Dangers of kimchi bond regulation

KOREAN ECONOMY

Tim Condon
ING senior economist

The Bank of Korea (BOK) released the well-advertised restriction on kimchi bonds, as foreign-currency denominated bonds issued in Korea are known. The new measure targets Kimchi bonds issued by Korean enterprises for the purpose of Korean won financing.

In a statement on its website the central bank said a joint investigation with the Financial Supervisory Service into banks' kimchi bond investments had "revealed problems." The main problem is that swapping kimchi bond proceeds into Korean won violates the spirit of the BOK's July 2010 "New Macro-Prudential Measures to Mitigate Volatility of Capital Flows."

The new measures restrict foreign loans to residents from foreign exchange agencies to overseas uses only.

The latest measure bars foreign exchange agencies — foreign exchange banks, investment trading companies, investment brokerage companies, collective investment schemes, discretionary investment advisory businesses, trust companies, insurance companies, credit unions, credit specialized financial companies, and merchant banking corporations — from investing in domestic foreign-currency bonds intended to be swapped into won. It takes effect on July 25, 2011.

The policy concern is the level of banks' external debt; banks may borrow offshore to fund their kimchi bond investments. However, the size of recent flows belies the concern. The BOK reported that outstanding kimchi bonds increased by $1.28 billion to $16.25 billion in the first quarter of the year.

Even if banks were responsible for all of the increase — the BOK data show they held 87 percent of outstanding kimchi bonds as of June 2011 — the amount is small compared with the $18.12 billion increase in banks' external debt.

The kimchi bond restriction treats a symptom whose cause lies elsewhere. Consider a Korean company with an AA- local credit rating and a BBB international rating that needs to raise won to finance a 3-year investment project.

One option would be to sell a straight won-denominated bond at a yield of 4.4 percent. Alternatively, it could issue a 3-year U.S. dollar denominated Kimchi bond at a yield of 1.7 percent and swap the proceeds into won.

The swap contract has a "pay" leg and a "receive" leg. In the pay leg the company pays 2.2 percent interest on the won it swaps the kimchi bond proceeds for. In the receive leg it earns 0.4 percent interest on the U.S. dollars it has exchanged for won. The effective interest rate is 3.5 percent or 90 basis points less than the cost of the straight won-denominated bond. The wide differential between the 2.2 percent 3-year cross-currency swap interest rate and the 4.4 percent yield on AA- rated 3-year corporate bonds is what makes it so attractive to swap Kimchi bonds into won.

The problem is not high corporate bond yields. Korea, like other investment grade jurisdictions in Asia, has experienced the reverse conundrum, lower local currency bond yields imported from the U.S. after the global financial crisis. The post-crisis average 3-year AA- corporate bond yield is 40bp below the pre-crisis average.

Depressed cross-currency swap rates are the main reason for the wide differential. The post-crisis average 3-year cross-currency swap rate is 140bp lower than the pre-crisis average. Unlike corporate bond yields, which spiked during the crisis, cross-currency swap rates plunged, actually turning negative at the height of the scramble for U.S. dollar liabilities. The won experienced a maxi-devaluation during those dark days and while it has subsequently reversed much of the extreme depreciation it hasn't reversed all of it.

Regulation on the kimchi bond market treats a symptom. The danger of treating symptoms is new ones will appear in uexpected places.

The won's 9 percent trade-weighted depreciation from the pre-crash level is the largest among all Asian currencies.

The won's performance is partly the result of policy. Large-scale foreign reserve accumulation — as of June foreign reserves were up $105 billion from their November 2008 low — has slowed its appreciation.

But this policy feeds expectations that the won is a one-way bet. A skewed supply-demand balance — exporters rush to sell their U.S. dollar proceeds forward anticipating windfall gains from won appreciation while the same anticipation restrains importers' demand for those dollars — depresses cross-currency swap rates.

The flip-side of the attractive kimchi bond swap is the moribund Arirang bond market, where foreign companies issue won-denominated bonds. Australia's kangaroo bond market demonstrates that foreigner issuance in the local bond market can take off when the bond proceeds can be profitably swapped into, for example, U.S. dollars. Depressed cross-currency swap rates make this unlikely in the Arirang market.

To illustrate, consider a BBB rated U.S. company that needs to raise 3-year U.S. dollars. Option one would be to sell a straight U.S. dollar-denominated bond at a yield of 1.7 percent.

The Arirang alternative would be to issue in the Korean market at 4.4 percent — assuming it secured an AA- local credit rating — and swap the proceeds into U.S. dollars. It would receive 2.2 percent interest on the Arirang bond proceeds it exchanges for the U.S. dollars and pay 0.4 percent interest on the U.S. dollars. The effective interest rate is 1.8 percent, 10bp above the yield on the straight U.S. dollar bond.

The BOK regulation on the kimchi bond market treats a symptom. The danger of treating symptoms is that new ones will appear in unexpected places. Greater two-way exchange rate risk would fix the cause.

