The Korea Economic Slice on KBC (Vol. 1.12)

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

By: **Robert Eberenz** July 1, 2010

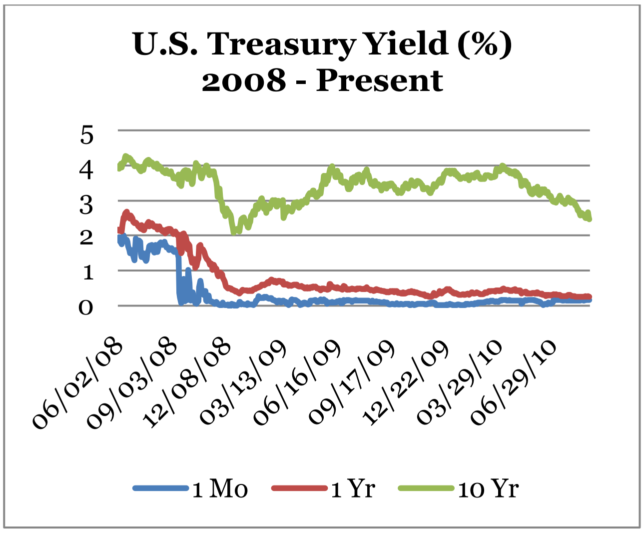
In 1933 the "Gold Standard" was pushed aside and the United States Dollar (USD) officially became tied to nothing. Later in 1944, during a gathering of global leaders in Bretton Woods, New Hampshire, international exchange rate policies were put in place to assure the system of "floating" global currencies. Yet it would be the Mr. John Maynard Keynes who went on to define this exchange of paper money as "fiat currency", or money where the "material substance… is divorced from its monetary value". More recently it has become crucial to have an understanding of what currencies are worth relative to each other and to actual assets, because the value of this floating paper is changing more erratically every day. Here we're going to look at what is moving Asian currencies now and whether these moves make since over the long term.

The "New Standard"

To begin discussing the current environment of exchange rates in Asia, we need to realize a simple truism that has existed for almost as long as the gold standard has been dead. This fact of life began after the Second World War, when the United States economy was seen as least damaged by war, most benefited by wartime industry, and well stocked with chests of conquered gold from "Axis" territories. By default, the international standard became the U.S. Dollar (USD) standard; where by volatile nations began pegging their currencies to the value of the USD as a system of exchange rate policy.

The key assumption has been that the USD is the strongest currency for weaker economies to tie their bills to. However, currencies tied to the USD are still fiat currencies because the USD is not truly a fixed asset. Unfortunately in volatile times, tying currencies to the USD, rather than gold, bears a host of risks. First, the USD is a fiat currency in itself and asset prices in USD's float with other currencies through market cycles. Yet paramount of all, are the pitfalls tied to monetary policy in the U.S. and thus the risk of the Federal Reserve printing new money. As new USD's are printed, other nations' pegged currencies are equally devalued.

Regardless of the more than 2 Trillion USD of printed money, U.S. Dollar denominated debt has been viewed as a safe haven "asset" throughout the current recession. The demand for U.S. debt can be seen below in the periods of *low* rates of return on U.S. Treasury bonds. (*A lower percent (%) yield signifies higher demand for the bonds.*)



We can see where the shorter term U.S. Debt dove towards 0% when the Lehman Brothers failure occurred in September 2008 and the

Federal Reserve made clear its campaign of aggressive rate slashing for an indefinite period of time. Since much of the shorter term debt has been in such high demand (at rates near 0%) for much of the downturn, economists have turned to longer term 10 Year Treasury Notes (green) as a bellwether of foreign demand for "safe" U.S. Dollar assets.

So what does all of this have to do with Asia or the Korean Won? Essentially there are two factors which are independently affecting the Chinese Renminbi (RMB) and Japanese Yen (JPY), while the Korean Won (KRW) is caught somewhere in between.

China De-pegged

The first and most obvious factor is observed in China, where the Chinese Renminbi has been defined by the value of the USD on-and-off for the past five years. The Chinese pegged the RMB to the Dollar, partly due to the volatility of their emerging economy but mainly because of the heavy trade between it and the U.S.

