Ⅰ. General Economic Trends

In 1996, the Korean economy experienced a slowdown in GDP growth due to the slackness of both export and domestic demand. Meanwhile, the current account recorded a greatly widened deficit and price inflation showed a pace similar to that of the previous year.

During the year, the growth rate of GDP in real terms declined sharply to 7.1 per cent from the 8.9 per cent of the previous year, reflecting the persistent slackness of economic activities from the fourth quarter of 1995. This was mainly attributable to lackluster exports and to subdued domestic demand, particularly facilities investment. By sector, the growth rates of manufacturing, construction and services all dropped.

The current account deficit widened sharply from the 8.9 billion dollars of the previous year to 23.7 billion dollars. There were two main elements in this expansion. Firstly, the trade account deficit moved more deeply into the red: imports sustained their relatively high growth centering on consumer goods while exports slowed sharply, owing to the fall in the international prices of main export products such as semi-conductors. Secondly, the deficits on both the invisible trade and unrequited transfers accounts widened, compared to those of the previous year, as a result of increased outlays for overseas travel and overseas transportation services.

In the year under review, consumer prices and producer prices increased by 4.5 per cent and 3.5 per cent, respectively, on a December-to-December basis, similar to their rises in the previous year. Viewing the movements of prices by class of item, those of agricultural and marine products displayed marked instability during the first half of the year but shifted to a downward trend from July onwards owing to

[Table 1] **Key Economic Indicators in Korea**[1]

	unit	1992	1993	1994	1995	1996[10]	1st half	2nd half
Gross domestic product	rate of increase(%)	5.1	5.8	8.6	8.9	7.1	7.3	6.9
Agriculture, forestry & fishing	"	6.0	-2.9	1.6	3.7	3.5	1.2	4.2
Manufacturing	"	5.1	5.0	10.5	10.8	7.4	7.1	7.8
Construction	"	-0.7	8.4	4.7	8.6	6.7	8.3	5.5
Services	"	6.9	7.6	10.8	10.1	8.2	8.4	8.0
Gross national product	"	5.0	5.8	8.4	8.7	6.9	7.2	6.7
Total consumption	"	6.8	5.3	7.0	7.2	6.9	7.4	6.6
Fixed investment	"	-0.8	5.2	11.8	11.7	7.1	6.6	7.6
Construction	"	-0.6	8.9	4.5	8.7	6.3	8.0	4.8
Equipment	"	-1.1	-0.1	23.6	15.8	8.2	4.8	11.5
Total exports(real)	"	11.0	11.3	16.5	24.0	14.1	14.8	13.5
Total imports(real)	"	5.1	6.7	21.7	22.0	14.8	14.3	15.2
Gross saving ratio[2]	%	34.9	35.2	35.4	36.2	34.6	-	-
Gross domestic investment ratio[2]	"	36.8	35.2	36.2	37.4	38.6	-	-
Unemployment rate[3]	%	2.4	2.8	2.4	2.0	2.0	2.0	2.1
Consumer prices	rate of increase(%)	4.5	5.8	5.6	4.7	4.5	3.8	0.7
Producer prices	"	1.6	2.0	3.9	3.4	3.5	1.6	1.8
Current account balance	billion U.S.$	-4.5	0.4	-4.5	-8.9	-23.7	-9.8	-13.9
Trade balance	"	-2.1	1.9	-3.1	-4.7	-15.3	-5.6	-9.7
Exports[4]	"	76.6	82.2	96.0	125.1	129.7	64.7	65.0
	rate of increase(%)	(6.6)	(7.3)	(16.8)	(30.3)	(3.7)	(11.0)	(-2.7)
Imports[4]	billion U.S.$	81.8	83.8	102.3	135.1	150.3	72.7	77.6
	rate of increase(%)	(0.3)	(2.5)	(22.1)	(32.0)	(11.3)	(11.5)	(11.1)
Invisible trade balance	billion U.S.$	-2.6	-2.0	-2.0	-3.6	-7.6	-3.8	-3.9
Unrequited transfers(net)	"	0.2	0.5	0.6	-0.6	-0.8	-0.4	-0.4
Exchange rate of won against U.S. dollar	end of period[5](₩)	788.4	808.1	788.7	774.7	844.2	810.6	844.2
		(-3.5)	(-2.4)	(2.5)	(1.8)	(-8.2)	(-4.4)	(-4.0)
	period-average[6](₩)	780.8	802.7	803.6	771.0	804.8	784.6	824.3
		(-6.0)	(-2.7)	(-0.1)	(4.2)	(-4.2)	(-1.3)	(-6.9)
M_2[7]	rate of increase(%)	18.4	18.6	15.6	15.5	16.2	14.6	17.8
		(18.6)	(17.3)	(17.6)	(13.7)	(17.8)	(16.2)	(17.8)
MCT[7][8]	"	24.7	22.9	23.5	21.6	21.7	22.5	20.9
		(24.9)	(23.2)	(23.6)	(22.0)	(18.6)	(22.5)	(18.6)
Yield on corporate bonds(three-year)[9]	period-average(%)	16.2	12.6	12.9	13.8	11.9	11.5	12.2

Notes:
1) Rates of increase are compared with the same period of the previous year except for those of prices, which are compared with the last month of the previous period.
2) Current price basis.
3) Figures of 1st and 2nd halves are seasonally-adjusted.
4) On a customs-clearance basis.
5) Figures in parentheses indicate appreciation(depreciation:-) rates compared with the end of the previous period.
6) Figures in parentheses indicate appreciation(depreciation:-) rates compared with the same period of the previous year.
7) Figures in parentheses indicate the average rates of increase in the last month of the period.
8) M_2+CDs+Money-in-trust.
9) Yields are for three-year corporate bonds guaranteed by a bank.
10) Figures for national accounts are preliminary.

good grain harvests and plentiful crops of vegetables. The upward trend in the prices of manufactured goods accelerated, mainly due to the rise in international crude oil prices and the depreciation of the Korean won. Prices of services also displayed a steep upward movement, centering on hikes in charges for public and private services.

Viewing monetary and financial movements, the growth rate of M_2, which had stayed at the 14 per cent level, on a period average basis, until April, showed an upward trend from May onwards, rising to as much as 17.8 per cent in December. Its acceleration was largely driven by portfolio shifts as funds migrated from banks' trust accounts, which are not included in this aggregate, to their saving accounts, which are, following the realignment of the system of banks' trust accounts. However, the growth rate of MCT (M_2+CDs+Money-in-trust), on which the effect of these shifts was neutral, eased to 18.6 per cent from the 22.0 per cent of the previous year on a December daily-average basis. Market interest rates continued on a downward track until April, but they shifted to an upward tendency from May onwards, mainly due to the deterioration in firms' financial status triggered by the slackness of exports and the accumulation of inventories. This rising trend, however, moderated from September onwards.

During the year, macroeconomic policy was conducted with a focus on maintaining aggregate demand at an appropriate level to stabilize prices and narrow the current account deficit. However, from September, while still seeking to preserve the basis for stability, various measures for the reinvigoration of business firms, such as assistance in factory site acquisition and facilitation of new business set-ups, were introduced in response to the deepening economic recession and the sharper-than-expected widening of the current account deficit.

The Bank of Korea conducted monetary and credit policies with a focus on the stability of money supply. In monetary management, as M_2 showed unstable movements from May, affected by the reform of the trust account system, the Bank concentrated its efforts on maintaining stability in the growth of MCT(M_2+CDs+Money-in-trust), on which the effects of the realignment of the banks' trust account system were broadly neutral. While sustaining a stable money-supply basis, it responded flexibly to short-term changes in financial market conditions, taking into account the movements of interest rates and the exchange rate.

