

III . Monetary Policy Operation

1. Inflation Target

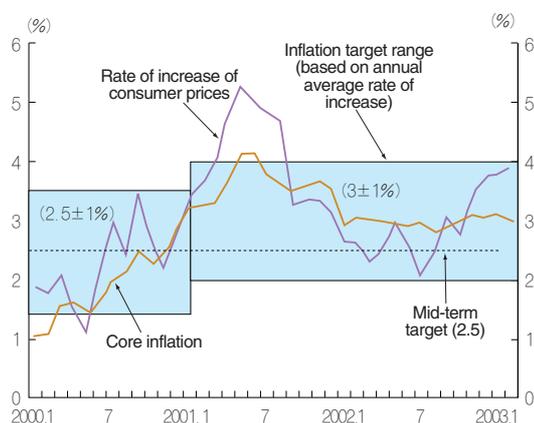
In accordance with Article 6 of the Bank of Korea Act, the Bank of Korea established, in consultation with the government, its inflation target for the year 2002 at $3 \pm 1\%$ on the basis of the average annual growth rate of core inflation, the same level and band as in the year 2001. At the same time, the medium term inflation target was maintained at the level of 2.5% originally established in December 1999.

The index employed as the reference was, as in the year 2001, core inflation, which strips out from the Consumer Price Index(CPI) non-grain farm products and petroleum-based fuels whose prices are subject to large temporary fluctuations, depending upon changes in weather, harvests, and international oil prices.

The Bank of Korea set the central point of its inflation target range at 3%, considering that, in view of the softening of demand side price pressures and the stability of prices of international raw material such as crude oil, the CPI was expected to rise slightly over the 3% level. However, given the uncertainty concerning the movements of the Korean won exchange rate and the obscurity concerning the timing and speed of the recovery of the world and domestic economy, a band of 1%p above and below this central point was then tolerated as in the year 2001. In order to maintain consistency in the operation of monetary policy and the credibility of monetary policy measures, the medium term inflation target was maintained at the level of 2.5% as in the year 2001.

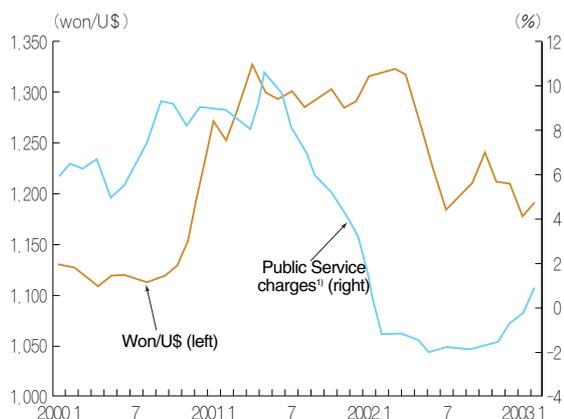
<Figure III -1>

Changes¹⁾ in Inflation Target and Rate of Increase of Prices



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

<Figure III -2>
Trends of Exchange Rate and Public Service Charges

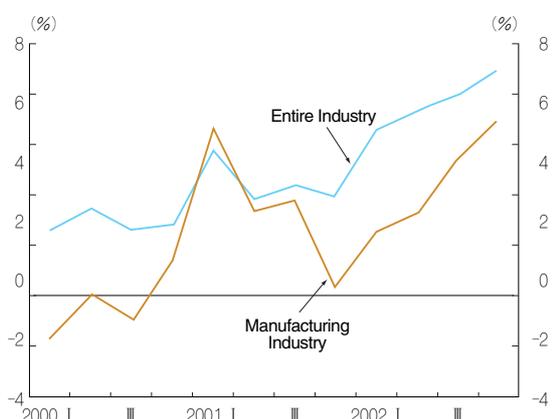


Note: 1) Compared with the same period of the previous year.
 Sources: Korea National Statistical Office, The Bank of Korea.

In the course of the year 2002, the annual rate of core inflation exhibited a stable pattern of movements, standing at the 3%, mid-point of its target range, rather lower than in the previous year's 3.6%. The main reasons why core inflation was contained within its target range were that, in spite of the acceleration of wage increases and the hike in real estate prices, demand side price pressures remained weak while the appreciation of the Korean won held inflation in check and charges for public services, exceptionally, were lowered.

Even though the rate of GDP growth stood at 6.3%, slightly above the level of the potential growth rate, because of the low rate of growth during the preceding year, the scale of the economy in itself was not so much greater than its potential level. Accordingly, demand side pressures on prices are estimated to have remained at a low level. And the exchange rate, in terms of the basic rate, declined by 3.1% from the previous year. Analyzing this with the Input-Output tables, this appreciation of the Korean won is estimated to have lowered the annual inflation rate of the CPI by 0.6%p. In addition, from early in the year 2002, charges for public services which had maintained an uninterrupted upward trend since 1985 were reduced, particularly those for mobile phones calls, piped gas, and medical treatment under public health insurance. This also had the effect of lowering consumer price inflation by 0.2%p.

<Figure III -3>
Trends of Unit Labor Costs¹⁾



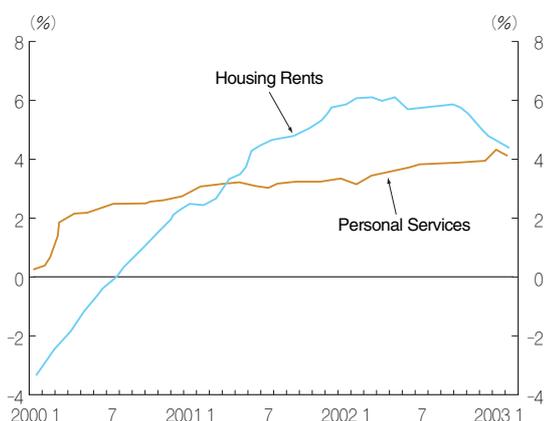
Note: 1) Unit labor costs = nominal wages/(constant GDP ÷ the number of persons employed).
 Source: The Bank of Korea.

Acting against this, on the wages front, the rate of increase of all industry nominal wages rose above 10%, pushing up unit labor costs by 7.8%, which was higher than the previous year's rise (4.4%) and acted to put upward pressure on prices. The rate of increase of charges for personal services accordingly rose more rapidly than in the previous year and contributed 1.0%p

to the rise in the consumer prices. Moreover, with the continuing imbalance between housing supply and demand, leasehold tenancy deposits maintained their upward trend and also housing rents, which are among the components of the CPI, continued on an upward trend, acting to make a 0.8%p contribution to the rise in consumer prices.

<Figure III -4>

Rates of Increase¹⁾ of Housing Rents and Personal Services



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

International oil prices maintained an upward trend from the beginning of the year following OPEC's measures to curtail production, the threat of a U.S. war against Iraq, and a strike by oil workers in Venezuela. Because, however, the level of oil prices was low early in the year, its rise on an annual average basis stood at only 4.6%, which corresponded to 1.0 dollar rise per barrel on the base of Dubai Light. Accordingly, the rise in international oil prices is estimated to have had a minor effect on prices, contributing only 0.1%p to the rise in consumer prices based on the Input-Output tables. Besides this, other international raw material prices showed only a small rise and exerted no great influence on prices.

