



## Why Is the KRW Weakening Despite Abundant U.S. Dollar Liquidity in the Foreign Currency Funding Market?

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Recently, a seemingly paradoxical phenomenon—often described as “poverty amid plenty”—has been observed in the foreign exchange market. In the foreign currency funding market, where participants borrow and lend foreign currencies, U.S. dollars are abundant, with many entities willing to lend even at low interest rates. By contrast, in the spot foreign exchange market, where U.S. dollars are bought and sold outright, market participants are reluctant to sell dollars and are instead seeking to purchase them. As a result, the USD/KRW exchange rate has risen (reflecting an appreciation of the U.S. dollar) and has shown little tendency to decline[Figure 1]. In financial markets, periods when funding is difficult to obtain are generally described as crises and are often characterized as times of severe liquidity shortages. From this perspective, the current situation—where U.S. dollar funding is readily available at low interest rates—can hardly be described as a crisis in the foreign exchange market.

Nevertheless, some observers have begun to draw comparisons between the elevated exchange rate in the spot foreign exchange market and the levels recorded during past foreign exchange and financial crises(in 1997 and 2008), going so far as to raise concerns about the possibility of another financial crisis. Even if such crisis narratives or pessimistic views are not fully supported by the underlying economic fundamentals, their widespread diffusion among economic agents can lead to the formation of one-sided expectations regarding the exchange rate, thereby increasing the risk of a self-reinforcing adverse cycle in the foreign exchange market.

To clarify why such concerns may be overstated, this blog post examines the background to the seemingly contradictory situation in which the exchange rate has risen despite ample U.S. dollar liquidity in Korea’s foreign exchange market. To this end, it is useful to begin by distinguishing between two segments of the foreign exchange market: the foreign currency funding market (swap market), where U.S. dollars are borrowed and lent, and the spot foreign exchange market, where U.S. dollars are bought and sold outright.

## U.S. Dollar Liquidity Is Abundant in the Foreign Currency Funding Market

In the foreign currency funding market, the most representative transaction is a foreign exchange swap. Under this arrangement, participants post Korean won as collateral, borrow U.S. dollars for use, and, after a specified period (for example, three months), return the U.S. dollars and receive the Korean won in exchange. At present, the interest rate on borrowing Korean won in Korea (for example, a three-month rate of 2.4 percent) is lower than the interest rate on borrowing U.S. dollars in the United States (for example, a three-month short-term rate of 3.6 percent). Accordingly, lenders of U.S. dollars seek to earn at least the interest rate differential (for example, 1.2 percentage points = 3.6% - 2.4%) over the lending period. In practice, however, because the U.S. dollar is the world's key reserve currency and is subject to strong global demand, U.S. dollar funding typically carries a premium, or additional spread, over and above the bilateral interest rate differential. In Korea as well, borrowers seeking U.S. dollars must pay an additional spread—referred to as the “arbitrage incentive” (for example, 34 basis points, or 0.34 percent)—in excess of the Korea - U.S. interest rate differential. As a result, obtaining U.S. dollar funding by swapping Korean won into U.S. dollars entails paying interest equal to the sum of the interest rate differential (for example, 1.2 percent) and the additional spread (34 basis points), amounting to a total of 1.54 percent (= 1.2% + 0.34%). The interest rate paid when borrowing U.S. dollars through such a time-bound exchange of Korean won and U.S. dollars is referred to as the 'swap rate'<sup>1)</sup>.

