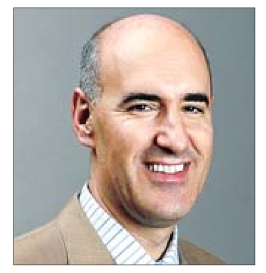
Roundtable: where are we heading for?

Despite a robust performance and upbeat outlooks for the Korean economy, uncertainties among investors and market participants are growing larger than ever due to a myriad of external challenges surrounding Asia's fourth largest economy, such as soaring oil prices, a slowdown in China's growth and lingering debt woes in Europe.

Against this backdrop, BusinessFocus has conducted in-depth interviews with five global economists to examine the current state of the economy and predict its future course. The following round-table discussion has been reconstituted based on separate interviews, which were conducted through emails and phone calls from April 11 to 19. **The full text of the interivews is available at our website (www.koreatimes.co.kr).** — ED.



Mauro F. Guillen
Professor of Wharton School of Business

Frederic Neumann
Co-head of Asian Economics Research, HSBC

Thomas Byrne
Senior vice president of Moody's in Singapore

Sharon Lam
Economist of Morgan Stanley Asia Research

Tim Condon
Managing director and head of research, Asia, ING

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Growth and inflation

Q: The International Monetary Fund (IMF) is maintaining Korea's GDP growth outlook of 4.5 percent for this year. But it raised its inflation forecast to 4.5 percent from 3.4 percent.

Tom Byrne: I agree with those figures. Although inflation forecast will likely average 4.5 percent for the year as a whole, I see the possibility of it trending down by year-end to 4.0 percent.
Sharon Lam: The IMF GDP forecast is reasonable. I expect Korea's GDP growth to normalize in 2011 after a robust post-crisis recovery in 2010. Meanwhile, I think domestic consumption will moderate faster this year as inflation is hurting consumers' real purchasing power.
Frederic Neumann: The challenge will be to maintain price stability. My inflation forecast for 2011 is at the upper end of what the IMF is predicting, which implies that for the full year headline inflation may be above Bank of Korea (BOK)'s target range.
Lam: For me, the IMF's inflation forecast seems to be more to the higher end. I expect consumer price index (CPI) growth to be highest in the second quarter and peak around June and July this year as food prices are easing after the winter months and the containment of foot-and-mouth disease. However, oil price is the swing factor and may delay the peaking of CPI growth.

Q: What do you think are the main obstacles to South Korea's economic growth this year?

Neumann: The number one risk facing Korea currently is the rise of oil prices. The Korean economy is heavily dependent on imports of crude and still highly oil intensive. Moreover, Korea is quite dependent on export growth and high oil prices could slow demand elsewhere in the world, thus dampening Korea's surging export performance.
Lam: Yes, highflying oil prices can slow down the global economy. In this scenario, Korea's current account will quickly turn into a deficit. If the Korean won depreciates, it will only exacerbate the inflation problem, causing further downside to domestic demand.
A shrinking current account surplus and hot money flows will also lead to volatility in the currency. It can cause large swings in exporters' profitability and can also complicate inflation outlook.
It will also attract speculation in the currency market which will increase the risk of foreign exchange losses in the private sector, at banks and even the central bank.
Mauro Guillen: I would say that the uncertainty about China's economic growth and inflation outlook, and uncertainty about the economic recovery in Europe and the U.S., which are South Korea's biggest markets, are the most significant sources. Uncertainty about energy prices is also important.
Neumann: A second big risk facing Korea is that low interest rates may over time encourage another rise in household debt. So far, of course, consumers have not raised their debt levels too aggressively, partly thanks to the government's prudent mortgage guidelines. But, as long as interest rates remain low, further debt build-up always remains a risk.

Q: By what degree will high inflation and high oil price undermine growth?

Byrne: The rise in oil prices is a headwind to Korea's economic growth. Should the oil price rise about $120 a barrel and remain there for a sustained period, the effects will be more severe.
Guillen: A high oil price is a tough problem for an importer from the dollar area, like Korea. If it stays high, it will slow down growth, maybe by 1 percentage point. Note that this problem also affects Korea's export markets in Europe and the U.S.
Neumann: Exactly. At these levels, oil prices can harm economic growth globally, and especially in the West. If this occurs, the real risk from high oil prices is not so much inflation but slump in growth. That's why it is so challenging for policymakers to react to rising crude prices.
Inflation, meanwhile, is driven primarily by food costs and rising pressure at the core level, and it is this that a central bank needs to address.
Lam: Inflation is harmful to consumption in Korea because Korean households' savings rate is very low at roughly 3 percent.
This means Korean consumers do not have enough savings to buffer against price increase.
Inflation therefore quickly eats into consumer sentiment and real purchasing power. High oil price is not only bringing inflation to Korea, but it can also bring trade deficits which can compress profit margins, deplete nominal national income, and weaken the currency.

