ANXIETY IN THE FINANCIAL SYSTEM

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Recently, the financial market has been in a state of apprehension. Although the stock market has rapidly rebounded from its trough since early June, many problems are still unsolved. Among them are uncertain prospects for oncoming bank restructuring, high volatility in stock prices, and an inadequate bond market for corporate bonds.

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While the real sector has maintained stable growth and inflationary pressure has been lower than expected, financial market instability may be difficult to resolve in the near future. Since the insufficient liquidity of investment trust companies (ITCs) is being covered by the banking sector, the investment market regained stability in mid May. In addition, because of uncertainty about corporate restructuring, market confidence is gradually plummeting and the system is showing signs of anxiety.

The external environment is also bringing unease to the financial market. With international oil prices approaching highs of 30 dollars per barrel, prices have been increasing and the balance of payments surplus is expected to fall. Furthermore, if US interest rates are raised as expected, it will be difficult to expect an early recovery of the stock market.

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The stock market seems to have had a bullish run. The Korea Composite Stock Price Index, or Kospi, closed at 731.88 on May 31. Volume was robust at 495 million shares valued at 4.29 trillion won ($3.80 billion). Factors include the US interest rate hike, the diminished trade surplus and rumors about a coming liquidity crisis. Although such a crisis is unlikely, the reports about an economic downturn are not totally groundless.

There may be another factor that is pertinent to the Korean stock market. When the market booms, money pours in heavily without a particular strategy as investors

Table 1. Recent Fund Movements

(unit: trillion won)

	1999	2000				
	Dec 31	Jan 31	Feb 29	Mar 31	Apr 30	May 25
Savings deposits	276.4	286.0	298.0	305.0	315.8	322.3
Stock market customer deposits	7.0	9.4	10.5	10.8	10.1	9.4
Equity-type beneficiary certificates	54.0	56.2	59.3	64.9	66.2	66.4
Bond-type beneficiary certificates	101.8	94.6	77.0	68.3	90.2	82.5

rush in. Then, when the market slows, the inflow dries up too quickly. This phenomenon undermines confidence when the market enters a downward trend.

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In the short term, the 700-level should be the lower limit with a high possibility of an upturn in the market as bargain hunters start buying with hopes of greater returns. For long-term prosperity, however, the market needs more than adventurous buyers. And the market should provide some good buying opportunities, in case there is a significant drop in U.S. equity prices.

The government hopes to encourage restructuring in the financial sector including mergers among banks. Experts are also pinning hopes on the government's determination for reform, but are requesting more clear-cut action plans or criteria for the industry.

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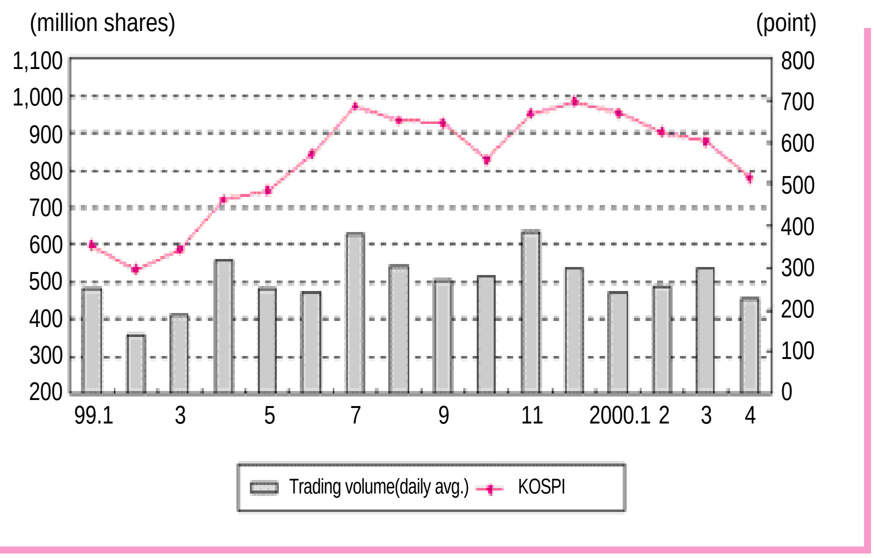
However, Korean markets have already discounted the strength in the economy and are focusing on the Fed's aggressive monetary policy and the uncertainty regarding investment trust companies. While these issues will probably remain on the minds of investors during the next few months, the positive fundamentals underlying the economy are expected to put a floor under the markets.

Interest rates, formerly stable, have risen suddenly. The yield on three-year corporate bonds has returned to the 10% range since April 20. The yield on national bonds has also shown a fast increase up to the 9% range due to the burden of financial restructuring. Interest rates in June are expected to steadily rise.

Restructuring at investment trust companies such as Daehan or Hankook ITC will be supported by 490 billion won of public funds. However, factors such as the liquidation of certain company walkouts, restructuring of the banking system, and the

Figure 1. KOSPI and Trading Volume



settlement of the Daewoo Motors problem will lead to instability in the financial system and will cause interest rates to rise. But the government has displayed its strong intention to keep the interest rate stable.

Interest rates are expected to rise by mid June due to an uncertain risk premium increase. Government bonds are expected to go up to 8.95~9.45 and corporate bonds to 9.95~10.45.

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The deterioration in the Korean current account is temporary and will be reversed by lower oil prices in the coming months. Ample capital inflows will strengthen the currency. But the inflows, coupled with the tight labor market, will also increase inflationary pressures.

The smaller trade surplus in the first quarter is due to a rise in oil prices, with petroleum products accounting for 20% of the import bill. This does not imply a change in the growth forecast. The trade surplus is expected to rise sharply in the months ahead, as the current oil price decline factors into deliveries.

The contraction of the trade balance has been more than offset by strong capital inflows, mainly portfolio investment. Inflows from new lending have contributed as well. The inflow of capital and the tight labor market are contributing to inflationary pressures that will likely trigger a substantial rise in interest rates next year.

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The central bank's policy to stabilize the won/yen cross rate has kept the real exchange rate and the consumer price index under control, so a rise in interest rates seems unlikely. Therefore, the won/dollar exchange rate is forecast to range from 1,070-1,100 won/dollar in June. VIP

Figure 2. Won/Dollar Exchange Rate and Foreign Stock Investment