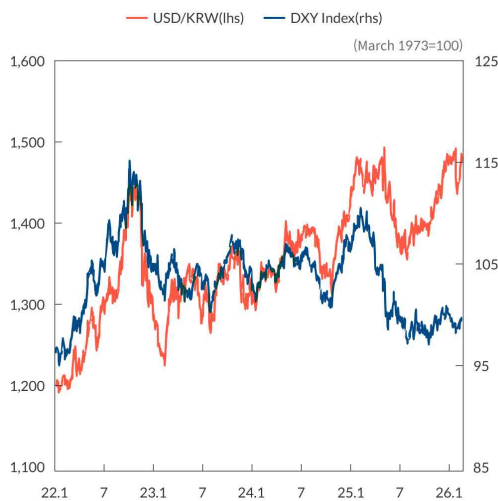
The size of the additional spread (the arbitrage incentive) is calculated using observed market data as the difference between the Korea - U.S. interest rate differential and the swap rate, and is shown as the shaded area in Figure 2. This additional spread narrows when the supply of U.S. dollars available for lending in the foreign currency funding market exceeds borrowing demand, and widens in the opposite case. The recent sharp decline in the spread<sup>2)</sup> indicates that U.S. dollar funding has become very readily available among financial institutions, including banks.

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1) By convention, the swap rate is quoted from the perspective of the U.S. dollar lender, as the interest rate paid to obtain the local currency (Korean won). Accordingly, it is expressed as a negative figure (-1.54 percent), indicating that the lender receives interest. At present, because U.S. interest rates are higher than those in Korea—a situation of interest rate inversion—the swap rate is negative. If Korean interest rates were to rise above U.S. interest rates, the swap rate would turn positive. Meanwhile, in the absence of any additional spread (the arbitrage incentive), the swap rate would be equal to the interest rate differential, implying that expected returns across currencies are equal. The theoretical condition under which this holds is known as 'Interest Rate Parity Theory'.

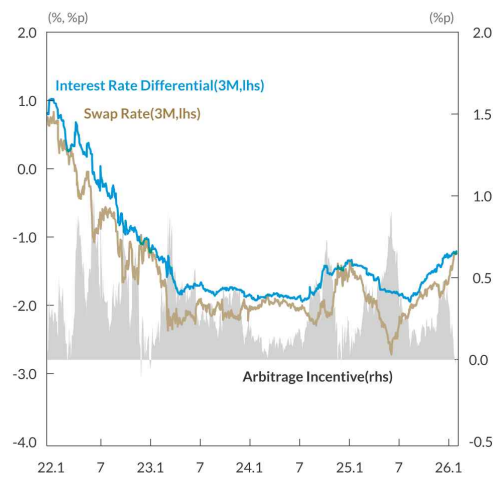
2) For three-month maturities, the spread narrowed from 41 basis points at end-June 2025 to 22 basis points at end-December 2025, and narrowed further to 4 basis points as of January 15, 2026.

**Figure 1. USD/KRW Exchange Rate and the U.S. Dollar Index**



Source: Bank of Korea; Bloomberg

**Figure 2. Three-Month Swap Rate and Korea–U.S. Interest Rate Differential<sup>1</sup>**



Note: 1) Monetary Stabilization Bond (91-day) minus Term SOFR (3-month)  
Source: Korea Money Brokerage; Korea Financial Investment Association

The recent abundance of U.S. dollar liquidity in the foreign currency funding market reflects, first, the presence of a large current account surplus<sup>3)</sup>, together with a shift in corporate behavior toward retaining, rather than selling (converting), the U.S. dollars earned from exports and accumulating them as foreign currency deposits. In particular, during November - December 2025, firms—especially small and medium-sized importers—tended to increase their foreign currency deposits<sup>4)</sup> whenever the exchange rate declined. This behavior can be interpreted as reflecting a precautionary motive to secure U.S. dollars in advance in anticipation of a potential increase in import payments associated with exchange rate depreciation.

In addition, the “Measures for Flexible Adjustment of the Foreign Exchange Soundness Framework<sup>5)</sup>”, announced by the Bank of Korea and the Korean government to promote foreign currency inflows, have also contributed to increasing foreign currency liquidity in the foreign currency funding market. At the same time, foreign bond inflows last year were 2.7 times larger than in the previous year. Given that more than half of these bond-related funds are invested using Korean won<sup>6)</sup> obtained by lending U.S. dollars through foreign exchange swaps, foreign

3) The current account surplus for 2025 is projected to amount to USD 115 billion, representing an increase of USD 16 billion from the previous year and the highest level on record.