Q: Following the global financial crisis, Korea's economic growth potential has been weakening further. The BOK says that the growth potential has fallen to 4 to 4.5 percent from 5 to 6 percent.

Guillen: The key here is to continue increasing productivity. Also, the Korean economy is increasingly a service economy. Therefore, the government needs to liberalize services.
Lam: I think a 4.5 percent potential growth rate for an economy at an income level like Korea is not low. A slow transition from a manufacturing-based economy to a service-based one is causing a mismatch in the supply and demand in the labor market demand.
The question is not about how to boost growth potential but how to maintain the current growth rate. I suggest the government maintains its emphasis on R&D not just for existing industries but also to find new growth industries, develop regional economies outside of Seoul, and accelerate the development of the service sector.
Neumann: I agree that potential growth of 4.5 percent is a very respectable rate given Korea's high income level. Raising this level further will be quite challenging, especially given the headwinds of an ageing population.
The government may need to strengthen productivity growth in the economy by putting further emphasis on research and development, and especially, improving productivity in the service and retail sectors of the economy, which lags the impressive manufacturing sector. Policies here include not only subsidies and targeted tax breaks, but also encouragement of competition among firms as well as liberalization.

Q: Is household debt a serious problem? Can it be tamed?

Guillen: I do not think it is as big a problem in Korea as it is in other countries. Also, Korean households have a high savings rate.
Tim Condon: I agree with Guillen. I do not think the high level of household credit is a problem. Korean people, like Americans, appear to be more risk-loving than others. They operate with more leverage and there is no reason to think they are incapable of determining for themselves the right amount for them.
Byrne: Household debt is not an immediate threat to Korea's economy. Most of the debt is in the housing market, which in Korea's case seems to be holding up.
Many mature, advanced economies have elevated household debt. This seems to be a function of well developed financial and capital markets. As long as monetary policy remains prudent and financial regulators remain vigilant, and as long as incomes are rising and unemployment remains low, this should not pose a threat to the economy.
Lam: The increase in household debt in the past few years was mainly caused by mortgages. Mortgage borrowing is skewed to the higher income group because of the stringent anti-speculation measures imposed on the property market, including the debt-to-income and loan-to-value restrictions.
The higher income groups are backed by strong asset support, and their asset to liability ratio is much higher. As a result, Korean banks' household loan delinquency ratio was still below 1 percent even during the global financial crisis in 2008-09.
However, we do see risks that credit quality can deteriorate if not carefully monitored. First, credit card issuance has recently exceeded the peak of the credit card crisis in 2002. In face of higher inflation and low savings rate, Korean consumers could be tempted to maintain their spending power by resorting to plastic.
Second, the government's policy focus on helping the low income groups can lead to an increase in loans available to those in this bracket. We agree that financial assistance needs to be given to the low income groups especially as interest rate is rising, but the authorities need to be careful of not lending excessively to the groups which are less capable of paying off their debt.

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Financial market and capital flow

Q: Is Korea vulnerable to volatile cross-border capital movement? Does it need more capital control measures?

Byrne: Volatile capital flows are most threatening under a set of circumstances that are not present in Korea: Low international FX reserves, current account deficits, inflexible exchange rate policy, and wide fiscal deficits or an overhang of government debt that is largely held by external creditors regardless of the currency in which the government debt is denominated.
Neumann: Korea has already instituted a number of policies to reduce the volatility of capital flows. These appear to be working. While the country remains a big recipient of capital inflows, these are now of a less volatile nature.
Still, further work may be necessary. For example, Korea still receives little foreign direct investment when compared to China, for example. Encouraging more foreign direct investment would likely enhance the stability of capital flows into Korea.
At this stage, it appears that Korea is not at risk of capital flow volatility. Capital controls, if any, should therefore be applied only gently and prudently to encourage the gradual development of Korea's financial markets.
Lam: Korea has seen a capital inflow of $48 billion into its equity market from 2009 to 2010. There is a risk on its financial markets if there is a sudden outflow of this capital. However, I believe such risk is not high as Korea has demonstrated robust resilience during the global financial crisis that is attractive to foreign investors.
Also, domestic investors have stepped up in the equity market. Foreign ownership in KOSPI is now at 36.3 percent which is much lower than the peak of 47.6 percent in September 2004, thereby reducing the impact of foreign capital movements in its stock market.

