

EXCHANGE RATE MAY HEAD DOWNWARD

Hee-Sik Jeong
(hsjeong@hri.co.kr)

Won/Dollar Rate Skyrockets Past 1,200 Won Once Again

Breaking away from its downward trend of staying in the 1,100s, the won/dollar rate rose sharply above 1,200 won in July. The range of won/dollar's movement was 50 won, up 4.5% since the end of June. The won/100 yen rate recovered to the 1,000-won line after three months; the yen/dollar exchange rate dropped to 114 yen, owing to the wakening Japanese stock market and the increasing U.S. current account deficit.

The Korean government's policy on the domestic foreign exchange market, the possibility of the Chinese yuan's depreciation and the chaos in the financial markets resulting from Daewoo business group's massive overhaul plans are the main causes of the skyrocketing won/dollar exchange rate. First, the effect of government's exchange control policy became visible, creating additional demand for dollars. In particular, commercial banks have purchased a large amount of dollars in Seoul's foreign exchange market for reserves of bad debts denominated in foreign currency. Second, since Standard & Poor's downgraded China's sovereign credit ratings, tensions surrounding the yuan's depreciation are reemerging. This caused most Asian currencies to depreciate, except for the Japanese yen. Third, the aftershock of the announcement of Daewoo's restructuring plans created instability in the financial markets, pushing the exchange rates up. Foreign investors in the domestic stock market quickly sold stocks amounting to 6 trillion won, with about 1 billion dollars flowing out from

Seoul's foreign exchange market. Additionally, the speculative dollar purchases made by offshore traders induced further depreciation of the won.

Exchange Rate Is Expected to Fall Down

It is expected that the upward trend of the won/dollar exchange rate will not continue. This is because the dollar supply from the current account surplus and inflow of foreign investment will exceed the demand for dollars in the foreign exchange market. The foreign exchange reserves, which amounted 64.9 billion dollars as of July 31, are expected to increase. Furthermore, foreign funds and the proceedings from business companies' asset sales will move into the domestic foreign exchange market. As the "Big 5" groups are mobilizing 15 billion dollars in the second half of 1999, the won/dollar exchange rate will be under pressure to fall down.

However, there are several countervailing factors. If the renminbi suddenly depreciates, the won/dollar exchange rate may well rise sharply.¹⁾ If the long-term interest rates rise above 10% and the domestic stock market continues to go through corrections, the dollar supply is expected to shrink by outbound foreign portfolio investment. This also will pull down the won's value.

In conclusion, as the yuan's depreciation and massive withdrawals of foreign investment are not likely to happen in the near future, the downward trend of the won/dollar exchange rate will resume soon. The future trend of the won/dollar exchange rate will largely depend on the above-mentioned external factors. **VIP**

1) The Korea Institute for International Economic Policy (KIEP) estimated that a 25% depreciation of the Chinese currency would take 1.5 billion dollars out of Korea's current account surplus.