In addition, the Bank sought to create a more favorable environment for marketbased monetary management, making it easier for its monetary policy tools to work effectively. Reserve requirement ratios were lowered twice, in April and again in November. The November move was coordinated with a reduction in the Bank's ceiling on its aggregate credit. Meanwhile, in its open market operations the Bank expanded its use of competitive bidding and diversified the tools available to it.

In addition, the Bank acted to increase the sphere of commercial banks' discretion in loan decision-making. It abolished the guideline ratio for banks' lending to manufacturers and lessened the number of sectors to which loans were prohibited. The price function of interest rates was also elevated by the abolition of the ceiling on interest rate premiums. In bank supervisory operations, the Monetary Board narrowed the category of business groups subject to credit control, eased its procedures for banks' expansion of their branch networks, and established a system for the evaluation of the management status of individual banks on the basis of their financial conditions.

Meanwhile, the government made provision through an amendment to the General Banking Act for a change in the composition of banks' boards of directors, whereby a certain proportion of the membership must be non-executive directors. The objective of this change is to help strengthen managerial responsibility and accountability in banks' management. Revision of the Financial Industry Restructuring Act provided an institutional basis for the enlargement of financial institutions' scale through M&A and facilitated the early liquidation of unsound financial institutions. Foreign exchange and capital account deregulation was energetically pursued, with the following measures being taken during the year: a shift to the simple filing of a report for foreign payments related to current transactions and the liberalization of foreign portfolio investment by individual residents.

Korea's entry to the Organization for Economic Cooperation and Development(OECD) in the last month of the year under review was considered likely to hasten the adoption of free market principles throughout the economy and its entry to the ranks of the world's advanced economies. Similarly, the Bank of Korea's admission to the Bank for International Settlements(BIS) should allow it to play a greater role in international conferences on monetary policy and in the drawing-up of international standards concerning bank supervision.

Global Economy Continues Expansion

During the year under review, the global economy maintained growth at a rate of around 4 per cent, continuing its pace of the previous year.

The advanced economies registered GDP growth at the 2.3 per cent level for the year, a little higher than that of the previous year. The U.S. economy grew by 2.4 per cent, helped by the three successive cuts in interest rates engineered by the Federal Reserve Board from mid-1995 onwards, which induced a steady rise in consumer spending and sharp increases in companies' facilities investment and residential building construction. The Japanese economy, which had failed to escape from the protracted recession that had gripped it since 1992, staged a somewhat muted recovery, thanks to a package of measures taken in September 1995 which cut rediscount rates and expanded public works. The European Union(EU) recorded lower economic growth than in the preceding year. The slowdown resulted from fiscal tightening by most member states to meet the convergence criteria for European Monetary Union, along with a downturn in construction and the contraction of facilities investment. But during the latter half of the year, a gradual recovery took place in response to stimulation measures, including successive reductions in interest rates.

The developing countries as a whole exhibited fairly good economic performance, growing at around the 6 per cent level. Among them, the Asian newly industrializing economies and the members of the Association of Southeast Asian Nations(ASEAN) continued their rapid growth at around the 6~8 per cent level, though this was generally lower than in the previous year in consequence of the advanced economies' reduced import demand and the fall in the international prices of electronic products. China's economy maintained its high growth rate of about 10 per cent largely driven by the expansion of inward foreign direct investment. The robust growth was not held back by the government's resort to financial and fiscal tightening in its concern over possible overheating of the economy. The Central and South American countries saw an acceleration in their growth spurred on increases in exports to the U.S. and intra-regional trade.

The countries in transition, despite wide variation in performance, showed a gradual overall upturn, benefiting from the structural reform efforts and the

[Table 2] **Key International Indicators**

	unit	1992	1993	1994	1995	1996
World real GDP growth[1]	growth rate(%)	2.7	2.7	4.0	3.7	4.0
Industrial countries	"	1.7	0.9	2.9	2.1	2.3
(U.S.)	"	2.7	2.2	3.5	2.0	2.4[2]
(Japan)	"	1.1	0.1	0.6	1.4	3.6[2]
(EU)[2]	"	1.0	-0.5	2.8	2.5	1.6
Developing countries[3]	"	6.4	6.3	6.6	5.9	6.3
(Asian NIEs)	"	5.8	6.3	7.6	7.4	6.3
(China)	"	14.2	13.5	12.6	10.2	9.7[2]
(Thailand)	"	8.1	8.3	8.8	8.7	6.7[2]
(Malaysia)	"	7.8	8.3	9.2	9.5	8.8[2]
(Western hemisphere)	"	2.8	3.2	4.7	0.9	3.0
Countries in transition	"	-13.5	-7.6	-7.6	-0.8	0.1
World trade volume[1]	rate of increase(%)	5.0	4.1	8.9	9.2	5.6
Industrial countries' imports	"	3.9	0.6	9.2	7.8	4.8
(U.S.)	"	7.5	9.2	12.0	8.0	6.5
Developing countries' imports[3][4]	"	9.8	8.9	8.1	11.6	11.3
Three-month Euro-dollar interest rate[5]	% per annum	3.4	3.4	6.5	5.6	5.6
U.S. ten-year Treasury bond yield rate[5]	"	6.7	5.8	7.8	5.9	6.4
Yen/U.S.$[6]	yen	126.7	111.2	102.3	94.0	108.8
DM/U.S.$[6]	DM	1.561	1.653	1.623	1.433	1.505
Oil prices[6][7]	U.S.$/bbl	20.6	18.5	17.2	18.5	22.2
Non-fuel primary commodity prices[6][8]	rate of increase(%)	-5.1	4.5	18.5	12.7	-9.7

Notes : 1) The values are IMF estimates.
2) Realized values.
3) The values are IMF estimates on October in 1996.
4) Except countries in transition.
5) As of the end of period.
6) On a period-average basis.
7) WTI spot prices.
8) Reuter commodity price index.

Source : World Economic Outlook, IMF, May 1997.

adoption of macroeconomic stabilization policies.

During the year under review, the total volume of world trade increased by around 5 per cent, a slower pace than that of around 9 per cent the previous year. This was largely attributable to the subdued import demand of the advanced economies, and particularly the continental European Union economies whose economic activities remained in deep recession.

Generally, international interest rates displayed a stable or downward range of movements. From March onwards, both long and short U.S. interest rates exhibited a steadily rising trend, but from September, they too turned to a decline in response to forecasts of a slowdown in business activities. German and Japanese interest rates showed a stable downward trend throughout the year, affected by the decreased financial demand and the continued relatively accommodating monetary policy stance of the monetary authorities.

Looking at international foreign exchange movements by major currency, the U.S. dollar maintained a firm tone against the Japanese yen and almost all European currencies during the year. This was largely attributable to the U.S. economy's sustaining of a steady upward trend, along with the maintenance of an interest rate gap between U.S. and most other advanced countries as a result of easy-money-policies in the latter. But the dollar weakened against sterling from the latter half of the year, reflecting the raising of interest rates in the U.K. amid continuing business exuberance.

International crude oil prices moved upward in the year to stand, by late December, at their highest level since the 1991 Gulf War. Their rise was driven by growing concern about a mismatch between demand and supply brought about by a very sharp cold spell, increasing tensions in the Middle East, and production setbacks in several oil producing countries. Grain prices showed a steep upward trend from April as imports from the developing economies increased, while grain stockpiles were drawn down worldwide. But from July onwards, they retreated sharply amid expectations of record harvests helped by favorable weather conditions.

