Effects of fluctuations in foreign exchange rates on corporate profitability

Noting that the effects of fluctuations in foreign exchange rates on corporate profitability have recently declined, this paper analyses what caused this change and examines if it is temporary or has already become a trend.

According to the result of the analysis, this weakened correlation between exchange rates and corporate profitability stems from the following factors: first, as the price elasticity of exports has gradually decreased thanks to the improved quality competitiveness of Korean products and increased overseas demand, businesses experience a smaller decrease in export sales when the won strengthens. Second, with the weight of settlements in US dollars decreasing, led by the increasing variety of export settlement currencies, the degree of strengthening of the won against the yen or euro is generally slighter than that against the dollar, or the yen and euro even move in the opposite direction to the dollar, partially offsetting the effects of won-dollar exchange rate fluctuations. Third, with their dependency on imports of parts and materials increasing, companies see their cost of production decreasing when the won strengthens. Fourth, there has been an improvement in the overall cost structure, as the ratio of labor costs to total sales has significantly decreased thanks to the efforts to cut costs.

For this study, an empirical analysis was conducted, with various factors affecting corporate profitability being set as explanatory variables, to estimate a model for the ratio of operating profits to net sales. According to the result of the analysis, the absolute value and significant level of the coefficient of foreign exchange rates declines to a greater extent when the period is set to include the pre-crisis period only than when set to include the post-crisis period as well. When estimation is made with the businesses divided into two groups - export- and domestic demand-oriented industries - , those highly dependent on exports experience a more severe deterioration in profitability, but both types of industries have seen the effects of fluctuations in foreign exchange rates decreasing since the financial crisis. This result implies that the recent weakening of the correlation between foreign exchange rates and corporate profitability is not a temporary phenomenon but an established trend.

Given the results of the analysis and the recent steady decline in the breakeven exchange rate resulting from cost-reduction efforts by businesses, overall exports are not likely to slow dramatically in the event of a deterioration in corporate profitability. However, export-oriented SMEs with weak competitiveness and profitability experience difficulties in ensuring an appropriate level of profitability, and for this reason, various efforts need to be made to prevent the strengthening won from dampening facilities investment and disturbing the upward trend of exports.

In addition, maintaining exchange rates at a certain level to ensure export growth and corporate profitability is no longer possible in the present environment, where capital moves freely and economic integration has progressed significantly, and therefore it is essential for businesses to regard exchange rate fluctuations simply as a given condition and strive to strengthen their competitiveness.