The Korea Economic Slice on KBC (Vol. 1.3)

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

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The Washington D.C. summit in 2008 crowned the Group of Twenty Nations (G20) as the official global economic summit of industrialized countries. Two years in, Korea is proud to have been chosen to Chair the 2010 G20 summit, which was kicked off in Busan last week for a meeting of the group's finance ministers. Hosting the G20 certainly represents a milestone on Korea's global economic ascent; however, the communiqué out of Busan begs a dissimilar fate for the unification of the group. In this edition of the Korea Economic Slice on KBC, we'll analyze the effects of the Busan G20 communiqué on Korea's economy and take a look at market moving economic data to be released in the week ahead.

The Busan G20: Finance Ministers' Summit

Korea's financial market has been anything but regular for much of the past two months, but then whose have? For separate, but equally important reasons, the policy shifts in the European Union and armistice violations on the Korean Peninsula have combined to beckon the focus of global markets to Busan, South Korea.

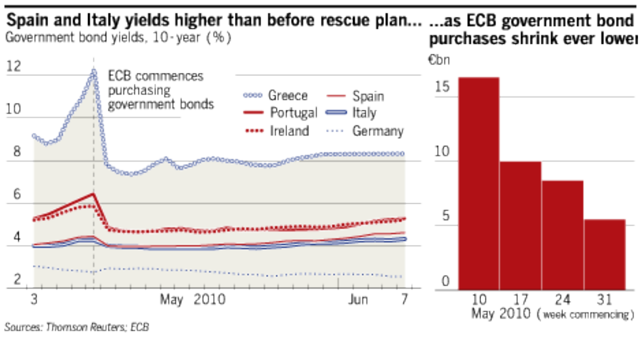
Last week, the Busan G20 summit called finance ministers from their 20 respective states, with intensions to further solidify the condition of sovereign finance throughout the globe.

First some background…

As a part of the EU "bailout", the European Central Bank (ECB) agreed to directly purchase the debt of certain countries, akin to the Term Asset Relief Program (TARP) purchases of poorly performing mortgages from U.S. banks in 2009. When the EU began purchasing Eurozone Government Bonds on May 7, 2010, yields initially dropped sharply. However, the yields on Spain and Italy's 10-year bonds are now higher than before EU purchases.

Starting off strong, the ECB purchased 16.5 billion Euros in the first week but only 5.5 billion last week (week #4) under the plan.

The charts below depict the direct relationship between ECB purchases and the riskiness (% yield) of government bonds:



(click chart to link to article at FT.com)

Alas, rationalizing this phenomenon where sovereign debt yields are rising and falling in tandem with nations far across the ocean, sometimes with few common currency swap lines or financial investments across borders, has alienated analysts towards opposite ends of the spectrum, due to differing stances on this issue.

Either way, higher yields for sovereign bonds have interrupted the global recovery in stocks, and demanded quite a bit of playing time at this round of the Group of Twenty.

The G20 Communiqué out of Busan seemed to agree on a great deal of redundant rhetoric, including calls for (a) greater financial market transparency and regulation, (b) increased respect of members' intellectual property and proprietary rights, and (c) a tax on global financial institutions to offset the costs of recessionary stimulus and suffering.

What wasn't agreed upon is much more interesting, and can be found in Article #2 of the communiqué. The message from the Global 20 somehow pledges to "safeguard [the] recovery and strengthen prospects for growth and jobs", while promising to "deliver fiscal sustainability [by accelerating] the pace of consolidation".

These two policies are most definitely mutually exclusive and are beginning to polarize the interests of major players, most notably the U.S. and Germany. According to the communiqué governments must continue artificially stimulating their economies and cut costs at the same time. Secretary Timothy Geithner of the U.S. sought support for continued global stimulus, while Germany's Wolfgang Schauble foreshadowed PM Merkel's 80 billion Euro, 4 year cost cutting plan, aimed at bringing Germany's deficit to 0.35%/year.

Most of Southern Europe has announced spending cuts in social programs, pensions, and government jobs over the next twelve months, while the faucet of monetary policy is already on "full blast" and stimulus injections have peaked. By our analysis, these Southern European countries with trade deficits and large percentages of debts held abroad will most likely fall into recession by the hands of fleeing creditors or consumers, cut-off from government handouts.

But where will this communiqué land within the ranks of the Korea financial machine and the central Bank of Korea?

Korea for the past 18 months has maintained a trade surplus, due to strong exports to China. If Korea can maintain strong export growth, this should allow for the consumer to be weaned from government stimulus without economic collapse.

Korea's External Investment Report in March also showed that Korea's debt held outside of Korea is a mere 47.9% of GDP, well below G20 leaders including UK (418%), Hong Kong (319%), France (196%), Germany (153%), and the U.S (96%).

Here, the combination of strong exports and relatively small externally held debt provides Korea with the comfort of time and the luxury of waiting for other countries to move first.

However, one place where Korea could rethink their strategy is in their currency reserve. The ROK has a massive reserve of foreign currencies, most notably U.S. dollars ($270+ billion), as a defensive measure to withstand the failure of a single currency (e.g. the EUR), and to support the resiliency of the Korean Won. Still, the increasing risk of global currency devaluation, the "end game" of a systemic sovereign debt crisis, begs it is prudent that Korea diversify its foreign investments away from debt and currencies, then increasing exposure to capital assets and precious metals.

Economic Data

For your weekly preview of economic data in the ROK, this week we'll focus on the *Household Loans by Depository Institutions*, set to be published by the Bank of Korea on **Wednesday**.

The Household Loans report for April 2010 will either (a) support claims that credit is expanding in the private market or (b) uncover how many households feel unwilling to take on extra credit in their current situations. In Q1 of 2010, household credit expanded by 5.4 trillion won over the previous month, and 8.1% year over year.

In order for the recovery in the Republic of Korea to sustain itself, reliance on strong exports to China and buoyant equity markets will become crutches too weak to support a Korean economy of stagnant credit growth and retrenching consumers. Therefore the results of this report on Wednesday will help us gauge the willingness of consumers to spend. Pay particular attention to the "merchandise credit" section of the report, which improved by 0.8 trillion won (18.2 %) over the course of Q1 2010 and is a bellwether of retail spending in the economy.

The Group of Twenty has gaped apart on their proposals to reach sovereign financial solidity, which may prove enough of an issue to polarize the once united group of decision makers. In our view, we expect to see a great deal of pain and suffering in the EU market over the next twelve months as "austerity measures" come into play and nations' leaders start to weigh the political ramifications of cutting costs in stagnant economies. However, Korea stands in a firm position facing the EU dilemma, so long as no single EU country defaults and sets off a chain reaction of financial collapse throughout the world. In this worst case scenario it would benefit the ROK to rebalance sovereign investments and plan to pick sides when the G20 looks for support. To stimulate, or to cut costs? That is the question…