4) The share of small and medium-sized enterprises in total corporate U.S. dollar deposit balances increased from 54 percent in January 2025 to 60 percent in December 2025.

5) The main elements of these measures include: (i) a temporary deferral, until end-June 2026, of supervisory burdens related to enhanced foreign currency liquidity stress tests; and (ii) a relaxation of the forward foreign exchange position limit for domestic subsidiaries of foreign banks to 200 percent.

6) In general, exchange rate volatility is higher than the volatility of returns from bond holdings. As a result, a substantial share of foreign investors in domestic bonds choose to obtain Korean won through swaps in the foreign currency funding market—rather than buying or selling Korean won directly in the spot foreign exchange market—thereby investing in domestic bonds without bearing exchange rate risk over the investment horizon.

bond investment has become a major source of U.S. dollar supply in the foreign currency funding market.

## **In the Spot Foreign Exchange Market, Strong Demand for U.S. Dollars Is Keeping the Exchange Rate at Elevated Levels**

In the long run, exchange rates are influenced by fundamental factors such as inflation differentials, differences in economic growth, and interest rate differentials between countries. In practice, however, the exchange rate is essentially a price determined in the spot foreign exchange market by the interaction of demand and supply for foreign currency. As a result, in the short run, imbalances in demand and supply at a given point in time play a decisive role in determining both the direction and the magnitude of exchange rate movements. That said, it should be noted that underlying these demand and supply conditions are fundamental factors as well as the expectations of various market participants.

Meanwhile, if one were to identify the single most important and observable factor driving movements in the USD/KRW exchange rate, it would be the global value of the U.S. dollar. The value of the U.S. dollar reflects the combined effects of numerous variables in the international economy and financial markets, as well as market expectations, and is commonly measured by the U.S. Dollar Index (DXY)<sup>7</sup>. Like most other currencies outside the group of major global currencies, the USD/KRW exchange rate generally tends to move in the same direction as the DXY and by a similar magnitude.

From this perspective, the upward trend in the USD/KRW exchange rate since 2022 can be interpreted as reflecting factors such as widening interest rate and growth differentials between Korea and the United States, as well as the relatively low returns on domestic financial assets [Figure 1]. In particular, in 2022, the U.S. Federal Reserve raised its policy interest rate by a cumulative 3.00 percentage points—from 0.00 - 0.25 percent to 3.00 - 3.25 percent by September—and expectations of further rate hikes intensified the appreciation of the U.S. dollar. By its peak in late September 2022, the U.S. Dollar Index had risen by around 19 percent from the beginning of the year, and the USD/KRW exchange rate increased by a broadly similar magnitude. Over the same period, the Bank of Korea also raised its policy rate, but by a much smaller margin of 1.25 percentage points (from 1.25 percent at the beginning of the year to 2.50 percent in August). As a result, by September, interest rates in the United States had already surpassed those in Korea.

Accordingly, the Bank of Korea faced the challenge of identifying an effective policy mix—combining foreign exchange and monetary policy measures—to address simultaneously elevated

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7) It is calculated as the geometric average of the U.S. dollar's exchange rates against six major currencies—the euro, Japanese yen, British pound, Canadian dollar, Swedish krona, and Swiss franc. An increase in the index indicates an appreciation of the U.S. dollar.

inflation, a sharp rise in the exchange rate, and the emergence of stresses in the real estate project finance (PF) market in September. With respect to the exchange rate, the authorities opted for a policy approach that allowed the USD/KRW exchange rate to fluctuate broadly in line with movements in the U.S. Dollar Index, thereby enabling the exchange rate to absorb external shocks. Constraining exchange rate depreciation more aggressively would have required substantially larger policy rate hikes. Had such a course been pursued, it could have triggered financial market instability, particularly in the real estate PF sector, and inflicted significant damage on the domestic economy. As a result of this policy mix, the exchange rate has fluctuated within a range that does not deviate markedly from movements in the U.S. Dollar Index, as illustrated in Figure 1.

