Capital controls in South Korea
The won that got away
A surgical strike in a volatile market

Jun 17th 2010 | SEOUL | from the print edition

Whenever South Korea's currency, the won, has fluctuated against the dollar in recent months, the authorities in Seoul have had a deep sense of déjà vu. They remember the dark days of 2008 when finance officials jetted around the world trying to convince people that their export-dependent country was not the next Iceland. It was a tough sell.

Back then local and foreign banks in Seoul had amassed huge short-term dollar debts. That was partly a result of foreign-exchange hedging in South Korea's large shipbuilding industry and partly thanks to a “carry trade” in which investors swapped cheaply borrowed dollars for won on the expectation that the local currency would rise. After the collapse of Lehman Brothers, there was rapid deleveraging. As South Korea's capital account plunged into the red at the end of 2008, the won tumbled (see chart). In 2008 it was the second-worst-performing currency in the OECD—after the Icelandic krona.

Fast forward to 2010 and South Korea has experienced the same pattern in miniature. An economy that the OECD this week said may grow by 5.8% this year has once again attracted lots of speculative foreign capital, funded by negligible interest rates in America and elsewhere. But investors have again proved fickle. Some of the biggest foreign banks in South Korea are European ones. When Europe's debt
crisis started to unfold, they began feverishly deleveraging, pushing down the won.

The government of President Lee Myung-bak has not been idle since it stared over the abyss in 2008, however. Advised by Hyun Song Shin, an economist at Princeton, it has pondered ways to control destabilising capital flows. It hopes this will influence thinking in the G20, which it chairs this year.

On June 13th it set limits on the build-up of foreign-exchange derivatives that it believes makes the won one of the most volatile currencies in the rich world. Local banks will be allowed to have foreign-exchange derivatives no higher than half their capital base. Foreign branches, which have greater access to hard currency, have a higher ceiling of 2.5 times their capital. The limits are close to current levels; they will be introduced with a three-month grace period; and some existing positions can be held for up to two years. That helped minimise disruption in currency markets—the won actually rose against the dollar the day after the measures were unveiled.

Lots of countries are now experimenting with capital controls: on June 16th Indonesia became the latest, introducing mild curbs on flows of hot money. But Mr Shin insists the limits are a “surgical response” to unique circumstances in South Korea. These include a shipbuilding industry that is paid in dollars over three years and needs to hedge its won costs by selling forward dollar contracts to banks. The country also lacks a deep local-bond market attractive to long-term foreign investors. There is, says Mr Shin, a maturity mismatch in South Korea between long-term assets and short-term liabilities that makes it vulnerable to sudden bursts of deleveraging. “Whenever Europe trembles, we are the first place to jump from,” he says.

The carry-trade activity also hampers monetary policy. Benchmark rates remain at a meagre 2%, which raises inflation fears. With some foreign-exchange limits in place it may be easier for the Bank of Korea to raise interest rates without attracting a renewed surge of speculative capital.

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