

# Asian Currency Research

## KRW - on negative watch

DBS Group Research

24 April 2008

USD/KRW - DBS forecasts, eop					
	23-Apr	2Q08	3Q08	4Q08	1Q09
<b>New forecast</b>	<b>993</b>	<b>1050</b>	<b>1100</b>	<b>1075</b>	<b>1075</b>
Old Forecast	--	1000	980	940	980
Consensus	--	975	954	935	928
Forwards	--	998	998	997	997

### We have downgraded our outlook for the won

The Korean won (KRW) has become visibly weak since the US mortgage/credit crisis broke out in July 2007. The most telling sign of this has been the inability of the KRW to benefit from the aggressive US rate cuts (300bps so far in Fed funds [FFR]). Instead, USD/KRW bottomed at 899 on Oct 31, the same day that Fed funds were cut for a second time to 4.50%. By then, the FFR was lowered by a cumulative 75bps, the quantum normally administered during periods when US financial markets are stressed.

As the Fed continued to lower the FFR after Oct 31, fears of US recession and slower global growth grew. Apart from hurting the won via falling equities, the post-October Fed cuts also triggered an aggressive unwinding of JPY carry trades, including those against the KRW. November was also an important period because the KRW was pressured by shortages of USD liquidity, courtesy of the US credit crunch.

### International liquidity is key

These episodes of won weakness are symptomatic of a broader structural problem confronting Korea. Over the past few years, the country's international liquidity position has deteriorated. Banks have increasingly borrowed from abroad (mainly cheap yen) to fund domestic loans, which have grown faster than deposits. With gross external debt now exceeding foreign reserves, the return of trade and current account deficits in 1Q08 was definitely unwelcome.

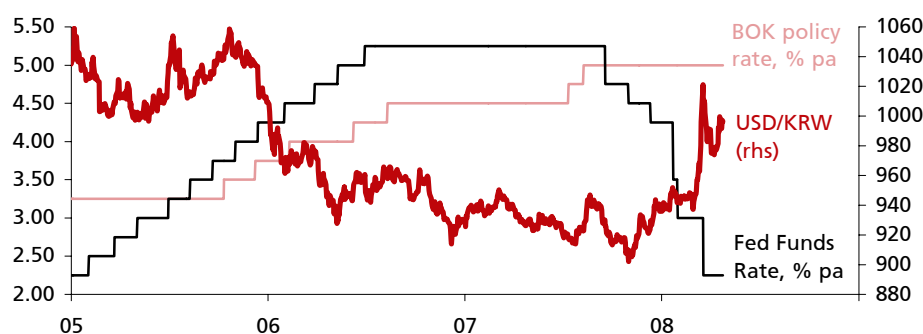
Hence, we can no longer discount the possibility that the KRW's appreciation since 2001 may have run its course. As such, we have decided to downgrade our outlook for the KRW.

**KRW did not rise despite aggressive US rate cuts**

**The won will drop to 1100 per USD on a 6-month horizon**

**Korea's international liquidity position has deteriorated significantly**

### Conspicuously, KRW did not benefit from aggressive US rate cuts



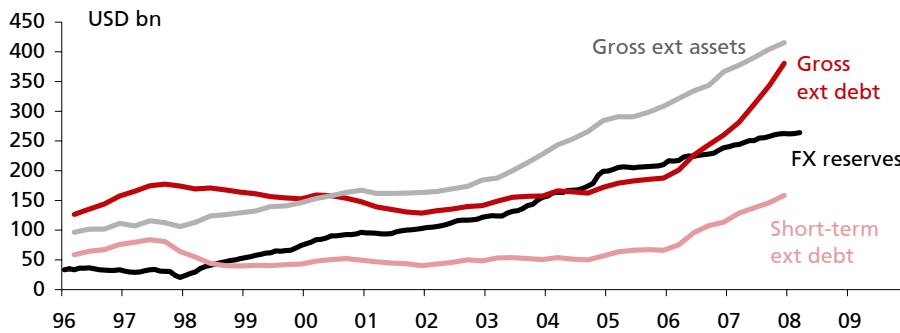
Sources: Reuters, DBS Research

### 1. External debt - little room for complacency

Since 2Q06, gross external debt has overtaken foreign reserves, with the debt-reserves shortfall widening to USD118bn in 4Q07. The last time this shortfall widened rapidly to more than USD100bn was before the 1997/98 Asian financial crisis. Not surprisingly, net foreign assets (NFA) at the central bank have fallen to USD35bn in 2007 from a peak of USD121bn in 2005. If this deterioration continues, NFA are likely to return to a deficit by 2009.

External debt surpassed foreign reserves in 2Q06

External debt is overtaking FX reserves at an accelerating pace



Sources: CEIC, DBS Research

More worryingly for the currency, short-term external debt has surged 2.4 times to USD159bn in 2007 from USD66bn in 2005. On current trends, short-term debt would exceed foreign reserves by 2012. Most will recall that one of the key catalysts for the KRW's fall in 4Q97 was the inability of foreign reserves to cover short-term external debt.

