Why rates will likely rise in Korea?

ECONOMY

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Markets are divided on the direction of monetary policy in Korea, pointing to a weakening yen as the key reason rates should be pushed down from their current 2.5 percent. Moody's Analytics think rates are more likely to rise. Monetary policy should remain steady for the first half of the year, before two 25-basis point rate hikes bring the rate to 3 percent by the end of 2014.

There are economic grounds for a hike. Korea's export-manufacturers should enjoy stronger demand, benefiting from a synchronized upswing in the global economy. Recoveries in the U.S. and Europe are expected to strengthen in 2014, while continued strong growth in China supports Asian demand. Domestic industries should benefit from low unemployment and expansionary monetary and fiscal policies. Rising consumer confidence should filter through to a pickup in consumer spending, while the government measures to support housing demand should help home prices rise in 2014 after they declined in 2013.

Faster GDP growth in 2014 will help reduce the output gap and lift prices. Low headline inflation around 1 percent masks emerging price pressures; core inflation, which strips out food and energy prices, is nearer to 2 percent and on a rising trend, suggesting domestic demand is building, while government subsidies for child care and education will fade in 2014.

Rising short-term bond yields signal higher policy rates; the six-month sits around 2.75 percent while the widely watched three-year yields a higher 3 percent. Consumer rate and price expectations are also rising.

Financial markets are unlikely to prevent the Bank of Korea from pushing rates higher. Recent signs indicate that the Federal Reserve's move to taper asset purchases will have a more muted impact on Korean markets than it appeared in mid-2013. Equities and bond yields have been broadly steady since December, and the won's fall against the dollar should help mitigate some of the pressure that exporters are facing from a weakening yen.

Korea enjoys solid investor demand relative to troubled Asian countries such as India and Indonesia because it reformed its financial system following the 1997-98 Asian financial crisis and has boosted foreign reserves and lowered external debt. Lower financial risk means the BOK can focus on economic and price stability.

The BOK will be concerned about leaving rates too low for too long for fear of creating financial imbalances, particularly after the credit and housing binge during the 2000s. A forward-looking central bank should also preemptively hike rates as inflation accelerates to prevent it from becoming a bigger problem down the track.

That said, risks to this forecast are to the downside. The falling yen is creating much angst among Korean authorities and the country's exporters. Further yen weakness could thus erode Korea's export competitiveness and cut profits. But we have been here before, and the central bank will probably intervene in foreign exchange markets to try and stem the currency's gains and reduce volatility rather than cut rates.

Currency appreciation also has a silver lining. Because Korea is one of the world's most intensive oil consumers and relies on imported petroleum, a stronger won should help lower the import bill and support manufacturing. It should also help rebalance the economy toward domestic growth, which could reduce Korea's exposure to external shocks. Businesses can focus on cutting costs, innovation and improving productivity to drive gains, something President Park Geun-hye has been promoting recently.

The bottom line is that rising rates are the result of a strengthening economy, which is a positive development.

Recovery or secular stagnation

GLOBAL ECONOMY

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Judging from the enthusiasm pervading financial markets around the world, it seems as if 2014 will be one of the best years ever for the global economy, and certainly the best since the beginning of the Great Recession. The easing of tensions in sovereign debt markets has been the single most important factor that the New Year inherited from 2013, especially in Europe. Risk premiums on the debts of the peripheral economies have come down steadily, and bank shares have recovered from their all-time lows.

Most forecasts anticipate that the global economy will grow at least one percentage point faster than in 2013. The renewed dynamism of the U.S. economy, notwithstanding the recent zigzags in the employment outlook, will be a determining factor. In addition, Japan is also showing signs of becoming a net positive contributor to global growth. Still, China will continue to be the world's most important source of growth, while other large emerging powers like India and Brazil sort out the bottlenecks preventing them from growing faster.

In spite of the fact that the worst is probably behind the eurozone, one cannot be yet optimistic about economic growth. The policies being implemented by most countries continue to baffle analysts, ourselves included: austerity measures in a situation of extremely high unemployment with inflation below one percent. The policy emphasis at the national level continues to be on balancing budgets and repairing fundamentals, while at the European level most of the efforts are aimed at laying the foundations for a banking union.

Is Europe entering a phase of "secular stagnation?" This is the biggest fear among many observers and some policymakers. It will take more than two or three years for austerity to deliver its promise of sustainable economic and employment growth. Unlike a few years ago, however, the European Central Bank has recently indicated its willingness to tackle deflationary stagnation through the use of exceptional monetary tools. In countries where domestic demand is depressed, only the external sector can deliver growth in the short run. With a strong euro, this is difficult. Another option is for the surplus economies, Germany prominently among them, to relax their policies concerning wages so as to stimulate demand from the European periphery.

