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The Economic Implications of Financial Opening and Future Tasks

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Deok Ryong Yoon Senior Research Fellow, International Macroeconomics Team, Department of International Macroeconomics & Finance (dryoon@kiep.go.kr)
Su Bin Kim Researcher, International Macroeconomics Team, Department of International Macroeconomics & Finance (sbkim@kiep.go.kr)
Sam Mo Kang Professor, Dong Guk University (sammokang@dongguk. edu)

Background and Purpose of the Study

Five years have passed since the onset of the global financial crisis yet the world economy has not regained its normal state. Consequently, each country is now more interested in policies for the well-being of its domestic economy rather than for economic cooperation with others. As measures to overcome the crisis, advanced countries are implementing unprecedented macroeconomic policies and emerging countries are attempting to induce real exchange rate undervaluation to increase their volume of exports. This atmosphere has created an environment that can easily prompt an outbreak of currency war. If currency war indeed breaks out, South Korea, whose degree of dependence on foreign trade reaches over 100%, will face current account deficit resulting from the acceleration of appreciation of the Korean Won. Also, it is highly likely that the price fluctuation will worsen and the overall macroeconomic variations will become unstable. Besides, if the macroeconomic environment were to deteriorate, we cannot rule out the risk of a sudden stop in capital flows.

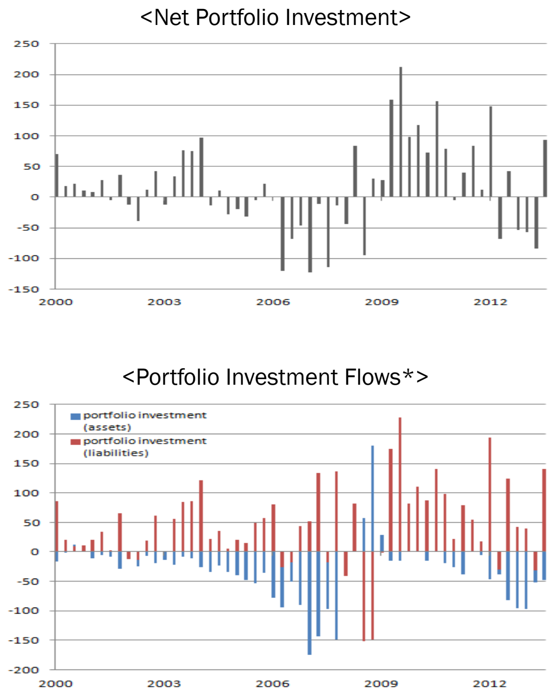
Such increased volatility of exchange rate and impact of changes in the exchange rates are the outcome of aggressive financial opening and financial liberalization in past years, alongside high dependence on trade. If we take these points into account, it is worthwhile to take a close look at changes in the system and policy regarding exchange rates and foreign currencies and the deregulation process of foreign exchange dealings, along with financial opening that has taken place since the currency crisis in 1997. Also, because exchange rates are heavily influenced by the supply and demand of foreign exchange and not by the Korean Won, which is not an internationally convertible currency, it is important to examine the history of the structure of foreign exchange supply and demand. This report will analyze the relationship between the exchange rates and the real and financial variables by reflecting those changes in both domestic and overseas financial environment and tries to propose appropriate policy directions for South Korea's foreign exchange market.

Evolution of South Korean Foreign Exchange System

The evolution of the South Korean foreign exchange system has taken place in response to its economic development and international environment. South Korea is a small-scale open economy with small foreign exchange market. The country has been operating on free floating exchange rate system since September 1997. Because of these characteristics, Korea is easily exposed and vulnerable to rapid fluctuations of exchange rate and external shocks. Such environment has given authorities reasons to conduct smoothing operations, that is, a limited and nonperiodic market intervention and adjustment.

Under the free floating exchange rate system, exchange rates are basically determined supply and demand of foreign currencies. We can describe the economic state of affairs related to and regarding foreign exchange supply and demand by looking at the balance of payments. For instance, the marked changes in the level of investment in securities shown by the financial accounts in the balance of payments (see Figure 1) indicate the increased weight of securities investment than the past, especially after the global financial crisis. South Korea has carried out the financial opening rapidly and was able to increase the openness of its capital market both de facto and de jure. This led to increased foreign investors' outlay in South Korea's securities, hence the marked changes we see in the figure.

Figure 1. Financial Accounts - Portfolio Investment Flows



Period: 2000. Q1 - 2013. Q3
*Assets indicate investment in foreign securities. Liabilities indicate securities investment made in S. Korea by the foreign investors.
Source: ECOS, Bank of Korea.

