WILL THE WON RECOVER IN 2001?

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Review of the won/dollar rate in 2000

Last year, the won strengthened against the greenback on average. The average exchange rate dropped from 1,138 won per U.S. dollar in 1999 to 1,130.3 won per dollar in 2000 despite an upward surge in the last quarter of the year.

The rate gradually declined because dollar supply continuously surpassed dollar demand amid stabilizing external factors. The current account surplus steadily increased while foreign direct and indirect investment remained brisk. The upgrading of the Korea's sovereign credit rating also contributed to the won's slight appreciation.

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However, since November, the won dramatically depreciated to over 1,200 won per dollar in the fourth quarter. The rapid drop of the won was caused by unstable domestic and foreign factors. First, hedging and speculative dollar demand in the NDF market suddenly increased in November. Onshore institutions which were dollar suppliers in the NDF market bought a lot of dollars to hedge their short positions in Seoul's spot market. As a result, the won rapidly dropped against the dollar by 10% for only two weeks. Additionally, instability in the Southeast Asian foreign exchange markets strongly stimulated dollar demand. Nasdaq's big correction and the yen's steep depreciation against the dollar were also reasons for the won's instability.

The net sell-off of stocks by foreigners for the first time last year in September and October also contributed to the weakening of the won.

Domestically, rumors of the possible bankruptcy of Hyundai Engineering & Construction began to circulate again in October, leading the won's decline. Moreover, the government's plan to accelerate corporate and financial sector restructuring was hindered by political instability once again. And the net sell-off of stocks by foreigners for the first time last year in September and October also contributed to the weakening of the won.

The recent foreign exchange market environment

Trade surplus will decrease

In 2001, Korea's trade surplus, which is one of the major sources of dollar supply, is predicted to decrease. First of all, the U.S. economic downturn and the

Japanese recession may induce world demand to decrease causing Korea's exports to decrease. Trade disputes also will be stepped up in Korea's major export sectors such as steel, shipbuilding and automobiles. The EU already intends to present an antidumping case to the WTO against the Korean government and shipbuilding firms.

Terms of trade and export profitability seem to be worsening.

Second, terms of trade and export profitability seem to be worsening. Even though the international prices of oil-related products and steel have risen considerably, the export price index rose by only 3.3% y-o-y due to depressed semiconductor and IT-related product prices. In contrast, the import price index increased by more than 17% due to price hikes in oil and other raw materials. As a result, the net terms of trade has deteriorated by 11.9% y-o-y in 2000. Corporate profitability in exports decreased by 7.8% y-o-y because the won-denominated product price fell and production cost rose. This trend will not change because major price conditions in 2001 are not so different from those in 2000.

Table 1. Export and Import Price Index

(%, y-o-y)

	1998	1999	2000
Export price index	-20.3	-2.3	-3.3
Import price index	-16.5	-0.1	17.3
Net terms of trade	-4.5	-2.1	-11.9

The polarization of export sectors will be severe.

Third, the polarization of export sectors will be severe. Exports of steel, automobile and ships are stagnating, whereas exports of IT-related products are steadily increasing. If the international price of DRAM goes down further and Korean firms can not promptly convert their major products from 64 DRAM to 128M DRAM, the trade surplus will fall sharply.

Eventually, total exports are expected to reach $ 191.2 billion, increasing 10.8% y-o-y, and total imports are forecast at $ 181 billion, a 12.8% increase y-o-y. The trade

Table 2. Exports of IT-related Products and Petroleum-related Products

($bil, %)

	1999	Jan-Nov, 2000	Difference
Total	143.7 (8.6)	157.5 (22.3)	28.8
IT-related	32.8 (39.6)	42.4 (45.4)	13.2
Petroleum-related	12.7 (14.0)	17.0 (51.2)	5.7

* Figures in parenthesis indicate yearly increase or decrease.

surplus is forecast at 10.2 billion dollars, a 2 billion dollar fall from the previous year.

Foreign fund inflows will slow

Credit crunch and distortion of financial intermediation may continue to the end of the first half.

As corporate restructuring proceeds and the asset soundness criteria of financial institutions are strengthened, major banks will not budge in their conservative attitudes to financial management to observe the BIS ratio for the time being. As a result, credit crunch and distortion of financial intermediation may continue to the end of the first half, and worries of financial instability will cause foreign fund inflows to decrease.

A more important element is the bearish U.S. stock market. U.S. corporate earnings growth dropped to a 3-year low, the same level as when Russia's default and the LTCM's bankruptcy attacked the U.S. economy. Therefore, a flight to quality, fund movement from the stock market to treasury market, can happen again, with the funds invested in emerging market including Korea returning to the U.S. Additionally, foreign funds already account for more than 30% of the Korean stock market's total market value, it is not likely that more money will be injected to keep portfolio balances with other emerging markets.

Second phase of foreign exchange liberalization induces capital outflows

The chronic liquidity problems of some big companies and the resulting drop in stock prices will likely contribute further to the outflow of funds.

From 2001, individual companies are no longer under the regulations on foreign exchange transaction any more, and residents' and non-residents' F/X transactions are fully liberalized. The second phase of forex liberalization, with the gear up of partial deposit insurance and composite taxation on financial income, may encourage capital outflow, even if the government's complimentary regulations will block off massive outflows. The chronic liquidity problems of some big companies and the resulting drop in stock prices will likely contribute further to the outflow of funds.

Yen and Taiwan dollar are under pressures

Still, Japan's private consumption has deteriorated again after a gradual recovery in the first half of 2000. With the stagnant Japanese economy, the yen is expected to be weakened further, moving in the range between 115~120 per dollar. In Taiwan, besides the recent political uncertainty, the collapse of stock market has severely deteriorated market sentiment, and financial institutions have taken serious bad debt burdens. Additionally, as semiconductor exports diminish and oil price hikes persist, the Taiwan dollar will be under depreciation pressure for the time being. These should exert upward pressure on the won/dollar exchange rate.

Prospects for 2001

The average won/dollar exchange rate will likely rise to 1,230 and peak over

1,250. The won is forecast to depreciate in the first half due to a few destabilizing factors early in the year. Most notably, the current account surplus is likely to shrink especially in the first quarter, reducing the supply of dollars on the market, due to depressed international prices of Korea's major export items such as semiconductors. As noted above, the decrease of foreign fund inflows and increase of fund outflows due to forex liberalization could also bring the won/dollar rate to above 1,250 in the first quarter.

However, the downside risks of the won will be limited in the second half as many of the unfavorable domestic and foreign factors listed above subside or disappear. First, the won will recover with the probable completion of the second stage of corporate and financial restructuring. As a result, other domestic financial markets will regain stability in the second half. The side effects of the three major financial policies including forex liberalization, partial deposit insurance and composite taxation on financial income, will also become apparent in the second half. Finally, the current account surplus, which will decrease significantly in the first half, is expected to increase again in the second half, due to a the drop of imports associated with slower economic growth.

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These factors will contribute to a rise in Korea's international credit rating, thereby encouraging the inflow of both foreign direct investment and portfolio investment funds.

Many of the external factors that will weaken the won in the first half of 2001 are also likely to decline in the second half. If the U.S. rate cuts induce successful soft landing of the U.S. economy, it will lead to the recovery of U.S. stock markets, which will in turn contribute to the stabilization of the won.

As a result, the won is forecast to gradually appreciate, approaching 1,200 won per dollar at the end of the year and the average won/dollar rate is estimated to record 1,230. VIP

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Table 3. Forecast: Won/Dollar Exchange Rate

	1Q	2Q	3Q	4Q
Won/Dollar(Avg.)	1,260	1,240	1,220	1,200