INTEREST RATES STOP RISING, BUT INSTABILITY STILL REMAINS

Bum-Koo Kim
(bkkim@hri.co.kr)

Market Instability Due to Rumor

The financial unrest and the rising trend of long-term interest rates reached its peaks in September mainly due to the rumor of a possible financial debacle dubbed "November Financial Crisis". The rumor had it that the current instability in the market would reach its worst in November, when investors with exposure to Daewoo bonds will be allowed to redeem 80% of their funds. Fears of the "November Financial Crisis" further worsened the market players' psychological unrest, which accelerated investors' redemption runs to the investment trust companies (ITCs). On the other hand, the commercial banks with relatively sufficient liquidity conditions thanks to the recent money inflow were still reluctant to buy bonds or offer loans to the ITCs. Such a passive attitude was strengthened by the potential huge losses from the workout program for the 12 Daewoo firms. The financial institutions that provided loans to them now have to offer exemptions or reductions in interest payments and to extend the maturities of their loans or swap loans for equities. Moreover, under the revised asset classification standards, they have to set aside 2~20% of their loans as loan-loss provisions, which would lower their capital adequacy ratios and worsen their financial status. The resulting imbalance in demand-supply conditions caused long-term interest rates to jump sharply. The corporate and government bond yields skyrocketed to 10.82% and 9.78%, respectively, the highest of the year.

Policy Measures Lowered Interest Rates

Interest rates stopped rising and moved down to the single-digit level immediately after the government's strong policy measures including building up the Bond Market Stabilization Fund (BMSF) were announced. The fund is scheduled to expand its size up to 20 trillion won. Many market watchers expect the fund to be contribute to pulling down the rates by improving the demand-supply conditions. However, it is quite unclear whether the fund's effect will be maintained because it is merely a tentative counter-measure against the current financial unrest.

Above all, worries about Daewoo-related bonds and the possible liquidity shortage of the ITCs are not subsided. Furthermore, some insist that the monetary authorities should shift to a tight monetary policy amid growing concerns over inflation. While the consumer price index can be maintained within the government's target of 2% this year, the current domestic and overseas economic conditions may make the prices unstable next year. They worry that the consumer price index will reach 3~4% next year. Under these unstable circumstances, it is urgently necessary for the government to suggest positive policy counter measures that are efficient enough to settle down the market players' psychological panic in order not only to stabilize the financial markets but also to build up favorable surroundings in conjunction with the preemptive anti-inflationary policy. VIP