

I. Overview

- 1 The Bank of Korea established an inflation target for the year 2001 of $3\pm 1\%$ in terms of core inflation. To maintain consistency in monetary policy and heighten its credibility, the medium term inflation target was kept unchanged at the previous year's level of 2.5%.
- 2 From the beginning of the year 2001, active monetary policy was needed to avoid an economic slowdown given the accentuation of the subdued trend of most major economic indicators. During the first half of the year, however, the major emphasis was placed on price stability and monetary policy was conducted prudently as inflation rose a little above the upper bound of its target range; a modest cut(25 basis points) in the overnight call rate target was therefore undertaken. The economic slowdown gathered pace from the start of the second half whereas the rate of price increases gradually slackened. Besides this, domestic and international economic uncertainties deepened, so the focus of monetary policy was placed on economic recovery, and the target call rate was reduced on three occasions by a total of 100 basis points.

In February, consumer and business confidence evaporated and the growth rate of exports fell sharply in response to the U.S. economic slowdown. The Bank thus cut its target rate by 25 basis points(5.25% → 5.0%) to avoid an

overly deep decline in business activity.

The target call rate was maintained at the 5% level right through until the end of June. The rationale for this decision was that consumer spending had shown stronger growth than expected, thereby lessening the speed of the economic slowdown, while the combination of higher oil prices, the weakness of the Korean won and rises in public service charges that had emerged from early in the second half of the preceding year, continued to drive inflation at a rate above the upper bound of its target range.

After having briefly shown an improved pattern of economic activity, real economic indicators began to deteriorate again from early in the second half. On the external front, concerns over a world-wide recession mounted amid a gradual increase in the obscurity surrounding the prospects for an early recovery of the U.S. economy. The rate of inflation, though still running slightly above the upper bound of its target range, began to ease from early June onwards and held out the prospect of a gradual return within its target range during the second half of the year. This was because the cost-push factors that had driven inflation in the first half of the year, such as the Korean won's depreciation and the rises in oil prices and public service charges, had weakened while demand side upward pressures remained virtually absent.

Taking into account this situation, the Bank brought down its target rate to

the level of 4.5% in two consecutive reductions of 25 basis points each in July and August. In the case of the cut in August, the Bank also signalled the accentuation of its stance of monetary easing to the markets by lowering the Liquidity Adjustment Loans rates by 25 basis points(4.5% → 4.25%) at the same time.

Right after the September 11 terrorist attacks on the U.S., the Bank promptly announced plans to increase the supply of liquidity in order to secure financial market stability. Soon afterwards, an extraordinary meeting of the Monetary Policy Committee was convened on 19 September. At this a number of positive measures were taken, including an additional reduction of 50 basis points in the target call rate(4.5% → 4%) and the lowering of the interest rates on Liquidity Adjustment Loans and Aggregate Credit Ceiling Loans by a further 50 basis points, with a view to checking the spread of the malign influence of the terrorist attacks.

From then until the end of the year, the target call rate was maintained unchanged despite expectations of its further reduction in view of the uncertainties surrounding domestic and external economic conditions. The rationale for the Bank's stance was the improvement in external conditions such as the signs of a turnaround in the U.S. economy in response to the likelihood of an early conclusion of the Afghanistan campaign while the side effects of the "War against Terrorism" on the economy did not appear as large as had at first been feared. In addition, the level of confidence

concerning economic recovery was heightened by the unexpectedly good showing of some leading domestic economic indicators, hikes in stock prices and increased activity in construction.

The trend of improvement in real economic activity was carried on into the year 2002. Consumer spending and construction investment continued buoyant and facilities investment shifted to an upward trend. Although there were factors present acting to destabilize prices, such as the Korean won's depreciation, from the second half of 2001 onwards, they exhibited downwardly stable trends. The Bank of Korea accordingly left its overnight call rate target unchanged at the level of 4 percent.

- 3** From the year 2001, broad money(M3), which had been hitherto employed as an intermediate target, was converted into a monitoring indicator of overall liquidity conditions. Liquidity was therefore supplied in response to the level of money demand, maintaining the overnight call rate at its target level. In the year 2001, the growth rate of M3 accelerated from the preceding year's 5.6% to 9.6% as a result of the recovery of the intermediary function of non-bank financial institutions including investment trust companies. This rate of increase was just inside its monitoring range established at the beginning of the year(6~10%).

