KOREAN FINANCIAL MARKET: INSTABILITY REMAINS

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The Korean financial market has demonstrated a steady recovery phase. Corporate illiquidity problem resulting from the Hyundai crisis has been gradually resolved since the Hyundai ITC succeeded in pulling AIG funds and the Hyundai Motor Company decided to strategically ally with the DaimlerChrysler group.

Stock market: modest recover y

Both the Korea Stock Exchange and the Kosdaq showed a modest recovery. In June, The KOSPI recovered to the level over 800-point mark, greatly helped by the massive stock buying activities of the foreigners. With the rising momentum, daily transaction volume has increased to 0.5 billion shares a day, the level of late May. In index futures, market basis converted to contango because basis generally keeps contango when the market is on a strong rising momentum. International factors did not affect the market negatively. The U.S. Fed seems likely to loosen somewhat a tightened monetary policy stance after six consecutive rate hikes since January. If we consider that the next FOMC meeting will be opened on August, market worries on the U.S. rate hike will not be spread at least on July.

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In the second half of 2000, however, the stock price index will likely remain unstable. In fact, investment trust companies (ITCs) that lost their customers' confidence due to their hard-to-resolve bad assets will have a difficult time in winning back customers. This will contribute to the worsening imbalance of demand and supply because the ITCs are major institutional investors in the market. The investment sentiment also could be discouraged by instability of the second phase financial sector restructuring in the second half. Even so, stock prices could rise toward the end of the year if it appears to investors that the financial and corporate restructuring proceeds smoothly and newly arising banks' bad assets are settled quickly. The improvement of the nation's sovereign credit rating due to the reconciliation between the North and the South will encourage the inflow of both

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Money market: credit crunch not resolved fully

Major leading banks including KDB decided to purchase corporate bonds due to the MOF's strong urge. Currently, while banks cannot but buy bonds, institutional investors having bonds do not resolve their own long positions by the speculation of the additional rate decline. As the BOK supports the market with one trillion scale of RP to assist the banks' pooling of the bond-type funds, the rate will further drop in the short term.

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However, despite the government's efforts to prevent it, domestic companies are expected to continue to face a credit crunch in the second half. Because the restructuring of the ITCs is still in progress, neither issuing new corporate bonds nor rolling over of maturing bonds will be easy. The maturity of a large amount - approximately 29 trillion won- of the corporate bonds issued in 1997 and 1998 are concentrated in the second half of 2000. Although companies will keep on searching for other sources of funding to pay back the principal of matured bonds, they will confront difficulty, despite the government's efforts to alleviate the credit crunch. Also, the gap in funding conditions between companies with good credit ratings and companies with weaker credit ratings is expected to widen even further. Furthermore, increasing inflationary pressures are likely to cause interest rates to rise. The price stability kept in the first half is likely to reverse its course in the second half due to the rise in wage, service charges and international oil prices.

Combining all these factors, the interest rate for the second half of this year is forecasted to move mostly in the range of 10 to 12 percent, which is higher than the average rate over the first half.

Foreign exchange market: the won's gradual strength

The won/dollar exchange rate will likely move within a somewhat higher band of 1,110~1,130 in the third quarter because the mounting bad debt problems of financial institutions and the liquidity squeeze of domestic companies will exert upward pressure. However, in the fourth quarter, the exchange rate is expected to fall to a level below 1,100. The won's strength will also be helped by an upgrade in Korea's sovereign credit rating and the advance of financial and corporate sector restructuring, which will lead to the increased inflow of foreign direct and indirect investment and an upgrade in the sovereign credit rating.

On the demand and supply condition in the foreign exchange market, there will be a continued edge of excess supply, although the degree will likely be less than in the first half. Foreign exchange supply will exceed demand by 4 billion dollars in the second half. Even though the inflow of foreign direct and indirect investment will decrease, the current account will demonstrate 4~5 billion surplus. Furthermore, FDI net inflow will reach 5 billion because of the resolution of the Daewoo subsidiaries. Domestic financial institutions and companies will also continue to attract lar ge amounts of foreign capital to proceed with restructuring. On the demand side, demand for foreign currency by domestic companies and banks will increase.

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However, there are a few factors that restrain the won's strength in the second half. These include the slowdown of the domestic economy, the possibility of the direct or indirect intervention by the government in the market and the surge of imports due to expanding facilities investment. VIP

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