

## I. Overview

- 1 The Bank of Korea set an inflation target of  $2.5 \pm 1$  percent for 2000, based on the annual average rate of increase of core inflation. It also established a mid-term inflation target of 2.5 percent to maintain consistency in monetary policy and suppress inflationary expectations.
- 2 Accordingly, the Bank carried out its monetary policy with an emphasis on achieving the inflation target. In conducting its monetary policy, it also placed a focus from May onwards on countering financial market instability and emergence of a corporate credit crunch at a time when several large companies were suffering from a shortage of liquidity.

The Bank had maintained its target for the overnight call rate at the comparatively low level of 4.75 percent for the sake of market stability up until January 2000. However, it decided to raise its target rate by 25 basis points to around 5 percent on February 10, judging that the market unrest aroused by the overhang of outstanding bonds issued by troubled Daewoo corporations, had been somewhat soothed. The raise sought to reduce the gap between short-term and long-term interest rates. The wide spread between them had had the undesirable consequences of a weakening of the linkages between the various financial markets and a concentration of funds at the short-term end.

The central bank maintained its target rate at the 5 percent level from February until September. Prices held stable in the face of brisk business activities up until May. Furthermore, another sign of credit crunch appeared as several large corporations including Hyundai Engineering & Construction suffered liquidity problems, so the Bank implemented its policies with an emphasis on financial market stability.

On October 5, the Bank raised its target rate to the 5.25 percent level, increasing it by 25 basis points. It took the view that inflationary expectations would become widespread unless appropriate monetary policy measures were taken to cope with rising prices promptly since, having followed a rapid upward track since June, prices rose sharply during September. The rate increase was also undertaken in the context of the partial soothing of market unease following the announcement of the early implementation of the second wave of corporate and financial restructuring.

After October, inflationary pressures were considered to have moderated while business activities showed a downturn. Thus the overnight call rate was maintained unchanged at its existing level.

The interest rate policy environment has changed greatly since the beginning of 2001. On January 3, the U.S. Federal Reserve slashed the federal funds rate by 50 basis points to avert the possibility of a hard

landing for the U.S. economy. Accordingly anticipations had formed in the Korean financial market that the Bank of Korea would also cut the key policy rate. However, despite the signals of economic slowdown, consumer prices shifted back to an upward trend and there was concern over price instability due to the depreciation of the won. Thus, the emerging trends in the real economy needed to be closely watched for a further length of time.

It was therefore at its policy meeting on February 8 that the Monetary Policy Committee resolved to adjust its overnight call rate target to 5 percent level, representing a cut of 25 basis points. The background was that the U.S. Federal Reserve had cut interest rates again on January 31 and Korean economic indicators had deteriorated more rapidly than had been expected while consumer and business confidence had suffered a sharp setback. Consumer prices, on the other hand, had risen steeply in January, led by public service charges and prices for agricultural and marine products. On the demand side, however, upward pressures were not considered unduly large. In this context, the Bank needed to revive consumer and investor confidence by a slight reduction in the overnight call rate.

- 3** The Bank was flexible in its handling of money supply, placing stress on the stability of the financial market. As companies had difficulties in raising funds through direct financing in 2000, their demand for bank

loans increased greatly. Under these circumstances, the Bank provided reserve money to allow banks to meet the demand. As a result, the growth of reserve money(period-average basis) increased from 12 percent in 1999 to 20 percent.

The Bank strove to improve the flow of funds. Through open market operations, it absorbed surplus funds from those banks that mostly handled retail financing, and supplied liquidity to those banks that mainly handled corporate financing or were suffering from a liquidity shortage.

Meanwhile M3 growth(period-average basis) stood at 5.6 percent during 2000, well below the target of 7~10 percent. The factors contributing to this were the decline in the pace of money supply as companies concentrated on repaying their loans to financial institutions to reduce their debt ratios late in 1999; the weakened role of non-banking financial institutions and particularly investment trust companies as a financial intermediaries; and the slow demand for funds in the corporate sector. However, taking into account the high growth rates of M2 and MCT(M2+CD+Money in trust) and the low take-up of overdraft facilities, market liquidity is considered to have been ample.

- 4 The Bank of Korea increased the Aggregate Credit Ceiling by 2 trillion won(7.6 trillion won to 9.6 trillion won) as of January 2001 to alleviate the funding difficulties of small and medium sized enterprises(SMEs) in

the course of restructuring. It also changed the method of allocation of credits under this facility to encourage financial institutions to extend credit to enterprises. For example, those financial institutions that purchase corporate bonds and commercial paper, or increase their corporate lending, receive increased allocations under the Aggregate Credit Ceiling.

In May 2000, the Bank adopted a Corporate Procurement Loan scheme whereby purchasing companies can apply for loans from banks to settle in cash payments due to their suppliers. The scheme was introduced to reduce the issue and circulation of post-dated promissory notes in commercial transactions. Under this scheme, the Bank refinances 50 percent of banks' loans of this kind to corporations at an annual interest rate of 3 percent; and the government provides tax incentives to those companies making use of these loans. As a result, the scheme has quickly taken hold. The Bank also introduced a system of Electronically-processed Secured Receivables Loans in February 2001. This was designed to benefit suppliers of companies belonging to the top 30 business group, which are subject to single borrower credit ceilings by the banks, making it hard for them to utilize the Corporate Procurement Loans. Under this system, suppliers receive payments due for delivered goods by making loans against the collateral of sales-on-credit receivables; and these loans are then redeemed by the purchasing companies. All transactions are conducted electronically.

Bank loans to SMEs increased by 16.9 trillion won during the fourteen-month period from January 2000 to February 2001. They were boosted by the Bank's support measures, including the increase of the Aggregate Credit Ceiling, and by banks' effort to recruit outstanding customers.

