FOREIGN EXCHANGE LIBERALIZATION AND THE FINANCIAL FUTURES MARKET

by Hee-Seong Kim
(e-mail: hiskim@hri.co.kr)

"Corporate and financial institutions can improve their international competitiveness by lower financial costs than before."

"The volatility of financial indicators such as domestic interest rates and exchange rates will increase."

First-Stage Plans of Foreign Exchange Liberalization

The Ministry of Finance and Economy (MOFE) announced the first-stage plans for the liberalization of foreign exchange on February 17. Corporate short-term foreign borrowings with less than one-year maturity will be permitted and bona-fide principles in forward transactions will be abolished. The limits and regulations on non-residents' domestic deposits, domestic corporations' long-term overseas loans, and foreign direct investment, among others, shall be liberalized as well. Further details of the liberalization are summarized in Table 1. The foreign investors' foreign exchange transactions related to domestic investment were already liberalized in July 1998. The second-stage plan for the liberalization of foreign exchange ("complete liberalization") will take effect in January 2001. The regulations on personal foreign exchange transactions and non-residents' short-term transactions shall be abolished completely.

There may be both positive and negative impacts on the economy. Foreign direct investment shall be increased due to the lower regulation of capital flows and upgraded sovereign credit ratings. Corporate and financial institutions can improve their international competitiveness by lower financial costs than before. However, the Korean won is likely to appreciate due to the increased foreign capital inflow. Increased overseas financing can make domestic corporations and financial institutions have higher foreign debt ratios than before. Above all, the volatility of financial indicators such as domestic interest rates and exchange rates will increase. Some experts even worry about the possibility of rising crimes related to foreign exchange transactions. These reasons are why the government needed supplementary measures.

The Supplementary Measures

In order to minimize excessive instability of the foreign currency market, the ceiling on the amount of borrowings by non-residents at the present 100 million won will be maintained. Also highly leveraged firms will be restricted from short-term foreign borrowings with less than one-year maturity. These measures are to prevent expected foreign exchange speculation, as foreign exchange transactions will be basically liberalized completely beginning April 1. MOFE announced the first supplementary measures for its foreign exchange liberalization plan on February 17. At the same time, MOFE will require foreigners to use only qualified banks for foreign exchange transactions so as to completely screen the inflow and outflow of foreign capital. MOFE will also operate a universal electronic network connecting the foreign exchange market, stock market, and futures markets in order to prevent foreign exchange speculation.

No matter what supplementary measures

〈Table1〉 First-Stage Plan for Foreign Exchange Liberalization

	Current	Reform
Deposit	- limits on non-residents' domestic deposit	- no restriction on more than 1 year due deposit and trust investment
Corporate Overseas Loan	- limits on the short-term (within 1 year) overseas borrowing and securitization	- liberalized
Securities	- restrict non-residents' domestic securitization	- liberalized
Foreign Direct Investment	- MOFE's permit required - pre-review on over-investment	- liberalized - liberalized
Domestic/ overseas Branch	- MOFE's permit and report required - specific industry restricted	- liberalized - liberalized
Derivatives	- bona-fide principle - limit on foreigners' won transaction - limit on the option transaction	- liberalized - maintained - liberalized
Real Estate	- limits on Non resident's domestic real estate purchase - limits on domestic residents' overseas' real estate purchase	- liberalized - liberalized
Overseas Local Financing	- partial restriction on usage	- liberalized
Foreign Exchange Transaction	- bona-fide principle - restriction on offshore Won transaction	- liberalized - liberalized

for foreign exchange liberalization have been prepared, however, the foreign exchange risk will be high enough to affect the other financial markets and corporate sector. For example, for a company whose revenues are primarily in Korean won but payments for imported facilities must be made in U.S. dollars, a strong dollar would mean an extra cost burden when denominated in won. This kind of foreign exchange transaction exposure might even lead to a bankruptcy if it worsens. However, most companies in Korea do not properly manage their foreign exchange exposures. Without foreign exchange risk management, Korean firms cannot acquire international competitiveness in a true sense. Since these volatile movements in exchanges rates can affect the values of assets and liabilities as well as the terms of trade or the cost structure of business transactions, Korean firms will face more and more need to hedge their various foreign exchange risks. The financial futures market which is scheduled to open soon will provide means to avoid these risks.

"Since these volatile movements in exchanges rates can affect the values of assets and liabilities as well as the terms of trade or the cost structure of business transactions, Korean firms will face more and more need to hedge their various foreign exchange risks."

〈Table 2〉 Government Supplementary Measures

classification	supplementary measures
Regulation of overseas loan	- reinforce prudential regulation - short-term overseas borrowing limit on high debt-ratio corporations
Regulation of non-residents' domestic financing	- limit on non-residents domestic borrowing - the foreign exchange business institutions usage requirement for non-residents investing in domestic stock market
Foreign asset and liability management	- long-term loan and long-term financing matching requirement - quarterly public announcement of corporates' asset, liability, payment guarantee, and derivatives transaction
Monitoring foreign capital movement	- universal electronic network connecting foreign exchange, stock, and futures market - international finance center and early warning system
Safeguard	- circuit breaker system - variable deposit requirement
Supervision foreign exchange related criminals	- reinforced supervision for the illegal foreign exchange transactions

"As standard hedging tools, these derivatives are expected to eventually contribute to more efficient allocation of capital as well as stabilized risk sharing."

The Necessity of Financial Futures Market

The Korea Futures Exchange (KOFEX) is scheduled to open in April. Located in Pusan, the KOFEX is currently running test operations. Once it is in normal operation mode, it will provide financial investors and businesses with ways to protect themselves from sudden fluctuations in exchange rates and interest rates as well. The launch of the KOFEX will enable investors to transact various financial products which are not yet available in the market. Basically, four new financial products will show up upon the opening of the KOFEX: won/dollar futures, won/dollar options, interest rate futures on certificates of deposit (CD), and gold futures. The KOFEX will continue to offer other adequate and efficient risk management tools in the future. In particular, many financial derivatives such as options, futures, and swap contracts will be introduced. As standard hedging tools, these derivatives are expected to eventually contribute to more efficient allocation of capital as well as stabilized risk sharing. Thus, it is hoped that the increased financial arising risk from drastic de-regulation and liberalization of Korea's financial market and exchange market can be safely absorbed. VIP