Inflationary expectations were boosted somewhat during the third quarter by the sharp rise in housing prices. Nevertheless, on the whole, as the rate of increase of prices slowed down, inflationary expectations showed a more stable pattern than in the preceding year.

2. Interest Rate Policy

<Table III -1>

Monthly Stance of Interest Rate Policy and Market Interest Rate Trends

	Interest rate policy direction	Market interest rate movements ¹⁾
Jan. 2002	Maintain current level of overnight call rate (4.00%)	Increase
Feb.	Maintain current level	Decline
Mar.-Apr.	Maintain current level	Increase
May	Increase by 25bp(4.25%)	Decline
Jun.-Sep.	Maintain current level	Decline
Oct.	Maintain current level	Increase
Nov.-Dec.	Maintain current level	Decline
Jan. 2003	Maintain current level	Decline
Feb.	Maintain current level	Decline

Notes: 1) Based on average monthly yield on three-year Treasury bonds.

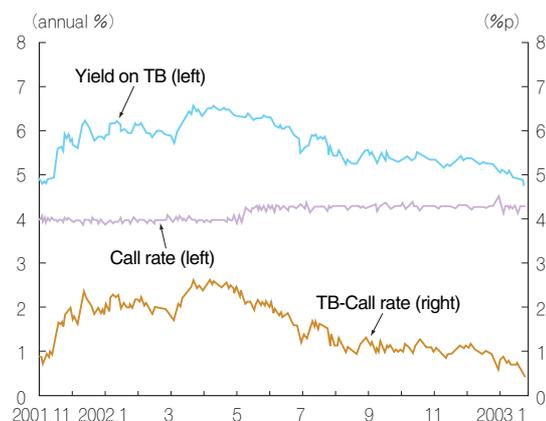
During the year 2002, interest rate policy was conducted with an emphasis on supporting the recovery of economic activity while paying careful attention to price stability. From early in the year, the real economy showed a comparatively rapid upward trend and market liquidity expanded greatly. As a result, judging that some fine-tuning was desirable from the viewpoint of monetary policy, the Bank of Korea adjusted the call rate target slightly upward by 0.25%p in May. From June onward the recovery trend of the real economy was still maintained and market liquidity continued its expansion centering on household loans, causing housing prices to rise by a large margin. However, with the mounting uncertainty of the external environment including the growing unease over the delayed global economic recovery and the looming threat of the outbreak of war between the United States and Iraq, the policy target, the overnight call rate, was maintained unchanged at its existing level.

Reviewed in detail by period, in January and February, even though the uncertainty surrounding the Korean economy still lingered, amid anticipations of improvement of real economic trends and sustained stability of financial markets, the call rate target was kept on hold at 4.0%.

During March and April, the economy continued to show a recovery trend centering on domestic demand. Nevertheless the call rate target was left at its existing level because, given the lackluster state of facilities investment and exports, it could not be confirmed for certain that the recovery of the real economy had yet acquired sufficient momentum for full recovery. With

<Figure III -5>

**Trends of Overnight Call Rate
and Yields on Treasury Bonds during 2002¹⁾**



Note: 1) Three-year Treasury bonds, Overnight call rate.

Sources: The Bank of Korea, The Korea Securities Dealers Association.

the obscurity of the timing of the US economy's recovery and the occurrence of factors such as the American imposition of tariffs on steel imports, the possibility that exports might not recover as anticipated could not be ruled out. In addition, a great deal of uncertainty existed with regard to the economic environment at home and abroad; the unease over relationship between labor and management, and the continuing financial instability in Japan. Meanwhile, asset prices including those of real estate and shares exhibited an upward trend and market liquidity was expanding driven by household credits, leading to worries over the possibility of an asset bubble and inflation. On the other hand, the economic recovery was still in its early stage and the rate of increase of prices remained at a low level. Taking all these into consideration, the Bank refrained from raising interest rates but adopted a wait-and-see attitude to observe a little longer the speed of the recovery of exports and facilities investment, the tendency of asset prices and the trend of household lending. At the same time, it conveyed a signal to the markets as to the possibility of a rise in the policy rate so as to soften the impact on them of a future rise in the call rate.

At the meeting of the Monetary Policy Committee held on May 7, the Bank of Korea raised its call interest rate target by 0.25%p from 4.0% to 4.25%. This action was taken to counter the possibility that anticipated external and internal imbalances, such as a weakening of the current account position and inflationary pressures, would arise and to consolidate the basis for economic stability.

Looking at the contemporary economic situation, while consumption expenditure and construction investment remained brisk, exports had shifted to an upward trend in fourteen months, and facilities investment presented

more favorable signs as businesses became more investment minded in line with the economic recovery. In consequence, upward pressures on prices were expected to increase on the demand side. Besides this, there were concerns that price conditions would deteriorate under the influence of the run-up in international oil prices and housing prices. There were also worries that, in view of the great expansion of household loans in a low interest rate environment, the asset markets might become overheated or inflationary anticipations among the general public might become widespread. Meanwhile, as a result of indications given on several occasions since the publication of monetary policy direction in April that the call rate might be raised, anticipations of a rise in the policy rate had largely been reflected in market interest rates. Therefore, an increase in the call rate was not seen to have any great impact on them.

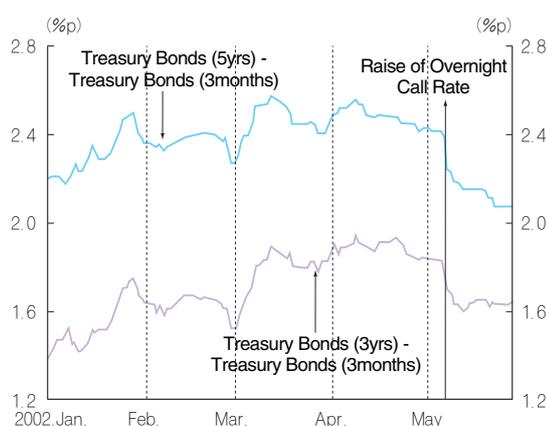
And in fact, after the raising of the call rate, short-term market interest rates rose in financial markets, to which banks responded by a slight upward adjustment of their deposit and loan rates, particularly those on short-term deposits and household loans. As a result, the rate of increase of household loans slackened off a little and the upward course of housing prices faltered¹⁾. Long-term market interest rates rose for a while immediately after the raising of the call rate target but then responded with a fall, causing the spread between long-term and short-term interest rates to narrow somewhat²⁾. This seems to have happened because the anticipations of a rise in the policy rate had largely

1) The increment of banks' household loans(monthly average) dropped from 6.7 trillion won in the period from February to May 2002 to 4.3 trillion won in June and July. The rate of increase of the contract prices of apartments in Seoul(monthly average) eased from 3.8 percent in the first four months of the year to 0.7% in May and June.

2) The spread between long-term and short-term rates(yields on three-year Treasury bonds versus call market rate) stood at 2.10%p on May 6, but narrowed to 1.87%p on June 3.

<Figure III -6>

Trends of the Spread between Short- and Long-term Interest Rates before and after the Raise of Overnight Call Rate



Sources: The Bank of Korea, Korea Securities Computer Corp.

