

## South Korea: Downgrading Our KRW Outlook

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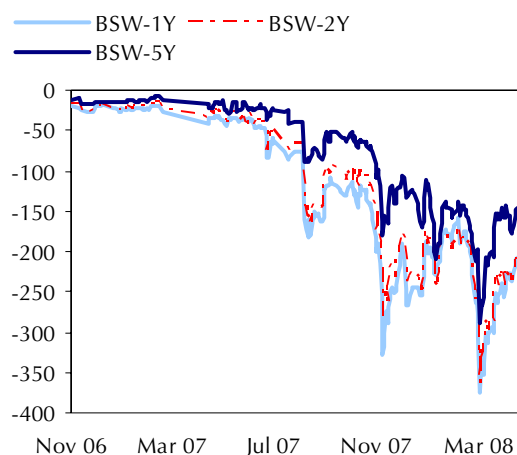
USD-shortage in South Korean's onshore spot market has continued to drive the widening of spreads between USD/KRW cross currency swap and KRW interest rate swap as evidenced in the 1Y basis swaps rising to more than -300bps towards end of March. As the forward trades are fixed against the 91-day CD rate, we expect to see such gyrations in the USD/KRW basis swaps towards the end of every quarter.

The main reasons for the USD shortage in Korea's onshore spot market can be attributed to the large USD-sales by local exporters in the forward market, continued stock sales by foreigners and the ongoing credit market turmoil making large financial institutions less willing to extend credit which is seen exacerbating the USD shortage situation in the spot market.

- (1) Local exporters, in particular the ship builders are actively hedging their USD proceeds in the forward market. On the other side of the transaction, banks which have long USD forward positions need to sell USD in the spot market in exchange for the KRW by borrowing USD from the swap market. Traditionally, South Korean banks are highly dependent on wholesale funding. Foreign banks operating in Korea which used to be able to supply the USD by borrowing from their parent banks overseas were faced with funding difficulty after the Korean government curbed short-term overseas borrowing in August 2007.

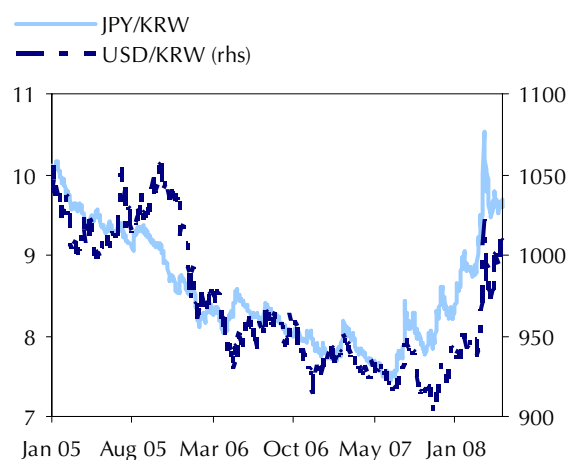
From 10 Aug 2007, the BoK only permitted foreign-currency loans for the purposes of overseas spending and facility investment within the country. The restrictions will apply to banks, insurers and other organizations that deal

Gyrations in USD/KRW basis swaps since the gov't's limit on bank foreign currency lending and the onset of the U.S. subprime crisis in Aug 2007



