APPARENT STABILITY BUT POTENTIAL NEGATIVE FACTORS

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"The credit crunch is more the result of institutions' reluctant attitude in supplying sufficient liquidity rather than the lack of money itself."

In terms of interest rates, the Korean financial market has been relatively stable in September. This is better than was originally expected earlier in the month when the government released its schedule for issuing about 13.9 trillion won worth of government bonds. Many experts anticipated that the "crowding-out effect" would negatively affect the private sector's liquidity and push up interest rates. In fact, the 3-year corporate bond rate rose to above 12% in mid-September from the 11% range of August. However, despite the massive money demand of the government, interest rates responded by rising less than 1% point.

This reflects that there is quite sufficient liquidity among financial institutions, which is in contrast to the tight credit crunch in the industrial sector. In other words, the credit crunch is more the result of institutions' reluctant attitude is supplying sufficient liquidity rather than from the lack of money itself. The Bank of Korea also planned to supply more liquidity to prevent against a possible financial shortage. The major means of this plan is purchasing RPs issued by the central bank. As long as the BOK keeps a flexible monetary policy, the issuance of government bonds will not squeeze significantly the pipeline of private funds.

There are, however, potential negative factors in the financial market. First, the enormous issuing of government and public bonds will be continued throughout the end of year and also next year. Second, financial restructuring is still in progress and so the base of the market is unstable. It might be severely affected by even mild shocks which would normally have only a negligible effect. Third, the international economic environment is getting more unfavorable. The financial crisis which swept through the Asian countries is extending its impact to Russia and South America. Thus, it is possible that the domestic financial market could fall into turmoil at any time.

In theory, interest rates are basically equal to the sum of the economic growth rate and the inflation rate. Assuming the growth rate for this year will be -6.0% and the inflation rate around 9.0%, interest rates should be around 3.0%. The gap between the actual rates and this theoretical rate mainly consists of the risk premium. This premium comes from uncertain variables including the effects of the restructuring process, severe recession, and the international financial instability. The domestic financial market will continue to remain vulnerable to such various unstable factors until financial restructuring is completed and a sound financial system is constructed. VIP

〈Table 1〉 Major Interest Rates

(End of Period, %)

	1997	1998			
		June	July	August	September 28
Corporate Bond Yield(3 yr.)	28.98	16.00	12.50	11.70	11.40
CD Rate(91 days)	25.00	16.30	12.29	10.20	10.35
Call Rate(1 day)	26.59	14.42	11.10	8.70	8.50