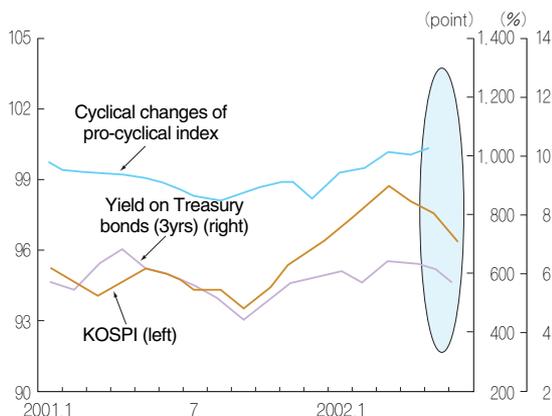
been reflected in market interest rates beforehand.

During June, the call rate target was kept unchanged at its existing 4.25%. Following release of figures showing that the rate of GDP growth during the first quarter of the year had registered 6.2%, consumption expenditure and construction investment continued to display a favorable trend and the recovery trend of exports and facilities investment also became evident. These developments in turn accelerated the speed of the recovery of the real economy. In this context, demand-side inflationary pressures were expected to build up gradually. On the other hand, however, in addition to the appreciation of the Korean won, the possibility of an asset prices bubble had to some extent been reduced through the correction of share prices and the faltering of the upward trend of real estate prices. Also, the anxiety over the spread of inflationary expectations among the general public had subsided. Moreover, it was considered that the export environment held many uncertainties including the obscurity of prospects for semiconductor prices internationally and the speed of a possible US recovery.

Moving into July, the upward trend of the real economy was sustained. Specifically, industrial production kept its high growth rate and facilities investment continued its recovery. In contrast, under the influence of financial market unease in the US and other major countries, share prices and interest rates fell at the same time by a large margin. This led to the emergence of a conspicuous disconnection between real economic indicators and financial indicators. Nevertheless, as principal institutions at home and abroad adhered to their optimistic view of the Korean economy's prospects and market liquidity flows maintained stable trends, it was hard to say that financial market instability had become generally

<Figure III -7>

Business and Financial Indicators in Mid-2002



Sources: Korea National Statistical Office, Korea Securities Computer Corp.

pronounced. The Monetary Policy Committee, taking into consideration the possibility that this financial market situation might affect the confidence of economic agents, even if it did not bring about a slowdown to any great degree in the recovery pace of the economy, resolved to maintain its target rate and observe the trend of changes in economic conditions a little longer. In August too, the policy stance was maintained in this vein. The background against which the decision to maintain interest rates unchanged was taken was the need to pay continued close attention to the effects of US financial instability on the domestic economy. A further part of the rationale for this policy was that, following the rise of call rate target in May, lending rates had risen and banks had tightened their lending policy, causing the rate of increase of household loans to ease off while at the same time concerns over excess liquidity had been somewhat moderated and the firm tone of the Korean won promised to hold prices stable for some time.

As housing prices, which had faltered temporarily in the second quarter, accelerated again from August onwards, the scale of the increase in household loans³⁾ expanded. In consequence, there arose the necessity to take positive countermeasure. However, the Monetary Policy Committee decided to leave the call rate target unchanged in September because of the continuing uncertainty of external conditions centering on the US economy and the shrinking of economic activity due to the torrential rains of August. The central bank, however, while keeping a watchful eye on changes in overseas conditions, made clear its determination to

3) After the rise in the call rate target in May, the scale of the expansion of household loans had contracted, but it widened again greatly from early August. The outcome of the survey concerning the use of household loans said that more than half of them were utilized for the purpose of housing purchases.

take resolute action in the event of concerns arising over disequilibria such as a worsening of the international balance of payments position or a rise in real estate prices. Meanwhile in the case of other countries, monetary policy had been aggressively relaxed in order to avoid economic depression, as a result of which the phenomenon of a rise in real estate prices had become general, and the question of whether monetary policy measures should be taken to deal with this situation had emerged as a contentious issue.⁴⁾

<Table III -2>

Trends of Policy Rate Changes in Major Countries during 2002

(%)

	US	UK	Euro-area	Canada	New Zealand
Dec. 2000	6.50	6.00	4.75	5.75	6.50
Jan. 2001	1.75	4.00	3.25	2.25	4.75
Feb.				2.00	
Mar.					5.00
Apr.				2.25	5.25
May					5.50
Jun.				2.50	
Jul.				2.75	5.75
Nov.	1.25				
Dec.			2.75		
Feb. 2003		3.75			

Sources: Central banks of individual countries and the ECB.

From late September onwards, though the upward trend of real estate prices had shown signs of slackening, the scale of increase in household loans exhibited an increase. The upward trends of the real economy were maintained with exports maintaining their upswing while production and consumption both experienced continued convincing growth. In contrast, there was heightened uncertainty over the external environment including concern over delay in the economic recovery of major advanced countries and the likelihood of war between the U.S. and Iraq. Along with the depression of share prices in major countries, domestic share prices also fell on a large scale, which served to further dampen the spirits of economic agents. Taking into overall account these and other domestic and external conditions, the call rate target was maintained at its existing level in October.

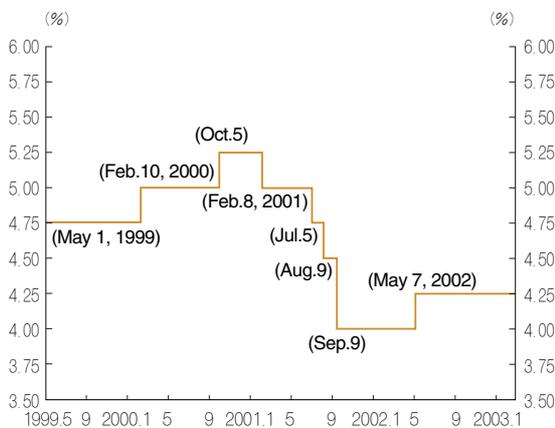
From early October, the real economy continued its solid upward trend with exports registering a high rate of growth and prices remained on a stable track.

4) In this context, Alan Greenspan, Chairman of the Federal Reserve, pointed out that it is very difficult for a central bank to definitely identify a bubble until after the fact, that is, when its bursting confirms its existence. He also said that nothing short of a sharp increase in short-term rates that engenders a significant economic retrenchment is sufficient to check a nascent bubble and that it seems reasonable to generalize that no low-risk, low-cost, incremental monetary tightening exists that can reliably deflate a bubble.

Housing prices showed a stable trend of movements following the government's implementation of anti-speculative measures and the scale of increase of household loans narrowed significantly. Viewing the external environment, it was recognized that the degree of uncertainty concerning the possibility of economic recovery in the advanced countries and the outbreak of a war between the United States and Iraq remained as large as ever. Taking into account this economic conjuncture, the Monetary Policy Committee left the call rate target unchanged in November and December.

<Figure III -8>

Trends of Changes in Overnight Call Rate Target



Source: The Bank of Korea.

Moving into the year 2003, the economic upswing seemed to be continuing, driven by the rapid growth of exports. Its pace, however, appeared to be decelerating due to weaker confidence among consumers and investors. Consumer prices accelerated their upward trend, influenced by the rise in both international oil prices and farm product prices. In contrast, real estate prices maintained stable trends. In the financial markets, market sentiment had become weaker due to sharp declines in both stock prices and market interest rates, while the downward trend of household loans continued. The external uncertainty constantly rose, driven by geopolitical factors, including the looming threat of the outbreak of a U.S. war against Iraq and the North Korean nuclear issue. In view of these domestic and external conditions, the Monetary Policy Committee kept the call rate target unchanged at 4.25% during January and February 2003.

