The recent experience of the Korean economy with currency internationalisation

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1. The pros and cons of Korean won internationalisation in the light of the recent financial crisis

Since the late 1980s, Korea has continued making institutional improvements aimed at providing the basis for Korean won internationalisation, in order to enlarge its benefits. Faced with the recent global financial turmoil, however, the internationalisation of the Korean won may be a two-sided coin. In other words, while the need for internationalisation has increased, its side effects cannot be underestimated.

The pros of Korean won internationalisation

Korean won internationalisation would have various economic benefits. It would enable domestic economic agents to avoid foreign exchange risk and save on foreign exchange transaction costs, help in the development of domestic financial and foreign exchange markets, reduce the need for external payment reserves, and generate seigniorage profits. Moreover, given the ongoing global financial crisis, the merits of internationalisation of the won may increase further in the long term.

First of all, if the Korean won were internationalised, the exchange rate risk of private economic agents, including exporters and importers, could be reduced. In particular, recent events in the Korean foreign exchange derivatives market such as the "knock-in/knock-out option"[2] and the "snowball" could be better managed. Moreover, importers would not need to pass-through the additional costs of currency depreciation to consumers, and thus inflationary pressures could be mitigated.

The second benefit of Korean won internationalisation is that the Korean economy would be more resilient to external shocks. For example, issuance of won-denominated overseas securities could help to reduce the possibility of double mismatches in currency and maturity. In this way, it could effectively respond to sudden capital outflows and strengthen its resilience to the shocks. That is, it could reduce the risk of currency mismatch from the burden of "original sin" inherent in emerging market economies, which could thus help to reduce the side effects of sudden foreign capital flows, such as boom-bust cycles or systemic sudden stops in the global financial markets. Moreover, securities issued overseas usually have long-term maturities (more than one year), and rollover risk, particularly during periods of financial turmoil, would be lessened.

Third, Korean won internationalisation would improve foreign exchange liquidity conditions and enhance the capital soundness in the financial sector. This would also contribute to a deepening of domestic financial markets through the introduction of new financial products.

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[2] An exotic currency option, named KIKO (knock-in/knock-out), was structured with buying one put option and selling two call options. Since 2006, KIKO has been widely used by Korean small and medium-sized enterprises for hedging purposes, as it bears no transaction cost. But the firms involved have suffered huge losses, as the Korean won has depreciated sharply in the wake of the global financial crisis.

In other words, an increase in capital inflows would have a direct and positive impact on foreign exchange liquidity. In addition, the capital soundness of domestic financial institutions would be enhanced through an increase in the issuance of won-denominated stocks. Furthermore, it would promote the introduction of new financial products and facilitate its transactions in the market, thereby contributing to the quantitative and qualitative development of domestic financial markets.

The cons of Korean won internationalisation

Given the ongoing tensions in the global financial market, however, the negative effects of Korean won internationalisation would also increase. On top of that, the Korean economy would be more easily exposed to speculative attacks if the won were internationalised. Amid the turmoil in the global financial market, attaining full liberalisation in the pursuit of currency internationalisation could aggravate capital flow volatility, heightening the chance of speculative attacks on the won. The speculation would, of course, increase the volatility in the financial market, especially in the exchange rate, thereby increasing the uncertainty of the whole economy in a country such as Korea, where external dependence is relatively high. In particular, the exchange rate could become more volatile if foreign exchange funding difficulties and the recession in the real sector were to continue, as in the current situation.

Furthermore, volatile capital flows into and out of Korea might undermine the autonomy and efficiency of monetary policy. Emerging market economies with premature currency internationalisation tend to be more vulnerable to external financial shocks, creating difficulties for monetary policy. In other words, massive capital inflows increase the cost of monetary policy operations and worsen the central bank's balance sheet in the process of sterilisation, while the capital outflows add to the difficulties in coping with the liquidity drain in the domestic financial market and squeeze the real sector economy. Additionally, before achieving a mature financial market, the large capital flows may cause a distortion in the financial market, rather than helping it to develop.

Overall, despite the various benefits of Korean won internationalisation in the long term, the short-term costs of pursuing it at this point in time are relatively large. It should be noted that the effectiveness of financial stability resulting from currency internationalisation would be limited in the current global financial turmoil where the financial market tensions of advanced economies are fast spreading into emerging economies. This reflects the fact that the emerging economies that lie somewhere on the scale between developed and underdeveloped countries face the greatest likelihood of a potential crisis, rather than reaping the full benefits of currency internationalisation.

