

## Peninsula stimulus packages... a time for change?

November 2008 - Author: Adrian Cowell, Fund Manager



**October 2008 was a rocky month on the Korean peninsula marked by absences, balloons and suspicious photographs, and the attainment of a critical currency stock index crossover! In the Republic of Korea (RoK) at end September, you needed KRW1,206.50 to buy one US dollar. By October 28 in the face of growing scarcity, you needed KRW1,459.30 for that same dollar, but just three days later it only required KRW1,306.05!**

The KOSPI (leading stock market index) was the exaggerated fairground mirror of the currency having closed September at 1,448.06. It dropped off precipitously to 938.76 as of the 24th close, crashing through the crossover support line, and 1,000 points, before “bouncing” to end the month at 1,113.06, still nearly 200 points “off-side” versus the currency. A top-to-bottom currency depreciation of 20% versus the dollar and, at its worst for non-resident equity investors, a compounding erosion in the KOSPI of 35%. Not pretty. Best to have been underweight! The rapid response from the research community was a surge to outdo each other in the zeal of their economic and earnings downgrades! It is a competitive world.

RoK President Lee Myung-Bak, had made “747” the central plank of MBnomics, his end 2007 cure-all election pledge to deliver 7% GDP growth, per capita income of US\$40,000 and to cement Korea as the world’s 7th industrial nation. The financial crisis has put paid to most of that and many have questioned the capability of his Minister of Strategy and Finance, Kang Man-Soo, in these straightened times, closely identified as he is with the 747-based MBnomics. Lee Myung-Bak in his address to the nation at the end of October commented that the economic crisis is “due solely to external factors” and that the RoK government has performed most effectively. Others beg to differ. The weaker Won was at first good for exports, and showed up in stronger corporate earnings in 1Q and 2Q, before its adverse effects started to bite more widely, ultimately leading to questions of national solvency and a loss in confidence. 3Q earnings reported in October-November simply served to underline. Foreign portfolio investors sold equities, KRW4.6tr on the KSE in the month for a grand total of KRW33.8tr in the year-to-end October, reducing market ownership to 28.58% down from its April 2004 peak of 44.12%.

Korea had little direct exposure to, or fallout from, the bankruptcy of US investment bank Lehman Brothers holding little by way of worthless Lehman notes, and the Korea Development Bank, government-owned investment banking aspirant, was mercifully prevented by the same government from finalising a bid to take Lehman over, lock, stock and smoking barrels. At the third time of asking, somewhat unkindly commentators have identified an alternative Korean Lee-Man Brothers, alive and well and at the heart of the establishment; the combination of “Lee” Myung-Bak and his Minister of Strategy and Finance, Kang “Man”-Soo. Despite increasing calls from business and political circles for the dismissal of Kang Man-Soo, Lee Myung-Bak is for the moment reading from the Tammy Winette song sheet and standing by his “Man”. Kang Man-Soo was a Vice Finance Minister at the time of the Asian crisis in 1997, and spent ten years out of the administration and out of the markets. This is more his second coming (or going) than a baptism of fire.

The banks have been in the vanguard, facing mounting foreign currency shortages and a liquidity crunch. The sector typically is reliant upon the wholesale funding markets to bridge its loan-to-deposit gap (the announcement at Bank Underground Station platform in London could perhaps be changed for the benefit of investors in Korean banks to a salutary “mind the loan-to-deposit gap”), and a portion of this gap is covered by short-term foreign currency borrowings which require rolling over. Loan growth has continued apace, way ahead of nominal GDP, provoking worries about deteriorating asset quality, and net interest margins continue to erode resulting in poor returns on assets and equity. Expectations of bankruptcies, particularly in but by no means confined to the construction sector, are growing.

Small and medium sized exporters had been extensively writing foreign exchange option contracts for many months in the mistaken belief that the Korean Won was a one way bet against the US dollar. These KIKO (knock in knock out), pivot and snowball structures were initially to hedge exports and lock-in margins, or as it now turns out in some instances to “over hedge”. All fine and dandy when the won was appreciating, but excruciating-to-life threatening in the face of currency collapse when the attendant multipliers kick in! A backlight unit assembler for TFT LCD panels filed for court protection having over indulged in KIKO contracts, and a green field yet-to-be ship builder has also been considering court protection. Non-performing loan (NPL) formation can probably only go in one direction with capital adequacy going in the other.

And there is the prospect of government requested national service (never knowingly refused)! To the unscrupulous selling of KIKO contracts to unsuspecting small corporates, can apparently now be added the unscrupulous cross-selling of investment funds to retail customers. And they still want to become investment banks. Core business please.

At the end of October the authorities responded with their stimulus package of US\$100bn of guarantees for banks to run to June 2009, a further US\$30bn in supply from the BoK, a bond repurchase agreement, and following an emergency meeting, a 75bps cut in interest rates to 4.25% (and another 25bps has since been taken off). An additional bilateral dollar swap line has been agreed with the US Federal Reserve. The market response has been muted. The banks' shares are now trading on an estimated 0.6 times '09 book value per share (which is cheap, of course assuming that the “book” is properly valued). But the banks 3Q'08 results have been very poor and the immediate outlook is far from rosy.

Whilst all of this had been building up, the FTSE (Financial Times Stock Exchange Index) recently announced that Korea will in due course be promoted from emerging market to developed market status. The last time that Korea was “promoted” was to join OECD, the so-called club of rich nations. This had been a key goal of President Kim Yong-Sam (last but not three) and arrival on this particular podium was promptly followed by the Asian crisis of 1997, when Korea came within a few billion dollars of bankruptcy. It is to be hoped that we are not in for a repeat! And we are probably not. Major corporate balance sheets are much stronger and capacity utilization is higher. Foreign currency reserves are far larger at over US\$200bn. The debt burden falls on small and medium enterprises (SMEs) and households suggesting that employment and domestic consumption will not be major economic drivers. Exports as and when will be the way out when customers regain sufficient confidence to purchase, or when they need to replace their mobile phones. A return to a current account surplus will support further rate cuts which will retain currency competitiveness but keep those KIKO contracts painful.

