# Ⅱ. Monetary and Foreign Exchange Policy

During the year, the Bank of Korea placed emphasis on maintaining the stability of money supply with a view to containing inflationary pressures on the demand side. At the same time, the Bank made efforts to improve its monetary policy instruments in order to prepare the environment for an indirect monetary control. The Bank also took various measures to expand financial support to small and medium enterprises (SMEs) which had been experiencing numerous difficulties as a result of the economic downturn. The Bank also pressed ahead the easing of restrictions on banks' lending operations in keeping with the progress of financial liberalization and financial market opening.

In monetary management, the Bank greatly eased the rigidities of the reserve base supply structure, by reducing reserve requirement ratios and lowering the aggregate credit ceiling, in order to pave the way for the setting up of an indirect monetary control. In addition, it pursued increased efficiency in its open market operations by enlarging the proportion of them conducted through competitive bidding, diversifying the bonds eligible to be used in them, and reducing the outstanding balance of Monetary Stabilization Bonds. In parallel with this, it made increasingly active use of open market operations involving sales of government and public bonds under repurchase agreements.

The Bank abolished the restriction on the size of the premium over banks' prime lending rates in order to improve the efficiency of the price mechanism of interest rates. It enhanced banks' autonomy in loan management by abolishing the guideline ratio on nationwide commercial banks' lending to manufacturers, diminishing the type of business restricted from receiving bank loans, and reducing the number of business groups governed by the rules for credit control. In addition, new credit evaluation standards for SMEs were drawn up and criteria for exemption from subsequent disciplinary sanction for bank staff who had extended loans in accordance with them were introduced in order to increase credit-based lending to SMEs.

In the area of foreign exchange policy, the government was active in its pursuit of reforms designed to meet the trend toward the liberalization and internationalization of the Korean economy as exemplified by entry to the OECD. Revision of the foreign exchange management system and foreign exchange and capital account liberalization were energetically promoted and measures for the development of the foreign exchange market were initiated.

The government undertook a comprehensive revision of the Enforcement Decree and the Regulation of the Foreign Exchange Management Act, bringing them into force as of June 1. The amendments were consistent with the liberalized tone of the revised Foreign Exchange Management Act of December 29, 1995. Under the revised system, the procedure required in making overseas payments for current account transactions was shifted from a system of validation by foreign exchange banks to a notification system. Also the government expanded the scope of liberalization for capital account transactions, all of which had previously required, in principle, the approval of the Minister of Finance and Economy, by separating them into two groups: those still requiring approval and those requiring declaration subject to screening or simple notification.

Domestic portfolio and bond investment opportunities for nonresidents were expanded, and the foreign investment system was brought into line with international standards through the revision of the Foreign Capital Inducement Act. The government also lifted the restrictions on outward investment to promote foreign direct and indirect investment, and in order to support smooth overseas fund-raising by domestic firms, it eased many restrictions on commercial loans from abroad and the issue of foreign currency securities.

To help diversify and develop the foreign exchange market, a Korean won-Japanese yen market for spot and forward transactions was established, and spot transactions were brought into conformity with customary international practice. The government also improved its system for the position management of foreign exchange banks.

A number of supplementary regulations were also amended following the country's OECD entry and the reform of the trade system.

# 1. Monetary Policy

## (1) Interest Rate Policy

### A. Abolition of Restriction on the Size of the Premium over Prime Lending Rate

On January 19, the Bank of Korea lifted the restriction on the size of the premium a bank could charge over its prime lending rate, which had been originally imposed in order to prevent a sharp run-up in bank lending rates in the course of interest rate deregulation. The lifting of the restriction aimed to enhance banks' discretion in determining interest rates as well as to give them greater incentives to offer financing to small and medium enterprises.

**[Table 3] Previous Structure of General Loan Interest Rates**

| Prime Rate | Premium | | |
|---|---|---|---|
| | by creditworthiness | by sector | by period |
| 9.0~9.5% | 2.5~3.0%p | 1.0%p | 2.0%p |

Moreover, on November 13, the Bank abolished the ceiling on the premium that could be imposed on lending supported by the "Aggregate Credit Ceiling System"[1], which had been restricted to no more than 1.5 percentage points over a banks' prime lending rate.

