UNCERTAIN EFFECT OF LOW INTEREST RATE POLICY

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Market interest rates have shown a continuous downward trend since April 26, when return rates in the bond market reached their intra-year peak. Although this trend was partially the consequence of risk-aversion in the capital market, it was more a deliberate effect of government efforts to mitigate the recession and boost business sentiment by lowering market interest rates.

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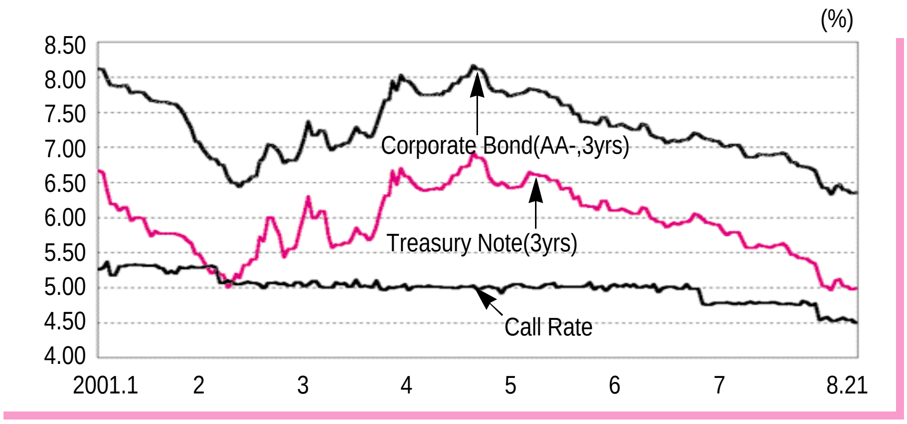
Figure 1. Market Interest Rates



As a matter of fact, the Bank of Korea has shifted its policy towards business control rather than price control, which is the inherent duty of the central bank, and this change was supported by waning inflationary pressure from the demand side. In addition, the overall inflation rate has started to stabilize. The annual increase in consumer price levels was relatively high, but this increase reflected high oil prices, hikes in public services fees and the high currency rate at the end of last year. The monthly increase rate has been very low since May and the core inflation rate, which excludes the agricultural prices except for grain, has shown stabilization.

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The government's low interest rate policy to stimulate business conditions faces its share of problems, however. First, the transmission mechanism for monetary policy currently does not operate well. The main reason for this malfunction is the lack of money demand for household consumption and the new equipment investment by firms. The reduction of funding costs due to lower interest rates does

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not provide enough incentive to consume more or to embark on new investments in particular. As for firms, investment demand depends primarily upon firms' prospects for future business conditions rather than funding cost.

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With a simultaneous slump in the world's economies, the growth-pull effect of exports has been drastically weakened, and to make matters worse, the possibility of recovery in the near future seems to be low. In addition, domestic sentiment appears to have further deteriorated. The latest Business Survey Index in August recorded 90.2, which was the lowest figure since May this year, and the Consumers' Expectation Index (CEI) in July recorded 98.4, a fall from 100.3 in the previous month. The implication of the CEI's fall is that depressed consumption will hinder the recovery of business in the future, since the it reflects consumers' perspective toward consumption in the next 6 months.

Table 1. Deposit Flows in Major Financial Intermediaries

(net increase, 100 mil Won)

	2001.3	4	5	6	7
Commercial Bank	36,835	80,229	59,367	79,330	46,130
- Fixed Deposit	7,637	7,924	11,415	-2,126	33,943
(Over a Year)	-13,184	-2,761	-16,026	-1,310	6,109
(Under 6 Months)	5,909	18,885	17,549	5,312	45,711
- MMDA	18,448	47,297	9,578	52,906	-22,149
- CD, RP, Cover Bill	899	8,967	26,032	16,513	17,726
Mutual Funds	37,675	-129,179	31,193	9,612	132,650
- MMF	33,521	-125,961	32,397	-15,527	72,115
- Bond-Type	18,991	7,919	3,163	9,792	46,198
(short-term)	7,780	3,387	203	10,959	33,018
(long-term)	11,211	4,532	2,960	-1,167	13,180
- Mixed Type	-10,832	-10,936	6,039	13,792	12,291
Trust in Bank	5,518	-8,807	-15,074	-3,637	-2,440
Merchant Bank	-14,526	14,260	-4,439	-10,235	5,524

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Meanwhile, some observers suggest that a low interest rate could shrink consumption demand. The rationale is that a low interest rate would reduce the interest income of households, and this reduction would wither consumption demand. Though the correlation between consumption and interest income is currently low, such a side-effect would undeniably be a negative factor in boosting business activity.

Nevertheless, this is not to say that expansionary monetary policy has no positive effect on the real economy. After two recent cuts in the call rate, liquidity in the money market has flowed into nondepository institutions, especially mutual funds, which has strengthened buying force and diversified the purchase-items in the bond market.

During the two months of June and July, net inflow into mutual funds amounted to 14.2 trillion won, and about 40% of that amount was in bond-type funds. Consequently, the rate of return in the bond market (TN, 3 years) fell by over 1% for about 3 months including August.

But what is more important than the interest rate cut is the rapid expansion of purchasing scope into risky bonds of speculative grade. Until July this year, the total issue of risky corporate bonds with BBB grades reached 5.76 trillion won, which was a 109.8% increase year over year and 150.5% increase from the previous month. And the return rate of those bonds have fallen, of course

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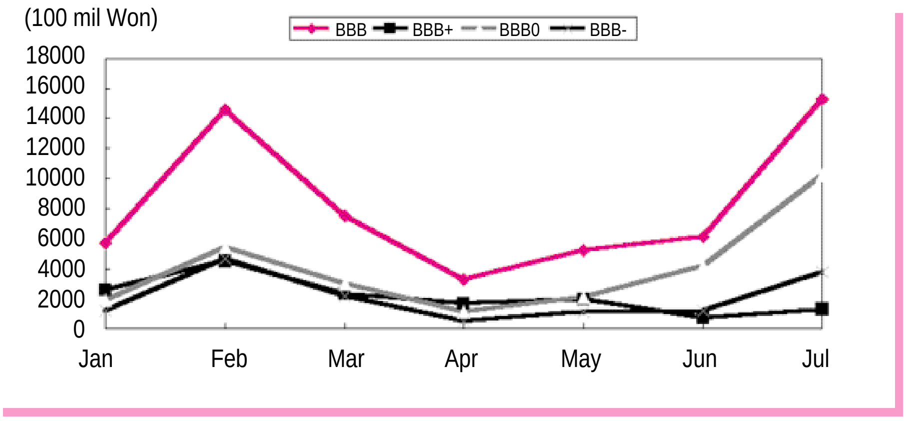
Figure 2. Issue of BBB Corporate Bonds



The improvement of supply and demand conditions and the wider purchasing scope in the bond market, however, has not yet had a direct boosting effect on the economy. This is because money demand from the business sector, if any, has been for working funds, not for new machinery and equipment investment that is essential for invigorating the stagnant business conditions. Traditionally, the elasticity of investment to market interest rate in the Korean economy is relatively low, and thus the level of new investment as a whole has primarily relied upon prospects for future economic conditions.

Therefore, it seems that the low interest rate policy is a preliminary step for the upcoming economic recovery, rather than for improving present conditions. When the economy starts to recover, the increase of money demand from the business sector and the reduction of financial costs due to low interest will surely accelerate the speed of recovery. Until then, the effect of any financial policies will inevitably be limited. Thus, all we can do is to maintain the present low interest policy, and by doing so, minimize the number of the bankruptcies in the current conditions. VIP

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