International Business

Competing in the Global Marketplace

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For several years Hyundai and its affiliate Kia, Korea’s fast-growing carmakers, have benefited from export-led growth. Hyundai sells 60 percent and Kia 80 percent of its production in foreign markets, particularly the United States, where they have been gaining share recently. By 2006 the two companies had about 4.3 percent of the U.S. market, and they hoped to double their market share there to 8.6 percent by 2010. Their success in foreign markets has been attributed to good product quality, reasonable design, and aggressive pricing. In the United States and EU, they price their cars below the prices of both domestic firms and the major Japanese companies such as Toyota and Honda. This low-price strategy has enabled the two affiliated companies to grow foreign sales, but their profit margins per car are low—as low as 3 percent on cars sold in the United States. This makes them very vulnerable to changes in the value of the Korean currency, the won, against the U.S. dollar.

In 2006, the won rose in value by about 7 percent against the U.S. dollar. It continued to appreciate throughout 2007, hitting a 10-year high against the dollar in October 2007. A stronger won means that Hyundai and Kia vehicles sold in the United States for dollars are recorded at a lower value when translated back into won, which has hurt the financial performance of both companies. In 2006, despite rising unit sales, profits at Hyundai fell 35 percent, and those at Kia fell some 94 percent. Kia had to sell 15 cars on average in the United States in 2006 to make the same amount of revenue and profit that it got from 14 cars in 2005. If the won continues to gain in value against the dollar over the long run, as many analysts predict, Hyundai and Kia may be forced to abandon their low-price strategy and start to raise prices in the United States.

Partly as a hedge against currency movements, Hyundai opened its first U.S. automobile plant in Montgomery, Alabama, in 2005, and also announced plans to build an engine plant close by. There is speculation that Hyundai will further expand its U.S. manufacturing presence in the near future, once the automobile market recovers from the severe slump it encountered in 2008 and 2009. Kia, too, is expanding its presence in the United States as a hedge against currency movements. In 2006 the company broke ground on a U.S. manufacturing plant in Georgia, which was scheduled to open in 2009. Although Hyundai and Kia saw their profits slump by almost 30 percent in 2008, sales of their cars held up relatively well despite the steep recession in the global auto industry. In fact, sales of their small cars in the United States actually increased in 2009, making the companies the only ones to register an improvement.1

1. Explain how the rise in the value of the Korean currency, the won, against the dollar affects the competitiveness of Hyundai and Kia exports to the United States.

2. Hyundai and Kia are both expanding their presence in the United States. How does this hedge against adverse currency movements? What other reasons might these companies have for investing in the United States? What are the drawbacks of such a strategy?

3. If Hyundai expects the value of the won to strengthen appreciably against the U.S. dollar over the next decade, should it still expand its presence in the United States?

4. In 2008 the Korean won depreciated 28 percent against the U.S. dollar. Does this imply that Hyundai and Kia were wrong to invest in the United States? How does this explain the relative strength of car sales from Hyundai and Kia in the U.S. market during early 2009?

Sources


Anatomy of a Currency Crisis: The Collapse of the South Korean Won

In early 1997, South Korea could look back with pride on a 30-year “economic miracle” that had raised the country from the ranks of the poor and given it the world’s eleventh-largest economy. By the end of 1997, the Korean currency, the won, had lost a staggering 67 percent of its value against the U.S. dollar, the South Korean economy lay in tatters, and the International Monetary Fund was overseeing a $55 billion rescue package. This sudden turn of events had its roots in investments made by South Korea’s large industrial
conglomerates, or chaebol, during the 1990s, often at the bequest of politicians. In 1993, Kim Young-Sam, a populist politician, became president of South Korea. Mr. Kim took office during a mild recession and promised to boost economic growth by encouraging investment in export-oriented industries. He urged the chaebol to invest in new factories. South Korea enjoyed an investment-led economic boom in 1994–1995, but at a cost. The chaebol, always reliant on heavy borrowing, built up massive debts that were equivalent, on average, to four times their equity.

As the volume of investments ballooned during the 1990s, the quality of many of these investments declined significantly. The investments often were made on the basis of unrealistic projections about future demand conditions. This resulted in significant excess capacity and falling prices. An example is investments made by South Korean chaebol in semiconductor factories. Investments in such facilities surged in 1994 and 1995 when a temporary global shortage of dynamic random access memory chips (DRAMs) led to sharp price increases for this product. However, supply shortages had disappeared by 1996 and excess capacity was beginning to make itself felt, just as the South Koreans started to bring new DRAM factories on stream. The results were predictable; prices for DRAMs plunged and the earnings of South Korean DRAM manufacturers fell by 90 percent, which meant it was difficult for them to make scheduled payments on the debt they had acquired to build the extra capacity. The risk of corporate bankruptcy increased significantly, and not just in the semiconductor industry. South Korean companies were also investing heavily in a wide range of other industries, including automobiles and steel.

Matters were complicated further because much of the borrowing had been in U.S. dollars, as opposed to Korean won. This had seemed like a smart move at the time. The dollar/won exchange rate had been stable at around $1 = won 850. Interest rates on dollar borrowings were two to three percentage points lower than rates on borrowings in Korean won. Much of this borrowing was in the form of short-term, dollar-denominated debt that had to be paid back to the lending institution within one year. While the borrowing strategy seemed to make sense, it involved risk. If the won were to depreciate against the dollar, the size of the debt burden that South Korean companies would have to service would increase when measured in the local currency. Currency depreciation would raise borrowing costs, depress corporate earnings, and increase the risk of bankruptcy. This is exactly what happened.