Economic Growth Slackens Due to the Slowdown of Investment and Exports

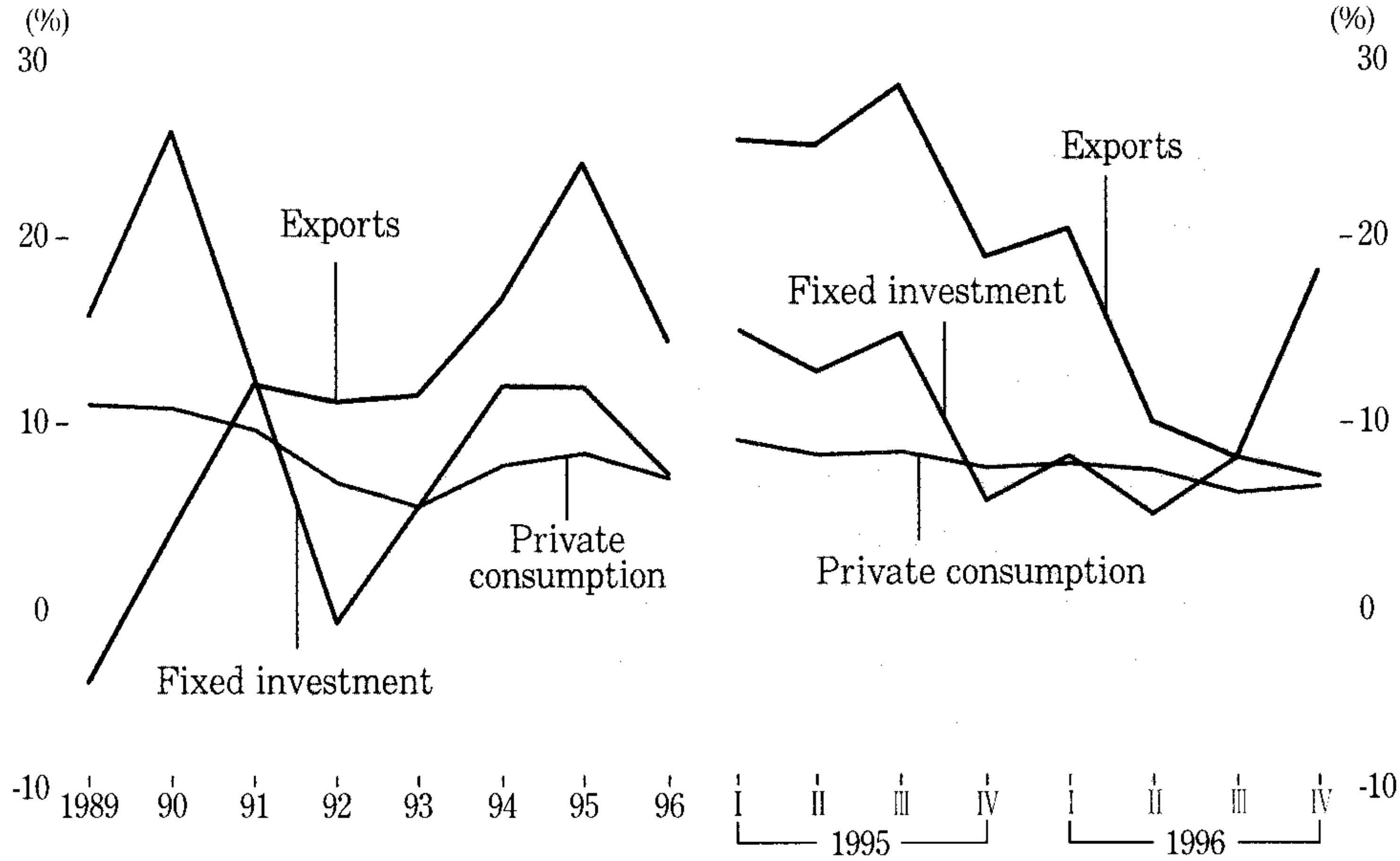
In the year under review, Korean GDP growth dropped to 7.1 per cent as against the 8.9 per cent of the previous year.

Looking at GDP growth by component of expenditure, the growth of final consumption expenditure eased somewhat to 6.9 per cent. It was mainly held back by the subdued pace of increases in consumer spending, especially on both durables and semi-durables, following the slowdown in economic activity.

The growth rate of fixed investment declined from the 11.7 per cent of the previous year to 7.1 per cent. Facilities investment recorded an 8.2 per cent growth rate, only half that of the previous year, being affected by the decline in business confidence amid the continued recession and by the large expansion in production capacity of the heavy and chemical sector that had been completed in the preceding year. Construction investment registered growth of only 6.3 per cent, reflecting the contraction of building construction investment, which was only partially offset by the briskness of infrastructure-related construction. Meanwhile, inventory investment increased greatly, owing to the build-up in inventories of manufactured products resulting from the slowdown in both domestic and overseas demand.

Despite the slowdown in fixed investment, increasing product inventories pushed the gross domestic investment ratio on a current price basis up to 38.6 per cent, rather higher than the 37.4 per cent of the preceding year. But the gross saving ratio on a current price basis slipped back to 34.6 per cent as the growth of consumer spending outpaced that of incomes. In consequence, the degree to which domestic investment was covered by domestic savings slipped back from 96.8 per

[Chart 1] **Rates of Increase by Expenditure**[1)]



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

cent in the preceding year to 89.6 per cent.

Total exports of goods and services, in real terms, slowed from the 24.0 per cent growth rate level of the previous year to 14.1 per cent, hampered by the weakness of industrial competitiveness and by the steady depreciation of the Japanese yen. Total imports, in real terms, increased by 14.8 per cent, less than the 22.0 per cent of the previous year. This was a result of the contraction of import demand brought about by slowdown in both domestic demand and exports.