Q: Will money keep flowing into Korea for the rest of the year, boosting the local equity market? What is the prospect of rate changes in the U.S. and Europe?

Lam: Currently, KOSPI is breaking historical highs thanks to strong export growth and investors' speculation of Korea gaining more market share from substituting Japan's supply disruption. Capital will shift back from developed markets to emerging markets once inflation peaks in emerging markets. We believe Korea will benefit from such trend when it happens.
Neumann: From a macroeconomic perspective, capital inflows will likely remain robust. In the United States we still do not expect a rate hike until the middle of 2012 and even in Europe, where the European Central Bank has already hiked rates, the scope for aggressive tightening appears limited.
Guillen: The Eurozone will continue to raise rates. At some point the Fed will need to follow suit. This will attract more money to those areas, but I don't think the effects on Korea will be significant.
One risk, as mentioned, is that the high oil prices, as well as other commodity prices, start to erode margins, which could hurt corporate profitability. But, generally, the outlook for the Korean market is still encouraging.

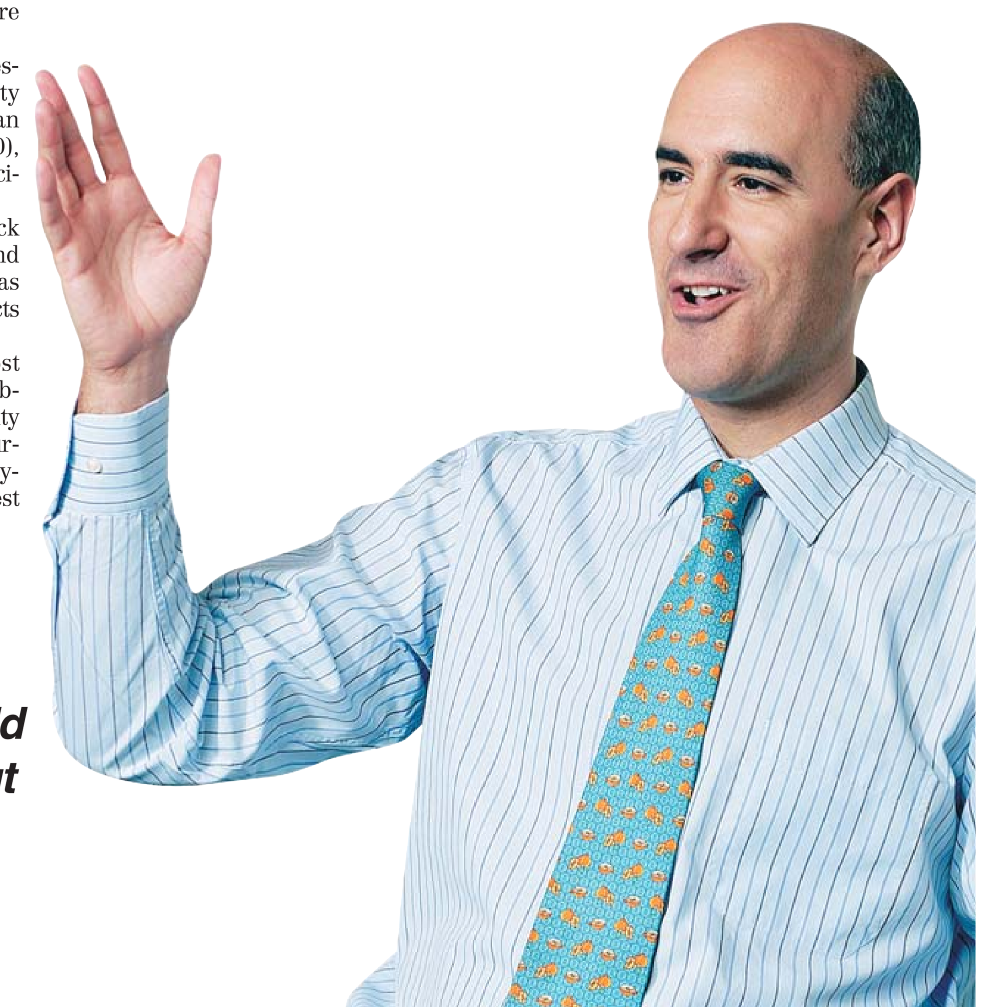
Q: What is your outlook for the course of the Korean won and its bond market?

