Monetary Policy Report

(September 2004)

THE BANK OF KOREA

September 2004

This Monetary Policy Report is published in accordance with the provision of Article 96 of the Bank of Korea Act, and with the resolution of the Monetary Policy Committee.

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Ⅰ. Overview

1 Since the start of 2004, the Bank of Korea has conducted monetary policy with a view to supporting a recovery of domestic demand while keeping a watchful eye on price stability.

2 With the entry into effect of the revised Bank of Korea Act, a shift was made to a medium-term inflation targeting system, and the inflation target for 2004~2006 was set at the rate of 2.5~3.5% in terms of average core inflation during the period.

3 In the previous year the Bank of Korea reduced its policy rate, the overnight call rate, on two occasions to stand at 3.75% and this was maintained unchanged until its adjustment in August 2004. On August 12, the call rate target was reduced by 25 basis points to 3.5% and at the same time the rates on Liquidity Adjustment Loans and Loans Under the Aggregate Credit Ceiling Facility were also brought down by 25 basis points to stand at 3.25% and 2.25% respectively. These actions were taken, in a climate of increasing downside risks to GDP growth, to stimulate consumer and investor confidence, by alleviating the burden of financial expenses weighing on households and companies, and to improve SMEs' fund-raising conditions.

4 Looking at the economic conditions that formed the background to these monetary policy decisions, firstly, despite the rapid growth of exports thanks to the accelerating global economic recovery, domestic demand in the form of private consumption and facilities investment maintained its lackluster pattern since the second half of the previous year.

At the beginning of the year it was expected that the rapid growth of exports since the previous September would gradually feed through to domestic demand and that a recovery trend, albeit modest, would be seen in private consumption and facilities investment. The growth rate of GDP in the first quarter, though, showed a deceleration from the preceding quarter's 2.7% to 0.7% on a quater-on-quater basis despite its acceleration from 3.9% to 5.3% on a year-on-year basis. Its weakness reflected the fact that private consumption and facilities investment remained subdued, while exports continued their strong upward pace. Successively, from April onwards consumer spending maintained a contracting trend. This was ascribable to the fact that households' balance sheets deteriorated due to an increase in repayments of principal and interest on their excessively heavy burden of financial debt, consumer confidence weakened, and that households' income growth was blunted owing to the fragility of the structure of employment and the delay of improvement in employment conditions. A full-fledged recovery of facilities investment remained elusive with companies continuing to follow a conservative management style owing to the increased uncertainty at home and abroad including the level of international oil prices and disturbed labour-management relations. Moreover, the surging production and exports of leading businesses such as the IT sector, which is highly dependent on imports for intermediate goods and production facilities, failed to feed through to domestic investment. Consequently, economic growth continued to be subdued with, for example, second quarter GDP growth reaching only 0.6% on a quarter-on-quarter basis. In addition, the polarization of the economy intensified between large companies and SMEs as well as between the export sector and the domestic demand sector with the growth of exports of sectors such as the IT industry incapable of generating an increase in production and investment in other industries. Particularly from July onwards, with the continued lackluster state of household consumption and corporate investment being compounded by the renewed sharp run-up in international oil prices and the possibility of a slowdown in the IT business worldwide, there was concern about economic growth weakening even further in future. Meanwhile the current account registered a surplus of 16.4 billion dollars for the first seven months of the year, reflecting the combination of a large-scale increase in exports with subdued domestic demand.

There was strong cost-side upward pressure on prices in line with the sharp run-up in international oil prices, but demand-side pressures weakened owing to the delayed recovery of domestic demand reflected in the low rate of increase in the prices of non-traded items such as services, and the slowed rate of increase in wages. Moreover, the exchange rate of the Korean won against the US dollar generally showed downward stability and real estate prices registered a small-scale fall owing to the government's series of stabilization measures. Both of these developments served as factors supporting price stability. Consequently, even though both consumer prices and producer prices showed a high rate of increase, core inflation held stable within its target range. Although some of the cost factors may come to influence core inflation after a certain time lag, leading to fears that it may temporarily reach the upper bound of its target range in the short term, it is judged that the inflation target can be attained from a medium term perspective.

5 In the financial markets, market liquidity conditions were generally smooth and the spread between long-term and short-term interest rates narrowed following the large-scale decline in market interest rates. The problems of excessive household indebtedness and the credit card companies' financial difficulties that had served as destabilizing factors in the previous year showed a mildly improved pattern. Corporate funding conditions were on the whole unproblematic for large companies and export oriented companies owing to the buoyancy of exports, but for those SMEs

having a high degree of dependence on domestic demand, they became more difficult owing to lackluster sales and the tightened screening of loan applications by financial institutions worried by the prospect of credits turning sour. Meanwhile the large-scale decline in market interest rates led to an expansion of Korean residents' investment in overseas securities. Nevertheless, nonresidents stepped up their introduction of funds for investment in Korean shares, so that the securities investment account registered a net surplus of 11.3 billion dollars for the first seven months of the year.

6 The Bank of Korea operated its Aggregate Credit Ceiling Facility with an emphasis on the strengthening of its financial support for regionally-based SMEs that were experiencing business difficulties because of the contraction of their local economies.

From April, the quota under the Aggregate Credit Ceiling allocated to the Bank's regional branches for the support of local SMEs was raised by 400 billion won. Besides this, the ceiling for trade finance was also increased by 400 billion won to counter SMEs' profitability weakening, following the run-up in international raw material prices. From the beginning of August, moreover, in order to further strengthen the incentives for banks to extend loans to SMEs, the reduction of the quota under the Aggregate Credit Ceiling for those banks failing to meet the required ratio of lending to SMEs was increased.

7 The Bank of Korea acted swiftly to counter factors making for financial market instability. When a strike broke out at KorAm Bank, it immediately formed a special task force to monitor the impact on the financial markets and to provide support for the seamless accomplishment of payments and settlements including the clearing of checks and bills. In addition, it conducted its daily open-market operations to facilitate

the stricken bank's trouble-free borrowing of call funds, so as to guard against possible liquidity problems owing to large-scale withdrawals of deposits. In a similar move to ward off the possibility of partial bottlenecks in the flow of funds, it acted to prevent the influence of the strike from developing into a systemic financial risk to the markets by, for example, mapping out a stage-by-stage plan for the supply of liquidity.

8 For the in-depth analysis of the management status of the banks, during the year to August, the Bank of Korea undertook joint examinations of seven banks together with the Financial Supervisory Service. Meanwhile, ahead of the application of the new BIS capital adequacy standards at the end of the year 2006, it also guided domestic banks to establish an error-free compliance by checking the state of their preparations including their risk management status. In addition, it published 'Financial Stability Report,' which analyzes and assesses in a comprehensive manner the stability of the financial system, to convey to the markets worries concerning the increased risk of households and SMEs and the possibility of the poor performance of nonbank financial institutions. To revitalize the system of cooperation among the relevant institutions, a 'Memorandum of Understanding Concerning the Joint Use of Financial Information' was also concluded with the Financial Supervisory Service and the Korea Deposit Insurance Corporation.

9 Various initiatives were pursued by the Bank of Korea with a view to heightening the effectiveness of its monetary policy.

From March the issue of 91-day Monetary Stabilization Bonds (MSBs) was placed on a regular basis with offers in the first and the third weeks of every month. In a similar vein, a system for the announcement of the Korea Inter-bank Offered Rate

(KORIBOR) was put in place from July 26; both of these initiatives being designed to galvanize the short-term financial markets. In future KORIBOR will not only form the basic interest rate for short-term fund transactions between banks, but it is expected to be widely employed as the basis for pricing decisions on financial derivatives and floating-rate loans.

A drive was also undertaken to heighten the general public's confidence in and understanding of monetary policy. A 'Monetary Policy Contest' was held, targeting college students from around the country, while a wide variety of educational programs was operated including 'Economic Classroom', 'Economic Camp for Adolescents' and 'Statistical Classroom'. In addition a diverse range of materials was published and distributed, including 'A Simple Explanation of Economic Indicators'. Apart from this, by undertaking surveys such as 'Public Survey of Monetary Policy', efforts continued to be devoted toward gathering public opinion and amplifying feedback channels with the public.

10 The safety and efficiency of the payment and settlement systems was improved while the central bank's holistic management and oversight functions in this regard were strengthened.

The work of systems reconstruction of the BOK-Wire was carried out in order to heighten safety and user convenience, while preventative measures to cope with disasters or systems failure and post hoc recovery program were systematically pursued. So as to reduce the burden of foreign exchange settlement risk on foreign exchange banks arising from time differences between countries, the BOK-Wire was linked to the US-based CLS (Continuous Linked Settlement) Bank, a specialist bank dedicated to the simultaneous settlement of international foreign currency transactions, as part of the construction of a foreign exchange simultaneous-settlement system in Korea being undertaken with the goal of having it in operation by the end of 2004.

In July, the method of adjusting funds between banks in connection with the clearing of cashier's checks was changed from a funds-transfer adjustment method calculated based on the cumulative total amount foregone to an interest-compensation method for the interest foregone. This was done in order to reduce the settlement risk and the funding burden on banks arising from net settlement between them. From August onwards, a 'Real-Time Information Exchange-Based Cash Payment System for Cashier's Checks' was brought into operation. This makes it possible for a fixed-denomination check issued by an other bank to be cashed at the counter of any bank after confirmation that it is genuine and has not been stolen.

Standards for assessment were also drawn up for the safety and efficiency of the major individual domestic payment and settlement systems and the task of assessment based upon them commenced. The continuous monitoring system was made more rigorous to allow a detailed grasp of the trends of payment and settlement operations and the operational status of the payment and settlement systems as a whole.

11 Looking at the future operating environment for monetary policy, in the second half of 2004, the growth rate of GDP is likely to ease from its 5.4% of the first half of the year to the 5% level. It is anticipated domestic demand will pick up gradually, but private consumption is seen to do little more than escape from its contracting trend in view of the weakness of the employment structure and households' adjustment of their liabilities. Meanwhile, the rate of increase of facilities investment is expected to be only modest in view of the delayed recovery of business confidence. Along with

this, construction business will be subdued and exports appear set for a decline in their growth rate owing to a base-period effect from their rapid growth in the second half of the previous year.

Even though demand-side pressure is seen to be weak for a considerable period of time, the pace of price increases is forecast to accelerate because of the lagged influence of the large-scale run-up in international oil prices and the upward adjustment of a number of charges for public utilities with cigarette prices also expected to be increased. Consequently, the rate of consumer price inflation will rise to around the 4% level during the second half of the year and core inflation is also anticipated to approach the upper bound of its target range from the start of the fourth quarter. The current account for the whole year is seen to register a surplus of over 20 billion dollars, its underlying surplus tone being sustained thanks to the buoyancy of exports in response to the expansionary trend of the advanced economies and the continuing strong growth of the Chinese economy.

12 In this situation, the Bank of Korea’s policy will be directed toward the balanced growth of domestic demand and exports by underpinning the recovery of private consumption and facilities investment. Monetary policy will be conducted preemptively to counter upward price pressures should there be concern over their aggravation in the course of the future revival of domestic demand.

In addition, given the prevalence of uncertainty at home and abroad, and the heightened sensitivity of financial institutions to the credit risk of households and SMEs, a constant watch will be kept on the status of the financial markets so that the central bank may react swiftly through, for example, open market operations in the event of symptoms of abnormality emerging.

Concerning the payment and settlement systems, the reconstruction of the systems related to BOK-Wire is to be completed by the end of 2004 and it is anticipated that this will establish a system allowing the interruption-free operation of BOK-Wire. Apart from this, in relation to the oversight of payment and settlement systems, work will continue on the evaluation of the safety and efficiency of the various settlement systems so that should unsatisfactory points come to light, improvements can be recommended. In addition the monitoring of settlement trends through new means of payment such as mobile banking is to be strengthened further.

Ⅱ. Financial and Economic Trends

1. International Economies

A. International Economic Growth

During the first half of 2004, international economic growth expanded centering on the USA and Japan, even though international oil prices rose considerably and geopolitical risk persisted in forms such as the turbulent situation in Iraq.

In the US economy, thanks to the sustained accommodating stance of monetary and fiscal policy, the pattern of recovery that had become evident during the latter half of the previous year was maintained in the form of a clearly-marked expansionary trend from the beginning of 2004. Facilities investment exhibited a rapidly swelling trend and, with the improvement of employment conditions, the rate of increase of private consumption accelerated and the brisk housing market activity continued. As a result, during the first half of the year, GDP growth registered a high year-on-year rate of 4.9%. Meanwhile, business activities displayed a sharp upward trend, in the course of which, inflationary pressures gradually mounted, leading the Federal Reserve to raise its policy target, the Federal Funds rate by 25 basis points from 1% to 1.25% on June 30, following this up on August 10 by additional 25 basis points rise to 1.5%[1].

<Table Ⅱ-1>

Trends of Economic Growth by Major Economies[1]

(%)

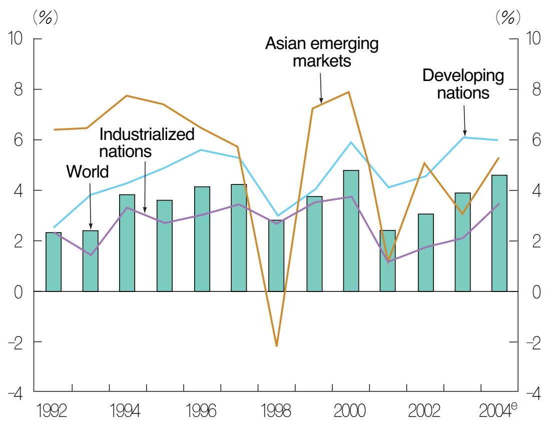
	2001	2002	2003	2004[e]
World	2.4	3.0	3.9	4.6
Industrialized nations	1.1	1.7	2.1	3.5
US	0.8	1.9	3.0	4.6
Japan	0.4	-0.3	2.5	3.4
Euro area	1.6	0.9	0.5	1.7
(Germany)	0.8	0.2	-0.1	1.6
Asian emerging markets[2]	1.1	5.1	3.0	5.3
Developing nations	4.1	4.6	6.1	6.0
Asia	5.6	6.4	7.8	7.4
(China)	7.3	8.0	9.1	8.5
Latin America	0.4	-0.1	1.7	3.9
World trade growth	0.1	3.1	4.5	6.8

Notes : 1) Based on IMF statistics (the figures in 2004 are prospects), apart from certain individual countries and Euro area which are based on their respective national statistics.
2) Korea, Taiwan, Hong Kong, Singapore.
Source : IMF, World Economic Outlook, Apr. 2004.

1) From January 2001 until June 2003, the US Federal Reserve reduced its policy rate on 13 occasions (6.5%→1.0%), and the hike in interest rates undertaken in June 2004 was the first for over four years since May 2000.

<Figure Ⅱ-1>

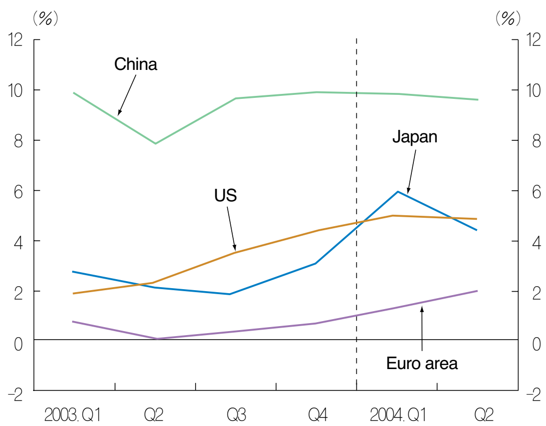
Trends of World Economic Growth



Source : IMF, World Economic Outlook, Apr. 2004.

<Figure Ⅱ-2>

Trends of Economic Growth[1] by Major Economies



Note : 1) Compared with the same period of the previous year.

The Japanese economy continued the convincing recovery trend that had become evident the previous year, breaking free of its protracted downturn. Both exports and equipment investment showed rapidly increasing trends, driving the business recovery, and even private consumption, so long in the doldrums, gave signs of recovery in an environment characterized by the improvement of labor market conditions and consumer confidence. As a net consequence, during the first half of the year, the growth rate of GDP rose to 5.2%. Meanwhile, producer prices showed evidence of a shift, albeit weakly marked, to an upward trend because of the run-up in international raw material prices. For their part, consumer prices exhibited a mild downward trend, as they had in the past.

The Chinese economy maintained its rapid growth trend that had been achieved also in the previous year. While domestic demand in the form particularly of consumption and facilities investment showed brisk activity, exports maintained a rapidly swelling trend, and for the first half of the year the growth rate of GDP came in at 9.7%. The Chinese government, worried about possible overheating of the economy, put in place a series of restrictive policies[2] in line with which the overheating of investment has gradually cooled and the rate of increase of industrial production shown a moderating pattern.

While other Asian economies maintained their trend of recovery that had become evident the previous year thanks to their exports to China, the growth rates of Taiwan, Hong Kong and Singapore rose particularly sharply compared with the previous year.

2) Among them, the rediscount rate (March 25) and reserve requirements (April 25) were raised, the equity capital ratio in overheated industrial sectors was adjusted upward (April 28) a directive halted lending to overheated industrial sectors (April 30), and regulations were tightened on capital transactions by foreign-invested businesses (July 1).

The economy of the euro zone showed a comparatively lackluster recovery in contrast to the trend of other regions. During the first quarter, worries mounted over the delay in recovery owing to the sluggishness of German consumption and investment, but during the second quarter the recovering trend became clearly evident, thanks to the gradual improvement of consumer and business confidence and the buoyancy of exports. GDP growth for the first half of the year consequently registered 1.7%.

B. International Financial Markets

<Table Ⅱ-2>

Trends of Short- and Long-term Interest Rates[1] in Major Economies

(annual %)

	2002 Dec.	2003 Dec.	2004		
			Mar.	Jun.	Aug.
Long-term[2]					
US	3.81	4.25	3.84	4.58	4.12
Japan	0.91	1.37	1.45	1.79	1.54
Euro area	4.20	4.29	3.92	4.32	4.02
Short-term[3]					
US	1.19	0.92	0.94	1.26	1.58
Japan	0.00	0.00	0.01	0.01	0.01
Euro area	2.87	2.12	1.96	2.12	2.11

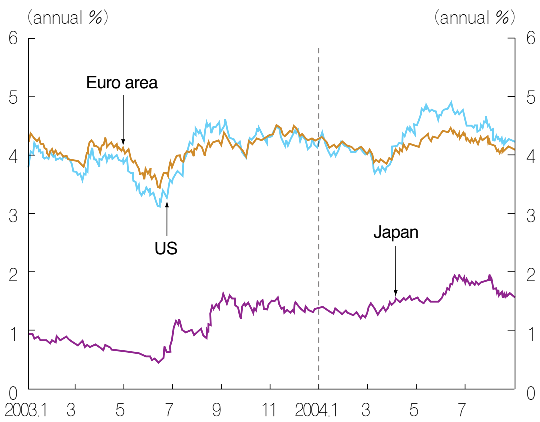
Notes : 1) Month-end basis.
2) Based on yields on 10-year government bonds.
3) Based on yields on 3-month Treasury bills, apart from Euro area, which is based on yields on 3-month EURIBOR.
Source : Bloomberg

From the start of 2004, the international financial markets reacted sensitively to changes in the policy stance of major countries, the movements of international oil prices, and the situation in the Middle East while reflecting the acceleration of the world economy's pace of growth.

During the first quarter, as the US Federal Reserve adhered to its low interest rate stance, US long-term interest rates (10-year Treasury bond yields) exhibited a downward trend under the influence of an increased appetite for US Treasuries on the part of Asian central banks in line with the expansion of their foreign exchange reserves and the increased preference for asset safety in view of the turbulent situation in the Middle East. From the beginning of the second quarter, they turned to an upward trend as anticipations grew of the Federal Reserve hiking interest rates amid increased inflationary pressure, improved labour market conditions, and the acceleration of the upward trend of business activity. From mid-June onwards, though, along with worries of the business recovery stalling out because of the sharp run-up in international oil prices, long-term rates shifted back to a downward

<Figure Ⅱ-3>

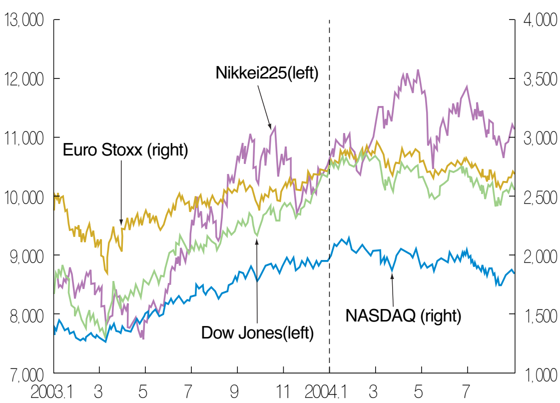
Trends of Long-term Interest Rates[1] of Major Economies



Note : 1) Based on yields of each country's 10-year government bonds.
Source : Bloomberg

<Figure Ⅱ-4>

Trends of Share Prices Indices[1] in Major Economies



Note : 1) Based on spot market price.
Source : Bloomberg

trend amid prospects that the Federal Reserve would suspend its policy of gradual step-by-step rises in interest rates. As of the end of August, they registered 4.12%, 0.13 percentage point lower than those at the end of the previous year.

Japanese long-term interest rates (10-year Treasury bond yields) also showed a mild downward trend until February, but subsequently maintained an upward trend as anticipations mounted of an acceleration of the business recovery and funds migrated into the stock market. From around mid-June onwards, however, they fell back again slightly on expectations that Japanese export growth would turn subdued amid worries over a slowdown in US economic growth, and that the GDP growth of the second quarter of the year would slow down. Consequently, as of the end of August, they registered a 17 basis-point rise over their level at the end of the previous year to stand at 1.54%.

Euroland interest rates exhibited a downward trend during the first quarter of the year as investment in euro-denominated bonds rose amid prospects of a strong euro while the low interest policy stance remained unchanged. Moving into the second quarter, they edged up against the background of a clearly marked recovery of the world economy. They fell back again after mid-June, showing a similar pattern of movements to interest rates in the USA.

Looking at share prices in major countries, US share prices by and large carried on their upward trend of the previous year until March, sustained by anticipations of economic recovery, but their movements then showed an underlying downward trend that was ascribable to increased perceptions of the risk of terror, the run-up in international oil prices and the likelihood of the US Fed's raising interest rates. Strikingly, from July onwards, their downward trend increased in scale amid worries of the growth trend being blunted by high oil prices and the weaker performance of major IT related businesses. As of the end of August, the Dow Jones industrial average index was off by 2.7% from the end of the preceding year and the NASDAQ index was down by 8.3%.

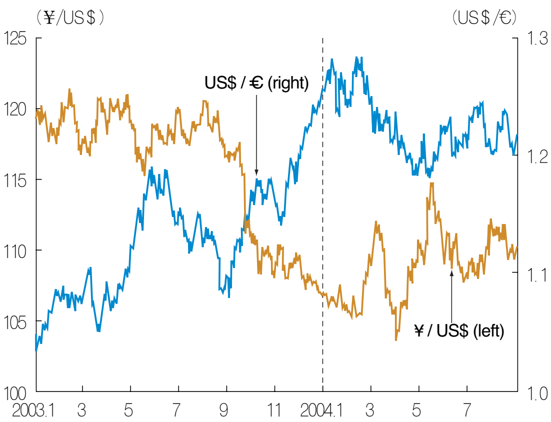
Japanese shares showed a steep upward trend from the beginning of the year, thanks to the business recovery and improved corporate performance. The Nikkei index reached, on April 26, a level of 12,164, its highest since August 2001. Subsequently, stock prices underwent a corrective adjustment on worries about the future of reform policy following a by-election defeat for the Liberal Democratic Party, persistently high oil prices, and the Chinese government's strengthening of its austerity policy, causing the Nikkei index to close at the end of August registering a level of 11,082, 3.8% up on the end of the previous year. In the euro-zone, share prices generally followed a synchronized pattern of movements with those of US, with the Euro Stoxx index as of the end of August shedding 3.3% from the end of the previous year.

