

**ECONOMICS:** ASIAN PERSPECTIVES—FEBRUARY 5, 2010

# Korea's Fundamentals Still Support a Strong KRW

■ **Anthony Chan**  
 Asian Sovereign Strategist—Global Economic Research

We have downgraded our forecast for Korea's trade surplus this year by US\$10 billion, to US\$30 billion. This will still be the third-largest surplus in the country's history, however, and we expect it—and other factors—to continue supporting a strong Korean won.

The Korean won (KRW) has been under selling pressure lately against the US dollar, as currency markets have traded on the risk of a rebound by the greenback. The release of Korea's January trade data, which showed a drastic reversal of the large monthly trade surplus into a small deficit, has exacerbated fears that the KRW's appreciation may be coming to a halt. We believe there is a strong seasonality factor behind the January deficit and that, seasonally adjusted, the trade account still registered a sizable surplus of around US\$3 billion (**Display 1**). The important point, however, is that the expected bounce in import energy and commodity prices from a low base has started to erode Korea's trade account through a deterioration in the terms of trade (that is, the relative change to import and export prices in US-dollar terms). This calls for an updated assessment of Korea's external balance.

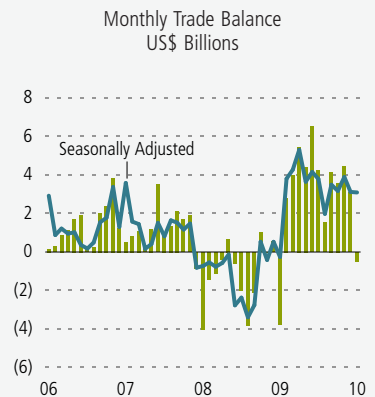
In our October 9, 2009 issue ("Korea's Fundamentals Remain Favorable to KRW Appreciation," we analyzed in detail the

factors behind the incredible rebound of KRW/USD from its cyclical low in first quarter 2009. The initial bounce came from the normalization of Korea's huge external debt repayments, which had weighed heavily on the balance of payments. This was followed by a dramatic return to sizable monthly trade surpluses as exports resumed, and foreign portfolio inflows—boosted by Korea's V-shaped economic recovery—also regained momentum. We argued that the deterioration in the terms of trade was unlikely to cause a large drop in Korea's huge trade and current account surpluses in 2010 and that capital inflows—and, to a lesser extent, an improved interest-rate differential—should replace trade flows as catalysts for further KRW appreciation.

### Terms of Trade Effect

How do things stand now? In January, the rebound in exports remained substantial at 47% year on year (nominal) but growth in imports also recovered markedly to 27% year on year. Our analysis of the latest available export and import price data

Display 1  
A Drastic Turn or a Seasonal Dip?



Source: CEIC Data and AllianceBernstein estimates

Display 2  
Getting Worse



Source: CEIC Data and AllianceBernstein estimates

(December) shows that US-dollar import prices have increased slightly more severely than expected at 16% year on year while US-dollar export prices have jumped to 7.5% year on year. US-dollar import prices of petroleum products—Korea’s most sensitive item of imported inflation—jumped more than 100% year-on-year.

The terms of trade have deteriorated rapidly but not as severely on a year on year basis as they did in 2008, when crude oil prices peaked at US\$140 per barrel (**Display 2**). Moreover, it is important to note that, despite the direct impact on Korea’s external balance, higher US-dollar import prices have not in themselves caused too large a jump in inflation—thanks to the 18% cumulative appreciation of KRW/USD over the past year. In KRW terms, imported inflation remained tame at –1.5% year on year in December, although this represented a steady increase (**Display 3**).

### Updated Trade-Account Forecasts

**Display 4** shows our updated forecast for Korea’s external balance. We have slightly adjusted the forecast for the terms of trade in 2010 and are now expecting that the deterioration in the coming year will not only wipe out but also exceed the gain in 2009. We still expect a significant rebound in both export and import volumes this year, however. The outcome is a US\$10 billion drop in the trade surplus in 2010 to US\$30 billion which, however, will still be the third-largest surplus on record. The decline in the size of the current account surplus will be similar. As a percentage of GDP, the surplus will drop

from around 5% to a still substantial 3% this year.

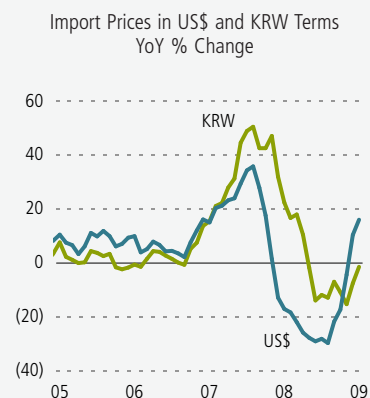
### Capital Flows

We think that a lower though still large trade surplus will continue to underpin a fundamentally strong KRW, although it will become less of a driver for further currency appreciation as it adjusts downwards. Instead, capital inflows will become a more important influence (the overall capital account surplus remained decent at US\$1.6 billion in December). Net portfolio inflows have receded recently because of renewed risk aversion (**Display 5**), but we think they will soon resume as long as Korea’s economic recovery continues unabated.

