NO SAFE HAVEN FROM TERRORISM'S RIPPLE EFFECT

Sang-Wook Kwak
(kwaksw@hri.co.kr)

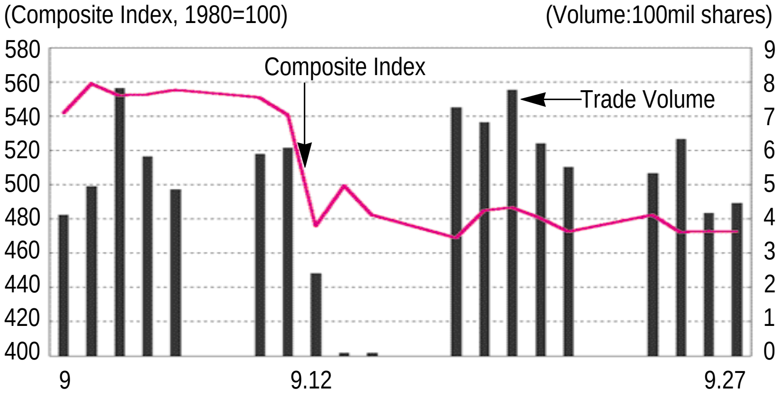
The shock from the terrorist attacks of September 11 spread all over the world, and the world financial markets showed sensitive responses. The US stock market experienced its biggest fall since the Great Depression and almost all stock exchanges over the world showed similar avalanches.

The Korean financial market was not a safe haven in this worldwide shock.

The Korean financial market was not a safe haven in this worldwide shock. The Korean stock market fell 64.97 points within a day and the return rate of the money market showed a sharp fall of around 12 basis points.

The most direct effect of the tragic events in New York will be upon the pattern of money flow in the world financial market as well as the seeming extension of the recession in the real economy. The world money flow is very likely to consolidate a "flight to safety or quality" and this trend will have a great influence upon the Korean financial market as a whole.

Figure 1. Korean Stock Market



Stock market

An overall flight to safety is expected to worsen demand and supply conditions in emerging markets.

An overall flight to safety is expected to worsen demand and supply conditions in emerging markets. Safety itself is largely related to the market as a whole as well as asset quality. The unsecuredness in emerging markets is partially related to political unstability and partial systematic drawbacks in the financial market. But no matter what, the concerns over the world financial market will probably motivate a money outflow from emerging markets.

Such capital outflows from the stock market is very likely to happen even in the US. This is because the United States is the very party hit by the terrorism and involved in the impending war, in addition to an already bleak economic outlook. Therefore, the European market is expected to be the alternative haven for the floating money in the world money market.

Anyway, jumping on this outflow trend in the emerging markets, foreign investment in Korean market is expected to fall. In fact, during the 11 days since the terrorist attacks, foreign investors in the Korean stock market recorded a net sale of 473.5 billion won. In contrast, during the previous seven days, they had purchased 7.9 billion won.

During the 11 days since the terrorist attacks, foreign investors in the Korean stock market recorded a net sale of 473.5 billion won.

Considering that the foreign investors were a prop in the Korean stock market, the outflow of foreign investment indicates a drain of purchasing power in the domestic market. To cover up this weakness in purchasing power, the government needs to take proper actions such as an earlier pension fund injection. As a matter of fact, the government announced stock market stabilization measures on September18 including the injection of a 2.2 trillion won pension fund and loosening of regulations regarding corporate buy-back operations.

The outflow of foreign investment indicates a drain of purchasing power in the domestic market.

In spite of these counter-measures, the resulting effects are uncertain since fundamental domestic and overseas business conditions are dismal. And especially if domestic investors strengthen their short positions motivated by the mass foreign selling, an additional drop in stock prices may be triggered.

Bond Market

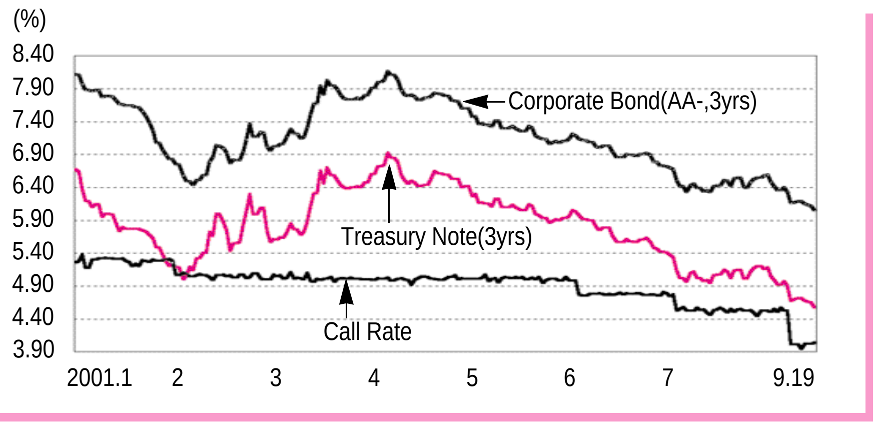
What is more important than the regional shift of money flow is the inter-market movement. Flight to safety naturally firms up demand in the bond market as a bond gives a fixed income flow and principal is generally guaranteed in the case of treasury or superior corporate bonds. In other words, the bond market offers lower risk than the stock market.

What is more important than the regional shift of money flow is the inter-market movement.

The above fact however, applies only to normal situations without extreme external shocks such as war. Because political or military dislocation could cause overall systematic failure of the financial market, the safety of bonds or the bond market itself becomes meaningless in the context of a severe external shock. At present, therefore, the stabilization or containment of war in Afghanistan is the prerequisite to maintaining the on-going dynamics in the bond market.

A happy feature of the misfortune is the unlikeliness that the war in Afghanistan will extend to other countries in the region. As it is expected that the war in the Middle East will be limited to local areas using special forces, the impact upon the

Figure 2. Interest Rates in Korean Bond Market



financial market will be restricted. Thus, even the outbreak of war will not cause overall systematic paralysis in the financial market.

The downward trend of interest rates will probably be accelerated by the latest interest rate cut by the monetary authority.

Given the external conditions above, the downward trend of interest rates will probably be accelerated by the latest interest rate cut by the monetary authority. After the announcement of the US consumers' confidence index, which showed a sharp fall below 100, FOMC in the Federal Reserve made a further 0.25% cut and this will probably lead the Bank of Korea to make a cut in its call rate.

The bond market, therefore, is expected to play a key role in financial intermediation.

The bond market, therefore, is expected to play a key role in financial intermediation, especially in the private sector's funding features for the time being. In addition, the corporate bond market will be the alternative place for corporate funding because depository institutions are sticking to conservative operation for provision of BIS capital ratio.

Remarks

As noted above, Korea's financial markets will be subject to the destabilizing effects of the recent terrorist incidents on capital flow in the world's financial markets. Exchange rate trends however have been an exception, with the won weakening against the dollar while the yen and euro have strengthened against the dollar since the incident. This reflects the fact that the yen and euro are recognized as international hard currencies, while the won is not. If a war arises, the market judges that it is safer to hold dollars rather than won, even though the US would be a participant.

Unlike in Europe or Japan however, the terrorist incident did not have as large an effect in Korea's foreign exchange markets. Compared to the movements in the yen and euro exchange rates, the won showed relatively little fluctuation and also had little effect on the bond market or stock market. One can only posit that the rising won/dollar trend will not last too long considering the weak dollar trends in the rest of the world. VIP