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March 1, 1990

To: Members of the Executive Board
From: The Secretary
Subject: Korea - Modification of Exchange System

Attached for the information of the Executive Directors is a paper on the recent modification to the Korean exchange system.

Mr. Dicks-Mireaux (ext. 7308) is available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

KOREA

Modification of Exchange System

Prepared by the Asian Department and the
Exchange and Trade Relations Department

(In consultation with the Legal Department)

Approved by P.R. Narvekar and A. Basu

March 1, 1990

In the attached communication dated February 27, 1990, the Korean authorities informed the Fund of the adoption of a new "market average exchange rate system," effective March 2, 1990.

Since February 1980, the Korean won has been linked to a multicurrency basket, consisting of a trade-weighted basket and the SDR basket, but other factors have also been taken into account. The Bank of Korea has established daily the Korean won-U.S. dollar exchange rate--the concentration rate-- while the exchange rate of the won against other currencies has been based on the U.S. dollar-foreign currency exchange rates in markets abroad. Under the new system, the Korean won-U.S. dollar rate will be based on the weighted average of interbank rates for Korean won-U.S. dollar spot transactions of the previous day. Interbank and customer rates will be allowed to float freely within specified margins.

The staff welcomes the modification of the exchange system which will enhance the influence of market forces in the foreign exchange market. At the conclusion of the 1989 Article IV consultation with Korea on October 6, 1989 (EBM/89/132, SUR/89/75), Directors encouraged the authorities to press ahead with proposals to this end. The recent measure is an integral component of the authorities' efforts to liberalize domestic financial and capital markets. The staff will examine in detail the new exchange rate system during the 1990 Article IV consultation discussions which are expected to be held on the 12-month cycle.

OFFICE MEMORANDUM

To: Mr. Narvekar

February 27, 1990

From: Seung-Woo Kwon

Subject: Change in Korea's Exchange Rate System

I have been instructed by my Korean authorities to inform the Fund of the change in Korea's exchange rate system which will become effective on March 2, 1990. The description of the new system is as follows:

1. The Korean Government will adopt the Market Average Exchange Rate System, effective on March 2 of this year, in order to promote the development of the foreign exchange market to keep pace with the overall liberalization of our economy, while, at the same time, gradually increasing reliance on market mechanisms in determining the exchange rate of the Korean won.

2. Under the new system, the won/dollar rate, to be called the Market Average Rate (MAR), will be determined by taking the weighted average of interbank rates of all local and foreign banks for won/dollar spot transactions of the previous day.

- In the case that a daily interbank transaction amount falls below 50 percent of the daily average transaction amount of the previous year, the MAR will be calculated on the basis of the two days' weighted average by adding it together with the transaction of the day immediately preceding.

- As each interbank transaction is concluded, the MAR will be calculated at the end of each business day by the Foreign Exchange Trading Office (FETO) of the Korea Financial Telecommunications Clearing Institute.

- The MAR will be recorded by the FETO through AP Telerate or Reuter monitor at 09:00 a.m. daily.

- The won exchange rate against other currencies will be determined by the arbitrage rate which takes into account U.S. dollar rates against other currencies in the international foreign exchange market.

- Interbank exchange rates will be allowed to float freely, but within a range set by the following formula:

Upper band: MAR + (MAR x 0.4 percent)

Lower band: MAR - (MAR x 0.4 percent)

- Banks will be permitted to set the T/T rates offered to their customers freely within the range of the market average exchange rate.

- The T/T rates will be determined in the same manner as the current system. The won's rate against the U.S. dollar will be set anywhere within the range of the MAR by the following formula.

$$\frac{\begin{array}{l} \text{T/T Exchange Rate} \\ \text{(against the U.S. dollar)} \end{array}}{\text{MAR} - (\text{MAR} \times 0.4 \text{ percent})} \quad \text{MAR} \quad \frac{\begin{array}{l} \text{T/T Selling Rate} \\ \text{(against the U.S. dollar)} \end{array}}{\text{MAR} + (\text{MAR} \times 0.4 \text{ percent})}$$

3. The won exchange rate against other currencies will be set anywhere within the range of the arbitrage rate by the following formula.

Upper band: arbitrage rate + (arbitrage rate x 0.8 percent)

Lower band: arbitrage rate - (arbitrage rate x 0.8 percent)

$$\frac{\begin{array}{l} \text{T/T Buying Rate} \\ \text{(against other currencies)} \end{array}}{\text{Arbitrage rate} - (\text{arbitrage rate} \times 0.8\%)} \quad \text{Arbitrage rate} \quad \frac{\begin{array}{l} \text{T/T Selling Rate} \\ \text{(against other currencies)} \end{array}}{\text{Arbitrage rate} + (\text{arbitrage rate} \times 0.8\%)}$$

4. There will be no MAR on March 2, namely the effective date. Instead, the Bank of Korea Concentration Rate from February 28 will play the role of the MAR on March 2."