Such changes can increase macroeconomic instability, including volatile exchange rates, as a result of excessive foreign capital inflows. Particularly, frequent flows of short-term capitals, hot money, can increase the impact on domestic economy and make the economy prone to external shocks. Therefore, foreign exchange authority has carried out not only market intervention but gradual institutional reform for foreign exchange dealings; actively sought measures to regulate capital flows that can compromise macroeconomic stability. For example, the government and related agencies jointly prepared the "Measures to Ease Volatility in Capital Flows" (June 2010) and implemented a set of three macroprudential policies, which consist of limits on forward exchange positions holdings, taxation on foreign investors' bond holdings, and levy on banks' foreign liabilities. In addition, the government is seeking various measures to cope fast with sudden capital flows.

Even though the series of system reform has helped improve South Korea's foreign exchange prudential and foreign payments capability, QE policies launched by advanced countries since the global financial crisis have enormous spillover effects on the country's foreign exchange and capital markets. Thus, it can be said that unless these destabilizing factors are alleviated, risk of capital outflows and expansion of exchange rates volatility resulting from changes in domestic and overseas economic conditions will remain.

Effects of Changes in Foreign Exchange Supply Channel on Exchange Rates

Before 1997, current accounts reflected the outcome of autonomous transactions while capital transactions were merely accommodating means. However, financial opening that took place after the currency crisis turned financial transaction itself into the autonomous ones. As a result, financial accounts have become the main channel of foreign exchange supply in the foreign exchange market and current accounts were no longer the main channel, as in the past. This is the most important change made in the relationship between current transactions and capital movements as a result of financial market opening and liberalization that started after the crisis in 1997.

Since the financial transactions became the main channel of foreign exchange supply, the volume of transactions in foreign exchange market has expanded and fluctuations in capital flows have become more frequent. Consequently, changes in exchange rates have become more volatile and frequent. To be specific, since the 2000s, volatility and range of exchange rates and tipping effect were tripled when compared with those in the period before the currency crisis. Also, not only the current account but also the financial account seems to influence exchange rates. These observations indicate that the impact of financial transactions on exchange rates has increased. Certainly, the impact of changes in current accounts on exchange rates has decreased. However we have observed that the current accounts still operate as the exchange rate determinant.

In addition, the financial opening has provided relatively easy access to foreign capitals and has eliminated bottlenecks in the financial market. Consequently, current accounts can determine the changes in financial accounts but not vice versa. Moreover, we observed that, after the financial opening, current account surplus leads to financial account surplus by signaling a country's economic competitiveness and giving expectations on foreign-exchange gain. In other words, the current and financial accounts move in the same direction for a period of time, hence, this implies that imbalance in international balance of payments has become a common phenomenon.

The series of observation laid out in this section can be interpreted as evidences for intensified tipping effect and volatility of capital movements in recent years.

Effects of Exchange Rates on Financial and Real Economy

First of all, the effects of exchange rate variability on import price inflation rate were much greater than that on consumer price inflation rate in all three countries: South Korea, China, and Japan. The exchange rate variability used to have more effects on consumer price inflation rate than on import price inflation rate in Korea but this was reversed since the 2000s. It seems that the change had occurred because of the stabilization of consumer prices and intensified competition between domestic and imported products following the expansion of FTAs.

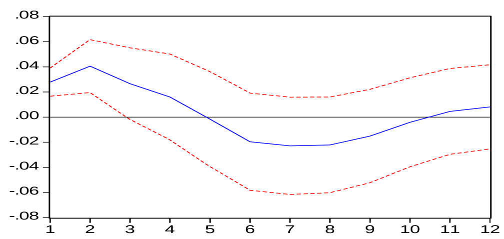
Second, it was observed that the effects of JPY/USD exchange rates on Korea's macroeconomic variables were as significant as that of the KRW/USD exchange rates. Especially, the effects of JPY/USD exchange rates on ratio of trade balance to GDP were significant. This implies that price elasticity of imports from Japan to Korea is considerably low and that Korea has a highly competitive relationship with Japan in the trade market.

Third, it was observed that although the exchange rate variability significantly affected the import and consumer price inflation rates, its effects on the rate of economic growth and trade balance were below expectations. Reasons behind this observation lay on the remarkable institutional transition that stems from an increased autonomy of financial market, following the financial opening, and also the fact that the level of exchange rates has more de facto effects on the real economic variables than the changes in the exchange rates.

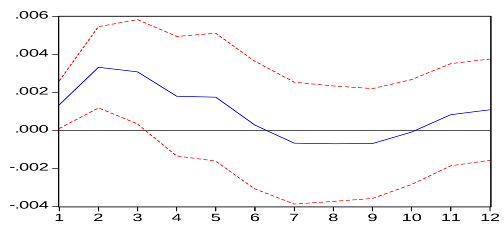
To sum up the results so far, the changes in exchange rates increase the import and consumer prices and negatively affect both the rate of economic growth and balance of trade; the impact of trade rival Yen exchange rates was significant to the Korean economy.