It also would create conditions where foreign participation in the local bond market, rather than jeopardizing macro stability, increased its depth, breadth and resiliency.

Ratings, info & market functioning

GLOBAL ECONOMY

Mauro Guillen
Wharton School professor of management
Emilio Ontiveros
Universidad Autónoma de Madrid professor

Besides bankers and speculators, rating agencies are perhaps the most bedeviled actors in global financial markets nowadays.

The fact that the largest ones are very profitable and account for a large share of the market further undermines their reputation. It is also problematic, many find, that American rating agencies dominate a market that is global in scale.

The financial crisis has enhanced the criticisms of the rating agencies. Many think that they failed to see the crisis coming, rating banks as safe just weeks before they collapsed.

Critics point out that during the ongoing sovereign debt crisis the rating agencies have contributed to the growing solvency problems of some countries by doing just the opposite, that is, moving quickly to downgrade in response to negative signals.

It is also common to come across the criticism that the rating agencies get carried away by stereotypical characterizations of the ability of countries to meet their financial obligations.

The most devastating criticism, however, has to do with the possibility that conflicts of interest led the agencies to underestimate risks.

The specific issue is with situations in which one part of the rating agency provides advisory services while the other rates securities. The existing firewalls between the activities of rating and advisory are widely considered to be too permeable.

While these criticisms are mostly valid, it is hard to imagine how global financial markets could possibly work without the information provided by the rating agencies.

Investors need an independent source of information about the quality of the securities available in the markets. Without them, the search costs for investors, especially individuals, would be very onerous.

Governments and companies issuing paper would face higher financing costs in the absence of rating agencies.

The uproar against the rating agencies has led to some quite radical proposals for tighter regulation. Both the European Union and the United States have introduced regulatory changes, with the former being much more aggressive.

We believe that any additional regulation should not interfere with the role that these agencies play.

For instance, it does not make sense to hold them financially liable because their natural reaction will be to provide more general and less informative ratings in order to avoid litigation, thus defeating the purpose.

Asking them to disclose their rating procedures might appear to be sensible at first, but it can lead governments and companies to game the system in order to get a good rating. Perhaps the most delicate regulatory aspect has to do with the interaction between ratings and banking regulations.

Regulation on rating agencies should not make them even less perfect, but help the users of ratings understand their limitations.

In many countries banks are asked to hold reserves in the form of highly rated securities.

This type of practice may create moral hazard because banks can be led to believe that they actually hold safe securities, leading them to lower the guard with other types of investments they undertake.

Regulating the rating agencies is difficult and fraught with many unintended negative consequences. We believe that it is impossible to fully eliminate conflicts of interest, but it is feasible to improve regulation in several respects.

Rating agencies should be encouraged to adopt better governance mechanisms, including internal audits and independent directors.

Some basic disclosure rules should be adopted. Europe and the United States should not diverge too much in their regulations so as to avoid regulatory arbitrage, that is, the practice of looking for the lowest regulatory cost across different markets.

In addition, it would be beneficial to the markets if there were more competition in the rating business. At the present time, three agencies from the United States dominate it. This does not mean that governments should establish rating agencies, however.

In sum, rating agencies are a necessary component of the financial system.

They are not perfect, but regulation should not make them even less perfect; regulation should help the users of ratings understand their limitations.

Mauro F. Guillen is the director of the Lauder Institute at the Wharton School. Emilio Ontiveros is the president of AFI and a professor at Universidad Autonoma de Madrid.

Man in charge

Korea's embrace of globalization

James Dixon
Visa Korea president

In a speech at Stanford University in March 2010, Ambassador Han Duck-soo said, "South Korea today is a developed, free market, industrial economy."

South Korea today is Asia's fourth largest and the world's 15th largest economy and is the world's ninth largest trading country.

The country has grown into a global hub of free trade with full access to two-thirds of the world's markets, representing about half the global population."

Globalization has been a huge factor in South Korea's growth and economic success. Modern South Korea is a leader in many industries, from technology and automobiles to music and entertainment.

According to the International Institute for Management Development (IMD), Korea's national competitiveness was ranked 22nd among 59 countries in 2011, its highest standing ever. This ranking has gone up for the past three years.

In regards to technology, South Korean corporate giant Samsung is supporting the country's globalization with its partnerships abroad.

Last year, Samsung announced collaboration plans with Dreamworks Animation in the U.S. to jointly produce 3-D televisions.

Additionally, South Korea, which once looked up to the success of high technology in Silicon Valley, is now the fastest country to complete a high-speed communications network infrastructure.

Another prime area of South Korea's growth and globalization can be seen in the automobile sector, particularly in the case of Hyundai Motor Co. and affiliate Kia Motors.

Last year, Hyundai-Kia surpassed Toyota as the biggest Asian carmaker in Europe.

This year, the company saw record growth and market shares in the North American market.

