



News

Emerging Markets Spotlight

No one doubts the exceptional success of the South Korean economy, home to world-leading companies. But for now, it's still an emerging market



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All asset classes are to some degree arbitrary, making divisions at the margin between two similar investments. One of the most enduringly controversial is the definition of emerging equity markets, excluding both frontier markets and developed markets. At the more developed end of the emerging market asset class are countries that could be classified as developed markets.

The original definition of emerging markets, by the IFC arm of the World Bank, was based on economic development, as measured by GNP/capita, but the definition used by the largest index provider, MSCI, is based around economic development, market size and liquidity, and market accessibility criteria. As per the MSCI methodology, four wealthy Gulf economies are emerging markets, as are the highly successful economies of South Korea and Taiwan.

South Korea is home to some world-leading technology companies. It is one of the few countries in the world to develop its own supersonic jet-fighter and it is a stable and reasonably mature democracy. The question is often asked, 'Is South Korea really an emerging market?' Well, events in the Korean domestic bond market since the end of September show why it probably still is.

The full events are too long to go into here, but in summary, a newly-elected provincial governor decided, for political rather than economic reasons, to push a local development company (that had developed Legoland Korea in the region) into bankruptcy, and to renege on the provincial government's guarantee of the development company's bonds.

The effect on domestic bonds was rapid and serious. New issuance by local government development and housing companies proved impossible through October, with some major borrowers with

investment grade credit ratings unable to place bonds. The specific bonds that the development and housing companies issue are called project finance asset-backed commercial paper, or PF-ABCP. These are also the main funding source for the nation's private sector property developers, which also saw their bond yields spike and began scaling back financing for new projects. And, in what very much looks like contagion, a mid-size life insurer delayed exercising a call option on some of its perpetual bonds, which is the first time this has happened since the financial crisis in 2009.

Despite the specific cause, this has come at a time of rising global interest rates and bond yields, a stronger US dollar, and a slowing Korean economy. The conditions were in place for financial stress, but the combination of volatile politics and weak institutions acted as a trigger. The overall effect has dramatically affected the whole Korean commercial paper market. Three-month Korean commercial paper typically has yields 0.25-0.5% higher than policy interest rates, but the gap at the end of November had reached 2.3% and still looked to be increasing.

So, despite generally tightening monetary policy through higher interest rates this year, Korean authorities have had to engineer a repurchase program to stabilise the market. At the time of writing, this was KRW 2.8trn (USD 2.1bn), but its size and scope have steadily increased, and more may well be required.

Ultimately, the creditworthiness of these instruments has not changed: this is a shock to confidence, a market panic in the style of the nineteenth century. The Bank of Korea and the Ministry of Finance are responding in the right way, and they have the monetary firepower to settle the market at some point. However, there must be some drag on Korean GDP growth and corporate earnings from this.

And this is why South Korea remains an emerging market. The long-term excess returns of emerging market equities over developed market equities are to compensate investors for the extra risk and volatility of emerging markets. That risk can come in many forms, but it definitely includes a single provincial politician pushing the local Legoland into default and blowing up the entire domestic commercial paper market.

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