



**A** As any student of recent economic history can tell you, when housing markets stumble, whole economies can fall. The latest cautionary tale is from South Korea, whose current economic woes have been compounded by its residents' unusual method of renting apartments.

# Keeping Up With **THE** Jeonse

BY MATT PHILLIPS



South Korea's economy, for so long the wonder of East Asia, is stuck in first gear – the second-quarter growth rate of 3.6 percent was alarmingly slow – thanks to lackluster consumer spending. And, as they tend to do, policymakers are looking for a short-term fix in the teeth of long-term problems.

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In July, officials loosened mortgage-lending restrictions at banks in an effort to boost the housing market, which has had four straight years of price declines in Seoul, the largest housing market in the country. The government also plans to increase tax deductions for spending on credit and debit cards in an effort to prod the populace toward the check-out register.

There's a catch, though: South Koreans are in no position to go on a borrowing binge. In fact, they've already gorged. Since the end of 2004, total household debt outstanding has surged by 107 percent. At the end of the first quarter it stood at a record high of 1,035 trillion won (roughly \$990 billion), or almost \$20,000 per person.

As a share of disposable income, household debt rose from 131 percent in 2002 to 164 percent at the end of 2012, the most recent year for which data are available from the OECD. That's far above the 135 percent average for the developed economies tracked by the OECD.

Of course, low interest rates – a global phenomenon – mean the monthly payments on this debt remain relatively modest. And South Korea isn't alone in bulking up on debt. Many countries – including the supposedly prudent Scandinavian nations – have high levels of household debt, too. South Korea is different, however. Unlike Scandinavians, South Koreans aren't borrowing to buy houses; increasingly, they're borrowing simply to rent them.

It all has to do with a highly idiosyncratic convention of the South Korean rental market: Many tenants who lease apartments don't actually pay rent. You read that right. They don't make monthly payments.

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**MATT PHILLIPS**, a former reporter for the *Wall Street Journal*, is markets and finance editor for *Quartz*, an online magazine specializing in business news.

**The Jeonse system might have been something of a secret weapon powering Korea's rapid economic development.**

Don't start planning your move to Seoul just yet, though. There's a big catch. To get one of those apartments, you need to plunk down, on average, the equivalent of almost \$300,000. Under the country's *jeonse* (sometimes transliterated as *chonsei*) system, tenants lend significant chunks of money to landlords in lieu of rent. (*Jeonse* is usually translated as key money.)

It works like this. In exchange for access to the property for a specified term – usually two years – tenants make a lump-sum deposit to the landlord, based on a percentage of what it would cost to buy the property. The transaction is essentially a loan, with the tenant as the lender, the landlord as the borrower, the interest foregone to implicitly cover the rent, and the house as the collateral.

*Jeonse* contracts have deep roots in Korea's history; indeed, they can be traced back several hundred years. But their popularity grew sharply in the 1960s and 1970s. Amid the country's rapid transformation into an urban, industrialized economy, South Korea faced two large problems: housing rural residents arriving in cities and financing economic activity. The *jeonse* system was an elegant solution to both.

"On the one hand, it's a household rental system," explains Hyun Song Shin, a professor of economics at Princeton who has studied *jeonse*. "But actually it's an informal lending scheme as well."



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Shin has a hunch that the system might have been something of a secret weapon powering South Korea's rapid economic development. Savings rates surged from the 1960s into the 1990s, in part, he argues, because people socked away significant sums for *jeonse* money. The system efficiently channeled that money to Korean landlords, many of whom were also small-business owners and entrepreneurs, and happy to forgo rent in favor of a lump sum to invest in their businesses. During the financial crisis of the 1990s, the system only became more entrenched as it allowed South Koreans to bypass a deeply troubled banking system.

**Most landlords of Jeonse are now no longer entrepreneurs who have access to investment projects with high returns.**

*Jeonse* worked well for decades, as rising home values and high interest rates made it relatively simple for landlords to take the cash that renters handed them and invest it in a way that would yield high returns. But the dynamic has recently changed. Household savings rates, which had hovered above 20 percent for much of the 1980s and 1990s, have dropped sharply, to under 5 percent. At the end of 2012, the last year for which data are available, the rate was a meager 3.5 percent.

So, what happened? The short explanation: In the wake of the Asian financial crisis, South Korea's banks started lending big to individuals. Between 1998 and 2009, household debt increased by about 13 percent annually,

far more rapidly than the growth rate of the economy. And as it's gotten easier to borrow, South Koreans have had less incentive to save. That's transformed the *jeonse* from a vehicle to build personal savings into something quite different. "If you don't have the *jeonse* deposit, you actually go and borrow it from the bank," said Shin, who this year took a position as head of research at the Bank for International Settlements in Switzerland. "And that used to never happen."

The view from the proverbial trenches is instructive. When Minwoo Park, a 33-year-old software engineer, rented his three-bedroom apartment in Seoul's Yeongdeungpo [CQ] district, he borrowed the lump sum needed for a *jeonse* contract from a bank. From his perspective, it made a ton of sense. Thanks to low interest rates, his monthly payment amounts to roughly one-quarter of what it would cost him to rent a comparable apartment. "It's a better deal," Park says. "Everyone prefers *jeonse*."