Left unchecked, short-term external debt would exceed foreign reserves by 2012

### 2. Korean banks rely more on foreign savings

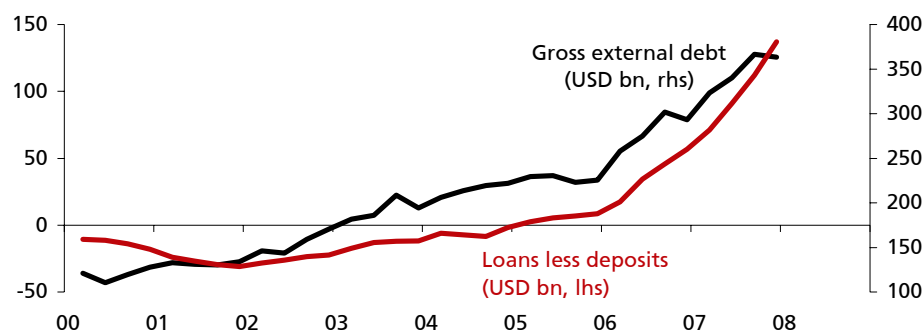
Korea is one of the few emerging Asian countries where loans outstrip deposits at commercial banks. Some of the shortfall is being funded by foreign savings, which is consistent with the rapid rise in the country's gross external debt level.

The US mortgage/credit crisis is likely to have encouraged some Korean banks to diversify their JPY liabilities towards USD-based liabilities. Not a surprising development given that the crisis forced an unwinding of JPY carry trades, and led to a globally weak USD via aggressive US rate cuts.

This goes some way to explain why the KRW was one of the few Asian currencies to become vulnerable to shortages in USD liquidity. In fact, it was this shortage that led to the Korean bond market turmoil last November, which helped to establish 899 as the bottom for USD/KRW on Oct 31. In hindsight, it was probably not coincidental the KRW's depreciation accompanied the significant widening credit spreads at Korean banks from November 2007 into 1Q08.

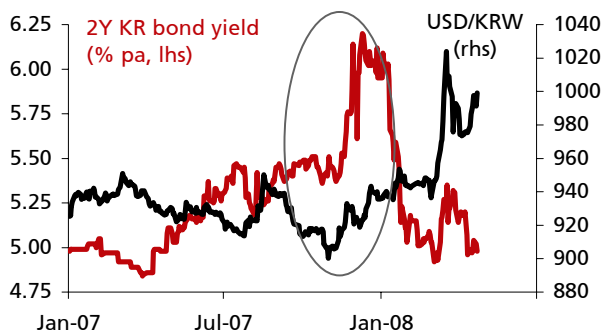
External borrowings, led by private sector, especially the banks, have risen sharply

As banks loans exceed deposits, external debt increases



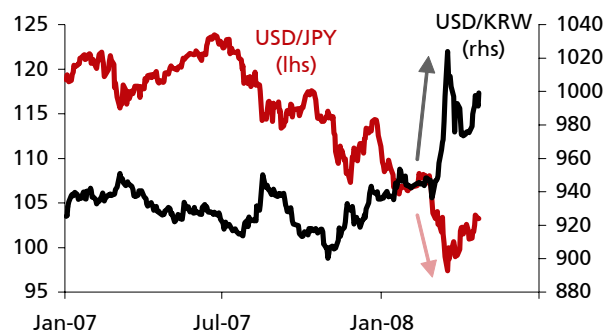
Sources: CEIC, DBS Research

USD shortages led to bottom in USD/KRW



Sources: Reuters, DBS Research

USD/JPY < 100 led to USD/KRW > 1000



Sources: Reuters, DBS Research

Nonetheless, the foreign savings that Korean banks rely mostly on for their funding needs are likely to originate mostly from Japan, especially in the past few years when the KRW was strong and the JPY weak. This was probably why the most aggressive sell-off in the KRW beyond the psychological 1000 level vs USD took place in March, when USD/JPY plunged below 100.

**Dependency on external borrowings leaves Korea vulnerable to credit crunch and JPY strength**

Under the circumstances, one should not be surprised that the Ministry of Finance & Economy (MOFE) has expressed a concern that current levels of foreign reserves might be too low. This also suggests that the central bank will take advantage of periods of USD weakness to accumulate dollars in its foreign reserves.

**Any KRW strength will be stymied by need to build foreign reserves**

**3. Trade deficit - worst in 11 years**

The merchandise trade deficit ballooned to USD5.9bn in 1Q08, its worst level in 11 years. The last time the trade deficit widened to around these levels was in 1Q97, before the outbreak of the Asian financial crisis in July 1997. Fortunately, as a percentage of GDP, the trade deficit amounted to but 2.3% in 1Q08, less than the near-6% ratio posted in 1Q97.