Looking at the period as a whole—from 2022 through mid-January of this year—the U.S. Dollar Index increased by around 4 percent, indicating an appreciation of the U.S. dollar, while the USD/KRW exchange rate rose by approximately 23 percent, reflecting a depreciation of the Korean won. This indicates that the divergence between the two has widened over this period. That said, this divergence is not unique to Korea. Over the same period, the Japanese yen depreciated by around 37 percent, a considerably larger decline in value than that observed for the Korean won.

This blog focuses on developments over the past year and seeks to explain the main factors behind the divergence between the USD/KRW exchange rate and the U.S. Dollar Index. Looking first at foreign exchange flows in 2025, Korea recorded a large current account surplus (USD 101.8 billion during January - November 2025). However, residents' overseas securities investment (USD 129.4 billion over the same period) and outward direct investment<sup>8)</sup> (USD 26.8 billion) far exceeded foreign investors' portfolio investment in domestic securities<sup>9)</sup> (USD 50.4 billion over the same period) and inward direct investment (USD 6.3 billion). At first glance, the scale of the current account surplus (foreign exchange supply) appears broadly comparable to the combined net outflows from securities investment (USD 79.0 billion = 129.4 - 50.4) and direct investment (USD 20.5 billion = 26.8 - 6.3), which together amount to USD 99.5 billion in foreign exchange demand, suggesting a broadly neutral impact on the exchange rate. In practice, however, substantial mismatches in supply and demand emerged in the spot foreign exchange market [Figures 3 and 4].

As noted earlier, while the proportion of U.S. dollars earned by exporting firms that are sold in the foreign exchange market has declined compared with the past, the supply of funds to the foreign currency funding market has increased through foreign currency deposits placed at financial institutions.

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8) In the direct investment figures, the item "Reinvestment of earnings," which represents profits reinvested locally, is excluded. The same treatment applies to foreign investors' direct investment.

9) The figures are based on balance of payments statistics for January–November 2025. As a result, differences arise compared with the "foreign investors' securities investment" figures for 2025 referred to in the following paragraph, owing to differences in the reference period and statistical compilation methodology.

Residents' overseas securities investment during January - November 2025 (USD 102.4 billion in equities and USD 27.0 billion in bonds) was heavily concentrated in equities, which accounted for around 80 percent of the total. As a result, most of these investments were converted into U.S. dollars and flowed overseas. By contrast, foreign investors' securities investment in Korea in 2025 (equities: -USD 7.1 billion; bonds: USD 49.1 billion) consisted solely of bond inflows, of which only about half are typically converted into Korean won. Consequently, U.S. dollar sales in the spot foreign exchange market remained limited.

Meanwhile, as this imbalance in U.S. dollar transactions became particularly concentrated in the fourth quarter of 2025, the decoupling between the USD/KRW exchange rate and the U.S. Dollar Index intensified markedly [Figure 5]. More specifically, residents' overseas equity investment recorded unprecedented outflows of around USD 30 billion during October - November 2025 [Figure 4]. Over the same period, while foreign investors expanded their bond investment in the fourth quarter of 2025, equity investment once again turned to net outflows, amounting to -USD 9.1 billion in November alone [Figure 6]. As most equity-related capital flows by both residents and foreign investors were converted into U.S. dollars and flowed out, the exchange rate came under strong upward pressure. By contrast, a substantial portion of foreign investors' bond investment funds was supplied as U.S. dollar liquidity through swap transactions, leading to ample liquidity in the foreign currency funding market. In addition to these developments, from late November onward, increased U.S. dollar purchases<sup>10)</sup> in the offshore non-deliverable forward (NDF) market further amplified this pattern. As a result, U.S. dollar supply in the foreign currency funding market increased, while demand for U.S. dollars in the spot foreign exchange market also rose, widening the imbalance between the two markets. This led to a situation in which "abundance" in the foreign currency funding market coexisted with a "shortage" of U.S. dollars in the spot foreign exchange market.