Looking at the exchange rate trends of the US dollar during the first half of the year, it showed a pattern of comparatively broad fluctuations against the Japanese yen. Until mid-February, the yen/dollar rate maintained a steady decline (appreciation of the yen) and remarks by the director of the IMF[3)] acknowledging the appropriateness of the Bank of Japan's intervention in the foreign exchange market prompted a sharp rise in the exchange rate. A subsequent large inflow of foreign

3) Koehler, the director of the IMF, in a press communique on his visit to Japan on February 25 praised it (the Bank of Japan's market intervention) as "a practical method that was effective in preventing deflation and maintaining financial stability"

<Figure Ⅱ-5>

Trends of Major Exchange Rates[1]



Note : 1) US$ /€ on New York market, ¥ / US$ on Tokyo market.
Source : Bloomberg

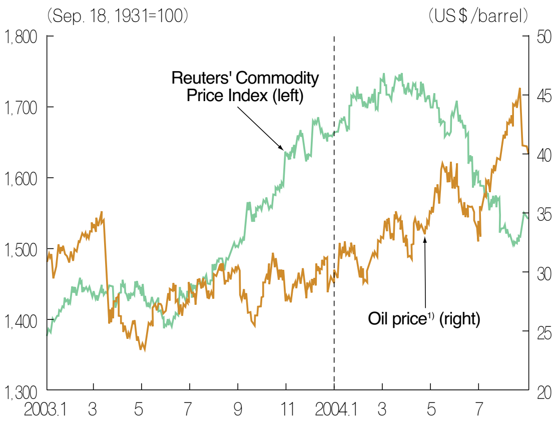
portfolio investment funds to the Japanese stock market, and increased dollar sales by Japanese corporations closing their fiscal year at the end of March led to a renewed sharp fall in the yen/dollar exchange rate. Subsequently, expanded purchases of foreign assets by Japanese investors and perceptions of the risk of terror against Japan caused a sharp rise in the yen/dollar rate. From the mid-May, however, the rate shifted to a downward trend on the continuing buoyancy of the Japanese economy. With the beginning of July, though, the yen/dollar rate rose again in response to Japan's lackluster retail sales and industrial activity, along with a decline in inward foreign investment in Japan. Consequently, the yen stood at 109.8 yen per dollar as of the end of August, which represented a depreciation of 2.6% against the US dollar from the end of the preceding year.

The US dollar showed a weakening trend against the euro from the beginning of the year. Exhibiting wide fluctuations, the dollar/euro rate rose to its highest level ever of 1.28 dollars to the euro on February 17. But subsequently the swift recovery of the US economy increased the likelihood of the Federal Reserve's raising interest rates and caused the dollar to shift back to a strengthening trend, regaining some of its lost ground. From mid-May onwards, as anticipations mounted of the revival of business activity in the euro zone and US bond prices were affected by the possibility of terrorist attacks, the dollar shifted back to a mild downward trend, trading at 1.22 dollars to the euro as of the end of August. In terms of the euro, this represented a 3.1% depreciation against the US dollar from the end of the preceding year.

C. International Raw Material Prices

<Figure Ⅱ-6>

Trends of Prices of International Raw Materials



Note : 1) International oil prices are based on Brent crude price.
Source : Reuters

International oil prices displayed a steep upward trend from the beginning of 2004. From the start of January, they rose precipitously as demand for petroleum mounted with the consolidation of the recovery trend of the world economy and OPEC's decision (February 10) to reduce oil production quotas against the background of heightened tension in the Middle East and the widening perception of the risks of terrorism. From early June, OPEC's agreement to increase production quotas[4] brought about a temporary countermovement. Prices, however, saw a renewed steep rise from July onwards because of supply problems including concerns over the bankruptcy of the Russian oil giant, Yukos, and the limits to OPEC's capacity to expand production against the background of the steady rise in demand brought about by persistently expanding global economy. Consequently, as of August 20, the price of oil (Brent crude basis) had risen to reach 45.46 US dollars per barrel, setting a new record high. Subsequently, however, it shifted to a downward trend influenced by expectations of a mitigation of political unrest in Iraq and the declaration by OPEC and Russia of their intention to increase oil quotas, to register 39.80 US dollars, at the end of August, a 9.5 US dollar rise from the end of the previous year.

Apart from crude oil, international raw material prices generally marked an upward trend from the beginning of the year, amid the rise in demand brought about by the worldwide economic recovery. From March, though, they shifted to a downward trend on prospects

4) At an extraordinary general meeting held in Beirut on June 3, OPEC members agreed to increase their total daily production quota by 2 million barrels per day (bpd) to 25.5 million from July 1 and by an additional 0.5 million bpd to 26 million bpd from August 1.

of subdued demand in the wake of the Chinese government's policy initiatives to rein in the overheated economy, the contraction of the wave of speculative purchases owing to the likelihood of hikes in US interest rates, and the promise of bounteous grain harvests thanks to improved weather conditions. As a net consequence, as of the end of August, the Reuters Commodity Price Index marked a 7.6% fall from its level of the end of the previous year.

2. The Real Economy

A. Economic Growth

<Table Ⅱ-3>

Trends of Major Economic Growth Indicators[1)]

(%)

	2002	2003p					2004p		
		year	1st half	2nd half	Q3	Q4	1st half	Q1	Q2
GDP	7.0	3.1	2.9	3.2	2.4 (1.6)	3.9 (2.7)	5.4	5.3 (0.7)	5.5 (0.6)
GNI	7.0	1.8	1.0	2.6	2.1	3.0	4.5	4.5	4.5

Notes : 1) Compared with the same period of the previous year.
2) Figures in parentheses refer to the seasonally adjusted rates of increase compared with the previous period.

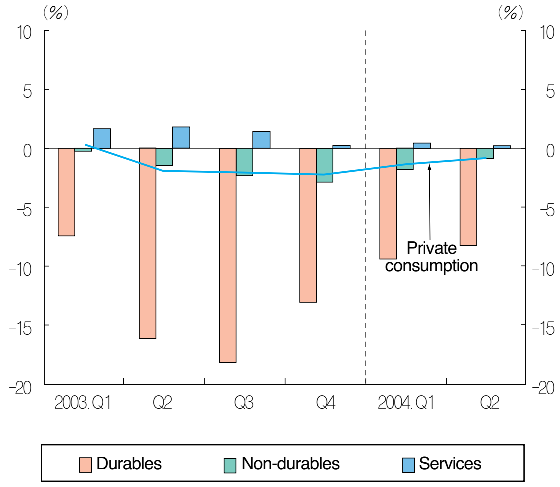
During the first half of the year 2004, domestic GDP growth (year-on-year), accelerated from its 3.2% in the latter half of the preceding year to 5.4%, thanks to the sustained large-scale growth of exports with the expansion of the trend of worldwide economic recovery, notably in the United States. On a quarter-on-quarter basis, though, the rate of growth (seasonally-adjusted basis) showed a weakening pattern, falling from 2.7% in the fourth quarter of the preceding year to 0.7% in the first quarter of 2004 and to 0.6% in the second quarter.

Real gross national income (GNI) registered a level of 4.5% for the first half of the year, falling below the rate of GDP growth owing to the worsening of the terms of trade brought about by the surge in international oil prices.

(Domestic Demand)

<Figure Ⅱ-7>

Trends of Changes[1)] in Major Consumption Indicators



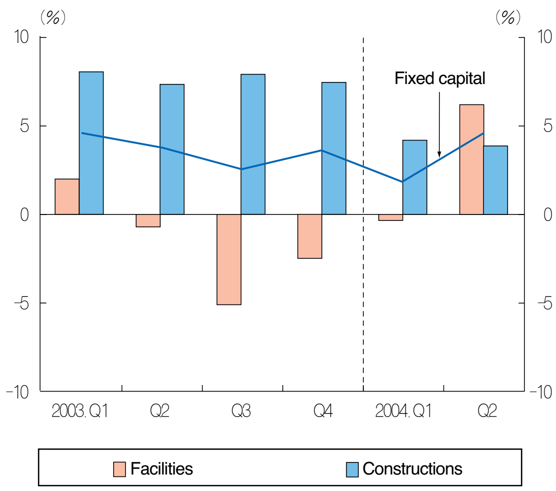
Note : 1) Compared with the same period of the previous year.

The rapid pace of export growth continued whereas private consumption and facilities investment still languished in the doldrums as they had the previous year, while construction investment saw its growth trend blunted.

Private consumption expenditures shrank by 1% year-on-year during the first half owing to the shriveling of consumption capacity as households adjusted their liabilities, and the growth of their incomes slowed. By type of spending, that on durables, which is sensitive to economic activity, persisted in its contracting trend, and that on services showed but a

<Figure Ⅱ-8>

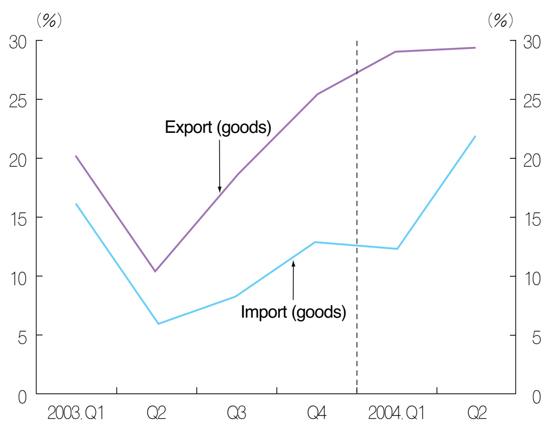
Trends of Changes[1] in Major Investment Indicators



Note : 1) Compared with the same period of the previous year.

<Figure Ⅱ-9>

Trends of Import and Export Growth[1]



Note : 1) Compared with the same period of the previous year.
Volume basis.

mild upward trend.

Facilities investment registered no more than a 3% of increase during the first half of the year as investment confidence shrank against the background of lackluster demand while an investment induction effect of leading export items such as IT products failed to make itself evident. Construction investment saw its first half growth slide from the 7.6% of the previous year to 3.9% as the rate of increase of non-housing building investment fell back sharply under the influence of the slowdown of activity in the real estate market while investment in civil engineering projects, including railways and electric-power facilities, was subdued.

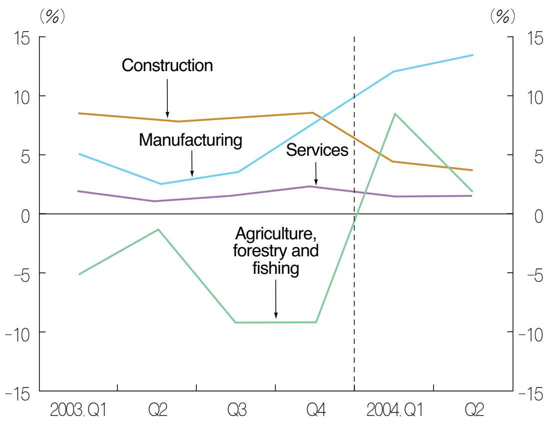
Exports (goods) chalked up a high rate of increase in the first half of 29.4%. Their expansion was led by buoyant exports of semiconductors, wireless communications equipment, automobiles and so forth in response to the gathering pace of economic recovery in the advanced countries, notably the United States and Japan, and the continuing high growth rate of the Chinese economy. On the other hand, imports (goods) saw their first-half growth accelerate from the 11% of the previous year to 17.3%, led by the large increase in imports of semiconductors, electronic parts and components, precision tools, and industrial machinery.

(Production)

Manufacturing and the agricultural, forestry and fishing sector both showed high rates of growth whereas the rate of increase slowed in the construction sector and services also presented a lackluster picture owing to subdued domestic demand.

<Figure Ⅱ-10>

Trends of Growth[1] by Major Industries



Note : 1) Compared with the same period of the previous year.

In the case of manufacturing, light industry (textiles, clothing, printing, and publishing) remained in the doldrums, but heavy and chemical industry sectors, including semiconductors, mobile phone handsets and industrial machinery, all rose markedly. As a net consequence, it showed a high year-on-year growth rate of 12.8% during the first half of the year.

In the agricultural, forestry and fishing sector, fisheries were subdued during the first half of the year owing to smaller catches whereas cultivated crops saw buoyant production as did the livestock industry owing to the preference for domestically-reared beef following a mad-cow disease scare. Consequently, the sector as a whole shifted from a decrease of production of 2.4% in the first half of the previous year to an increase of 3.6% during the current year to June.

Services registered a low overall rate of increase of 1.5%. Even though communications, transport and storage remained brisk owing to the expansion of high-speed Internet use and the increase in export volumes, this was largely offset by the persistently lackluster performance of wholesale and retail trade, hotels and restaurants owing to the delayed recovery of consumer confidence.

Meanwhile the construction industry was held to a growth rate of 4% with the constant increase shown by building construction for housing use being offset by a contraction of civil engineering activity. Electricity, gas and the water exhibited a robust rate of growth (5.9%) owing to the increase in demand for gas for power-generation.

B. Employment and Wages

Despite brisk production activities owing to the precipitate growth of exports, a recovery in employment conditions was delayed amid the protracted depression of domestic demand. During the first half of the year, nominal incomes rose at a considerably lower rate than in the same period of the preceding year.

(Employment)

From the start of 2004, the rate of participation in economic activities rose and the number of people in employment increased. On the other hand, the number of people classified as unemployed also increased, rising from a monthly average of 779 thousand in the first seven months of the previous year to a monthly average of 830 thousand in the same period of 2004. This was because the increase in the number of persons joining the economically active population exceeded that of the increase in the number of persons in employment. Consequently for the year to July the unemployment rate rose from a monthly average of 3.4% the previous year to 3.5%. Quarter-on-quarter (seasonally adjusted) unemployment also maintained a continuing upward movement, standing at 3.4% in the first quarter this year and 3.5% in the second quarter, before rising to 3.6% in July.

Viewing employment trends by industry, the declining trend in the agricultural, forestry and fishing industry was maintained, reflecting the exodus from the land and the islands but manufacturing employment shifted to an increase, centering on the electronics and machine tool sectors. Employment in services also saw an acceleration of its rate of increase that was concentrated in the business services sector.

<Table Ⅱ-4>

Trends of Major Employment Related Indicators

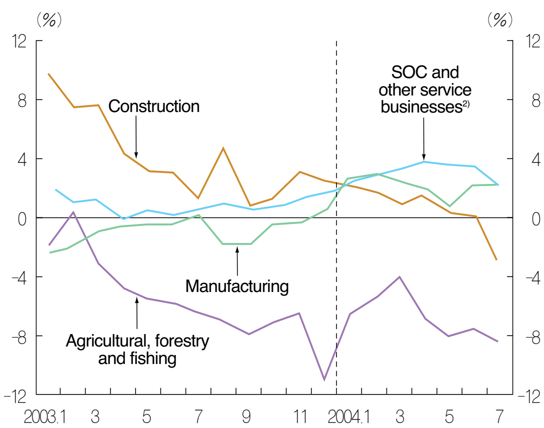
(million, %)

	2003			2004			
	year	1st half	2nd half	1st half	Q1	Q2	Jul.
Economically active population	22.9	22.7	23.1	23.3	23.0	23.5	23.6
(rate of growth)[1]	0.2	0.1	0.2	2.2	2.4	2.1	1.4
Economic participation rate	61.4	61.1	61.7	61.8	61.2	62.5	62.4
Number of persons employed	22.1	22.0	22.3	22.4	22.1	22.7	22.8
(rate of growth)[1]	-0.1	0.0	-0.3	2.1	2.2	2.0	1.3
Number of persons unemployed	0.78	0.78	0.78	0.83	0.88	0.79	0.81
Unemployment rate	3.4	3.4	3.4	3.6	3.8	3.3	3.5
(S.A.)	-	3.3	3.5	3.4	3.4	3.5	3.6

Note : 1) Compared with the same period of the previous year.
Source : Korea National Statistical Office

<Figure Ⅱ-11>

Trends of Growth[1] in the Number of Persons Employed by Industry



Notes : 1) Compared with the same period of the previous year.
2) Excludes construction.
Source : Korea National Statistical Office

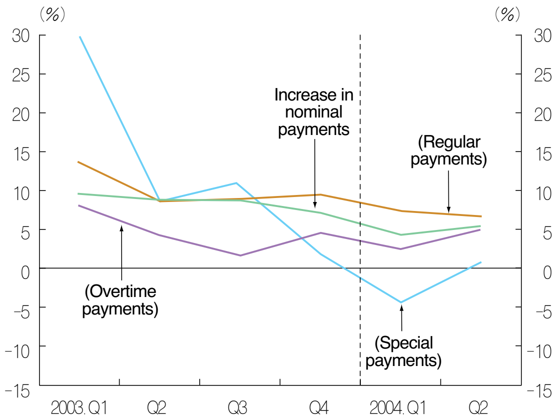
On the other hand, employment in the construction industry continued to maintain a subdued rate of increase but during July it shifted to post a 3.1% contraction.

By type of employment, the number of persons in regular or full-time employment showed a steady increase, centering on manufacturing, while the number of those employed on a daily or casual basis marked only a small increase, so that among those in waged employment, the proportion of those working on a temporary or casual basis dropped slightly from 49.8% during the first seven months of the preceding year to 49.3% during the same period this year.

Looking at indicators of working hours, meanwhile, the average working-hours a week shortened from 49.5 hours in the first seven months of the preceding year to 48.6 hours for this year to July. The number of people working less than 18 hours a week, however, increased to a monthly average of 732 thousand in the year to July as against a monthly average of 622 thousand persons in the same seven-month period of the preceding year.

<Figure Ⅱ-12>

Trends of Wage Increases[1)]



Note : 1) Compared with the same period of the previous year.
Source : Ministry of Labor

(Wages)

The all industry nominal wage (based on businesses with at least 10 workers) saw a sharp deceleration in its growth from the 11.0% during the first half of the preceding year to just 4.7% for the same period of this year. The rate of increase of real wages, deflating nominal wages by the rise in the Consumer Price Index(CPI), fell from the 7.2% of the first half of the previous year to just 1.4%.

Looking at the make-up of the increase in nominal wages, the rate of increase of regular wage payments rose 7% and that of overtime payments by 3.6%. Meanwhile that of special payments fell 2.6% because of a base-period effect resulting from the payment of large performance-related bonuses at the beginning of the preceding year.

C. External Transactions

During the first seven months of 2004, the current account registered a surplus of 16.4 billion dollars thanks to buoyant exports, but the capital account showed a 1.8 billion-dollar deficit. The external reserves held by the Bank of Korea increased by 14.3 billion dollars during the seven-month period.

(Current Account)

The scale of the current account surplus during the first seven months widened sharply from the 1.2 billion dollars of the same period of the previous year to 16.4 billion dollars, centering on the goods account.

Looking at the component accounts, the goods account surplus expanded substantially from 8.5 billion dollars in the same seven-month period of the previous year to 23.2 billion dollars, owing to the buoyancy of exports. Meanwhile because of the increased import of transport services and of other services, the scale of the service account deficit in the year to July narrowed slightly from the 5.0 billion dollars of the previous year to 4.2 billion dollars. The income-account deficit widened to 0.9 billion dollars for the year to July in response to enlarged external payments of dividends and interest. The current transfers deficit widened to 1.7 billion dollars owing to sharply increased overseas remittances by domestic residents.

<Table Ⅱ-5>

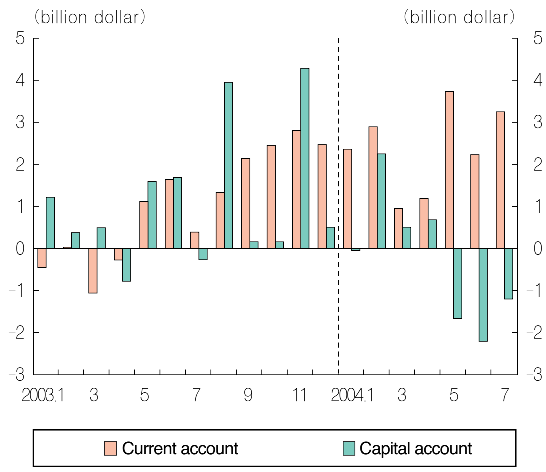
Balance of Payments

(billion dollar)

	2003p			2004p	
	year	1st half	2nd half	1st half	Jul.
Current account	12.3	0.9	11.4	13.2	3.2
Goods	22.2	7.0	15.2	19.0	4.2
(exports)	197.6	91.1	106.6	124.9	22.2
(imports)	175.5	84.1	91.4	105.9	18.0
Services	-7.6	-4.0	-3.6	-3.4	-0.8
(credits)	32.7	15.2	17.5	19.4	3.3
(debits)	40.3	19.1	21.2	22.7	4.1
Income	0.6	-0.8	1.4	-0.9	0.0
Current transfers	-2.8	-1.3	-1.5	-1.5	-0.2
Capital account	13.1	4.5	8.6	-0.6	-1.2
Financial account	14.5	5.2	9.3	0.3	-1.0
Direct investment	-0.2	-0.6	0.4	1.7	-0.6
Portfolio investment	18.0	2.7	15.3	9.6	1.6
Other investment	-3.2	3.1	-6.4	-11.0	-2.1
Other capital account	-1.4	-0.7	-0.7	-0.9	-0.1
Increase(-) in reserve assets	-25.8	-6.6	-19.2	-12.7	-1.5
Errors and omissions	0.4	1.3	-0.9	0.1	-0.5

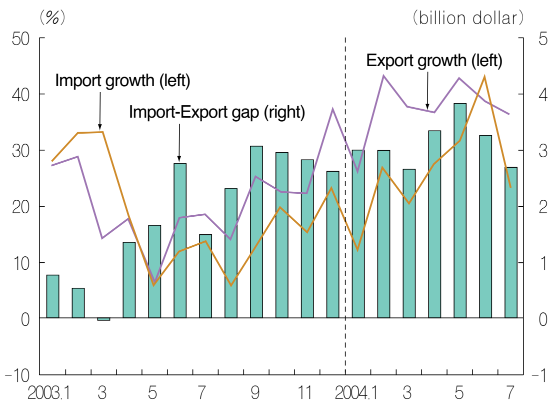
<Figure Ⅱ-13>

Trends of Current and Capital Accounts



<Figure Ⅱ-14>

Trends of Import & Export Growth[1] and Import-Export Gap



Note : 1) Compared with the same period of the previous year. Customs clearance basis.
Source : Ministry of Commerce, Industry and Energy

During the year to July exports (customs clearance basis) registered a 38.0% rise over the same seven-month period of the previous year (104.5 billion dollars) to stand at 144.3 billion dollars, driven by China's sustained high growth and the acceleration of the economic recovery in major countries, notably the USA and Japan. By type of item, semiconductors, mobile phones handsets, automobiles and other major export products all experienced a sharp increase.

Imports (customs clearance basis) expanded 25.3% over their performance in the previous year to July (100.8 billion dollars) to register a figure of 126.4 billion dollars for the first seven months. By import category, imports of consumer goods were subdued owing to the shrinking of consumer spending, but those of capital goods including parts and components and machine tools expanded on the back of the increase in exports while those of raw materials rose substantially under the impact of the surge in international oil prices.

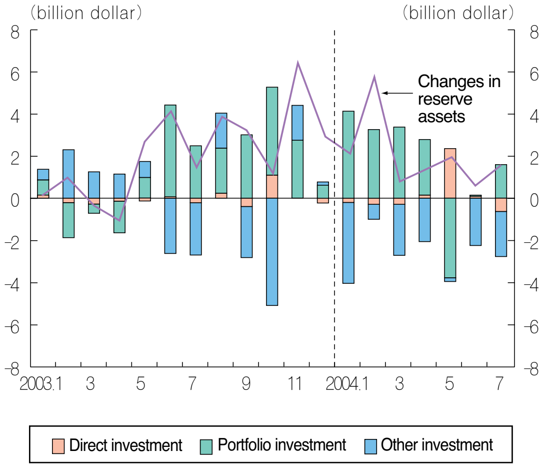
(Capital Account)

The capital account shifted from a surplus of 4.2 billion dollars in the first seven months of the preceding year to a deficit of 1.8 billion dollars for the year to July.

