The Korea Economic Slice on KBC (Vol. 1.5)

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

By: ***Robert Eberenz*** June 24, 2010

The moment that Europe and the U.S. have been lobbying for over the past nine months finally arrived, as China ended the rule based exchange rate "peg" of the Renminbi, or Chinese Yuan, to the U.S. Dollar. According to analysis from Citigroup Asia the policy, aimed at letting the Yuan float to a higher value relative to the global basket of currencies, will be a sure positive for China and Asia as a whole. While the immediate implications may lead one to this conclusion, the mid-term reprocussions of a stronger Renminbi may tell a starkly different tale. We'll explain what a floating Yuan means to Korea investors. We will also preview and review several market moving reports, helping to give subscribers a better grasp of current economic health and prospects for growth here in the ROK.

The Floating Renminbi

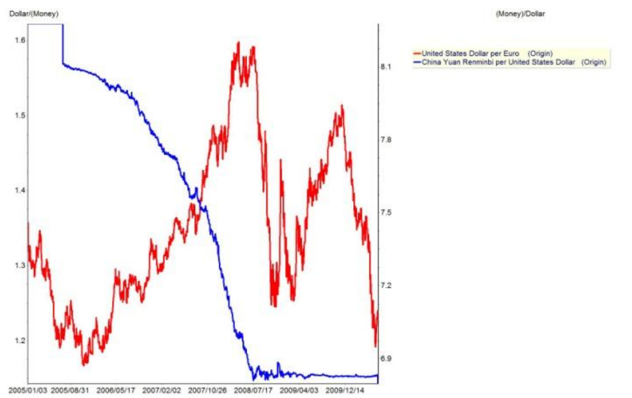
The Renminbi and Yuan are one and the same unit, labeled CNY in the world of Forex traders, and the focus of an international debate over exchange rates.

Britain and the EU had been putting a great deal of pressure on the United States to use leverage and influence to get the CNY "de-pegged" from the USD. By the end of 2009, the U.S. dollar had largely depreciated due to the infamous carry trades, which borrowed USD at cheap interest rates in order to fund leveraged positions in risky investments across the globe.

Germany, Europe's largest economy and the solvent anchor to which the Euro is moored, led campaign to float the CNY as the Euro rose relative to the USD and the CNY throughout the second half of 2009. Germany competes with Chinese goods directly in many manufactured product sectors, and was unable to compete given a CNY pegged down to the falling USD.

In the above right visual, one can see where the Euro (red) rose from April to December in 2009, before diving lower due to the Greek debt crisis, which alleviated much of the stress from the undervalued Yuan.

CNY/USD vs. USD/EUR



Note: A falling CNY/USD represents an appreciating CNY.

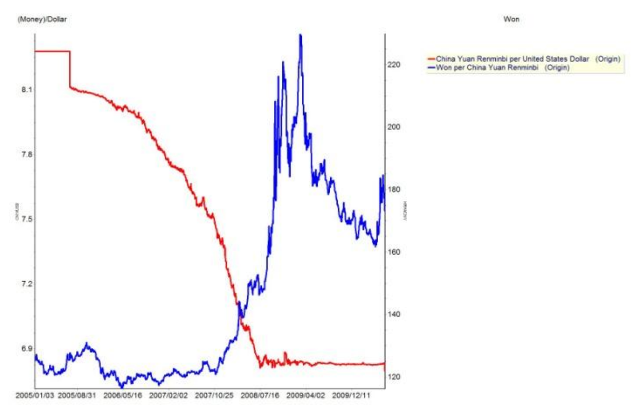
China has now announced that the CNY (blue above) will begin a managed float, whereby the "translucent hand" of China's central bank will allow the exchange rate to appreciate over the course of 2010. According to economists interviewed by Bloomberg, the CNY may appreciate by 2% between now and the end of the year.

The appreciating currency will most likely be negative for struggling consumers in the West, who have come to rely on cheaper Chinese alternative goods throughout the recession. Remember, the U.S. and other wealthy western economies that carry current account (trade) deficits with China, will feel a floating CNY as unfavorable for consumer prices but positive for the competitiveness of domestic industries.

