GRIM OUTLOOK FOR THE ECONOMY CRIPPLING FINANCIAL MARKETS

Seung-Myung Lee
(reeon@hri.co.kr)

Market interest rates continued their downward slide due to the grim economic forecast and abundant market liquidity.

Market interest rates continued their downward slide due to the grim economic forecast and abundant market liquidity. As of the end of June, the three year AA- corporate bond rate was 7.1%. The spread on corporate bonds with a rating of BBB-, the lowest investment grade, slid 4.28 percentage points at the end of May and 4.11 percentage points at the end of June. This shows that corporate credit risk diminished a bit recently.

Table 1. Interest Rate Trends

(end of month, annual rate, %)

	2001.1	2	3	4	5	6	7.3
Government bonds (5year)	5.95	5.95	7.03	7.39	6.67	6.20	6.42
Government bonds (3year)	5.68	5.43	6.31	6.80	6.17	5.93	6.05
Corporate bonds (3year,AA-)	7.38	6.77	7.69	8.05	7.37	7.10	7.21
CP (91days)	6.66	6.20	6.06	6.19	5.98	5.69	5.69
Call rate (Overnight)	5.27	5.05	4.94	5.01	5.00	5.03	4.96

However, the stock market is currently riding on a downward trend. This can be attributable to weak investor sentiment stemming from worries about the postponed economic recovery and the weak U.S. stock market.

There has been some debate over when the economic recovery will begin. Earlier, the consensus was that the nation's economy would rebound around the end of this year as the U.S. economy would presumably turn around in the second half of 2001. Lately, the mood has shifted toward pessimism. Many people forecast that the U.S. economic slump may last longer than previously expected, as shown in poor corporate performance and the surging unemployment rate.

Economic uncertainty lingers as the financial and corporate restructuring seems to be losing some steam and the IT sector slump continues

Domestically, economic uncertainty lingers as the financial and corporate restructuring seems to be losing some steam and the IT sector slump continues, along with the hardship of semiconductor industry. Hence, some even predict that economic recovery is not likely before the second quarter of 2002.

Amid the uncertain outlook for the nation's economy, coupled with weak business investment, the government announced that it would provide more than 7 trillion won in assistance through banking channels. In fact, capital investment continued to slide in May by 6.6 percent from a year ago, the seventh consecutive month of decline. The government also plans to further expand guarantee ceilings of state-run funds to allow greater access to financing by businesses.

The government is said to tap in 1 trillion won to Seoul Guarantee Insurance Corporation. The funds are to be raised through the issuance of new bonds by the Korea Deposit Insurance Corporation. The package is part of assistance of up to 6 trillion won to be furnished through the state-run guarantee corporation. The funds will be used to pay the guaranteed portion on investments marketed by investment trust companies. The government will also provide 1 trillion won in special loans through Korea Development Bank to be used for capital investment during the third quarter.

The government is said to tap in 1 trillion won to Seoul Guarantee Insurance Corporation.

In the same context, the Bank of Korea lowered the overnight call rate by 0.25% to 4.75% in order to help the economy escape from the current severe downturn. It expects that cutting the interest rate will encourage household consumption and improve business investment sentiment, stimulating the economy out of the doldrums. It seems that financial market conditions have continued to improve thanks to ample market liquidity. However, concerns about the economic slowdown and still-weak corporate sector credibility are crippling the financial market.

The Bank of Korea lowered the overnight call rate by 0.25% to 4.75% in order to help the economy escape from the current severe downturn.

The issuance of corporate bonds surged in June, while outstanding commercial paper (CP) issuance declined. The net issuance of corporate bonds reached 2.78 trillion won in June, up from 1.38 trillion won in May. On the other hand, outstanding CP issuance in June fell by 1.67 trillion won, as businesses paid off CPs to lower their debt ratios.

In the meantime, fueled by short-term deposits, local banks saw their deposits jump by 7.93 trillion won in June. Time deposits with a maturity of one year or more dipped by 0.13 trillion won from May, but those with less than a six-month maturity climbed by 0.53 trillion won and short-term deposits rose by 1.65 trillion won.

Deposits rose due to the flow of idle money into short-term savings accounts and such a trend will persist unless the stock market recovers its elasticity.

Banks' corporate lending dropped by 0.87 trillion won in June, partly due to seasonal factors such as half-year settlements by corporations. On the other hand, their household lending rose by 4.25 trillion won during the same month.

It looks like overall financial liquidity conditions are fairly good. But the real problem lies in the fact that the phenomenon of short-term floating of funds still exists in financial markets. Last year, many firms were plagued by the credit crunch which choked business activities. It was mainly due to the uncertainty surrounding the corporate restructuring process. It looks like what matters most for stable financial markets this year is how to clear uncertainty about the timing and extent of the economic rebound. Hence, the policy makers need to achieve a balance between corporate and financial restructuring and economic stimulus. VIP

The real problem lies in the fact that the phenomenon of shor t-term floating of funds still exists in financial markets.