The Korea Economic Slice on KBC (Vol. 1.8)

An Exclusive Report from Korea Business Central and DS - Financial Market Analysis

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Surprising the world now twice in six months by leading rather than following the G20 nations, South Korea has spearheaded dual mandates which have put the central Bank of Korea (BOK) on the offensive. Clearly Korea hasn't forgotten the woes of 1998 and 2008, when the KRW dropped precipitously and twice scarred the investment portfolios of international players. It is now certain that currency protection is the name of the game in Seoul. This week we'll identify how Korea's monetary policy stacks up against its rival "Asian tigers", and determine where Korea may find itself tomorrow as a result of today's environment.

Leading the Pack

The G20 have all come to similar conclusions, "mature economies are over levered to a breaking point and must face cost cutting proposals, however the recoveries in these very economies could crack when government stimulus support is removed". While the only workable strategy has been proposed by the prudent and frugal Germans, in any other country (e.g. Spain, Portugal, Italy, Ireland) the cost cutting proposed would be political suicide.

Luckily for the host country of this year's G20, public debt is only an indirect threat to Korea's health, via European bank defaults that are heavily invested in the ROK.

While the G20, minus Korea, has continued bouncing rhetoric back and forth concerning sustained stimulus plans and fiscal responsibility, Korea has outlined currency futures trading caps to protect the Korean Won (KRW), continued increasing its foreign currency reserves beyond 275 billion USD, and last week raised its benchmark rate from 2.0% to 2.25%. All on the heels of President Lee Myung Bak's proposal to scale back Korea's stimulus package, given the OECD and IMF have both upgraded their 2010 growth forecasts towards an average of 5%.

To put things in perspective, we'll take a look at the comparative differences between the Bank of Korea's policy and that of Hong Kong, Singapore, and Taiwan; three other developing countries branded with Korea as the "Asian Tigers". From the 1960's to 1990's these economies were some of the first to follow the high intelligence economy model, first pioneered in Japan.

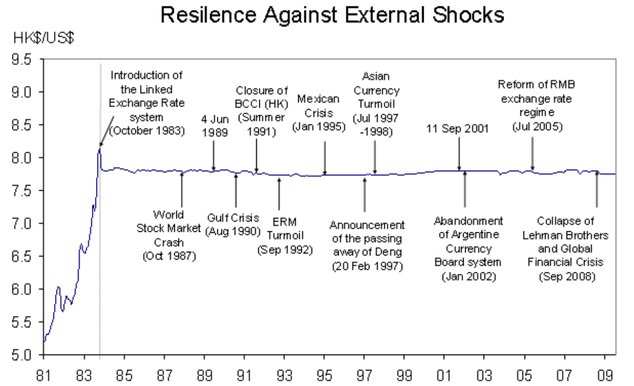
Feeding the Tigers

All Asian economies are faring much better than their Western counterparts, but to what degree? Here we'll help individuals better understand the process of monetary decision making in Asia as it effects Korea.

Hong Kong

Forged on the natural resource of a deep water harbor and a British colony until 1997, this quasi-sovereign Chinese state has become the New York City of Asia. Hong Kong is a center of Asian-international trade, banking, and the foreign gateway to investing in China. Monetary policy is based around a "Linked Exchange Rate System", where the government uses an exchange fund of foreign reserve currencies and assets to stabilize the static exchange rate between the Hong Kong Dollar (HKD) and the U.S. Dollar (USD).