Condon: I think I am in the consensus in expecting the won-dollar exchange rate to go lower. The break of 1,100 was important and this raises the uncomfortable question for the BOK and the finance ministry — "how low can it go?" My six-month forecast is 1050.
Lam: My opinion is that it will be difficult for the Korean won to outperform this year. First, Korea's current account is shrinking on high oil prices and could even turn into a deficit if oil price surges higher.
Second, the Korean government is unlikely to relax on the macro-prudent measures it has put on restricting external leverage and thus capital inflow in the form of external debt will be limited.
Neumann: I expect only limited appreciation over the course of this year to roughly 1,070 against the U.S. dollar. In recent weeks, the currency has rallied strongly, and in the short-term this may continue. However, we believe that over the second half of the year the exchange rate may drift up again towards our year-end target.
Condon: Korea's economy is doing fine. The BOK is near the end of its normalization. But bond yields, which collapsed during the Lehman crash, have not retraced to their pre-Lehman crash levels.
I think this is because they are linked, via Korea's exchange rate policy, to the U.S. Treasury yields. The 10-year U.S. Treasury bond yield moved from 4 to 5 percent before the Lehman crash to 3 to 4 percent after, where I expect it to stay into the medium term. So KTB yields also will stay structurally lower than before, which is interesting. All of these lead me to expect that 2011 will be an excellent year for KOSPI.

Monetary policy

Q: Is the Bank of Korea doing well? Do you think it needs to be more independent from the government?

Lam: I think the BOK should have raised the interest rate more last year to anchor inflationary expectation and to control inflation.
However, it is not too late to catch up yet and I think the BOK has been doing the right thing by raising rate every other month since November. Any central bank's policy will have to be forward-looking.
Condon: The only way to judge a central bank's performance, especially an inflation-targeting central bank like the BOK, is its performance on inflation.
Korea has been hit by food and oil shocks and there is some evidence that these have had second-round effects on core inflation. But the BOK has been slowly but steadily normalizing the base interest rate and so far the higher core inflation has not shown up in treasury bond yields, which is the ultimate test of its performance.
The authorities demonstrated impressive institutional depth in responding to the Lehman crash. Their performance warrants optimism in their ability to respond to future shocks.
Byrne: The BOK is facing more inflationary pressures from the supply side (global commodity prices and foot-and-mouth disease in Korea) than the demand side (positive output gap in 2010), probably greater than the Bank may have anticipated.
But the fact is, the BOK has a very good track record on managing inflationary expectations and second round effects of supply shocks. Korea has had a long period of price stability since the effects of the Asian Financial Crisis abated.
Neumann: The BOK is already one of the most independent central banks in Asia. It has an established track record in maintaining price stability and we continue to expect the central bank to pursue its mandate vigorously. In my view, the policy-framework of the Bank of Korea is among the best Asia has on offer.



"High commodity prices could hurt corporate profitability. But the general outlook for the Korean market is still encouraging."

Global liquidity's U-turn to emerging markets

Analysis

Park Jung-je
Korea Investment & Securities

The yen's liquidity has been a preoccupying subject for me recently. As the Bank of Japan pursues an aggressive monetary policy to tackle the earthquake crisis, Japan has emerged as a new source of global liquidity and concerns are waning regarding the possible about-face for the U.S. and European monetary policies.

Since October 2010, global liquidity has been flowing into advanced economies from emerging economies, reversing its previous trend. This decoupling of growth in advanced and emerging economies implies that the two have different macroeconomic conditions and different monetary policy stances. Ben Bernanke, the U.S. Federal Reserve Chairman, called this a "two-speed global recovery."