1) In March 1994, the Bank of Korea replaced the automatic rediscount facility with an aggregate credit ceiling system. Under the new system, individual credit ceilings are allocated among banks on the basis of each bank's loan performance in terms of, for example, the discount of commercial bills, loans for foreign trade, and loans for materials & parts production.

### (2) Rediscount Policy

On November 8, the Bank lowered the aggregate credit ceiling from 9,200 billion won to 6,400 billion won. Its main objective was to siphon off the excess liquidity released following its reduction of reserve requirement ratios. In addition, the Bank (as of December 23) withdrew 200 billion won of its loan to the fertilizer procurement account of the National Agricultural Cooperative Federation, which had been maintained at a level of 570 billion won since 1983.

Also the Bank changed the method of allocating aggregate credit quotas to individual banks: on January 30, five per cent of the total ceiling was assigned among individual banks on the basis of their credit-based loans to small and medium enterprises; on October 31, the Bank raised the ratio of the deduction from the credit quota for individual banks that depended heavily on short-term borrowing; from November 29, the deduction ratio applied to banks whose loans to the household sector were more than the all-bank average was raised in order to restrain such lending.

### (3) Open Market Operations Policy

#### A. Efficiency of Open Market Operations System Enhanced

During the year, the Bank of Korea took several measures to enhance the efficiency of its open market operations. Firstly, it made use of the competitive bidding system for its offers of RP transactions and the issuance of Monetary Stabilization Bonds. The competitive bidding ratio for the Bank's RP transactions (the proportion of the total offered through competitive bidding) rose from 76 per cent in 1995 to 99 per cent in 1996, and that for the issuance of MSBs from 33 per cent to 89 per cent over the same period.

In line with this, the Bank purchased government bonds outright to the value of 427.8 billion won in order to facilitate its open market operations. On December 26, it began to issue coupon-bearing Monetary Stabilization Bonds with a maturity of two years in a move to diversify the instruments available to it for open market operations.

[Table 4] **Competitive Bidding Ratios for the Bank's RPs and Issuance of MSBs**

Unit: per cent

| | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|
| RP Transactions | 28.6 | 49.6 | 75.7 | 99.1 |
| Issuance of MSBs | 36.5 | 31.5 | 33.0 | 89.1[1] |

Note: 1) Excludes the issuance of MSBs in connection with the reduction of banks' reserve requirements on April 23.

## B. Outstanding Balance of Monetary Stabilization Bonds Reduced

During the year, redemption of MSBs amounted to 795 billion won, bringing down their outstanding balance to 25 trillion won at the end of the year.

The first quarter saw a net redemption due to stable monetary growth. However, sizable net issuance occurred in the second quarter when the Bank needed both to sterilize inflows of portfolio capital and to absorb the excess liquidity associated with the lowering of reserve requirement ratios.

But in the third and fourth quarters, MSBs shifted back to a net redemption position as the swelling current account deficit and the slowing of capital inflows alleviated the expansionary pressures on the money supply.

[Table 5] **Issuance and Redemption of Monetary Stabilization Bonds**

Unit: billion won

| | 1995 | 1996 | | | | |
|---|---|---|---|---|---|---|
| | | year | I | II | III | IV |
| Net issuance | 485 | -795 | -296 | 3,310 | -1,517 | -2,293 |
| Issuance | 39,458 | 30,725 | 8,536 | 8,425 | 3,659 | 10,104 |
| Competitive tender | 12,243 | 23,705 | 7,142 | 4,581 | 3,594 | 8,388 |
| Direct sale | 27,215 | 7,019 | 1,394 | 3,844 | 65 | 1,717 |
| Redemption | 38,974 | 31,520 | 8,832 | 5,115 | 5,175 | 12,397 |
| Outstanding balance | 25,825 | 25,030 | 25,529 | 28,840 | 27,323 | 25,030 |

### C. Active Employment of Transactions Involving Government and Public Bonds under Repurchase Agreements

The Bank of Korea made active use of repurchase agreements involving government and public bonds during the year in order to maintain money supply at an appropriate level.

