housing construction in a wealthy suburb of Seoul, 40 billion won in debt could not find a buyer—the first time in history that GUC failed to sell out its bonds.

But the fallout is not limited to local government bonds; it impacts the whole of South Korea's bond market, worth more than $2 trillion. Corporate bonds are considered less safe than local government bonds. If few buyers are brave enough to buy local government bonds under these conditions, even fewer buyers can muster enough courage to buy corporate bonds. One of the safest corporate bonds in South Korea is issued by Korea Electric Power Corp. (KEPCO). The returns for KEPCO's three-year bond had climbed from 2.184 percent to 5.825 percent since the beginning of this year. But in its latest issuance, the KEPCO three-year bond worth 200 billion won (about $146 million) could not find a buyer.

Domestic trouble has led to international trouble. On Nov. 1, South Korea's Heungkuk Life Insurance Co. declined to exercise the call option on its dollar-denominated bonds worth $500 million. Although the bonds' term was 30 years, South Korean issuers have almost always exercised the call option to buy back the bonds after a shorter amount of time—usually between five and 10 years. The last time a similar non-call occurred was in 2009, in the wake of the global financial crisis. The non-call crashed the value of Heungkuk Life's bonds, as it signaled to the market that the company could not come up with the money to buy back the bonds. Worse, Heungkuk Life's non-call dragged down the value of other bonds issued by South Korean companies generally—and even bonds issued by other large Asian companies such as AIA Group and the Bank of East Asia in Hong Kong. As the shock rippled through the international bond market, Heungkuk Life abruptly made a 180-degree turn and said it would borrow money to exercise the call option after all, reportedly under heavy pressure from South Korea's financial regulators. Such back-and-forth, however, does little to restore international investors' trust in bonds issued by South Korean companies.

Unable to find liquidity either inside of the country or out, South Korea is now facing a nationwide credit crunch. South Korean financial institutions have stopped offering auto loans, as interest rates have climbed to a prohibitive level. Many of South Korea's housing redevelopment plans, which often cost hundreds of millions of dollars to turn old houses into new high-rises, are being suspended because they cannot find financing, putting enormous pressure on South Korea's real estate market, which has been losing value at a record pace. On Oct. 20, Lotte Engineering & Construction, the construction arm of Lotte Group, South Korea's fifth-largest *chaebol*, or family-owned conglomerate, had to take out an emergency loan of 500 billion won (about $365 million) from its affiliate Lotte Chemical amid speculation that it was facing a potential bankruptcy along with several other large construction firms.

To prevent the credit market from seizing up completely, the South Korean government stepped in by providing a liquidity facility of more than 50 trillion won (about $35 billion). The Bank of Korea also injected 42.5 trillion won (about $31 billion) to stabilize the short-term bond market, and South Korea's five largest banks also pledged to provide up to 95 trillion won (about $67 billion) in liquidity. There is an absurdist quality to these measures: On the one hand, the Bank of Korea has been aggressively raising the benchmark interest rate to curb inflation by reducing liquidity, but on the other hand, the South Korean government is injecting liquidity to the market to stave off a total economic collapse.

Although the measures did calm the market somewhat, South Korea is not out of the woods yet. The country's credit default swap premium, a measure of likelihood for a national-level credit event (such as a moratorium or other failure to pay back debt), is 75.61 basis points as of this writing, the highest it has been in nearly seven years.

Clearly, Kim Jin-tae did not understand the implications of his own action. The far-right politician is not known for his economic erudition, as he gained notoriety by being the standard-bearer for impeached President Park Geun-hye and claiming that the 1980 Gwangju Uprising, in which South Korea's dictatorship massacred thousands of pro-democracy protesters, was a North Korean insurrection. As the Legoland bond debacle spread, Kim issued a statement in which he complained that Gangwon never defaulted on the bonds and only sought to restructure GJC—apparently unaware that the latter would automatically lead to the former. Belatedly, the provincial government allocated a special budget to pay the entirety of the bonds, which only served to remind everyone how unnecessary it was for Gangwon to complain about the debt amount in the first place.

South Korean media have compared Kim to disgraced former British Prime Minister Liz Truss, an apt analogy. For purely political reasons, both leaders caused an entirely gratuitous self-inflicted wound to their countries' economies, destroying trust in what was supposed to be a sure thing—pension funds for Truss, government-backed bonds for Kim. The same lesson applies to Britain, South Korea, and everywhere: Electing bad politicians leads to a bad economy.

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