### Currency Outlook

Even taking into consideration near-term headwinds, we think our six- and 12-month targets for KRW/USD at 1,100 and 1,050, respectively (compared with 1,050 currently), do not look too demanding on fundamental grounds. Besides, with Korea’s foreign exchange reserves fully recouping the losses incurred during the Lehman Brothers panic (they reached a new high of US\$274 billion in January) and with inflation becoming a bigger concern as the year proceeds, we see no reason for the Bank of Korea to repeat the heavy foreign exchange intervention it carried out last year to cap the pace of currency appreciation. Finally, the risk of a drastic fall in ¥/USD in the foreseeable future—an event that would sharply increase Korean policymakers’ concern over the country’s exchange-rate competitiveness with Japan—remains slim, in our view. ■

Display 3  
No Rapid Pass-Through Effect



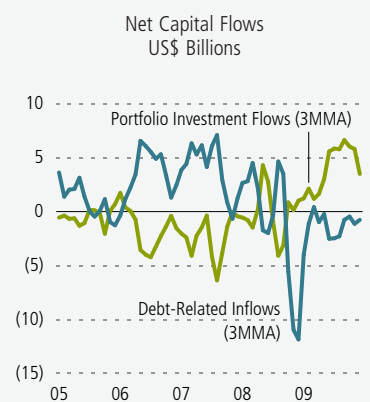
Source: CEIC Data and AllianceBernstein estimates

Display 4  
External Surplus to Remain Sizable

Current Account Forecast				
(% Change)	2007	2008	2009	2010F
<b>Export Growth</b>				
Value	14.2	14.2	(13.7)	20.6
Volume	13.4	9.2	0.8	15.0
<b>Import Growth</b>				
Value	15.4	21.8	(25.7)	26.1
Volume	7.3	4.8	(9.6)	11.0
Terms of Trade* (US\$ Billions)	(6.3)	(10.8)	4.3	(7.9)
Trade Balance	14.6	(13.3)	40.4	30.1
Current Account Balance	5.9	(5.8)	42.7	32.6
% GDP	0.6	(0.6)	5.2	3.2

\*Export prices relative to import prices  
Source: CEIC Data and AllianceBernstein forecasts

Display 5  
Portfolio Inflows Have Receded



Source: CEIC Data and AllianceBernstein estimates

---

This document reflects the views of AllianceBernstein and sources believed by AllianceBernstein L.P. to be reliable as of the dates cited. No representation or warranty is made concerning the accuracy of cited data. Nor is there any guarantee that any projection, forecast or opinion will be realized. The views expressed may change at any time. References to stocks, securities or investments should not be considered recommendations to buy or sell. The value of investments, and the income from them, can fall as well as rise and you may not get back the original amount invested. Past performance is not a guide to future performance. The value of overseas securities will be subject to exchange-rate fluctuations. Under no circumstances should this information be construed as investment advice. Nor should it be construed as sales or marketing material for any financial instrument, product or service sponsored or provided by AllianceBernstein or its affiliates or agents.

**Note to Canadian Readers:**

AllianceBernstein provides its investment management services in Canada through its affiliates, Sanford C. Bernstein & Co., LLC, and AllianceBernstein Canada, Inc.

**Note to UK Readers:**

UK readers should note that this document has been issued by AllianceBernstein Limited, which is authorised and regulated in the UK by the Financial Services Authority. The registered office of the firm is: Devonshire House, One Mayfair Place, London W1J 8AJ.

**Note to Taiwan Readers:**

This information is provided by AllianceBernstein funds Taiwan Master Agent, AllianceBernstein Taiwan Limited, SFB operating license No.: (97) FSC SICE no. 049. Address: 57F-1, 7 Xin Yi Road, Sec. 5, Taipei 110, Taiwan R.O.C. Telephone: 02-8758-3888. AllianceBernstein Taiwan Limited is a separate entity and an independently operated business.

**Note to Singapore Readers:**

This document has been issued by AllianceBernstein (Singapore) Ltd. (Company Registration No. 199703364C.) The Company is a holder of a Capital Markets Services Licence issued by the Monetary Authority of Singapore to conduct regulated activity in fund management.

**Note to Hong Kong Readers:**

For Financial Representatives General Information only and shall not be regarded as provision of investment advice.