While these companies are proving their great success abroad, globalization in the domestic market has not yet reached its full potential.

There is still a passive view that international competition would greatly hurt local businesses. Some opinions even express that Korean companies fall short of global standards and would experience difficulty competing with foreign brands.

The previous examples alone prove otherwise. Korean products and services have not only seen acceptance but also very high demand from both local and foreign consumers. In short, the Korean brand as a whole should feel more confident about what is has to offer.

Furthermore, it is not only the large conglomerates that are driving globalization. There is a huge movement in the spreading of Korean culture abroad, also known as the "Korean wave."

Lucy Williamson from BBC News noted, "The success of the South Korean economy was, for decades, laid at the door of the big "chaebol" or family firms.

While conglomerates such as Samsung and Hyundai still form the backbone of the country's financial structure, many people now believe that the Korean national brand itself is changing to reflect this new passion for the Korean wave."

A recent concert held by SM Entertainment in Paris received thousands of European fans that came to cheer on their favorite Korean singers.

The enormous success of Korean pop, or K-pop, has inspired the South Korean government to use it to promote Korea's pop culture as a new international growth industry.

In addition, the Ministry of Culture, Sports and Tourism has plans to promote academic research and experience programs for Korean pop culture.

Korean movies have also contributed to the rapid increase in the domestic film market. Since the beginning of this year, more moviegoers have been opting to watch Korean films.

According to the Korean Film Council, 8.48 million people watched Korean films at cinemas in February compared to 4.98 million who watched foreign films.

Even with the option of foreign films, the numbers show that Korean films are able to more than hold their own at the box office.

Hence, South Korea's diverse portfolio and established success shows that it has what it takes to compete both abroad and here in its hometown.

To quote another line from Ambassador Han's speech at Stanford, South Korea's "growth and prosperity depend on open markets and free capital flows."

This applies both externally and internally, in a complete embrace of globalization.

With all of the amazing accomplishments the South Korean brand has made out "there," why wouldn't it be able to make it "here," on its own turf?

Enhancing legal industry key to competitiveness

By Yoon Byung-chul

"Bad Samaritans" written by professor Chang Ha-Joon has become very popular due to the recent enactment of the Korea-EU FTA.

In the book, he states that a nation does not become more powerful simply by having more commerce and free trade but will only win the market race by how much it can enhance its "knowledge" industries and by doing so, exporting high-tech, high-value goods.

One such important "knowledge" industry, which greatly supports the nation's economy, is the legal industry. Let me give you an example. In 2007, an international dispute broke out between a Chinese and Korean private corporation over soybeans. At that time, there was a serious food shortage problem in China and measures were taken to restrict exports of the food.

A Korean company that had contracted with the Chinese company to be supplied with soybeans faced difficulty in securing supply due to the measures taken by the Chinese government. This was only resolved through legal measures and actions taken by Korean lawyers who understood not only the issues, but the cultural sensitivities involved.

Since July 1, the legal market has been open in Korea. However, the attitude of the Korean people with regard to the legal market contrasts starkly to the more protectionist and supportive attitude shown towards other local industries such as agriculture. However, the legal industry, like any other important industry, needs the people's attention and support to thrive under this sudden competition.

The Korean car industry could only become such a dominant player in the international stage because it had the support and commitment of the Korean government and people for over forty years.

The Korea legal industry can also grow to become a dominant market player with the same amount of support. Such support must come from Korean companies who are major users of the legal industry.

The legal market Pandora's box is now open, and we must support and arm our legal industry.

Such companies must understand the importance of the applicable law to a dispute or an M&A. In many disputes, Korean companies have agreed to adhere to English law in international contracts which puts them on the back-foot from the beginning because it is an unfamiliar law to them.

Korean companies now have the bargaining power in many instances to push for Korean law to govern the contract and it should utilize this power to ensure disputes are dealt with in a manner familiar to them. Support must also come from the government.

Singapore only has a population of 4.5 million but in terms of the legal industry it is a giant. For the last twenty years, in order to become a hub for international disputes, the Singapore government has made major investments, such as building a landmark building in the heart of the city state to make it a center for international dispute resolution.

Due to investments like this, disputes which relate to Korean law or have Korean parties are resolving their disputes in places like Singapore and London. These are the types of investments needed by the government to ensure our legal "knowledge industry" does not become subsumed by foreign competition.

People call the 21st century, "Asia's century." Every foreign lawyer I speak to says that Korean lawyers have the most globalized mindset in Asia. With our children studying abroad from an early age or fervently studying English or Chinese, our next generation of lawyers is already internationalized with a multi-cultural outlook.

Korea will succeed in this new era only if we prevail in knowledge industries. The legal market Pandora's box is now open and we must support and arm our legal industry so that the legal industry becomes as synonymous with Korea as automobiles, mobile phones and semi-conductors.

Yoon Byung-chul is a lawyer with Kim & Chang law firm.