Meantime north of the De-Militarized Zone (DMZ) in the Democratic Peoples' Republic of Korea (DPRK) an altogether different stimulus package may or may not have been employed. It remains to be seen whether this has been more or less effective than that applied south of the DMZ. Photographic evidence is inconclusive.



*South Korean Soldier stands guard on the DMZ with North Korea in the background.*

The Dear Leader, Kim Jong-II, failed to attend the military parade in Pyongyang on 9th September to mark the 60th anniversary of the founding of the DPRK. A 60th anniversary is of huge significance according to the Chinese calendar marking 5 rounds of 12, a complete life cycle. It is inconceivable that the Dear Leader would willingly miss such a momentous event. This was the first such military parade that he has missed since becoming head of the DPRK military in 1991.

It seems that Kim Jong-II suffered a stroke on or around 14th August, that he was attended to by a team of five Chinese military doctors who operated on him, and that he has been possibly recuperating. A French neuro-surgeon,

services allegedly secured by eldest son Kim Jong-Nam, also flew to Pyongyang but he has denied performing any operation. Kim Sung-Ho, head of the RoK National Intelligence Service reported that; "Although he is not in a state to walk around, he is conscious. We understand that he can control the situation and he is not in an unstable condition". And if he can't, and he is unstable....

The veracity of recovery reports has been undermined firstly by the Dear Leader's prolonged absence from volunteering on-the-spot guidance to whomsoever was privileged to receive it, and secondly by the later release of a rash of photographs showing Kim Jong-II discharging official duties. One video clip showed Kim Jong-II accompanied possibly by Prime Minister Yon Hyung-Mok, who had unfortunately (and presumably mistakenly) been dead a number of years. Others were snaps at a military football match taken from his right hand side showing a full head of hair and no obvious weight loss. He congratulated the winners on "successfully applying the Korean-style sporting method" (well one team was going to get it right weren't they, even if the match had to go to sudden death!). Brain surgery and a full head of hair? And no weight loss?

And then there was the supposedly autumnal visit to a female artillery unit for morale boosting on-the-spot guidance with full summer foliage in the background! It was reported; "He highly praised them on their success in training and put forward highly important tasks which could serve as guidelines for bolstering up the heroic Korean People's Army as invincible revolutionary armed forces".

There was the concert in Pyongyang where he listened to an operatic rendition of "May the Motherland Prosper", and finally the mother of all photographs to prove beyond all reasonable doubt that he is back.....a group photo with yet another military unit....except that close inspection of shadows cast by those on parade suggests that the sun shines from a totally different angle on the Dear Leader than it does on those standing around him! What is so strange about that?

So dead or alive, wanted or otherwise, who is running the place? There are rumours of further strokes. Who is holding the Dear chop? Nominations include Chang Sung-Taek, head of the secret police and husband of Kim Jong-II's younger sister, Kim Kyong-Hui. He has apparently been quite successful at eliminating rivals. Probably not wise to bet against him!

There is no designated dynastic successor to the Dear Leader, his three sons being too young amongst other notable faults. There is younger half brother Kim Pyong-II, loser of a power struggle long ago but with some early military connection. He has been in de facto exile for the last thirty years as a serial DPRK Ambassador and is currently in Poland, and there is also half sister Kim Kyung-Jin married to Kim Kwang-Sup, another serial Ambassador in exile currently in Austria. Could one of these have or want a future role?

South of the DMZ, private activist groups have resorted to launching into the atmosphere hundreds of thousands of propaganda leaflets in helium filled balloons to be propelled northwards on gentle southerlies. The balloons carry delayed action timing devices to release the leaflets which are intended to promote concepts of freedom and to provide medical bulletins on the health of Kim Jong-II. The DPRK has demanded action to stop the launch of the balloons which have been branded as psychological warfare. The Rodong Sinmun (official party newspaper) stated; "If Lee Myung-Bak and his horde of traitors stick to the road of reckless confrontation with us and defame our dignity, this will compel us to make a crucial decision".

Failure of the Dear Leader's personalised stimulus package north of the DMZ, and all the succession uncertainty that that will bring, will undoubtedly not be good for the RoK economy....irrespective of what Lee-Man Brothers may or may not do in the interim. Success and the doctors will most likely put Hennessy Cognac off-limits.

The United States has removed the DPRK from the list of states sponsoring terrorism (it is not certain whether this will be seen as promotion or demotion)....and has added a President-elect to the mix. What does the Dear Leader or his stand-in make of that? More missiles please nurse?

## Postscript

On Wednesday 12th November, the DPRK announced in a potentially balloon-popping statement that it will close the land border with the RoK effective from 1st December. The decision has apparently been taken because "reckless confrontation...was beyond the danger level". The DPRK further commented that; "The South Korean puppet authorities should never forget that the present inter-Korean relations are at a crossroads of existence and total severance".

Relations between North and South have deteriorated since the election of conservative President Lee Myung-Bak, and the dawn shooting of a South Korean tourist at the Mt Geumgang resort in the summer. The operations of around 80 RoK companies in the Kaesong Industrial Park in the DPRK employing over 30,000 North Korean workers will be threatened by closure of the border. The industrial park, Mt Keumgang resort and tour visits to the historic sites at Kaesong earn the DPRK an estimated US\$50m annually.

However the DPRK in the middle of winter is not a prime tourist destination, so there is time for relations to improve when the weather does.... or with the changing of one or two of the three guards, said Alice!