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Non-Deliverable Currency and Procyclical Capital Flows: Analysis with Australian and Korean Data

An open economy may restrict offshore trading of its currency e.g., for fear of speculative attacks from offshore. The currency control, however, may impede the functioning of hedging markets. By comparing the cross-border banking in the ideal state where banks use cross-currency swaps to borrow from abroad in home currency and the alternative state where the currency control blocks it, I find the followings. In the former, the combination of long-term currency swap and offshore bond issuance helps re-allocate risks to the parties that can best bear them. The full hedging against currency risks thereby facilitates banks and firms to specialize at the global level. In the latter, the currency control makes the host country unable to hedge and suffer from procyclical capital flows. A juxtaposition of Korean data against those of Australia during the period 2001-2010 produces evidence in support of the hypothesis.