Broken down by component account, the direct investment account underwent a shift from the previous year's deficit in the first seven months of 0.8 billion dollars to a surplus of 1.1 billion dollars. This was ascribable to the large-scale expansion of inward foreign direct investment as a result of Citigroup's acquisition of KorAm Bank, which more than counteracted the effects of residents' increased outward direct investment. The scale of the surplus on the portfolio investment account widened to 11.3 billion

<Figure Ⅱ-15>

Trends of Capital Account by Item



dollars for the year to July as against 5.2 billion dollars in the same period of the preceding year, owing to the net inflow of foreign funds for equity investment. The other investment account shifted from a surplus of 0.7 billion dollars in the first-half of the preceding year to a deficit of 13.1 billion dollars for the year to July owing to the expansion of interoffice loans originated by the domestic branches of foreign banks which acted as a main contributor to the capital account deficit.

3. Prices

(Consumer Prices)

The Consumer Price Index (CPI) rose 2.8% during the year to August compared to its level in the December of the previous year, and by 3.6% on a year-on-year basis. This was ascribable to the sharp run-up in the prices of agricultural and fisheries products and of petroleum products from the beginning of the year.

<Table Ⅱ-6>

Trends of Movements[1] of Major Prices

(%)

	2003			2004			
	year	1st half	2nd half	Q1	Q2	Jul.	Aug.
Consumer Prices	3.4 (3.6)	1.8 (3.8)	1.6 (3.3)	2.1 (3.3)	-0.1 (3.3)	0.6 (4.4)	0.9 (4.8)
Agricultural & marine products	8.9 (5.9)	0.4 (4.4)	8.5 (7.3)	6.6 (8.6)	-3.3 (10.7)	2.2 (14.1)	5.3 (16.3)
Industrial products	1.4 (2.3)	0.6 (3.5)	0.8 (1.2)	1.2 (1.1)	0.5 (2.2)	0.2 (3.2)	0.5 (3.6)
(Petroleum products)	4.3 (6.0)	-0.2 (9.1)	4.5 (3.0)	4.5 (3.2)	1.0 (8.3)	1.4 (11.1)	2.1 (13.5)
Services	3.5 (3.6)	2.7 (3.7)	0.8 (3.8)	1.7 (3.4)	0.2 (2.7)	0.5 (3.0)	0.1 (3.0)
(Rents)	2.8 (3.5)	1.7 (4.1)	1.1 (3.1)	0.3 (2.6)	0.3 (1.8)	0.1 (1.5)	0.0 (1.3)
(Public service charges)	2.0 (2.5)	2.6 (2.1)	-0.6 (2.8)	1.8 (2.2)	-0.2 (1.0)	1.0 (2.1)	0.2 (2.6)
(Private services)	4.7 (4.5)	3.3 (4.3)	1.3 (4.6)	2.3 (4.4)	0.5 (4.2)	0.4 (4.3)	0.0 (4.1)
Cost-of-living	4.2 (4.1)	2.1 (4.0)	2.1 (4.1)	3.3 (4.1)	-0.4 (4.6)	0.9 (5.8)	1.5 (6.7)
Core inflation	2.8 (3.1)	2.0 (3.2)	0.7 (3.0)	1.5 (2.8)	0.4 (2.7)	0.3 (3.1)	0.3 (3.2)

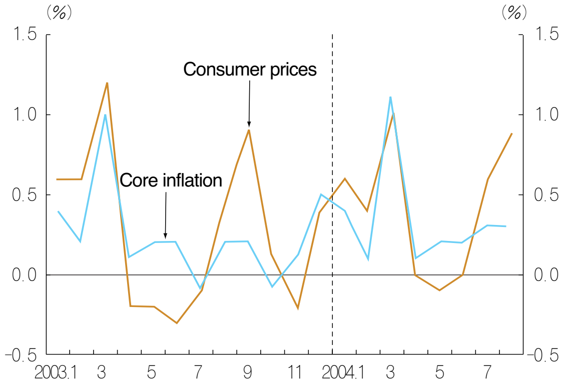
Note : 1) Compared with the last month of the previous period apart from figures for July and August, which are compared with the previous month.
Figures in parentheses refer to rates of increase compared with the same period of the previous year.
Source : Korea National Statistical Office

Viewed by period, the prices of agricultural and marine products rose steeply during the first quarter, largely because of the sharp rise in the price of pork and other alternative meats following poor harvests, mad cow disease, and bird flu. This was compound by the run-up in international prices for raw materials including crude oil, and the increase in charges for services and public utilities including city gas tariffs, tuition fees for private educational institutions and registration charges. From the beginning of the second quarter, however, the prices of agricultural products fell back thanks to a seasonal increase in shipments; electricity tariffs and other charges for public utilities were reduced; and the upward trend of petroleum product prices was blunted by the lowering of import duties, leading to a slight deceleration of consumer price inflation. During July and August, the scale of price increases expanded, because the prices of agricultural products rose sharply due to the rainy spell and scorching heat wave and the increasing trend of international oil prices persisted together with the hike of changes for public services including bus and subway fares.

The rate of increase in the cost-of-living index, which consists of daily necessities bought frequently by

<Figure Ⅱ-16>

Trends of Movements[1] in Consumer Prices and Core Inflation



Note : 1) Compared with the previous month.

<Table Ⅱ-7>

Trends of Movements[1] in Producer Prices

(%)

	2003			2004			
	year	1st half	2nd half	Q1	Q2	Jul.	Aug.
Producer prices	3.1 (2.2)	0.7 (2.1)	2.4 (2.2)	3.6 (4.2)	0.7 (6.2)	0.4 (7.0)	0.9 (7.5)
Goods	3.2 (2.0)	0.4 (2.1)	2.7 (2.0)	4.7 (4.8)	0.9 (7.7)	0.3 (8.7)	1.2 (9.5)
(Agricultural, forest & marine products)	12.1 (5.7)	-1.2 (1.6)	13.5 (9.9)	10.8 (18.1)	-5.6 (18.5)	3.6 (20.0)	3.7 (20.4)
(Industrial products)	2.7 (1.8)	0.5 (2.1)	2.2 (1.3)	4.4 (3.9)	1.6 (7.4)	0.1 (8.5)	0.9 (9.1)
Services	2.9 (2.3)	1.3 (2.1)	1.5 (2.5)	1.2 (3.1)	-0.1 (2.9)	0.5 (3.0)	0.4 (3.2)

Note : 1) Compared with the last month of the previous period apart from those for July and August which are compared with the previous month.
Figures in parentheses refer to rates of increase compared with the same period of the previous year.

<Table Ⅱ-8>

Trends of Movements[1] in Stage-of-Processing Prices

(%)

	2003			2004			
	year	1st half	2nd half	1st half	Q1	Q2	Jul.
Gross index	4.1 (1.9)	0.2 (1.7)	3.9 (2.4)	5.5 (6.7)	4.2 (4.7)	1.2 (8.7)	0.7 (10.3)
Raw materials	9.1 (6.4)	-0.5 (7.3)	9.6 (5.5)	13.0 (15.8)	8.7 (7.6)	4.0 (24.6)	3.6 (26.4)
Intermediate goods	4.9 (2.2)	0.9 (1.7)	3.9 (2.7)	6.9 (7.8)	5.0 (5.9)	1.8 (9.7)	0.3 (11.4)
Final goods	1.7 (0.7)	-0.5 (0.6)	2.2 (0.8)	1.4 (2.8)	2.0 (2.3)	-0.6 (3.3)	0.5 (4.4)

Note : 1) Compared with the last month of the previous period apart from those for July which are compared with the previous month.
Figures in parentheses refer to rates of increase compared with the same period of the previous year.

consumers, rose faster than consumer prices as a whole.

Core inflation, which strips out the prices of petroleum fractions and of agricultural products other than cereals from the CPI, meanwhile, rose by 2.5% during the first eight months from its level in December the previous year and by 2.8% on a year-on-year basis.

(Producer Prices)

Producer prices rose 5.6% during the year to August as against their level in the December of the previous year and on a year-on-year basis they increased 5.6%, showing a large expansion in the scale of their increase from the previous year.

Viewed by period, during the first quarter the scale of the increase in prices expanded sharply, because of the severe winter and heavy snows, along with outbreaks of bird flu and mad cow disease, led to repeated sharp rises in the price of alternative types of meat while industrial products rose on a greatly expanded scale under the influence of the upswing in raw material prices including those for crude oil, nonferrous metals and grains. In the course of the second quarter the prices of agricultural, forest and marine products showed a downward trend for three straight months, thanks to increased shipments while the prices of industrial products rose on a greatly reduced scale. During July and August, there was a renewed large rise in the prices of agricultural and marine products owing to reduced shipments while charges for services also rose, led by those for transport services.

By stage of processing, meanwhile, prices of raw materials rose on a large-scale under the influence of the surge in international raw material prices.

<Table Ⅱ-9>

Trends of Movements[1)] in Import and Export Prices

(%)

		2003			2004			
		year	1st half	2nd half	1st half	Q1	Q2	Jul.
Export prices	Won-basis	3.3 (-2.2)	-1.4 (-4.2)	4.7 (-0.1)	2.4 (4.4)	1.1 (2.6)	1.3 (6.4)	1.4 (9.2)
	Contract currency-basis	2.9 (1.3)	-1.1 (1.4)	4.0 (1.2)	5.9 (6.7)	3.5 (3.6)	2.3 (10.0)	1.3 (10.8)
Import prices	Won-basis	6.5 (1.8)	-0.5 (0.9)	7.0 (2.7)	5.1 (8.2)	3.1 (4.8)	1.9 (11.7)	1.6 (14.3)
	(raw materials)	6.8 (2.5)	-0.8 (2.0)	7.7 (3.1)	6.7 (9.6)	4.2 (5.2)	2.4 (14.2)	2.0 (16.7)
	(capital goods)	4.3 (-1.8)	0.5 (-3.9)	3.8 (0.5)	-3.5 (1.0)	-2.6 (2.6)	-1.0 (-0.6)	0.0 (1.6)
	(consumer goods)	6.3 (-0.6)	1.3 (-3.3)	5.0 (2.3)	1.1 (4.2)	0.6 (3.1)	0.4 (5.3)	0.0 (7.4)
	Contract currency-basis	5.5 (5.0)	-0.1 (6.3)	5.6 (3.8)	8.5 (9.9)	5.6 (5.4)	2.7 (14.7)	1.7 (15.1)
Exchange rates[2)]		4.9	7.3	2.6	3.4	2.7	4.0	1.9

Notes : 1) Compared with the last month of the previous period apart from those for July which are compared with the previous month.
Figures in parentheses refer to rates of increase compared with the same period of the previous year.
2) Won/US$ basis, year-on-year average rate of increase during the given period.

The prices of intermediate products rose sharply during the first seven months centering on those of petroleum and petrochemical products, posting a rise of 6.2% for the first seven months of the year on the basis of their level in the previous December, and by 7.2% on a year-on-year basis.

(Import and Export Prices)

In the course of the first seven months of the year, export prices on a contract currency basis rose by 7.2% compared to their level the previous December on the back of rising demand generated by the recovery of economic activity worldwide. On a Korean-won basis, however, their rate of increase came in lower, registering 3.8%, in view of the strengthening trend of the Korean won against the US dollar.

Import prices rose 10.2% during the year to July on a contract currency basis, while on a Korean won basis the increase was 6.7%. Strikingly, raw material prices surged 8.7% owing to the sharp run-up in crude oil prices. The import prices of consumer goods rose 1.1% while those of capital goods fell 3.5%.

(Real Estate Prices)

Housing prices fell 0.4% during the first seven months of the year in comparison to the December of the previous year. The prices of detached houses and multi-family dwellings continued their downward trend while the scale of the increase in apartment prices was greatly blunted. Led by the prices of apartments scheduled for reconstruction apartment prices generally rose from February onwards at a period of year favoured for moving house and under the influence of the commencement of large-scale rebuilding projects. Their upward trend decelerated sharply from early May

<Table Ⅱ-10>

Trends of Movements[1] in Housing Prices and Leasehold Deposits

(%)

	2003			2004			
	year	1st half	2nd half	1st half	Q1	Q2	Jul.
Housing prices	5.7	4.4	1.2	-0.1	0.0	-0.1	-0.3
<Apartments>	9.6	6.1	3.3	1.0	0.6	0.4	-0.2
- Seoul	10.2	4.6	5.3	1.6	1.0	0.6	-0.4
(Gangnam)	14.3	6.3	7.5	2.0	1.2	0.8	-0.4
- Daejeon	28.4	18.4	8.5	4.0	1.7	2.3	0.2
Leasehold deposits	-1.4	0.7	-2.1	-0.9	0.1	-1.0	-0.8
<Apartments>	-0.3	0.8	-1.1	0.5	0.9	-0.4	-0.6
- Seoul	-3.2	-1.2	-2.1	-0.3	0.8	-1.1	-0.7
Land prices	3.4	0.9	2.5	2.5	1.4	1.1	..

Note : 1) Compared with the last month of the previous year.
Sources : Ministry of Construction and Transportation, Kookmin Bank

onwards in the wake of the designation of certain areas in which the reporting of housing transactions was made mandatory and discussion concerning the early implementation of a system of clawing back the development profits from rebuilding; and it shifted to a mild downward trend from early June. In contrast, a comparatively rapid upward trend became evident for apartment prices in the Daejeon and Chungcheong-areas, which reflected anticipations of the shift of Korea's administrative capital.

In the case of housing leasehold deposits, they moved mildly upward during the February to April period, influenced by the demand for moving house at the start of the new school year, but from May onwards they shifted to a downward trend, thanks to the expanded supply of available housing following the increase in new apartment blocks being built for rental. As the net consequence, they declined by 1.7% in the year to July from their level in the last month of the previous year.

Land prices, meanwhile, showed an upward trend that was concentrated on areas that are strong candidates for development, including Greater Seoul and the Chungcheong region, under the influence of the planned development of new satellite cities and move of the country's administrative capital.

4. Financial Markets

A. Price Indicators

(1) Interest Rates

From early in the year 2004, both long- and short-term market interest rates marked a generally downward trend, owing to concerns about the delayed recovery of domestic demand amid ample market liquidity thanks to the continued accommodating monetary stance. Notably, they declined on an even larger scale after the Bank of Korea's reduction of its policy rate, the target for the overnight call rate, on August 12. Financial institutions' interest rates on deposit and lending also maintained a downward trend in response to the decline of market interest rates.

<Table Ⅱ-11>

Trends of Major Market Interest Rates[1)]

(annual%)

	2002 Dec.	2003 Dec.	2004 Mar.	2004 Jun.	2004 Aug.
Call (one day)	4.52	3.95	3.74	3.78	3.52
CD (91days)	4.90	4.36	3.90	3.93	3.52
CP (91days, A1)	5.03	4.55	4.12	4.02	3.69
Treasury bonds (3yrs.)	5.11	4.82	4.50	4.24	3.56
Corporate bonds (3yrs., AA-)	5.68	5.58	5.30	4.84	4.11

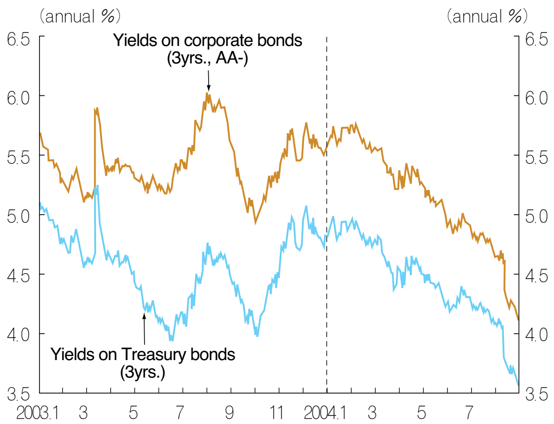
Note : 1) Month-end basis
Source : Korea Securities Computer Corp.

(Long-Term Market Interest Rates)

At the beginning of the year, long-term market interest rates enjoyed a brief rise on anticipations of a change of the US Federal Reserve's interest rate policy stance[5)], the expanded issue of Treasury Bonds for Foreign Exchange Market Stabilization, and the continued upward trend of share prices generated by expectations of a recovery of business activity.

<Figure Ⅱ-17>

Trends of Major Long-term Market Interest Rates



Source : Korea Securities Computer Corp.

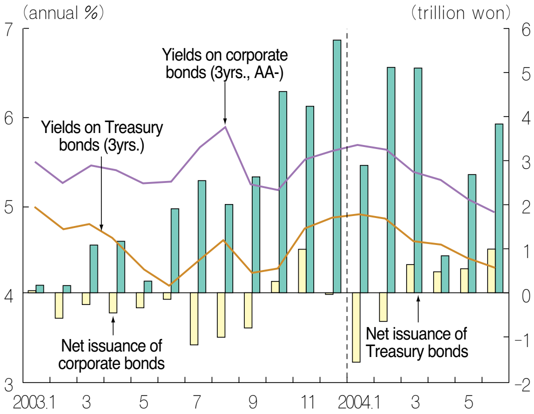
But from February onwards, amid waning anticipations of business recovery in view of the heightened geopolitical risks, long-term interest rates shifted to a steep downward trend given the favorable interplay of market supply and demand, including the expanded purchase of securities in response to the ample market

5) The US Federal Reserve on January 28 deleted from its policy statement the phrase "maintain low interest rates for a considerable period of time" that it had employed since August last year.

liquidity brought about by the early disbursement of the budget. Notably, from mid-March, US long-term interest rates shifted to an upward trend on the continuation of the trend of business expansion and the consequent likelihood of an early rise in interest rates by the Federal Reserve, whereas domestic long-term interest rates evidenced a decoupling from US interest rates, maintaining their downward trend in response to the strengthening of the more restrictive China's policy stance, the persistence of higher oil prices, worries over the delayed recovery of domestic demand and the continued buoyant tone of bond market supply and demand. Long-term interest rates showed an additional large-scale fall in response to the lowering of the Bank of Korea's call rate target on August 12, causing yields on 3-year Treasury bonds to register a level of 3.56% as of the end of August, much lower than at the end of the previous year (4.82%).

<Figure Ⅱ-18>

Trends of Yields[1] on Corporate and Treasury Bonds and Net Issuance



Note : 1) Monthly average.
Source : Korea Securities Computer Corp.

Viewing the trends of the issuance of principal types of bonds during the first half of the year, that of the Deposit Insurance Fund bonds and the Non-Performing Loan Management Fund bonds showed a large-scale net redemption whereas the issuance of Treasury bonds and Monetary Stabilization Bonds were stepped up, so that the overall scale of bond issuance expanded from that during the same six-month period of the previous year.

<Table Ⅱ-12>

Trends of Issuance[1] of Major Bonds

(trillion won)

	2002	2003			2004
		year	1st half	2nd half	1st half
Government bond	15.9	37.5	7.6	29.9	21.2
(Treasury bond)	4.7	25.9	4.5	21.4	20.1
Corporate bond[2]	-8.1	-4.0	-2.1	-1.9	0.3
Financial debenture[3]	27.4	8.5	6.7	1.8	10.0
ABS[4]	6.7	-1.9	-1.8	-0.1	-0.6
Special bond[5]	8.4	-27.2	-2.3	-24.9	-17.0
MSB	5.2	21.2	13.1	8.1	19.9
Total	55.5	34.2	21.3	12.9	33.8

Notes : 1) Based on the value of net issuance.
2) Excludes those issued by companies under court receivership in process of mediation or workout.
3) Industrial Finance bonds, SMEs' Finance bonds, Kookmin Bank's bonds, etc.
4) Secondary CBO, CLO, ABS of receivables, etc.
5) DIF bonds, KEPCO bonds, Credit card bonds, Installment bonds, Leasing bonds, etc.

The issue of Treasury bonds was expanded greatly from the same period of the previous year in view of the need to maintain foreign exchange market stability and bring forward fiscal spending as part of the government's stimulation of domestic demand.
That of MSBs was also expanded in order to siphon off the continued money supply through the foreign sector as a result of the current account surplus and non-residents' introduction of funds for investment in

<Table Ⅱ-13>

Status of the Changes of Holding Bonds by Institutions

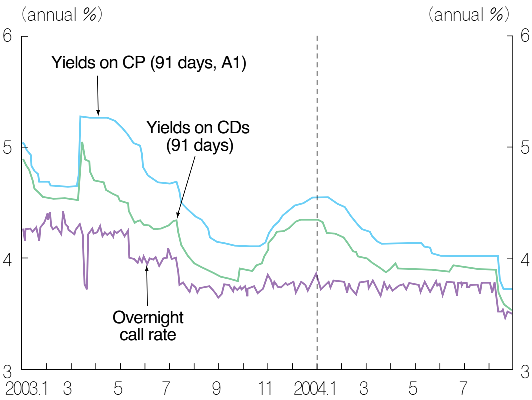
(trillion won)

	2003			2004
	year	1st half	2nd half	1st half
Banks	6.1	9.0	-2.8	-2.5
Banks' Trust	-8.7	-6.1	-2.6	-2.9
Investment trust	-7.5	-4.0	-3.5	15.9
Pension funds	25.1	12.2	12.9	9.1
Insurance companies	15.9	8.5	7.4	4.1

Source : Korea Securities Depository

<Figure Ⅱ-19>

Trends of Major Short-term Market Interest Rates



Source : Korea Securities Computer Corp.

domestic shares. In contrast, the issue of card companies' paper shrank sharply amid investors' lack of economic confidence given the contraction of domestic demand and the high level of the card companies' arrears. Meanwhile, there was a net redemption of Deposit Insurance Fund bonds and of ABS.

Viewed from the perspective of the demand for bonds, the investment trust companies, whose deposit-taking shifted to an upward trend from early in the year, and pension funds, which experienced an increased necessity for the operation of their funds in the form of long-term bonds, both maintained a sustained net purchase position. In the course of the fall in market interest rates, however, sales predominated for the purpose of short-term profit-taking amid a flattening of the rate of increase on deposits taken by the banking sector.

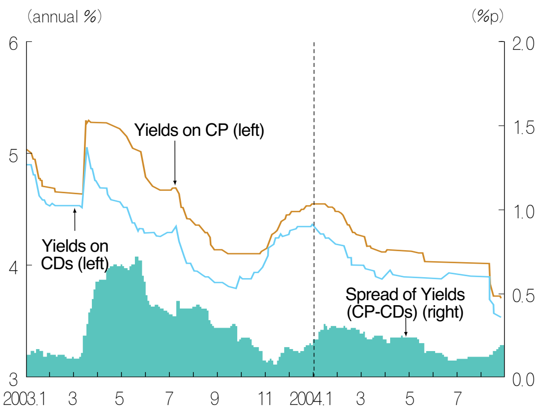
(Short-Term Market Interest Rates)

Short-term market interest rates declined to a considerable extent from the beginning of the year in line with the easing of long-term interest rates, and the expanded appetite for purchases of short-term financial products as a result of the ample market liquidity. Following the reduction of the call rate target in August, they showed an additional large-scale fall.

While the accommodating monetary policy stance was maintained, short-term market interest rates adhered to a downward trend in an environment characterized by the flow of funds into short-term financial products, such as the money market funds (MMFs) offered by investment trust companies, against a background of abundant market liquidity thanks to the inflow of foreign capital for equity investment, the current account surplus, and the bringing forward of the disbursement of the budget. In consequence, secondary market yields on CDs (91 days) eased from their level of 4.36% at the end of the preceding year to stand at 3.88% as of March 22. Subsequently, their downward trend came to a halt under a recognition that the differential between short-term market interest rates and call market interest rates had narrowed excessively, so that their trend generally flattened out. This was maintained until August when they again witnessed a large-scale fall following the lowering of the call rate target, bringing secondary market yields on CDs (91-day) to a level of 3.52% as of the end of August.