Recently the Chinese again detached their currency from the U.S. Dollar, which many predicted would cause the value of the RMB to rise, which it did, initially. The bet was that China's currency should be worth much more due to its large trade surpluses with foreign trade partners amidst a dollar peg, but we see now that negative economic data from China's industrial sector has had analysts rethinking whether the trade surplus will sustain its girth.

Due to fears, we are seeing the RMB lose much of its new value after an initial spike at the end of June, and today saw that China's Purchasing Manager's Index bottomed in the last month to beat expectations. For now, the fate of the RMB seems tied to the faith in the Chinese recovery relative to foreign peers.

The New Flight to Safety

While economic strength seems to be a positive factor in China, economic weakness and deflation are not serving to hurt the Japanese Yen. The JPY has hit 18 year highs against the USD, as it nears the 80/$1 mark, and could reach higher in the short-term.

Despite negative economic news from Japan, the basic concept of devaluation due to money printing is finally becoming an important issue to central banks and private financial institutions across the globe.

During 2008 and 2009 the stimulus spending mentality led by the U.S. made it acceptable for nations to print any quantity of money in order to "stimulate growth". Currently we are seeing that the levels of growth achieved through such spending are less than encouraging and an emerging force of critics now argue in favor of "austerity measures". If stimulus is a hopeful measure to create growth, austerity would be the backstop to prevent disaster when stimulus proves unsustainable.

Japan's economy has been stimulating growth for years and has seen such price and wage reduction in the country that the stimulus spent during the current recession hasn't altered their debt/GDP ratio as severely as in Europe, the U.S. and other Asian countries.

Miraculously, it would seem that the JPY, in a country with roughly 200% Debt to GDP, may become a new "safe haven" currency.

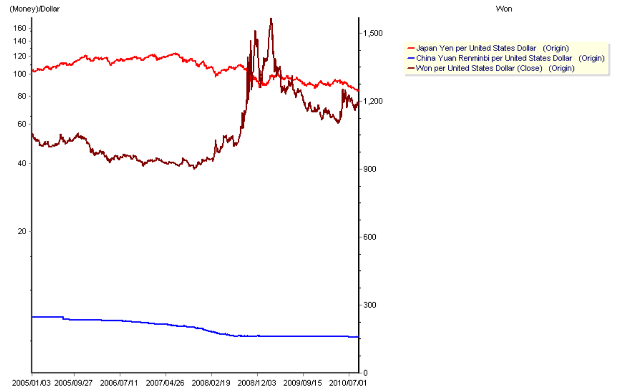
Somewhere Between Japan and China

The Korean Won has a bit of both environments from China and Japan. Korea trades heavily with the U.S., China, and Japan; and uses USD reserves to attempt to actively support their currency. If Korea's economy fares well and continues to grow, we should also see interest in KRW denominated assets raise, similar to the effects of economic growth on the RMB.

However, we know that Korea does not have a traditionally deflationary environment and are getting reports of wage and price growth in the current recovery. We also know that Korea's debt to GDP ratio is much lower, at 33.8% in 2009, which will support the currency moving forward.

The Korean Won exchange rate is directly dependent on the regional strength of the JPY and the RMB, due to its status as a new coming player and trade with Japan and China. If the trends in China and Japan's paper money continue to show higher values in USD, we can also expect to see the KRW appreciate. Ultimately, the recovery in Asia and Korea has outpaced competitors in Europe and North America; lending support to the Won.

JPY vs. KRW vs. RMB



Asia and its currencies continue to climb and for now the fiat paper of the East is gaining value over their western counterparts. The USD may continue to appreciate if the global economy declines further, due to the "safe haven" play, but the effects of printing new money and suffering growth will reverse trends in many regions. From the strength in U.S. Treasuries, the USD, and the JPY, we can deduce signals of fear and retrenchment from investors that will continue to support Asian currencies until it's confirmed that Asia is next on the "double dip" recession chopping block. The JPY and RMB would both fare badly if markets signal a return towards a global recession, as the Dollar and then gold would have their turn to advance. The constant bobbing and dipping of currency exchange rates and asset prices are perpetual reminders of that step towards a fiat system in 1933, but for now the clear beneficiaries continue to be recovering Asian countries, not the least of which is the Won and the Republic of Korea.