The Korea Economic Slice on KBC (Vol. 1.7)

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

By: ***Robert Eberenz*** July 8, 2010

It's no secret that large bureaucratic machines aren't designed to predict the future of volatile, or even traditionally cyclical, economies. So perhaps it is premature to put much emphasis on the 1.25% upward revision of the International Monetary Fund (IMF) South Korea growth outlook. The increased optimism will put even more pressure on the Bank of Korea meeting, which will announce a core rate decision soon after the release of this report. This week we'll review Korea's stimulus measures that, according to the IMF, are largely to thank for the higher outlook. Then we'll review the continued courtship between increasing foreign reserves, short term foreign debt, and long term assets held within the borders of the ROK; referencing the 2008 Won disaster that was narrowly prevented.

Korea's "Green" Stimulus

Most Americans believe ardently that their political alliance has something to do with the financial prosperity of their economy as a whole. They feel that the president in the office and his cronies in congress can actually dictate higher or lower GDP, depending on where money is spent. Objective economists mostly agree that such fantasies are worth no more than the American flag sunglasses taped to the back of these politicians' political platform brochures.

When money is spent on an economy, the effects are equal, regardless of where the dollars are spent. When the government stimulates demand by giving consumers cash to spend, the effects are identical to when taxes are cut and the government instead forgoes otherwise collected revenues. Hard-liners on both sides will fight this truth to their grave, demanding that *their party's* method of stimulating the economy is better; but their cries are misplaced and always self serving.

In Korea we've most recently tasted stimulus, compliments of head chef Lee Myung-Bak, priced at $38 Billion USD (4.1% of 2008 GDP; *Source: IMF*).

Under President Lee's stimulus, nearly 80% of the funding was earmarked for "green" projects, aimed at creating nearly 1 million jobs and leading Asia as a Green R&D innovator. The Breakthrough Institute reported that Korea also plans to spend $85 Billion USD on Green development, matched by 1.6 Billion USD from private firms, before the end of 2014.

As mentioned before the Korean economy has recovered with gusto; perhaps upwards of 5.75%, says the IMF. On June 7, 2010, The Korea Herald reported that President Lee's cabinet announced a policy to pull back the stimulus from a projected 4.7% of 2009 GDP to a mere 1.1% of GDP; representing a 3.6% drop, from highest stimulated G20 member to well below the 1.9% average.

Despite the pullbacks in spending plans mentioned above, the Korean economy continues to buck cooling trends in the China and U.S. manufacturing sectors; putting increased pressure on the Bank of Korea to take a progressive stance in their announcement today.

How effective was President Lee's internationally celebrated "green stimulus", if the spending plans have now been cut by more than 75%?

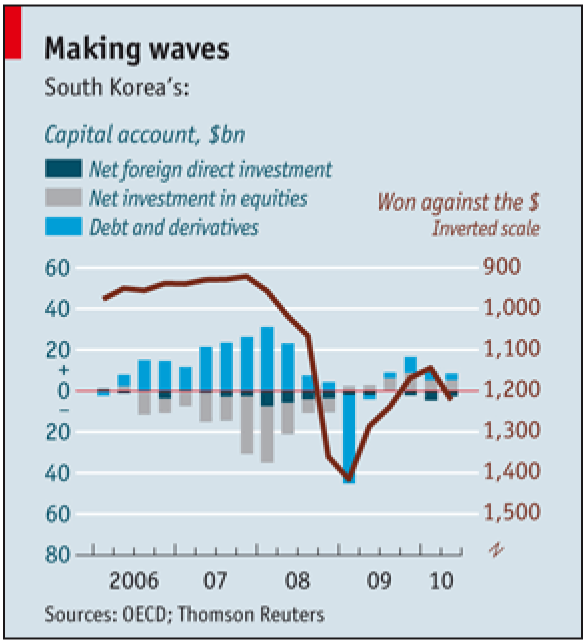
How much of the "green" money will go?

Minus the compulsory contributions of private firms in the R&D of "green", products such as LED bulbs, solar batteries, and hybrid vehicles, stimulus support has been defined mostly as credit guarantees and direct investment by the Korea Development Bank. How much of this was initially aimed at creating jobs, or how many jobs will actually be forged is unknown.

We do know that the focus of all nations now oscillates around fiscal sustainability. The financial viability of whole countries and their currencies, notably the developed Global Twenty (G20) set to convene in Seoul in mid November, have been called into question for the first time in the post war era.

Remembering the Won

As we discussed in Volume 1.4 of this series, Korea is no stranger to currency crises. In 2008, the Korean Won experienced a drastic tumble as depicted in the chart below (linked to the full Economist.com article):



The Economist quoted Princeton University economics professor Hyun Song Shin; saying,

There is a maturity mismatch in South Korea between long-term assets and short-term liabilities that makes it vulnerable to sudden bursts of deleveraging. "Whenever Europe trembles, we are the first place to jump from," he says.

Derivatives tied to the Won are heavily traded in Korea, and lead some to believe that the Won is potentially one of the most volatile currencies among the OECD nations. The OECD has projected growth at 5.8% in 2010, even higher than the recent IMF adjustment. These derivatives, largely KRW futures, serve to hedge the risk of holding working capital in durable industries, such as the concentrated Korean ship building space, where products are under construction for multi-year spans.

The "carry trade" also had an effect on the Won, as it did on many "risky" global assets set to appreciate in global recovery. This specific carry trade was a strategy by investors and firms, where by borrowing U.S. Dollars at cheap rates and then exchanging into Won, individuals realized profits from the increasing value of Korea's currency. This trade unwound much earlier in Korea than in much of the developed world, where carry trades continued in other currencies and assets up until recent months.

Whether the Korean Won will take a dive similar to that which occurred in 2008 is difficult to judge, but the underlying trend is beginning to look more negative.

Banks will have to operate under stricter derivative caps, decreasing aggressive hedging strategies and forcing firms to rely less on profits from derivatives and futures trading.

Korea's stimulus has been widely successful in its mission to achieve an economic rebound in the ROK, while investing heavily in environmentally sustainable products and projects. However, we know from last week's report that 13% of Korea's GDP is derived from exports to China and the U.S. alone, work force participation is low for a developed economy, and the KOSPI can't break away from declining investor confidence across global markets. The Korean Won is meanwhile held somewhat hostage by speculators, hesitant foreign investors, and heavily hedged industries. If the Bank of Korea does move forward with a rate increase today, we will see an initial appreciation of the KRW but a drop in the Korean stock market. The path forward for Korea balances on a jagged ridge where economic growth is both blessing and curse. What would you rather President Lee… a stronger won or a weaker economy? Our money is on a 2.0% benchmark rate for a seventeenth consecutive month, and thus a lower Won.