

# NO FEBRUARY LIQUIDITY CRISIS

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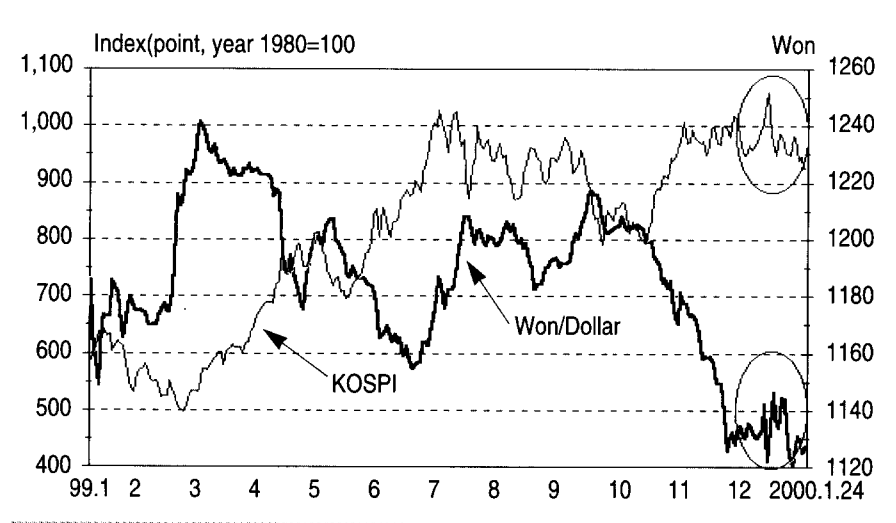
The KOSPI showed a near 90-point fall from January 4th to 25th. There are many negative elements in the stock market, such as the increases in oil prices and U.S. interest rates, and uncertainty in financial markets due to the approval of a 95 percent redemption of Daewoo-related bonds scheduled for Feb. 8 and repercussions from the Nara Banking Corporation's suspension of business. The KOSDAQ, meanwhile, continued to fall throughout the week, at one point hitting the 180 mark. Although prospects for the market are excellent over the long term, these adverse factors will cause the KOSPI to fluctuate very severely within the 900~1,000 range. The stock market is not likely to rebound in the short term, but will probably show large fluctuations.

*There are many negative elements in the stock market.*

As for concerns over Daewoo issues, investment trust companies and the government have prepared for an expected rush of cash calls on February 8th. Thus the investment trust companies will not face a liquidity problem and the market will stabilize immediately thereafter. Since investment trust companies (ITCs) have secured substantial liquidity to meet the expected redemption, the current purchasing power of ITC's in the market is limited. For the time being, funds are forecast to flow into short-term financial products such as those offered by banking institutions, leaving the stock market with fewer funds to work with. Accordingly, the market will remain dry and very volatile for most of the month. However, the long term prospects for the Korean stock market are fairly good since the earnings projections are looking good.

*Even with Daewoo problem, the long-term prospects for the Korean stock market are fairly good.*

Figure 1. Stock Market Index and Exchange Rate



*The Won/US dollar exchange rate was very volatile*

The Korean won/US dollar exchange rate was very volatile during January, 2000. This was because market participants were not sure about the direction of government foreign exchange policy. The supply of foreign exchange to Korea is expected to exceed its demand by about \$6.7 billion this year in the market. On the supply side, the current-account surplus and foreign direct investment will reach around \$12.5 billion and \$8 billion respectively, while foreign investment in local stocks and bonds will amount to \$5 billion. Long-term overseas borrowing by local financial institutions will stand at around \$6 billion, and loans from international financial agencies will reach \$1 billion. The demand for foreign exchange will include \$10.6 billion for principal payment of long-term foreign loans, \$1 billion to be repaid to the International Monetary Fund (IMF), \$5.47 billion for interest payments on long-terms loans, and \$3.21 billion for interest payments on short-term loans. Interest on foreign currency stabilization bonds, issued by the government to stabilize the value of the won, will amount to \$5.5 billion. The oversupply of foreign exchange is expected to keep the Korean currency rising against the dollar this year.

— Table 1. The Expected Dollar Supply and Demand in the Local Market —

*(Unit: Billion Dollars)*

<b>Dollar Supply</b>		<b>Dollar Demand</b>	
The current account surplus	(12.5)	Principle payment for the loan	(10.6)
Foreign direct investment	(8)	Repayment to IMF	(1)
financial market investment	(5)	Interest payment of LT loans	(5.47)
Long-term overseas borrowing	(6)	Interest payment of ST loans	(3.21)
Loans from international agencies	(1)	Interest on foreign currency - stabilization bonds	(5.5)
<b>Total Dollar Supply</b>	<b>32.5</b>	<b>Total Dollar Demand</b>	<b>25.78</b>

The won may fall sharply against the dollar in the first half of this year if the Daewoo Group crisis is not solved smoothly. Thus, the government plans to deposit \$500 million in an offshore investment fund, as a won-weakening device, to be launched by domestic investment-trust and securities firms in February. The fund's total size will likely amount to \$2.5 billion with \$500 million from the government and the rest from non-governmental investors. This offshore fund will contribute to stabilizing the foreign exchange markets, helping to reduce upward pressures on the won. At the same time, the fund could provide more investment opportunities and foreign exchange risk management for domestic investors. In order to attract individual investors' participation, the government is planning to exempt capital gains tax of 22% on profits in sale for individual investors who participate in this fund.

*There is an inflationary pressure.*

The government is trying to keep prices down. This is because inflationary pressure is expected to build up this year from higher raw material prices, wage increases and the country's continued economic growth. The consumer price index is

**Table 2. Major Financial Market Indexes**

	end of '97	end of '98	Dec. 28, 1999	Jan. 25, 2000
Corporate Bond Yield (3 yr.)	28.98	8.00	9.95	10.26
CD rate (91days)	25.00	7.70	7.35	7.20
Call rate (overnight)	26.49	6.61	4.74	4.74
KOSPI	376.31	562.46	1,028.07	891.22
Won/\$ rate	1,695.00	1,209.20	1,142.50	1,127.10

expected to rise more than 3 percent this year, and the central bank's monetary policy will be to stabilize inflation to ensure continued economic growth. The M3 money supply will be increased by about 7 percent to 10 percent. The central bank will take pre-emptive steps if signs of inflationary pressures emerge. Due to the above stabilization policy and sufficient market liquidity, a sharp rise of interest rate is not expected. However, bond demand is not sufficient to control expected supply in the market. For the time being, bond yield is not likely to decrease. The current 3-yr corporate bond yield is 10.26.

The government has decided to make 36.2 trillion won available against a possible liquidity crisis facing investment trust companies. The central bank's direct intervention is also scheduled if necessary. Thus, the February liquidity problem is not likely to happen, but the financial market is still unstable. Furthermore, even though the current financial market's risk was managed by emergency policy, Korea still needs a new financial system and the government has to lay the groundwork for its introduction. **VIP**

*The February liquidity problem is not likely to happen.*

**Figure 2. Short-Term Policy for Financial Market Stabilization**

