

FINANCIAL CRUNCH AGAIN? IT DEPENDS ON POLICY EFFECTIVENESS

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Looming anxiety about a financial crunch

Anxiety about a financial crunch is coming up again. Though market interest rates and the Composite Stock Price Index (CSPI) improved after the government's June 16 announcement of financial market stabilization, these figures are becoming shaky again. Policy inconsistency and ineffectiveness seem to be at the center of the problem.

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The stabilization of both bond and stock markets up to mid-July stemmed from the market expectation that the government measures would be effective only if they were executed as scheduled. The 10 trillion won Special Fund for Bonds (SFB) was expected to absorb corporate bonds maturing at the end of this year, and the sale of Non Tax Funds (NTF) by investment trust companies (ITCs) was expected to enhance liquidity in the stock market.

Causes of financial instability

But, from mid-July, the stock index plunged by nearly 150 points and the corporate bond return rate reversed its downward trend. The major causes of this situation seem to be the following: First, funding of the Special Fund for Bonds is

Figure 1. The trend of KOSPI and trade volume

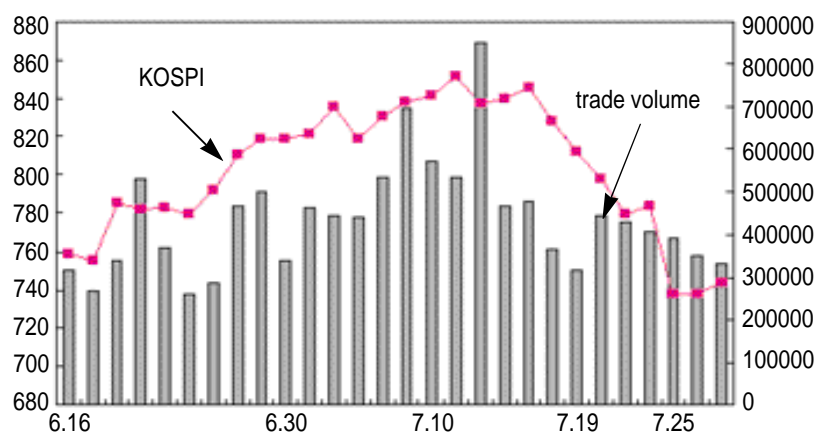


Table 1. Corporate Bonds Due at the End of this Year

	(hundred million Won)						
	2000.7	8	9	10	11	12	SUM
Corporate Bond	55,462	25,753	26,570	26,248	35,095	97,678	266,806 (53.2) ¹⁾
High Yield Fund²⁾	14,162	3,309	5,295	607	29,666	19,729	72,770 (37.2)
CBO	1,976	12,340	7,620	4,332	302	121	26,691 (65.5)

Footnotes : 1) The weight of bonds below BBB-. 2) New High Yield included

faltering, causing concern about the possibility of successful conversion for corporate bonds due at the end of this year. This concern is increasing market risk, pulling down the stock price index and raising market interest rates.

The delayed operation of non tax funds by ITCs has consequently delayed liquidity injection into the stock market.

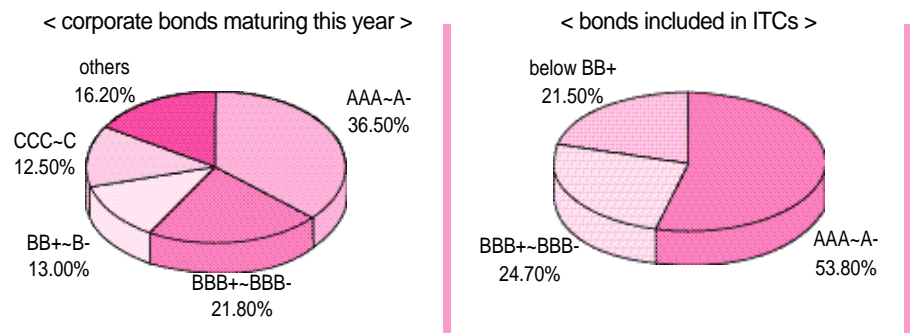
Second, the delayed operation of non tax funds by ITCs has consequently delayed liquidity injection into the stock market. This in turn forced investors to place tremendous disappointed offerings into the market, taking down the stock price index. The delay of this non tax fund was primarily due to the National Assembly's crippled operation. It was originally scheduled for sale from July 1st, but due to delayed legislation in the National Assembly it was postponed to August.

In addition, when the government was said to be considering an Agricultural Special Tax of 2% on the NTF, the investors were so perplexed that they hesitated putting their money into the fund.

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Third, with the delayed sale of the primary CBO, a sort of asset-backed security, the conversion issues of middle class enterprises came to face difficulties. From the beginning, it seems that a specific plan including a detailed scheme about the CBO issuance was not given to underwriters, and it was difficult to catch up with the market situation. The government regulations relating the sale of primary CBO have been frequently changed. Also, because the investors asked to substitute other bonds

Figure 2. Credit Rate Distribution of Corporate Bonds Maturing this Year



of higher credit ratings, such as Hyundai Motors, for some underlying risky assets, at around July 15, the scheduled date of sale, the sale of CBOs was postponed to August. And thus, as time passed, the difficulty of rolling-over issues faced by middle class firms increased the possibility of bankruptcy, which led to apprehension in the overall financial market.

These three apparent causes of the Korean financial market's dismal situation, however, might have originated from a more fundamental root. And that would be inconsistency and ineffectiveness of government policy.

The key factor in the loss of credibility, and therefore, the effectiveness of policy was the inconsistency revealed in the Agricultural Tax debate and procedures relating to the CBO fund.

But what is more important is the ineffectiveness of policy associated with overall financial restructuring. The deficient funding for SFB, for instance, was primarily caused by the hesitation of banks who stood in fear of restructuring in the banking sector. The oncoming M&As in the banking industry forced the banks to focus primarily on BIS ratios rather than earnings, which, in turn, made them hesitate in raising funds for SFB. In addition, it is undeniable that this almost compulsory restructuring process driven by the government is causing the conservative operation of banks.

Appropriate policy measures

Although the government is aiming to create large and specialized banks by introducing financial holding companies, it is not likely to achieve this goal. Because the banks likely to be included into the holding company are apparently the ones that cannot survive by themselves, it is still open whether financial holding companies can accomplish their expected synergy effect. As is well known, a financial holding company was introduced voluntarily among competitive banks to avoid government regulations preventing commercial banks from entering the investment banking sector.

Now the government appears to be enforcing this unproven system to the market. This compulsory action will not only have difficulty achieving its original goal but also may become a cause for another financial crunch, through the extremely conservative operations of banks.

The best policy the government can make at this stage seems to be overcoming its inconsistency so far and to prepare legal and systematic devices (including financial holding companies) to build a more efficient financial system. This would be the optimal level of government intervention in the market and deviation from this would lead to severe moral hazard problems for economic agents as well as ineffective policy.

Will there be another financial crunch in Korea? It just depends upon policy effectiveness. **VIP**

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