<Figure Ⅱ-20>

Trends of Spread of CP over CDs



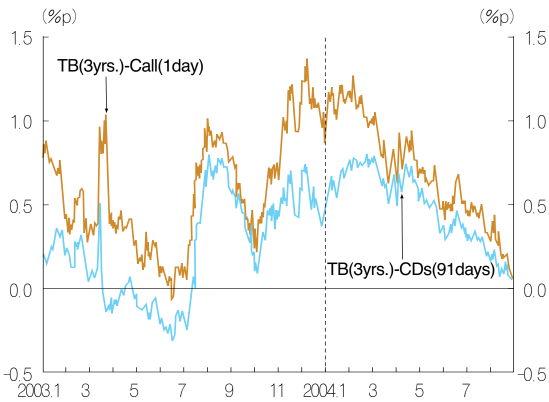
Source : Korea Securities Computer Corp.

Meanwhile the gap[6] between secondary market yields on CDs and CP showed a slight short-lived widening at the beginning of the year, but after this it generally narrowed again in line with the downward stability of short-term market interest rates, shrinking from 0.19 percentage point at the end of the previous year to 0.17 percentage point as of the end of August.

(Spread between Long- and Short-Term Interest Rates)

<Figure Ⅱ-21>

Trends of Spread between Short- and Long-term Interest Rates



Source : Korea Securities Computer Corp.

The spread between long-term and short-term interest rates narrowed in line with the sharp fall of long-term rates. The spread between secondary market yields on Treasury bonds (3-year) and call market rates (overnight) continued to shrink substantially except the beginning of the year. Meanwhile, that between secondary-market yields on Treasuries (3-year) and on CDs (91-day) widened slightly until the end of February but gradually narrowed thereafter.

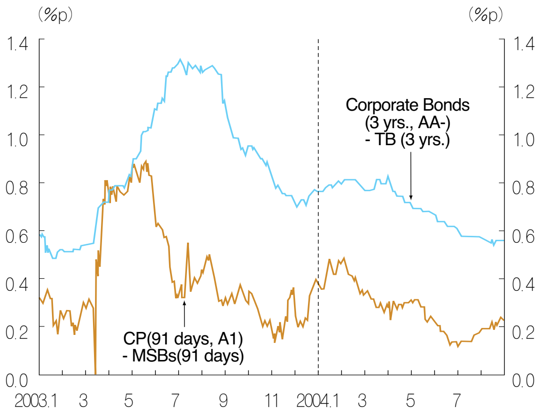
6) An interest rate differential arises in reflection of the different credit standing of the issuers of CDs, which are banks, and that of issuers of CP, which include ordinary (non-financial) companies and financial companies (securities companies, credit card companies and instalment finance companies).

It is attributable that with the call interest rate target on hold at the 3.75% level until July, the scope for additional downward movement of short-term interest rates was restricted, and long-term interest rates, meanwhile, fell by a large margin owing to the constantly increased appetite for bonds and worries over the delayed recovery of domestic demand. This implied a flattening of the yield curve. The spread between long-term and short-term interest rates narrowed further after August 12 when the call rate target was lowered, because the fall in long-term interest rates was steeper than that in short-term rates.

(Risk Premiums)

<Figure Ⅱ-22>

Trends of Risk Premiums



Source : Korea Securities Computer Corp.

Risk premiums, which are the differences between the interest rate yields obtaining on various risk-bearing assets and non-risk bearing assets, showed narrowing movements in line with the overall downward trend of interest rates.

The risk premium on corporate bonds (3-year, AA-) over Treasury bonds (3-year) initially retained its upward trend evident since the end of the previous year as a result of the existence of a mood of unease over credit card companies. However, as economic worries over credit risk subsided somewhat thanks to the improvement in the issues of credit card companies and household indebtedness, the tendency to seek out relatively high yields became more pronounced with the large-scale of the decline in Treasury yields. In consequence, the risk premium shifted to a rapidly narrowing trend from the latter part of February onwards, easing from 0.76 percentage point at the previous year-end to just 0.55 percentage point as of the end of August.

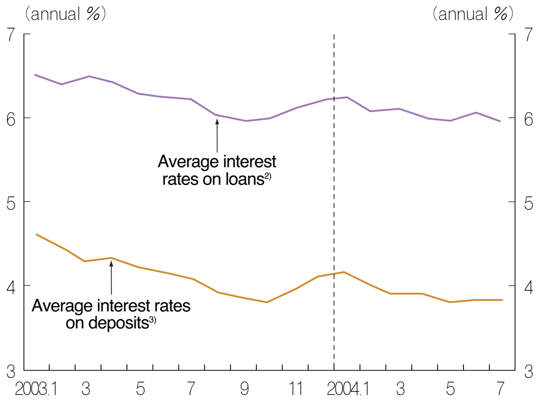
The risk premium on short-term assets between commercial paper (91 days, A1) and Monetary Stabilization Bonds (91 days) showed a swiftly declining trend from the latter part of February, narrowing from its 0.37 percentage point at the end of the previous year to 0.12 percentage point at June 29, before widening somewhat after the latter half of July to stand at 0.22 percentage point as of the end of August.

(Interest Rates on Financial Institutions' Deposits and Loans)

Financial institutions' deposit and lending rates carried on their upward trend evident since the previous October at the beginning of the year but from February onwards they shifted to a downward trend that reflected the decline in market interest rates.

<Figure Ⅱ-23>

Trends of Interest Rates[1] on Bank Deposits and Loans



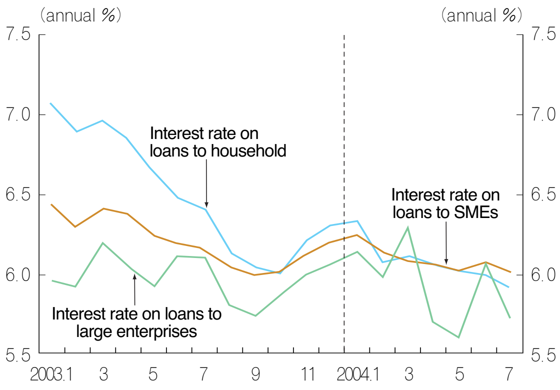
Notes : 1) Based on newly extended loans and deposits.
2) Excludes overdrafts and minus account loans.
3) Excludes demand deposits and savings deposits with instant access.

The average interest rate on bank deposits (newly-taken deposit basis) rose slightly around the beginning of January, as some banks increased their rates on time deposits in reflection of upturn in market interest rates. Subsequently, though, influenced by the downward shift of market interest rates, banks lowered interest rates on deposits in a move that centered on time deposits. As interest rates paid on market-based financial products also declined with interest rates on bank deposits generally maintaining a downward trend, the average interest rate on bank deposits dropped to 3.84% during July as compared to 4.12% in the last month of the preceding year.

Banks' average interest rate on loans (newly-extended amount basis) showed a broadly similar range of movements to that of the average interest rate on deposits, dipping to 5.96% during July as compared to 6.20% in the December of the previous year.

<Figure Ⅱ-24>

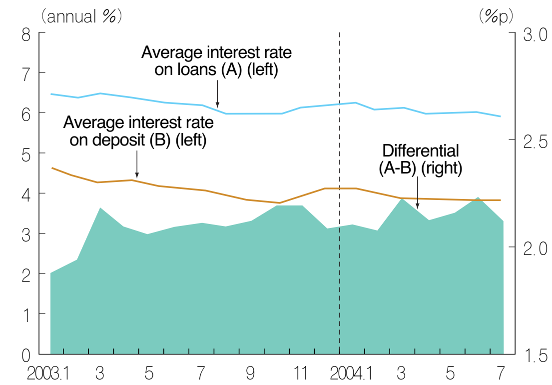
Trends of Average Interest Rates[1] on Bank Loans by Borrower



Note : Based on newly extended loans.

<Figure Ⅱ-25>

Trends of Spread between Interest Rates[1] on Deposits and Loans of Banks



Note : 1) Based on newly extended loans and deposits.

<Table Ⅱ-14>

Trends of the Major Indicators of Stock Market

	2002	2003		2004		
		1st half	2nd half	1st half	Jul.	Aug.
KOSPI[1]	627.55 (-9.5)	669.93 (6.8)	810.71 (21.0)	785.79 (-3.1)	735.34 (-6.4)	803.57 (9.3)
Volume(million shares)[2]	857	602	482	421	359	315
Value(billion won)[2]	3,042	2,018	2,414	2,557	1,609	1,587
KOSDAQ Index[1]	443.60 (-38.6)	497.50 (12.2)	448.70 (-9.8)	385.18 (-14.2)	331.21 (-14.0)	355.66 (7.4)
Volume(million shares)[2]	320	410	406	330	263	256
Value(billion won)[2]	1,205	1,114	1,043	761	451	479

Notes : 1) Year-end basis. Figures in parentheses refer to percentage changes compared with the previous year-end apart from figures for July and August which are compared with the previous month.
2) Daily average.
Source : Korea Securities Computer Corp.

Strikingly, the average interest rate on loans to large companies rose for a while above that obtaining on loans to households and SMEs in view of the high interest rates applied on the funding support given to LG Card by some banks during March. Afterwards, it nevertheless fell back sharply, mirroring the low level of large companies' demand for funds resulting from the combination of an export boom and lackluster investment. During June, it underwent a corrective adjustment in reaction to increased lending to large companies whose record of performance did not come up to par, before easing back to 5.72% in July.

The average spread between banks' interest rates on deposits and loans (newly handled amount basis) widened slightly from 2.08 percentage points in the December of the preceding year to 2.12 percentage points in July, with deposit interest rates and lending rates both heading downward.

(2) Share Prices

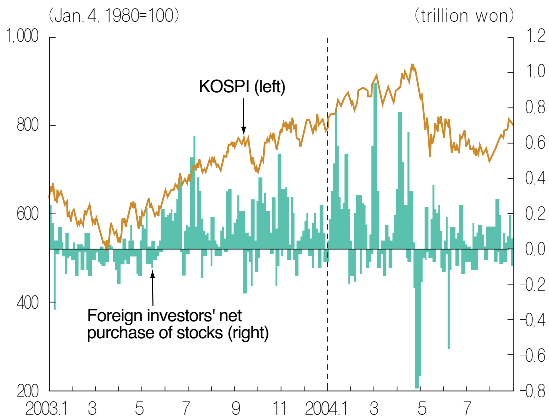
(Korea Composite Stock Price Index)

From the start of 2004, the Korea Composite Stock Price Index (KOSPI) maintained an underlying downward trend. Although it sustained a strong upward trend until the mid-April, it then marked a sharp fall. Subsequently, it showed a generally downward pattern of reiterated fluctuations from mid-May through to early August. It subsequently experienced a corrective movement in reaction to an early inflow of funds for bargain-hunting, and rose on a substantial scale, following the reduction of the call rate target on August 12.

From the beginning of 2004, KOSPI sustained its steep upward trend of the previous year. Amid high hopes of a recovery of business activity at home and abroad, foreign investors greatly expanded the scale of their purchases against a background of rising US share prices and buoyant operating results from domestic businesses. In mid-March, there was a short-lived correction in reaction to the downturn in US share prices, but the upward trend was quickly resumed and it rose to 936.06 on April 23, 15.5% higher than at the close of the previous year.

<Figure Ⅱ-26>

Trends of KOSPI and Foreign Investors' Net Purchase of Stocks



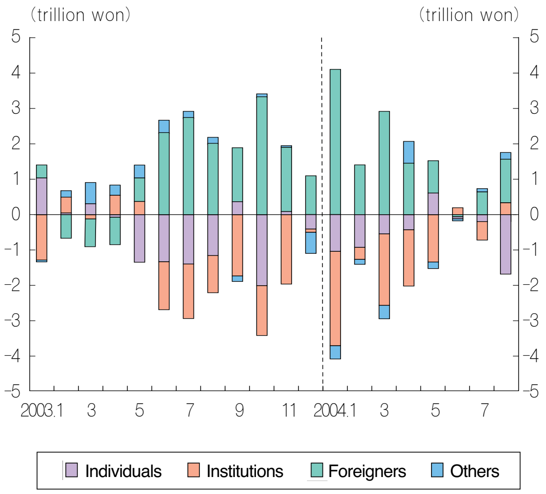
Source : Korea Securities Computer Corp.

Subsequently, though, as the Chinese government announced its determination[7)] to rein in the overheated economy and worries mounted that the surge in international oil prices would derail the recovery of domestic demand, share prices shifted to a steeply downward trend. Notably, foreign investors, who had continued their large-scale net buying, realized their profits amid worries over the scale of the short-term rise, and they shifted to a large-scale net selling position from the latter part of April, precipitating the decline of KOSPI to 728.98 on May 17. Share prices, subsequently, underwent a brief corrective phase, as foreign investors shifted back to a net buying position showing a short-lived rebound, but then exhibited repeated fluctuations, falling to its lowest level for the year to 719.59 on August 2. This sharp fall was followed by a wave of bargain hunting and foreign investors shifted to a continuing upward trend in their net purchases. In addition, encouraged by the reduction of the call rate target on August 12, KOSPI saw a large-scale correction that brought it to 803.57 by August 31, a level 0.9% below that at the end of the previous year.

7) On April 28, Wen Jiabao, Chinese Prime Minister declared: "In order to rein in inflation and the overly rapid growth of the Chinese economy, very tough and effective measures are needed at an early stage."

<Figure Ⅱ-27>

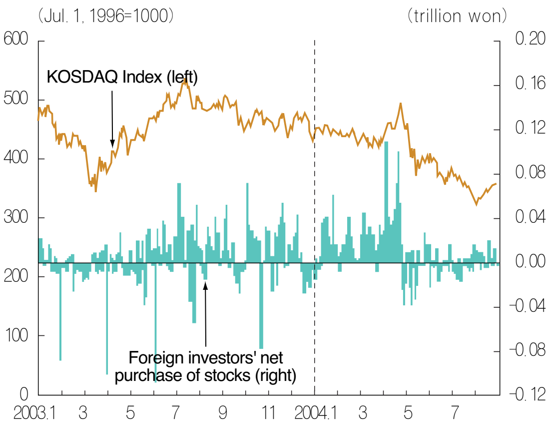
Trends of Net Purchase of Stocks on the KOSPI Market by Type of Investor



Source : Korea Securities Computer Corp.

<Figure Ⅱ-28>

Trends of KOSDAQ Index and Foreign Investors' Net Purchase of Stocks



Source : Korea Securities Computer Corp.

Looking at the trends of share transactions by type of investor, foreign investors drove the rise in share prices, maintaining a large-scale net buying position from the beginning of the year in response to an environment characterized by continued export buoyancy and improved corporate performance. From mid-April, however, they progressively narrowed the scale of their net purchases and moved to a large-scale net selling position as investors involved in carry trade type transactions[8] withdrew their funds in response to China's indications that it would tighten its restrictive stance and the increased likelihood of a hike of interest rates by the US Fed. From mid-May onwards, foreign investors resumed their net buying trend, but on a much reduced scale. For their part, domestic institutional investors and private investors both adhered by and large to a net selling trend.

(KOSDAQ Index)

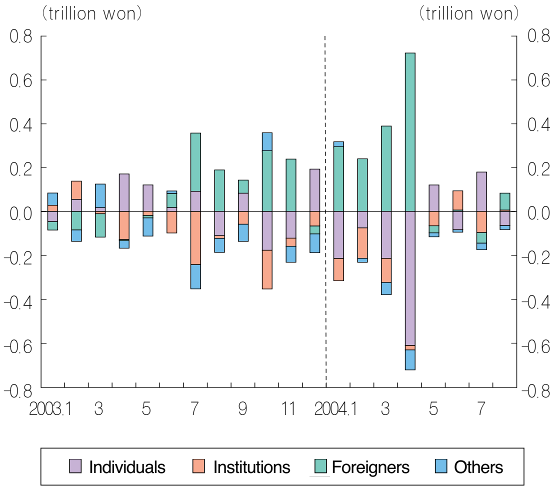
The KOSDAQ index diverged from the movements of the composite stock index, persisting on its downward course from the latter half of the previous year.

Apart from a short-lived rally from late March, the KOSDAQ index persisted on its downward trend owing to the delayed recovery of domestic demand and the weak operating performance of major Internet companies. It underwent a mild correction at the beginning of August, causing it to register a level of

8) These are speculative type transactions involving short-term borrowing at low interest rates in a weakening currency to invest in high yielding assets denominated in a strengthening currency without hedging the risk of changes in exchange rate and interest rates. Against the background of the continuation for some time of low US low interest rates and a weak dollar, investment funds were introduced on a large-scale into the financial markets of the newly emerging market countries in the expectation of large profits, but when anticipations built up from the beginning of April of an early rise in US interest rates and a consequent strengthening of the dollar, it is estimated that some of these funds were withdrawn.

<Figure Ⅱ-29>

Trends of Net Purchase of Stock on the KOSDAQ Market by Type of Investors



Source : Korea Securities Computer Corp.

355.66 as of the end of August, 20.7% below that at the end of the previous year.

The same pattern of differentiation of transaction trends by type of investor as on the Stock Exchange was also observed in the KOSDAQ market, with foreign investors being net buyers whereas domestic institutional and individual investors were net sellers.

B. Quantitative Indicators

(1) Money

During the first half of 2004, the growth of money supply moved away from the previous year's downward trend, shifting to a generally smooth upward course. Notably, narrow money, M1 showed a comparatively steep growth rate.

<Table Ⅱ-15>

Growth Rate[1] of Major Monetary Aggregates

(%)

	2002 Dec.	2003 Dec.	2004 Mar.	2004 Jun.	2004 Jul.
M3	13.3 (12.9)	5.0 (8.8)	5.3	6.0	7.9p (5.5p)
M2	14.1 (11.5)	3.0 (7.9)	2.7	4.4	4.6 (3.4)
M1	15.2 (22.5)	5.4 (6.9)	8.3	9.2	10.2 (8.6)
Reserve money	9.7 (14.3)	6.6 (6.5)	7.2	4.3	3.2 (5.3)

Note : 1) Based on monthly average. Compared with the same month of the previous year.
Figures in the parentheses refer to yearly average, apart from those for Jul. 2004 which are average balance from Jan. to Jul. 2004.

(Monetary Aggregates)

During July, the growth rate (average balance basis) of M3, which covers overall liquidity, rose from its 5.0% in December the previous year to stand at 5.9%. Its growth rate fell slightly to 4.9% during January but shifted to an upward trend from the beginning of February as deposit-taking by investment trust companies and others showed a buoyant tone against a background of a current account surplus and inflows of foreign capital for investment in equities, together with the bringing forward of planned fiscal spending.

The growth of broad money M2 showed a similar pattern of movements to that of M3, slipping back to 2.4% during January before accelerating steadily to reach 4.6% during July. However, as the rate of increase in deposit-taking by banks turned subdued,

<Figure Ⅱ-30>

Growth Rate[1] of Major Monetary Aggregates

Note : 1) Based on monthly average.
Compared with the same month of the previous year.

M2 showed the lowest growth rate of the major monetary aggregates.

The growth rate of narrow money M1, an indicator of short-term liquidity, accelerated sharply from the beginning of the year in response to the expanded supply of money through the government and overseas channels, so that it rose to 10.2% in July, reflecting the build-up of businesses' holdings of surplus funds.

Although reserve money saw a large-scale rise in its growth rate during January in response to the demand for funds over the Lunar New Year holidays, it subsequently exhibited relatively mild growth, owing to the reduced demand for cash in response to stagnant domestic demand.

(Money Supply by Sector)

Looking at the components of money supply by sector during the first half of the year on the basis of M3, the supply of money through the overseas sector and the government sector expanded greatly compared to the same period of the previous year, whereas the supply through the private sector contracted.

<Table Ⅱ-16>

M3 Supply[1] by Sector

(trillion won)

	2002	2003			2004
		year	1st half	2nd half	1st half
M3 changes	138.0	54.0	23.4	30.6	46.5
Government	2.5	11.2	1.5	9.7	13.4
Public sector	-7.0	-19.7	-5.4	-14.2	-10.8
Private sector	149.1	60.0	37.4	22.6	19.9
(Loans and discounts)	115.4	76.6	46.3	30.3	29.5
(Securities)[2]	13.8	-18.1	-8.6	-9.4	-16.4
(Loans in foreign currency)[3]	17.5	2.9	2.0	0.9	1.9
Foreign sector	-10.4	31.8	2.5	29.3	18.2
Others	3.9	-29.3	-12.5	-16.8	6.1

Notes : 1) Changes based on period-end balance.
2) Corporate bonds, CP, etc.
3) Advanced payment against foreign currency payment guarantees, foreign currency credits, etc.

The scale of money supply through the overseas sector rose steeply from 2.5 trillion won in the same six-month-period of the previous year to 18.2 trillion won for the first half of 2004, owing to the large-scale current account surplus and the inflow of foreign portfolio capital for investment in equities.
In the same two periods, the supply of money through the government sector expanded from 1.5 trillion won to 13.4 trillion won in response to the bringing forward of fiscal disbursements to stimulate domestic demand.
On the other hand, the scale of money supply through the private sector fell from 37.4 trillion won in the first

half of the previous year to 19.9 trillion won for the same period of this year in response to the reduced demand for funds by both households and businesses.

(2) Financial Institutions' Deposits

Looking at the trends of deposit-taking by financial institutions from the beginning of 2004, that by investment trust companies, which had suffered a large-scale contraction the previous year, shifted to an increase. In contrast, deposit-taking by deposit money banks (bank account basis), which had increased the previous year, was slightly decreased.

(Deposit Money Banks)

From the beginning of 2004, deposit-taking by deposit money banks was subdued because of the migration of deposits owing to the reduction of interest rates on deposits despite the effects of the expansion of liquidity supply through the overseas and government sectors. The total decrease for the year to August amounted to 3.3 trillion won.

Broken down by types of deposit, demand deposits suffered 3.8 trillion won reduction while savings type deposits shrank by 7.9 trillion won owing to the reduction of interest rates on deposits and the migration of instant access products such as money market deposit accounts (MMDA) into investment trust companies' money market funds (MMF). In contrast, the appetite for short-term marketable deposit products such as CDs and RPs increased owing to relatively heightening their yields by the reduction of interest rates on deposits, while banks also expanded the scale of their sales of CDs in order to raise their Korean won liquidity ratios, bringing about a relatively large-scale upward trend in their issuance.