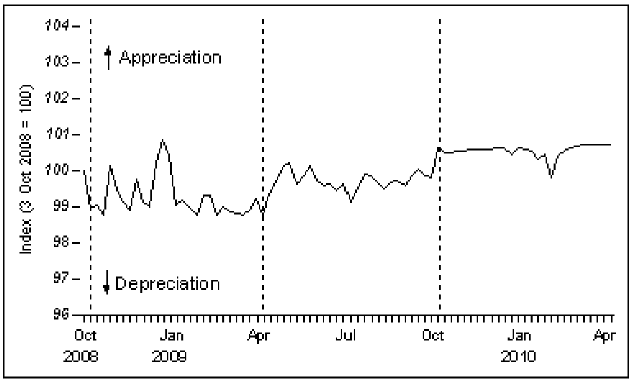
Hong Kong utilizes a rate fixing scheme, where mortgage borrowing costs are decided by adding a premium to the 3 month HIBOR market rate. Recently as much as 3% has been suggested to be added to HIBOR to raise record low interest rates and stem home prices, which increased 5.3% in 1Q2010, on top of 28% in 2009. The chart below references the track record of the HKD against the USD.



Since the Chinese Yuan will continue a regulated float, the HKD will become worth relatively less in comparison and potentially fuel higher prices in an oversaturated real estate market due to increased mainland investment.

Singapore

A gateway to Malaysia, the fourth largest financial market in the World, and also a stunning deep water port, Singapore offers much of the same as Hong Kong. Singapore this week announced that its 2010 GDP growth forecast of 13 and 15 percent, up from previous estimates of 9 percent after the 2Q2010 reading showed 22% growth. Singapore, utilizes currency revaluation as a monetary tool and has announced plans to appreciate the Singapore dollar over the course of the year, in an effort to fight inflation forecasts ranging up to 3.5%. Below, we can view the history of Singapore's currency valuation, based on a basket of world currencies and represented in index form.



------ indicates release of Monetary Policy Statement

As the Singapore Dollar increases in value, other Asian currencies will appreciate with it, as Asian economies move to fend off inflation synonymous with high growth, causing interest rates to rise elsewhere.

Taiwan

Home to the Republic of China party, who were banished to the island by the PRC in 1949, Taiwan has endured many unruly power struggles and a haphazard growth pattern over the past forty years.

Though in 1Q2010, Taiwan saw the fastest pace of economic growth since records began in 1978, at 13.3% year-over-year. Taiwan uses a core rate setting system similar to western central banks, and on June 24, 2010 raised its 10 day discount rate to 1.375% from 1.25%, where it had stagnated since 2008.

Elsewhere in Asia, Malaysia lifted its overnight policy rate to 2.75% from 2.5% on July 9. Thailand also broke the silence, following the settling of the bloodiest protests in twenty years, when it raised its benchmark rate from 1.25% to 1.5% on July 14.

Korea On The Flip Side

While the growth outlooks throughout Asia are being upgraded and emphasized every day, the monetary brake pads have met the rim in nearly every major economy from Malaysia to Hong Kong. While Korea may have not been the first Asian nation to endorse a higher benchmark interest rate via the BOK, the central bank has been cautiously adding to USD reserves while protecting the net debt position of the country, through KRW futures trading caps. Unfortunately, these massive growth rates are now baked into the Asian stock market valuations and are assumed to run out of steam as the policies of financial regulators across the region come into effect. Korea's own finance minister, Yoon Jeung Hyun, forecasts Korea's growth in 2010 to grow to 5.9%. However headwinds still persist, such as the raised unemployment rate from 3.3% to 3.5%, which erased prior improvements to the October 2008 level. According to Bloomberg, the Korean Won "has retreated 3.9 percent so far this year, Asia's worst performance." Perhaps part of the reasonis due to a lower level of growth, when compared to its "tiger" peers, has speculators steering clear. After all, currencies tied to economies with hot growth levels and higher interest rate potential will yield more in this environment.

The potential for growth has been attained in Asia. Now to see where these lip smacking growth rates can go from here… We know that the market prices in all available information, so the current levels of growth should be of no regard when we look to the future chances of success. The World has yet to operate under a paradigm where cheap money and government stimulus are not givens. The Korean labor market looks a bit shaky after the withdrawal of stimulus, but the overall economic picture looks healthy and sustainable. While the KRW may continue to underperform its rival Asian currencies, the potential for the Won to rise against Western currencies in the higher interest rate and growth environment should increase. Still the main obstacle to full success lies in the health of big European banks and the ability of Western accountants to get their national balance sheets in order.