Manufacturing and Construction Decelerate Their Growth Pace

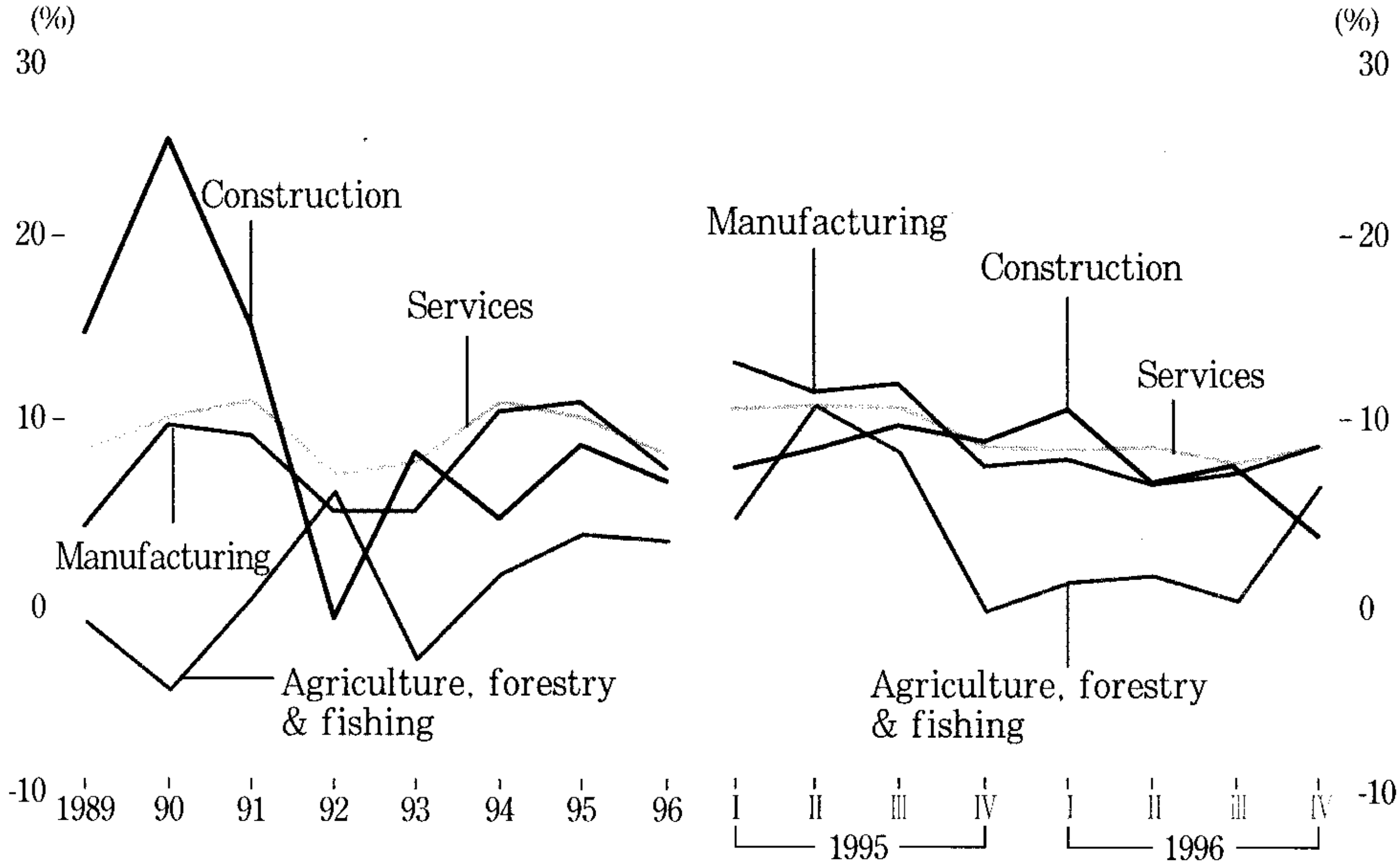
Looking at the pattern of growth by sector of economic activity, most industries registered lower growth than in the preceding year, owing to the sluggishness of business activities.

In the manufacturing sector, production increased by only 7.4 per cent, less than the 10.8 per cent of the previous year. The heavy and chemical industry, though, continued its high growth rate of above 10 per cent. This level of growth was bolstered by the expansion of production in the semi-conductor and automobile sectors, which had recently completed the installation of additional manufacturing capacity. However, the production of light industries decreased, centering on footwear and on textile fibers, underlining the pronounced weakening of their competitiveness in domestic and international markets.

The pace of growth in the construction industry declined to 6.7 per cent, less than the 8.6 per cent growth of the previous year. Private construction slumped because of the lackluster pace of both residential and non-residential building construction investment, reflecting respectively the continued backlog of unsold apartments and the slowdown of business activities, whereas government construction showed brisk activity with the expansion of infrastructure and other public works projects.

The service sector registered a growth rate of 8.2 per cent, also less than the 10.1 per cent of the previous year. Within this sector, the wholesale and retail trade displayed a lower growth rate than that of the previous year, due to the dullness of both domestic demand and exports. However, communications continued to register strong growth,

[Chart 2] **Growth Rates by Industry**[1)]



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

thanks to the remarkable expansion of mobile communications and information communication services. Financial businesses showed nearly the same growth rate as that of the previous year, led by the increase in banks' interest income, which offset the effects of the decrease in securities companies' commission earnings during the long bear market.

Agriculture, forestry and fishing production increased by 3.5 per cent, mainly due to the bountiful rice harvest and good fish catches

Manufacturing Employment Decreases

During the year, the total number of people in employment rose by only 1.9 per cent, lower than that of the previous year, reflecting firms' reluctance to take on new recruits. At the same time, the economically active population increased by 1.9 per cent, the same rate of increase as that of total employment. In consequence, the unemployment rate remained at the previous year's low level of 2.0 per cent.

Viewing the pattern of employment by industry, that in the agriculture, forestry and fishing sector continued to decline as it had in the previous year. Manufacturing employment, significantly, decreased by 2.0 per cent, centering on the textile, footwear and general machinery sectors. In contrast, services and construction sector employment both maintained a brisk pace with a 4~5 per cent expansion, matching that of the previous year.

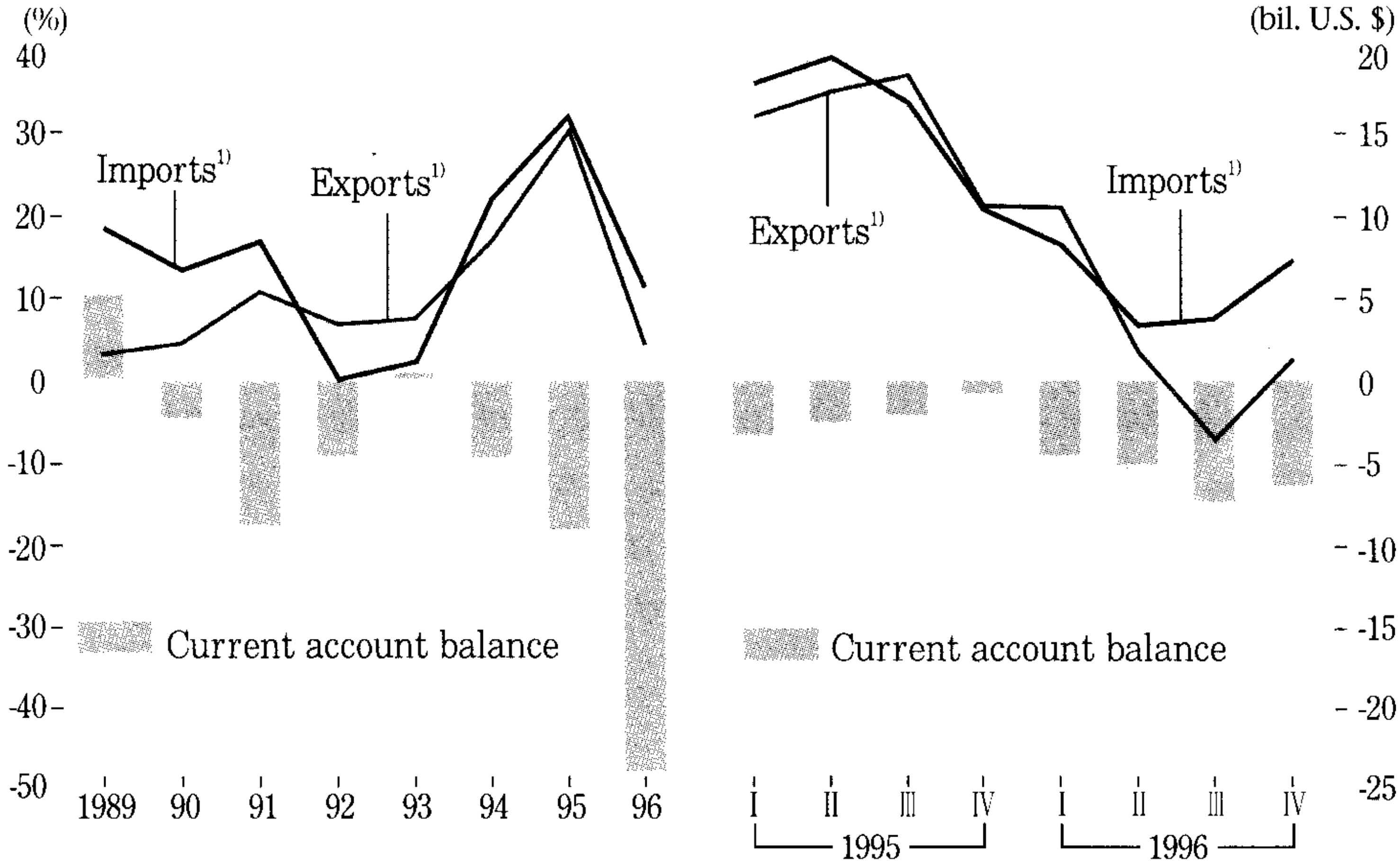
All-industry wage increases registered a high rate of 11.9 per cent, somewhat above that of the previous year, despite the general downturn in economic activities. By industry, there was a sharp acceleration of the rate of wage increases in transportation, storage and communications as well as in manufacturing. That of those in the financial and insurance sector, in contrast, fell back sharply, with the rate of increase being only half that of the previous year.