<Box III -1>

Asset Price Movements and Monetary Policy

It is generally agreed that rapid changes in asset prices, which have the potential to threaten financial stability and exert inflationary pressure, should be addressed by the central bank's monetary policy. However, opinions as to how this should be done are divided.

Experts who stress indirect and selective measures to counter asset-price bubbles argue that it is desirable for the central bank to counteract the movements of asset prices in an indirect and selective manner only when a rise in asset prices emerges as inflationary pressure. They point out the concerns over the intensification of economic instability by way of the heightened volatility of growth and inflation where monetary policy countermeasures are taken once a specific target level that has been envisaged for asset prices is breached. The reasons for this are as follows. First, monetary policy exerts an influence over the economy as a whole and not just the asset markets. Second, it is uncertain whether a stable mutual relationship can be established between changes in interest rates and changes in asset prices. Finally, it is difficult to judge accurately whether a rise in asset prices represents an improvement in economic fundamentals or simply speculative froth.

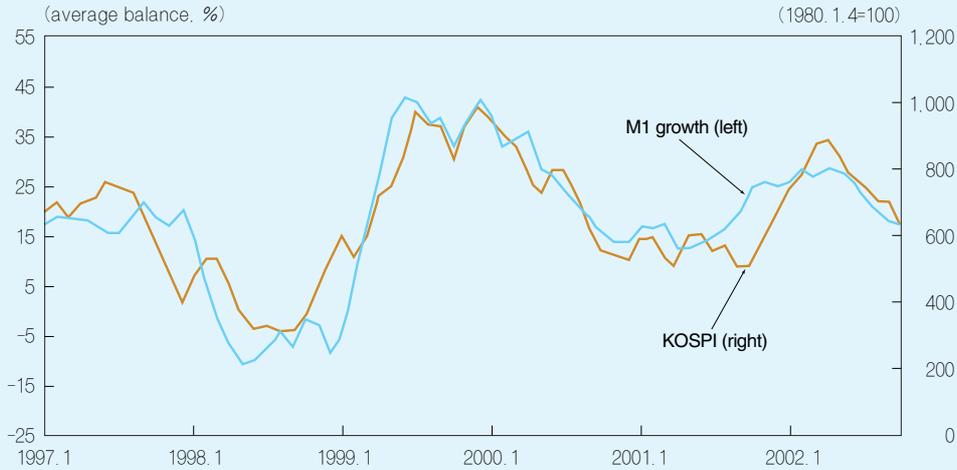
On the other hand, advocates of pre-emptive and aggressive countermeasures emphasize that economic stability can be achieved by reducing the possibility of the occurrence of asset price bubbles at an early stage when a central bank acts positively to counter asset-price bubbles. They urge the importance of intercepting the linkage between asset bubbles and monetary expansion pre-emptively before the bubbles grow bigger because the former are principally caused by the latter. However, they indicate that it is not necessary to counter all movements in asset prices in a mechanical manner and that the phenomenon of changes in asset

Trends of M1 Growth and the Rate of Increase in Housing Prices¹⁾



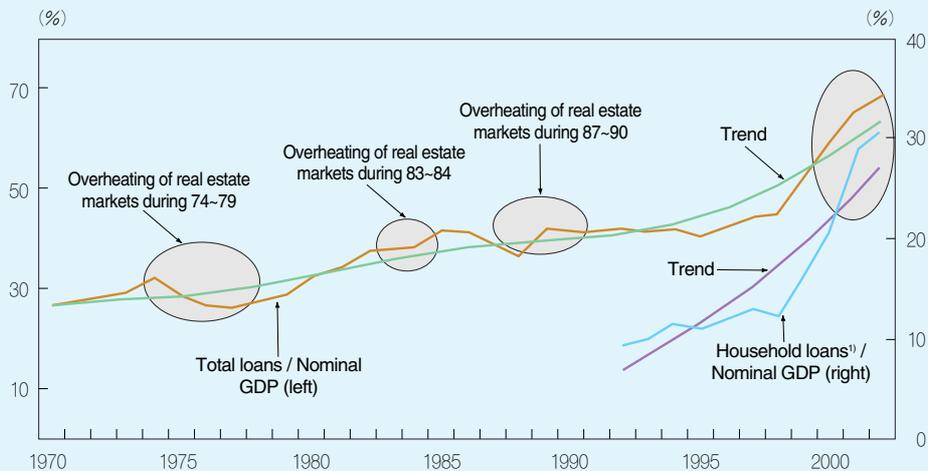
Note: 1) Compared with the same month of the previous year.

Trends of M1 Growth¹⁾ and KOSPI



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

Share of Total Loans and Household Loans in GDP



Note: 1) Statistics on household loans have been gathered since 1992.

prices should be tackled differently according to whether it derives from fundamentals or from the reshuffle of portfolios.

In the case of Korea, there have been a close correlation between monetary expansion and asset prices such as those of real estate and shares. The Bank of Korea, recognizing that the household lending boom initiated by some financial institutions on the basis of low interest rates underpinned the rise in real estate prices that emerged during the year 2002, judged that, in order to bring the real estate market under control, it was desirable to tackle it with monetary policy in conjunction with the government's stabilizing measures.

In this connection, the Bank of Korea raised its overnight call rate target by 0.25%p from 4.0% to 4.25% on

May 7, 2002. In doing so, it sought both to preempt inflationary pressure and to rein in over the exuberance of household lending. But the rate of increase of household loans, which had subsided following the upward adjustment of the policy rate, started to climb again at a rapid pace from August onwards and real estate prices also showed a steep upward trend over the same period. The desirability of additional monetary policy actions to counter these developments became evident. Further interest rate adjustment, however, was suspended because of the heightened uncertainty over economic conditions at home and abroad, including domestic and international financial market instability and the possibility of the outbreak of war between the United States and Iraq.

<Box III -2>

The Effects of the Rise in the Call Rate Target on May 7, 2002

The effects of the rise in the call rate target are deemed, first of all, to have emerged relatively clearly, centering on the financial markets.

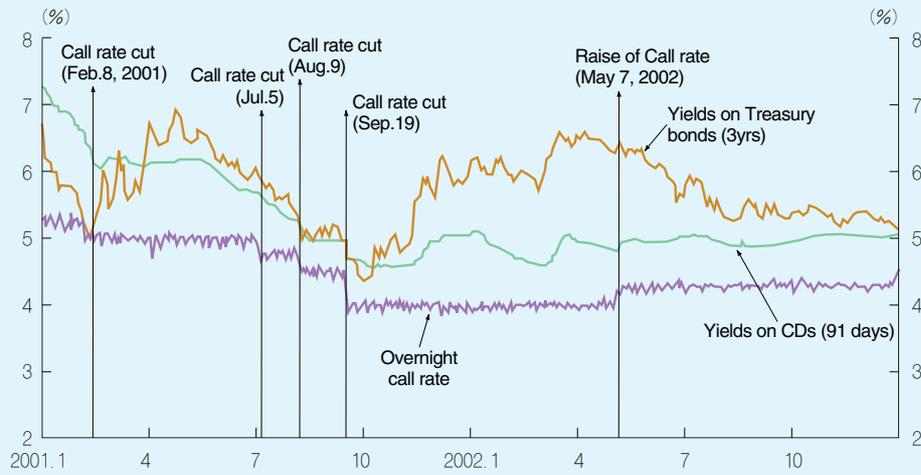
Banks responded to the slight increase in the call rate target, the policy rate, by the prompt upward adjustment of their deposit and lending rates, particularly short-term deposit interest rates and interest rates on household loans.