2. Evaluating the progress in Korean won internationalisation

Developments in Korean won internationalisation

Much progress has been made in Korean won internationalisation, at least in terms of its unit of account. Convertibility and exchange of the won, the entry of the won in physical form in exports/imports, and won deposits by non-residents have all become liberalised. In current transactions, the conclusion of won-denominated transactions, as well as the settlement of transactions in Korean won, have also become liberalised (June 1996). In addition, since January 2006, the authorisation of most capital transactions involving the Korean won has been changed from an approval basis to a reporting basis. In November 2007, the "Plans for enhancing the market-friendliness of the foreign exchange transaction system", which include a plan for Korean won internationalisation, were announced. The measures include the liberalisation of Korean won exports/imports, the upward adjustment of the amount of a non-resident's borrowing in Korean won from KRW 10 billion to 30 billion, and the settlement of floor capital transactions in overseas exchanges. These areas are considered to have a relatively small impact on the foreign exchange market, but are considered essential for improving the global acceptability of the Korean won.

However, internationalisation of the Korean won as a means of payment or store of value (borrowing, lending, securities issuance) is not fully permitted, and some of the capital transactions must be reported to the government or the Bank of Korea (BoK). In detail, non-residents' Korean won borrowings and securities lendings in excess of KRW 30 billion, capital transactions between non-residents, and securities issuance by non-residents should be reported to the Ministry of Strategy and Finance or the BoK. Additionally, won-denominated current transactions among non-residents using non-residents' Korean won transaction accounts are prohibited. However, won-denominated current transactions between residents and non-residents are permitted, and are available only through non-residents' Korean won transaction accounts. The Korean government will pursue mid- to long-term measures towards internationalisation more prudently, such as lifting procedural restrictions on over-the-counter (OTC) capital trades and won borrowings, and permitting the free settlement of capital transactions in the won.

Table 1

Development in KRW internationalisation by transaction types

(end-2008 basis)

Transaction Types		**Details**	**Extent of Liberalisation**
▪ Convertibility of KRW		Unlimited convertibility of KRW	Liberalised
▪ KRW exchange		KRW exchange in Korea and abroad	Liberalised
▪ KRW exports/imports		Cross-border carrying of KRW in physical form	Liberalised
▪ KRW deposits		Non-residents' KRW deposits	Liberalised
▪ Current Transactions		Conclusion of KRW-denominated transactions	Liberalised
		Settlement of current transactions by KRW	Liberalised
▪ Capital Transactions	Conclusion of transactions	KRW-denominated fund procurement by non-residents	Report to the Ministry of Strategy and Finance or the BOK required[1]
	Payment and Settlement	Settlement of capital transactions by KRW	Permitted within a limited scope[2]

[1] Non-residents report to the Ministry of Strategy and Finance for the issuance of won-denominated securities; non-residents report to the BoK for borrowing of over KRW 30 billion. [2] Limited to the payment and settlement of domestic securities and futures investments, and the settlement of floor transactions in overseas exchanges.

The Korean government has chosen Korean won internationalisation as one of its major national goals for the next five years, and has been working on that goal. However, due to the recent deepening of domestic and external financial instability, its policy stance has shifted to a more prudent approach. As a result, the government announced last October that it would postpone indefinitely the second stage of its foreign exchange liberalisation measures.

Current use of the Korean won in external transactions

Thanks to institutional improvements, the use of the Korean won has increased steadily for every type of transaction, although it is not so frequently used by non-residents, except in domestic stock and bond investments.

First, the exchanging of Korean won (in its physical form) for other currencies has increased, due to the increase in overseas travel among Koreans and the entry of foreigners into Korea, but the amounts involved are not that significant.

Table 2

Trends of KRW Imports/Exports

(hundred million won)

Transaction Types		**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Banks	Exports	514	594	1,199	1,406	1,497	1,512	4,062
	Imports	43	72	281	248	682	1,161	822
Individuals	Exports	5	7	9	7	6	17	14
	Imports	827	559	661	797	837	1,024	736
Korean tourists abroad[1]		535	709	883	1,008	1,161	1,332	1,200
Foreign tourists in Korea[1]		712	475	582	602	616	644	689

[1] In tens of thousands.