Figure 2. The Effects of KRW/USD Exchange Rate Increase* - A 1 Standard Deviation Shock

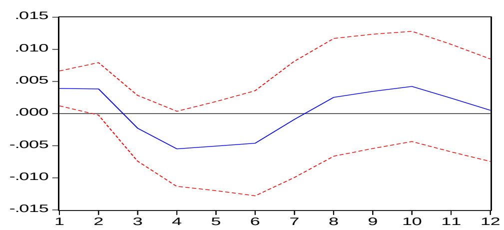
<Import Price Inflation Rate>



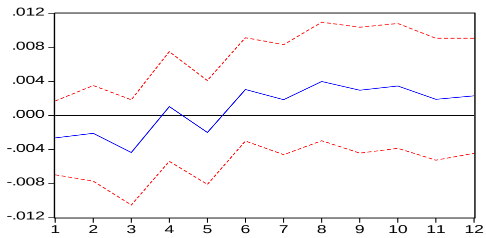
<Consumer Price Inflation Rate>



<Rate of Economic Growth>



<Ratio of Trade Balance to GDP>



* The KRW/USD exchange rates increase indicates the exchange rate depreciation.

Policy Implications

1. Establishment and Implementation of Long-term Plan for Structural Development

The Korean government has been establishing various development plans regarding the foreign exchange market with the majority being applied. However, the government still needs to find measures to build an active and future-oriented system for long-term developments. For example, as detailed action plans for the internationalization of the Korean Won are still insufficient, the government could provide institutional support for recent currency swap agreements that were signed simultaneously. Institutional support is particularly required for the recent currency swap agreements with the countries, such as Malaysia, UAE, and Indonesia, because there are institutional differences with these countries and their financial markets are not as open as that of the U.S. or European Union.

2. Diversification of Participants in Foreign Exchange Market and Capacity Building of Private Sector

Although South Korea is holding enough amounts of foreign exchange reserves for emergency, it is the government who hold the reserves, and thus, the channels that are connected to the private sector are absent. South Korea's foreign exchange market is a dealer market, where a number of participants determine the market exchange rates, and the level of exchange rates highly depends on the government's policy, so the government is always responsible for the exchange rates. It shows limits of South Korea's current foreign exchange system and indicates that there is a lack of support that enables the private sector to autonomously build market stability. Therefore, it is necessary to pursue an institutional development to introduce the new stage where the private sector leads the foreign exchange market and plays an important role in determining the exchange rates.

3. Development of Policy Measures for Market Volatility Adjustment

South Korea has been adjusting the excessive volatility by a smoothing operation. However it is clearly desirable to minimize any market intervention. In the context of capacity building of the private sector as mentioned above, primarily, measures to hedge the risks needed to be sought to respond to the volatility of private-led market. As the role of private sector grows, there will be less necessity for interventions and even when the information regarding smoothing operation is publicized, its impact will be lessened.

4. Continuous Policy Efforts for Current Account Management

According to the result of this study, current accounts determine as far as the direction of investment capitals of financial accounts, which means that the current accounts are basically influence the financial market. It is a common phenomenon that prevails in emerging countries whose domestic currency is not internationally compatible. Until the internalization of the Korean Won is realized, continuous policy efforts to maintain the current account surplus are required. However, an excessive surplus should not be overlooked as it could turn into a rapid deficit.

5. Countermeasures Against Sudden Stop

Among the capital inflows that were made through the financial market, portfolio capital inflows, which aim for short-term profit, involve possibility of a sudden stop following any changes in international environment or market circumstances. Such event could bring not only an increased volatility but also a new crisis. Although various measures have been proposed to cope with the sudden stop, including foreign exchange reserves expansion, currency swap expansion, and introduction of payment system using domestic currencies, it is hard to say that there are enough measures that can be operated immediately for possible crisis. Thus, the government needs to continuously put efforts to expand measures that can be operated to secure the stability of foreign exchange and capital market.

6. Preventing Exchange Rates Volatility

Since an increase in exchange rates affects important financial variables, including inflation—measures that can prevent rapid fluctuations of exchange rates—are required to stabilize the prices. South Korea has been conducting smoothing operations whenever the exchange rates change rapidly. However it is time to enhance the ability of the market itself to control temporary volatilities in foreign exchange supply by increasing its efficiency.

This process would entail the policy that makes foreign exchange market to mature and foundation for the matured foreign exchange market would be a continuous operation of safety device that maintains the trust in the market. For instance, efforts to expand foreign exchange reserves and currency swap agreements would help build trust of domestic and overseas economic agents in the foreign exchange market.

Besides, considering that the impact of the Yen exchange rates on the Korean economy is as significant as that of the dollar exchange rates, measures to reduce shocks on a cross currency caused by the changes in the exchange rates are also required. In other words, we need to introduce a system that can respond to the changes in the exchange rates of respective major currencies. Possible alternatives could include, for instance, diversification of currently dollar-oriented foreign exchange market and efforts to increase the use of domestic currency in payments. KIEP