OPINION

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Assessing the Drivers of Recent Won Depreciation and Its Macroeconomic Implications

The recent rise in the KRW/USD exchange rate is assessed to reflect a combination of structural factors—such as increased overseas securities investment driven by ageing and slower growth—and cyclical factors, including co-movement with the Japanese yen and the AI investment boom. Nevertheless, external soundness appears broadly solid, given the expansion of net foreign assets, net foreign portfolio inflows, low exchange-rate volatility, and favorable readings in CDS spreads and short-term external debt indicators. Despite concerns that a weaker won could raise import costs, the direct effect on consumer inflation is estimated to be limited when the year-on-year increase in the 2025 average exchange rate is taken into account. In an environment of heightened uncertainty in trade policy, won weakness may also have some scope to support exporters' price competitiveness. Overall, with external soundness remaining solid, it is appropriate to avoid a simplistic interpretation of the exchange-rate level, while maintaining a balanced focus on volatility management and cost burdens on vulnerable sectors.

The KRW/USD exchange rate has remained at elevated levels, at one point rising to around KRW 1,480 intraday, amplifying concerns about financial-market instability and inflation pressures via higher import prices. Some have argued that rising prices of imported raw materials could deteriorate corporate profitability and households' real income, placing a heavier burden on low-income households and small and medium-sized enterprises. At this juncture, it is important to assess the exchange-rate level objectively and rationally—guarding against excessive fear—while considering appropriate policy responses. Since the recent won weakness reflects structural changes in the Korean economy, this note analyzes the structural

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

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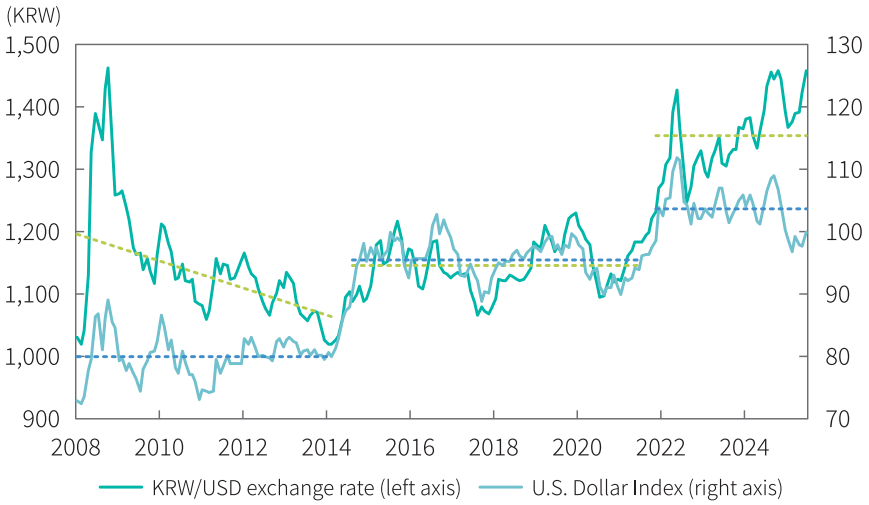
and cyclical drivers of the exchange-rate increase and assesses the implications for external credibility and the macroeconomy.

Structural drivers of the rise in the KRW/USD exchange rate

As shown in <Figure 1>, the KRW/USD exchange rate traded around an average of roughly KRW 1,150 in the pre-pandemic period (2015–2021). Since the pandemic, however, it has formed a new equilibrium range around KRW 1,350—about KRW 200 higher on average. This structural upward shift in the exchange-rate level can be understood as the result of combined external and domestic factors.

Figure 1. Long-run trends in the KRW/USD exchange rate and the U.S. dollar index since the Global Financial Crisis



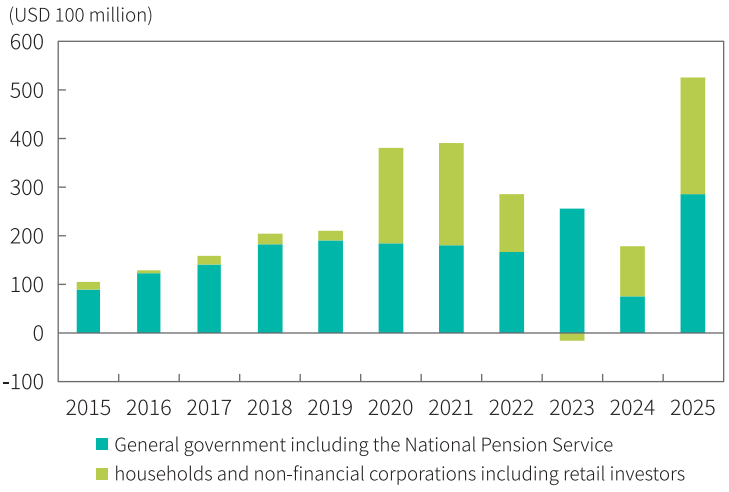
Note: Monthly-average exchange rate. The dotted lines denote trend lines within each subperiod: June 2008–June 2014 (first), January 2015–December 2021 (second), and April 2022 onward (third).
Source: Refinitiv; Bank of Korea.