Current Account Deficit Widens Sharply

Exports, on a customs-clearance basis, edged up only by 3.7 per cent, far less than the 30.3 per cent rise in the previous year, due to the fall in the international prices of major export items and the continued weakness of the Japanese yen. By commodity group, exports of heavy industrial and chemical products stood at approximately the same level as that of the previous year. This was largely attributable to the poor performance of exports of semi-conductors, iron and steel products, and petroleum products, which offset the favorable performance in cars and ship-building. Exports of light industrial products also showed lackluster growth, reflecting decreased footwear and clothing exports. Seen by region, exports to developed countries continued to slow, with those to the U.S., Japan, and the EU all dropping markedly. On the other hand, exports to developing countries and countries in transition retained their comparatively high growth rate, with those to China, Central and South American countries, and Eastern Europe all showing steady gains.

Imports, on a customs-clearance basis, increased by 11.3 per cent for the year. By commodity group, the pace of increase of capital goods imports and raw materials imports slowed sharply due to the sluggishness of domestic demand and exports. In contrast, imports of consumer goods maintained a substantial increase. An immediate contributor was the surge in international grain prices during the first

[Chart 3] **Balance of Payments**



Note: 1) Percentage change compared with the same period of the previous year, on a customs-clearance basis.

half, while their longterm rise continued to be boosted by the progressive opening of the domestic market and changes in consumer taste toward greater sophistication and diversity. By region, imports from the advanced countries posted low growth, as those from Japan decreased with the slowing of facilities investment. However, those from the developing countries grew by approximately 20 per cent as imports from them increased rapidly, particularly those of crude oil from the Middle-East and those of consumer items from China and Southeast Asian countries.

As imports outpaced exports, the trade balance deteriorated to a deficit of 15.3 billion U.S. dollars, on a balance of payments basis, as against the 4.7 billion U.S. dollars of the previous year. Viewing the trade balance by region, as measured by the difference between exports and imports on a customs-clearance basis, the trade balance with developing countries marked a surplus similar to that of the previous year, while the deficit on trade with the advanced countries widened to more than 10.0 billion dollars. In particular, the bilateral deficits with the U.S. and the EU more than doubled and more than trebled, respectively, from those of the previous year.

The deficit on the invisible trade and unrequited transfers account widened to 8.4 billion U.S. dollars from the 4.2 billion U.S. dollars in 1995, affected by increased outlays for foreign travel and overseas transportation services.

As a result of the widening of the deficits on trade and invisibles, and the expansion of the deficit on unrequited transfers, the current account moved deeply into the red to the tune of 23.7 billion U.S. dollars as against the 8.9 billion U.S. dollars of the year before. Consequently, the ratio of the current account deficit to GDP rose to 4.9 per cent during the period under review from the 2.0 per cent in 1995.

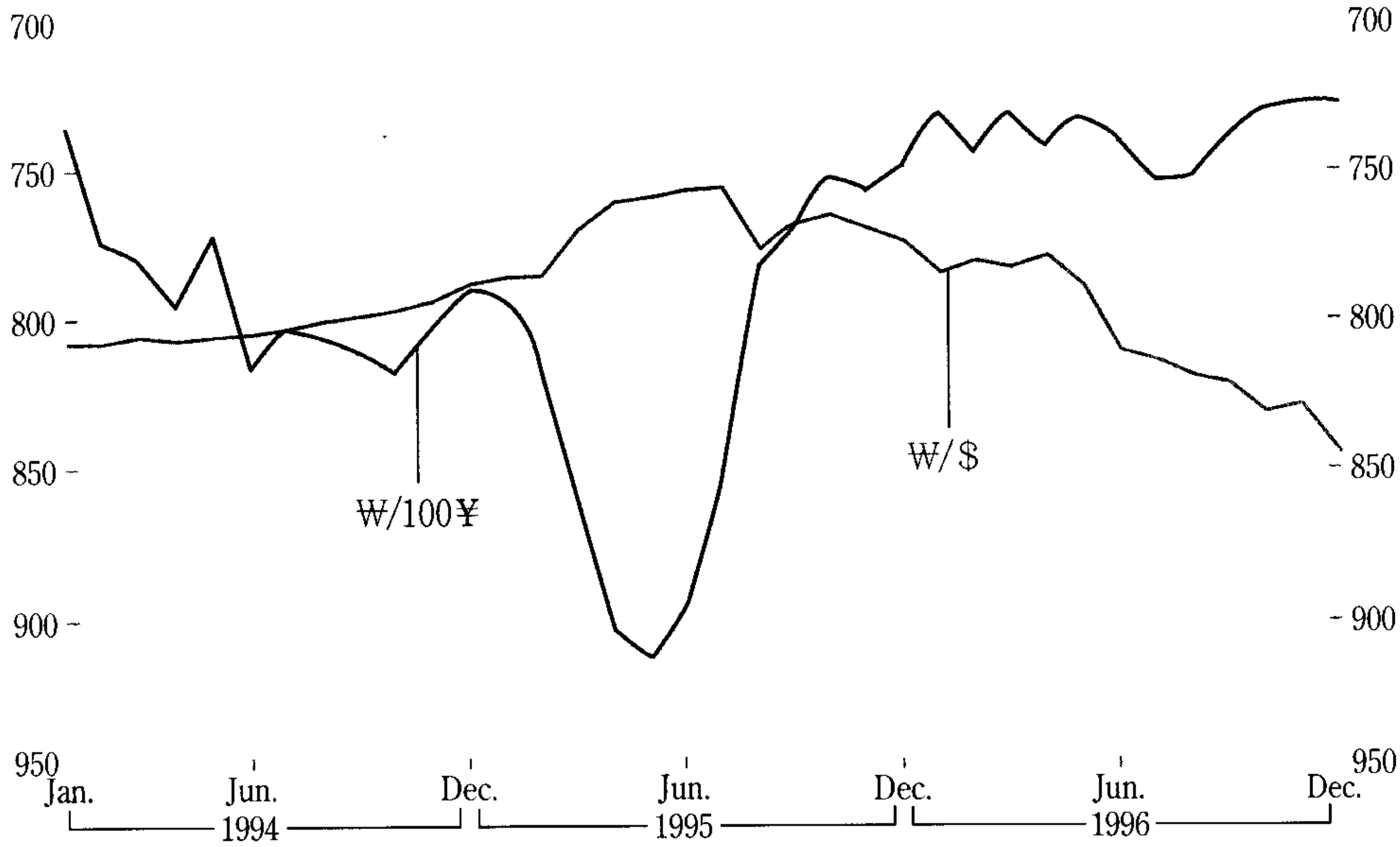
Meanwhile, the capital account recorded a net inflow of 17.2 billion U.S. dollars for the year, as the inflow of external funds for portfolio investment amounted to 4.4 billion U.S. dollars while trade credits received and the issue of foreign currency securities by development institutions both increased remarkably.

