In this era of uncertainty, nothing seems more uncertain than the won-dollar exchange rate. From 2015 and onward, the rate of the Korea won against the US dollar has depreciated from around KRW 1100 per dollar to slightly over KRW 1200 after the US rate hike in December 2015. After reaching KRW 1230 in February 2016, however, the won changed its course and began appreciating until July. But August is a completely different story. The won rate began to exhibit extremely unstable movement, rising over 1 percent a day for a few days, followed by even bigger falls the next day. When almost all Asian currencies (except for the Chinese yuan) were strengthening against the US dollar, the Korean won showed weakness in the month of August.

The daily fluctuation of the won’s exchange rate is relatively extreme compared to other currencies. For example, on August 16, 17 and 19, its exchange rate was much higher against the dollar than both the Japanese yen and the Taiwanese dollar. During this period, the average rate of change in the exchange rate was 0.91 percent for the Korean won, but 0.23 percent for the yen and 0.47 percent for the Taiwanese dollar. It’s only natural then to ask two major questions—first, why is the Korean won showing weakness against US dollar? And second, why is the Korean won’s daily exchange rate more unstable than other Asian currencies?

The answer to the first question lies in the US rate hike, or its probability. Indeed, the won’s rate is closely connected to the US hike; when the US rate was expected to be raised throughout 2015, the won showed steady depreciation until December 2015. When the possibility of a further rate hike seemed remote in early 2016, the won began to reverse its course and continuously fell until July 2016. In August, when a number of influential presidents of the Federal Reserve Banks publicly stated about the possibility of the US rate hike in September, it shocked the Korean exchange market more than any other market, causing the Korean won to falter at an alarming pace.

As to the second question about the instability of the Korean won, the country’s economy is more dependent on international trade for its growth, and also more open to global investors with relatively freer regulatory environments. These factors of a more open Korean economic structure and freer regulations are hard to deny, but there seems to be very important hidden factor behind the curtain of greater fluctuation of the Korean won—the response from exchange rate policy makers.

Traditionally, the Korean government has been maintaining a strong laissez-faire stance in regards to the management policy of the exchange rate. That is, the government has been subscribing to the policy of minimum intervention in the exchange market, believing it to be more efficient than any other option. Therefore, regardless of whatever happens in the exchange market, almost every participant expects no specific ‘intervention’ by the authority to reverse the market force, rendering the markets more unstable. You can call this “benign neglect”. There are two fundamental reasons for this behavior; first, the Korean economy needs no intervention in the exchange markets because it is very strong and healthy in terms of foreign reserves and the current account surplus. Official reserves of USD 370 billion and the current account surplus of USD 100 billion are more than enough to safeguard the Korean economy from outside shocks. Second, intervention in the exchange market by the authority is one of the crucial actions to be monitored by the US authority, especially under the BHC Act of 2016.

The future direction of the Korean won in 2016 really depends on the US rate hike. If the Feds decide to raise it both in September and December, the won could jump to KRW 1250 or even to KRW 1300. This is because a higher US rate will render significant outflow of tens of billion dollars of capital from Korea. If there is one rate hike in 2016, the effect of the won rate will be less serious. Some would also welcome the depreciation on the grounds that it would help stimulate ailing export industries. It is hard to expect where the won is headed without knowing first where the US rate will go and also how the Korean government would react. But with the US rate hike likely to take place and the Korean government being so benignly neglectful about exchange market intervention, the rate of the Korean won rate could continue to show signs of instability.

By Professor Se Don Shin
Dean, Sookmyung Women’s University
Former Senior Economist, Bank of Korea
seshin@sm.ac.kr