By mid-1997, foreign investors had become alarmed at the rising debt levels of South Korean companies, particularly given the emergence of excess capacity and plunging prices in several areas where the companies had made huge investments, including semiconductors, automobiles, and steel. Given increasing speculation that many South Korean companies would not be able to service their debt payments, foreign investors began to withdraw their money from the Korean stock and bond markets. In the process, they sold Korean won and purchased U.S. dollars. The selling of won accelerated in mid-1997 when two of the smaller chaebol filed for bankruptcy, citing their inability to meet scheduled debt payments. The increased supply of won and the increased demand for U.S. dollars pushed down the price of won in dollar terms from around won 840 = $1 to won 900 = $1.

At this point, the South Korean central bank stepped into the foreign exchange market to try to keep the exchange rate above won 1,000 = $1. It used dollars that it held in reserve to purchase won. The idea was to try to push up the price of the won in dollar terms and restore investor confidence in the stability of the exchange rate. This action, however, did not address the underlying debt problem faced by South Korean companies. Against a backdrop of more corporate bankruptcies in South Korea, and the government's stated intentions to take some troubled companies into state ownership, Standard & Poor's, the U.S. credit rating agency, downgraded South Korea's sovereign debt. This caused the Korean stock market to plunge 5.5 percent, and the Korean won to fall to won 930 = $1. According to S&P, "The downgrade of . . . ratings reflects the escalating cost to the government of supporting the country's ailing corporate and financial sectors."

The S&P downgrade triggered a sharp sale of the Korean won. In an attempt to protect the won against what was fast becoming a classic bandwagon effect, the South Korean central bank raised short-term interest rates to over 12 percent, more than double the inflation rate. The bank also stepped up its intervention in the currency exchange markets, selling dollars and purchasing won in an attempt to keep the exchange rate above won 1,000 = $1. The main effect of this action, however, was to rapidly deplete South Korea's foreign exchange reserves. These stood at $30 billion on November 1, but fell to only $15 billion two weeks later. With its foreign exchange reserves almost exhausted, the South Korean central bank gave up its defense of the won November 17. Immediately, the price of won in dollars plunged to around won 1,500 = $1, effectively increasing by 60 to 70 percent the amount of won heavily indebted Korean companies had to pay to meet scheduled payments on their dollar-denominated debt. These losses, due to adverse changes in foreign exchange rates, depressed the profits of many firms. South Korean firms suffered foreign exchange losses of more than $15 billion in 1997.
Case Discussion Questions:
1. What role did the Korean government play in creating the 1997 crisis?
2. What role did Korean enterprises play in creating the 1997 crisis?
3. Why was the Korean central bank unable to stop the decline in the value of the won?
4. In late 1997, the IMF stepped in with a rescue package that included $55 billion in emergency loans to support the currency. These loans had the effect of stabilizing the won and over the next few years South Korean enjoyed a strong recovery. If the IMF had not stepped in, what might have occurred?

Sources

The Russian Ruble Crisis and its Aftermath

PRELUDE

In the early 1990s, following the collapse of communism and the dissolution of the Soviet Union, the Russian government implemented an economic reform program designed to transform the country’s crumbling centrally planned economy into a dynamic market economy. A central element of this plan was an end to price controls on January 1, 1992. Once controls were removed, however, prices surged. Inflation was soon running at a monthly rate of about 30 percent. For the whole of 1992, the inflation rate in Russia was 3,000 percent. The annual rate for 1993 was approximately 900 percent.

Several factors contributed to the spike in Russia’s inflation rate. Prices had been held at artificially low levels by state planners during the Communist era. At the same time there was a shortage of many basic goods, so with nothing to spend their money on, many Russians simply hoarded rubles. After the liberalization of price controls, the country was suddenly awash in rubles chasing a still limited supply of goods. The result was to rapidly bid up prices. The inflationary fires that followed price liberalization were stoked by the Russian government itself. Unwilling to face the social consequences of the massive unemployment that would follow if many state-owned enterprises quickly were privatized, the government continued to subsidize the operations of many money-losing establishments. The result was a surge in the government’s budget deficit. In the first quarter of 1992, the budget deficit amounted to 1.5 percent of the country’s GDP. By the end of 1992, it had risen to 17 percent. Unable or unwilling to finance this deficit by raising taxes, the government found another solution—it printed money, which added fuel to the inflation fire.

With inflation rising, the ruble tumbled in value against the dollar and other major currencies. In January 1992 the exchange rate stood at $1 = R125. By the end of 1992 it was $1 = R480 and by late 1993, it was $1 = R1,500. As 1994 progressed, it became increasingly evident that due to vigorous political opposition, the Russian government would not be able to bring down its budget deficit as quickly as had been thought. By September the monthly inflation rate was accelerating. October started badly, with the ruble sliding more than 10 percent in value against the U.S. dollar in the first 10 days of the month. On October 11, the ruble plunged 21.5 percent against the dollar, reaching a value of $1 = R3,926 by the time the foreign exchange market closed!

Despite the announcement of a tough budget plan that placed tight controls on the money supply, the ruble continued to slide and by April 1995 the exchange rate stood at $1 = R5,120. However, by mid-1995 inflation was again on the way down. In June 1995 the monthly inflation rate was at a yearly low of 6.7 percent. Also, the ruble had recovered to stand at $1 = R4,559 by July 6. On that day the Russian government announced it would intervene in the currency market to keep the ruble in a trading range of R4,3000 to R4,900 against the dollar. The Russian government believed that it was essential to maintain a relatively stable currency. Government officials announced that the central bank would be able to draw on $10 billion in foreign exchange reserves to defend the ruble against any speculative selling in Russia’s relatively small foreign exchange market.

In the world of international finance, $10 billion is small change and it wasn’t long before Russia found that its foreign exchange reserves were being depleted. It was at this point that the Russian government requested