INCREASED BOND MARKET VOLATILITY AND COUNTER-MEASURES

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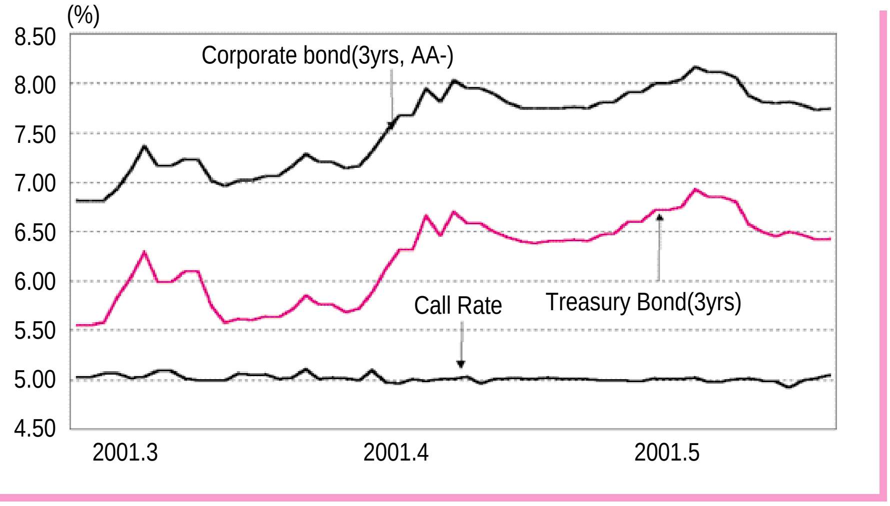
Figure 1. Market Interest Rate Trend



Reason for increased volatility

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Considering the fundamental factors, one reason for the increased market interest rate seems to be concern about inflation. During the first quarter, consumer prices rose about 4.2% compared to the same period last year and inflationary pressures are expected to further accelerate in April.

Furthermore, as many indexes for the Korean macroeconomy have turned out better than anticipated, some market players expect that the market interest rate will rise further with the coming business recovery.

The main and direct cause of the market interest rate’s rapid rise, however, was the temporary deterioration of bond market supply and demand conditions rather than fundamental changes. Most companies needed to secure large sums of cash for tax payments at the end of April. More than 4 trillion won was needed for the surtax, and major companies had to pay about 3 trillion won in corporate tax according to a settlement of accounts at the end of last year. Thus, the major players in the bond market had to sell their bond assets to secure cash, which triggered the upturn of the interest rate.

In addition, as the return rate of the money market fund (MMF) in investment trust companies (I&T) declined, bond selling was accelerated. As a rule, MMF is evaluated to historical price. But when there is a loss of more than 1% of the difference between the historical and market price, regulations state that bonds should be sold in the MMF.

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Table 1. Total Bond Holdings and Money Market Funds in ITCs

(billion won)

	Jan 2001	Feb	Mar	Apr 1 to Apr 24	Balance on Apr 24
MMF	9,730.7	3,448.1	3,352.1	-3,993.7	39,327.9
Total bond holdings	3,461.6	3,191.9	2,489.7	-2,941.3	92,456.0

source: Bank of Korea

In practice, some I&Ts acquired a lot of bonds to enhance their operational return rate during January and February when the market interest rate was very low. But as they confronted liquidity shortages and a rise in the market interest rate, they were pressured to sell their assets including bonds.

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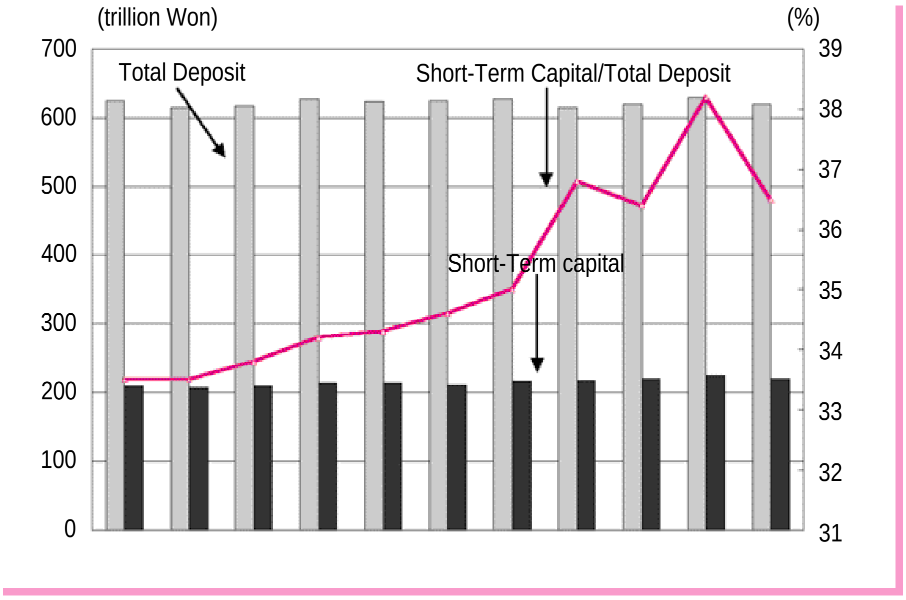
The main cause of the fall in demand was the shorter maturity in deposit reception in the overall financial intermediaries. With unclear prospects for business conditions and the direction of the market interest rate, most money in the market flew into short-term commodities. The reduction of maturity of deposit led to short-term operation of internal funds, and this change in the fund operation led to a contraction in demand for bonds.

Among the causes mentioned above, the overall short-maturity condition of the market capital was the lasting factor since last year. Thus, the most direct cause of the recent interest rate fluctuations was the aggravation of supply and demand conditions.

Figure 2. Short Term Capital in the Money Market



source: Bank of Korea

Perspectives on stabilizing the market

The MMFs, which recently experienced a large scale outflow of funds, started to stabilize at least on the surface in late April. However, with little chance of the escaped funds returning, and the mid to long term increase trend in market interest rates, funds are expected to continue leaving the investment trusts. Market interest rates, which were stable going into mid-May, can still go on a rapid upturn.

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Although expanding the demand base for domestic bonds is a fundamental way of reducing fluctuation of market exchange rates, this should be done on the long-term. To reduce fluctuation within the current market structure, open market operations should be used to flexibly manage the payment reserves of financial institutions.

In addition, the amount of treasury bond issues, which is the main factor in the recent supply problems in the bond market, should be flexibly adjusted according to demand conditions in the market, and issue dates and maturities should be carefully adjusted as well. VIP