FX WORRIES AND FOREIGN HEDGE FUNDS

by Hee-Seong Kim

Fears of a Currency Crisis

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The Korean won plunged to a record low of 913.80 won against U.S. dollar on Sep. 18. This was the first time that the won had broken the 910 level since the country introduced the market average exchange system in March 1990. The steep fall in the value of the won has been enough to cause some apprehension of a currency crisis. In fact, a majority of the country's corporate financiers believe that a currency crisis could happen in Korea if the recent financial nervousness continues, according to a survey conducted by the Korea Chamber of Commerce and Industry announced on Sep. 12. The survey, based on a poll of 426 financiers at companies and financial institutions, said 99% of them replied that the country's financial markets remain unstable. Altogether 66% of them said the instability is very serious and 60% of them think that a currency crisis could hit Korea if financial markets remain volatile. Such a currency crisis could be initiated by the attack of an international speculative fund, a so-called "hedge fund".

The Increased Volatility of Foreign Exchange Rates

First of all, in order to understand the current international FX market, the historical trend of volatility in exchange rates throughout the world needs to be analyzed. Table 1 shows the increased volatility in exchange rates that has occurred during the postwar period. Volatility is measured by computing the standard deviation of month-to-month exchange rates and dividing by the mean to allow comparison. This statistic is called the coefficient of variation. The table shows how exchange rate volatility has generally risen and how much more risk is

〈Table 1〉 The Volatility of Exchange Rates

Reriod	Volatility, %			
	Can$	UK£	DM	Jap¥
1950-1959	4	0*	0*	0*
1960-1969	4	8	8	0*
1970-1979	6	13	22	15
1980-1989	5	14	22	34
1990-1993	5	7	9	21

* Less than 0.5%

* Source: Standard deviation of month-end-to-month-end exchange rates as published in International Financial Statistics, divided by the mean exchange rate over the period 1950-1993 (International Financial Statistics, International Monetary Fund, Washington, D.C.)

consequently faced even on a constant amount of international trade and investment.

There is no consensus as to why exchange rates have become more volatile than in the past. Some analysts attribute the increased volatility to flexible exchange rates, which were adopted around 1973. However, others say the previous fixed-exchange-rate system could not cope with the larger shocks that have occurred since that time—jumps and drops in oil prices, international conflicts, and so on. What is fairly certain is that the increased globalization of investment has played a role in raising volatility with more hot money skipping from financial center to financial center in search of the highest return. Another factor may have been the enhanced technology for moving money and transmitting information, which has allowed both to move at the speed of light. Whatever the reason, consequence of the greatly increased exchange rate volatility has been a parallel increase in the importance of understanding the methods of managing foreign-exchange risk.

The Possibility of a Financial Crisis in Korea

Several Asian countries, such as Malaysia, Indonesia and Thailand, have recently experienced the influence of hedge funds (hot money) on their currency markets. It is an important question as to whether or not any possibility of a hedge fund's attack on the Korean currency exists. One domestic economic institute confirmed that a 400 billion won hedge fund operating in the Korean stock market, amounting to some 0.3% of the total market capital, shows no signs of leaving Korea. The volume of the hedge fund amounted to 2% of the US$22 billion total overseas investment in the market. However there are no indications that investors in the fund are worried over the 7% devaluation of the won against the dollar, and fund managers of foreign securities companies feel that there is no significant movement expected

The government also does not define the current situation in Korea as a crisis which requires a guarantee for every transaction. In other words, the government thinks that the possibility of a crisis actually occurring in Korea is quite low. Although some Korean financial institutions are having difficulties, not all Korean financial institutions have large exposures to insolvent corporations and many have adjusted to recent cyclical challenges very well. Macroeconomically, Korea has a much higher and more stable growth rate than Thailand had in 1996 and Mexico had just before the peso crisis. According to a government official, Korea also has a much lower current account deficit to GDP ratio than either Mexico or Thailand. Mexico's ratio in 1994 and Thailand's in 1997 stood at 7.8% and 7.9%, respectively. In contrast, Korea's ratio was 4.9% last year and is expected to fall to about 3% this year. Korea also has a much more stable debt-service ratio of 5.8% in 1996, compared with 11.1% in Thailand in 1996 and 28.0% in Mexico in 1994. And while Mexico and Thailand supported overvalued currencies to attract foreign investment despite large current account deficits, Korea has continued to incrementally adjust its exchange rate to reflect the market value. Vice Minister of Finance and Economy Kang Man-Soo argued that since most foreign exchange transactions are related to either real transactions or mid-to-long-term capital movements, sudden and large short-term speculative capital inflows are unlikely in Korea. However, the Korean capital market is going to be opened within 3 years and be exposed to foreign hedge funds much more than before. Therefore, the possible hedge fund's attack sce-

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A Plausible Hedge Fund Attack Scenario

George Soros' Quantum fund is a well-known hedge fund which has tallied a 33% annual return historically, vs 7% for stocks. The initial aim of the funds, which were developed in the 1950s, was to protect against market risk and earn greater returns in terms of sluggish stock market performance. But hedge funds now describe a kind of management that is far more aggressive. In other words, Soros' Quantum fund makes money by anticipating economic shifts around the world. Let us look in retrospect at one example. In 1992 Soros thought the British pound would lose value because of political and economic pressures. He borrowed billions of pounds and converted them to German marks. When the pound collapsed on September 16, Soros repaid the pounds at the lower rate and pocketed the difference. His profit was almost $1 billion. The whole idea behind hedge funds is to have some money invested with people whose returns are not going to be totally determined by whether the market is up or down. It is a different risk. Therefore, hedge funds even shine in volatile markets.

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This being the case, then how could hedge funds attack the Korean financial market if the market were opened? First of all, they could use the arbitrage and spread transactions between domestic and overseas' forward exchange markets. They also could use the stock market, stock index futures and option markets to exploit the benefits from the exchange rate's volatile movements. This is because there is a positive correlation between the value of the Korean won rate and the Korean Stock Price Index. For example, if they expect a steep fall in the value of the won, they could take a short position in the KOSPI 200 Futures market. They could also make money by having a long position on KOSPI 200 put options and a short position on call options. In other words, they can not only participate in the FX market but also other financial markets to make money when the Korean FX market is highly unstable.

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How To Cope With Currency Risk

Transactions of foreign exchange derivatives expanded sharply during the second quarter of this year. According to the Bank of Korea on September 5, the transaction of foreign exchange derivatives instruments totaled US$146.6 billion during the April-June period. This represents a growth of 32.8% from the US$110.4 billion recorded during the first quarter. Forward exchange transactions, in particular, showed brisk growth, jumping by 42.9% to US$107 billion. Meanwhile, the financial futures transaction market registered a mere 11.5% growth to US$39.6 billion. Forward exchange transactions rose sharply as corporations as well as financial institutions actively traded forward exchanges in order to hedge against foreign exchange risk resulting from the volatile move of foreign currencies. Therefore Korean financial market should be developed to allow economic participants to hedge their FX risks conveniently.

First of all, the government has to keep enough foreign currency reserves on hand to be able to stabilize the volatile FX market if necessary. Also, the FX forward market need to be expanded and stimulated. Related government regulations should be eliminated while financial supervision should be reinforced. In particular, the Korean financial futures exchange should be established as soon as possible. VIP