LIQUIDITY FLOWS ACROSS FINANCIAL SECTORS

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Overall Liquidity Condition in the Financial Market

The domestic financial market has recently shown strong signs of vitality with a vast transfusion of its lifeblood, liquidity. Due to the increasing money supply and lasting slowdown of money demand, the overall liquidity conditions in the financial market have remained at an over-supply level in the 1st quarter of 1999. The surplus liquidity is mainly due to elastic monetary policy of the Bank of Korea aimed at the real economy's recovery and also the growing inflow of foreign portfolio investment. The M2 has increased 30.1% (year over year) on average during the 1st quarter, a high climb from the 14.5% of a year ago. The net inflow of foreign portfolio investment amounted to about 2.3 trillion won during the same period.

How Money is Being Circulated

There were three main characteristics in the liquidity flows across the domestic financial institutions during the 1st quarter. The first is the high demand for short-term financial products. Depositors showed a preference for the short-term products such as MMF and short-term investment; the financial institutions also preferred to deposit their excess liquidity into other institutions' short-term products than to extend loans or to purchase long-term bonds. Second, a large amount of money has entered the bullish stock market. The outstanding balance invested into stock investment trusts (including mutual funds) has increased about 2.2 trillion won and customer deposits at securities companies also gained about 1.3 trillion won in March. Third, money has moved to the secure "good" financial institutions from the ailing ones as the second round of restructuring progresses. Ailing institutions with bad financial structures have faced a massive outflow of deposits. Meanwhile, deposit accounts of banks who completed restructuring have attracted quite a large amount of money.

More detailed liquidity flows across the financial institutions are as follows. First, the intensive money inflow into bond investment, which amounted to about 33.6 trillion won last January thanks to the relatively high yields,

Table 1. Recent Trends of the Major Money Aggregates

(year over year, average, %)

	1998		1999			
	Q1	Avg.	Jan	Feb	Mar	Q1
M2	19.0	14.5	26.3	30.0	33.6	30.1
MCT	7.5	10.8	3.1	5.3	6.9	5.3
M3	14.0	14.9	13.1	-	-	-
RB	-7.2	-7.7	-8.7	4.4	7.2	0.6

Source: Bank of Korea

began to decline from February because their yields have been lowered under the Financial Supervisory Commission's regulatory actions on short-term financial products. On the other hand, the stock investment trusts have steadfastly gained additional money inflow; the bullish domestic stock market lured private investors away from less attractive sectors and products. Second, bank accounts witnessed a significant increase in outstanding deposit balances. In line with the short-term liquidity moving into the stock market, demand deposits shrank. Meanwhile, time & savings deposits have increased with their recovering competitive edge over bond investment trusts. Leading banks which completed their internal restructuring continued their sales campaign with high interest rates offered for a limited time to attract depositors. But trust accounts of the banks have faced a continual money outflow because of the relatively low yields compared to those of the non-bank financial institutions. Customers also turned away because of trust accounts' exclusion from the depositor insurance program and the ban on sales of development trusts. On the other hand, thanks to the bullish market, customer deposits at the securities companies are experiencing a sharp surge up to 6 trillion won as of the end of the first quarter. Third, international merchant banks have lost deposits since last February due to the second round of restructuring and the drop in deposits from investment trust companies, which faced money outflows from the short-term bond investment trusts.

Influence on the Bond and Stock Markets

The surplus liquidity condition in the financial market resulted in the downward stability of the domestic

Table 2. Recent Trend of the Deposits in the Financial Institutions

(increase/decrease during the period, billion won)