Source: Bloomberg

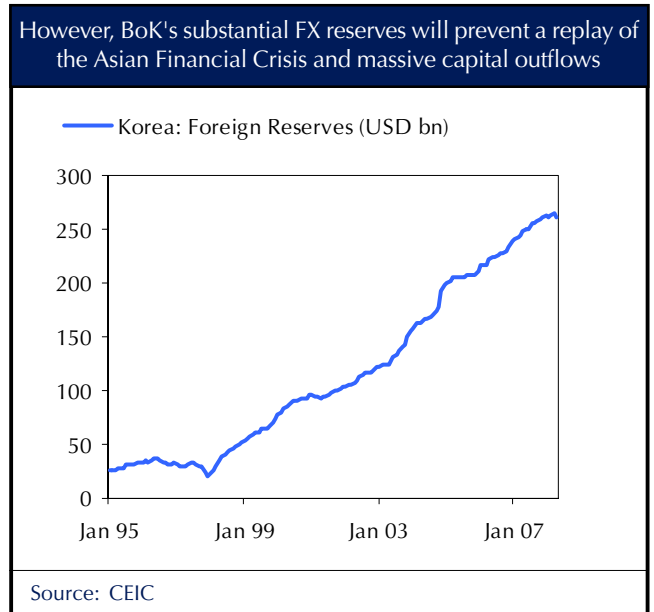
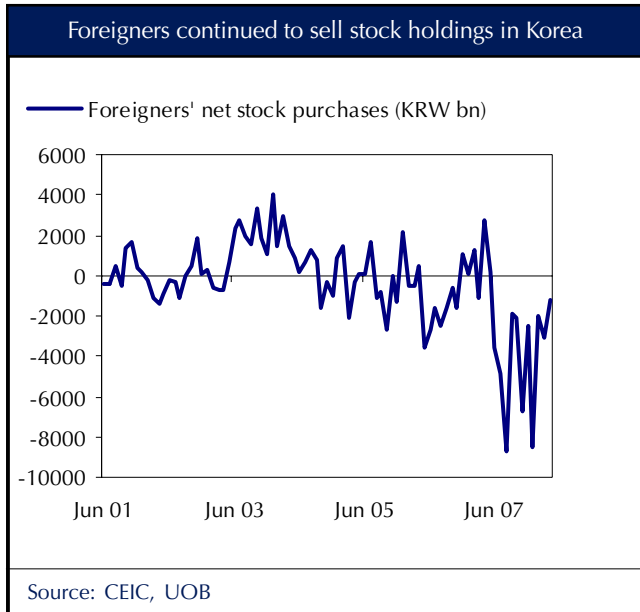
KRW has weakened significantly so far this year



Source: CEIC, UOB

with foreign currency loans. Starting 1 Jan 2008, local branches of foreign banks in Korea will be allowed to claim tax write-offs of interest expenses of up to three times the bank's capital for borrowings from their parent banks, down from six times previously. The main motivation behind the moves was to prevent a blowup in short-term external debt which took place during the Asian Financial Crisis a decade ago. External borrowings by locally-based financial institutions rose by US\$6.28 bn in Mar compared with US\$5.53bn in Feb. However, BoK's substantial FX reserves would guard against a replay of the crisis and massive capital outflows.

- (2) Foreigners have remained net sellers at the Korean stock market since June 2007. In the first four months this year, foreigners have sold net KRW14.75 tn worth of Korean stocks as compared with total of KRW27.18 tn sold in 2007. This has reduced demand for USD forward. In addition, the government's move to cool the property market by allowing Koreans to invest in overseas properties have also increased demand for hedging by selling USD forward.



### Revising our USD/KRW Forecast Higher

Such gyrations in the USD/KRW basis swaps are expected to put upward pressure on the spot USD/KRW. In the spot market, the weakening of the KRW will also be underpinned by record oil prices and deteriorating trade surpluses. With import demand rising due to surge in commodity prices and external demand facing squeeze from a global slowdown, the finance ministry expects the trade surpluses to fall to around US\$7 bn this year from US\$14.6bn in 2007. The country is expected to post current account deficit of US\$10 bn this year - first time since 1998.

Political pressure for an interest rate cut as early as May to lift domestic growth rate to 6% this year could also hurt the KRW outlook. This was despite the jump in domestic inflation to near 4-yr high of 4.1%/y in Apr. Indeed, the Korean government appeared to have taken the sharp fall in KRW to 1,000/USD in stride, suggesting that growth instead of inflation concern was the priority for now. There were discussions of a supplementary budget and probably a corporate tax cut in June to boost the economy. The finance ministry has set its USD/KRW assumption at 990 in its 2009 budget.

The KRW has depreciated 7.8% against the USD since the start of the year with KRW falling to 1,014.65/USD. Against major trading partners, the KRW has also shown substantial weakness as JPY/KRW rose to around 9.7 from 8.4 at the beginning of the year. We have raised our USD/KRW forecast to 980 at year-end from 920 previously, factoring in around 4.5% KRW depreciation vs USD this year.

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