The Bank of Korea handled abrupt changes in the financial market through the flexible supply of liquidity. In the case of the large redemption of

investment trust companies' MMFs(Money Market Funds) in April, which threatened to destabilize the bond market, and immediately after the terrorist attacks on the U.S. in September, commercial banks were supplied with additional reserve money through open market operations. The scale and timing of issues of Monetary Stabilization Bonds(MSBs) were also flexibly adjusted at those times. In November, when bond rates rose sharply for a short period of time, early redemptions of MSBs and outright purchases of government and public bonds were carried out in order to soothe the market instability.

- 4 The Bank of Korea sought to strengthen incentives for commercial banks to lend to the corporate sector, which was experiencing difficulties in fund raising in the course of restructuring and the slowdown of economic activity.

The Aggregate Credit Ceiling was raised by 2 trillion won in January 2001 and by a further 2 trillion won immediately after the terrorist attacks on the U.S., bringing the total size of the facility to 11.6 trillion won. The method of quota allocation under the facility was also changed to encourage banks to provide more funds to the corporate sector than to households. From March 2001, quota allocation methods were adjusted, for a period of one year only, so as to reflect performance in lending to large enterprises (excluding the top four business groups) and purchases of corporate bonds and commercial paper. From March 2002 onwards, the Bank augmented its preferential quota for credit-based lending to small and medium sized

enterprises(SMEs) while reducing the quota for banks that had increased household lending.

From June 2001, exports of products in electronic form including those of software via the Internet also became eligible for trade finance support from the Bank. On the other hand, the Bank changed the rule for its post hoc management in maintaining the ratio of lending to SMEs, encouraging banks to expand their lending to entities involved in the construction of social overhead capital(SOC).

To provide seamless financial support for regionally based companies, the amount of the Aggregate Credit Ceiling allocated to the Bank's regional branches was raised by 0.3 trillion won(2.7 trillion won → 3.0 trillion won) in October 2001. Also in December, eligibility for support was extended to include service areas which are now contributing more to economic growth.

The amount of the Aggregate Credit Ceiling assigned to Corporate Procurement Loans was raised from 1 trillion to 3 trillion won during the year 2001 and it was lifted further to 4.3 trillion won from February 2002. This was done with a view to promoting advanced settlement practises in commercial transactions by reducing the use of commercial bills.

The Bank introduced a system of Electronically-processed Secured Receivables Loans in February 2001, which allows SMEs to receive

settlement in cash for goods delivered to companies belonging to the top 30 business groups. To help this system come into active use at an early date, it was included among the items eligible for support under the Aggregate Credit Ceiling. In contrast, support for the discount of commercial bills is being gradually reduced. As a result, the total amount of loans designed to replace bill-based transactions, such as Corporate Procurement Loans, reached an amount equivalent to 77% of the total of commercial bills discounted. Judging from this, cash settlement appears to be rapidly replacing settlement by means of bills.

- 5 In January 2001, the Bank of Korea raised the maximum credit ceiling on its Liquidity Adjustment Loans by 1 trillion won(2 trillion won → 3 trillion won) to intensify the function of the central bank's loan system in securing financial stability. At the same time, the ceiling on Daylight Overdrafts was increased from 100% of a commercial bank's average current account balance held with the Bank to 200% thereof, and the range of securities eligible as collateral was widened to include government guaranteed bonds.

The Bank and the Financial Supervisory Service conducted joint examinations of fifteen banks from January 2001 through February 2002 to obtain information on the status of financial institutions and strengthen monitoring of their management.

- 6 The accommodating stance of monetary policy exemplified by the four successive reductions in target call rate contributed greatly to avoiding an economic recession in Korea during the year 2001.

Real GDP growth rate registered 3.7% in the first quarter but it declined subsequently to 2.9% in the second quarter and 1.9% in the third quarter, due mainly to the lacklustre performance of facilities investment and exports. In the fourth quarter, however, it stood at 3.7% owing to the large increase in consumer spending and construction investment. As a result for the year as a whole, GDP grew at a rate of 3%. In fact, the Korean economy recorded a relatively satisfactory growth performance in 2001, given that other Asian newly industrializing countries such as Taiwan and Singapore saw negative growth from the second quarter onwards.

Consumer prices rose rapidly during the early half of the year, but during the latter half their pace eased or showed a falling pattern. For the year as a whole they registered a relatively high rate of increase of 4.1%, principally as a result of increases in public service charges and the depreciation of the Korean won. Public service charges rose 7.5% for the year due to the sharp rise in health insurance fees and piped gas charges, which contributed 28% of the overall rise in consumer prices. The Korean won depreciated 14.2% against the U.S. dollar as compared to the previous year, which also put upward pressure on prices. The sharp rise in housing rental charges similarly acted as a major factor in the upward trend of consumer prices.