During the year, the total volume of the Bank's RP operations amounted to some 70 trillion won with 68 transactions, of which 58 involved the use of competitive bidding. Unlike last year, purchases of government and public bonds under resale agreements, or reverse RPs, exceeded sales.

Particularly from the beginning of the third quarter, the Bank greatly enlarged its purchase transactions, as the foreign sector turned into a net absorption channel.

[Table 6] **Transactions under Repurchase Agreements Involving Government and Public Bonds**

Unit: billion won

| | 1994 | 1995 | 1996 | | | | |
|---|---|---|---|---|---|---|---|
| | | | year | I | II | III | IV |
| Purchases | - | 12,424 | 38,902 | 4,108 | 4,404 | 17,024 | 13,366 |
| | (-) | (15) | (31) | (3) | (3) | (14) | (11) |
| Sales | 171,444 | 38,838 | 31,350 | 9,100 | 15,750 | 2,700 | 3,800 |
| | (137) | (61) | (37) | (12) | (16) | (3) | (6) |
| **Total** | 171,444 | 51,262 | 70,252 | 13,208 | 20,154 | 19,724 | 17,166 |
| | (137) | (76) | (68) | (15) | (19) | (17) | (17) |

Note: Figures in parentheses represent the number of RP transactions.

### D. Restructuring of the Call Market

With effect from October 31, the government restructured the call market.

Most prominently, the Korea Money Brokerage Corporation (KMBC) was established as a specialist brokerage house with its capital being subscribed by 120 financial institutions, including banks, merchant banking corporations, securities companies, insurance companies, and leasing companies. This brokerage house can broker not only call loans and money-at-call but also short-term money market instruments like certificates of deposit (CDs), repurchase agreements (RPs), and other bills. Under its articles of association, the KMBC should engage principally in the brokerage business, but it is also authorized to undertake dealing business on a limited scale.

For an interim period, up until February 10, 1997, it was provided that the eight Seoul-based merchant banking corporations which had thitherto been acting as call market brokers could continue to offer their brokerage services.

### (4) Reserve Requirement Policy

The Bank reduced the average reserve requirement ratio by 3.9 percentage points, bringing it down from 9.4 per cent to 5.5 per cent in two steps taken on April 23 and November 8. The objectives of lowering reserve requirements were threefold: to improve the profitability of commercial banks; to provide a level playing field between banks and nonbanks; and to prepare the environment for the operation of a system of indirect monetary management.

[Table 7] **Reduction of Banks' Reserve Requirement Ratios**

Unit: per cent

| Type of deposit | Previous | Apr. 23 | Nov. 8 |
|---|---|---|---|
| Checking deposits, Passbook deposits, Savings deposits, Preferential savings deposits, Company savings deposits, Time & savings deposits with a maturity of less than two years | 11.5 | 9.0 | 7.0 |
| Time & savings deposits with a maturity of more than two years | 8.0 | 6.0 | 4.0 |
| Workman's property formation savings deposits, Mutual installments deposits, Housing installments deposits, Workman's long-term savings deposits, Workman's savings deposits for housing | 3.0 | 3.0 | 2.0 |
| Average | 9.4 | 7.4 | 5.5 |
| Residents' deposits in foreign currency | 11.5 | 9.0 | 7.0 |

In addition, to absorb the corresponding amount of surplus liquidity released through the reduction of reserve requirements, the Bank issued Monetary Stabilization Bonds on April 23 and reduced the "aggregate credit ceiling" on November 8.

### (5) Loan System of Banking Institutions

#### A. Autonomy in Loan Management Increased

The Bank continued to ease regulations on the loan management of commercial banks with a view to strengthening their competitiveness.