Externally, a key factor was the sharp rise in the U.S. dollar index after the pandemic, driven by the Federal Reserve's aggressive policy-rate increases relative to other major economies. However, the medium-term level of the exchange rate is not explained by dollar strength alone; it is also shaped by the cumulative effects of domestic fund flows and changes in the investment structure. Domestically, as ageing progresses, domestic saving—especially long-term funds such as pension assets—has expanded, while weakening growth momentum and constraints on domestic investment opportunities have strengthened institutional and retail

investors' preference for foreign assets. This tends to structurally increase demand for U.S. dollars in the FX market.

These structural developments are also visible in trends in residents' overseas securities investment. <Figure 2> decomposes residents' overseas securities investment since 2015 into (i) "general government (including the National Pension Service)" and (ii) the "nonfinancial sector (including individual investors)." Since 2018, residents' overseas securities investment has generally exceeded USD 20 billion per year and remained high, suggesting that a medium- to long-term portfolio reallocation toward foreign assets is under way rather than a temporary concentration. In this process, overseas investment by general government (including the NPS) has formed a relatively resilient underlying trend despite cyclical swings in activity and sentiment, while overseas equity investment by individual investors surged in 2020–2022, went through an adjustment, and has expanded again since 2024. Moreover, these changes in the supply–demand structure can interact with expectations about domestic–foreign relative returns—particularly the market's perception of the medium-term equilibrium level of long-term interest rates—thereby influencing interest-rate differentials and exchange-rate expectations. Indeed, bond markets have been assessing the U.S. equilibrium rate as close to 4%, while Korea's is viewed as in the mid-2% range; such perceptions may strengthen expectations of won weakness over the medium term by increasing incentives for overseas investment through anticipated interest-rate differentials.

Figure 2. Residents' overseas equity investment by sector

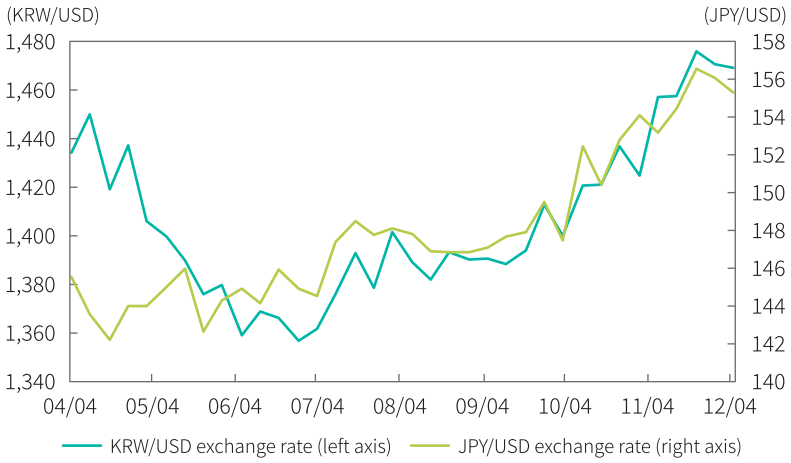


Note: For 2025, data cover January–October.
Source: Bank of Korea.

Cyclical factors and co-movement with the Japanese yen

Recent exchange-rate increases are difficult to explain by structural factors alone; cyclical factors appear to have accelerated the pace of depreciation. Since late 2024, the KRW/USD exchange rate has at times diverged from movements in the U.S. dollar index. For example, even during periods in 2025 when the dollar index declined, the KRW/USD exchange rate continued to face upward pressure, co-moving with the JPY/USD exchange rate. The yen's weakness this year can be interpreted as reflecting market reassessments of the pace of Bank of Japan rate hikes, as well as expectations of fiscal expansion in Japan and the associated policy mix. In addition, as issues commonly facing Korea and Japan—such as a strengthening U.S. protectionist stance and pressure to increase investment in the United States—have come to the fore, market participants have increasingly treated the JPY/USD exchange rate as an important reference rate for the KRW/USD exchange rate (see <Figure 3>).