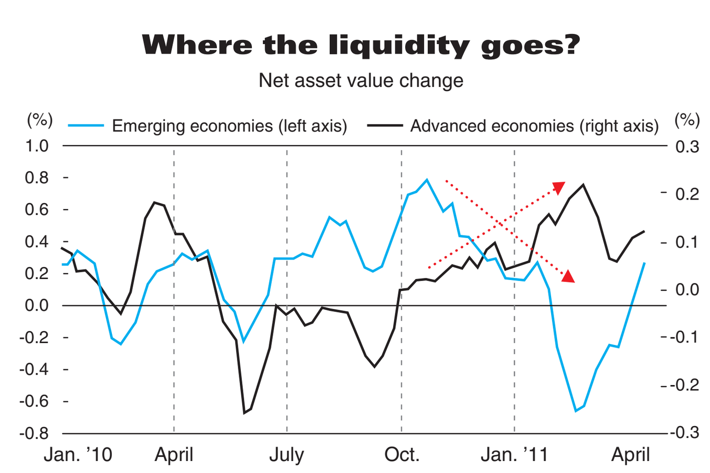
The question is whether global liquidity will find its way back to emerging economies. Global liquidity has shifted from emerging economies toward advanced countries since October 2010. It is time to make a judgment call as to whether the money flow will remain as is or reverse to emerging markets. I believe emerging markets will be the next destination for global liquidity and a wise investor must take into consideration growth momentum in emerging markets for the following three reasons.

First, inflationary pressure in China and other emerging markets should peak in the first half of 2011 and subside afterward. Emerging economies have fallen out of favor mostly because they tightened policy measures to curb inflationary pressure. Commodity prices were the main culprit behind the mounting pressure. But a simulated analysis of the CRB futures index, a key gauge of commodity prices, shows inflationary pressure will quickly stabilize after peaking in May 2011.

Second, China, a leading emerging economy, has taken enough tightening measures. China's M2 growth, a major indicator of money supply, is down to the government's target of 16 percent. As M2 growth affects consumer prices with a time lag, prices will reflect the impact of monetary tightening down the road.

Third, emerging economies are showing greater tolerance toward their currencies appreciating. Chinese Premier Wen Jiabao said in mid-April the country would make its exchange rate scheme more flexible to rein in inflation. His comments indicate the RMB's appreciation may accelerate. If such is the case, China does not need additional monetary policy tightening.

When policy tightening risks dwindle, the growth potential of emerging economies will have strong appeal to the market.

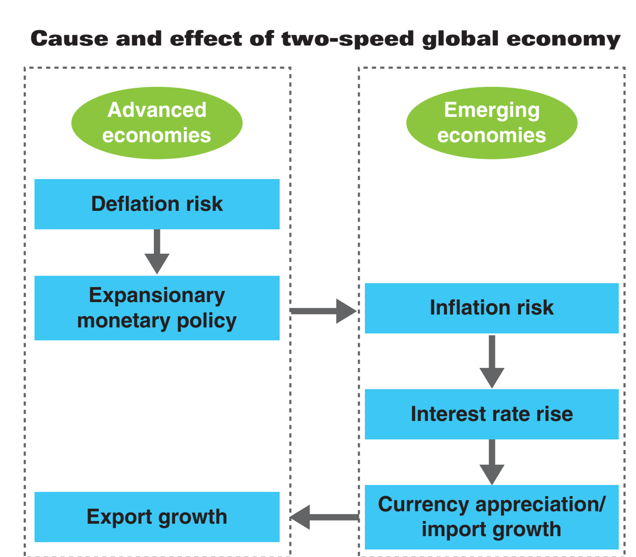


*4-week moving average

Source: Korea Investment & Securities

Among others, China and its domestic demand merits attention. According to China's GDP growth for the first quarter of 2011 released in early April, consumption made greater contribution to GDP growth than investment for the first time in decades.

As such, I believe Korean companies that benefit from China's growing domestic demand are promising investment targets. Based on the KIS Universe — a basket of stocks that Korea Investment & Securities has created to mimic the broader market — "buy calls" include leading China plays such as AmorePacific, Lock&Lock, Orion, The Basic House, CJ O Shopping and NCsoft.



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Uncertainties cloud Korean economy

Analysis

By Jung Sung-ki

Despite a faster-than-expected recovery, the outlook for the Korean economy still remains unclear due to lingering uncertainties abroad, such as rising oil costs, China's slowing growth rate, the knock-on effect from the Japanese earthquake and the European sovereign debt crisis, according to government officials and economic analysts.

The rise in oil prices, in particular, is a headwind to Korea's economic growth, as the fourth largest economy in Asia is heavily dependent on imports.