<Table Ⅱ-17>

Trends of Deposits[1] by Financial Institutions

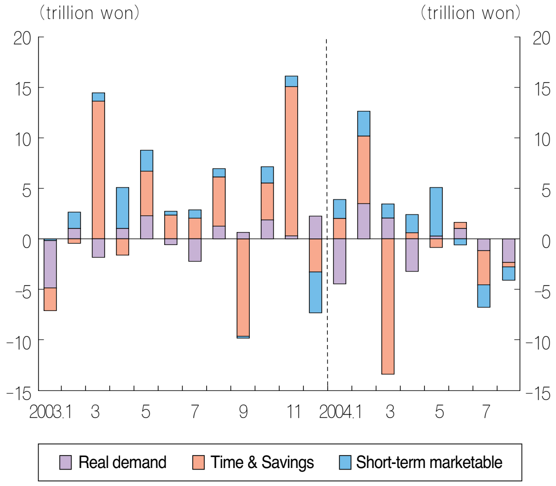
(trillion won)

	2003			2004			
	year	1st half	2nd half	Q1	Q2	Jul.	Aug.
Deposit money banks[2]	39.9	23.0	16.9	2.6	4.6	-6.5	-3.9
Real demand	1.4	-2.8	4.1	1.2	-1.9	-0.9	-2.2
Time & savings	29.3	16.7	12.7	-4.5	0.6	-3.5	-0.5
(Time)	14.7	8.8	5.9	1.5	1.2	-1.2	2.8
(Instant access)	15.7	7.3	8.4	-5.2	-1.8	-2.6	-3.3
<MMDA>	14.6	11.5	3.1	-1.1	-3.0	-2.4	-0.9
CD+RP	9.3	9.7	-0.3	5.5	6.0	-2.1	-1.2
Cover bills	-0.2	-0.6	0.4	0.3	-0.1	-0.1	0.0
Banks' trust account	-15.7	-9.3	-6.4	-5.5	-0.3	-1.0	-0.7
Specific money trust	-6.7	-4.1	-2.6	-3.1	-0.8	-0.4	-0.1
Trust investment companies	-28.6	-17.1	-11.5	17.0	-1.4	6.8	3.9
Short-term bond type	-3.5	0.8	-4.3	-0.2	1.3	2.9	2.6
Long-term bond type	-3.7	1.6	-5.3	0.4	2.4	1.2	1.3
MMFs	-7.2	-12.3	5.1	14.6	-3.6	2.1	0.5
Stock type	-1.0	0.9	-1.9	-0.5	-0.5	-0.4	0.0
Mixed type	-13.1	-8.1	-5.0	2.7	-1.9	-0.7	-1.4

Notes : 1) Based on changes during the period.
2) Includes due from governments and excludes deposits of the Korea Development Bank.
Source : Representative Associations

<Figure Ⅱ-31>

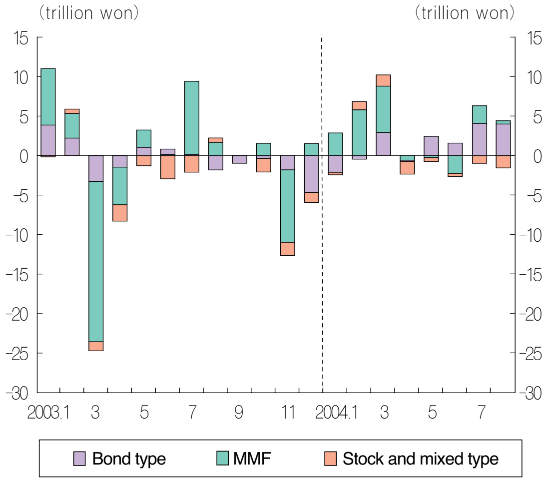
Deposits[1] at Deposit Money Banks by Product



Note : 1) Based on changes during the month

<Figure Ⅱ-32>

Deposits[1] at Investment Trust Companies by Product



Note : 1) Based on changes during the month.
Source : Investment Trust Association.

By period, bank deposits contracted somewhat during January because of the demand for funds over the Lunar New Year holidays and the payment of value-added tax, but from February onwards the expanded supply of liquidity through the government and overseas sectors and the return of funds taken out over the Lunar New Year holidays brought about a sharp increase centering on short term deposits. From the beginning of March, however, they again suffered a large-scale decline because of the reduction in interest rates on time deposits, and the collection of corporate income tax, which together offset the briskness of demand deposits engendered by the inflow of housing subscription funds. They continued to show a mild downward trend in April. From early in May, though, despite the downward trend of time deposits, deposit-taking as a whole shifted back to an upward trend owing to a large-scale increase of deposits centering on short-term marketable products such as CDs. In June, the mild upward trend continued owing to the briskness of deposit-taking by instant access accounts following the expansion of government expenditures. From July, however, deposit-taking again showed a large-scale contraction under the impact of payments of value-added tax and the persistent downward trend of market interest rates.

(Investment Trust Companies)

The previous year, investment trusts companies had suffered a loss of deposits amounting to 28.6 trillion won amid worries over defaults on card companies' bonds in the wake of the weakening of credit card companies' management status. In line with the gradual amelioration of credit card companies' problems, however, deposit-taking by investment trust companies showed renewed buoyancy, most notably in the case of MMF's, and bond type beneficiary certificates. For the first eight months of the year, their deposits registered an increase of 26.3 trillion won. Investment trust companies' deposits shifted to an upward trend centering on MMFs at the beginning of the year thanks to the renewed inflow of funds that had been withdrawn to meet the demand for settlement funds toward the end of the previous year. Subsequently, there was a further large-scale flow of funds into MMFs, owing to the decline in market interest rates, the migration of floating funds and portfolio shifted away from the banking sector together with bond-type beneficiary certificates coming back into favour after suffering a lengthy period of decline. As a consequence, deposits continued to expand until late March. From the beginning of the second quarter, however, deposit-taking by investment trust companies decreased slightly, because the downward trend of long- and short-term market interest rates flattened out while payments of value-added tax fell due in April and funds were needed for the semi-annual closing of accounts during June, bringing about the movements of funds out of MMFs. After July, as the downward trend of market interest rates was sustained, the flow of deposits into investment trust companies shifted back to an increase with large rises in the case of bond-type beneficiary certificates and MMFs.

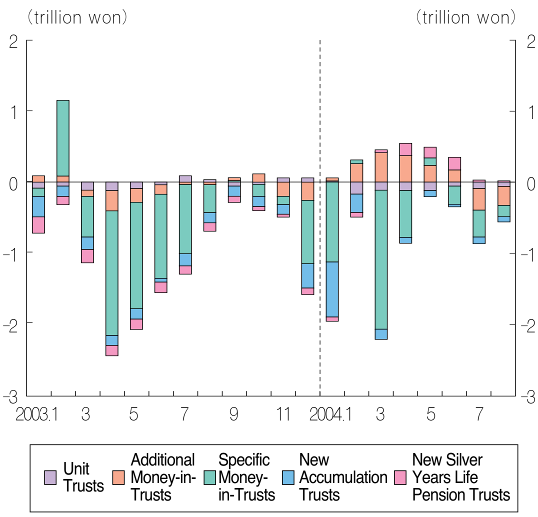
Meanwhile, stock-type investment trusts and mixed-type investment trusts both clung to their persistently declining trend of the previous year.

(Banks' Trust Accounts)

Banks' trust accounts saw a continuation of their sharply declining trend of the previous year, falling by a total of 7.7 trillion won for the year to August. This was ascribable to the sharp contraction of specific money in trust and the persistent retirement from the

<Figure Ⅱ-33>

Deposits[1] at Banks' Trust Accounts by Product



Note : 1) Based on changes during the month.

sector of money placed in funds reaching maturity such as new accumulation trusts, further handling of which ceased. These movements more than offset a mild increase in additional money in trust and new silver years life pension trusts.

(3) Corporate Financing and Household Loans

From the beginning of 2004, corporate funding conditions were generally smooth thanks to buoyant exports in the case of large companies and export-oriented SMEs, and the holding back of large-scale facilities investment. But small-scale businesses dependent on domestic demand whose credit standing was weak experienced difficulties owing to the shrinking of domestic demand and the tendency of financial institutions to differentiate strongly in terms of credit ratings. Looking at businesses' channels of external fund-raising, the upward trend of borrowings from banks slackened while they were able to break away from the trend of net redemption in fund-raising from the direct financing market, but the overall scale of fund-raising was not large.

<Table Ⅱ-18>

Bank Lending[1] by Sector

(trillion won)

	2002	2003 year	2003 1st half	2003 2nd half	2004 Q1	2004 Q2	2004 Jul.	2004 Aug.
Large companies	0.1	-4.3	-0.5	-3.8	1.2	-2.3	0.6	0.2
SMEs	37.1	35.0	26.6	8.4	7.0	4.1	2.0	-0.6
Households	61.6	30.6	13.9	16.7	5.1	6.3	1.2	3.0
Others[2]	-0.2	0.9	1.6	-0.7	1.1	1.0	-0.7	-0.3
Total	98.6	62.2	41.6	20.7	14.5	9.1	3.2	2.4

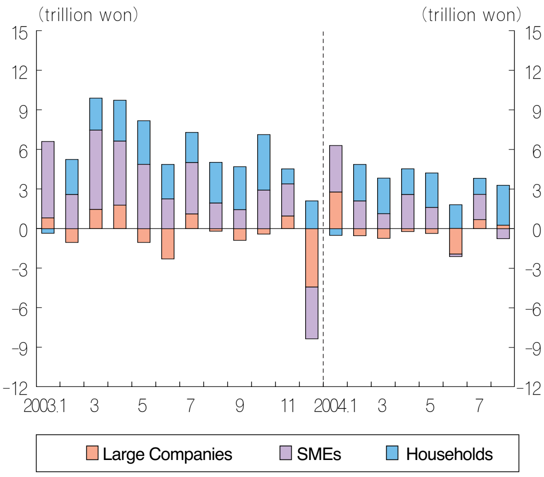
Notes : 1) Includes trust account lending (except discount of CP). Based on changes during the period.
2) Lending to public and other entities.

(Bank Lending)

During the first eight months of the year, bank lending (including trust accounts) increased by 29.1 trillion won, slowing its pace of increase from the previous year.

<Figure Ⅱ-34>

Bank Lending[1] by Sector



Note : 1) Based on changes during the month.

Seen by sector, lending to large companies continued the net redemption trend of the previous year, decreasing by 0.2 trillion won during the first eight months of the year in response to the softening demand for borrowings brought about by the holding-back of facilities investment owing to the obscurity of business prospects and abundant liquidity in terms of cash and near cash on the part of large companies thanks to the buoyancy of exports. Lending to SMEs increased by 12.5 trillion won over the same period, but the rate of increase slowed substantially compared to the previous year. It is attributable that in the case of export-oriented SMEs, as the funding situation improved, their appetite for borrowings was not large, but in the case of domestic-demand oriented SMEs, although there was a call for borrowings, banks tightened their credit application screening procedures in response to worries over loans' turning sour.

<Table Ⅱ-19>

Mortgage-Loans[1] of the Housing Finance Corporation

(billion won)

2004					
Mar.	Apr.	May	Jun.	Jul.	Aug.
35	364	764	1,124	1,428	1,740

Note : 1) Month-end basis.

Lending to household saw its rate of increase narrow from the previous year as it registered an increase of 15.7 trillion won for the year to August. Although, despite housing market activity's shrinking, loans against housing collateral showed a constantly increasing trend, there was a slackening of the demand for borrowings by households through, for example, minus account owing to the shrinkage of consumers' confidence and banks also tightened their credit analysis and screening with a view to securing the soundness of household loans. Meanwhile from March 25, mortgage loans initiated by the Housing Finance Corporation were sold through nine financial institutions (seven banks, two life insurance companies) and, as of the end of August a total of 1.7 trillion won had been handled in such loans.

(Direct Financing)

Businesses had made a net redemption of funds from the direct financing market in the previous year, but from early 2004 they engaged in net fund-raising. The scale of fund-raising, however, was limited to 1.7 trillion won during the first eight months of the year and the direct financing market was unable to present a pattern of brisk activity.

<Table Ⅱ-20>

Trends of Corporate Fund Raising[1) by Direct Financing

(trillion won)

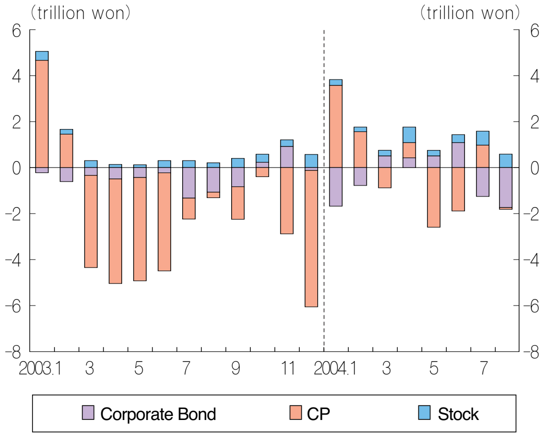
	2003			2004			
	year	1st half	2nd half	Q1	Q2	Jul.	Aug.
Corporate bond issuance(net)[2)	-4.0 (-1.8)	-2.1 (0.4)	-2.0 (-2.2)	-1.7 (-1.7)	1.9 (2.4)	-1.2 (-1.2)	-1.7 (-0.7)
CP issuance (net)[3)	-22.6	-11.0	-11.6	4.4	-3.7	1.0	-0.1
Stock issuance[4)	2.8	0.9	1.8	0.5	1.1	0.5	0.6
Direct financing total	-23.9	-12.2	-11.7	3.3	-0.7	0.4	-1.3

Notes : 1) Based on changes during the period.
2) Excludes those issued by companies under court receivership, in process of mediation or workout. Figures in parentheses exclude those incorporated into primary CBOs and new bonds promptly underwritten by Korea Development Bank (KDB).
3) Based on CP discounts by securities companies, merchant banks and bank trust accounts.
4) Based on companies listed on the Korea Stock Exchange or KOSDAQ, but excludes fund-raising by financial institutions and debts for equity swaps by creditor financial institutions for the purpose of structural adjustment of corporations.
Sources : The Financial Supervisory Service, Representative Associations

Corporate bonds saw a net redemption of 2.6 trillion won for the year to August sustaining the trend of net redemption evident since 2002. From the beginning of the year, a large-scale net redemption position prevailed owing to the abundance of surplus funds in line with large businesses' export boom in a climate of unease related to the problems of credit card companies. From March onwards, however, there was a shift to a trend of net issuance, albeit small in scale, with an increasing appetite for corporate bonds owing to the widening of their interest rate premium over Treasuries. Another contributory factor was companies' expanded issue of corporate bonds in order to engineer the long-term stability of debt structures amid worries that domestic interest rates would follow suit with the shift of the US long-term interest rates to an upward trend. From July, though, there was a shift back to a net redemption position in line with the large expansion of bonds reaching maturity against the background of businesses' feeble demand for investment funds.

<Figure Ⅱ-35>

Trends of Corporate Fund Raising[1) by Direct Financing



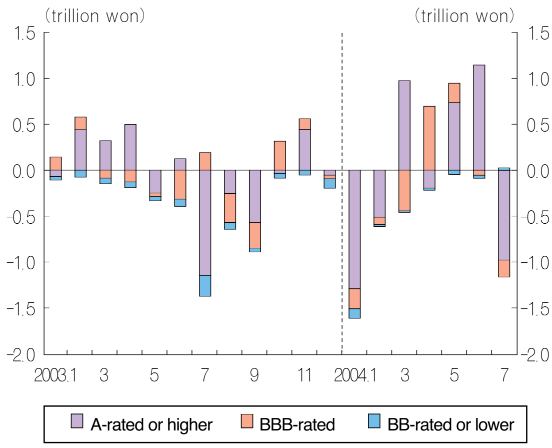
Note : 1) Based on changes during the month.
Sources : The Financial Supervisory Service, Representative Associations

There was a continuation of the phenomenon of credit differentiation, so that in terms of credit ratings (on the basis of corporate bonds issued by public subscription), the weight of A-rated corporate bonds issued (total amount basis) rose slightly from 68.7% the previous year to 69.7% for the seven six months of 2004, whereas that of bonds rated BBB or lower saw a decline in their share of total issuance. In particular, the trend of net redemption continued in the case of bonds rated BB or lower, which are classed as speculative grades.

During the year to August, CP showed total net issuance of 1.7 trillion won. Around the beginning of the year there was net issuance with the reissue of some of the paper that had been temporarily retired on

<Figure Ⅱ-36>

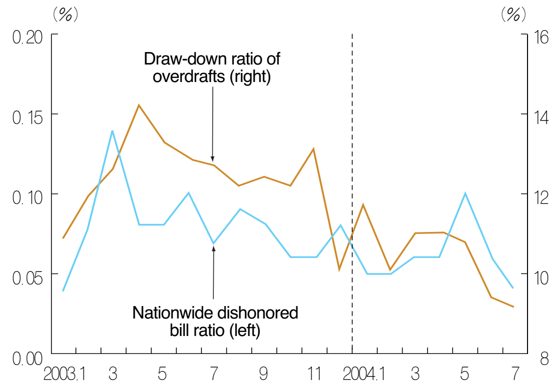
Trends of Net Issuance[1] of Corporate Bonds by Credit Rating



Note : 1) On the basis of corporate bonds issued by public subscription. Based on changes during the month.

<Figure Ⅱ-37>

Nationwide Dishonored Bill Ratio[1] and Draw-down Ratio of Overdrafts



Note : 1) After adjustment for electronic settlement amount.

<Table Ⅱ-21>

Trends of the Rate of Arrears in Lending to Businesses

(%)

	2002 Dec.	2003 Dec.	2004 Jan.	Feb.	Mar.	Apr.	May	Jun.
Lending to businesses	1.8	1.9	2.4	2.5	2.4	2.6	2.8	2.0
Large companies	1.1	0.6	0.2	0.3	0.3	0.4	0.4	0.4
SMEs	2.0	2.1	2.8	2.9	2.8	3.0	3.2	2.3
(Sole proprietorships)	2.1	2.1	3.1	3.1	2.9	3.1	3.3	2.4

Source : The Financial Supervisory Service

a large-scale in advance of the closing of accounts at the previous year-end in order to manage debt ratios. From March onwards, however, it showed by and large a trend of net redemption with CP being retired through the issue of corporate bonds and businesses' demand for funds remaining at a generally low ebb.

For the first eight months of the year, corporate fund-raising through the stock market presented a slightly improved pattern from the previous year, amounting to some 2.7 trillion won. Breaking this amount down between the two markets, fund-raising on the floor of the Stock Exchange was on a scale of some 1.4 trillion won and that raised through the KOSDAQ market came to some 1.2 trillion won.

(Corporate Funding Conditions)

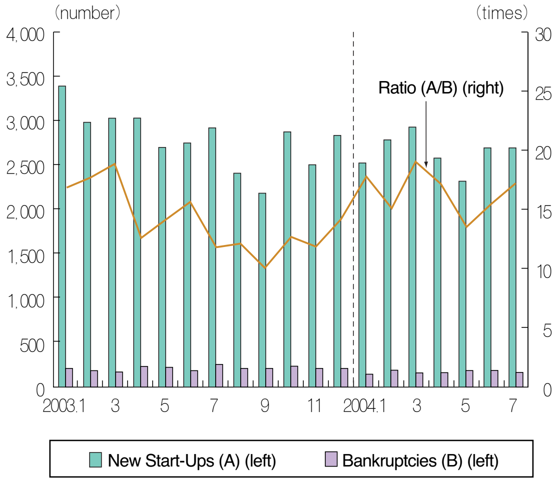
In the first seven months of the year, corporate fund-raising conditions were generally favorable, reflecting the ample market liquidity, but small-scale businesses oriented to domestic demand experienced difficulties.

The rate of default on bills (after adjustment for electronic settlements) presented stable movements around a generally low level apart from a brief spike in May associated with the handling of a default on a primary CBO for the support of venture businesses guaranteed by the Technology Credit Guarantee Fund. In addition, the draw-down ratio of overdraft facilities, an indicator of the urgency of businesses' demand for funds, exhibited a continuation of its mild downward trend from the previous year.

The rate of arrears on lending to businesses, though, showed a steady upward trend centering on sole proprietorships and SMEs dependent on domestic

<Figure Ⅱ-38>

No. of New Corporate Start-Ups and Corporate Bankruptcies in Eight Cities[1]



Note : 1) Seoul, Busan, Daegu, Incheon, Gwangju, Deajeon, Suwon, Ulsan.

demand as a result of the tightening of banks' risk management and the persistently subdued level of domestic demand.

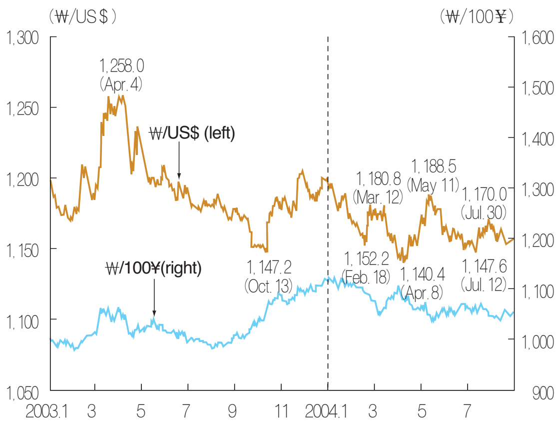
The ratio of new corporate start-ups to corporate bankruptcies in eight major cities including Seoul showed a generally high level, displaying repeated fluctuations from the beginning of the year, because, in contrast to the latter half of the previous year, the number of new start-ups increased whereas that of corporate bankruptcies shifted to a contraction.

5. Foreign Exchange Markets

(Exchange rate)

<Figure Ⅱ-39>

Trends of ₩/US$ and ₩/100￥[1)]



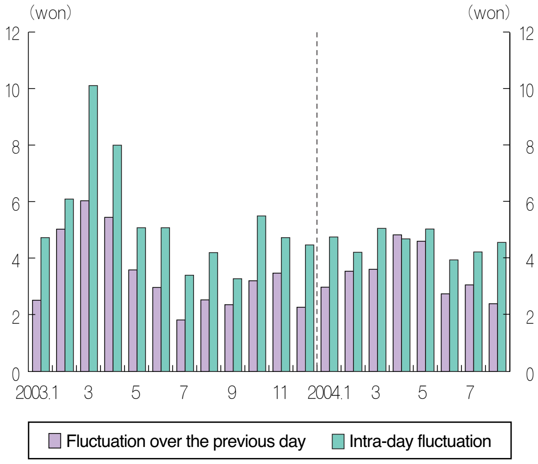
Note : 1) Closing price basis.

From the start of the year 2004, the exchange rate of the Korean won against the US dollar showed a pattern of fluctuations in line with changes in external and domestic conditions.

The won/dollar exchange rate fell from the beginning of the year in response to heightened pressure for the appreciation of Asian currencies around the time of the G-7 meeting (February 6~7). It declined from 1,192.6 won per dollar at the end of the previous year to 1,152.2 won per dollar as of February 18. Reacting to the National Assembly's resolution of the bill for impeachment of the President on March 12, the exchange rate rose sharply to 1,180.8 won per dollar, sequentially falling back amid the continuing inflow of foreign funds for portfolio investment to stand at 1,140.4 won per dollar as of April 8. After this, with the likelihood of the US Fed's raising interest rates and the surge in international oil prices, the exchange rate rose to 1,188.5 won per dollar on May 11, but the influence of the buoyancy of exports and the strength of the Japanese yen caused it to shift to a downward trend, so that the Korean won changed hands at 1,147.6 won per US dollar by July 12. The exchange rate then underwent a corrective adjustment to register 1,153.0 won to the greenback as of the end of August in response to worries over the delayed recovery of domestic business activity, the sharp run-up in international oil prices and the weakness of the Japanese yen in terms of the US dollar. As a result, Korean won appreciated by 3.4% against the US dollar since the beginning of 2004.

<Figure Ⅱ-40>

Trends of ₩/US$ Fluctuations



<Table Ⅱ-22>

Trends of Foreign Exchange Reserves[1)]

(billion dollar)

	2001	2002	2003	2004		
				Mar.	Jun.	Aug.
FX reserves	102.8	121.4	155.4	163.6	167.0	170.5

Note : 1) Period end basis.

<Table Ⅱ-23>

Trends of Changes in Korea's Sovereign Credit Ratings[1)]

	S&P	Moody's	Fitch IBCA
1997	A+(Oct.24) A-(Nov.25) BBB-(Dec.10) B+(Dec.22)	A3(Nov.27) Baa1(Dec.10) Ba1(Dec.21)	A+(Nov.18) A(Dec.3) BBB-(Dec.11) B-(Dec.23)
1998	BB+(Feb.17)	-	BB+(Feb.2)
1999	BBB-(Jan.25) BBB(Nov.11)	Baa3(Feb.12) Baa2(Dec.16)	BBB-(Jan.19) BBB(Jun.24)
2000	-	-	BBB+(Mar.30)
2001	BBB+(Nov.13)	Baa2(Nov.30)	-
2002	A-(Jul.24, outlook : S)[2)]	A3(Mar.28) upward adjustment of outlook (S→P,Nov.15)[2)]	A(Jun.27, outlook : S)[2)]
2003	-	downward adjustment of outlook (P→N, Feb.11)[2)]	-
2004		upward adjustment of outlook (N→S, Jun.11)[2)]	

Notes : 1) Figures in parentheses refer to the announcement dates.
2) P(Positive), S(Stable), N(Negative)

During the first eight months of the year the average intraday range of the won/dollar exchange rate movements narrowed from the preceding year's 5.4 to 4.5 won. In contrast, the range of its day to day fluctuations registered 3.4 won, a similar level to the previous year's.