This pattern has largely persisted through January 2026. In the case of the National Pension Service, strategic foreign exchange hedging is implemented flexibly in response to market conditions. As a result, the increased strategic ambiguity surrounding this framework appears to have contributed to easing foreign exchange supply - demand imbalances. However, while foreign equity investment has shifted from inflows at the beginning of the year to outflows, high-frequency data on individual investors' overseas securities investment indicate that outflows have continued at a pace similar to that observed in October - November of last year<sup>11)12)</sup>, when

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10) When offshore investors purchase U.S. dollars in the NDF market, the counterparty banks take short positions in forward foreign exchange contracts. To neutralize these positions, banks purchase U.S. dollars in the spot foreign exchange market and then execute sell-and-buy swap transactions (spot dollar sales combined with forward dollar purchases) in the foreign currency funding (swap) market. Through this process, U.S. dollars are supplied to the foreign currency funding market.

11) According to balance of payments financial account statistics, overseas equity investment by the category "nonfinancial corporations, households and NPISHs." (which is treated as a proxy for retail investors) reached a record high of approximately USD 7.4 billion in October 2025. Taking into account the compilation lag in balance of payments statistics (with the latest data available through November 2025), reference to foreign securities custody and settlement data from the Korea Securities Depository indicates that overseas securities investment amounted to USD 2.2 billion during January 1-15, 2026.

investment volumes expanded sharply [Figure 4]. This is assessed to reflect the fact that, although returns in the domestic equity market have been very strong from last year through this year, expectations of returns on U.S. equities—formed over a long period—remain elevated.

## **To Restore Stability, It Is Necessary to Ease Expectations of Further Depreciation of the Korean Won**

Owing to the factors discussed above, the current situation—characterized by an abundance of U.S. dollar liquidity in the foreign currency funding market and historically low U.S. dollar borrowing costs—is fundamentally different from the foreign exchange and financial crises of 1997 and 2008, when access to U.S. dollar funding was severely constrained. Conditions for borrowing U.S. dollars are highly favorable not only in the domestic market but also in global markets. Specifically, credit spreads on foreign currency-denominated bonds (Korea Paper, or KP) issued by domestic financial institutions and corporations remain at historically low levels of around 50 basis points. In addition, spreads on Korean government foreign exchange stabilization bonds are stable at the mid-30 basis point range, while credit default swap (CDS) premiums are also hovering at around 20 basis points. Foreign exchange and financial crises fundamentally arise when a country's external payment capacity<sup>13)</sup> weakens—that is, when credit risk increases and access to U.S. dollar funding becomes impaired. In such circumstances, both the cost of U.S. dollar borrowing (credit spreads) and the exchange rate tend to rise simultaneously. In other words, crises are triggered when the spot foreign exchange market and the foreign currency funding market interact strongly in an adverse direction, with demand for both U.S. dollar borrowing and spot purchases increasing at the same time.

Therefore, simply pointing to a higher exchange rate and asserting the possibility of a traditional sovereign default or foreign exchange crisis, as experienced in the past, is not warranted. For example, although the Japanese yen has depreciated by nearly twofold since 2010, Japan—holding substantial overseas assets—is not regarded as being in a foreign exchange crisis. Over the same period, the Korean won has depreciated by a much smaller margin of around 30 percent. Moreover, Korea is a net external creditor with ample foreign exchange reserves and sizable net external assets, placing the current situation well outside the range of conditions typically associated with a crisis. Accordingly, there is no reason to fear a recurrence of past-style financial crises or to overreact solely on the basis of exchange rate movements.

That said, the spread of unfounded pessimism—claiming that a rise in the exchange rate is, in

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12) Some seasonal factors are also at play. Retail investors tend to sell overseas equities in December to take advantage of the capital gains tax exemption (up to KRW 2.5 million) and then repurchase them in January. Over the period from 2021 to 2025, 17.9 percent of annual net overseas equity purchases by retail investors occurred in January.

