IS THE DECLINE IN INTEREST RATES BENEFITING MOST FIRMS?

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In October, the major money market interest rates entered into 10% range, which is the lowest level ever. The interbank offered call rate and CD rate declined to a historically low level of around 7%, while the three-year corporate bond rate dropped to 10%. The drop in interest rates was led by the Bank of Korea (BOK), whose monetary policy stance changed from being tight to easy.

By lowering interest rates on government bonds that are sold to financial institutions through open market operations, the BOK has tried to achieve two final objectives. The first objective is to lower interest rates on bank loans. The second objective is to resolve the credit crunch. The mechanism the BOK wants to use is fairly simple. Lowering the government bond rate and call rate means a reduction in the yields on banks' assets. Therefore, banks may cut the savings rate to reduce their costs. As a result, banks may cut their lending rate as well. In addition, banks may increase their lending volume because there are no safe assets that guarantee high returns for their extra liquidity.

However, the real world is not as simple as the BOK thinks. Even though the lending rate applied to creditworthy big firms has dropped to around 13%, relatively small firms still pay a high risk premium that raises their actual borrowing rate to around 17~18%. Many small firms continuously complain that they will not be sustainable under such high financing costs.

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A more serious problem is that the credit crunch is not being solved at all in spite of the BOK's efforts. The statistics show that banks are still hesitating to lend money to firms. The net volume of bank lending up to October 20 was a negative 1.9 trillion won.

The main reason for the high risk premium and continuous credit crunch is the still-high credit risk in the corporate sector, which stems from the ongoing corporate restructuring and deteriorating cash flows.

As long as the government and the BOK keep their policy stance, representative market interest rates such as the three-year corporate bond rate and the call rate are expected to stabilize around current levels. However, most firms which are not highly creditworthy will benefit little from the downward trend in market interest rates because the problems of the high risk premium and the credit crunch will not be resolved easily due to difficulties of resolving the credit risk in the corporate sector. VIP

〈Table 1〉 Major Interest Rates

(End of Period, %)

	1997	1998			
		July	August	September	October 29
Corporate Bond Yield(3 yr.)	28.98	12.50	11.70	11.90	10.00
CD Rate(91 days)	25.00	12.29	10.20	10.12	7.70
Call Rate(1 day)	26.59	11.10	8.70	7.38	7.30