Figure 3. KRW/USD and JPY/USD exchange rates



Note: Weekly data.
Source: Refinitiv; Bank of Korea.

This cyclical environment appears to have amplified exchange-rate pressures in the short run by interacting with increased investment in U.S. equities amid the AI investment boom. As noted earlier, overseas securities investment has been expanding on a medium- to long-term basis (a structural trend), but in particular years the magnitude can increase sharply depending on private-sector risk appetite and exchange-rate expectations. As shown in <Figure 2>, during January–October 2025, overseas equity investment by general government (including the

NPS) and by individual investors rose to unusually high levels—equivalent to 3.8 times and 2.3 times, respectively, their full-year 2024 amounts. In other words, atop the structural trend toward more overseas investment, 2025 saw a short-term concentration of residents' overseas investment that drove a surge in dollar demand, which may have further lifted the exchange rate through short-term flows and expectations.

Meanwhile, global investment banks have noted that the cyclical factors that fueled the recent exchange-rate rise may gradually ease. Factors cited as supportive for the won include Federal Reserve rate cuts alongside gradual normalization by the Bank of Japan, potential inflows associated with Korea's bond market joining the World Government Bond Index (WGBI), and a domestic economic recovery. The median end-2026 KRW/USD forecast compiled by Reuters is KRW 1,418.5, which is below the current level. However, as this forecast implies, even if cyclical factors fade, the downward adjustment in the exchange-rate level could be limited as long as structural drivers—such as increased overseas securities investment—remain in place. Accordingly, the future path of the KRW/USD exchange rate is likely to evolve around the higher baseline level determined by structural factors, while cyclical factors such as rate expectations, risk appetite, and co-movement with other currencies drive its direction and volatility.

Macroeconomic implications and assessment of external credibility

A higher KRW/USD exchange rate has both positive and negative effects: it can boost exports via improved price competitiveness, while also reducing domestic real income through higher import prices and potentially increasing financial instability. As inflation rose after the pandemic, surging import prices—especially for energy and food—added to pressures on domestic prices and consumption, amplifying concerns about the adverse effects of exchange-rate depreciation. Moreover, if the exchange rate spikes rapidly and volatility increases, confidence in the won can weaken and capital outflows may intensify, creating risks to financial stability.

First, despite these concerns, recent indicators of external soundness have remained stable. As shown in <Table 1>, volatility has stayed relatively low even as the KRW/USD exchange rate has risen, and there have been no notable signs of stress in external credibility indicators such as Korea's CDS spreads or foreign capital-flow dynamics. From September through November 2025, foreign portfolio investment recorded average monthly net inflows of USD 4.7 billion,

while CDS premia on Korea's Foreign Exchange Stabilization Bonds (FESB) remained stable in the low-20 bp range.

Table 1. Recent trends in exchange-rate volatility, CDS spreads, and net inflows of foreign portfolio investment

	2024	2025	Sep	Oct	Nov
Average daily volatility	0.46	0.50	0.39	0.44	0.43
Net inflows of foreign portfolio investment (USD bn)	207.7	346.2	91.2	22.9	26.8
(Equities)	20.2	-82.5	43.4	30.2	-91.3
(Bonds)	187.6	428.7	47.8	-7.2	118.1
FESB CDS premium (bp)	34	28	20	24	23

Note: Average daily volatility is the conditional volatility estimated from a GARCH model using daily exchange-rate returns. Foreign portfolio investment refers to net inflows over the period, and the FESB(Foreign Exchange Stabilization Bond) CDS premium is the period average.

Source: Bank of Korea.