13) As of the third quarter of 2025, Korea's net external financial assets stood at USD 1.1 trillion, while the share of short-term external debt remained at 21.9 percent, continuing to stay below the post-2021 average of 24.5 percent.

itself, evidence of weakening economic fundamentals—calls for caution. Such narratives can lead to self-fulfilling capital outflows and additional upward pressure on the exchange rate, thereby imposing substantial costs on the economy. Moreover, if the exchange rate were to rise to and remain at elevated levels, it could intensify domestic inflationary pressures and increase the burden on domestic demand, small and medium-sized enterprises, and the general public. In this respect, while alarmist interpretations should be avoided, it is nevertheless necessary to respond with a sense of vigilance to the potential adverse effects of sustained exchange rate depreciation.

Accordingly, while continuing to strengthen fundamental factors over the medium to long term, it is necessary in the short term to ease supply - demand imbalances and thereby mitigate the formation of one-sided expectations regarding the exchange rate. While increasing overseas investment through U.S. dollar purchases in anticipation of higher expected returns may be rational from the perspective of individual economic agents, such behavior does not necessarily lead to desirable outcomes from the standpoint of overall financial stability, a risk that policymakers must remain mindful of. In this context, the foreign exchange market measures announced by the Bank of Korea and the Korean government in December 2025—including verbal intervention and steps to stabilize foreign exchange supply and demand<sup>14)</sup>—can be viewed as short-term policy responses that took these considerations into account, and are assessed to have reduced, to some extent, the decoupling from the U.S. dollar.

In 2026, the USD/KRW exchange rate has continued to be influenced primarily by conditions in international financial markets—including U.S. dollar strength and Japanese yen weakness—while still facing additional upward pressure stemming from domestic factors specific to Korea. This appears to reflect not only strong resident demand for overseas investment but also expectations that the Korean won will remain relatively weaker than other currencies. Encouragingly, global investors continue to maintain confidence in Korea’s economic fundamentals. For example, major international investment banks generally project that the USD/KRW exchange rate will decline over time from its current level.

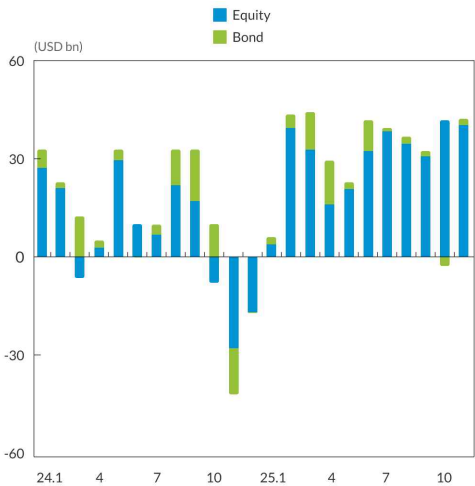
Accordingly, there is a need to pursue a consistent policy approach aimed at stabilizing expectations that have formed over several months. In particular, the National Pension Service’s new investment framework leaves room for adjustments to its foreign exchange hedging and overseas investment strategies, and thus may serve as a factor improving foreign exchange supply and demand over both the short and long term. In addition, Korea’s scheduled inclusion in the

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14) Specifically, foreign exchange soundness levies imposed on foreign exchange banks were temporarily waived for six months, and it was decided to pay interest for six months on excess foreign currency reserve deposits held by financial institutions at the Bank of Korea. In addition, for retail investors, a temporary reduction in capital gains tax on overseas equity sales was introduced when the proceeds are reinvested domestically for the long term, alongside the introduction of forward foreign exchange products for retail investors and tax deductions for capital gains when exchange rate hedging is undertaken. Furthermore, the income exclusion ratio applied to dividend income received by domestic parent companies from overseas subsidiaries was raised from 95 percent to 100 percent.

