UNEASY SYMPTOMS IN FOREIGN EXCHANGE MARKET

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Won/Dollar Rate Falling Down Back into 1,100-Won Range

Stabilizing between 1,200 and 1,210 won for most of August, the won/dollar rate plunged back to 1,180 won level once again at the end of August. But further appreciation was blocked by the government's buying dollars in the market. The won's appreciation is due to public corporations' selling dollars and inflow of foreign capital in the domestic stock market. KEIC (Korea Export Insurance Corporation) sold 0.7 billion dollars in the market for the Daewoo Business Group's support. Foreign funds returned to the Korean stock market and were converted for buying stocks, thus supplying more dollars.

Recently, the foreign exchange market in Seoul is lately showing uneasy symptoms, such as the abruptly increasing foreign investors' transaction in the domestic stock market and the shrinking daily trade volume of the foreign exchange market. First, the volume of foreign investors' transaction in the domestic stock market increased above 10 billion dollars for one month. This created some confusion in the foreign exchange market, enlarging the volatility of the won/dollar rate. The daily average volatility of the won/dollar rate is up to 0.7% since Daewoo crisis, which means the volatility increased by 40% compared to that of the first half of 1999. Second, the daily trade volume of the exchange market, which increased more than 2.3 billion dollars in June, has decreased to 1.6 billion dollars at the latest. This means that except for the foreign investors' investment-related transactions, other players' shares in the market are shrinking fast. Continued decrease of daily trade volume may result in over-shootings and over-plunges in the exchange rate even with a moderate amounts of transaction.

How to Reduce the Risk

Up to now, the government promptly reacted to the Daewoo problem, while foreign creditor banks are expected to negotiate on the terms of debt rescheduling. From the viewpoint of the domestic financial markets, Daewoo problem seems to be in the process of being resolved smoothly; from foreign bankers' view, it is just a beginning. If the Daewoo problem drags on, there is a possibility that foreign capital investment would outflow from the domestic financial markets. In particular, if foreigners rush to sell their stocks in a short period of time, the won/dollar rate will instantly skyrocket. If this is the case, the Korean economy will face a test on whether it possesses or not a cushion to absorb such shocks.

In this respect, more foreign currency reserves are needed. Enough amount of foreign currency reserves is estimated around 90 billion dollar level, which is equivalent to the amount of imports for three months plus short-term foreign loans and foreign investment balance in the domestic stock market. Another way to waive the potential shock is to enlarge the trade volume of the exchange market. In order to do so, policy makers should work ways out to induce other sources of private supply and demand of dollars so that they can offset unexpected shocks from the foreign exchange market. VIP