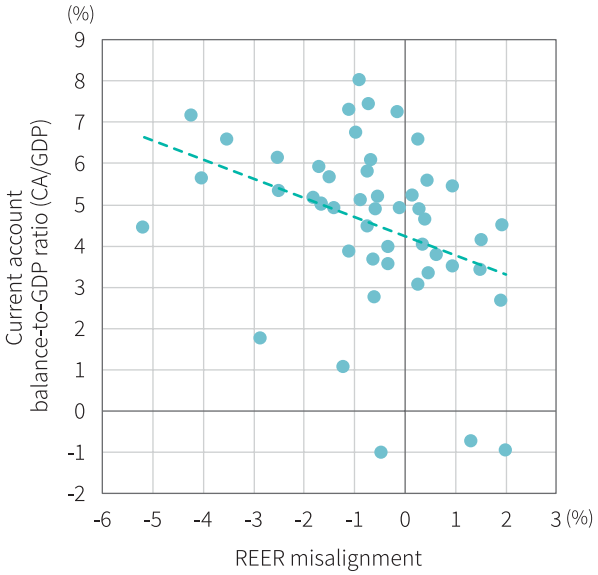
This stability can also be linked to the significant accumulation of net foreign assets (NFA) as overseas investment has expanded—one of the factors often cited behind the exchange-rate rise—alongside Korea's solid fundamentals. Korea's NFA exceeded USD 1 trillion for the first time at end-2024, reaching about 54% of GDP as of 2025 Q3. A larger NFA position implies a greater buffer for securing foreign-currency liquidity if needed by repatriating overseas assets, and if the won becomes excessively undervalued, private-sector repatriation flows can help stabilize the market. In addition, unlike the two past crises when a rapid increase in short-term foreign-currency borrowing was a key vulnerability, structural risks have been reduced through strengthened FX prudential regulation and management of short-term external debt. Whereas the short-term external debt ratio rose sharply and exceeded 50% of GDP shortly before the 1997 and 2008 crises, it stood at about 14% of GDP as of 2025 Q3. In this context, Bank of Korea Governor Chang-yong Rhee's remark that "unlike the past, when the exchange rate above 1,400 KRW per USD raised financial-stability concerns, there is no FX market instability now" can be understood.

The direct impact of exchange-rate depreciation on consumer inflation is also assessed to be limited. According to Bank of Korea estimates, a 1% increase in the KRW/USD exchange rate raises consumer prices by about 0.03 percentage points. On this basis, if the 2025 average

KRW/USD exchange rate is assumed to rise by about 4% year-on-year (using an average of KRW 1,420 up to December 12, 2025), the direct contribution to the CPI inflation rate is estimated at roughly 0.1 percentage points. In addition, the prevalent expectation that global commodity prices, including crude oil, will trend lower and stabilize going forward also helps mitigate inflation concerns. In particular, falling oil prices can reduce import prices and may offset a substantial portion of the domestic price pressures arising from exchange-rate depreciation.

Meanwhile, while the export-stimulating effect of a weaker won has diminished relative to the past—given the increasing technology intensity of exports and the larger share of imported intermediates—it can still serve as a buffer for exports and the current account through price competitiveness. As shown in <Figure 4>, a more undervalued won tends to be associated with an improvement in the current account balance. Especially in an environment of heightened trade-policy uncertainty, exchange-rate depreciation may help offset part of the loss of price competitiveness stemming from U.S. tariff increases, thereby easing pressures for an export slowdown. For example, reflecting unit-price cuts in response to tariff increases, the automobile export price index in November 2025 fell 8.5% year-on-year in contract currency terms. In won terms, however, the decline was limited to 2.8%, suggesting that the exchange rate absorbed part of the price-adjustment shock.

Figure 4. The won's real effective exchange rate and the current account



Note: 2013 Q1–2025 Q3. The gap (misalignment) in the real effective exchange rate is estimated by applying the Berger & Kempa (2014) model to Korean data; a negative value indicates undervaluation of the won. To reflect J-curve effects, the current account is measured with a two-quarter lag relative to the real effective exchange rate. (Berger, T., & Kempa, B., 2014, "Time-varying equilibrium rates in small open economies: Evidence for Canada," Journal of Macroeconomics.)

In sum, given the larger external buffers relative to the past—such as the accumulation of net foreign assets—and the expectation that exchange-rate pass-through to inflation will be limited, it is judged less likely that a high exchange rate will translate into an immediate and broad-based shock to the real economy, compared with past high-exchange-rate episodes during financial crises. Ultimately, what matters is not the level of the exchange rate per se, but the speed of change. If the exchange rate remains high for some time without abrupt swings, economic agents can secure time to adjust costs and prices, thereby absorbing shocks, and potentially gain time for structural adjustments such as changes in production and import structures. Accordingly, while avoiding a simplistic interpretation of the exchange-rate level, it is important to maintain a balanced focus on whether volatility is rising, the cost burden on vulnerable sectors, and how changes in overseas investment flows affect FX supply–demand conditions and financial markets.