**Adjustments of Deposit and Lending Rates of Banks
after the Raise of the Call Rate Target**

	Banks	Adjustments	Date
Deposit rates	Woori	- Household MMDA 3.8% → 4.0%	May 8
	Korea Exchange	- CDs · RPs · Cover bills rise by 0.2%p each	May 9
	Woori	- Time deposits & Deposits for application to prepurchase apartments to be built 0.1%p	May 16
Lending rates	Woori	- 3 month floating rate loan 6.4% → 6.6%	May 8
		- 1 year fixed rate loan 7.32% → 7.62%	May 7
	Seoul	- a base rate of household credit loans, etc. 8.71% → 8.89%	May 10

The movements of market interest rates are considered to have moved reflecting several factors. In order to conduct a predictable monetary policy, which averted unpredicted shocks to the market, the Bank of Korea sent signals indicating a possible rise in interest rates to the markets through several channels in advance of the actual upward adjustment of the call rate target. Immediately after the rise in the call rate target, viewing the movements of market interest rates, the benchmark yields on three-year Treasury bonds rose temporarily and then fell. These movements may result from the fact that market participants were already anticipating an

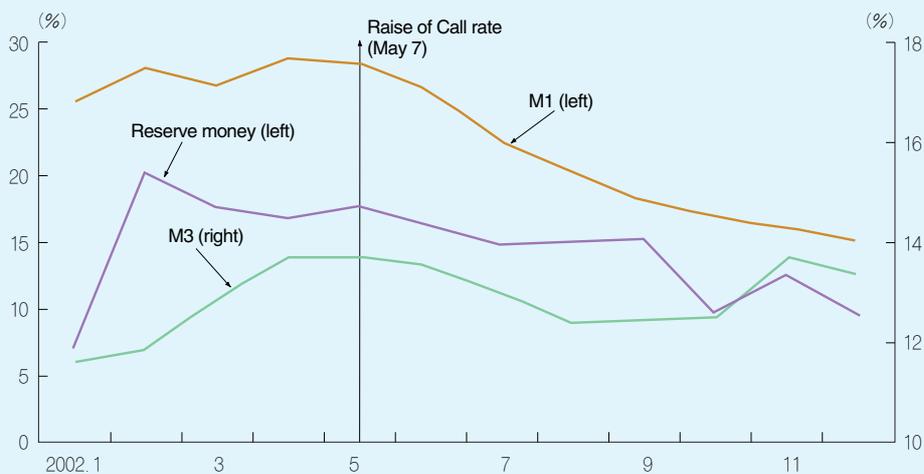
Trends of Major Interest Rates



increase of the call rate target. As a result of the influence of the market liquidity reduction caused by this upward adjustment of the call rate target, the rate of increase of the major monetary indicators displayed a declining trend from the second week in May onwards.

Growth Rates of Major Monetary Aggregates

(average balance)



Due to the rise in interest rates on household loans in the wake of the rise in the call rate target, the scale of the increase in banks' supply of household loans shrank on a relatively large scale. In addition to the rise in the interest rates of household loans, the government's real estate market stabilization measures and the emergence of seasonal factors caused the upward trend of real estate prices to subside to a large degree during May and June.

The influence exerted by the rise in the call rate target on May 7 on share prices and the exchange rate is

Trends of the Call Rate Target¹⁾, Housing Prices¹⁾, and Household Loans



Notes: 1) Compared with the previous month.
 2) The rate of increase.
 3) Based on changes.

evaluated as not having been particularly large. This may well be because their movements were greatly swayed by external factors: those of domestic share prices by US stock market trends and those of the exchange rate by the trends of the Japanese yen.

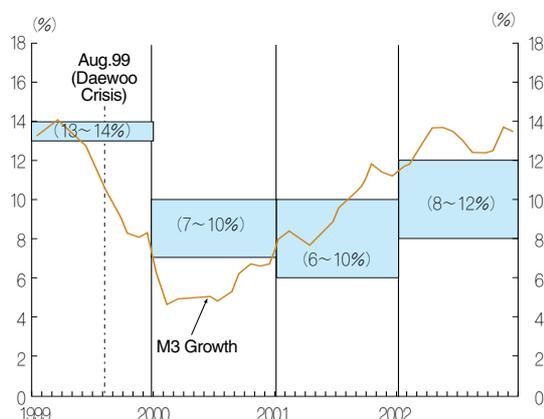
3. Money Supply

Money was, in principle, supplied so as to keep the call market interest rates stable at the level of the target set by the Monetary Policy Committee. In the short term, however, money supply was undertaken flexibly, taking into consideration conditions of the financial markets.

The growth rate of M3(average balance) rose to 13.7% in April and May as a result of the expanded supply of liquidity centering on financial institutions' household loans. During the latter part of the year, however, it fell back to around 12.5% in response to the rise in the call rate target in May by the Bank of Korea and policy initiatives, of both government and the Bank of Korea, to rein in household lending. In early November, M3 growth climbed back up again for a while to around 13% in the wake of the expansion of fiscal spending and the inflow of foreign stock investment funds, which together offset the effects of the reduced scale of increase of household loans, but from early December onwards, it again exhibited a declining path. The average annual growth rate of M3 rose from the previous year's 9.6% to 12.9%. Accordingly, it ran slightly above the upper bound of its monitoring range(8~12%) established at the beginning of the year. This is attributable to the fact that the monitoring range for the monetary aggregates established since the year 2001 does not have the character of a policy variable but that of an information variable, which implies that, if the growth rate of M3 breaches its monitoring range during the year, no immediate action is taken to counter this, but money supply is adjusted flexibly in accordance with financial and economic conditions.

<Figure III -9>

Trends of M3 Growth Rate and Monitoring Range



Source: The Bank of Korea.

<Table III -3>

Trends of Reserve Money¹⁾

	(billion won, %)		
	2001	2002	2003, Jan.~Feb.
Reserve money	29,376 (11.5)	33,579 (14.3)	35,833 (8.6)
Currency in circulation	16,424 (9.5)	18,363 (11.8)	19,759 (6.9)
Total reserve deposits	12,952 (14.0)	15,217 (17.6)	16,074 (10.7)

Notes: 1) Changes in average balances(based on daily average balance).

2) Figures in parentheses refer to growth rates over the corresponding period of the preceding year.

Source: The Bank of Korea.

During the year 2002, the rate of increase of the reserve base(average balance) accelerated to 14.3%, in comparison to 11.5% the previous year. This expansion was mainly attributable to two factors. The first factor was the increased demand for funds on the part of the general public due to the buoyancy of real economic activity and anticipations of rising asset prices. The second factor was the high rate of increase of reserve requirements due to the great expansion of short-term floating funds, which attract high reserve requirements, caused by the continuance of the low interest rate stance, and the narrowing of the spread between long-term and short-term interest rates.