With effect from March 2, it completely abolished the guideline ratio for commercial banks' credit to the manufacturing sector. In March and again in August, regulations were eased concerning the extension of credit to businesses considered luxury-oriented or undesirable, such as hotels, restaurants, spa-resort developments, and high-class hairdressing salons.

Also, restrictions on the call market were removed. Previously the Bank had discriminated against banks in open market operations when they provided call loans to non-bank counterparts. However, from June 25 they were able to supply call loans to non-bank financial institutions without incurring any disadvantages.

#### B. Rules for Credit Control on Conglomerates (Chaebol) Revised

In keeping with financial liberalization, the Bank revised its "Rules for Credit Control on Business Groups".

First, with effect from July 1, the Bank exempted the groups ranking between the eleventh and thirtieth largest from the rules for credit control. Therefore only the ten largest groups remained subject to the regulation. This change reflected the fact that the ratio of loans to relatively small-scale business groups to total loans had continued to decline. However, the Bank will continue to give particular attention to the regulation of the credit limit on loans to large groups.

Second, in order to consolidate the prime bank's role as a creditor, the Bank expanded the scope of firms covered by the prime bank system from the thirty largest business group to all business groups whose total outstanding credit (=loans+guarantees) from the banking system was over 250 billion won. The prime bank was similarly made responsible for gathering and administering information on the companies involved and the disclosure of relevant information to other financial institutions. And also, in cases where a company is in danger of insolvency due to management incompetence, the prime bank may call together the other banks involved with the company to form a committee for the drawing-up and execution of appropriate measures.

In addition, to encourage the participation of private capital in infrastructure projects, the Bank (as of March 18) released the ten largest business groups from the duty of raising funds directly or internally when they purchase real-estate for constructing air or sea cargo handling facilities.

### C. Credit-based Lending to Small and Medium Enterprises Encouraged

Two significant steps were taken during the year to increase credit-based lending to SMEs, which had been experiencing difficulties in the course of financial liberalization and industrial restructuring.

First, in March, the Bank and the Korea Federation of Banks put into effect new credit evaluation standards which will be applied exclusively to small and medium enterprises (SMEs). Previously banks had applied the same yardstick to both large enterprises and SMEs. The new credit evaluation standards for SMEs put more weight on non-financial items such as business prospects and managerial skills in order to provide a more positive evaluation of promising SMEs. In addition, the new standards allow the application of different scores and evaluation items even among SMEs according to size and business field, thereby taking into account their widely-divergent individual characteristics. Also the principle was established that credit-based loans should be made available to SMEs scoring more than a certain number of points on the table.

Second, the Bank and the Korea Federation of Banks introduced new criteria for exemption from disciplinary proceedings for bank staff who had been involved in the extension of loans that had subsequently turned sour.

### D. Foreign Currency Loans for Purchasing Domestic Machinery Allowed

The Bank allowed the extension of foreign currency denominated loans for the purchase of domestic machinery in order to support the domestic capital goods industry and improve the current account position through the expansion of demand for such items.

The extension of these loans is subject to an overall ceiling (2.5 billion U.S. dollars in 1996). In pursuit of support to SMEs, loans were made available only where either the purchaser or the machine-builder falls into the SME category.

When SMEs purchase equipment, they can borrow up to 100 per cent of the total cost (in the case of large enterprises, a ceiling of 70 per cent applies). And no single enterprise can borrow more than 15 million dollars.

However, the Bank expanded the scheme on November 1, allowing the extension of foreign currency denominated loans when a large enterprise purchases machinery produced by another large enterprise.

## (6) Banking Institution Deposits

### A. System of Banks' Trust Accounts Realigned

With effect from May 1, the government realigned the system of bank trust accounts. Its intention in doing so was to correct certain abuses which had crept into the system, whereby trust products had attracted large inflows of short-term funds through the manipulation of dividend rates, which enabled them to offer guaranteed high yields.

The reforms thus sought to restore the intrinsic characteristics of banks' trust accounts, namely, that of offering long-term products with variable, performance-based yields.

To this end, in the first place, the minimum maturity of trust account products was lengthened from one year to one and a half years.