In Korea, a country that averages trade surpluses and beneficiary of increased Chinese consumer demand, the benefits of the increasing CNY will be initially very positive for economic growth. Most analysts agree that with a stronger currency, China will buy more goods from its strongest suppliers and extend the export driven recoveries in Japan, Korea, and developing Asia.

The chart below provides us with a look at the exchange rate history between the USD, KRW and CNY.

CNY/USD vs. KRW/CNY



As before, we see the CNY/USD (this time in red) and now also the KRW/CNY (blue). As the blue trend line rises, it represents the decreasing value of the Won compared to the Yuan.

The chart depicts much of the increased export growth to China, due to Korean goods that became cheaper in Chinese customers' currency, from 2008 to mid-2009.

All said, the CNY revaluation will benefit Korea as the Chinese currency buys more goods per unit from producers here on the Southern half of the peninsula. The question remains, just how freely the CNY will float? We argue that it will float under close supervision, as it did between 2005 and 2008, forcing U.S. and Korea relations to continue indirectly impacting the exchange rate between Korea and China.

As the world's reserve currency, the Dollar can be both blessing and curse to foreign markets as its value changes dramatically. Hopefully, the recent events will allow Korea to work towards a more direct exchange rate relationship with China, where stronger Renminbi are good for exports and cheaper Dollars maintain demand for Korean equities.

Economic Data

With regards to economic data in the coming week, we are first looking into two reports which measure the health of economic activity in Korea from the views of consumers and businesses.

The *Composite Consumer Sentiment Index (CSI)* and *Business Survey Index (BSI)* results, targeting June, will be released on Friday June 25 and Wednesday June 30 respectively.

In May, the CSI reported broadly positive results, where household respondents reported a change of +5 in the "domestic economic situation" category (the largest increase since December 2009). The May CSI headline figure of 111 (+1 change) will be difficult to beat, especially given negative sentiment witnessed in stock markets during the June period.

The BSI remained unchanged from April to May, at 103, where export manufacturing missed estimates by -6 points and June's headline estimate dropped by -8 from the prior month. By contrast, domestic oriented demand increased by +3 to mark the first 100 reading in the domestic metric since before Lehman's failure. Still, the June BSI is likely to fall at least -3, to a headline figure of 104, due to decreased estimates in both manufacturing profitability and non-manufacturing business conditions.

Crucial economic news out of the *Average Interest Rate Trends* report on Monday, and *Industrial Production* and *Retail Sales* data on Tuesday, will set the stage for weekly KOSPI trading action.

On a positive note, last month's Interest Rate Trends report for April showed the average interest rates on new consumer loans falling to

5.45%, while the mean yield on new loans dropped for a third consecutive month to 5.46%.

Industrial production has served Korea valiantly in recent months, which increased by 19.9% in April compared to the previous year's data, but down from the March 22.5% level. Look for markets to applaud any yearly growth levels near or above April's reading when the news breaks.

Perhaps retail sales can begin to improve as credit costs decline, but the past two months have documented continued weakness through the Korea Retail Sales report. In April, month to month retail spending dropped by 1.7%, compared to a 1.3% decline in March; a frightening warning shot from the domestic consumer base centered in Seoul. Korea will embrace growth from foreign demand, on the higher floating Yuan, but the recovery in Korea will be hard pressed to sustain itself should domestic demand continue to accelerate its decline.

Markets initially cheered news of an appreciating Chinese Renminbi, because less competitively priced Chinese goods will likely make every other nation's "piece of the pie" a tad bit larger. But will the managed float actually change the dynamics of the World economy, or decrease the risks which faced each country in the days prior to the news? In the medium term, these policies will be very favorable to the Korean economy from the demand side of the Korean export equation, and could serve as the extra push needed to boost employment and confidence. There are however equally important threats to the fragile recoveries in Korea and abroad, which should be closely measured via equity markets, credit spreads, and economic data previewed in this report. Stay vigilant and watch for signs of weakness from China... If China's economy begins to show signs of either cooling or overheating, the investment outlook in Korea will become equally less certain.