Second, use of the won for the settlement of current transactions,[3] such as imports/exports and service transactions, has also been rare. The currencies used in current transaction settlements (in 2008) ranked from the US dollar (83.8%), to the euro (6.4%), and the Japanese yen (6.0%), while the KRW accounted for only 0.1%.

[3] The settlement of current transactions in Korean won is a won-denominated transaction, and is allowed only between parties concerned using non-residents' Korean won transaction accounts. Opening a Korean won clearing account under the name of a foreign financial firm is not allowed.

Table 3

Current Transaction by Settlement Currencies in Korea

(billion dollars, %)

Transaction Types		1996	2000	2002	2004	2006	2007	2008
Trade (A)	USD	228.4 (84.9)	277.5 (82.7)	281.8 (83.8)	417.1 (82.0)	552.1 (78.1)	639.9 (83.3)	791.8 (84.6)
	JPY	21.5 (8.0)	29.1 (8.7)	28.5 (8.5)	46.9 (9.2)	48.5 (6.9)	53.8 (7.0)	61.9 (6.6)
	Euro	–	6.3 (1.9)	19.0 (5.6)	34.5 (6.8)	46.4 (7.0)	59.9 (7.8)	65.7 (7.0)
	KRW	–	–	0.3 (0.1)	0.6 (0.1)	1.6 (0.2)	1.9 (0.2)	0.9 (0.1)
Services (B)	USD	55.6 (78.5)	73.0 (80.6)	74.4 (78.4)	108.1 (79.7)	137.8 (79.1)	173.5 (81.6)	201.4 (80.8)
	JPY	8.6 (12.1)	9.4 (10.3)	7.6 (8.1)	9.7 (7.2)	9.8 (5.6)	11.4 (5.4)	8.7 (3.5)
	Euro	–	0.8 (0.9)	4.7 (5.0)	7.3 (5.4)	12.7 (7.3)	16.3 (7.7)	10.6 (4.3)
	KRW	–	–	0.3 (0.3)	0.6 (0.4)	1.3 (0.7)	2.0 (0.9)	0.6 (0.2)
Current Transactions (A+B)	USD	284.0 (83.5)	350.5 (82.3)	356.1 (82.6)	525.2 (81.5)	689.9 (82.8)	813.4 (82.9)	993.2 (83.8)
	JPY	30.1 (8.9)	38.5 (9.0)	36.2 (8.4)	56.7 (8.8)	58.3 (7.0)	65.2 (6.6)	70.6 (6.0)
	Euro	–	7.1 (1.7)	23.7 (5.5)	41.8 (6.5)	59.1 (7.1)	76.2 (7.8)	76.3 (6.4)
	KRW	–	–	0.5 (0.1)	1.2 (0.2)	2.9 (0.3)	3.9 (0.4)	1.4 (0.1)

Third, non-residents' investment in won-denominated financial products (equities and bonds) has been mostly liberalised, and transactions in this area have been very active. Non-residents' investments in Korean stocks and bonds increased in volume until 2007. Last year, however, they declined sharply due to the global financial crisis. Conversely, Korean won deposits and borrowings, and Korean won securities borrowings, have been small.

Table 4

Trend of Non-residents' Investment By Transaction Type[1]

(trillion won, %)

	2005	2006	2007	2008
Stock Investment	269.9(37.1)	273.1 (35.2)	325.4 (31.0)	70.8 (27.4)
Bond Investment	3.3 (0.5)	4.6 (0.9)	21.7 (2.6)	37.9 (0.4)
Won Deposit and Money Trust	0.3	0.5	0.6	2.5
Won Borrowings	0.4	0.6	0.7	0.7
Won Securities Borrowings	0.1	0.1	0.7	0.6

[1] Balances at period ends. [2] Figures in parenthesis are the shares in total market capitalisation (in percent).

Fourth, of Korean won foreign exchange transactions between foreign exchange banks and non-residents, non-deliverable forwards (NDFs) and overseas remittances of Korean won have increased every year.

Table 5

Trends of FX Transactions Involving Korean won

(hundred million dollars)

	2005	2006	2007	2008
NDFs[1]	26.1	42.2	65.3	94.3
Remittance of money received from selling real estate in Korea[2]	0.8	0.6	1.5	0.1
Overseas remittance of Korean won[2]	17.1	20.5	25.2	39.6

[1] Volumes of daily transactions (based on new purchases + sales). [2] Based on non-residents' KRW transaction accounts.