<Table III -4>

Trends of Reserve Money Supply and the Scale of Liquidity Adjustment

(based on changes, average balance, trillion won)

	2001		2002				2003	
	year ¹⁾	1/4	2/4	3/4	4/4	year ¹⁾	1~2	
Reserve money	4.0 (11.5)	1.6 (14.9)	0.1 (17.0)	0.6 (15.1)	1.1 (10.7)	3.4 (14.3)	1.1 (8.6)	
Liquidity adjustment ²⁾	+15.7	+3.5	+0.3	+2.8	-2.5	+4.1	+4.0	
(MSBs)	+12.7	+1.3	+4.1	+1.8	-1.8	+5.4	+1.9	
(RP)	+3.0	+2.2	-3.8	+1.0	-0.7	-1.3	+2.1	

Notes: 1) Sum total of the amounts of movement during each quarter

2) (+) refers to withdrawal, (-) refers to supply

3) Figures in parentheses refer to growth rates over the corresponding period of the preceding year.

Source: The Bank of Korea

The Bank of Korea adjusted market liquidity by way of routine open market operations, while paying close attention to maintaining financial market stability. Besides this, it made flexible adjustments to liquidity in order to avoid disruption of the interplay of fund supply and demand, or the contraction of economic activities due to increases in the seasonal demand for funds around Chuseok(autumn harvest moon festival) and the Lunar New Year, or due to unavoidable reasons such as natural calamities. In this connection, the scale of net issuance of Monetary Stabilization Bonds (MSBs), which are issued to absorb liquidity, was reduced in comparison to the previous year(12.7 trillion won→5.2 trillion won). This reflected the shrinking of monetary supply through the foreign sector(12.4 trillion won→9.1 trillion won), as a result of the reduced scale of the current account surplus and the shift of foreign stock investment funds to a net outflow. In the fourth quarter of the year, however, the Bank of Korea provided liquidity to markets by way of its repurchases of MSBs and RP purchases in order to moderate anticipations of the temporary upward pressures on the call rate in the wake of the lowering of the Aggregate Credit Ceiling(11.6 trillion won→9.6

<Table III -5>

**MSB Issuance · Interest Payments ·
Reserve Money Supply from Foreign Sector**

(billion won)

	1998	1999	2000	2001	2002
MSBs outstanding ¹⁾	45,673	51,489	66,378	79,121	84,278
(Changes)	(22,198)	(5,816)	(14,889)	(12,743)	(5,157)
MSB interest payment ²⁾	4,841	3,799	4,666	4,873	4,802
Reserve money supply through foreign sector ¹⁾	64,648	93,308	119,123	131,478	140,577
(Changes)	(-6,488)	(28,660)	(25,816)	(12,354)	(9,100)

Notes: 1) End of year outstanding. 2) During the year.
Source: The Bank of Korea

trillion won). In addition, the Bank took positive steps to counter financial market instability arising from the overreaction of market participants to changes in domestic and external conditions. In January 2003, there was a greatly increased mood of unease among investors because of the looming threat of war between the US and Iraq and the North Korean nuclear issue. As a result, there was a rapid expansion of demand for highly-rated bonds judged relatively stable. Besides this, there occurred a short-term disequilibrium between the supply and demand of bonds. All this caused interest rates on bonds to fall steeply while, at the same time, the spread between long-term and short-term rates shrank sharply. In response to this, the Bank of Korea sought to foster market stability by expanding its supply of bonds through the resumption of window sales⁵⁾ of MSBs(two-year maturity, 1.9 trillion won), which had been nine months since April, 2002. In early February, with the continued concentration of market liquidity on the bond market, it expanded⁶⁾ its ongoing issuance of MSBs to maintain the interplay of the supply and demand for bonds.

5) This is a liquidity adjustment measure by which the Bank of Korea designates in advance the interest rate on successful bids according to market liquidity conditions apart from its regular electronic auction (every Tuesday), so as to withdraw liquidity.

6) During January 2003 there was a net issuance of 2.3 trillion won of MSBs and this was followed by net issuance of a further 2.8 trillion won in February.

4. Credit Policy

(Curbing the Excessive Increase of Household Loans and Strengthening Financial Support for Industrial Sectors)

Because of the expanded extension of household loans by financial institutions, there was a continued inflow of liquidity to the real estate and other asset markets. In consequence, housing prices rose sharply within a short space of time and SMEs that relied heavily on borrowings from banks had difficulty in obtaining access to funds, giving rise to concerns of the erosion of the basis for economic stability. During 2002, in a bid to counter this, the Bank of Korea sought to operate the Aggregate Credit Ceiling so as to curb the excessive increase of household loans by financial institutions and, while siphoning off the excess liquidity, strengthen constantly the incentives for the supply of funds to industrial sectors.

As an initial step, in March 2002, the Bank adjusted upward from the previous 40% to 60% the assessment weight(deduction item) of household loans in the evaluation of performance in corporate funding support that is considered in the allocation of the Aggregate Credit Ceiling, thereby cutting the Aggregate Credit Ceiling quota of those banks that were active in providing household loans. Following this, in May, it raised this assessment weight to 80% in order to rein in more tightly the increase in household loans. At the same time, it expanded from 50% to 75% of the shortfall the deduction from the Aggregate Credit Ceiling for those banks failing to comply with the ratio of lending to SMEs⁷⁾. Meanwhile, it raised from 300

7) Nationwide commercial banks 45%, local banks 60%.

<Table III -6>

**Trends of Aggregate Credit Ceiling and
Its Interest Rates**

(trillion won, annual %)

	Mar. 98~	Sep. 98~	Jan. 2001~	Sep. 2001~	Oct. 2002~
Credit ceiling	5.6	7.6	9.6	11.6	9.6
Interest rate	5.0	3.0	3.0	2.5	2.5

Source: The Bank of Korea.

billion won to 500 billion won the quota, which is 50% of the net amount of increase of the funds eligible (excluding corporate procurement funds) under the Aggregate Credit Ceiling that are extended by banks in order to induce greater preference by banks for lending to SMEs rather than to households.

In addition, from October, it lowered the Aggregate Credit Ceiling, which had been raised to 11.6 trillion won immediately after the terrorist attacks on the United States in September 2001, by 2 trillion won to bring it back to its previous level of 9.6 trillion won. This measure was taken to absorb some of the market liquidity and to check the formation of inflationary expectations among the general public resulting from the sharp rise in housing prices. But in spite of the step to reduce the Aggregate Credit Ceiling, the quota of the Aggregate Credit Ceiling available for branches of the Bank of Korea, whose purpose is to support regional SMEs, was raised slightly by 600 billion won so as to help financial institutions to expand more loans to regions' preferential support sectors or regionally specialized industries. At the same time, while the allocation ratios for the total amount of lending to SMEs and the newly extended amount were adjusted downwards(43.6%→40.0% for the former, 43.6%→20.0% for the latter), that on the basis of the net amount of increase was adjusted upwards(12.8%→40.0%) in order to provide even larger allocations under the Aggregate Credit Ceiling to banks that actually increased SME lending.

