

PERSPECTIVES ON THE INFLOW OF FOREIGN CAPITAL

by Hee-Seong Kim

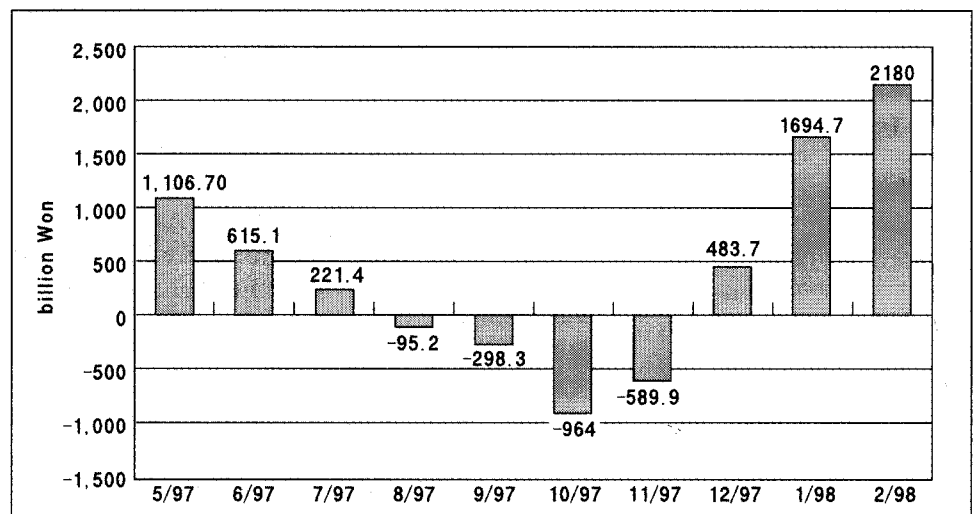
“This trend is likely to continue with foreign institutions piling into the market in the wake of hedge funds that sparked the rally in January 1998. Of course, continued inflows depend on more strength from regional stock markets.”

The Korean stock market plunged to a recent low of 350.68 on December 12, 1997, but by the close on January 30th 1998, it had recovered an amazing 59%. More signs of confidence in Asia have also been emerging. One early signal came when the high-profile bargain hunter, Sir John Templeton, disclosed in early January that he had begun buying back into South Korea. The primary driver for foreign investor optimism has been the bounce in many of the Asian markets—for instance South Korea’s bounce, making it one of the world’s best-performing markets. Caught by the upward momentum, foreign investors have

invested their money in Asian funds. Foreign investors seem to feel the current Asian market has bottomed out and are expecting the momentum of positive economic reform.

Therefore, the Korean stock market has been experiencing consistent infusions of new foreign cash so far in 1998. Foreign net buying in February reached a record monthly high of 2.18 trillion won. This trend is likely to continue with foreign institutions piling into the market in the wake of hedge funds that sparked the rally in January 1998. Of course, continued inflows depend on more strength from regional stock markets. If markets fall again, foreign

〈Figure〉 The Flow of Foreigners’ Net Purchase in the Korean Stock Market



Source: Korean Stock Exchange

investors are likely to retreat. The amount of foreign investors' net purchases in the Korean stock market has been reached 18 trillion won, almost 20% of the total market value, since 1992.

For investors in emerging markets, Korea is attractive because they see progress on economic reforms as well as cheap asset prices. A decision in early February by Morgan Stanley to double its Korea weighting in its emerging market index has given additional stimulus. Moreover, the Korean government said that it would allow foreign hostile takeovers of Korean companies within March instead of delaying them until 1999 as was previously scheduled. South Korea plans to open its protected property market to foreign investors from July 1998 in an effort to attract capital from abroad. The lifting of the land ownership restrictions is linked to efforts to restructure Korean industry by encouraging the foreign purchase of assets to help reduce corporate debt levels.

Generally, direct investment should enable a more efficient allocation of capital throughout the world than hot money does. Foreign direct

investment (FDI) allows developing countries to grow fast as well as take advantage of the transfer management expertise and technology. Unfortunately, however, South Korea has restricted FDI but allowed hot money instead.

Hedge funds that invest primarily in Asia achieved, on average, a negative return of 30.5% in 1997, according to Van Hedge Fund Advisers International. Van Hedge tracks the performance of 2,600 hedge funds worldwide, of which some 120 invest primarily in Asia. A Soros fund was reported to have purchased a 5% stake in a Thai electronics firm, GSS Array Technology PCL in February and also invested \$45 million in the Philippines. This shows how money is starting to selectively trickle back into some Asian economies. The average emerging market hedge fund gained 12.1% in February, in contrast to the -7.9% in January. This improved performance of emerging market hedge funds was boosted by the bounce in Asian stock markets including South Korea. The Financial Times reported on March 4, 1998 that foreign investors, mostly hedge funds, have already sold 1.6 trillion won worth of shares.

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<Table 1 > The Rate of FDI over Total Fixed Capital (%)

Country	1990	1991	1992	1993	1994	1995	1996
South Korea	0.8	1.0	0.6	0.5	0.6	1.1	1.3
Indonesia	2.8	3.6	3.9	4.3	3.8	6.7	8.5
Malaysia	16.8	23.8	26.0	22.5	15.9	12.1	13.2
Philippines	5.2	6.0	2.1	9.6	10.5	9.0	7.3
Thailand	7.1	4.9	4.8	3.6	2.3	2.8	3.2

* Source: Ministry Of Finance and Economy

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As Asian currencies and markets plunged last year, many foreign investors sold stock and sought a haven in cash. Now, however, as Asian markets stabilize somewhat, this cash position is declining. Many fund managers plan to cut their cash positions. The theory is that once cash gets put back to work in a market, stock will rise. But some fund managers remain skeptical that new buyers outnumber those who are selling. Many remain cautious about the Korean market, foreseeing more bankruptcies and an unstable foreign exchange market. Favored shares among foreign investors are becoming too expensive, while many others are considered too risky because of looming solvency problems among Korea's debt-heavy companies. Any signs of economic reforms stumbling or negative public reaction to industrial restructuring will dampen the sen-

timent that has driven the market. And as the currency appreciates further, foreign investors will tend to sell their stocks because of foreign exchange gains on top of a rise in share values.

Things in Asia do look better, especially compared to mid-December 1997. In particular, the Korean market's systemic risk has declined. Therefore, foreign capital inflow can be expected. However, the current inflow of foreign capital is tending to be speculative in nature, which seeks high risk-high return during a short period. It is necessary to find the solution on how to maximize the benefits of capital flows to Korea, while minimizing both the amount of panic and damage speculative funds can do.

As the first step, it is imperative that Korea tries to restore lost international confidence through improved accounting transparency, market discipline, and structural reform. **VIP**

<Table 2> International Hedge Fund Performance, February 1998 (%)

Style Performance	January 1998	February 1998	1997	1993~1997 Net Comp. Annual Ret.
Aggressive Growth	1.2	7.3	14.3	17.3
Emerging Markets	-7.9	12.1	-5.9	24.4
Macro	-0.8	2.7	19.9	13.8
Market Neutral Arbitrage	1.2	1.4	18.9	14.3
Market Timing	0.2	4.5	18.2	11.9
Opportunistic	-0.9	4.2	22.4	20.5
Several Strategies	-1.9	2.8	15.2	15.2
Short Selling	-1.8	-7.1	7.7	-2.3
Special Situations	0.4	3.1	23.0	19.7
S&P 500	1.1	7.2	33.4	20.3

* Source: Van Hedge Fund Advisors, Inc., 1998