**2008 could mark the first return to C/A deficits since the Asian crisis of 1997/98**

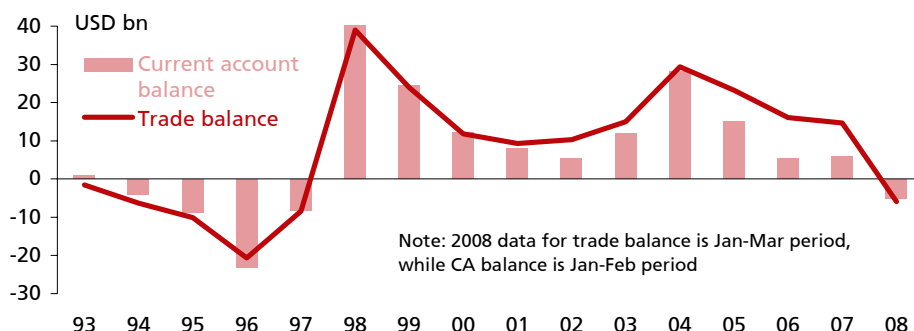
Still, there is little room for complacency. The trade deficit has led to a reversal in the overall current account (CA) balance as well. The CA deficit amounted to USD5.1bn in the first two months of 2008, in sharp contrast to the USD6.0bn surplus posted for the whole of 2007. If this trend persists, it would be first annual deficit recorded since 1997.

**4. KRW suffers when US markets/economy become unfriendly**

The KRW is also known to be vulnerable whenever the US economy threatens the well-being of the global economy. Back in 2000/2001, when the US tech bubble burst and led to a global manufacturing recession, the KRW depreciated sharply against the USD, from a low of 1100 in Sep 2000 to a high of 1367 in Apr 2008.

**KRW tends to falter when US economy struggles**

Risk of external balances returning into deficit position again

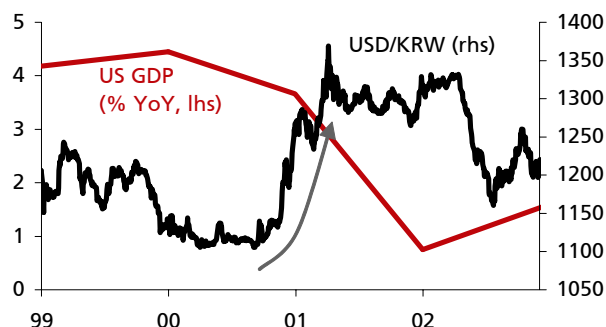


Note: 2008 data for trade balance is Jan-Mar period, while CA balance is Jan-Feb period

Sources: CEIC, DBS Research

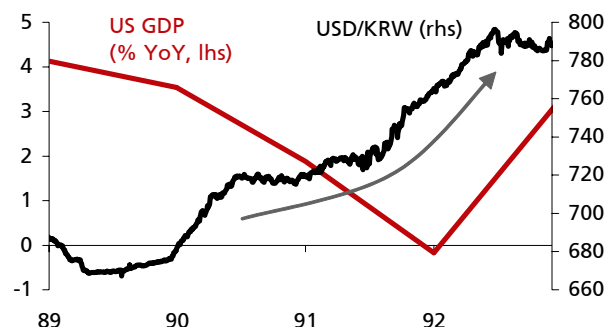
Today's US mortgage/credit crisis is anything but hi-tech despite all the fancy financial engineering. But weak US demand is weak US demand and Korea is one of Asia's more externally-driven economies. Looking farther back, the won also suffered in 1991, the last time the US was pressured by a weak housing sector. In this light, it is little surprise that the KRW's depreciation so far in 2008 has already outpaced the whole of 2007.

USD/KRW rose during Y2K in 2000/01



Sources: CEIC, DBS Research

USD/KRW rose during US recession in 1991



Sources: CEIC, DBS Research

**Bottomline - KRW on negative watch**

The bottom line is this: The improvement in Korea's international liquidity position appears to have run its course, and with it, the rationale to stay bullish on the KRW.

Our primary concern lies with the rapid accumulation of external debt in Korea over the past few years. Lacking deposits, commercial banks have been tapping foreign savings to expand their loan book. This currency mismatch in banks' assets/liabilities has increased the vulnerability of Korea's financial sector to the credit crunch in the US, as well as to a rapid appreciation in the funding currency, namely the JPY.

Moreover, the return of trade and current account deficits in 1Q08 is also unwelcome, particularly given the outlook for a slower global economy and rising inflation. For now, exports are still holding up, but slower global growth will take some toll on revenues. It will also take a toll on the won, if the past is any guide. Meanwhile, imports are higher because of more expensive crude oil and higher food prices.

Another obstacle to KRW appreciation is the need to rebuild foreign reserves, which has slipped below gross external debt. This fits in with the new government's goal to focus the key policy levers -- lower interest rates, higher fiscal spending and a competitive exchange rate -- at cushioning the Korean economy against potential headwinds in the global economy.

Hence, we see scope for USD/KRW to extend its rise towards 1100 over the next six months into 3Q08, before settling in a range between 1050-1100 thereafter.

**The won will drop to 1100 per USD on a six-month horizon**

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