The truth of the matter is that, in addition to Europe, the U.S. continues to grow well below its potential. In spite of rock-bottom interest rates, investment is not growing fast enough to strengthen the stock of capital and to boost employment. The other danger is to see new asset bubble emerge. Analysts wonder whether stock prices are reaching bubble levels. Meanwhile, the real estate market has staged a strong comeback, with prices just 6 percent below the level in the first quarter of 2008. Higher and more stable levels of home equity may provide a boost in the form of greater consumption by households.

Former Treasury Secretary Larry Summers has proposed to exorcise fears of secular stagnation by increasing the role of the government's budget through increased investment, and the introduction of incentives to encourage private investment.

The goal is to ensure that lax monetary conditions result in higher productive investment as opposed to a financial bubble. There are few signs, however, that historically low interest rates are leading companies to step up their investments. It seems that other uncertainties, mainly about economic growth, are standing in the way.

It is also important to realize that financial markets continue to operate following templates, rules and regulations similar to those preceding the crisis. Therefore, the present euphoria is not necessarily, or likely, driven by market efficiency. This happens to be a problem in emerging economies as well as in Europe and the United States.

One of the greatest threats to global stability lies in the high levels of private debt in China, a country that still lacks a modern banking system. Thus, there are many reasons to be wary about the optimism of financial markets in the New Year. Significant risks remain.

CEO COLUMN

'Creating new beauty ritual': answer for sluggish cosmetics market

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In 2013, the cosmetics market suffered due to the economic recession. Economic difficulties hit consumers and they shifted their purchasing behavior toward more price-sensitive goods. Luxury cosmetic brands were directly influenced by fewer consumers shopping at department stores. The brand shops held promotional sales events every day to attract consumers. The cosmetics market has grown slowly and competition is more heated than ever. It might be difficult for the beauty industry to recover quickly from the recession in 2014; however, I still have an optimistic view of the potential of the Korean beauty market for various reasons.

First, human nature has infinite needs and desire for beauty. This desire is stronger than any monetary rewards, as beauty enables all individuals to express their personalities and gain self-confidence. Second, there is a rising trend of creating new product categories beyond skincare. Skincare has asserted its position as the flagship category in the Korean cosmetics market in terms of weight about two-thirds of the market in 2013. However, we see the signs of rising trends in make-up, hair care and coloring, body care and instrumental cosmetics, among other things, which demonstrate the high potential of the Korean market. Third, communication channels have diversified while distribution channels have converged to increase contact with consumers. Personalized advice and services fuel this new proximity, which is omnipresent: on the Internet, via smart phones, tablet PCs and in sales outlets.

I truly believe that creating a new beauty ritual for consumers is the key for companies to overcome this challenge, because the cosmetics market is both a supply-led market driven by innovation, and a demand-led market bolstered by consumer's needs. Creating a new beauty ritual can be done by setting new trends or introducing innovative products that address cosmetic needs that consumers were previously unaware of. Here are two examples of success which have been growing quickly last year: hair coloring and instrumental cosmetics.

In 2012, the hairdressing market continued its two-digit growth compared to previous years by marking a 14 percent growth. In particular, the hair coloring market grew by 27 percent, driving overall growth. The number of Korean women who have colored their hair brown has increased from 28 percent in 2007 to 34 percent in 2013. Hair coloring creates a dramatic change in women's appearance, bringing immediate satisfaction to consumers. Hairdressing in cyclical markets is closely connected to the latest trends, which have a notable impact on how often customers use a hairdresser's services for a new hairstyle. Hairdressing in cyclical markets is closely connected to the latest trends, which have a notable impact on how often customers use a hairdresser's services for a new hairstyle. L'Oreal Profesionnel Paris, a professional hair care brand, took the initiative to be an official sponsor of the 2014 S/S Seoul Fashion Week for the first time. Hairdressers then take their inspiration from the brand's collections to offer their customers the latest trends. This effort to set a trend has resulted in good performances.

Another example of recent success is instrumental cosmetics, which is a new category that is growing fast, especially the strategic segment of sonic machines and technologies. Technology of this type is complementary to skincare products and can generate a new ritual not only for cleansing but also for visible skin transformation. Such beauty devices are durable in an economic slowdown due to their good performance over a long period as compared to price, resulting in high consumer satisfaction. The success of Clarisonic-instrumental cosmetics brand launched in Korea demonstrates that the strategy of creating a new ritual really works.

It is through innovation, services, remarkable quality, and great performance that beauty brands are continuing to attract, win over, and ensure the loyalty of consumers in this economic recession.