WHY MAINTAIN HIGH INTEREST RATES?

by Hee-Seong Kim

"The increasing bank closures will have a negative effect on capital flows as well as on interest rates in the short term."

"Higher interest rates have the merit of encouraging companies to shift their financing from debt to equity and restructure their business with haste."

Signaling a "Big Bang" Ahead

The Bank Supervisory Boards ordered six financial institutions to improve their management and issued recommendations of management improvement to another six banks whose ratios of paid-in capital based on BIS standards were between 6~8%. At the same time, the government shut down two more merchant banks. These actions seem to be a signal of the government's strong commitment to the IMF-recommended financial industry restructuring. Restructuring of the banking industry will have a considerable impact on other financial industries, ultimately leading to a full-scale financial "big bang." However, due to increasing distrust of the entire banking system, it could also aggravate financial market instability. The increasing bank closures will have a negative effect on capital flows as well as on interest rates in the short term. Therefore, as the won is showing no sign of recovery against the dollar as of late, market interest rates are expected remain at the burdensome annual rate of around 20% or so.

Lower Interest Rates in the Fourth Quarter

As IMF strongly recommends an overall restructuring of the Korean economy, more firms and financial institutions will go bankrupt. The IMF has made it clear that a lowering of call rates will be allowed only after the exchange rate stabilizes at the 1,300 level. This means that the call rate should be maintained at higher than 20% before the exchange rate reaches the 1,300 level. The IMF recently forecast that the won-dollar exchange rate would decline to 1,300 by year's end. As a result, the current capital crunch faced by domestic firms will continue for a while. In other words, a business unit, if it is unable to earn enough cash flow to cover its operational costs, cannot survive any more. The total number of business declaring bankruptcy in January reached a record 3,223, up 226 from the previous record in December. In spite of criticism by several Harvard economists', the IMF insists that it is prescribing the right medicine for Asia's crisis. Higher interest rates have the merit of encouraging companies to shift their financing from debt to equity and restructure their business with haste. Unsound banks shall be shut down. Interest rates on three-year bonds went down to 19.84% on March 2, for the first time in over 20 days. The money market has stabilized since the government report on the current account surplus in February. However, the interest rates look likely to stay high at least through March. VIP

〈Table〉 Major Bond Yields(%)

	Corporate[1]	Bank Debenture[2]	Monetary Stabilization[2]	National Housing[3]
Dec. 1 ('97)	17.50	15.50	14.80	14.35
Dec. 31 ('97)	28.98	22.00	14.80	17.15
Jan. 30 ('98)	18.50	18.50	14.80	15.95
Mar. 2 ('98)	19.84	20.50	14.50	15.20

* Note: 1) 3 - year maturity, 2) 1 - year maturity, 3) 5 - year maturity