The Korea Economic Slice on KBC (Vol. 1.10)

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From a Western financial professional's perspective, South Korea has traditionally been overlooked. The most familiar big three finance hubs in the East were forged in Singapore, Hong Kong, and Tokyo. However, Korea is redefining itself as a major marketplace for a specific breed of financial product, for better or worse, broadly labeled "derivatives". For those having flash backs to calculus at the thought of the word, don't fret… you're actually on the right track. Here we'll give a crash course on derivatives and their place in financial markets, inspect their recent appearance in emerging markets, and theorize as to the effect they will have on Korea's global financial presence and the economy as a whole.

Derivatives: Rationale and Economic Benefit

A derivative is simply a contract with a value that is derived from the value of an actual asset (i.e. stocks, bonds, commodities, currencies, etc.). Take a minute to review the definitions of the two main types of derivatives traded in Korea below:

Futures – "Futures are agreements to buy or sell another asset at a future date at a price agreed upon today."

Options – "Options are contracts that give the holder the right to buy or sell another asset at *or before* a future date at a price agreed upon today.

Futures and options are both very similar by design, with the main difference between them being that Futures have a specific expiration date and options can be exercised at any time up until expiration.

Futures were first introduced in the U.S. in agricultural markets in the mid 1800's due to massive "spot price" swings (the spot price is the market price of a product at the point of sale). In those days all of the crop would be harvested and sent to market simultaneously, causing the spot price to fall near harvest time and spike in months when there was little supply of actual product. Using futures, farmers could negotiate a price for a certain shipment of crop before the harvest had even been collected. The first main economic benefit of derivatives was thus found; "price discovery". *Price discovery* is the phenomenon which occurs when farmers and milliers come together and agree on prices they are willing to pay for future product, eliminating the imprecise and volatile nature of spot market prices before the introduction of futures.

The second economic benefit of derivatives is "hedging". *Hedging* is a term which means to decrease or eliminate risk. Food producers found that they could purchase futures on agricultural products that were used in the production of their products, to protect against volatile swings commodity prices. If an unexpected spike in the price of input commodities occurred, the future contracts held by the producer would become more valuable and offset the additional costs of production.

Nowadays, the majority of individuals trading derivative products are looking to achieve a hedge from the positions, or perhaps they are hoping to profit by speculating on the movement in the price of the derivative.

Derivatives in Korea: SKY is the Limit

A recent study by Professor Ahmet Karagozoglu of Hofstra University, on the viability of introducing derivatives to emerging markets highlights three specific criteria of success, initially coined by economists Bricheux, savre and Tachon in 1992. Besides a stable legal environment, the emerging market would need underlying assets (stocks, bonds, commodities, etc.) which were **risky, volatile, highly traded by volume,** and a part of a **mature spot market (underlying asset market)** with **well established dealers.**

Korea began its derivative history by offering one contract, the KOSPI 200 Index Future contract, in 1996. Since that time the Korea Stock Exchange (KSE), the KOSDAQ, and the Korea Futures Exchange were consolidated into a single marketplace, known now as the Korea Exchange (KRX). On the KRX there are currently three (3) index futures, single stock futures, equity (stock) options, Korea Treasury (KTB) futures, a handful of Forex futures, U.S. Dollar options, and commodity futures (Lean Hogs and Gold).

The KOSPI 200 future was a hit from its introduction in 1996, achieving the #1 ranking for highest trading volume of all futures contracts across the globe in 2003. Continuing the legacy, the infantile Equity Linked Warrant (ELW) market, which are options on blue chip Korean stocks, has already risen to #2 in the world by volume. The ELW market in Korea is second only to Hong Kong, touting daily volume increases from $536 million to $1.37 billion over just one year.

So, what does all of this mean for the underlying assets? Some argue that the ratio of options volume to underlying volume in Korea is too large, and results in unnecessary volatility. This explains why the KRX has capped the daily trading range of KOSPI 200 futures at +/- 10% of the previous session's close.

The truth is, the derivative market in Korea is a vibrant and growing sector of the financial market as a whole, but the majority of the volume of futures and options traded on the KRX are the byproduct of retail investors seeking the highly leveraged returns that are inherent of derivatives.

In terms of economic benefit, the majority of options available and coming soon to the KRX should theoretically assist in *price discovery* of the underlying assets, but are under-utilized as a hedging vehicles by comparison and do not translate into higher volume in the spot market. If however, Korea were able to expand the commodity futures and options market on the KRX beyond Lean Hogs and Gold, the spot market for commodities could potentially expand and offer Korean firms domestic hedging alternatives.

KRX Open for Business

So, where to from here? What does it all mean for Korea's economy?

In basic terms it means that Korea has defined itself as a destination for top tier western investment banks seeking commissions and market making revenues from both the offering of new derivative products and the brokering of their transactions.

Alibaba recently reported that Newedge, a joint venture between French rival investment banks Societe Generale and Credit Agricole, is setting its aim on "5% of the S. Korea derivatives market over the next three to five years." As a part of the strategy the group has expanded its workforce by 30%, bringing high income positions to the Korea market and world class investment banking experience to Korea's young SKY University graduates.

Furthermore, there may be public benefits to the zestful demand for derivatives, as President Lee weighs the advantages of adding a 0.01% tax to transactions of the products, which currently trade tax free.

The long-term opportunities and risks associated with a boisterous Korean derivatives market are uncertain, where core market price volatility could suffer from a disproportionate volume of futures and options. Still, the immediate benefits are easily distinguishable. High salary jobs, greater international banking exposure to the Korean financial market and Korean firms, additional domestic hedging opportunities for Korean institutions, and perhaps new government revenues from transaction taxes, all point towards greater market share among the Asian financial centers.