Within the balance of payments, the enlarged current account deficit offset the favorable capital account position; hence the overall balance of payments shifted to a deficit of 5.7 billion U.S. dollars from a surplus of 3.0 billion U.S. dollars in 1995. Meanwhile, the country's foreign exchange reserves stood at 33.2 billion U.S. dollars as of the year-end, a similar level to that at the end of the previous year.

Korean Won Continues to Depreciate Against the U.S. Dollar

The value of the Korean won in terms of the U.S. dollar continued its gradual fall until May. However, from June onward the Korean won began to depreciate more rapidly against the U.S. dollar, affected by the widening current account deficit and the strengthening of the dollar in international foreign exchange markets. As a result, by the year-end the Korean won had fallen against the U.S. dollar by 8.2 per cent. However, against the Japanese yen, it strengthened by 3.1 per cent, as the Japanese yen depreciated more steeply against the U.S. dollar in international foreign exchange markets than did the Korean won.

[Chart 4] **Exchange Rates of the Korean Won**[1]



Note: 1) End of month basis.

Foreign Exchange and Capital Account Liberalization Progresses

To meet the needs of the increasingly open economy as epitomized by Korea's entry to the OECD, the government continued to ease regulations concerning foreign exchange and capital account transactions while redoubling its drive to develop the domestic foreign exchange market. It continued to liberalize capital in-and-out flows: the liberalization of residents' overseas portfolio investment was extended; small and medium enterprises(SMEs) were given leave to take out foreign commercial loans for the import of capital goods; ceilings were raised on non-residents' portfolio holdings of equities and bonds; and the system of obtaining consent for external payments related to current transactions was changed to the simple filing of a report. As part of the government's efforts to develop the Seoul foreign exchange market as a sophisticated international market, the system of spot settlement was revised in keeping with international practice, a domestic Korean won-Japanese yen market was established, and the ceiling on banks' foreign exchange position was raised.

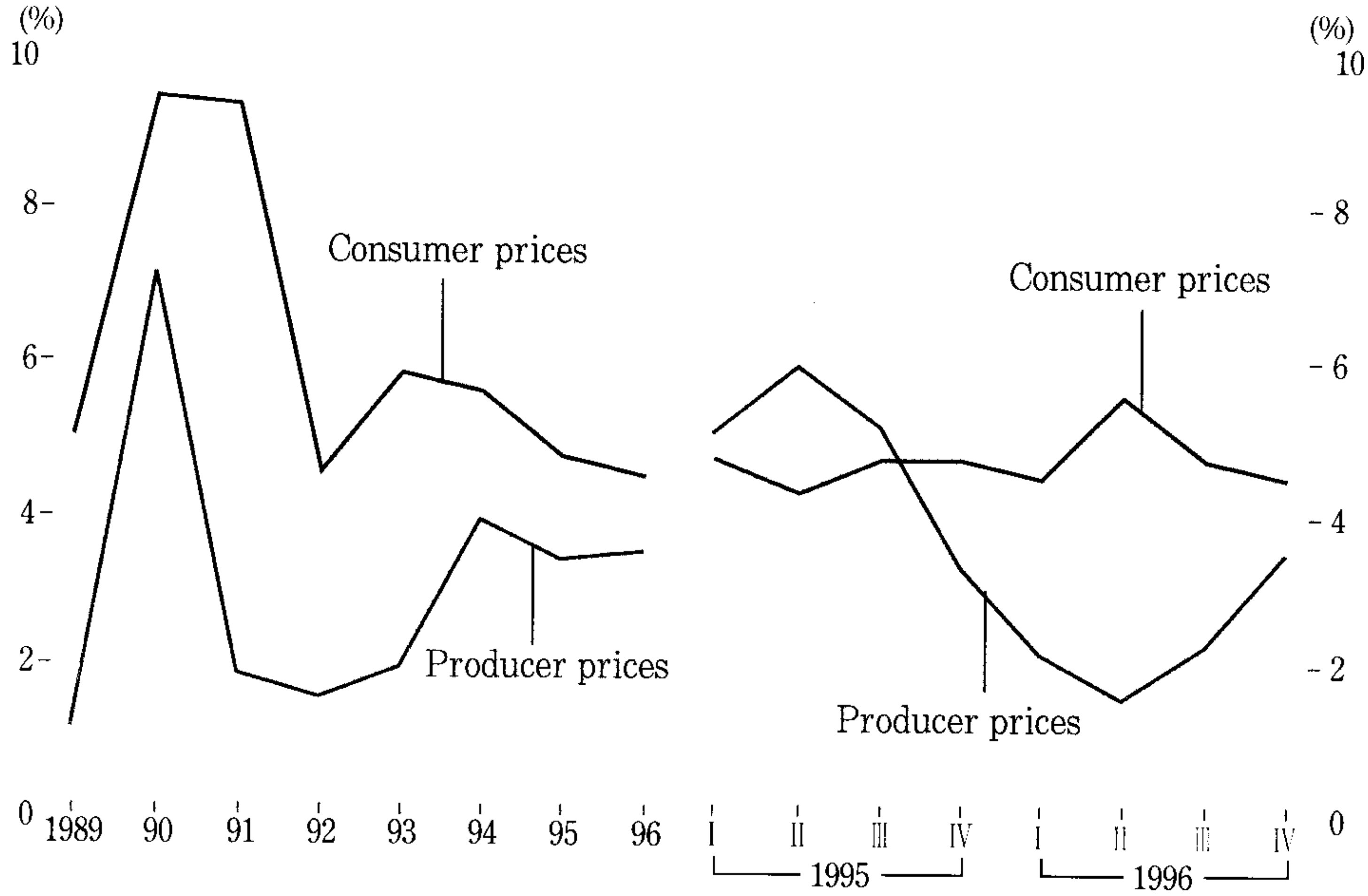
In addition, a swap system for foreign portfolio investment was introduced to alleviate the expansionary pressures on money supply through the foreign sector and stimulate domestic financial institutions' international financing activities.

Consumer Prices Continue to Rise at around the Four Per Cent Level

Prices exhibited a range of movements broadly similar to those of the preceding year, with consumer prices and producer prices rising by 4.5 per cent and 3.5 per cent, respectively, over the last month of the previous year.

By commodity, the prices of agricultural products showed a steep upward trend in the first half, centering on fruit, harvests of which were poor following unseasonably cool weather. However, during the second half of the year, the trend

[Chart 5] **Price Increase Rates**[1)]



Note: 1) Percentage change over the last month of the previous base period.

of farm prices shifted to a downturn, owing to good vegetable and cereal crops. The prices of manufactured goods, though, accelerated their upward trend due to higher international energy prices, the depreciation of the Korean won, and the raising of tax rates on petroleum products. Charges for services also maintained a sharply rising trend, owing to the upward adjustment of charges for public services and the general increase in charges for personal services.

Land prices maintained the previous year's mild upward trend, but house prices showed a somewhat steeper upturn, centering on apartments in the Greater Seoul area.

