The Korea Economic Slice on KBC (Vol. 1.4)

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

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Stock markets around the world have found solace in the leaked, then officially released, China Export data; showing a 48.5% increase in exports in May from comparable data in 2009. Conveniently timed with the past week's global equity rally that followed the China Export numbers, were several announcements from South Korean financial leaders. First, Korea announced new measures to tighten restrictions on Currency Futures trading, and then proposed an indefinite re-opening of the currency swap lines between the Bank of Korea and The U.S. Fed, which were closed in February 2010. The mere talk of currency crisis in the EU is beginning to send chills up the spine of Korea, where the KRW has lost 10% against the USD since the beginning of the year; more than any other Asian country. This week's Korea Economic Slice will focus on the macro-economic forces moving the KRW and effects of new policies on the currency.

Korean Won Forex 101: The Balance of Payments

Depending on which doors you're knocking on, you'll get a spree of economists with a hundred different theories on the significance and effects of a nation's capital account on its currency.

What is the Capital Account?

The "capital account" of a country is essentially the net flow investment payments moving out of the country. Therefore a capital account surplus would be defined as higher levels of investments in foreign denominated currencies. The capital account represents one of two major components, together making up the "balance of payments" (BOP) macro-economic identity. Its sister component is then the "current account", which is more commonly known as the trade surplus/deficit of a nation.

BOP = Current Account - Capital Account +/- Balancing Mechanism

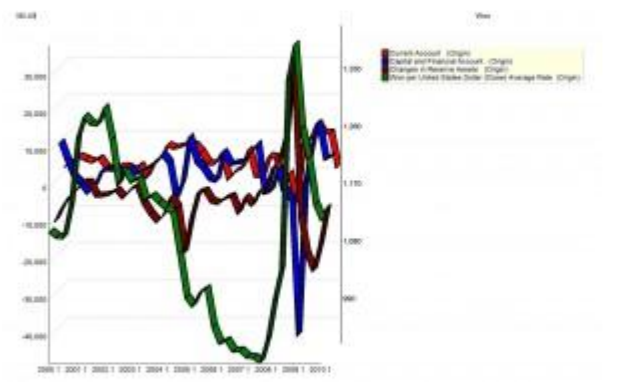
Together the current account and capital account must net a zero sum balance of payments over the long run, explaining why countries that run large current account (trade) surpluses end up amassing large sums of foreign currency based assets in their capital accounts (e.g. U.S. Treasury Bonds).

The most prominent example of this concept is the China BOP equation, where China runs a large trade surplus and consequently must end up with more U.S. Dollars, which are invested mostly in Treasury bonds. It is especially important that China keep the BOP equation exactly even, because China has been using a rule based exchange rate "peg" since 2008, where the Renminbi's value is by definition pegged to the U.S. Dollar.

In nations with "floating" exchange rates, currency value shifts can be used as a "balancing mechanism" to equalize the BOP. When the current account and capital accounts are running an overall surplus, a floating currency will appreciate, while an overall deficit will pull the currency's value down. Contrarily, when the exchange rate is fixed the only feasible alternative is to adjust internal demand (government stimulus) or money supply (printing/absorbing currency), as practiced in China today.

So now that we have a basic understanding of foreign exchange from a macro perspective, let's take a look at Korea's Balance of Payments components over the past 10 years.

S. Korea BOP Components (2000-2010)
Quarterly Data



(Click the graph to expand…)

First, let's zero-in on the current account portion of the visual, which will give us a record of the foreign trade levels since January 2000. As you can see, Korea has run a trade surplus in most of the last ten years, except for 2008 when the country actually ran a deficit.

Referring to our explanation of the balance of payments from before, this would explain the increasing value of the Korean Won (KRW) over that same period (see KWN/USD in green decreasing, representing the increasing KWN value). Here the Won acted as a "balancing mechanism" and increased in value to equalize the growing current account surplus and volatile capital account levels. During this period we saw the net change in foreign reserve assets (dark red) oscillating around zero, allowing the capital account to stay mostly positive as more won were invested abroad than foreign currencies were in Korea.

However, in mid-2008, something very unexpected happened. Lehman Brothers was allowed to fail by U.S. regulators and a global flight to safety prompted many less developed countries to hoard U.S. Treasuries and USD's. In the chart we can see this policy as it was adopted in Korea, where "changes in reserve assets" (dark red) showed up to 30 billion USD added to Korea's reserves each quarter.

In a matter of quarters, the current account and capital accounts entered a deficit, as foreign reserves were amassed and the KRW plummeted. The combination of investors shunning Korean assets and the Bank of Korea hoarding USD based Treasuries resulted in the Won's decline. Since the recovery of global markets, the KRW has increased back to its ten year average, near 1170, but the recent trend of the Bank of Korea to resume stocking up foreign reserves (dark red) has led investors and economists to worry. Mainly, analysts fear that rising USD reserves will again drag the capital account to a deficit and have negative effects on the value of the Won.

Capital Account Massage

This week it was announced that the Bank of Korea would enact new regulations to restrict the trading of KRW futures by 50% of the equity of domestic firms and 250% of foreign banks' equity capital. The method was announced as an attempt to decrease the volatility of the KRW by curbing the speculation on its movement.

Fears that the policies put in place will decrease international confidence in the KRW are justified, but there are stronger forces at work behind this new policy.

When customers go to Korean banks to buy dollars, those dollars are many times acquired by purchasing KRW futures and thus adding to the short-term debt position of the country. By capping the amount of futures that any firm is allowed to purchase, Korea hopes to keep its short-term debt levels lower.

In both 2008 and 1998, Korea felt the effects of excessive short-term borrowing. In both periods the Korean market saw liquidity crunches, where Korean firms' borrowing proved unsustainable amidst declining economic fundamentals.

Korea has recently called for swap lines with the U.S. Fed opened during the financial crisis, to be re-opened. Bernanke and the Fed have so far not agreed. The swap lines were closed in February 2010, around the same time that the Bank of Korea resumed adding to its reserve of U.S. Dollars, and would alleviate fears of a liquidity crisis in Seoul.

As it seems, the recent announcement by the Bank of Korea will effectively act as a sort of "capital account massage", where short-term debt levels, via KRW futures trading, will be nudged lower, in turn releasing pressure from the capital account as Korea adds to its war chest of dollars.

Should the global trend of rising debt yields continue, these new policies will have positive effects in the short term by creating incentives against overweight leverage in Korean banks. However, implications of a fully fledged currency crisis in Europe would certainly include another rush to U.S. Dollars. In this worst case scenario, a cap on the amount of KRW futures trades would actually cause investors to pull out of Korean assets of all breeds early, given the fear that a cap would tie firms' hands when they most needed exposure to hedging. Korea , chair of the 2010 G20, has taken a pioneering stand by adopting these new futures trading caps, in an effort to bypass more direct solutions to the risk of liquidity crises (e.g. central bank swaps). Markets initially reacted pessimistically to the new KRW futures regulation, but we've yet to see how the policies will affect Korea's Capital Account and the value of its currency.