Reasons behind the slow progress in Korean won internationalisation

Despite the government's efforts to internationalise the Korean won, in line with its foreign exchange liberalisation measures, use of the won is still minimal. This is because acceptability of the won is below that required for an international currency. This implies that, in order for a country's currency to become internationalised, what is needed goes beyond just the institutional overhaul, such as foreign exchange liberalisation; spontaneous overseas demand for the currency is also inevitably required.

I have outlined below a comparison between Korea and other major economies, in terms of economic size in trade and production, fiscal soundness, external and internal stability of their currency value, degrees of financial market maturity and trade structures. These are regarded as key elements for determining the acceptability of international currency.

First, in terms of economic size, Korea ranked 12th in world trade volume and 13th in GDP (2007 basis). Considering that the currencies of Australia, Switzerland and Hong Kong SAR – which are smaller than Korea in terms of trade and economic size – are more internationalised, I would say that Korea, to a large degree, meets the conditions for currency internationalisation, in terms of its economic scale.

Table 6

Shares of main countries in world trade and GDP[1]

(2007 basis, %)

	US	**Japan**[2]	**Germany**[2]	**Korea**	**Australia**	**Switzerland**	**Hong Kong**
Trade	11.4	4.7 (6.5)	8.5 (7.9)	2.6	1.1	0.0	2.6
GDP	25.3	8.0 (11.4)	6.1 (5.4)	1.8	1.7	0.8	0.4

[1] Weights in comparison to the world total. [2] Figures in parenthesis show the weights in 1985, when currency liberalisation was actively pursued.

Source: IMF, *International Financial Statistics* and *World Economic Outlook*.

Second, the fiscal soundness of Korea has been strong in comparison to advanced and other emerging economies. The public debt of the Korean government as a percentage of GDP is considerably smaller than those of developed countries such as the United States, Japan and Germany.

Table 7

Public Debt[1] **in main countries**

(2007 basis, %)

	US	**Japan**	**Germany**	**Korea**	**Australia**	**Switzerland**	**Hong Kong**
Public Debt/GDP	63.1	195.5	65.0	32.1	8.9	43.5	12.5

[1] Based on general government.debt.

Sources: IMF, *The State of Public Finances (2009)*; Swiss National Bank; HKMA.

Third, domestic inflation, which shows the internal value of the Korean won, has been broadly stable overall since 2000, but has exceeded those of advanced economies such as the United States and Japan, as well as Australia and Switzerland. The exchange rate of the Korean won against the US dollar, which is an indicator of the external value of the won, has been more volatile than those of other major economies' currencies. It seems to me that the won does not fully satisfy the requirements for an internationalised currency, in terms of the stability of its value.

Table 8

Price and exchange rate movements in main countries[1]

(In per cent)

		2001	2002	2003	2004	2005	2006	2007	2008
CPIs	US	1.6	2.5	2.0	3.3	3.4	2.5	4.2	-0.1
	Japan	-1.2	-0.3	-0.4	0.2	-0.4	0.3	0.7	0.4
	EU	2.0	2.3	2.0	2.4	2.2	1.9	3.1	1.6
	Korea	4.1	2.8	3.5	3.6	2.8	2.2	4.0	4.1
	Australia	6.0	2.9	3.1	2.4	2.4	3.2	3.0	3.7
	Switzerland	1.0	0.6	0.6	0.8	1.2	1.1	0.7	2.4
FX Rates[2]	Yen/Dollar	-11.3	-2.9	8.0	7.2	-1.9	-5.2	-1.2	14.0
	Dollar/Euro	-3.0	5.5	19.6	10.0	0.0	0.9	9.1	7.4
	Won/Dollar	-12.4	3.2	4.9	4.2	11.7	7.2	2.8	-15.8
	Dollar/ Aus. Dollar	-11.0	5.1	20.0	12.9	3.4	-1.2	11.3	1.6
	Swiss Franc/ Dollar	0.1	8.5	15.7	8.2	-0.3	-0.5	4.4	10.9

[1] Annual average. [2] Appreciations (+) or depreciations (-) against US dollar.

