Korean Equities: Rewards For A Seoul Sacrifice?

Put a Band-Aid on it. Sweep it under the rug. Stick your finger in the dike. There's no shortage of homilies regarding temporary solutions to long-term problems. The moral of the story remains: If you don't fix it right the first time, you'll have to come back later and clean up an even worse mess, one partially of your own making. This is the situation and opportunity now presented by markets in east Asia in general and South Korea in particular.

The global financial crisis of 1997-1998 began in South Asia, specifically with the devaluation of the Thai baht on July 2. The problems spread quickly to Indonesia and Malaysia, and then to East Asia, where South Korea was the hardest hit. In each case, a combination of international credits and the promise of domestic reforms stopped the bleeding. The monetary largesse required for these operations was last seen fueling the global equity boom of 1999, may it rest in peace.

Unintended Consequences

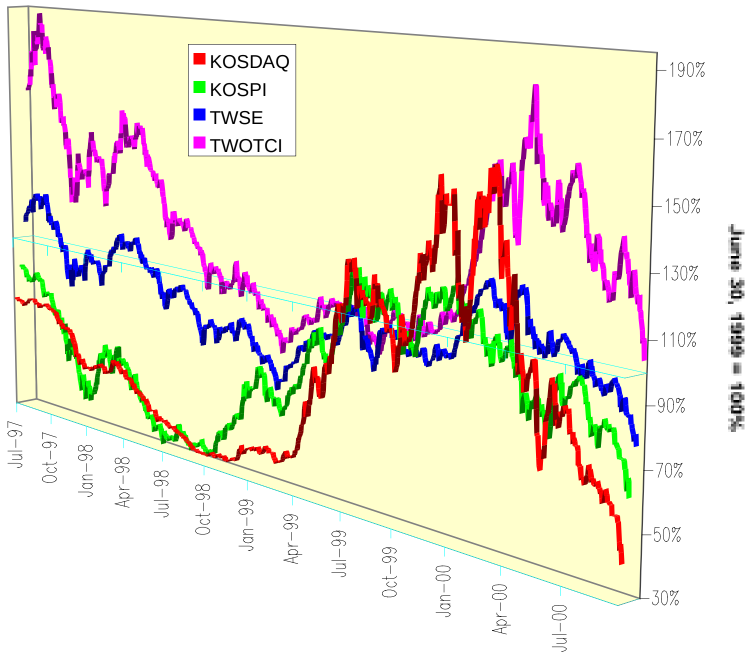
Pity the central banks in their quest for divinity: Whenever excess liquidity is created, it then must be destroyed to avoid creating an inflationary spiral. This is a difficult process as it risks uneven currency movements and threatens to puncture recently created asset bubbles; one only need recall the 1929 and 1989 experiences of the Federal Reserve and the Bank of Japan, respectively, in this regard. The collapse of and newly launched rescue attempt for the euro illustrates the currency management problem well.

Even the current surge in crude oil prices has its roots in 1997-1998 period. As Asian energy demand fell and Russian exports increased in order to earn hard currency, the price of crude oil fell. By early 1999, gasoline was at its lowest inflation-adjusted price ever. As investment in exploration and production fell, demand recovered, and we are now at the highest price levels since the Persian Gulf War.

Since crude oil is priced in dollars, the jump in crude oil has been amplified in currency and equity markets worldwide. So far in 2000, only the Israeli shekel and Mexican peso outside of the countries that peg their currencies to the dollar have gained against the greenback. The dollar-peg group, which includes South Korea and Taiwan, has been forced into keeping their interest rates high to match the Federal Reserve's series of rate hikes beginning June 30, 1999 in order to maintain their exchange rates.

Just as the S&P 500 and NASDAQ diverged in late 1999 and early 2000, so the flagship indices of South Korea and Taiwan, the flagship Korean Composite (KOSPI) and Taiwan Weighted (TWSE) diverged from their small stock indices, the KOSDAQ and TWOTCI, as illustrated in the chart below.

South Korea And Taiwan Equity Markets



The dollar peg's costs have hurt the South Korean and Taiwanese bourses in comparison to other East Asian markets. To-date in 2000, the KOSPI is down 46.2% and the TWSE Index is down 21.7% in local currency terms, while the Hang Seng 100 is off just 14.1%, the Nikkei 225 is off 16.5%, and the Shenzhen B index is actually up a quite respectable 23.5%. The KOSDAQ, for those still licking their wounds over the NASDAQ's travails, is down a whopping 70% so far in 2000.

The Path Not Taken -- Yet

Both South Korea and Taiwan took an export-led path to economic development, and this path was funded by generous U.S. aid during the Cold War. The result, while spectacular from a macroeconomic viewpoint, was state-directed crony capitalism and a "no one's going to let us fail" attitude that was reinforced by the global rescue effort in 1997-1998.

Export competition from China, a slowing of international investment in the aftermath of the Asian financial crisis, high oil prices, and softer semiconductor prices all contributed to derailing this model. Moreover, the emerging high tech economy rewards entrepreneurial enterprises far more than the large state-directed combines, or chaebols, that have characterized the Korean economy.

Only now does the Seoul government appear willing to force structural changes in return for its $44.4 billion effort to shore up weak financial institutions beset by bad loans and its provision of $3.5 billion in debt service guarantees for the struggling venture sector. The government is pressing for a sale of Daewoo Motors; Ford withdrew its $7 billion bid for the No. 2 auto maker last week. Finance Minister Jin Nyum is encouraging mergers in the banking sector, and is promising that the proposed assistance won't turn into permanent life support.

The best news for Korea, however, may be the international effort to support the euro. The quickest way to firm the euro is to weaken the dollar via lower interest rates, a move probably overdue anyway given the softening U.S. economy. This will take some of the interest rate pressure off the dollar-peg group and make the beaten-down KOSPI and KOSDAQ attractive assets for those who still believe in buying low.