Not everybody can score as good a deal as Park, who was easily able to get a loan for the *jeonse* payment thanks, in part, to the solid salary he earns working in the mobile advertising industry. (He declined to offer specifics.) But the current economics of the *jeonse* are a clear win for tenants. Stagnant South Korean housing prices have pushed more would-be buyers to hold off on purchases. Many of them have opted for *jeonse* apartments as they wait for housing to recover. That's boosted demand for *jeonse* apartments. And with supply constrained – landlords aren't as eager to let all the gravy go to tenants – *jeonse* prices are soaring. "Now the *jeonse* is kind of a problem," said Dongrok Suh, a Seoul-based partner at McKinsey and Company.

*Jeonses* aren't risk-free; they're loans, and sometimes loans don't get paid back. Of course, *jeonse* tenants have some protection:



If the landlord defaults on the contract and doesn't return the *jeonse* on schedule, the tenants are entitled to get it when the house is sold.

But remember, the *jeonse* is a lump-sum payment, based on a percentage of the house's value. Traditionally, that percentage was somewhere between 40 and 60 percent. That provided the tenant/lender with a large margin of safety in case of default. But as demand for *jeonse* apartments has risen, so has the percentage landlords are asking tenants to pay. That figure is now often between 70 and 80 percent – and in some instances has reached 90 percent, leaving a much smaller safety cushion.

Moreover, many landlords simply don't have the cash to pay back their tenants. Citing a Bank of Korea report, the *Economist* recently noted that 10 percent of the country's 3.7 million *jeonse* landlords could have difficulty repaying the money they owe to tenants. In other words, they are stuck in the system because they need to find another *jeonse* ten-

ant in order to pay off the previous occupant.

But the *jeonse* is problematic for the South Korean economy for reasons beyond the risk of a cascading financial bust. For one thing, the rising size of *jeonse* payments sucks more and more money out of productive investment. "In the past, *jeonse* security deposits were used to build additional houses, or increase business investment," wrote analysts for Nomura, the Japanese financial giant. "Most landlords of *jeonse* are now no longer entrepreneurs who have access to investment projects with high returns."

Note, too, that higher *jeonse* payments also siphon cash from the consumer sector – a problem at a time when the South Korean economy is operating at less than capacity.

The government is trying to wean South Koreans from the *jeonse* system through a series of policy changes. It has moved to make some component of ordinary rental payments tax deductible, reducing the financial advantage of the *jeonse* option. It's also easing

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tax burdens on landlords in an effort to coax more building owners to switch from the *jeonse* system to conventional rental arrangements. “By lessening the burden of those paying monthly rent and decreasing the demand” for *jeonse*, the Ministry of Land, Infrastructure and Transport explained in a press release, “we expect to lessen the discrepancy in the market and stabilize the prices.”

There are signs that things are moving in the direction that the government is hoping for. The share of South Korean apartments rented under monthly payments is increasing, though *jeonse* contracts still account for a little over half. Meanwhile, there are signs of life in the South Korean housing markets. The average price increased by 0.9 percent in the first six months of 2014, after a 0.2 percent decline in 2013, according to Kookmin Bank, one of the largest mortgage lenders in the country.

But more broadly, critics argue that the government’s plan to push people away from renting homes and back into buying them is a short-term fix that won’t solve the underlying problem. South Korea is subject to some of the most disruptive demographic trends among advanced economies.

In part, this is to be expected: As countries grow wealthier, birthrates typically fall. But the drop-off in South Korea has been precipitous. Since the 1970s, the national birthrate has fallen by roughly two-thirds, to just 1.2 births per woman of child-bearing age – the lowest among all developed economies.

Moreover, the declining birthrates have been accompanied by other signs of growing societal stress. Suicides have soared: South Korea’s rate, 25.9 per 100,000 people in 2011, made it the highest among the countries tracked by the World Health Organization. Divorce rates have also risen, even as the number of couples getting married has been

slipping. The prospects for young people have grown so grim that 20- and 30-somethings have invented a new term, *sampo-jok*, which translates loosely (according to the *Korea Times*) as “those who have given up on three things – dating, marriage and children – due to economic reasons.”

That doesn’t bode well for consumption growth; typically, much consumer spending is done during the early years of starting a family, when people buy houses and cars. And it likely won’t be fixed by pushing the country further into debt. The high cost of living – including outsized spending on *jeonse* payments and sky-high educational costs – is seen as one of the prime reasons young couples put off marriage and have fewer children when they do tie the knot. “There is a direct link between this financial insecurity and South Korea’s declining birth rate,” wrote McKinsey Global Institute analysts in a recent report on South Korea’s growth prospects.

South Korea’s president, Park Geun-hye, gained office in early 2013 in part on the back of vows to ease the nation’s economic malaise – in particular, the growing strains of a heavily indebted middle class. And she has taken some action, including establishing a largely symbolic “national happiness fund” to help some South Koreans refinance their debt at lower interest rates, and pushing the fiscal stance of the country toward expansionary spending.

But when push comes to shove, South Korea seems to be taking the position that the solution to the economic doldrums is another round of consumer borrowing. That would be awfully convenient. As the recent experience of the United States suggests, though, coaxing over-extended borrowers to go back to the bank for more is tough, no matter how enticing the terms. And that could mean South Korean efforts to rekindle growth might not bear fruit for quite some time. 