GOVERNMENT POLICY ON FOREIGN EXCHANGE MARKET

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The Won/Dollar Rate Under Pressure to Fall Down

In spite of the government's continued efforts to purchase dollars in the exchange market, the won/dollar exchange rate dropped sharply below the 1,160 won range. The main causes of the downward trend are the current account surplus and foreign investment, which contributed largely to the dollar oversupply in the exchange market. The current account surplus through amounts to 11 billion dollars May this year. The inflow of foreign investment has increased to 6.7 billion dollars during the same period. Above all, the recent fall of the won/dollar exchange rate induced the exchange market players, fearing the won's further appreciation, to sell dollars from their foreign deposits. This could lead to an additional drop in the won/dollar exchange rate without government intervention.

Thus, the government has designed an exchange control policy that includes three plans, aiming to induce the demand for dollars to solve the dollar oversupply in the exchange market. First, the Bank of Korea will issue foreign currency denominated bonds and directly buy 4 billion dollars in the market during the second half of 1999. The advantage of this method is that it does not affect the won supply. Second, the government will require commercial banks to hold dollars in place of won for a bad debt reserve. This policy will create an additional demand of 2 billion dollars. Third, the government will induce the commercial banks to repay the short-term foreign debts early.

Downward Trend Not Likely to Change

If the government's exchange control policy proceeds as planned, the won's appreciation is expected to be somewhat alleviated. Yet it is likely that the downward trend of the won/dollar exchange rate will not be reversed dramatically for the time being. With the yen/dollar rate being sustained around 120 yen by the year-end, the won/100 yen rate, an index of export competitiveness, is forecast to fall down to 930 won. At this range of won/100 yen rate, Korean industries can hardly keep their price competitiveness. Many experts agree that 950-1,000 won/100 yen rate is Korean businesses' break-even point where reasonable profits can be guaranteed from their export products.

In the second half of 1999, foreign direct investment and portfolio investment will further increase with the upgraded sovereign credit rating of Korea. This will continue to push up the won's value. It is not clear whether the BOK or the Korean government is planning to intervene in the market and thus reverse this trend in the near future or not. Facing the upward trend of won's value in the coming months, however, Korean businesses are waiting for more efficient measures from the government side. In place of a "single-shot" style intervention, the BOK and the MOFE need to develop and implement appropriate schemes to induce banks and companies to purchase more dollars in the market. Providing incentives to repay foreign debts prior to won-denominated debts would be a good example. VIP