STOCK MARKET WILL STABILIZE AS UNCERTAINTY CLEARS

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The Korean stock market seems to have forgetten the first quarter's bullish run. Because of synchronization with the Dow Jones index, the KSE experienced a near 300-point fall in April. The KOSDAQ index also dramatically fell while the NASDAQ investors are in debates about the bubble of advanced tech stocks.

Futhermore, investment trust companies (ITCs), major institutional investors, have recently been the main net-sellers in the market since the ITCs had to secure substantial liquidity to meet the expected redemption. So institutional investors including ITCs have concentrated on extremely short-term spot-futures arbitrage trading which induces risk-free gains.

Investment trust companies (ITCs), major institutional investors, have recently been the main net-sellers in the market.

Additionally, uncertainty on how much money should be injected to clean out the ITC accounts has been also haunting foreign investors. This market uncertainty has made the recent trading flow from short-term speculators. Foreigners overbought 1.2 trillion won in January, and conversely sold 9,576 futures contracts. In February and March, they temporarily took long positions on futures, but they aggressively took short covering as the market became unstable in April. Since long term foreign funds like pension funds do not hedge with index futures often, recent foreign investors have turned out to be short term traders. These trading patterns have widely spread as the market became too volatile with the DOW's rapid decline. Therefore, individual investors worried about trading losses have been reluctant to purchase stocks aggressively. As a result, funds are flowing into more stable short-term financial products with relatively high yields such as those offered by banking institutions, leaving the stock market with fewer funds. In fact, about 15 trillion won of ITC's financial products have flowed into short-term products for three months.

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Table 1. Recent Movement of Funds

(unit: trillion won)

	1999		2000			
	11. 30	12. 31	1. 31	2. 29	3. 31	4. 18
Savings deposits	-	276.4	286.0	298.0	305.0	312.2
Stock market customer deposits	9.6	7.0	9.4	10.5	10.8	11.6
Equity-type beneficiary certificates	55.1	54.0	56.2	59.3	64.9	65.8
Bond-type beneficiary certificates	111.4	101.8	94.6	77.0	68.3	93.0

As the situation was rapidly aggravated, the government announced that it plans to inject additional public funds into two ailing ITCs as part of measures to stabilize the local financial market. Over 5 trillion won may be needed to restructure the two ITCs. It won't be easy for them to keep their promise. Since the government spent part of the retrieved money to buy Daewoo bonds and for other expenses, only 7 trillion won is left in the fund. Investors' fears about corporate liquidity problem also set fire to the market which has been under downward pressure.

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However, ITC's problems, have been transparently publicized, a fact which is reflected by the current level of stock indices. Although the Korean government has demonstrated its strong will for improving the chaebol's corporate governance, it has cooperated to stabilize the financial market and the BOK has elastically operated the quantity of Monetary Stabilization Bonds (MSBs). So the financial market will stabilize as financial market's distress gradually cools off.

Furthermore, as Korean stocks are included in the FT/S&P world and regional index, foreign inflows into equity are likely to recover. Especially, securities stock that had been undervalued will contribute to bullish sentiment in the medium and longer term, and IT-related stock prices will go upward with the NASDAQ's recovery. Therefore, market sentiment will gradually recover, and ultimately overall indices will ride a rising curve.

The won/dollar exchange rate, which showed strong downward momentum in the first quarter, has been steady because foreign stock investment decreased following the U.S. stock market crash and the unexpected fall of the trade surplus due to the hike of oil prices.

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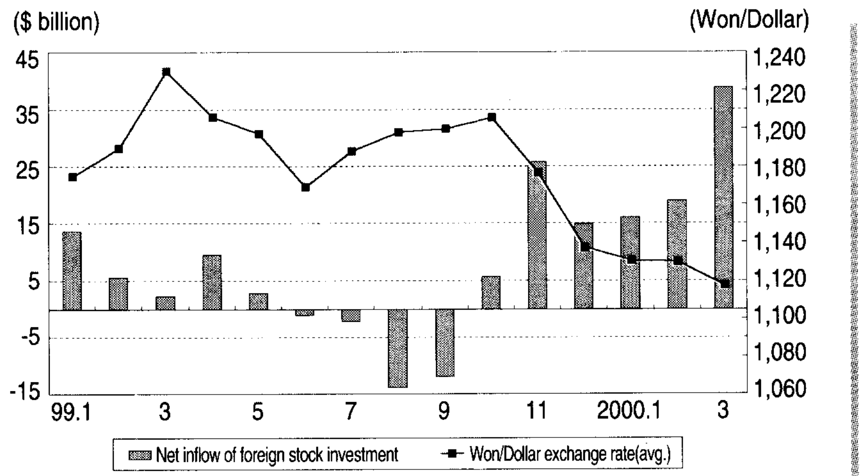
However, the uncertainty over the general elections is now gone and the expected rise of the stock market will contribute to the appreciation of the won. Even though the current account surplus will diminish due to increased imports, the inflow of foreign direct investment funds will increase since the credit rating on Korea is expected to rise during the second quarter. Furthermore, the BOK will find it difficult to maintain its policy of curbing the appreciation of the won by intervening in the foreign exchange market. The BOK purchased an enormous amount of dollars in efforts to prevent the won's appreciation for the last two years. At the same time, the central bank assumed too many liabilities by issuing bonds in order to absorb excessive liquidity in the market.

The won/dollar rate that the government seems to be targeting this year is around 1,090. Of course, while the government does not disclose the exchange rate level it deems as desirable, it does disclose various macroeconomic targets, including dollar-denominated per capita GDP, which makes it possible to calculate the target exchange rate with high accuracy. This is something like a self-fulfilling prophecy. It will induce foreign portfolio investment, which in turn will make the exchange rate move in that direction. Hence, the Korean currency will appreciate to 1,050 per dollar

Figure 1. Won/dollar Exchange Rate and Foreign Stock Investment



by the end of this year.

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In connection with the rise in the U.S. interest rate, the BOK may soon attempt to conduct interest rate hikes. In fact, the BOK is hinting at a rise in the benchmark short-term interest rate this year again to counter building inflationary pressures amid a continued economic upswing. Inflation is predicted to reach 1.5 percent in the first quarter, go up to 1.8 percent in the second and continue to rise to 3.1 and 3.2 percent in the third and fourth.

Although the rates would be annualized at about 2.4 percent, which is within the government's goal of three percent, we can see that inflationary pressures are expected to build up in the coming months. A rapid drop in excess supply amid continued economic growth and growing pressure for wage increases will also be main factors increasing inflationary pressures.

Additionally, the government's massive issuance of foreign exchange stabilization bonds to protect against an exodus of hot money will also result in rate hikes. For these reasons, the monetary authorities may initiate a belt-tightening policy to retrieve circulating currency, leading to hikes in the interest rate.

However, the Ministry of Finance and Economy has repeatedly said that it will use a lot of means to rein in interest rates because, at the time the second phase of financial restructuring kicks off, higher interest rate may expand bad loans held by financial institutions and worsen corporate financial conditions.

Therefore, two conflicting forces are expected to clash with each other in May, so the interest rate will remain steady. VIP