ARE FINANCIAL MARKETS SLOWLY RECOVERING?

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Stock Market: Will January's rally continue ?

The new year has started with a rally in both the blue-chip Korea Stock Price Index (KOSPI) and the tech-heavy KOSDAQ markets. The KOSPI recorded a further rise to about 600 points in the middle of January this year from the previous month's level of around 500 points. Meanwhile, the KOSDAQ passed 70 points from the previous month's 50 points. The boost in these indexes can be attributed somewhat to the "January effect" and a reduction of economic uncertainty.

The new year has started with a rally in both the blue-chip Korea Stock Price Index (KOSPI) and the tech-heavy KOSDAQ markets.

The government stimulus package announced early this month is another reason for this rally. The package is expected to have a positive impact on local stock prices in the first half of the year, but its effect will depend largely on how much external economic conditions, such as the American business cycle and oil prices, improve. Stock prices will be affected favorably by the stimulus package, because it shows the government's firm resolve to push for financial and corporate restructuring and prop up the sagging economy. However, external economic conditions, such as a continued U.S. interest rate cut and the stability of the U.S. stock market, need to improve before the stimulus package can serve its intended purpose. Under the stimulus package, the government plans to allot about 70 percent of its fiscal spending in the first half. The advancement of government budget spending is expected to boost the GDP growth rate by 0.77 percentage points. One major reason for the KOSDAQ rally is the scheduled introduction of index futures on February 1. There are 50 stocks involved with index futures, and these stocks contributed to the January rally.

The recent upward trend was also caused largely by optimistic forecasts for the Korean economy. That is, the Korean economy has been confronted with a time of transition including the possibility of a soft-landing in the economy and the end of three-year financial crisis. However, the government has not yet solved the problem of uncertainty in the economy. And businesses have continually been confronted with a credit crunch because of strengthened work-out criteria. The financial restructuring is still delayed because of lack of flexibility in the labor market. Moreover, external factors of stock market such as the rise of oil prices and upward trend of the foreign exchange rate have made the stock market unstable.

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Recently, the government has boosted the stock market by increasing fiscal spending. However, this kind of boost policy will probably be insufficient to reduce the economic uncertainty. Last month's slackness in the stock market was caused by a collapse in the basis of major demand sources: especially institutional investors such as commercial banks, venture capital, and mutual funds. Therefore, there is a necessity to support demand sources that could be substitutes for institutional investors.

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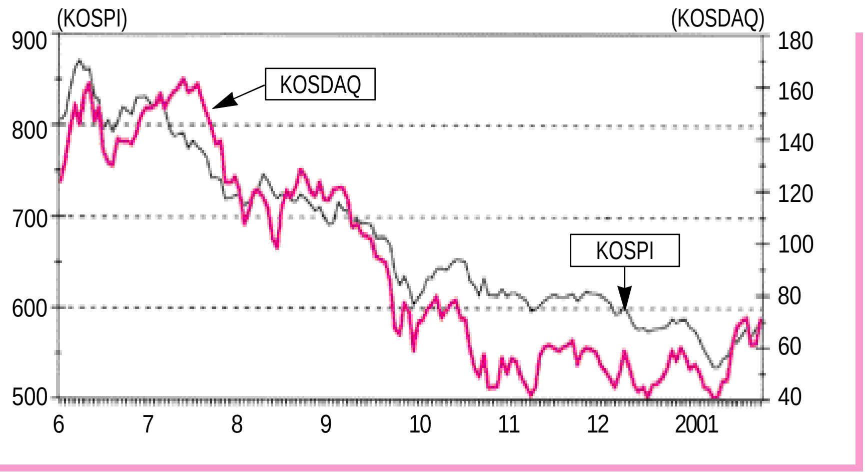
To boost the stock market, the government should first complete financial restructuring. Continued delay of financial restructuring will increase the risk of companies going bankrupt by preventing financial intermediaries from functioning properly. The government also should activate the junk bond market, which accounts for 30% of corporate bonds. If junk bonds reach maturity and are not redeemed, they may pull a company into bankruptcy. In addition, the government should induce short-term floating money into the stock market. At present, short-term floating money amounts to about 200 trillion won in all.