The inflation target established at the beginning of 2001 was based on the composition of the price index for the year 1995 and, on the basis of this, core inflation for the year under review registered 4.2%, above the 4% upper bound of its target range. The newly released statistics at the beginning of 2002, using the rebased year 2000 price index, however, show core inflation for the year as having recorded 3.6%, which was within its target range.

Exports declined because of the business slowdown in the advanced countries including the U.S. and the sharp fall in the prices of information technology(IT) related items. Imports, meanwhile, fell even more sharply in response to subdued domestic business activities and the drop in oil prices. As a net result, the current account registered a surplus of 8.6 billion dollars for the year.

In the financial market, interest rates fluctuated in line with changes in the business outlook, but generally maintained a downwardly stable course in view of the rather low level of corporate demand for funds and the absence of any major problems for companies in fund-raising.

As for the foreign exchange market, the net supply of foreign exchange continued for the year and the exchange rate of the Korean won against the U.S. dollar maintained its stable trend overall. From November onwards, however, the Korean won softened against the U.S. dollar, reflecting the

weakening of the Japanese yen. Foreign currency reserves built up steadily throughout the year, despite the complete repayment in August 2001 of the borrowings from the IMF, and they stood at 105.1 billion dollars as the end of February 2002.

- 7 The Korean economy is expected to accelerate its pace of growth during the year 2002 along with the improvements in the external and internal environment. But there still exist uncertainties in external conditions in that the pace of recovery of the U.S. economy is expected to be rather flatter than that from other recent downturns and the anxieties over the Japanese economy have not completely disappeared.

On the prices front, despite the rise in business activity, the stable trend should be continued through the mid-part of the year because of the ample supply capacity, and for the year as a whole, inflation should be rather lower than in the preceding year. Factors still remain that make for price instability in the form of the rise in real estate prices, the possibility of the persistent weakness of the Japanese yen and a run-up in oil prices caused by the expansion of the “War against Terrorism”.

The scale of the current account surplus is likely to narrow considering that exports are set to increase with the recovery of the world economy but imports are also likely to accelerate their expansionary trend and the services account will also deteriorate.

- 8 Taking overall account of these conditions, the Bank of Korea set its inflation target at $3\pm 1\%$ in terms of core inflation, the same level as in the previous year and maintained its medium term target at 2.5% with a view to ensuring the consistency of monetary policy.

Price rises are seen to remain stable within the target range, provided unexpected disequilibria do not arise. Every effort will be made to hold in check the latent factors that might disturb price stability, allowing this year's inflation target to be met and, from next year onwards, the inflation rate should converge rapidly on its medium term target of 2.5%.

While focusing on achieving the inflation target, the Bank will operate its interest rate policy instruments flexibly, responding to changes in domestic and external conditions. Particular care will be given to asset price movements, including those of real estate. It is meanwhile considered desirable for the effectiveness of monetary policy to improve the method of operation of the inflation targeting system from the current method of setting a target annually.

The utmost efforts will also be made to ensure the stability of the financial markets. It is anticipated that financial market conditions will be better than last year's but that major financial variables may become more volatile as domestic and external conditions evolve. Appropriate market stabilization measures will be undertaken in the event of an abrupt and temporary shift in

interest rates caused by the markets' over-reaction. Money will be supplied flexibly by, for example, providing appropriate liquidity in a timely manner to financial institutions should they face temporary liquidity problems in the course of financial restructuring. In this context, the Bank has established a monitoring range for M3(period-average basis) growth of 8~12%, somewhat higher than last year's 6~10%, in view of the likelihood of increased private-sector money demand with the recovery of business activity.

This year, endeavors will be continued to strengthen the incentives for financial institutions to expand credit-based corporate lending and improve settlement practises in commercial transactions between companies. This should allow SMEs to raise the funds they need without problems.

The Bank will make every effort to enhance the effectiveness and transparency of monetary policy, facilitating the prompter and more accurate transmission of its policy intentions to the real sector and the financial markets. The Bank will also augment its activities in checking and analyzing the soundness of financial institutions' management and make active use of the information thus obtained in its monetary policy.

Efforts will also be devoted to heightening the security and efficiency of the payments systems. To this end, BOK-Wire will be operated more efficiently and settlement risk managed more tightly. At the same time, a drive will be mounted to develop and generalize the use of electronic settlement systems.