The exchange rate of the Korean won against the Japanese yen, meanwhile, fluctuated around the 1100 won per 100 yen level until the end of March before falling back from the mid-April to the 1,060 won per 100 yen level. As of August 31, the Korean won traded at 1050.6 won per 100 Japanese yen, which represented an won appreciation of 6.1% over its level at the end of the preceding year.

(Foreign Exchange Reserves)

As of the end of August, the foreign exchange reserves showed an increase of 15.1 billion dollars from their level of 155.4 billion dollars at the end of the preceding year to stand at 170.5 billion dollars due to the predominance of supply of foreign exchange resulted from the persistent surplus of current account and the increase of operating profit from holing foreign exchange reserves.

The composition of the foreign exchange reserves as at the end of August consisted of securities holdings valued at 143.4 billion dollars (84.1%), 26.3 billion dollars in foreign currency deposits (15.4%) and 0.7 billion dollars (0.4%) in the position at the IMF. As such, securities holdings constituted the major part of the foreign exchange reserves.

(Overseas Borrowing Environment)

The Korea's sovereign credit rating saw no change

<Table Ⅱ-24>

Spreads on Foreign Exchange Stabilization Fund Bonds and Short-term Borrowings

(bp)

	2003	2004		
	Dec.	Mar.	Jun.	Aug.
FESF(2008)[1]	45	48	39	25
Short-term borrowings[2]	18	16	11	11

Notes : 1) Spread on US T-notes, period-end basis.
2) Spread over Libor, period-average basis.

from the beginning of the year. In consideration of the easing of the North Korean nuclear issue, Moody's changed the outlook for government credit rating from negative to stable on June 11.

The premium on Foreign Exchange Stabilization bonds (2008 maturity basis) widened from 45 basis points at the end of the previous year to 56bp as of the end of April against a background of the reduced appetite for newly emerging markets' bonds in response to expectations of the US Fed's raising interest rates and worries over the slowdown of China's growth trends. Under the influence of Moody's upward adjustment of the outlook for the sovereign credit rating, and anticipations of the Federal Reserve's step-by-step hike of interest rates, though, it subsequently narrowed to 25 bp as of the end of August.

Ⅲ. Conduct of Monetary Policy

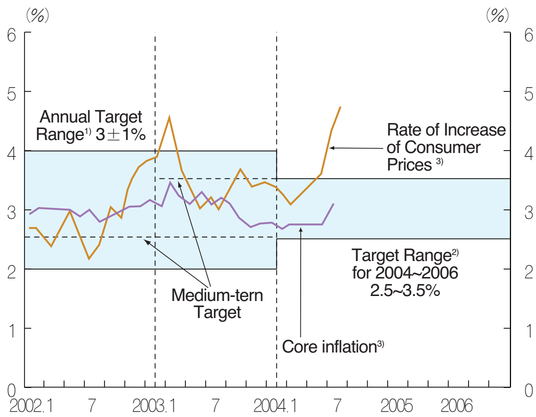
1. Inflation Targeting

Under the revised Bank of Korea Act, which came into force from January 2004, a shift has been made from the previous annual inflation targeting system to a medium-term targeting system[1]. The Bank of Korea, in consultation with the government, set an inflation target for 2004~2006 of 2.5~3.5% in terms of average core inflation during the period.

The period of the inflation target was established for the three years from 2004 through 2006 in consideration of the time lag in the transmission of monetary policy and precedents in foreign countries. The target range was established as 2.5~3.5% since the appropriate level of inflation which buttresses the stability of the economy and corresponds to underlying economic conditions is estimated to be of the order of 3%. A further consideration was the desirability of maintaining policy consistency by aligning it to the medium inflation target that had been announced in 2003, in tandem with the annual target. The targeted indicator selected was, as in the past, core inflation, which strips out the prices of petroleum-based fuels and farm products other than grains, both of which are subject to wide temporary variations. The average rate of increase during the period was decided as the criterion for assessing whether the inflation target had been attained in order

<Figure Ⅲ-1>

Changes in Inflation Target and Rate of Increase of Prices



Notes : 1) Based on annual average rate of increase.
2) Based on average rate of increase during the period.
3) Compared with the same month of the previous year.
Source : Korea National Statistical Office

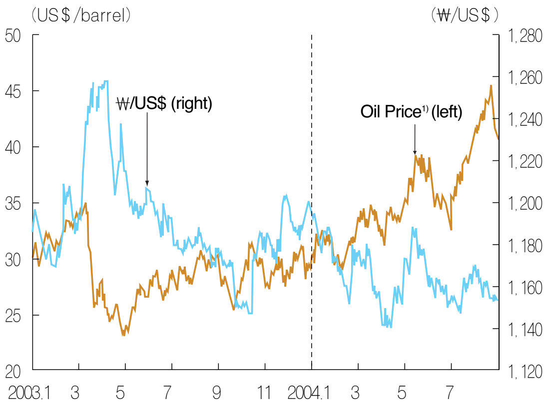
1) Article 6 (1) of the Bank of Korea Act prior to its revision required the Bank of Korea to establish an inflation target 'every year', but under the revised Act the phrase 'every year' is deleted and the Bank of Korea is able to establish an inflation target from a medium term perspective.

to allow monetary policy flexibility.

For the year to August, the year-on-year rate of core inflation remained stable within the medium-term target range at 2.8%.

<Figure Ⅲ-2>

Trends of Exchange Rate and International Oil Prices

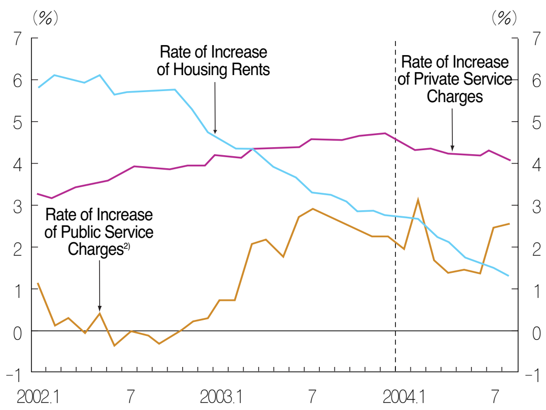


Note : 1) Based on Brent crude oil.
Source: Reuters

Looking at the movements of core inflation, upward pressure on prices from the demand side was analysed as insignificant in view of the sustained stagnation of domestic demand with, for example, the shrivelling up of private consumption and the delay in the recovery of facilities investment. Upward pressure on prices from the wage side was also slight because the rate of increase of all industry nominal wages in the first half of the year stood at 4.7%, much lower than the 11.7% of the same period the previous year. The fact that the annualized average exchange rate of the Korean won against the US dollar during the year to August fell by 40.9 won, 3.5% appreciation, from the same period of the previous year, because of the sustained current account surplus, also served as a factor making for price stability.

<Figure Ⅲ-3>

Trends of Housing Rents, Public and Private Service Charges1)



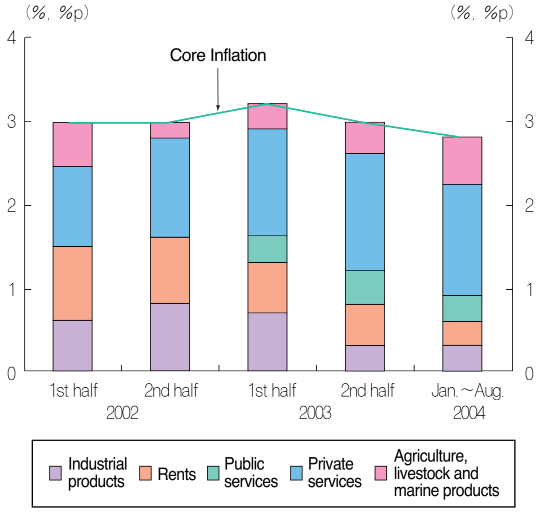
Notes : 1) Compared with the same month of the previous year.
2) Excludes charges for city gas.
Source : Korea National Statistical Office

On the other hand, the run-up in international oil prices acted to put upward pressure on consumer prices. Notably, too, in the period from the latter half of the previous year through to the end of March, a steep upward trend was exhibited by prices of cereals and pulses including corn and soy beans, and those for nonferrous metals such as nickel owing to the recovery of the global economy and heavy Chinese demand. International oil prices had only a small direct effect on core inflation, but they exerted an influence on the general public's inflationary expectations.

Broken down by category for the year to August, because of the continued stagnation of domestic demand owing to the shrinking of consumer

<Figure Ⅲ-4>

Degree of Contribution[1] to Core Inflation



Note : 1) Compared with the same period of the previous year.

confidence, the price of industrial products exhibited a modest rise of 0.9%, lower than their 2.1% rise in the same period of the previous year despite a rise in cost resulting from the run-up in international raw material prices. Their contribution to core inflation fell from 0.7 percentage point to 0.3 percentage point. Leasehold deposits showed stable trends owing to the increased availability of newly built apartments, so that their contribution to core inflation fell from 0.6 percentage point the previous year to 0.3 percentage point. In contrast the prices of grains and pulses and of the products of animal husbandry accelerated their upward trend to 7.7% as against 3.7% in the same period of the previous year, with the prices of pork and other alternative types of meat rising sharply in response to outbreaks of bird flu and mad cow disease. Charges for public utilities rose by 2.0% and private service charges by 4.3%, a similar rate of increase to that in the same period of the previous year.

2. Call Rate Target

<Table Ⅲ-1>

Trends of Major Economic Indicators

(%)

	2003					2004		
	year	Q1	Q2	Q3	Q4	Q1	Q2	Jan. ~ Aug.[2]
GDP Growth[1]p	3.1	3.7	2.2	2.4	3.9	5.3	5.5	-
(Private)	-1.4	0.3	-1.8	-1.9	-2.2	-1.4	-0.7	-
(Facilities)	-1.5	1.9	-0.6	-5.0	-2.4	-0.3	6.2	-
(Construction)	7.6	8.0	7.3	7.9	7.4	4.1	3.8	-
(Exports)	15.7	15.9	8.4	14.9	23.1	26.9	27.2	-
Current Account[3]p	12.3	-1.5	2.4	3.8	7.7	6.2	7.0	3.2
(Goods)	22.2	1.2	5.8	6.8	8.4	8.6	10.4	4.2
(Services)	-7.6	-2.3	-1.7	-2.7	-1.0	-1.9	-1.5	-0.8
(Income)	0.6	0.3	-1.0	0.5	0.9	0.2	-1.2	0.0
Core Inflation[4]	3.1 (2.8)	3.2 (1.6)	3.2 (0.5)	3.1 (0.3)	2.7 (0.5)	2.8 (1.5)	2.7 (0.4)	3.2 (0.5)
Rate of Increase of CPI[4]	3.6 (3.4)	4.1 (2.4)	3.4 (-0.6)	3.2 (1.3)	3.5 (0.4)	3.3 (2.1)	3.3 (-0.1)	4.5 (1.5)

Notes : 1) Compared with the same period of the previous year.
2) Those for current account are figures for July.
3) In billion US dollar.
4) Compared with the same period of the previous year. Figures in parentheses are the rate of increase compared with the last month of the previous period.

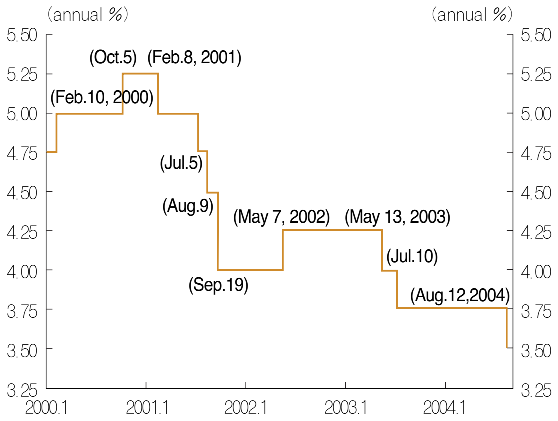
After lowering its policy rate, the call interest rate target, on two occasions the previous year, the Bank of Korea kept its policy rate unchanged at 3.75% until the adjustment in August 2004. On August 12, because of the increased downside risk to economic growth, it undertook a downward adjustment of 25 basis points in its call rate target from 3.5% to 3.25% in order to improve fund-raising conditions for SMEs and to boost consumer and business confidence by reducing the burden of financial expenses on households and businesses. At the same time it also lowered respectively by 25 basis points the interest rate on its Liquidity Adjustment Loans, bringing it to 3.25%, and that on Loans Under the Aggregate Credit Ceiling Facility, adjusting it down to 2.25%.

Examining the background of this decision, despite the steep growth of exports in line with the expansion of the global economic recovery, the real domestic economy continued to present the same lackluster pattern centering on consumer spending and facilities investment as it had in the latter half of the previous year.

At the beginning of the year, the anticipation was that the rapid growth of exports since the previous September would gradually begin to feed through to domestic demand, and that private consumption and facilities investment would show a recovering trend, albeit rather weak. Despite the sustained strongly increasing trend of exports, first quarter GDP growth, fell back from 2.7% to 0.7%, compared to the preceding quarter, while showing an advance from 3.9% to 5.3% on a year-on-year basis. From the beginning of the second quarter, private consumption

<Figure Ⅲ-5>

Changes in Overnight Call Rate Target



maintained its shrinking trend in response to the low ebb of consumer confidence and the blunting of the growth pace of household incomes caused by the weakening of the employment structure, the postponement of improvements in the job market, and the weakening of households' balance sheets owing to stepped-up repayments of principal and interest on their crushing financial debt. Facilities investment presented a picture of delay in any fully-fledged recovery as those businesses that led production and exports such as IT sector enterprises failed to translate their export growth into domestic investment because of their high degree of dependence on imported intermediate inputs and production facilities. This state of affairs was exacerbated by businesses' conservative management style in response to heightened uncertainty at home and abroad typified by volatile oil prices and fragile labor management relations. Accordingly, economic growth continued its subdued pattern with that for the second quarter making a rise of just 0.6% compared with the previous quarter. What is more the polarization of the economy intensified between export-oriented businesses and domestic demand-oriented businesses, and between large companies and small and medium enterprises. The was mainly because as the export growth of the IT related industries was unable to feed through into an increase in production and investment in other industries. From early July, in particular, there was concern over a further weakening of economic growth in view of the possibility of a slowdown of the IT business worldwide and a renewed surge in oil prices. Meanwhile, the current account accumulated a surplus of 16.4 billion dollars for the year to July thanks to a combination of a large-scale increase in exports with subdued domestic demand.

Prices were subject to strong upward pressure on the cost side because of the steep surge in international oil prices but demand pressure was very weak with only a low rise in non-tradables such as services owing to the delay in the recovery of domestic demand. Meanwhile the rate of increase in wages flattened out. In addition, the Korean won showed a trend of overall appreciation against the US dollar and real estate prices fell back slightly owing to a series of government measures to stabilize the market. All these factors served to assist in keeping prices stable. In consequence, even though the rates of increase of consumer prices and producer prices were both high, core inflation remained stable within the bounds of the inflation target. The future course of core inflation may be affected by the influence of cost push factors acting after some time lag and there was concern that it might rise to the upper bound of its target range in the short-term, but from a medium term perspective it was judged that core inflation would attain its target. In addition, housing prices had been showing a mild downturn following the package of housing market stabilization measures unveiled on October 29, 2003.

Financial market liquidity conditions have been smooth and, with market interest rates showing a sharp decline, the spread between long-term and short-term interest rates has narrowed. The issues of household debt and the credit card companies' difficulties, which unsettled the financial markets last year, have shown a somewhat improved pattern. Corporate funding conditions have been generally seamless for large companies and export-oriented businesses but difficulties have increased for small and medium sized enterprises with a high degree of dependence on domestic demand owing to depressed sales and the more rigorous credit screening of financial institutions worried about loan assets turning sour. Residents have stepped up their

<Table Ⅲ-2>

Trends of Policy Rate Changes in Major Countries

(annual %)

	US	UK	ECB	Canada	Australia
Dec. 2001	1.75	4.00	3.25	2.25	4.25
Dec. 2002	1.25	4.00	2.75	2.75	4.75
Feb. 2003		3.75			
Mar.			2.50	3.00	
Apr.				3.25	
Jun.	1.00		2.00		
Jul.		3.50		3.00	
Sep.				2.75	
Nov.		3.75			5.00
Dec.					5.25
Jan. 2004				2.50	
Feb.		4.00			
Mar.				2.25	
Apr.				2.00	
May		4.25			
Jun.	1.25	4.50			
Aug.	1.50	4.75			

Sources : Central banks of individual countries and the ECB.

outward portfolio investment in response to the sharp decline in domestic market interest rates but, meanwhile, there has been a large-scale inflow of foreign funds for investment in equities, as a result of which the securities investment account registered a surplus of 11.3 billion dollars for the year to July.

Looking at the adjustment of policy interest rates by major countries, the US Federal Reserve raised its policy rate in two steps undertaken in June and August by 50 basis points in all, responding to the increase in inflationary pressure in the course of the continuing strong growth of the US economy. The Bank of England increased its policy rate in four steps during the year to August by a total of a full percentage point. The Bank of Canada, in contrast, lowered its policy rate in three steps by 75 basis points in all as inflation remained below its target and the scale of the contraction of domestic demand was larger than expected. For its part, the European Central Bank left its policy rate on hold at 2%, the lowest level since the launch of the euro.

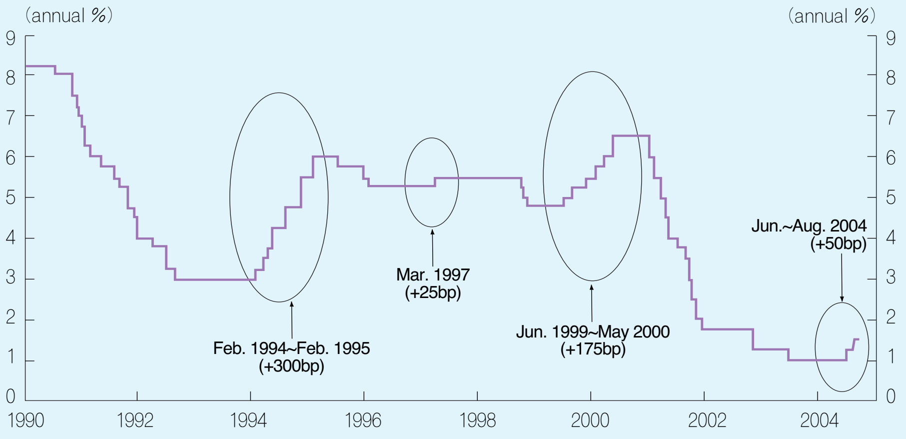
<Reference Ⅲ-1>

The US Fed's Hike of Interest Rates: Background and Outlook

The US Federal Reserve increased its Federal Funds target interest rate by 25 basis points on June 30 and again on August 10, against a background of the emergence of inflationary pressures in line with the US economy's robust growth trend and improved labor market conditions. It noted that to the extent that some of these upward pressures on inflation were caused by temporary factors and, in future, core inflation was expected to show a low level, policy accommodation would be removed at a pace that was likely to be measured. It indicated, however, that it would respond to changes in economic prospects so as to fulfill its obligation to maintain price stability. Accordingly, the financial markets anticipated that there would be a further 25 basis points or so rise in interest rates at each subsequent meeting of the Federal Open Markets Committee for some time, bringing the Federal Funds target rate to between 2.0 and 2.25% by the end of 2004 and to around the 4% level by year-end 2005.

In order to react preemptively to inflation from the beginning of the 1990s, the US Federal Reserve carried out a large-scale upward adjustment of interest rates in the periods from February 1994 to February 1995 and from June 1999 to May 2000. There was a contrasting pattern in the two instances between the financial markets' anticipations concerning the rise in interest rates and the Federal Reserve's actual actions and the markets' reactions to them. First of all, when the rise in interest rates began in 1994, the US economy was expected to break free of its downturn and show solid growth of somewhere above the 3.5% level and the Federal Reserve shifted to severe tightening from its accommodating policy stance that had been maintained for around two years. In February 1994, when the Federal Reserve carried out its initial hike, the financial markets were looking for a rise of around 1 percentage point, but the Federal Reserve, acting against a background of high economic growth and labor-market conditions approaching the level of full employment, raised interest rates in the period up until February 1995 in seven steps by a much higher than expected 3 percentage points, resulting in a sharp rise in long-term interest rates. In 1999, on the other hand, it was in an environment characterized by rapid growth of the US economy thanks to the effects on the 'new economy', the irrational exuberance of the stock markets and buoyant labor market conditions that the Federal Reserve raised interest rates six times during an eleven-month period by a total of 175 basis points in order to nip inflationary pressures in the bud. While at that time long-term interest rates showed a tendency to rise in an advance reaction prior to the Fed's actual hike of interest rates, at the beginning of the year 2000, the yield curve was inverted with long-term rates showing a downward trend in response to the reduced issuance of Treasuries as a result of the achievement of a surplus on the US fiscal account.

Trends of Federal Funds Rate since 1990



It is anticipated that in the process of raising interest rates in future the Federal Reserve will do its utmost to avoid malign side-effects such as a sharp rise in long-term interest rates due to the abrupt change of the policy environment in 1994 or inversion of the yield curve brought about by the financial markets' jumping the gun prior reaction in 1999. In the light of past experience, it is considered very likely that it will adopt a gradual approach to minimize the impact on the financial markets. The Federal Reserve has already signalled to the markets through several channels that it intends to raise interest rates gradually, but that, if it becomes necessary, it will not hesitate to raise them more rapidly. Because most financial market players expect the Federal Reserve to raise interest rates, long-term interest rates are forecast to show a smooth upward trend provided it carries out the hike in a gradual manner.

3. Financial Market Stability

(Monitoring and Reacting to the State of the Financial Markets)

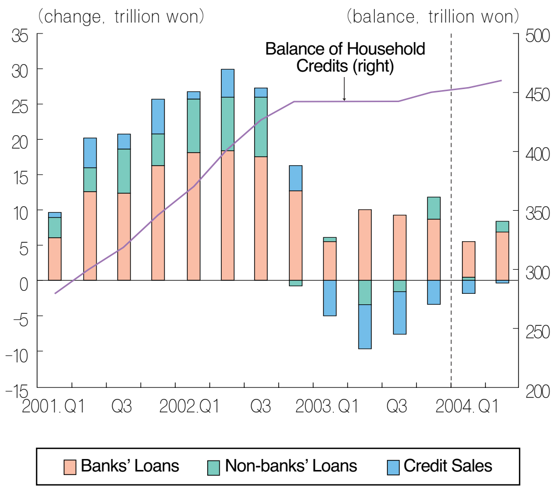
The Bank of Korea strives to bring about financial stability by keeping a careful check on destabilizing factors and initiating the appropriate counter actions promptly.