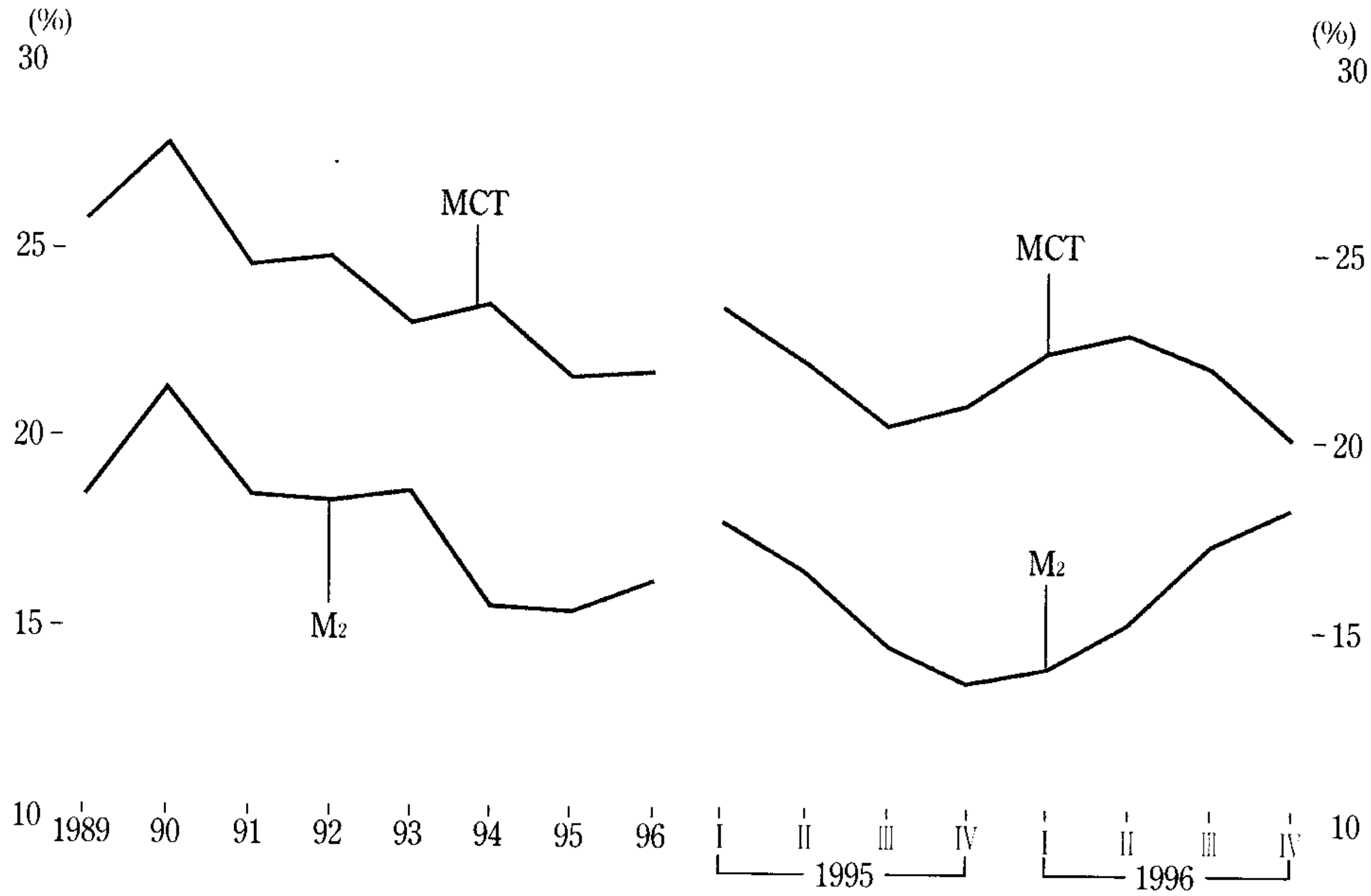
BOK Stabilizes Money Supply

The emphasis of monetary and credit policies during the year was directed toward the securing of financial market stability through supplying money flexibly while at the same time containing liquidity at a level appropriate to avoid the inflationary pressures.

The target range for the growth of the money supply(M_2) was set at a range of from 11.5 per cent to 15.5 per cent on a December daily-average basis. The growth rate of M_2, which had hovered around the 14 per cent level until April, shifted to a steeper upward trend after May. It was affected primarily by the shift of funds from banks' trust products into their deposit accounts following the realignment of the trust account system, which included the extension of minimum maturities on money-in-trust and the raising of the penalty for mid-term cancellation. Accordingly, the Bank of Korea focussed on the stable management of the broad monetary aggregate, MCT(M_2+CDs+Money-in-Trust), while allowing a greater degree of flexibility in the supply of M_2, whose movements had become less predictable. In consequence, the growth rate of MCT, on which the effects of the realignment of the banks' trust account system were broadly neutral eased from the 22.0 per cent of the previous year to 18.6 per cent, on a December daily-average basis, whereas the growth rate of M_2 registered 17.8 per cent, much higher than 13.7 per cent of the previous year.

While supplying liquidity in appropriate quantities, the Bank of Korea availed itself of a certain degree of latitude in the short term in order to ensure the stability

[Chart 6] **Increase Rates of Principal Monetary Indicators**[1]



Note: 1) Percentage change compared with the same period of the previous year, on an average-balance basis.

of the financial and foreign exchange markets, by taking the movements of price variables such as interest rates and exchange rates into account. The Bank strove to expand the availability of financial resources for SMEs that faced managerial difficulties in the course of the business downturn. It pursued the expansion of credit-based lending to them by establishing criteria for evaluation of their credit status and for bank employees' immunity from disciplinary sanction concerning approved loan operations. Along with these measures, it expanded the scale of support for foreign currency loans to SMEs and enlarged the fund for the purchase of domestic machinery produced or purchased by SMEs eligible for foreign currency loans.

Operating Environment of the Monetary and Credit Policy Improves Substantially

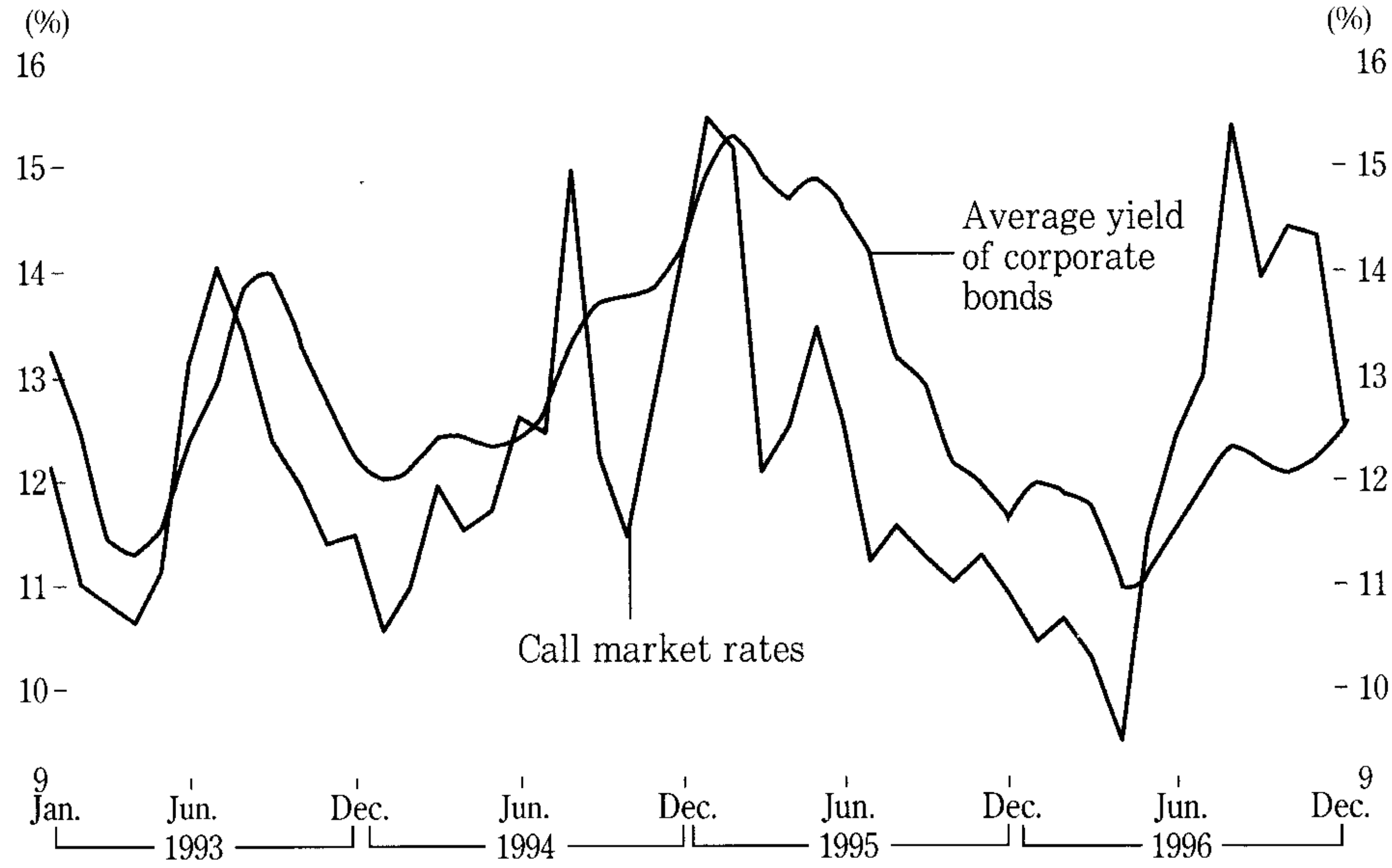
During the year under review, considerable progress was made in improving the environment for the operation of the monetary policy instruments needed to adjust liquidity levels using indirect monetary management techniques. The average reserve requirement ratio was reduced in two steps, taken on April 23 and November 8, from 9.4 per cent to 5.5 per cent. The November reduction was particularly helpful in lessening the rigidities in the supply structure of reserve money as it was made in parallel with a lowering of the aggregate credit ceiling designed to absorb the consequent release of liquidity. In its open market operations, the Bank expanded its use of competitive bidding and diversified the tools available to it by effecting simple government bond purchase operations and issuing two-year Monetary Stabilization Bonds.

