ACTIVE CREDIT SUPPORT POLICIES REALLY WORK, EASING CREDIT CRUNCH AMID ECONOMIC SLOWDOWN

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In the financial market, domestic interest rates continued to decline as the 3 year government bond yield hovered around 5% and the AA- corporate bond yield fell to the 6% range. This was mainly due to ample short-term liquidity in the banking sector reflecting the tendency of 'flight to quality', which caused the short-term floating of funds last year.

But as interest rates dip downward, the corporate bond market is slowly reviving. Investment grade corporate bonds are receiving much attention as the yields on government bonds continued to decline this year. Low interest rates are likely to continue for the time being.

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Table 1. Interest Rate Trend

(end of period, % per year, %p)

	Oct. 2000	Nov.	Dec.(A)	Jan. 2001	Feb. 8(B)	B-A
Government Bond(3yr)	7.64	7.16	6.70	5.68	5.21	-1.49
Corporate Bond(3yr)	8.59	8.35	8.13	7.38	6.82	-1.31
Monetary Stabilization Bond(1yr)	7.06	7.02	6.83	5.71	5.43	-1.40
CD(91days)	7.02	6.94	6.87	5.94	5.80	-1.07
CP(91days)	7.24	7.26	7.26	6.66	6.51	-0.75

The Bank of Korea lowered its one-day call rate by 0.25% in February to 5% as part of its efforts to cope with the rapidly slowing economy. Some expect that the central bank will ease interest rates further in the months ahead in order to keep the economy from falling into a hard-landing. This rate cut was largely expected though, as concerns have been mounting recently over weak industrial production, exports, and a gradually rising unemployment rate.

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Figure 1. KOSPI Trend

The stock market looks like it is experiencing a correction as the KOSPI is hanging around 600 points and the KOSDAQ index is near 80 points. Even though the extent of stock price synchronization with the U.S. market appears to be much lower than in the past, the steep slowdown of the U.S. economy and expected deterioration of earnings performances in U.S. firms still come into play for the currently staggering domestic stock market.

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Anyway, the financial market appears to have regained confidence following a series of policy measures providing liquidity to firms with temporary liquidity shortages. The government recently announced that it would increase repayment guarantees for the corporate sector by two state-run credit agencies up to 54 trillion won. In this measure, the two state-run credit guarantee agencies will guarantee 50% repayment of primary CBOs(collateralized bond obligations) that will be issued, based on the pool of corporate bonds issued by large companies with difficulties in repaying or rolling over their mature bonds. In addition, they will also guarantee up to 70% of the repayment of CLOs(collateralized loan obligations).

These measures seemed to help many viable firms with temporary liquidity shortages get away from the pinch and maintain operation amid the economic slowdown.

Some companies were also helped to refund their maturing bond issues through the Korea Development Bank's quick purchase of 500 billion won worth of corporate bonds in January.

Some criticize the government's new policy measures on the grounds that it may bail out the non-viable firms under restructuring by easing the credit crunch, with the ultimate burden falling to taxpayers in case of future defaults. However, these

measures seemed to help many viable firms with temporary liquidity shortages get away from the pinch and maintain operation amid the economic slowdown.

The government's plan to facilitate corporate and financial sector restructuring is also accelerating as the February deadline for the second phase of restructuring is just around the corner. In the second phase financial restructuring, the government plans to pursue the "hardware" side of restructuring financial institutions including M&As between healthy banks. This is to block off the contagion risk from insolvent enterprises and non-banking institutions' burdens of bad loans that lead to the financial unsoundness of banks.

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Although the financial market appears to have regained stability, many issues have to be resolved in order for the financial market to function properly.

The credit crunch is obviously not contained within the banking sector but the source and the solution of the problem are interwoven between the corporate sector and the banking sector. In other words, the scarcity of credit is a result of the interaction between the tight restructuring standards of the corporate and financial sectors, i.e. 200% debt-equity ratio for the former and 8% BIS ratio for the latter. Considering the recent economic downturn, strictly imposing these ratios may be too harsh for the parties concerned.

It looks like the government's active corporate credit support policies are working to ease the corporate credit crunch at this time. However, factors such as strict imposition of higher viability standards for the financial sector as well as exchange rate volatility may negatively affect corporate credit. And there is a possibility that the credit crunch may return, if not prepared, when many corporate bonds mature in the second half.

Hence, with the recent deterioration of economic fundamentals and cooling market sentiment, the second phase financial restructuring needs the government authorities' credibility and leadership more than ever to block the spread of financial instability. And companies definitely need to prepare for the economic slowdown by emphasizing cash-flow and actively pursuing investor relations. VIP

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