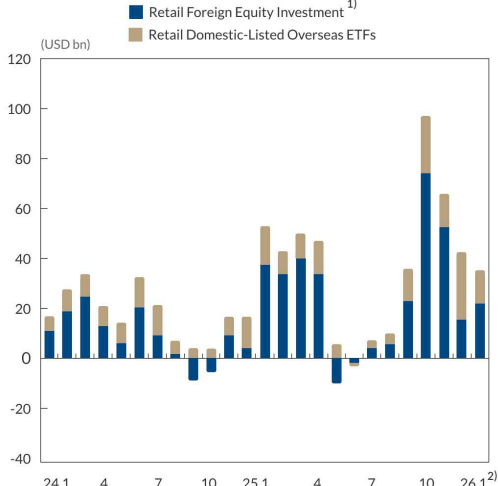
World Government Bond Index (WGBI) in April this year, along with ongoing efforts to enhance access to the domestic capital market in preparation for potential inclusion in the MSCI Developed Markets Index, are expected to bring about tangible improvements in foreign exchange supply and demand conditions. As these improvements interact positively with shifts in market expectations, the current mismatch—characterized by “scarcity” in the spot foreign exchange market and “abundance” in the foreign currency funding market—is expected to be gradually resolved.

**Figure 3. Overseas Securities Investment by the National Pension Service<sup>1</sup>**



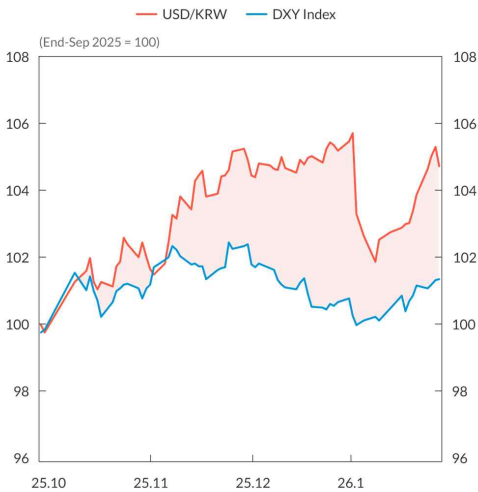
Note: 1) In balance of payments financial account statistics, the category “general government” is treated as overseas securities investment by the National Pension Service.  
Source: Bank of Korea

**Figure 4. Overseas Equity Investment by Retail Investors**



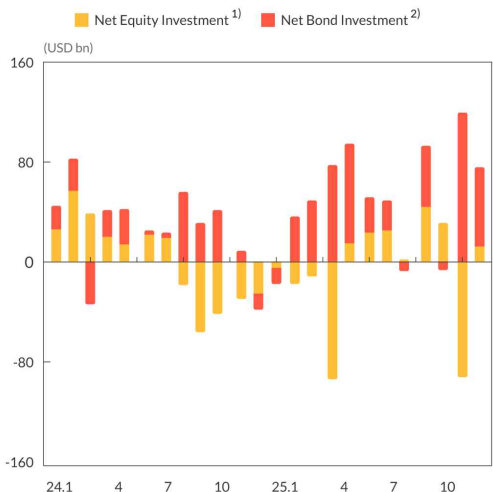
Notes: 1) Balance of payments statistics through November 2025; Korea Securities Depository data thereafter.  
2) For January 2026, data are based on January 1–15.  
Source: Bank of Korea; Korea Securities Depository; Korea Exchange

**Figure 5. Decoupling between the USD/KRW Exchange Rate and the U.S. Dollar Index since October 2025<sup>1</sup>**



Note: 1) The exchange rate at end-September 2025 is indexed to 100.  
Source: Bank of Korea; Bloomberg

**Figure 6. Foreign Investors’ Investment in Domestic Securities**



Note: 1) ETFs, ELWs, and ETNs are excluded. Based on listed bonds; repo transactions and maturing amounts are included.  
Source: Koscom; Bank of Korea estimates