KOREAN FINANCIAL MARKET : UNCERTAINTY REMAINS

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The Korean financial market is showing continuous growth. Sustained growth depends on the success of corporate and banking restructuring efforts. Even though macroeconomic indexes are favorable, the financial market is still shaky due to external shocks.

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Stock market: uncertainty with blue chips

During mid August, the composite stock price index (KOSPI) recovered to around 730 after the bearish market of early August. However, on August 31, foreign investors massively dumped their holdings of blue chips including Samsung Electronics, which brought jitters to the stock market. As a result, the KOSPI index plunged nearly 31 points from 718.93 on the previous day to 688.62. Nearly 11 million shares of Samsung Electronics, valued at 300 billion won, were sold by the foreign investors. One reason for this event was sluggish expectations for semiconductor-related shares in the U.S. stock market. If the same trends occur at Hyundai Electronics, the future of the Korean financial market will be uncertain. On September 1, the KOSPI gained 3.57 points to settle at 692.11.

The tech-heavy KOSDAQ index closed at 108.59 on August 31, and plunged about 58 percent so far this year. In response to the sluggish KOSDAQ market, the Ministry of Finance and Economy announced a package of measures to revitalize the struggling market. The goal of this package is to adjust the oversupply of shares in the market by boosting market participation of institutional investors and lowering the share distribution rate. These measures include restrictions on stock sales by majority shareholders of KOSDAQ companies and individuals in special relationships with them to 5 percent of their holdings a month even after one year. Authorities will also strictly control new issues. In addition, tax breaks will be provided for M&As among companies trading on the KOSDAQ market. The announcement of this package did not have an immediate impact, with the KOSDAQ gaining a mere 0.35 points to close at 108.94 on September 1. However, this plan is expected to contribute to a stabilized market in the medium or long run.

The Korean stock markets are expected to revive in the near future. Some favorable external conditions include the following. First, the government announced an implementation schedule of the financial sector restructuring plan, capital market stabilization measures for relieving the capital crunch, and revitalization measures of the KOSDAQ market. In addition, the Fair Trade Commission approved Hyundai's

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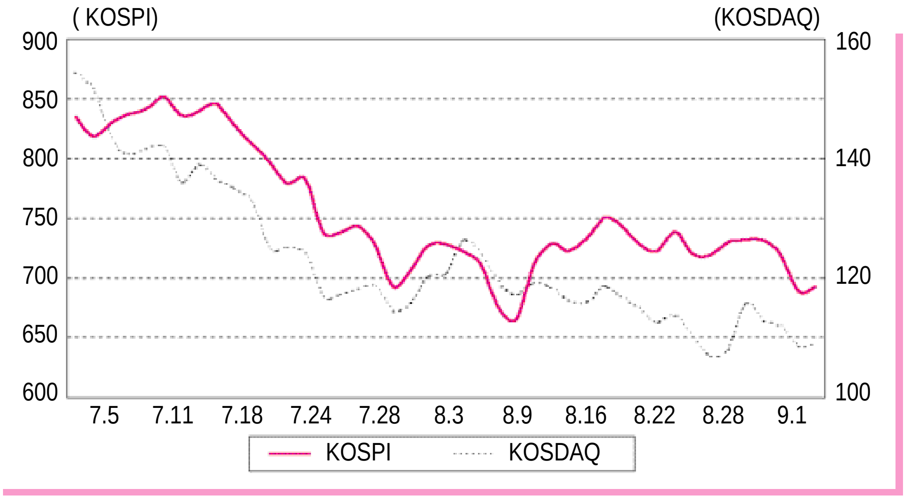
Figure 1. KOSPI and KOSDAQ Indexes



request for the spin-off of its automotive affiliate after a two month delay. Second, current economic data indicates that the U.S. economy is approaching a soft landing in the coming period, which implies that the Federal Reserve will hold interest rates steady for the time being. Third, the hike of Korean industrial production in July due to strong exports will be good news for the markets.

Money market: temporary relief from the credit crunch

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Korea's inflation rose 0.8 percent in August. Increases in domestic consumer prices will occur with a negative impact on the Korean financial market. The hike of consumer prices is attributed to higher medical fees and crude oil prices. International oil prices are at their highest since the 1990 Gulf War. Dubai oil for delivery rose to $29.51 per barrel as of September 1, more than double the price of last year, and the figure is still breaking records daily. The Bank of Korea began considering raising the call rate to suppress inflation pressure. This will be bad news for the Korean financial market since financial reform is still underway. It seems that a gradual hike in the call rate is inevitable in the long run.

To cope with the widespread concerns over a credit crunch, the government

Table 1. Major Interest Rates

(End of Period, %)

	1997	1998	1999				2000			
			Q1	Q2	Q3	Q4	Q1	Q2	July	Aug.31
Call Rate(1 day)	26.59	5.53	4.88	4.85	4.80	4.84	4.90	5.09	5.11	5.14
CD rate(91 days)	25.00	7.70	6.55	6.35	7.70	7.34	7.01	7.18	7.06	7.05
Corporate Bond Yield(3yr.)	28.98	8.00	7.96	7.95	9.95	9.95	9.98	9.37	9.17	8.98
Tresury Bond Yield(3yr.)	-	6.95	6.50	7.20	9.03	9.03	9.00	8.31	8.07	7.79

Source: Bank of Korea

announced new measures to stabilize the capital market on August 23. The newly announced measures consist of raising bond funds of 10 trillion won in addition to the current 10 trillion won worth of bond funds and encouraging to dedicate more than 1/3 of PCBO (Primary Collateralized Bond Obligations) to firms issuing bonds with credit ratings below BB. In addition, the government will increase the coverage of guarantees from 40 to 50 percent of the PCBO.

It seems that the market is positively accepting the newly proposed measures in that market funds are distributed directly to corporations. The Bank of Korea prepared incentives for banks to lend more money to corporations rather than to households.

Considering the new measures to stabilize the money market and seasonal effects on money supply from the Chusok holidays, the credit crunches for corporations are expected to be resolved at least in the short term and interest rates are expected to decline slightly.

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Foreign Exchange Market: a continuous downward trend

During the past couple of weeks, the Korean won/dollar rate showed stability at around 1,114 won per dollar and gradually a downward trend by closing at 1,105 won against the dollar on September 1. As net stock purchases by foreigners recorded at 290 billion won during mid August, the demand for dollars from refinery industries and public sectors removed the oversupply of the dollar.

The gradual appreciation of the Korean won is attributed to a trade surplus of $1 billion and funds from foreign investors in the Korean stock market. Accordingly, the strength of the won is inevitable and desirable. As long as there is a surplus in the balance of payments, there will be appreciation pressure. Excess intervention of foreign currency accelerated domestic inflation.

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Figure 2. Won/Dollar Exchange Rate and Foreigners' Stock Investment