

# FINANCIAL MARKET OUTLOOK

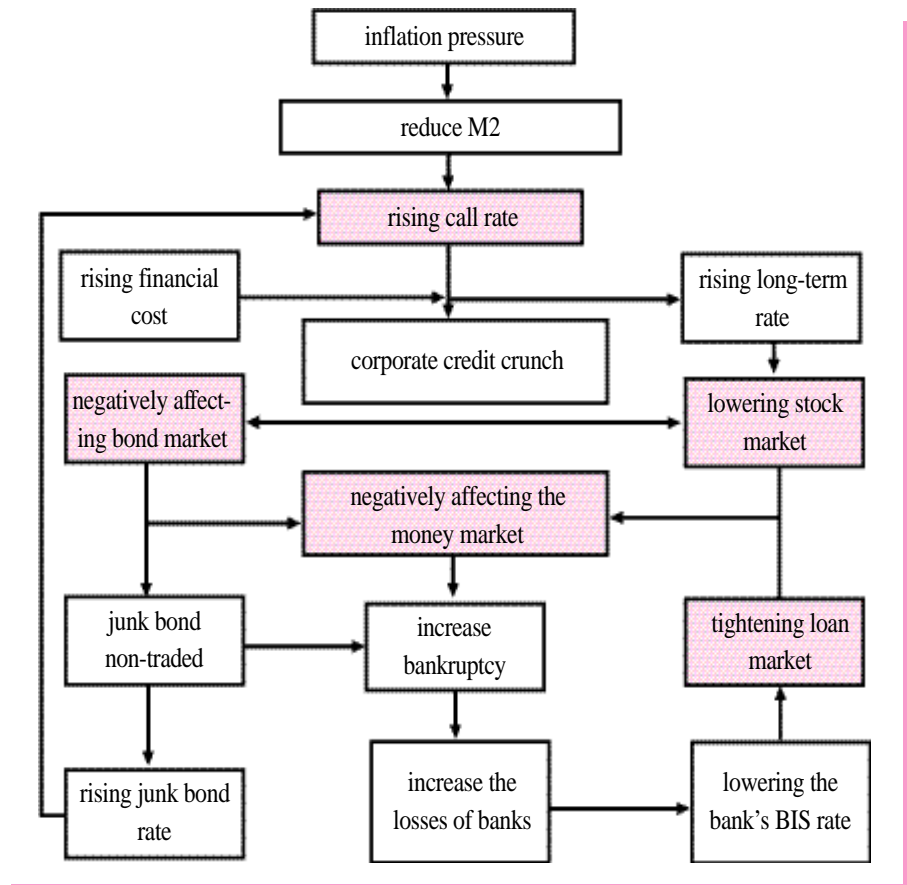
Department of Financial Market Analysis

Interest rates to be stable for the time being

*Demand pressures from the peaking of the business cycle will cause consumer prices to rise.*

It is expected that the monetary authorities will reduce the supply of the money (M2) near the end of 2000 because of several factors. The first factor is the threat of inflation. In the end of 2000, consumer prices will rise above 4.0 percent year-on-year. The rising trend of consumer prices will be prompted by cost pressures such as the rise in oil prices, farm products prices, medical service charges, public utilities charges, and housing prices. In addition, demand pressures from the peaking of the business cycle will cause consumer prices to rise. Generally, the most effective policy to reduce the pressure of inflation is increasing of interest rates, especially the short interest rate (the call rate). To increase the short interest rate, the monetary authorities

— Figure 1. Impact of Money Retrenchment on the Capital Market —



have to reduce the supply of money (M2). As a result, the short term interest rate will rise and this will raise the long term interest rate sooner or later.

However, because the government has to finish the financial and corporate reforms by the end of 2000, it will not be able to increase interest rates before then. If the interest rates are increased in the near term, the government's goal of financial and corporate reforms will fail because the cost of reforms would rise.

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Therefore, it is expected that interest rates will be stable until the end of the 2000, but they will be gradually raised in 2001. Inflationary pressure in 2001 will be stronger than in 2000.

The amount of expired corporate bonds is estimated to reach about 88.6 trillion won in 2001, and the additional public funds is expected to reach about 40.0 trillion won. Credit crunches will be more likely next year than this year. And more government bonds will be issued due to the need for public funds. As a result, the corporate bond rate and government bond rate will be higher than they were this year.

Therefore, in 2001, companies with bad credit ratings will have a hard time issuing corporate bonds. As a result, the possibility of bankruptcy for these companies will be higher in 2001. Therefore, these corporates have to finish corporate restructuring by the end of this year.

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### *Korean won to be appreciated next year*

The government has been preparing for the second stage of liberalization of foreign exchange, which will be implemented early next year. This will temporarily give an impulse to the financial market. The inflow or outflow of foreign exchange from domestic market will rapidly increase. Therefore, the foreign exchange rate will fluctuate in the short term. And the government will intend to make early repurchases of the remaining Fund credit balance amounted about \$ 6.0 billion in 2001. This factor will be effected as the rise of foreign exchange rate in next year.

*The inflow of the foreigner's stock investment funds will be continually increased in 2001 if the corporate and financial reforms are successful.*

However, the government will effort to gather the dollars by inducing the investment of the Japan amounted about \$ 7.0 billion. And Korea's foreign exchange reserves reached \$91.66 billion as of Sept. 15, up \$230 million from the end of last month. The BOK attributed the increase to domestic financial institutions' repayment of foreign exchange deposits to the central bank and an increase in profit from investment of its foreign exchange reserves. Korea's foreign exchange reserves, \$74.05 billion at the end of 1999, have been growing steadily in the past year. Also, the inflow of the foreigner's stock investment funds will be continually increased in

2001 if the corporate and financial reforms are successful. As a result, the foreign exchange rate will be lower than that of this year.

Stock market performance depending on structural reform

If the corporate and financial reform will be accomplished by the end of this year, including rapid recovery from the crisis and its large foreign exchange reserves, it could upgrade Korea's current triple-B credit rating. This means the upgrading of the level of the stock market. However, as the previous case, the stock market will be divided by the good company and bad company as the division of money market. The bad company will be faced with the possibility of bankruptcy and their stock price will be crashed. However, the good company will be grow rapidly by the help of rising bank's loan and the funding from the stock market.

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There will be three major factors in the capital market: oil prices, semiconductor prices, and corporate and financial reform. These factors will be unstable in 2001. Therefore, the capital market will fluctuate according to these factors. In figure 2, the probability of scenario is about 20.0%. If this case occurred in 2001, the capital market will be confused. The probability of scenario is about 50.0%. If this case occurred in 2001, the capital market will be polarized into two sectors (division of good and bad companies). The probability of scenario is about 30.0%. If this case occurred in 2001, then the capital market will be stable, and corporate and financial reform will be completed in the short term. **VIP**

Table 1. Capital Market Scenarios

	Factors	Stock Price Index	Interest Rate	Exchange Rate	Money Market
Scenario	- Oil price : \$30~\$40 - 128DRAM : \$10~\$20 - Reform : delayed	450~600	13%	1200₩/\$	credit crunch
Scenario	- Oil price : \$20~\$30 - 128DRAM : \$20~\$30 - Reform : continued	750~850	10~11%	1100₩/\$	volatile
Scenario	- Oil price : \$10~\$20 - 128DRAM : \$30~\$40 - Reform : continued	850~950	9~10%	1000₩/\$	stable