When a strike broke out at KorAm Bank (declaration of strike was June 25, and actual commencement of strike action June 28), an action plan was at once drawn up and announced in order to dispel promptly the financial markets' mood of unease. Straight after the strike broke out, a 'Special Task Force' was formed so as to keep a detailed check on the progress of the strike and the consequent impact on the financial markets and the status of payments and settlements. In reaction to the possibility of shortages of funds due to heavy withdrawals arising at KorAm Bank, a certain latitude was exercised in the reserve management of financial institutions as a whole, thereby supporting KorAm Bank's seamless raising of funds by means of call-market borrowings. At the same time staff were seconded to KorAm Bank so as to underpin the friction-free operation of payment and settlement including the clearing of checks and bills. Furthermore, in order to prevent instability generated by the strike at KorAm Bank spreading to infect the financial sector as a whole by way of systemic risk, a multi-stage liquidity supply plan was drawn up and announced in order to deal with continuing large-scale withdrawals of deposits: those banks with surplus funds were to be strongly urged to extend call loans to KorAm Bank; funding support was to be made available to KorAm Bank through RPs in the event of its being unable to raise call funds easily; in the eventuality of funds shortages becoming larger and more acute because of the prolongation of the strike, support would be provided through, for example, Liquidity Adjustment Loans. Largely as a result of these efforts for financial market stability, the scale of the withdrawal of deposits from KorAm Bank was limited to 2.4 trillion won despite the prolongation of the strike from June 28 to July 12.[2)]

Latent factors making for domestic financial market instability were kept under constant watch, among them the credit risk of the household and corporate sectors and the difficulties of the credit card companies. There being some improvement from the previous year in the problem of household indebtedness and the troubles of the credit card companies, the level of risk in the financial market as a whole was assessed to have gradually lessened. Indications emerged of the likelihood of a soft landing for the problem of household debt: the growth of household loans decelerated greatly from the previous year; a range of measures to assist those blacklisted for credit was put in place including the launch of the Bad Bank; a long-term mortgage system was introduced with the establishment of the Housing Finance Corporation; and financial institutions arranged trouble-free extensions of the maturity of loans against housing collateral.
In the case of credit card companies, there was some improvement in their management status through mergers with parent banks, debt restructuring, recapitalization, and the downsizing of organizations and staff; at the same time, there was also a modest decline in the rate of arrears on the payment of card receivables. While this process was underway, the Bank of Korea continued its accommodating monetary

<Figure Ⅲ-6>

Trends of the Amount of Change and the Balance of Household Credit



2) In the case of the strike at ChoHung Bank from June 18 to June 22, 2003, deposit withdrawals reached 5.4 trillion won.

stance and maintained ample market liquidity.

With the liberalization from the beginning of February 2004 of interest rates on demand deposits and on company deposits at less than seven days notice in accordance with the revision of the 'Regulation Concerning Financial Institutions Deposit and Loan Rates' issued by the Bank of Korea on December 24, 2003, the major part of the existing body of regulation concerning banks' deposits was abolished. While putting in place these interest rate deregulation measures, the Bank of Korea is continuing to keep watch on the influence they have on the financial markets, for example, on interest rate trends and the flow of market funds. From the results of its observations, no problems are evaluated as having arisen in regard to the feared run-up in demand deposits interest rates or large-scale portfolio shifts between financial institutions or financial products.

Additionally, the central bank publishes 'Financial Stability Report' twice a year (April and October), providing a comprehensive analysis and evaluation of the stability of the financial system as a whole. It also conveys through this report to the markets its concerns regarding the increased credit risk of the household and SME sectors and the possibility of insolvencies in the non-bank financial institution sector.

(Holding of Joint Examinations and the Analysis of the Management Status of Financial Institutions)

The Bank of Korea kept a close watch over the stability of the banking sector and gathered information necessary for the drawing up and implementation of efficient monetary and credit policies by holding joint examinations of banks with the Financial Supervisory Service (FSS) and by its intensive analysis of the

<Table Ⅲ-3>

Performance of Joint Examinations

2000	Domestic banks	Hanvit, Korea Exchange, Daegu(3)
2001	Domestic banks	Hanvit, Chohung, Seoul, Korea Exchange, Peace, Pusan, Kwangju, Kyungnam, Jeonbuk, Cheju(10)
	Foreign bank branches	Citi, Deutsche, HSBC(3)
2002	Domestic banks	Korea First, KorAm, Shinhan, Chohung, Kookmin, Woori, Daegu, Industrial Bank of Korea, National Federation of Fisheries Cooperative, National Agricultural Cooperative Federation(10)
	Foreign bank branches	Tokyo Mitsubishi, BOA, Standard Chartered(3)
2003	Domestic banks	Pusan, Korea Exchange, Korea First, Shinhan, Hana, Kwangju, Kyungnam, KDB(8)
	Foreign bank branches	Citi, BNP Paribas, JP Morgan Chase(3)
Jan. ~Aug. 2004	Domestic banks	Chohung, Korea Exchange, Kookmin, KorAm, Daegu, National Agricultural Cooperative Federation(6)
	Foreign bank branches	HSBC(1)

management status of financial institutions.

During the first eight months of 2004, joint examinations of seven banks were held and the management status of financial institutions as a whole was intensively analyzed on a regular basis. Through its joint examinations, it was able to gather the necessary on-site information for the conduct of monetary and credit policy and the preemptive detection of factors making for financial instability arising from the management status of individual banks including their asset soundness, credit policy and securities investment holdings. In addition, it improved the transmission effects of monetary policy through bringing to light, and taking corrective measures against, breaches of regulations and errors by checking compliance with regulations and guidelines concerning monetary and credit policies, particularly Aggregate Credit Ceiling loans, reserve requirements and payments and settlements.

To assist in drawing up effective monetary and credit policies, a 'Survey of Financial Institutions' Lending Behavior' is carried out every month, covering the analysis of credit risk, financial institutions' lending policies and the demand for borrowings.

In connection with the intended implementation from the end of 2006 of the new BIS capital adequacy regime, the readiness of individual domestic banks is being regularly checked through investigation of the state of their risk management while the impact of implementation on the domestic economy and banks is the subject of intensive analysis.

The three main institutions involved in financial supervision, the Bank of Korea, the Financial Supervisory Service and the Deposit Insurance

Corporation, on January 20 concluded a tripartite 'Memorandum of Understanding Concerning the Sharing of Financial Information' to strengthen the system of co-operation between the three parties and to lighten the regulatory burden on financial institutions. At the same time the memorandum expanded the scope of information concerning the management activities of non-bank financial institutions.

<Reference Ⅲ-2>

Status of Credit Card Companies' Management and Details of Principal Measures to Support People Blacklisted for Credit

(Management Status of Credit Card Companies)

During the year 2003 credit card companies registered huge losses, with their management status being greatly weakened, owing to their credits to the household sector turning sour. From the latter half of that year, however, they engaged in a very tough restructuring drive which involved recapitalization and mergers. As a result of these efforts, a modest improvement began to be seen in their management status from early in 2004.

Several credit card subsidiaries of banks were absorbed by their parent banks through mergers (Kookmin Card, September 2003; Korea Exchange Bank Card, February 2004; Woori Card, March 2004), and suffered severe rationalization of their organizations and staff. Samsung Card solved its liquidity problems through merging with Samsung Capital in February 2004, concluding an agreement with Samsung Life Insurance concerning liquidity support by 5 trillion won in March 2004, and increasing its capital by 1.5 trillion won in April 2004. LG Card, placed under the joint management of its creditors, was able to pursue rehabilitation thanks to the receipt of support in the form of the extension of the maturity of its debts and fresh liquidity from the creditor body and from LG Group by 2.9 trillion won in March 2004 and debt-for-equity swaps by one trillion won in January 2004 and 2.5 trillion won in July. In addition, the credit card companies redoubled their efforts to control risk by, for example, severely curtailing the weight of ancillary operations including cash advances from 53.5% during the year 2003 to 39.6% for the first half of the year 2004, on which the rate of losses had been very high and tightening the criteria for the recruitment of new cardholders.

In consequence the credit card companies showed a clearly marked downward trend in their arrears rates from the beginning of 2004 and during the first quarter of the year showed a pattern of improved profitability with several of them, for example, returning to profit.

Trends of Credit Card Companies' Arrears Rates and Profit Status[1)]

(%, trillion won)

	2003				2004	
	Q1	Q2	Q3	Q4	Q1	Q2
Operation income	2.9	2.6	2.4	1.7	2.4	2.0
Operating expenses	3.7	3.7	2.9	5.6	3.7	3.6
Operating profit	-0.8	-1.0	-0.5	-3.9	-1.3	-1.6
(before allocation to bad loan expenses)	1.1	1.6	1.1	1.3	1.1	0.5
Net profit	-0.9	-1.2	-0.8	-4.9	-0.1	-1.4
Arrears rate[2)]	9.5	9.1	10.0	13.6	12.0	10.9

Notes : 1) On the basis of six stand-alone companies.
2) Period end basis.
Source : Financial Supervisory Service

(Details of Principal Measures to Support of People Blacklisted for Credit)

In order to find a solution to the problem of people blacklisted for credit, which had become an economic and social problem, a range of measures were drawn up to assist them. For those persons blacklisted as credit defaulters who had been registered to a single financial institution, individual financial institutions were guided to provide support voluntarily by way of the debt restructuring and the extension of maturities. In the case of those registered as credit defaulters to several financial institutions, the following three plans were put in place to support their rehabilitation. Firstly, through individual workout programmes of the Credit Recovery Committee, for those with total debts of less than 300 million won having an income above the minimum subsistence level (earnings of 1,055 thousand won per month), up to one third of their total debts could be forgiven and the remainder of the debt paid off by installments over a long term (eight years). Secondly, through an asset liquidity company (Sangrocksue SPC; an asset liquidity company jointly established by five banks and five credit card companies), for those having above the minimum subsistence income with debts of less than 100 million won, up to 30% of their debts could be forgiven with the remainder being paid by installments over the long term (eight years). Thirdly, Hanmauem Finance, a kind of Bad Bank, was launched on May 20, 2004, through which debtors were encouraged toward the voluntary redemption of their obligations. For those debtors over six months in arrears on debts of less than 50 million won, after the advance payment of 3% of the principal, the amount in arrears apart from this advance payment would be converted to a long-term and low-interest loan extended by Hanmauem Finance (up to eight years, 6% per annum). The original creditor financial institution would receive beneficiary certificates from its sale of the loan to Hanmauem Finance, and subsequently receive dividend payments depending on the bad bank's performance in collecting the loan. Because the support received by credit defaulters through it does not involve the writing-off of interest or principal, it is considered that the problem of moral hazard is relatively small. Considering, nevertheless, that no ceiling was set on the income of those eligible to receive support, several supplementary provisions were put in place; services were restricted only to those who were eligible as of March 10, 2004, and if payment fell into arrears again, debtors would be at once classified as credit defaulters and would also be liable to repay the arrears of interest they had been allowed to postpone at the time of the loan's assumption by the Bad Bank.

Consequently the number of persons blacklisted as credit defaulters, which had increased by 1.1 million during 2003, declined by 26 thousand persons during the first half of 2004. After taking into account a reduction in numbers by 250 thousand people due to reclassification excluding tax delinquents and those unable to pay court obligations, an increase of those blacklisted as credit defaulters stood at only 220 thousand persons.

Credit Default Trends[1)]

(period end basis, thousand)

	2002				2003				2004	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2[2)]
Credit defaulters (A)	2,455 (0.5)	2,260 (-19.5)	2,455 (19.5)	2,636 (18.1)	2,957 (32.1)	3,225 (26.8)	3,502 (27.7)	3,720 (21.8)	3,768 (4.8)	3,694 (-7.5)
Credit card related Credit defaulters (B)	1,106 (6.4)	1,123 (1.7)	1,303 (18.0)	1,494 (19.1)	1,767 (27.4)	1,985 (21.7)	2,204 (21.9)	2,397 (19.3)	2,591 (19.4)	2,520 (-7.1)
B/A(%)	45.1	49.7	53.1	56.7	59.8	61.6	62.9	64.4	68.8	68.2

Notes : 1) Figures in the first quarter of 2002 are based on the criterion for credit defaulter registration before its upward adjustment from above 50 thousand won to above 300 thousand, and figures in 2004 exclude tax defaulters and those unable to pay court obligations (first quarter 150 thousand, second quarter 145 thousand) in line with the revised credit information management regulation. The figures in ( ) refer to increase or decrease during the period.

2) Excluding persons deceased (102 thousand) according to the updating project of credit default information.

Source : Korean Federation of Banks.

4. Credit Policy

<Table Ⅲ-4>

Aggregate Credit Ceiling Allocations[1]

(trillion won)

Sorting		Sum
Quota allocated to financial Institutions	Quota to support settlements	2.5
	General Quota	2.5
	Sub total	5.0
Quota allocated to the BOK's regional branches		4.5
Retained reserve		0.1
Total		9 6

Note : 1) As of the end of Aug. 2004.

Operation of the Aggregate Credit Ceiling Facility was conducted with emphasis on strengthening financial support for regionally-based SMEs (small and medium enterprises), which were suffering difficulties in their business because of the contraction of the regional economies.

From April onwards, the amount allocated under the Aggregate Credit Ceiling to the Bank of Korea's regional branches was increased by 400 billion won. In addition, in order to counter the weakened profitability of small and medium exporters hit by the sharp run-up in international raw material prices, the quota allocated for the support of trade finance was also increased by 400 billion won.

In allocating individual quotas under the Aggregate Credit Ceiling, from August onwards, the scale of the differential applied according to compliance with guideline ratios on lending to SMEs was widened, with a view to heightening financial institutions' inducement to handle lending to them. The deduction from the individual quota for those banks failing to comply with the guideline ratios on lending to SMEs was adjusted upwards from 75% to 100%, while the ratio of the additional allocation under the Aggregate Credit Ceiling to those banks complying with these guideline ratios was increased from up to 100% to up to 200%. Also, in allocating loan quotas under the Aggregate Credit Ceiling, the method of evaluating fund operation performance was changed so as to favor those banks that increased the ratio of lending under the Aggregate Credit Ceiling to SMEs and to those with high rollover ratios on lending to SMEs.

<Table Ⅲ-5>

Trends of Bill Substitution-Related Loans and Commercial Bill Discounts[1)]

(trillion won)

	2002 Dec.	2003 Jun.	2003 Dec.	2004 Jun.	2004 Jul.
Corporate procurement loans(A)	11.1	13.5	12.4	14.1	13.9
Electronically - processed secured receivables loans	3.4	4.4	6.3	6.0	6.6
A+B	14.5	17.9	18.7	20.2	20.5
Commercial bill discounts[2)](C)	14.0	12.8	13.2	12.1	12.9
(A+B)/C	1.04	1.40	1.42	1.67	1.59

Notes : 1) Based on month-end balance.
Based on won-denominated loans from bank accounts.
2) SMEs basis.

Efforts were continued to help the practice of cash settlement of commercial transactions to take root between businesses. From April, the ratio accorded in allocating quotas under the Aggregate Credit Ceiling in recognition of commercial bill discount performance was reduced from 20% to 10%. Consequently, a ratio of the volume of cash-based settlement under bill substitution related loans to commercial bill discount performance increased further from 1.42 times at the end of the previous year to 1.59 times at the end of July 2004. In line with the strengthening of the priority given to financial support for regionally-based SMEs and small and medium exporters, however, the overall ceiling on settlement support was reduced slightly from the previous 2.7 trillion won to 2.5 trillion won.

The Bank of Korea, meanwhile, drew up and put into effect from April a plan for strengthening the administration of the Aggregate Credit Ceiling designed to constantly heighten the efficiency of the system of lending under this facility. It also sought to avoid the occurrence of errors in performance reports and breaches of regulations on the part of financial institutions by compiling and distributing a compendium of notifications that brought together questions and answers related to the operation of major regulations, circulating to financial institutions examples of errors and major breaches of regulations concerning the Aggregate Credit Ceiling. What is more, it heightened sanctions against those financial institutions found in the course of its joint examinations with the FSS to have broken regulations or committed errors repeatedly as a result of negligent management, disadvantaging them still further in allocating support under the Aggregate Credit Ceiling as well as reducing their existing quotas.

5. Monetary Policy Instruments

The Bank of Korea strengthened its drive to improve its monetary policy toolkit and heightened the credibility and transparency of its policy formulation and execution.

(Improvement of Monetary and Credit Policy Instruments)

As part of its plan for the further development of the money market, the Bank of Korea sought to raise the benchmark status of the 91-day rate by launching from the third week of March the issue on a regular basis in the first and third weeks of every month of its 91-day Monetary Stabilization Bonds (MSBs), previously issued without a fixed timetable. Before this, the secondary market yield on the CDs had been used as the benchmark 91-day interest rate in calculating the hypothetical price of financial derivatives including interest rate swaps, share index futures and Treasury futures. The volume of CDs issued, however, is on a small-scale and secondary market transactions in them are not very active. Moreover, problems arose because of the lack of continuity in their issuance cycle. Accordingly a heightened need had arisen for a more stable benchmark short-term interest rate, and it was anticipated that by putting the issue of 91-day MSBs on a regular basis, the yield on them would become established as the benchmark rate for 91-day securities. It was also forecast that it would have a positive effect on the development of the derivatives market and the bond market and on the formation of short term interbank interest rates such as KORIBOR (Korea Inter-bank Offered Rate). Apart from this, by diversifying the range of securities issued at fixed dates[3], the basis of demand would be widened and the burden of matching redemption with new issuance arising from the increased scale of MSBs outstanding would be lightened.

In a parallel move, the Bank of Korea adjusted its hours for accepting bids for MSBs to make them more market friendly. Generally on the days on which bids were submitted, the trading of bonds in the market had shown a listless pattern prior to the announcement of tender results. In order to alleviate this problem of lackluster bond transactions as players sat on the sidelines awaiting the results of tenders and to make provision for the possibility[4] of the submission of three tenders a day following the regular issue of the 91-day bond, the Bank of Korea increased the frequency of auctions from twice a day to three times a day, and adjusted tender hours, bringing them forward slightly.[5]

In a further move, the Bank of Korea, in co-operation with related financial institutions, introduced a system for publishing the Korea Inter-bank Offered Rate (KORIBOR), which is similar to the UK's Libor. For this purpose a 'Base-Rate Committee' was formed consisting of the financial directors of the related institutions[6] to draft the related regulations and, after trial operation from April 12, KORIBOR was formally

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3) Following the setting of a regular schedule for the issue of 91-day MSB's, the monthly schedule is as follows; two-year and 91-day MSB's are issued in the first and third weeks of every month, and 364-day MSB's in the second week and 182-day MSB's in the fourth week.
4) With the addition of the 91-day bond to the 546-day bond and the two-year bond offered to the markets through auctions of MSB's in the first and third weeks of the month, it became possible to submit tenders up to three times a day.
5) Prior to alteration: 10:20~11:00, 14:00~14:20.
Following alteration: 10:10~10:30, 11:10~11:30, 13:30~13:50.
6) The 'Base Rate Committee' brought together twelve institutions; the Bank of Korea, the Korea Federation of Banks, eight nationwide commercial banks, Industrial Bank of Korea, and the National Agricultural Cooperative Federation. On June 25, it was renamed the 'KORIBOR Expert Committee' and placed under the auspices of the Korea Federation of Banks.

announced from July 26. KORIBOR is not only the benchmark short-term rate formed in the short-term funds market through interbank transactions but it is also expected to act as a baseline rate for loans linked to market interest rates and pricing decisions concerning derivatives.

(Efforts to Heighten Monetary Policy Credibility)

The Bank of Korea devoted much energy toward heightening the transparency and credibility of its formulation and implementation of monetary policy so that its effects could be smoothly transmitted to the financial markets and the real economy.

And immediately after the monthly policy setting meeting of the Monetary Policy Committee, the Governor holds a press conference in which he explains in detail the background of the policy decisions taken. To heighten the transparency of the policy-making process, the decisions of the Monetary Policy Committee are later published in the Bank's 'Monthly Bulletin'.

In parallel with this, monthly meetings are held of the 'Economic Trends Discussion Meeting', which brings together eminent academics and directors of major economic research institutes, and the 'Financial Consultation Meeting', whose membership is made up of the presidents of financial institutions. The Bank thereby gains a reference base for the formulation of policy by gathering a wide range of on-the-spot information and listening to the opinions of outside experts. A broad spectrum of initiatives is also directed toward amplifying feedback channels and gathering the opinions of the general public through, for example, the holding of the ' Public Survey on Monetary Policy'.

Efforts were continued to heighten public understanding of monetary policy and to raise its credibility in the eyes of the general public. As a means of these efforts, the Bank held ‘Monetary Policy Contest’, in which college students nationwide took part. In order to help the general public understand the Korean economic situation more readily, various explanatory booklets were revised and distributed by the Bank, including ‘A Simple Explanation of Economic Indicators’ and ‘Korea’s Financial Markets’. In addition, the frequency of ‘Economic Class’, an economic education program targeting the general public, was increased from monthly to twice a month, apart from which a wide range of educational programs was prepared and held for young people, including ‘Economic Camp for Adolescents’, ‘Model School for the Economic Education of Youth’, ‘Statistical Class’ and ‘Economics Cyber Class’. These were some of the many ways in which the Bank of Korea actively carried out its role as the primary economic education center among the general public.

6. Payment and Settlement System

<Table Ⅲ-6>

Scale of Settlement[1] Handled by BOK-Wire

(unit, trillion won, %)

	1st half of 2003	1st half of 2004	changes (%)
<Volume>			
Domestic currency funds transfer	5,045(75.6)	5,660(86.6)	12.2
(Gross settlement)	4,368(65.5)	5,020(76.9)	14.9
(Net settlement)	676(10.1)	640(9.8)	-5.5
Treasury funds transfer	1,589(23.8)	828(12.7)	-47.9
BOK loans & discounts	26(0.4)	27(0.4)	4.0
Government and public bonds	13(0.2)	17(0.3)	34.5
Total	6,673(100.0)	6,532(100.0)	-2.1
Foreign currency funds transfer	10(-)	10(-)	0.0
<Value>			
Domestic currency funds transfer	82.7(95.4)	101.8(95.6)	23.1
(Gross settlement)	68.5(79.0)	88.7(83.3)	29.5
(Net settlement)	14.2(16.3)	13.1(12.3)	-7.8
Treasury funds transfer	2.3(2.7)	2.6(2.4)	10.4
BOK loans & discounts	0.9(1.1)	0.9(0.9)	0.8
Government and public bonds	0.8(0.9)	1.2(1.2)	54.3
Total	86.7(100.0)	106.5(100.0)	22.8
Foreign currency funds transfer (million dollar)	124(-)	166(-)	33.4

Note : 1) Daily average basis.
Figures in the parentheses refers to shares in total(%).

In order to promote the more stable and efficient operation of the Korean payment and settlement system, the Bank of Korea made improvements in the related systems and strengthened its holistic management and oversight functions in relation to the principal payment and settlement systems.

(Heightening the Safety and Efficiency of the Payment and Settlement System)

From July, the method of adjusting funds balances between banks in relation to the exchange of cashier's checks where the issuing bank and the paying bank differed was changed from a funds-transfer adjustment method calculated based on the cumulative total amount foregone to an interest-compensation method for the interest foregone.[7] Accordingly, the scale of net settlement between banks in relation to the exchange of cashier's checks was greatly reduced, with not only the burden of settlement funds but also settlement risk being lowered.

Moreover, in order to make the use of cashier's checks more convenient, a system was drawn up whereby, when a customer requests payment in cash at a counter of the bank against a fixed denomination cashier's check issued by another bank, then it can be paid

7) When a bank receives from a customer a cashier's check issued by another bank, it makes cash payment (or credits deposit interest) to the customer the same day but only receives payment of the proceeds of the check from the issuing bank on the following business day, so that a burden is imposed on the paying bank for the period. To compensate for this payment burden, the issuing bank provides an interest free call loan for the same amount (based on the cumulative total of funds) to the paying bank, which is redeemed on the following business day. This method is known as the funds-transfer adjustment method calculated based on the basis of the cumulative total amount foregone. The method whereby only the interest on the amount is paid is known as the interest-compensation method for the interest foregone.

straightaway in cash after checking through Interbank Funds Transfer System whether the check is not stolen or forged. This 'Real-Time Information Exchange-Based Cash Payment System for Cashier's Checks' was brought into effect from August. Following the system's introduction, because of the time lag between payment of the check to the customer in cash and the receipt of the proceeds from the issuing bank on the following business day, a settlement risk was borne by the paying bank. To manage this settlement risk, this cash payment service was added to those transactions whose settlement performance was guaranteed by the provision of securities collateral and those subject to the establishment of a net debt caps.

