IMPACT OF NEW BOND MARKET POLICY

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Vulnerable Korean Bond Market

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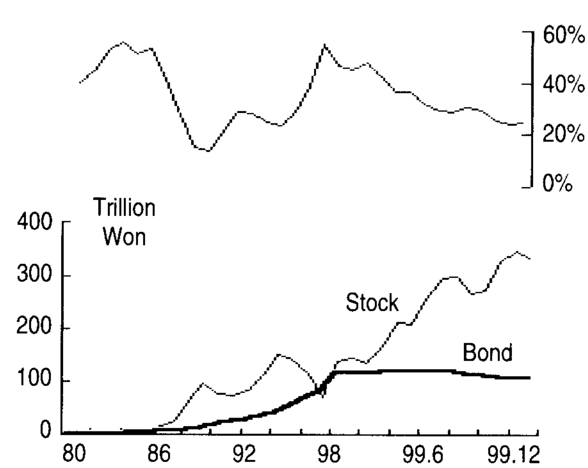
The bond market is the channel through which governments and corporations that need to borrow money are matched with investors who have funds to lend. The U.S. bond market, with more than $14.2 trillion in outstanding balance as of September 1999, is even larger than the U.S. stock market, which had a combined market value of approximately $12.3 trillion in the end of 1996. In Korea, the situation is vastly different. The Korean bond market, representing more than 410 trillion won in outstanding balances in the end of 1999, is only 30% of the total capital market.

<Figure 1> Share of Outstanding Balances and Trend of New Securities Issues



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After the second half of 1999, the bond market shrank because of investment trust companies that held insolvent Daewoo bonds. Viewed more closely, however, such shrinkage was mainly caused by the bond market's systemic weakness. 80% of bond demand was dependent on investment trust companies (corporate bonds) and banks (treasury and state bonds).

When the demand of such institutions decreases, substitute demand cannot sustain newly issued supply or transactions in the secondary trading market. As a result, the interest rate fluctuates. Other negative factors also affect the bond market. First, the Treasury bond is not the main stake in the Korean bond market. The share of Treasury bonds was only 16.0% of the bond market as of the end of 1999, while in the U.S., Treasury bonds accounted for 22.8%. In addition, Korean Treasury bonds are divided into various maturities and rates. Owing to such variety, the Treasury bond rate cannot play an important role as a benchmark rate.

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Low liquidity is another major problem facing the Korean bond market. Since the absence of a benchmark rate discourages transactions in fixed income securities, there is a chronic vicious cycle oscillating between liquidity and the benchmark rate.

A third issue is the efficiency of the secondary market, which is needed to vitalize the Korean bond market. Currently, bonds can be traded in the OTC market through the telephone. Therefore, the dealer determines the price of bonds because the only choice a customer has is choosing the best prices among those presented by the dealers. In other words, the infrastructure is not sufficient to back up an efficient bond market.

Policy to revitalize the bond market

To revitalize the bond market, the government will promote the Treasury bond as a benchmark debt instrument in the domestic money market, like the U.S. Treasury bond. To do so, it will introduce fungible issue, which is the same maturity, face rate bonds periodically to be issued to reduce the variety of bonds, to expand the supply of bonds, and to elevate the liquidity and continuity of bonds. Also, the government will issue long term maturity bonds (maturity over 5 years) and participate in the secondary market. The treasury bonds will be issued with an advance and periodical notice. The periodically issued bonds will let the customer forecast the availability of newly issued bonds. When customers bid on new bond issues, the government will adopt the Dutch method[1].

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Currently, only brokerage houses and merchant banks can sell bonds to the general public. To promote the Treasury bond market, the government will provide loans to dealers when they buy the bonds. At the same time, it will allow the participation of inter-dealer brokers, who will act as wholesale brokers. The minimum capital requirement for inter-dealer brokerage will be set at 30 to 50 billion won and that for a bond-only dealer at 3 billion won or lower. To expand the demand base of the bond market, the government will allow financial institutions besides securities companies to trade bonds. The government will also survey and remove barriers to foreign investors to promote foreign investment in the bond market. In addition, the government intends to introduce a Delivery vs. Payment system and a

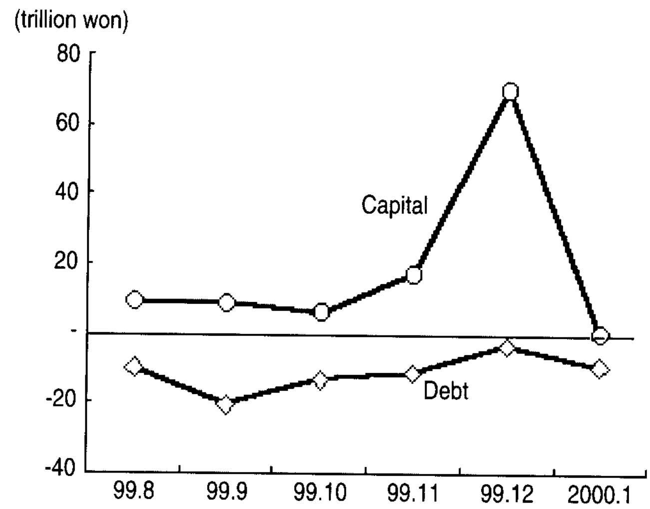
1) In the Dutch method, all winning bidders pay the same price per item, which is the lowest successful bid.

Dematerialization system, which is simultaneously the settlement and delivery of bonds through linking BOK-wire and Korea Securities Depository. Dematerialization is a system in which the title of securities is approved, transferred, and alienated without the actual object of securities, which indicates the right and obligation to them.

Impact of bond market policy on corporate financing

The companies that met the 200% debt-to-equity requirement at the end of 1999 have discretionary power of financing. Before the end of 1999, they concentrated on raising capital to meet the requirement. However, the situation is slightly changed. Now, firms are not willing to finance capital, which is the most expensive financing method. The new bond market policy is expected to facilitate bond issue.

<Figure 2> Recent Trend of Corporate Direct Financing



Recently, ABS issues, which occupied 16.9% of the total bonds market in 1999, have significantly increased after the introduction of the ABS system 1 year ago. The companies, which have experienced difficulties in raising middle and long term capital after crisis, would be easily financed by the ABS system. In addition, 84% of backed assets are bonds. The companies can easily liquidate their investment assets - bonds, land, and machinery- through the ABS system.

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The government has continuously tried to revitalize the bond market. However, the market would not come up to the government's expectations because of its lack of willpower. To make the bond market policy a success, the government needs to maintain its policy and draft up strong actions. VIP