	98.10	11	12	99.1	2	3
Banking account	27,434	31,523	15,396	-1,590	103,510	42,648
Demand deposits	-5,388	-4,629	33,487	-23,847	14,513	-11,841
Savings deposits	58,794	52,435	30,594	29,626	98,544	69,686
Short-term deposits	-25,972	-16,283	-48,685	-7,369	-9,547	-15,197
Money in trust	-17,720	-6,197	-8,112	-42,752	-40,858	-61,786
Investment trust companies	233,185	109,105	24,093	336,203	69,401	-1,892
Short-term bond investment trusts	168,960	17,422	-86,394	242,592	40,242	-63,708
Long-term bond investment trusts	67,548	72,135	109,947	81,670	27,507	33,420
Stock investment trusts	-943	-948	4,022	15,538	4,363	21,173
Securities investment savings	-2,380	20,496	-3,482	-3,597	-2,711	7,223
International merchant banks	63,741	11,701	-45,962	76,252	-2,727	-64,232
Bills issued	73,103	15,996	-38,494	66,823	-7,461	-63,884
CMA	-166	794	2,629	4,689	-3,634	-8,514
Bills resold	-9,196	-5,089	-10,097	4,740	8,368	8,166
Securities Companies	-	-	-	-	-	-
Customer Deposits (end of.)	5,110 (22,156)	9,379 (31,535)	6,238 (37,773)	11,235 (49,008)	-8,841 (40,167)	13,130 (53,297)

Source: Bank of Korea

interest rates and the bullishness in stock market. Korean Stock Exchange Price Index (KOSPI) rose sharply to break the 600 point mark at the end of March, and day after day in April, the KOSPI kept its upward force to consecutively break the records for the last 21 months. This bullishness has been supported by the unceasing money inflow to the stock market directly or indirectly through the stock investment trusts or mutual funds. On the other hand, the sufficient short-term liquidity coupled with the government's strong will to boost the economy pushed the call rate downward to enter into 4% range. But the long-term rate, especially 3-year corporate bond yield, showed relative rigidity in 8% range during the 1st quarter, although it continued its downward trend.

Outlook for the 2nd Quarter

In the second quarter, the government and the BOK will maintain their flexible monetary policy stance; as the economy recovers, however, inflationary pressure might emerge, and there is a possibility that this flexible stance will face a challenge well into the third quarter. In spite of this potential change in the third quarter, at least during the second quarter the situation will remain similar in terms of money supply in the overall financial market. Two components of this trend, the lasting slowdown of money demand and steady liquidity inflow to the financial market, will continue.

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In terms of liquidity movement across financial institutions, three main characteristics—high demand in short-term financial products, influx to the stock market and outflow from ailing financial institutions—are likely to remain strong even during the second quarter. For investment trust companies, a slight hike in liquidity inflow is expected due to the sales pitch of stock investment trusts and the introduction of a new type of MMF with a relatively high yield. Reinforcing capital soundness after completion of restructuring, banks will continue to induce a considerable amount of liquidity to time deposits. The introduction of unit type trusts in mid-April will slow down the liquidity ebb from trust accounts. Securities companies will continue thriving on growing customer deposits with low interest rates and the bullish stock market. Among the non-bank financial institutions, their general situation will be differentiated according to their financial soundness. As the second round of restructuring progresses, polarization in the liquidity status among institutions will deepen. In particular, some international merchant banks are likely to face a massive money outflow as the Financial Supervisory Commission suspended business of Daehan International Merchant Bank in early April because it failed to meet the capital adequacy requirement.

Against this backdrop, the good performance in the domestic bond and stock markets will continue during the second quarter. Despite the slowed money inflow into the bond investment trusts, the overall demand for bonds will remain strong, thanks to the continuous inflow to the entire financial market. With this background, the corporate bond yield slid down into 7% range and national treasury bond yield to 6% range in early April. As the business cycle turned upward, long term interest rates are expected to rise further in the second half of this year. This is the reason why one should believe the demand for long-term bonds will be limited: investors' preference for short-term products will continue for the second quarter, stemming from expected higher interest rates. For stock market, the lasting low interest rates and money inflow to the stock market will support the domestic stock market's sustained bullishness in spite of the correction stage following the recent sharp rise and the large amount of right offerings. VIP