In buying and selling foreign currencies, foreign exchange settlement risk arises when simultaneous payment for the currency sold and receipt of the currency purchased cannot take place because of time differences between countries. In order to curtail this risk, introduction of the Continuous Linked Settlement (CLS) system is being pursued with the target of having it up and running by the end of 2004. As part of this process, in March, development of the CLS system in Korea began by creating link between the system of the CLS Bank[8] and the system of BOK-Wire. In order that CLS Bank may transfer Korean won funds through its current account held with the Bank of Korea as a participant in the BOK-Wire, the problems that may

8) CLS (Continuous Linked Settlement) Bank Int. was established in 1999 in New York as a private institution supported by 66 financial institutions from 17 countries, in order to bring about payment versus payment for the settlement of foreign exchange transactions worldwide. It commenced operations for the continuous linked settlement of foreign exchange in September 2002 with seven designated settlement currencies; the US dollar, Japanese yen, UK pound, euro, Swiss franc, and Canadian and Australian dollars. The Singapore dollar, the Swedish krone, the Danish krona and the Norwegian krone were additionally designated as settlement currencies in September 2003, and they are expected to be joined at year-end 2004 by the Korean won, the Hong Kong and New Zealand dollars and the South African rand.

arise from the institutional and technical aspects are being studied and plans devised for their resolution.

Apart from this, in order to raise the crisis response capacity of all those involved in the operation of the BOK-Wire, a simulated exercise took place in June to test the manual execution of funds settlement operations between participating institutions should it be impossible to carry out operations normally because of computer failure or disaster.

<Table Ⅲ-7>

Classification of the Payment and Settlement Systems Subject to Assessment

Systemically Important Payment Systems[1] (6 systems)	BOK-Wire	
	Interbank System	Interbank CD System
		Interbank Funds Transfer System
		Electronic Banking System
	Check Clearing System	
	Settlement System of the Over-the-Counter Bond Market	
Prominently Important Payment Systems[2] (9 systems)	Interbank System	CMS System
		Electronic Funds Transfer at the Point of Sale System
		Local Banks Shared System
		Electronic Money (K-CASH) system
		B2C Electronic Commerce Payment System
		B2B Electronic Commerce Payment System
	Giro System	
	Securities Settlement System of the Korea Stock Exchange	
	Securities Settlement System of the Korea Securities Dealers Association Quotation	

Notes : 1) Systems that may paralyze the financial market in case settlement is not completed through them.
2) Systems that may greatly affect the economy and damage the public confidence on payment systems and currency if there is a failure to complete settlement through them.

(Strengthening Oversight of Payment and Settlement Systems)

In keeping with the entry into effect of the revised Bank of Korea Act entrusting the Bank of Korea with the functions of holistic management and oversight concerning the Korean payment and settlements system, plans were worked out for the assessment of the safety and efficiency of the major payment and settlement systems and their assessment of them was carried out.

As an initial step, fundamental standards for assessment were drawn up for the three categories of Systemically Important Payment systems, Prominently Important Payment systems and other payment systems. These standards are broadly on a par with the international standards laid down by the Bank for International Settlements (BIS) in its ‘Core Principles for Systemically Important Payment Systems’[9] and the International Organization of Securities Commissions (IOSCO) in its ‘Recommendations for Securities

9) The Committee on Payment and Settlements Systems (CPSS), set up by the central banks of the G 10 countries under the auspices of the BIS in January 2001, compiled and published ten core principles for the putting in place of international criteria for the design and operation of payment and settlements systems. Central banks were charged with applying these core principles.

Settlement Systems'.[10] And the task of assessing the adequacy of the standards for Systemically Important Payment Systems and Prominently Important Payment Systems was then undertaken. In addition, a continuous monitoring system was constructed to allow the operational status of all the country's payment and settlement systems and the payment and settlements trends of financial institutions to be grasped.

10) The CPSS and IOSCO in November 2001 published a report involving 19 headline recommendations for the application of guidelines for the design, operation and oversight of securities settlement systems.

Ⅳ. Monetary Policy for the Future

1. Environment of Monetary Policy

A. World Economic Environment

<Table Ⅳ-1>

Outlook for World Economic Growth

(%)

	2003	2004e	
		IMF	OECD
World growth rate	3.9	4.6	3.4[1]
(US)	3.0	4.6	4.7
(Japan)	2.5	3.4	3.0
(China)	9.1	8.5	8.3
(Euro)	0.4	1.7	1.6
World Trade Growth	4.5	6.8	8.6

Note : 1) Members of OECD
Sources : IMF, World Economic Outlook, Apr. 2004.
OECD, OECD Economic Outlook, Jun. 2004.

From the latter half of 2004 world trade is expected to show a comparatively firm upward trend in line with the continuing strong growth trend of the world economy as a whole. There nevertheless still remain factors acting to create uncertainty in the world economy such as the trend of international oil prices and geopolitical risks including the situation in Iraq.

The US economy is seen to maintain throughout the latter half of the year and onwards the strong growth trend that it showed in the first half of the year. Thanks to the increase in corporate profits, the increasing trend of facilities investment should be sustained while the trend of improvement in the labor market is expected to continue, so that private consumption will also retain its convincing growth trend. US exports are forecast to remain buoyant owing to the low exchange value of the US dollar, but imports will also show a large-scale increase, leading to a further widening of the scale of the trade deficit. During the latter part of this year, though, the pace of growth is seen to slacken slightly from that of the first half in view of the generally expected gradual rise of interest rates while, at the same time, there will be a weakening of the supportive effect, sustained for some time, of the earlier tax cuts on private consumption.

Throughout the latter half of the year, the Japanese economy is forecast to continue its clearly marked upward pattern. Domestic demand in the form of facilities investment is seen to continue to increase uninterruptedly thanks to the favorable evolution of corporate earnings. Private consumption should also continue its recovery trend with the expansion of golden-age related consumption and the launch of new IT products, against a background of rising consumer confidence. Exports, which have spearheaded the upward trend for some time, are forecast to continue buoyant, centering on capital goods, in spite of the cooling of US and Chinese growth rates.

Chinese growth trends are expected to ease off somewhat as the effects of the tightening measures undertaken to cool down the overheated economy are beginning to bite. Although the upward trend of private consumption will continue thanks to increased personal incomes, the spread of urbanization and the upgrading of consumption, the growth trend of facilities investment, which had shown signs of overheating for some time, is seen to flatten out. Although exports will retain their robust growth, the rate of their increase may slacken somewhat owing to the rise in US interest rates.

Euroland’s economy is forecast to step up the pace of its recovery trend somewhat over the latter half of the year. The trend of recovery of domestic demand is seen to become fully-fledged in line with a large-scale increase of facilities investment, thanks to improved corporate profitability, and to the buoyancy of exports being complemented by increased individual consumption owing to an improved employment situation. Even though the strong tone of the euro is expected to persist, exports are seen to maintain their convincing growth trend for some considerable time owing to the continued expansion of the world economy.

<Table Ⅳ-2>

Outlook for Oil Prices[1]

(US$/barrel)

		date of forecast	2004				
			Q1	Q2	Q3	Q4	year
actual value			32.0	35.4			
CERA[2]	Ⅰ	Aug. 2004			42.5	41.4	37.8
	Ⅱ				42.5	47.4	39.3
CGES[3]	Ⅰ	Aug. 2004			42.0	41.7	37.9
	Ⅱ				42.5	48.0	39.6
	Ⅲ				42.0	42.9	38.2
OEF		Aug. 2004			38.0	35.7	35.2
Lehman Brothers		Jul. 2004			40.6	39.6	36.9
Barclays Capital		Aug. 2004			39.6	41.1	36.8

Notes : 1) Period average basis of Brent oil.
2) Ⅰ assumes the soft landing of Chinese economy and a product increase of oil producing countries.
Ⅱ assumes setback in oil supply due to terrors and increasing oil demands.
3) Ⅰ supposes maintaining status quo.
Ⅱ assumes futher increase in oil demands as a result of cold winter.
Ⅲ supposes a strong expansion of world economy.
Sources : CERA, CGES, OEF, etc.

International oil prices are anticipated to remain at a high level for some time, although dipping somewhat around the beginning of the fourth quarter. Their strength reflects the limit on oil-producing countries' capacity to increase output, the possibility of protracted geopolitical risk, and the increasing demand for oil reflecting the continuing growth trend of the world economy. In the event of attacks against production and distribution facilities, the possibility of further price rises cannot be discounted. Prices of other raw materials are foreseen to remain generally stable during the latter half owing to the Chinese government's actions to rein in the overheated economy, the slackening of speculative demand, and the expansion of supply capacity. Because there was a sharp run-up in prices from the last half of 2003 until February 2004, the annualized average rate of increase this year is expected to post a high level compared to the previous year.

Despite the Federal Reserve's hikes in interest rate, the US dollar is likely to show a trend of underlying weakness against other major currencies because of the large-scale US current account deficit.

B. Domestic Economic Environment

Korean GDP growth (year-on-year basis) in the second half of the year is seen to ease to 5% as against its 5.4% during the first half. This is because of a base-period effect brought about by the surge in exports during the latter half of the previous year, which will result in a decline in the year-on-year rate of growth of exports. The impact of this will be to offset the positive impact of private consumption's escape from its protracted downward trend toward the beginning of the latter half, and an anticipated gradual

<Table Ⅳ-3>

Outlook for GDP Growth Rate[1)]

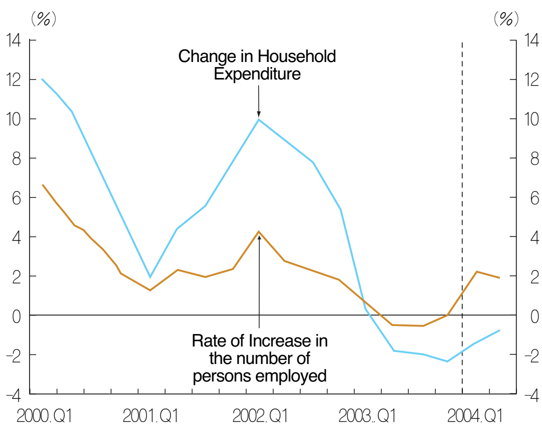
(%)

	2003p	2004p				
		Q1	Q2	1st half	2nd[e] half	year[e]
GDP	3.1	5.3	5.5	5.4	5.0	5.2
Private Consumption	-1.4	-1.4	-0.7	-1.0	1.9	0.5
Facilities Investment	-1.5	-0.3	6.2	3.0	5.9	3.1
Construction Investment	7.6	4.1	3.8	3.9	2.6	3.2
Exports of Goods	18.7	29.2	29.5	29.4	14.5	20.5
Imports of Goods	10.8	12.4	22.2	17.3	11.9	13.1

Note : 1) Year-on-year basis.

<Figure Ⅳ-1>

Trends of the Number of Persons Employed and Household Expenditure[1)]



Note : 1) Year-on-year basis.

recovery trend for facilities investment.

Private consumption and facilities investment are now expected to see their recovery delayed further than originally anticipated. Private consumption is expected to show a recovery trend breaking free during the latter half of the year from its decreasing trend, albeit very weak owing to the weakening of consumer confidence brought about by the fragility of the employment structure, households' paying down of their liabilities, and the low rate of increase of household incomes. There are high hopes for the recovery of facilities investment in view of the strong pressure for adjustment of the stock of installed capacity, including the rise in capacity utilization rates for existing facilities brought about by the large-scale increase of production over a lengthy period. Even so its rate of recovery is seen to be distinctly lackluster in view of the tendency centering on SMEs to prefer relocation of production facilities overseas, the delayed recovery of businesses' willingness to invest in view of their worries over the protraction of the depression of domestic demand, and the low domestic-investment generation effect of exports of IT products. Construction investment is forecast to slowdown gradually from the beginning of the latter half onwards although it will maintain a rate of increase for some time thanks to the expansion of investment in the infrastructure projects financed by the private sector and the fulfillment for the most part of already approved housing plans. Although the likelihood of the weakness of the US dollar against other major currencies will act as an unsettling factor, exports are seen to continue their buoyant trend, thanks both to increased import demand generated by the sustained growth trend of the world economy, and the raising of the quality competitiveness of major export products. From the beginning of the fourth quarter, however, the rate of increase will decelerate owing to the base-period effect of the surge in exports from the previous September onwards. Meanwhile, it is difficult to foresee any large-scale improvement in labor market conditions, despite the strengthening of government job creation efforts.

<Table Ⅳ-4>

Outlook for Price Increase[1)]

(%)

	2003	2004				
		Q1	Q2	1st half	2nd[e] half	year[e]
Consumer prices	3.6	3.3	3.3	3.3	3.9	3.6
Core Inflation	3.1	2.8	2.7	2.6	3.3	3.0

Note : 1) Year-on-year basis.

Price increases are likely to gather pace in the second half of the year as compared to the first half as the lagged effects of upward cost side pressures such as the surge in international oil prices work through, offsetting the effects of factors making for price stability including the prospects of the blunting of the upward trend of the prices of other internationally-traded raw materials, the weak trend of the US dollar, and the lackluster recovery of domestic demand. Accordingly, annualized average core inflation is expected to move around the 3%, mid-point of its 2.5~3.5% target range for the three-year period from 2004 to 2006. In particular, the increases in charges for public utilities imposed at the beginning of the second half of the year[1)] and the increase in cigarette prices awaited in November are seen to push core inflation to the upper bound of its target range (3.5%), and such a situation is expected to persist into the first half of 2005. The rate of increase in the Consumer Price Index is forecast to accelerate its upward trend during the latter half of the year so as to reach a level of around 4% compared to the same period of the previous year, largely owing to international oil prices, which are currently running far above original predictions.

The current account should maintain its underlying

1) From the beginning of July, express bus and cross-country bus fares were raised by an average of 9% and 12%, respectively, while the basic fare for city buses in Seoul was raised by 14% and that for the Seoul subway by 25%.

<Table Ⅳ-5>

Outlook for Current Accounts

(billion dollar)

	2003p	2004p				
		Q1	Q2	1st half	2nd[e] half	year[e]
Current account	12.3	6.1	7.1	13.2	8.0	22.0
Goods	22.2	8.6	10.5	19.1	13.6	33.0
Export[1)]	193.8 (19.3)	59.3 (37.7)	64.0 (39.0)	123.3 (38.4)	128.5 (22.7)	252.0 (30.0)
Imports[1)]	178.8 (17.6)	52.7 (19.2)	55.3 (32.6)	108.0 (25.7)	117.0 (26.0)	225.0 (25.8)
Services, income and current transfers	-9.8	-2.5	-3.4	-5.8	-5.6	-11.0

Notes : 1) Customs clearance basis.
Figures in parentheses refer to year-on-year changes(%).

surplus during the latter half of the year owing to the continued strong growth of the Chinese economy and the expansionary trends of the advanced economies including the USA, Japan and the EU member states. For the year as a whole, the scale of the current account surplus is expected to be over 20 billion dollars.

In the financial markets, financial institutions are seen to maintain their conservative lending policies during the latter half of the year. But, given the ample market liquidity, funding conditions are seen to be generally trouble-free because of the weakness of demand for funds from households and businesses. The blunting of the upward trend of household lending since 2003 will be carried on throughout the latter half of the year. Owing to the subdued housing market activity, loans against housing collateral will not show a large increase and lending in forms such as ‘minus account loans’ is likely to post no more than a feeble rise under the influence of banks’ more rigorous credit screening and consumption’s hesitant recovery trend. In the corporate sector, too, because of the abundance of surplus funds, there is unlikely to be a large increase in borrowings of external capital even if facilities investment does recover. Because of the weakening of operating performance caused by the prolonged downturn of domestic demand, and the consequent tightening of financial institutions’ lending policies, funding conditions for small-scale enterprises have become more difficult. Since financial institutions are experiencing bottlenecks in the operation of their funds owing to the subdued demand for household loans, however, they are thought to be unlikely to cut back severely on their loans to such enterprises.

At home and abroad the outlook for economic conditions is subject to a number of uncertainties. On the external front, the expectation prevails that international oil prices will show gradual stabilization toward the end of the year 2004, but if geopolitical risks such as terrorist attacks against oil facilities increase, then, contrary to present expectations, the current high level of oil prices may persist for a long time and there will be a possibility of additional rises. In relation to the Federal Reserve's interest rate policy, the general consensus is that it will raise interest rates gradually. If the Fed, however, judges that there is a sharp rise in inflationary pressures, the possibility exists that it will choose to raise interest rates by a large margin within a short period. Although China's tightening measures are designed to bring about a soft landing for its economy, which has been showing strong signs of overheating, if the austerity policies are further strengthened, and overseas conditions deteriorate more than expected, the possibility of the occurrence of a hard landing cannot be completely excluded.

Domestically, in the event of financial institutions intensifying their tendency toward the differentiation of credit, it is likely that funding conditions will worsen still further for small-scale businesses. Apart from this, if various forms of political and social disruption become more widespread, the recovery of consumer and business confidence will be adversely affected.

<Reference Ⅳ-1>

The Influence of Rises in International Raw Material Prices on Domestic Prices

Rises in international raw material prices are generally transmitted to domestic prices through the channel running from import prices via producer prices to consumer prices. There are, however, different time lags by type of product before a rise in international raw material prices is transmitted to domestic prices. In the case of crude oil, it is estimated that there is about a one-month time lag before a rise is fully transmitted to producer prices such as those for basic petrochemical products and synthetics and to consumer prices such as those for gasoline, heating oil (Bunker C), and diesel. This is because changes in prices for basic petrochemical products or petroleum products are linked to changes in international prices in the previous month. The length of time, however, before the effects of changes in international oil prices feed through completely to domestic prices is seen as rather longer because the rise in prices for these products brings about a rise in the cost of services and of other manufactured products for which they are intermediate inputs, and they are also a factor in raising public expectations of inflation. In the case of other raw materials, as their prices are fixed for a certain period under agreed contracts, or they pass through various stages of production and distribution, the changes in international prices are reflected in domestic product prices after a time lag of several months. Meanwhile, changes in domestic general prices are not only influenced by the prices of raw materials but by changes in medium and long-term factors such as the state of the economy and productivity, so that it is difficult to estimate accurately in isolation the time lag with which a rise in international raw material prices feeds through to affect domestic general prices.

In the case of a 10% change in the individual prices of major import products, it is estimated from the year 2000 Input-Output Tables that the scale of the influence such a rise for crude oil exerts on domestic prices leads to a 0.37% change for consumer prices and a 0.61% change for producer prices. Apart from crude oil, it is estimated on the basis of the Input-Output Tables, that the pass-through effect of a rise in raw material prices is the largest, in the case of consumer prices, for natural gas (0.18%) and, in the case of producer prices, for integrated circuits (0.16%), natural gas (0.12%), and naphtha (0.10%). However, in using the Input-Output Tables, we can only measure the largest price pass-through effects and it is troublesome to grasp the time lag of the transmission of the price changes. Moreover, because of the overall input structure of the Input-Output Tables and the annual specificity of their production structure, there is the limitation that shifts in the price structure such as changes in the relative price structure and those in the production and import structure cannot be smoothly reflected in the results.

The Price Transmission Effects of a 10% Change in the Prices of Major Import Products

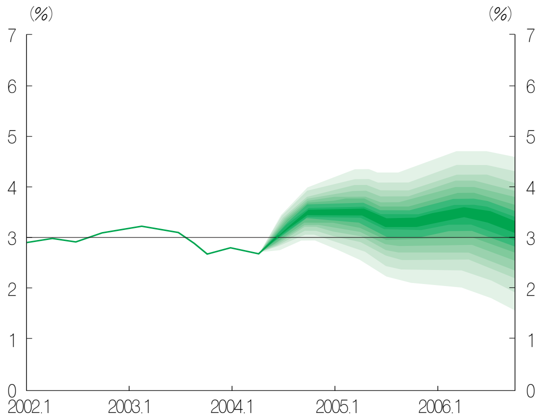
(%)

	Import coefficient[1]	Consumer prices	Producer prices
Crude oil	100.0	0.37	0.61
Natural gas	100.0	0.18	0.12
Corn	95.1	0.04	0.03
Pulp	84.0	0.04	0.05
Integrated circuits	38.1	0.03	0.16
Bituminous coal	100.0	0.03	0.07
Meat carcasses	27.9	0.04	0.01
Naphtha	41.1	0.02	0.10

Note : 1) (import amount/total demand amount)×100

<Figure Ⅳ-2>

Core Inflation[1] Projection



Note : 1) Compared with the same period of the previous year

2. Direction of Monetary Policy

A. Flexible Conduct of Monetary Policy

Monetary policy will continue to be conducted as at present, paying careful attention to price stability, while underpinning the recovery of consumer spending and facilities investment. Looking at the fan-chart displaying both the projected paths of inflation and the same time the degree of uncertainty associated with them, it is forecast with a 90% degree of confidence that the annualized average rate of core inflation, which is the indicator employed for the inflation target, will remain within its medium-term target range (2.5~3.5%) during 2004. In the latter half of 2004 and the first half of 2005, however, core inflation is seen to move closer to the upper bound of its target range (3.5%) and there is a possibility that it may rise slightly above it. And it may be predicted, with a 60% degree of confidence that the annualized average rate of core inflation will remain within its medium-term target range during 2005. Accordingly, in case demand-pull upward pressures on prices emerge faster than anticipated in the course of the recovery of domestic demand, adding to the existing cost-push pressures stemming from high oil prices and so forth, preemptive monetary policy action will be undertaken.

Given the high degree of uncertainty surrounding economic conditions at home and abroad, should the environment deteriorate more than expected, monetary policy will be implemented in a manner appropriate to the circumstances at the time in order to minimize the negative impact.

While the pace of the recovery of domestic demand is expected to be very mild, at the same time latent upward pressures on prices exist, so it is difficult for the Bank of Korea using monetary policy alone to assure both price stability and an appropriate level of economic growth. Accordingly, it will intensify its efforts to operate monetary policy in a harmonious policy mix not only with the government's fiscal and foreign exchange policy, but with various micro economic policies. In a similar vein, it intends to strengthen consultation with the financial supervisory authorities with a view to securing the effectiveness of monetary policy, insofar as financial supervisory policy exerts an influence on the effects of monetary policy and on its transmission channels.

B. Improvement of Monetary Policy Instruments

The Bank of Korea intends to operate, as indeed it has been doing, the Aggregate Credit Ceiling in such a way as to heighten the practical effectiveness of financial support for SMEs in view of the worsening of their fund-raising conditions brought about by the stagnation of domestic demand and financial institutions' strengthened credit differentiation.

Together with this, interest rates on lending under the Aggregate Credit Ceiling will be basically decided with further stress on improving fund-raising conditions for SMEs and alleviating the burden of their financial expenses, after taking into consideration the movements of market interest rates and banks' deposit and lending rates.

C. Strengthening of Efforts for the Stability of the Financial Markets and the Payment and Settlement Systems

The Bank of Korea is persevering in its endeavors for financial market stability. Although the management troubles of credit card companies, which had acted for quite some time as a destabilizing factor in the financial markets, are expected to continue on an improving path, financial institutions are still highly sensitive to the credit risk of households and SMEs, given the high degree of uncertainty surrounding economic conditions at home and abroad. Accordingly a close watch will be kept on the financial markets so that if worrying symptoms do appear, flexible actions to counter them can be undertaken involving, for example, open market operations. Improvements are also expected in the safety and efficiency of the payment and settlement systems. As an initial step, the reconstruction of the BOK-Wire system, which forms the backbone of the nation's payment and settlement systems, is being undertaken in order to heighten its safety and convenience, with the final stages of the reconstruction being completed by the end of 2004. For the uninterrupted operation of BOK Wire, the systematic measures to prevent systems failure or disaster and recovery measures will be established. In order to heighten the efficiency of financial institutions' retail operations, the method of the exchange of Giro payment slips among banks is being changed to an electronic information transfer method that does not involve their physical movement. The assessment of the efficiency and safety of the BOK-Wire, the principal retail settlement systems, and the securities settlement systems is expected to be completed within the very near future. Where shortcomings are brought to light, the Bank of Korea, as a overseer of the country's payment and settlement system will issue a recommendation for improvement to the operating institution. Apart from this, a constant check will be kept on the operational status of all payment and settlement systems and monitoring activities will also be strengthened in regard to the trends of settlement using new payment media such as mobile banking.