CAUSE OF FINANCIAL TURMOIL STILL UNSETTLED

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The financial turmoil over the last two or three weeks originated from the foreign exchange market, and the shock reached all financial sectors. The yen's rapid depreciation caused the won to follow suit, which led to higher return rates and declining stock prices.

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Reason for won's steep depreciation

The Korean won's value has long been linked to the Japanese yen. While the yen/dollar rate reflects the fundamental economic conditions of Japan and the US, the Korean won is primarily affected by the yen/dollar rate. Furthermore, the influence of yen on the won is asymmetric, with the correlation between the two currencies much stronger when the yen depreciates. The yen's depreciation lowers the price competitiveness of Korean commodities in the world market, which puts downward pressure on the won.

While Japan's ongoing recession and prevailing worries in the financial market were enough to depreciate the yen, the fall of the Korean won was not caused exclusively by the rising yen/dollar rate. Another reason was speculative demand arising from anxiety over the Korean financial market.

Table 1. Won/Dollar & Yen/Dollar Exchange Rate*

	Oct 2000	Nov 2000	Dec 2000	Jan 2001	Feb 2001	Mar 2001
Won/Dollar	1,139	1,212.10	1,259.70	1,259.00	1,250.80	1,327.50
Yen/Dollar	108.81	111.11	114.41	116.43	116.60	124.50

* end of period

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The foreign exchange market, the seismic center

The rapid rise of the exchange rate will have a direct influence on domestic

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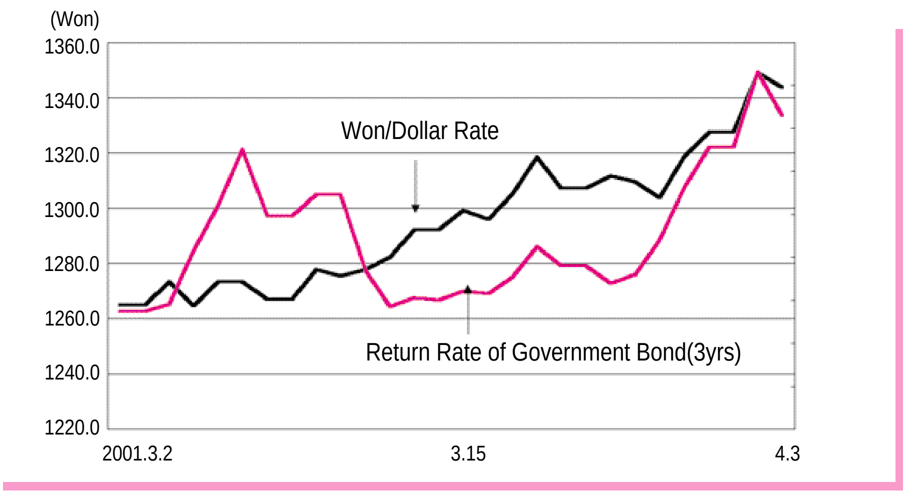
price levels through import prices. With recent concerns over inflation, the exchange rate's rise imposed a much heavier burden to the monetary authority. The consumer price level rose by 1.9% since late last year and this trend is expected to continue for the time being.

The expectations for a rise in overall price levels have put downward pressure on bond prices. Since the central bank's announcement concerning overheating in the treasury bond market, buying power in the bond market has plunged and the return rate has fluctuated within a small band. In a sense, participants in the bond market seem to have sought the obvious materials available to decide buying or selling. The obvious prospects for the upcoming price trend must have given them a clear signal to sell the bonds.

—Figure 1. Correlation of Foreign Exchange Rate and Bond's Rate of Return—



The rise of exchange rates has another implication related to the government's interest rate policy. While lower policy rates are prevailing in almost all countries including the US, inflation pressure from the exchange market has made the Bank of Korea hesitant to cut the call rate.

The perception of the situation above accelerated the market participants' sale and conduct in the bond market and consequently raised the return rate.

Moderate impact on the stock market

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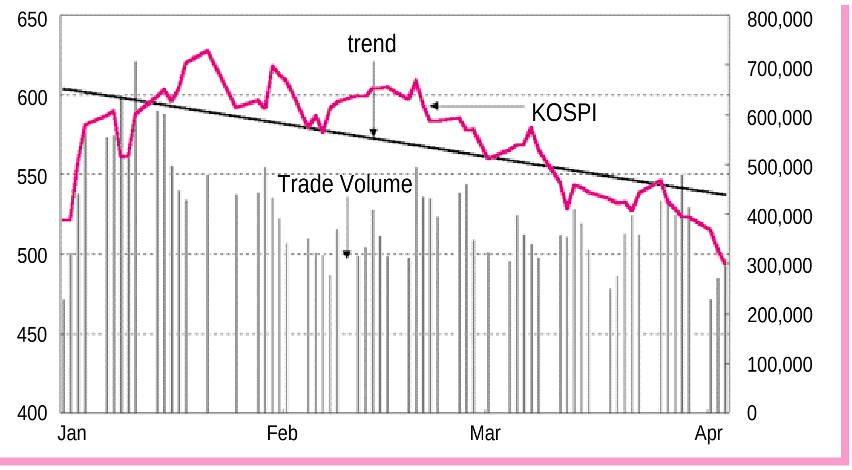
The foreign exchange market's negative impact on the stock market was not too serious. Except for a short period early this year, the Korean stock market has shown a continuous downward trend. The brief upturn of the Korean stock market in January was not caused by fundamental improvement of domestic business

Figure 2. KOSPI and Trade Volume Trends



conditions, but by the increased share of risky assets in international investment funds due to the interest rate cuts in the US. Therefore, it was hard to expect upward movement in stock prices without fundamental improvement, and an eventual downturn was inevitable.

The exchange market's effect on stocks was somewhat psychological. Apprehension that the shock from the exchange market might spread to the overall financial market cooled down buying enthusiasm in the stock market. But the direct damage from the exchange market was not so deep compared to other factors. The most significant cause of the KOSPI's fall below the 500 level was thought to be the NASDAQ's drop. The shock from the foreign exchange market mereley seems to have exacerbated the KOSPI's fall.

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The aftermath

Although the immediate effects of the shock seem to have passed, the ultimate cause of the disturbance was not completely removed. When the Japanese government announced countermeasures against Japan's severe economic recession, the yen's depreciation seemed to cease. With disappointment at the actual policy contents however, signs of depreciation have appeared again. Currently, the won's depreciation is being narrowly checked by direct intervention by the Bank of Korea and therefore the possibility of additional depreciation still exists.

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Considering that the Bank of Korea's direct intervention is limited by its dollar reserves, the key in stabilizing the exchange market will be to control speculative attacks. As long as the Japanese economic recession and financial market anxiety do not disappear however, there will remain the possibility of another financial shock from speculative attacks in the foreign exchange market. VIP