Fourth, in terms of financial market development, Korea's domestic financial markets have grown steadily, while also becoming more open externally. However, they are insignificant in terms of trading volume among global financial market transactions and are qualitatively immature with a lack of sophisticated financial products. The daily trading volume in Korean stock and the foreign exchange market, as well as the outstanding of the bond market, are smaller than those of major advanced economies. In particular, the daily trading volume in the foreign exchange market is only one quarter that of Australia, whose economic size is similar to Korea.

Table 9

Main indicators in stock, FX and bond markets

(hundred million dollars)

	US	UK	Germany	Japan	Australia	Switzer-land	Korea
Stock Market[1, 2]	1,921	115	126	160	19	32	43
FX Market[1, 3]	10,303	19,834	1,576	2,658	1,599	2,564	406
Bond Market[4]	251,545	13,842	28,522	94,681	7,525	2,620	18,596

[1] Daily average trading volume. [2] Based on January 2009. [3] Based on April 2007, including transactions with customers. [4] Outstanding of bonds issued at end-Q3 2008.

Source: World Federation of Exchanges and the BIS ("Foreign Exchange and Derivatives Market Activity in 2007").

Fifth, it is generally believed that, the more market dominance a country's exported goods have, the higher the possibility of its currency being used in global trade settlement. Korea exports more goods to regional countries such as Japan, China, and Southeast Asian countries compared to the United States and Europe. If the Korean won were more frequently used for the settlement of regional trade, it would enhance the economic benefits.

Table 10

Destination of Korea's exports

(in per cent)

	2002	2004	2006	2007	2008
US	20.2	16.9	13.3	12.3	11.0
Euro Region	13.4	14.9	14.9	15.1	13.8
Asian Region	47.6	51.0	51.8	50.8	50.7
(Japan)	9.3	8.5	8.2	7.1	6.7
(China)	14.6	19.6	21.3	22.1	21.7
(South East Asia)	11.3	9.5	9.9	10.4	11.7
Others	18.9	17.2	20.1	21.8	24.5
Total	100.0	100.0	100.0	100.0	100.0

Source: Korea International Trade Association.

3. Concluding remarks

Let me conclude my presentation with suggestions for future policy plans.

If the Korean won is further internationalised in the long term, we can expect various benefits. Especially when the world economy is in financial crisis, as is currently the case, domestic businesses and financial institutions would have greater opportunities to secure foreign currency funding, and the impact of global shocks would be eased. Nonetheless, Korean won internationalisation needs to be firmly grounded on global demand for the currency. If we rush to pursue this goal when it remains beyond our power, it might trigger the risk of speculative attack and hamper the autonomy of our macroeconomic policy. We would therefore need to work prudently towards this goal, paying close attention to domestic and global conditions.

In this respect, it will be important for us to focus our economic policies on preventing excessive real economic contraction and promoting macroeconomic stability, thereby inducing a natural improvement in the acceptability of the Korean won in the medium to long term. Implementing further institutional measures for foreign exchange liberalisation and Korean won internationalisation would have to be pursued conservatively, taking into consideration the progress in global financial market normalisation and the recovery of the domestic economy.

In times of global crisis, such as the current one, we need to further strengthen regional currency and financial cooperation in order to establish a foundation for Korean won internationalisation and to maximise its potential benefits. The consolidation of Asian regional cooperation, together with that between advanced and emerging market economies, such as the Korea-US currency swap agreement, would serve as an engine for recovery in overcoming a global economic recession.

To help achieve this, it will be necessary to create efficient ways of promoting the increased use of regional currencies in trade settlement, and of expanding the Asian Bond Fund (ABF) to help further develop Asian bond markets. The volume of Korea's trade with China and Japan accounts for 19.6% and 10.4%, respectively, of its total trade. However, the use of those countries' currencies in Korea's trade settlement is small, due to a less developed hedging market for exchange risk. We therefore need to review the measures to facilitate trading in the won/yen futures market and the possibility of introducing a won/renminbi futures market, making progress towards the establishment of spot markets for those currencies.

In addition, we need to work to lower the possibility of currency crises due to unstable global capital flows and currency mismatches, while also promoting internationalisation of regional currencies. We can do both of these by fostering the further development of Asian bond markets by, for example, expanding the demand for regional bonds through increasing the size of the ABF. Last February, the Korean government decided to lift the withholding tax levied on foreigners when they invest in Korean bonds, thereby expanding the demand for Korean won bonds.

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