Meanwhile, in order to provide effective support for damage recovery for SMEs in the region of Kangwon Province, where damage from typhoons and torrential rains had been concentrated in September 2002, a quota of 30 billion won in Aggregate Credit Ceiling Loans(60 billion won on the basis of loan amount

provided by financial institutions) as emergency support was provided. Funding support was also made available to businesses damaged by flooding in other areas through their designation as objects eligible for preferential support.

(Continued Efforts to Promote the Establishment of the Bill Substitution Scheme)

The Bank of Korea devoted continuing efforts to promote the even more active use of the bill substitution scheme, so that it would become firmly rooted in commercial transactions between corporations.

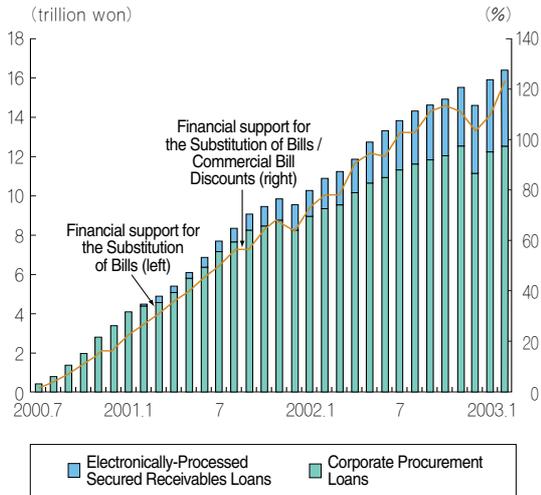
As a first step, from January, the amount set aside under the Aggregate Credit Ceiling for banks providing loans for Corporate Procurement Loans was raised from its previous 3 trillion won to 4.3 trillion won

Meanwhile, from April 2002, the Bank reduced from 80% to 70% the performance recognition ratio for the discount of commercial bills when calculating individual banks' quotas under the Aggregate Credit Ceiling, and, from October, this figure was further reduced to 50%, removing incentives for the handling of commercial bills. The extra funds freed up by this measure from the Aggregate Credit Ceiling were provided as resources for the support of other SMEs funds including trade financing, Electronically-processed Secured Receivables Loans and funds for the production of basic materials and parts.

In January and February 2002, in order to increase the awareness among companies of the bill substitution scheme, the Bank participated in joint forums held to explain the government's support measures for SMEs in major cities across the nation.

<Figure III -10>

Trends of Financial Support for the Substitution of Bills



Note: 1) Corporate Procurement Loans plus Electronically-Processed Secured Receivables Loans.
 Source: The Bank of Korea.

Thanks to these efforts, the actual performance figures for cash settlement based on the bill substitution scheme such as Corporate Procurement Loans expanded greatly, and from July 2002 they surpassed the scale of commercial bill discounts. Compared to commercial bill discounts, the performance of cash settlement based on the bill substitution scheme rose sharply from 63% as of the end of January 2001 to 109% as of the end of January 2003. The practice of cash settlement in commercial transactions has become firmly rooted, by virtue of the rapid advance in the substitution of cash settlement for settlement by means of bills. Accordingly, it seems that corporate cash flow has been greatly improved.

5. Monetary Policy Instruments

The Bank of Korea intensified its endeavours to improve its monetary policy instruments and heighten transparency and credibility concerning the formation and execution of monetary policy while, at the same time, augmenting the payments and settlements system and its in-depth analysis of banks' management status.

(Improvement of Monetary Policy Instruments)

As a first step, it refined the instruments used in its open market operations so as to make their use more market-friendly.

Taking into consideration the increase of the scale of the issuance of MSBs, the tendency toward enlargement of the volume of trading in the secondary market, and the convenience of its counterpart financial institutions, in June 2002, it raised both the units for the lowest bid amount and the lowest successful offer in its competitive auctions for MSBs from the previous 0.1 billion won to 5 billion won.

In addition, in December, it completed construction of a system for capturing detailed information of call transactions brokerage in real-time from funds brokerage companies in order to monitor at all times the short-term liquidity conditions of financial institutions.

Besides this, in January 2003, it shifted the timing of the public announcement of the planned competitive auctions for MSBs from the day of the auction itself to the business day immediately preceding the auction. In

<Table III -7>

Status of Loan System of the Bank of Korea

	Function	Limits	Interest rate
Liquidity Adjustment Loan	<ul style="list-style-type: none"> Signal the direction of interest rate policy through adjustment of loan interest rates in line with the direction of monetary policy Pursue stabilization of the financial market through prompt supply of funds to banks facing temporary liquidity shortages that apply for the loans 	3 trillion won	3.75% p.a. (4.75% p.a. when borrowing for three or more consecutive months)
Aggregate Credit Ceiling Loan	<ul style="list-style-type: none"> Induce banks to expand loans to SMEs 	11.6 trillion won	2.5% p.a.
Temporary Loan	<ul style="list-style-type: none"> Supply funds to banks facing fund shortage for settlement (or reserve requirements) 	Within amount of liquidity shortage	Overnight call rate +2%p
Daylight Overdraft	<ul style="list-style-type: none"> Provide settlement funds to banks facing temporary settlement funds shortages during a given day 	200% of average balance of current account	Interest-free
Special Loan	<ul style="list-style-type: none"> Lender of last resort loan 	Operated when needed	

Source: The Bank of Korea.

a further move, it set a regular schedule⁸⁾ for the timing of its issues of short-term MSBs for each maturity type. Thanks to this step, bidders in the competitive auctions for MSBs improved their capacity to estimate their day-to-day fund demand and supply situation. Not only did this enable them to operate their funds more stably, but it also contributed to invigorating the short-term financial markets by facilitating the more active trading of bonds.

In April 2002, the Bank of Korea improved the operations of its loans system and the related methods of securing collateral and lending procedures. In the past, specific collateral had been taken for each individual loan. This was now changed to a method whereby collateral is taken comprehensively for the entire amount of loans to each individual bank. Lending procedures were also simplified as follows. In the past, after the collection of an existing loan at maturity, a fresh loan had been extended. This was now changed to a method whereby the Bank collects or provides only the difference between the new loan and the existing loan amount.

In order to avoid confusion arising after banks shifted to Saturday closing from July, the related systems were revised and supplemented concerning matters such as the designated time of payment of the principal and interest on financial products. In relation to time-limited deposits such as time and savings deposits, CD's and cover bills, it was made possible to carry out cancellation, repurchase or payment of principal and interest on the preceding business day where the appointed day was a Saturday. Where the appointed day of payment of principal and interest on MSBs fell

8) The issue of short-term MSBs was fixed, in principle, for the second week of the month for one year maturities and for the fourth week of the month for 182 day maturities

on a Saturday, payment now fell due on the immediately preceding business day. And in connection with loans extended in the form of Corporate Procurement Loans or Electronically-processed Secured Receivables Loans for objects supported under the Aggregate Credit Ceiling, where the date on which the period of a loan expired or the date of presentation of a bill of exchange by a selling company fell on a Saturday, the appointed contract date was treated as though it were a public holiday and the term of the contract was extended until the next business day.