Figure 1. KOSPI and KOSDAQ Indexes



Money Market: The junk bond market has to be activated

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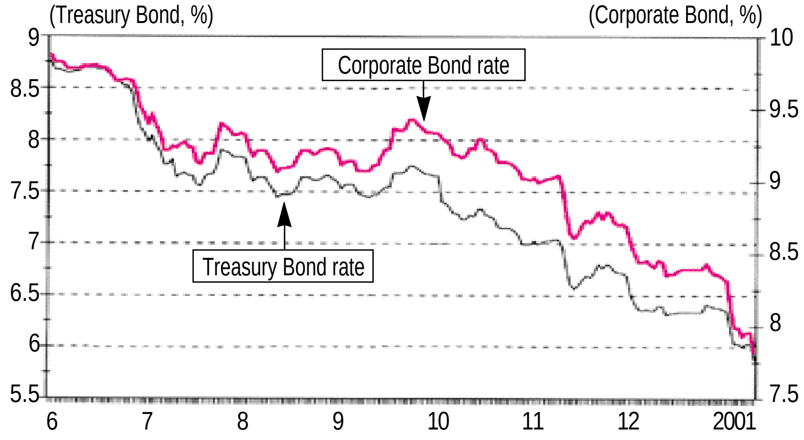
Corporate bond trading has started to pick up, bringing relief to companies formerly denied access to the bond market. The bond market is showing signs of life after remaining moribund since the Daewoo Group debacle. One visible sign is that there is growing demand for corporate bonds rated BBB- that had previously been shunned by risk-averse investors. This virtuous circle started operating in the financial market following the U.S. interest rate cut. The unexpected U.S. interest rate cut touched off an inflow of foreign investment into Korea, boosting the stock market and luring domestic funds that had been searching for investment opportunities.

Figure 2. Government and Corporate Bond Rates



The steady growth in demand for high-risk, high-return corporate bonds stems partly from the low yield on risk-free government bonds that currently hovers at around 6 percent. The low yield forced financial institutions to invest part of their customers' funds into corporate bonds to offer them higher returns. The yield differential between bonds rated BBB- and AA- now stands at 3.5 to 3.7 percentage points. The spread has been narrowing lately, reflecting a growth in demand for low-rated bonds. In addition, the funding difficulties of high-risk companies are expected to ease substantially this month as financial institutions are scheduled to issue primary collateralized bond obligations and collateralized loan obligations for them.

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The problem is this year. Overall, 60 trillion won worth of corporate bonds are scheduled to mature this year. Among those bonds, about 30% are expected to be included with junk bonds. Although the government bond and corporate bond rates are expected to record below 10% next year, junk bond (below BBB-) rates will probably record more than 15% to 20%. That is, the money market will be seriously polarized between the bonds of healthy companies and ailing companies. As a result, when the ailing companies reach the maturity date for their bonds, they will be confronted by the possibility of bankruptcy.

Foreign Exchange Market: Effects of second-stage foreign exchange liberalization

The won/dollar rate rose further to 1,300 won per dollar in the middle of January from about 1,200 in December last year. And the yen/dollar rate recorded a further rise to 120 in the middle of January from the previous month's level of about 110. The won and yen rates have sharply risen compared with the previous month. This trend is expected to continue through the new year.

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In June 1998, the government announced a two-stage foreign exchange liberalization plan. The first stage went into effect in April 1999. The second stage of foreign exchange liberalization began on January 1, 2001. In the second-stage liberalization, the remaining foreign exchange related regulations will be abolished although the government recently announced supplementary measures that would somewhat limit full liberalization. The supplementary measures are mainly to prevent massive capital flight and the inflow and outflow of illegal funds.

Above all, second-stage foreign exchange liberalization will enhance Korea's international credibility since the government will fulfill the promise it made to the IMF when it was bailed out. In addition, the foreign exchange market will become more efficient due to the expected jump in foreign exchange transaction volume. Moreover, companies will greatly benefit. As for domestic companies, they will also be given more room to manage their overseas foreign currency holdings as they see fit.

In addition to second-stage foreign exchange liberalization, the partial deposit insurance system and aggregate taxation for financial income have also been put into effect simultaneously this year.

However, a possible side-effect of the liberalization is sudden, massive capital flight. Although the government recently announced supplementary measures as a safety device to second-stage liberalization plan, there is still some possibility that capital flight may occur. Moreover, the foreign exchange rate has recently showed a much instability. In addition to second-stage foreign exchange liberalization, the partial deposit insurance system and aggregate taxation for financial income have also been put into effect simultaneously this year. As a result, the foreign exchange rate is expected to fluctuate due to the foreseen capital movement. VIP

Figure 3. Exchange Rates (won/dollar, yen/dollar)