

STRENGTHENING WON AND POLARIZATION OF THE STOCK MARKET

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

The anticipated "February liquidity crisis" related to the redemption of Daewoo bonds did not arise, and the critical point passed without any serious trouble. However, some uncertainties still remain in the financial markets. In particular, the Korean won's continued strengthening against the dollar and the serious polarization of the stock market showed up again as factors of instability in February.

The "February liquidity crisis" did not arise.

Although the market uncertainties related to the February crisis and the call rate increase were settled, there still remain some unstable factors in the financial markets.

First, the exchange rate has kept a downward trend with high volatility. The Korean won, which broke through the 1,200 won per dollar level in November last year, appreciated to 1,115.3 won per dollar in mid-February, the highest level since December 1997. The won's strength was mainly due to excess foreign exchange caused by the continued inflow of foreign stock investment funds. The net inflow of foreign investment funds amounted to 3.5 billion dollars during the first two months this year, equal to 65% of 1999's total net inflow.

The more serious problem is that the won's value fluctuated wildly with the inflow and outflow of foreign stock investment funds. The daily trading volume in the foreign exchange market stayed at around 2 billion dollars, but the daily variation reached up to 20 won this year, which is much higher than the range of 5~6 won in 1999. In particular, the inflow/outflow volume of foreign stock investment funds occupied more than 20% of total forex trading volume this year, compared to 11% in 1999.

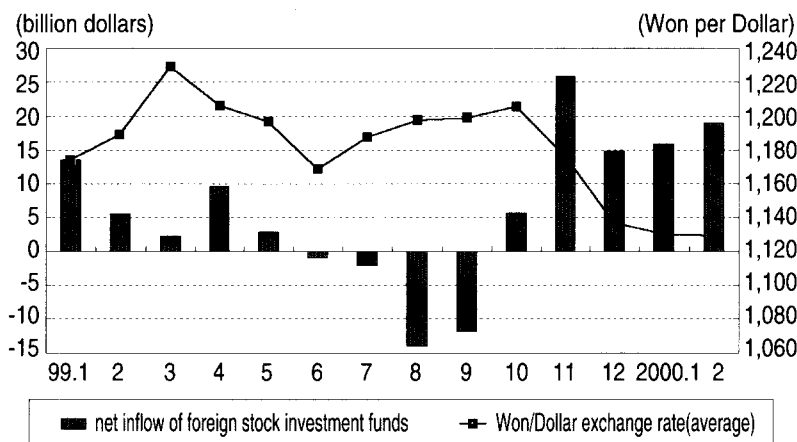
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Table 1. Major Interest Rates

	(End of Period, %)								
	1997	1998	1999				2000		
			Q1	Q2	Q3	Q4	Jan	Feb	Mar 2
Call rate(1 day)	26.59	6.53	4.88	4.85	4.80	4.84	4.76	5.03	5.05
CD rate(91 days)	25.00	7.70	6.55	6.35	7.70	7.34	7.20	7.01	7.01
Corporate Bond Yield(3 yr.)	28.98	8.00	8.10	7.96	9.95	9.95	10.12	9.90	9.93
Treasury Bond Yield(3 yr.)	-	6.95	6.50	7.20	9.03	9.03	9.00	8.91	8.95

Source : Bank of Korea

Figure 1. Net Inflow of Foreign Stock Investment Funds and Exchange Rate



Coupled with the Japanese yen's recent weakness, the strong won will hurt Korean exports' price competitiveness and worsen the trade balance, which nearly recorded a surplus of 412 million dollars during the first two months of 2000 due to the \$1.37 billion of exports on the last day of February. In addition, the high volatility of the won's value would make market participants and corporations suffer from growing uncertainty in the foreign exchange market.

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A second factor of instability is the revived polarization between the Korea Stock Exchange(KSE) and the Korean Security Dealers Association Quotation(KOSDAQ) in the stock market. While the KOSDAQ index almost reached 270 in February, the Korean Stock Price Index(KOSPI) sharply fell to 819.01, the lowest level since late October 1999. The daily amount of trades (in won) in the KOSDAQ exceeded 5 trillion won, overtaking that in the KSE for more than 10 days on end since Feb 8, and the daily trading volume of shares exceeded 2 trillion won, overtaking the KSE's on Feb 17. As a result, KOSDAQ's total market capitalization increased to about 100 trillion won, which is more than 30% of KOSPI's.

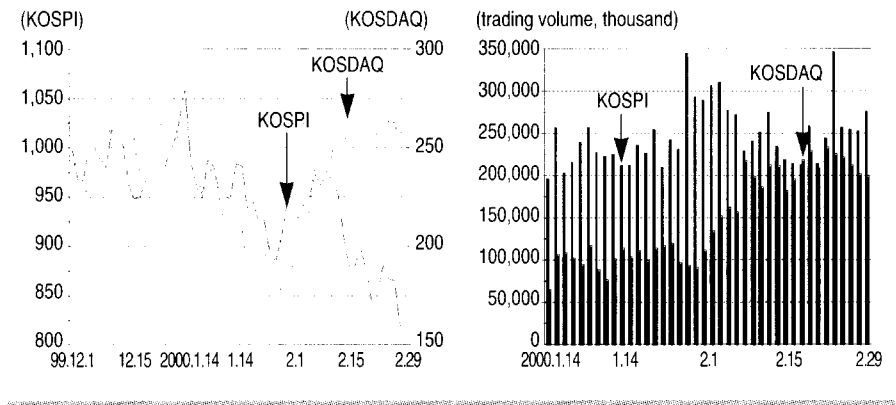
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While the polarization in the second half of last year was initiated by foreign and individual investors, recently, it has been led by foreign and institutional investors. According to the KSE, foreign investors' net buying in the KOSDAQ recorded 947 billion won in February, while their net buying in the KSE recorded merely 778 billion won. And ITCs posted more than 684 billion won in net buying of KOSDAQ stocks and more than 1.2 trillion won in net selling of KSE stocks during the same period.

Although the polarization in the stock market is regarded as a natural phenomenon reflecting the global "paradigm shift" from conventional manufacturing industries to the internet and information technology industries, many experts

indicated that excessive polarization would hurt the national economy by fostering speculation and bubbles in the stock market, and would curb the fund raising of manufacturing companies.

Figure 2. Index and Trading Volume in the KSE and KOSDAQ



Finally, external circumstances got more and more unfavorable. International oil prices exceeded 30 dollars per barrel(WTI) and the Japanese yen weakened, reaching around 110 yen per dollar. Furthermore, it is highly expected that the U.S. Fed will raise its Fed-fund rate again by 25~50 basis points in the FOMC meetings scheduled in late March, which will have a serious negative effect on U.S. and international stock markets.

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To settle these unstable factors in the financial markets, the government has taken several policy measures since mid-February. It frequently intervened in the foreign exchange market by absorbing oversupplied dollars and issuing about 700 billion won in Foreign Exchange Stabilization Fund Bonds. It also announced stabilizing policies to promote trading in the KSE such as eased requirements for listing, tax aid and changes in trading time and regulations. In spite of such efforts, however, the government's policies seem to be having limited impact on the financial markets because the won's strength and the stock market polarization are caused by market pressure, which is expected to continue for the time being.

Therefore, the won/dollar exchange rate, which remains at around 1,130 won due to government intervention, is expected to fall to around 1,100 won within several months, and the polarization of the stock market is predicted to continue through the year. Furthermore, the domestic interest rate will not fall below the mid 9% level because of faster-than-expected economic growth and the resulting worries about inflationary pressure. **VIP**

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