The Bank continued to work toward financial deregulation in order to ensure that all financial market transactions take place on the basis of a well-functioning market mechanism. To enhance the price function of interest rates, restrictions on interest rates premiums were abolished. The Bank also scrapped its guideline concerning the share of banks' lending to manufacturers, which restricted their autonomy in loan management, and it reduced the number of sectors barred from receiving credit from the financial sector. In addition, it narrowed the category of business groups subject to credit control from the thirty largest interlinked business groups to the ten largest such groups.

Market Interest Rates Continue to Raise from May

Looking at the movements of market interest rates, yields on corporate bonds continued on a downward track until April. But from May they exhibited an upward movement, mainly due to the worsening of firms' financial status triggered by the slackening of exports and the accumulation of inventories; by the latter part of August they had risen to the 12.6 per cent level. After September, their upward trend eased thanks to the postponement of issues of government bonds and the reduction of banks' reserve requirement ratios, and they slipped back to around the

[Chart 7] **Major Interest Rates[1]**



Note: 1) On a period average basis.

12 per cent level. But in early December, they climbed back up to 12.6 per cent due to the extensive issuance of corporate bonds.

Call market rates also rose continually from May to touch 15.4 per cent in August; but their trend subsequently reversed, taking them back down to 12 per cent around the end of the year.

Overall Deposit-Taking by Financial Institutions Slows

The total deposits of financial institutions, both bank and non-bank, increased by 17.0 per cent on a year-end basis, showing a lower pace of growth than in the previous year.

Deposits at deposit money banks rose by 18.9 per cent, similar to the figure for the previous year. This was attributable to the large increase in inflows to mutual installment deposits and time deposits, whose attractiveness had been enhanced by the realignment of the banks' trust account system and the reduction of reserve requirements. There was also a favorable increase in banks' sales of cover bills.

However, these buoyant figures were partially offset by the decrease in demand deposits and the dip in sales of negotiable certificates of deposit(CDs).

The growth rate of deposits at non-bank financial institutions rose by only 16.2 per cent, less than that of the previous year. This was because money-in-trust, which was affected by the realignment of the banks' trust account system, showed a large decline while merchant banking corporations' deposit-taking was sluggish. Investment trust companies were an exception in that their deposit-taking increased favorably due to the introduction of MMFs.

The growth of deposits at deposit money banks outpaced that at non-bank financial institutions, bringing the share of deposit money banks in total deposits up to 31.1 per cent at the end of the year under review, a little higher than the 30.6 per cent of the previous year.

Stock Market Continues to Sink

The stock market was gripped by a bearish mood throughout most of the year as it had been the previous year: stock prices fell and turnover declined. During the first quarter of the year, stock prices showed lackluster movements. From early April, they staged a rally amid a brief return of investor confidence inspired by the raising of the ceiling on foreign investment and the reduction of banks' reserve requirement ratio. But they shifted back to a weakening trend from mid-May in response to the chilling of confidence by the upturn in market interest rates, market concerns about economic prospects, and the announcement of large new issues. They subsequently continued to fall steeply until the end of the year. As a net consequence of these developments, the Korea Composite Stock Price Index(KOSPI) declined by 26 per cent on a year-end basis to stand at just 651 points at the close of trading for the year. Moreover, during the year, average daily stock turnover registered only 490 billion won, the same subdued level as that of the previous year.

In line with the inertia in the secondary market, the raising of capital through public and right offerings decreased to 5.0 trillion won, rather less than that of the previous year. In contrast, the net issuance of corporate bonds expanded to 15.3 trillion won, significantly exceeding that of the previous year. This was in itself a reflection of the deterioration in firms' financial status.

The Expansion of Government Spending Slackens

The emphasis of fiscal policy during the year under review was placed on raising the economy's long-term growth potential, and strengthening support for improvement in the quality of life for the general public. These objectives were pursued subject to the constraints of maintaining the budget volume and the fiscal balance at appropriate levels.

Fiscal expenditures increased by 14.7 per cent, on an overall account(net) basis, less than in the previous year. Nevertheless, the ratio of fiscal expenditures to gross national product(GNP) at current prices rose from 20.9 per cent in the previous year to 21.6 per cent in 1996, as the rate of increase of government expenditures outpaced that of GNP. By account, the general account expanded by 14 per cent, much lower than its 20 per cent growth of the previous year, helped by the restraint of major items, such as defence expenses and personnel expenses, and despite the compilation of the supplementary budget. The growth of special accounts also slowed from the 17 per cent increase of the previous year to a 14 per cent increase, owing to the subdued expansion of the Government Investment and Loan Special Account and the Grain Management Special Account.

The growth of total tax revenues slowed from the 17.8 per cent of the previous year to 13.9 per cent, owing to the slowdown in collections of income tax and corporate income tax resulting from the economic downturn and the reduction in tax rates. The ratio of tax revenues, including local tax, to nominal GNP stood at the 21.1 per cent level, a little higher than in the previous year.

The government strengthened its fiscal support to some sectors, such as infrastructure, SMEs, education, science and technology, with a view to augmenting growth potential. In addition, it expanded spending on areas such as social welfare programs, environmental improvement and the safety management of public facilities, all of which are likely to improve the quality of life.

Meanwhile, it reformed the tax system in order to help strengthen businesses' international competitiveness and encourage savings. The major revisions were the strengthening of tax incentives for SMEs and technology development, the introduction of tax exempt long-term savings products, and the reduction of the ceiling on expenses for business entertainment.