In October, the provisions on the interest on the payment of arrears of Article 9 (1) of the Enforcement Decree of the Act Concerning the Registration of Money-Lending Businesses and the Protection of Financial Consumers” entered into effect. A ceiling was established on the maximum rate of interest on arrears through this stipulation that it should not exceed more than 1.3 times the rate of interest stipulated in the contract.

(Heightening the Transparency and Credibility of Monetary Policy)

The Bank of Korea devoted intensive efforts to heightening transparency and credibility concerning the formation and execution of monetary policy so that its policy intentions could be transmitted to the financial markets and the real economy more effectively. It also actively sought to deepen understanding among the general public concerning the conduct of its policy.

Immediately after the monthly policy setting meeting of the Monetary Policy Committee, the Bank makes the details and background of the decision on policy known to the public. In addition, it also grasps and

<Table III -8>

Performance of Joint Examinations

		Banks
2000		Hanvit, Korea exchange, Daegu (3)
2001	Commercial banks	Hanvit, Chohung, Seoul, Korea exchange, Peace, Pusan, Kwangju, Kyungnam, Jeonbuk, Cheju (10)
	Foreign bank branches	Citi, Deutsche, HSBC (3)
2002	Commercial banks	Korea First, KorAm, Shinhan, 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 Jan.-Feb.	Commercial banks	Pusan (1)

Source: The Bank of Korea.

analyzes in detail market anticipations and reactions to the policy stance. As a result, the feedback relationship between the central bank and the financial markets has been greatly amplified. What is more, when a change of the monetary stance has appeared necessary, the Bank has conveyed signals to the market in advance so that the predictability of policy has been heightened, thereby minimizing the impact of such adjustments on the financial markets.

Besides this, since April 2002, monthly meetings have been held of the “Economic Trends Discussion Meeting”, consisting chiefly of leading figures from major economic research institutions and academia. Since May 2002, the “Financial Consultation Meeting”, bringing together the heads of financial institutions, has also met each month. Through these channels, the Bank learns the opinions of outside experts and gathers a wide range of on-the-spot information for effective use in policy formulation.

Meanwhile, December 2002, the English language version of “Monetary Policy in Korea” was published and distributed. This work was undertaken to foster deeper understanding among foreigners concerning monetary policy in Korea under an open economy.

(In-depth Examination of the Management Performance of Financial Institutions)

In order to heighten the practical appropriateness of its policies, the Bank of Korea sought to gain an in-depth understanding of the management status of financial institutions to utilize it in the conduct of monetary policy.

In the course of the year 2002, joint examinations were held with the Financial Supervisory Service(FSS) on

<Table III -9>

Scale of Settlements¹⁾ Handled by BOK-Wire

(Unit, billion won, %)

	2000 (a)	2001 (b)	changes(%)
<Volume>			
Gross Settlement	3,727(70.7)	3,984(72.4)	6.9
Net Settlement	794(15.1)	751(13.6)	-5.4
Supply and Demand of Treasury Funds	702(13.3)	730(13.3)	4.0
BOK Loans and Discounts	35(0.7)	27(0.5)	-22.9
Settlement of Government and Public Bonds	11(0.2)	11(0.2)	0.0
Sum of Domestic Currency Funds Settlement	5,269(100.0)	5,503(100.0)	4.4
Foreign Currency Funds Settlement	9(-)	9(-)	0.0
<Value>			
Gross Settlement	60,047(79.5)	62,812(78.2)	4.6
Net Settlement	12,457(16.5)	14,149(17.6)	13.6
Supply and Demand of Treasury Funds	1,636(2.2)	1,808(2.3)	10.5
BOK Loans and Discounts	796(1.0)	883(1.1)	10.9
Settlement of Government and Public Bonds	612(0.8)	633(0.8)	3.4
Sum of Domestic Currency Funds Settlement	75,548(100.0)	80,285(100.0)	6.3
Foreign Currency Funds Settlement (million US\$)	113(-)	88(-)	-22.1

Notes: 1) Daily Average.

2) Figures in parentheses refer to shares in total (%).

Source: The Bank of Korea.

13 banks. Through these, the Bank was able to gather information on banks' management for use in the effective conduct of monetary policy including their credit operations stance and securities investment strategy, while, at the same time, assessing the transmission mechanism of its own policies.

A "Memorandum of Understanding(MOU)⁹⁾ concerning the Joint Examination of Financial Institutions" was concluded between the Bank of Korea and the Financial Supervisory Service in October 2002 with a view to minimizing the burden on the operations of financial institutions that are examined and ensuring mutual respect of the distinctive rights of the two parties with regard to joint examinations.

Making use of the financial institutions' management assessment model, the Bank of Korea endeavoured to evaluate and analyze thoroughly banks' management soundness and risk management status. Through the quarterly survey of banks' lending behavior, the Bank analyzed the trends of their attitude toward lending and demand for borrowings and trends of their credit risk, and utilized these findings in the conduct of its monetary policy. In addition, its periodical publication, "Financial System Review", contains analytical materials with regard to financial system stability.

The Bank participated actively in the establishment of the new BIS capital adequacy ratio, which is expected to be introduced in 2006. It sought to ensure that the distinctive characteristics of the Korean economic conditions were incorporated in the new Concordat

9) The principal items of the MOU are that a) the FSS is to give BOK prior notice about its quarterly examination plan, b) the examination materials required by both parties are to be obtained by FSS, and c) information acquired by either party in the course of the examination is to be made available to the other party.

(draft), for example, through the easing of minimum capital requirements concerning loans to SMEs and the ratio reflecting operational risk.

(Augmenting the Payment and Settlement System and Heightening its Stability)

The Bank of Korea strove to enhance the safety and efficiency of the payments and settlements system and to develop and augment new electronic payments and settlements systems.

As an initial step, in March 2002, it introduced a B2B electronic payments system for commercial transactions so that the payment and settlement of commercial transactions between companies carried out over the internet could be processed through the interbank shared network. In addition, in September, the Bank implemented cashiers' check truncation nationwide, whereby the process of the exchange of checks can be completed through transfer of information on the details of transactions without the need for the physical movement of checks.

In order to strengthen the operational efficiency and risk management of BOK-Wire, an optimal queuing management method¹⁰⁾ was adopted in August. Meanwhile, the ratio of the value of the collateral to be posted to net debt¹¹⁾ was raised from 20% to 30% of the net debit cap for participants' settlement in real-time

10) In order to ameliorate the queuing situation when there is a bunching of payment transfers between participants and a particular participant is unable to make immediate settlement of a payment transfers request because of a temporary shortage of current account funds, cross payments that are wait-listed between participants may be offset so that they can be settled at the same time across the current accounts for the balance.

11) This has the meaning of the maximum net amount of debt calculated by subtracting the total of payment requests made to all other participants from that of payment requests received from all other participants.

through the electronic funds transfer systems including the shared electronic network system, Funds transfer and the CD/ATM System.

The “Regulation on the Operation and Management of the Payment and Settlement System” entered into effect in February 2002, in order to enhance enforcement of internationally agreed standards and the basis for the central bank’s surveillance in relation to the security and efficiency of the payments system. As part of the plan to heighten the transparency of operations of payments and settlements system, in March 2002 a “Report on the Operations and Management Status of the Payment and Settlement System” was compiled and published for the first time. This explains payment and settlement trends during the previous year and the Bank of Korea’s implementation of related measures.