Bank of Korea Governor Kim Choong-soo echoed those worries earlier this month. "The run-up in oil prices associated with the political unrest in the Middle East and North Africa, the aftermath of the Japanese devastating earthquake and the fiscal problems of certain European countries will act as major downside risk factors," Kim said April 21 after a rate-setting meeting.

Growth slowdown for China

Another risk to the Korean economy is a potential cooling of the Chinese economy, according to experts.

"Korea has been among the best positioned economies to take advantage of China's extraordinary rise," HSBC senior economist Frederic Neumann said. "A setback in China, however, could also cool export growth in Korea."

Inflationary pressure in China is also likely to spread to Korea, and the contraction of the world's second largest economy could hurt the latter's exports.

The People's Bank of China raised the deposit reserve requirement ratio by 0.5 percentage points to 20.5 percent recently in an effort to keep inflationary pressure down. In March, China's inflation rose to a 32-month high of 5.4 percent on increasing domestic demand.

Park Young-joon, a researcher at the Korea Institute for International Economic Policy, said that inflation in China tends to precede that in Korea by seven months.

He said that a one-percent increase in China's consumer prices cause Korea's to go up 0.12 to 0.15 percent, and the impact tends to last for a long time.

"Studies show that inflation in China had little influence on Korea until the 1990s, but, in the 2000s, became one of the most important overseas factors for inflation in Korea along with oil prices," Park said, adding that the effect of a ten-percent increase in Dubai oil prices is equivalent to a one-percent rise in China's consumer prices.

Korean firms that operate locally in China saw nearly 60 percent of their revenue from sales there in 2009 — up nine percent from 2006. Weaker consumption as a result of the slower economic growth could hurt Korean companies.

Korea and other Asian countries are expected to be adversely affected by short-term supply disruption, weaker demand from Japan, following the deadly earthquake last month.

Impact of Japan's earthquake

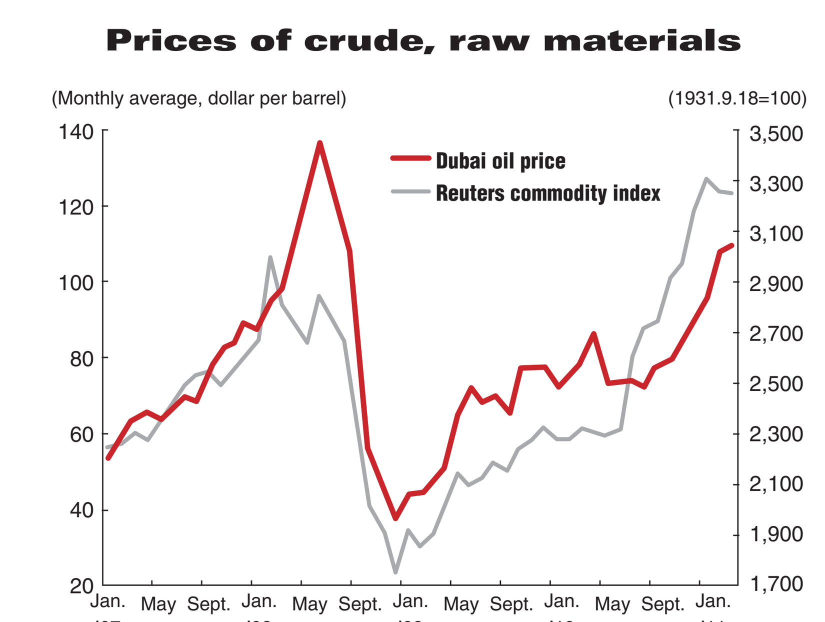
But reconstruction demand from Japan should benefit Asia by year's end, analysts say.

Korea mostly exports machinery and manufactured metals to Japan, as well as petroleum products, chemicals and food products. Demand for these items will suffer in the immediate aftermath of the disaster amid disruptions, though shipments should strengthen during Japan's reconstruction phase.

Given Korea is reliant on imports from Japan, particularly electronic parts, as inputs to its production processes, supply shortages will crimp output and thus harm the Korean GDP growth, according to Moody's Analytics.

On the upside, Korea competes with Japan in semiconductors, autos and steel, and thus has the opportunity to boost its market share if a factory shutdown in Japan persists.

Analysts cite uncertainty about the economic recovery in Europe and the United States, two of Korea's biggest markets, as a potential obstacle to Korea's economic outlook.



Source: Bank of Korea

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