- 5 The Bank endeavored to rearrange its monetary policy instruments. With the adoption of the Liquidity Adjustment Loans system in August 2000, the Bank now can stabilize the financial market by supplying funds promptly to those banks that suffer temporary liquidity shortages. In the meantime, by adjusting interest rates on such loans, together with changes in the level of its target for overnight call rate, the Bank is able to signal more clearly its policy intentions to the financial markets. It also introduced a daylight overdraft facility in September 2000 to enhance the stability and efficiency of the payments and settlements system. Under this, needed funds are automatically provided (on a real time basis), subject to certain limits, to banks experiencing temporary shortages of settlement funds during the day.

The Bank and the Financial Supervisory Service conducted joint examinations of three banks in 2000 and one bank as of February 2001 to obtain financial information for the more efficient conduct of monetary policy and to check on compliance with its policy guidelines.

- 6 While taking into consideration the state of the financial markets and

business activities, the focus in the conduct of monetary policy was placed on price stability. Helped by these efforts, prices remained within their target range. To a limited extent, since the beginning of 2001, the financial markets have been showing signs of recovery.

Economic growth slowed from the fourth quarter of the previous year, but for the year 2000 as a whole, real GDP registered growth at the high level of 8.8 percent. Despite this strong growth, annual core inflation remained within its target range of  $2.5 \pm 1$  percent, with an increase of 1.8 percent (a 2.3 percent increase in the Consumer Price Index). Yet from early in the second half of the year, prices accelerated their upward pace, affected by higher international oil prices and public service charges. They showed a similar pattern in the early months of 2001 in response to the depreciation of the won along with the rise of medical fees and other public service charges and of agricultural and marine product prices. Meanwhile the scale of the current account surplus, which had been narrowing up until April 2000, held steady at a little above 1 billion US dollars for most of the remaining months. For the year 2000, as a whole, the current account posted a surplus of 11 billion dollars.

The financial markets were unable to break free from their unstable pattern of movements after May 2000. Stock prices fell steeply from May onwards amid concerns over the liquidity problems of some large companies and uncertainties concerning structural reform in the corporate

and financial sectors. Financial institutions remained cautious in their lending to the corporate sector, averse to the high levels of credit risk. Since the beginning of 2001, however, with the mild recovery of stock prices has come more active corporate lending while market interest rates have maintained their downward stability. The corporate credit crunch is consequently showing signs of a partial easing.

The foreign exchange market showed stable movements in response to the excess supply of foreign currency in 2000. From November onwards, however, the won depreciated sharply because of the weakening of other major currencies against the US dollar and concerns over the country's loss of external credit standing in the wake of the delayed restructuring process. At the outset of the new year of 2001, the expectations of the won's further depreciation lessened amid renewed inflows of foreign portfolio investment funds. The won has been fluctuating in sympathy with the yen against the dollar, showing a similar pattern of movements.

- 7 The economic slowdown since the fourth quarter of the previous year is expected to continue on for some time in 2001. Annual growth is forecast to be slightly lower than its potential level. Prices will show a relatively high rate of increase, driven by the won's depreciation, the repercussions of high international oil prices and hikes in public service charges, whose combined effects can be only partially mitigated by weak demand. The rise in consumer prices in the first half of the year will temporarily move

above 4 percent compared with same period of previous year; however, it is projected to decline to the 3 percent level in the second half with its upward trend blunted. The current account will remain in surplus for the fourth consecutive year since 1998 despite the decline in exports. The main contributory factor is flagging imports owing to the domestic economic downturn. The scale of the current account surplus, however, is expected to narrow.

- 8 Taking all these factors into account, the Bank of Korea set the inflation target for 2001 at  $3 \pm 1$  percent. It also maintained the mid-term target at the 2.5 percent level.

In the year 2001, the Bank will continue to implement its interest rate policy flexibly. While placing its main focus on achieving price stability, it will also give consideration to the status of business activities and the financial markets. What is more, capital flows are highly volatile due to the increasing uncertainties of external conditions. Under these circumstances, the Bank will stand ready to adjust the target interest rate while keeping a vigilant eye on exchange rate and foreign exchange market movements.

The Bank also intends to remain flexible in its supply of money, taking account of financial market conditions. From the year 2001 onwards, M3 growth, previously the intermediate target, will be used as a monitoring

indicator. In consideration of this year's inflation target and the prospects for economic growth, its monitoring range has been set at 6~10 percent on an annual average basis.

The Bank of Korea will continue to strengthen the incentives for banks to expand corporate lending, making use of the Aggregate Credit Ceiling and open market operations to facilitate a smooth flow of corporate funds. It also will devise complementary measures to encourage widespread use of the Corporate Procurement Loans scheme and Electronically-processed Secured Receivables Loans, both of which were adopted to upgrade settlement practices in commercial transactions.

The Bank of Korea will supply liquidity flexibly and intensify its efforts to prevent sharp swings in market interest rates so as to stabilize the financial markets. In addition, it intends to heighten the health of the financial system, by providing Liquidity Adjustment Loans to financial institutions facing temporary liquidity shortages.

As the Bank has decided to use M3 as a monitoring indicator rather than the intermediate target, the monetary policy regime has shifted to pure inflation targeting from 2001 onwards. In line with this fundamental change, the Bank will strengthen its capacity to analyze and forecast inflation, and heighten the transparency and credibility of its policies. It also intends to strive harder to build a public consensus in favor of price

stability by facilitating a wider understanding of monetary policy. Meanwhile the Bank will expand its joint examination with the Financial Supervisory Service of banks to grasp the management status accurately and obtain the relevant information required for effective monetary policy.