Won appreciation: its disproportionate effects on SMEs and policy measures

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In 2021, as the spread of COVID-19 subsides gradually, the global economic growth rate is expected to rebound due to the base effect and the current, aggressive economic stimulus measures. In last November, the Korea Institute for International Economic Policy (KIEP) predicted that the global economy in 2021 will record a growth rate of 5.0%, which is an improvement from -5.1% in 2020. The International Monetary Fund (IMF) also predicted that the global economy will grow by 5.2% in 2021 after recording -4.4% in 2020. With the election of candidate Joe Biden as the President of the United States, this global economic recovery is contributing to the strengthening of the Korean won. On December 22nd, 2020, we saw the won-dollar exchange rate already fall to below 1,100 won to levels recorded one year and 11 months ago. Market practitioners and experts also predict that the won's strength is highly likely to continue.

It is fortunate that if the won continues to soar, Korea can be relatively free from pressure on the exchange rate appreciation. However, since the strong won may have a negative impact on export competitiveness, we need to pay attention to the effects of the exchange rate and possible policy responses.

Against this backdrop, Ju H. Pyun and I empirically analyze the effect of exchange rates on Korean export companies and suggest relevant policy directions. In Han and Pyun (a chapter within a forthcoming KIEP Policy Analysis), using Korean firm-level variables such as export, productivity, markups, value-added, number of workers, profitability, and investment, we estimate the correlation between industry-specific exchange rate and these variables. In particular, in order to analyze these effects by the size of firms, we divide the entire sample into quintiles based on sales or total capital, thereby estimating the correlations for each sub-sample.

The first main result is that exports and operating profits of smaller firms—in terms of total capital or sales—are more sensitive to exchange rate changes than larger exporting firms. For example, while won appreciation and exports have a negative relationship in the regression analysis using the whole sample, the elasticity for smaller exporting firms is statistically significant and larger than one but the elasticity for larger exporting firms is less than one and not statistically significant. In addition, the downward pressure of the won appreciation on corporate profitability is found to be more evident in smaller exporting firms, while the negative impact of the won appreciation is statistically insignificant for larger exporting firms.

We also find that exchange rate changes affect the market concentration and thus the effects on markups also vary across firms with different size. For example, when the won appreciates, the Herfindahl Hirschman index (HHI) tends to increase and the estimated coefficient is significantly different from zero. Furthermore, when the won appreciates, the markups of firms in the first quintile—although not statistically significant—tend to decline, while an increase in the markups in the fifth quintile is the most pronounced.

In addition, while the correlation between won appreciation and the investment of exporting firms is also negative in the analysis with the entire sample of exporting firms, the negative effect on smaller exporting firms is more pronounced than on larger exporting firms. Consequently, all these results imply that the won appreciation could disproportionately decrease exports of smaller firms and, thus, deteriorate their profitability, lessen market shares, and darken their prospects for future growth, thereby weakening their current investment.

Based on our results about the disproportionately larger negative effects of the won appreciation on smaller firms, policymakers need to implement policy measures to encourage Korean SMEs to sustain exports more robustly against the impact of external sector shocks such as exchange rate changes.

To this end, my suggestion for relevant policy directions is twofold. First, more policy efforts are needed to reduce the information gap between large and small firms in order to lower the threshold for SMEs' entry into foreign exporting markets. One such example could be the information gap in terms of the FTA rules of origin. Second, the role of policy loans and trade insurance for SME exports needs to be re-established in accordance with changes in the market environment. In response to changes in the global market environment, it is necessary to shift the current approach from a quantity-based support mainly stemming from government funds to a market-friendly support approach through expanding cooperation with private financial firms. In addition, we in Korea maintain two export credit agencies within the country—the Export-Import Bank of Korea (Korea Eximbank) and the Korea Trade Insurance Corporation (K-SURE). These two organizations fulfill their own unique missions but some tasks overlap—Korea Eximbank’s external debt guarantee and K-SURE’s mid- to long-term export insurance, for example. The two organizations should solve the problem of overlapping tasks, thereby contributing to the increase in exports of SMEs. KIEP