KEEPING INTEREST RATES LOW CRUCIAL FOR CURBING RECESSION

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Recently, domestic stock markets have been in the doldrums as the world stock markets did not show good performances. The benchmark Kospi hovered below 550 and the Kosdaq Index lingered around 70 in the middle of March.

In the U.S., the Dow Jones Industrial Average tumbled below 10,000 while the Nasdaq Index dipped below 1,900. Overseas stock market woes came from growing concerns over the slowing U.S. economy, Japanese economic turmoil and under-par performances of many companies, especially those in the IT industries.

Due to the plunge of U.S. stock markets and Japan's economic woes, domestic investment sentiment has worsened. In the same context, it brought about the current stock market doldrums that the foreign investors' net buying position showed a slowdown since February this year.

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Table 1. Stock Market Indexes

(unit: points)

	1998	1999	Nov. 2000	Dec. 2000	Jan. 2001	Feb.	Mar. 13
KOSPI	562	1028	509	504	617	578	527
KOSDAQ	76	256	67	52	84	76	68

In early March, the monetary authority decided to keep the overnight call rate untouched at the current level of 5.0%. It was quoted as saying that in order to maintain stable market interest rates and bring about constant improvement in corporate credit, it is vital to reduce corporate credit risk by promptly implementing market-based structural reforms.

Currently, market interest rates are maintaining low levels despite some irregularities. The 3-year government bond yield rebounded to 5.9% in early March after it showed ups and downs based on the grim prospects for the sluggish economy and investors' flight to quality. But the yield fell as a government plan to implement a medium and long-term tax cut to avoid recession was revealed in the middle of March.

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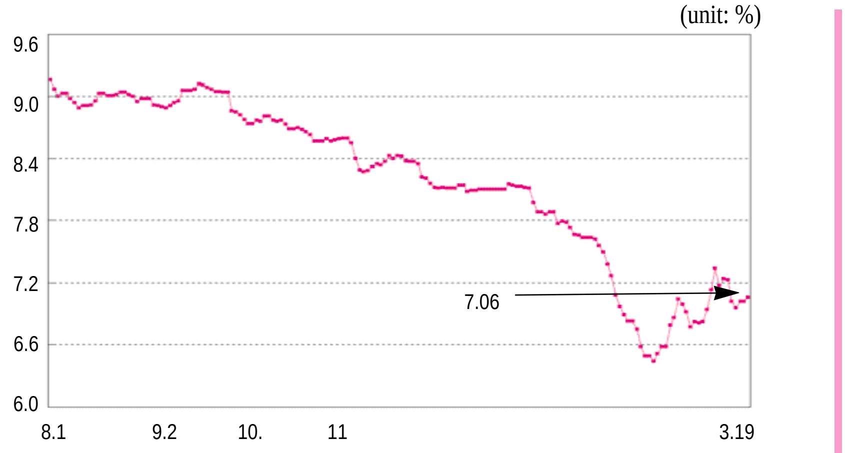
There is an expectation of more rate cuts in the financial market, as the domestic economy has continued to slow. In addition, it is likely that the Federal Reserve will

Figure 1. Recent Trend of Yield on 3 year corp. bond



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reduce the federal funds rate by as much as 0.5%p at the FOMC meeting scheduled on March 20 as the U.S. economy has showed no signs of recovery during the first quarter of 2001. The Federal Reserve disappointed stock investors as it did not slash the interest rate in early March, although a rate cut was expected. Anyway, the current mood of the world economic slowdown represented by the U.S. downturn and Japanese economic woes can be easily translated into an interest rate cut.

That's the upshot for lower interest rates. But there is still lingering concern over corporate credit risk in the domestic financial markets, which has brought anxiety. That is why market interest rates recently became volatile.

Other factors pertaining to market volatility include an increase in short-term deposits at banks and other secondary financial intermediaries. Short-term time deposits with maturities of less than one year have increased their share, while overall bank time deposits have increased. The weight of time deposits with maturities of less than one year to all time deposits increased from 25.4% at the end of June 1997 (just before the financial crisis) to 43.6% at the end of 2000.

This can be attributable to the fact that depositors tend to shy away from long-term time deposits due to the currently unstable financial markets with financial and corporate restructuring under way and an uncertain economic outlook.

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Fortunately, the corporate credit crunch seems to be gradually easing. While market interest rates have maintained an underlying downward trend, there has been a large increase in the issuance of corporate bonds and commercial paper.

Corporate bond issues surged this year. According to the Financial Supervisory Service, the bonds issued by domestic companies during the first two months of this year was 3.5 times the amount raised during the same period a year ago. From January through February, bond issues reached 11.3 trillion won, up 40.8 percent from a year ago. What was remarkable was that even speculative grade bonds which

Table 2. Trend of Corporate Financing

(unit: trillion won)

	Oct. 2000	Nov. 2000	Dec. 2000	Jan. 2001	Feb. 2001
Bank Lending(Total)	5.4	3.9	-3.9	3.9	-0.7
Big Business	1.3	-0.1	-3.5	3.1	-0.6
Small & Medium	1.4	1.0	-0.4	0.8	-0.1
Corp. Bond Issue(Net)	1.0	-0.8	-5.2	0.4	3.4
CP Issue(Net)	1.2	-0.3	-5.3	6.4	-0.2

(Source: Bank of Korea)

were totally shunned by investors last year began to make an appearance in the bond markets. Issues of bonds rated below BBB reached 2.02 trillion won, up 680.4 percent from a year ago.

What was remarkable was that even speculative grade bonds which were totally shunned by investors last year began to make an appearance in the bond markets.

Although corporate bond issuance has been rising this year, the outstanding balance of treasury bonds and monetary bonds is enormous. As of the end of February, the government issued bonds worth 144.8 trillion won in all, with 74.5 trillion won in treasury bonds and foreign exchange equalization bonds and 70.3 trillion won in monetary stabilization bonds.

One worrisome factor is that excessive issue of government bonds tends to curb demand for corporate bonds. This negative impact of excessive government bonds choking the demand for corporate bonds in the bond market is called the ‘Crowding-out Effect’.

In particular, as investors rush to buy safe government bonds, the fragile corporate bond market cannot work properly to replenish fresh capital for normal business operation and facility investment. And as a result, firms may be put into a liquidity crunch.

Hence, given that individual investors are scarce for the bond market other than institutional investors such as banks, investment and trust companies, the oversupply of government bonds along with investors’ strong tendency of flight-to-quality may hurt the corporate bond market.

Summing up overall financial market conditions, it seems that investor sentiment is gradually shifting from safety to profitability in the choice of financial instruments. This is due in large part to lower interest rates. It looks like the flight-to-quality phenomenon hampering the domestic financial markets last year is gradually easing nowadays.

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This is good from the standpoint of the nation’s economy since it may revamp the virtuous cycle of funds, channel funds to firms with productive investment opportunities and help the economy properly work. And that is why interest rates should be kept low, especially in the severe economic slowdown. VIP