To discourage the use of trust products as alternative vehicles to demand deposits in attracting short-term funds, the penalties for mid-term cancellation, which had ranged between 0.75 and 1.75 per cent, were raised to between 2.0 and 3.0 per cent, depending on the remaining period to maturity.

Moreover, banks undertaking trust account business were allowed to set charges at their discretion within a maximum of 2.0 per cent per annum.

The government also announced its intention to bring about a progressive reduction in the scale of the funds managed as "Development Money-in-Trust", which offers fixed-yield dividends.

In addition, contracts offering guarantee of principal were prohibited for performance-based dividend products with the exception of those which have the characteristics of long-term pension trusts.

### B. Restrictions on Maximum Denomination of Household Checks Eased

Ceilings on the maximum size of household check that could be drawn had previously been set up at five million won for individual proprietors in good credit standing and at one million won for all other householders.

However, with effect from April 22, banks were allowed to determine this ceiling at their own discretion for all individual proprietors within a maximum of five million won per check.

### C. Reserve Requirements on Household Long-term Savings Determined

Following the introduction of tax-exempt long-term savings for households with maturities from three to five years, the Bank of Korea, on October 17, imposed reserve requirements on them.

The reserve requirement ratio on household long-term savings was set at 3 per cent, taking into account the desirability of maintaining it at a level consistent with existing long-term savings products enjoying tax incentives such as workman's long-term savings and long-term savings deposits for housing.

With regard to interest rates, banks were allowed to determine the rates on the newly-introduced products on the basis of their business judgment. This was in view of the fact that interest rates on all installment-type deposits with maturities of more than 6 months had already been deregulated.

## (7) Revision of the General Banking Act and the Act Concerning the Merger and Conversion of Financial Institutions

### A. Revision of the General Banking Act

In keeping with the opening and globalization of financial markets, the General Banking Act was revised with a view to strengthening the accountability of banks' management and increasing their soundness.

The revision made changes in the composition of a bank's board of directors, stipulating that at least 50 per cent of its membership should consist of non-executive directors. Furthermore it laid down that candidates for president or auditor of a bank could only be recommended by a session of the board of directors in which only non-executive directors participated. Non-executive directors were to be appointed from among representatives recommended by large shareholders(50%), small shareholders(30%), and the board of directors(20%).

In regard to the ceiling on bank share holdings by a single person, a new article was inserted to allow the establishment of a banking subsidiary by a foreigner, by permitting a single person to hold more than four per cent of a bank's stock within a limit approved by the Superintendent of Banks of the Bank of Korea. In the case of a bank established as a joint venture with foreigners or controlled by a financial entrepreneur, a single individual may hold its stocks within a limit approved by the Superintendent of Banks of the Bank of Korea.

Moreover, to improve the managerial autonomy of banks, the maximum limit of ten years on the period of a loan was abolished. And slight amendments of a bank's articles of incorporation no longer required the authorization of the Monetary Board but could be made upon simple notification to it.

### B. Revision of the Act Concerning the Merger and Conversion of Financial Institutions

In order to provide the institutional framework for the restructuring of the financial industry, the "Act Concerning the Merger and Conversion of Financial Institutions" was extensively revised and retitled as the "Financial Industry Restructuring Act".

The revision stipulated that, to encourage voluntary mergers between financial institutions, government measures of support for such mergers be announced in advance. It also simplified the merger process and shortened the period of time required for a merger.

In the case of an insolvent financial institution, the regulatory authority is empowered to order corrective measures to be taken such as increasing its capital or disposal of its stockholdings according to the degree of financial frailty or engineer a merger with an other institution. Moreover, the revised Act stipulates that the regulatory authority may take appropriate measures in the case of a weak financial institution unlikely to recover from its difficulties such as having it cease its business operations, imposing a business suspension for a certain period, or revoking its license.

## 2. Foreign Exchange Policies

### (1) Alterations in the Foreign Exchange Management System

#### A. Restraints on Current Account Transactions Relaxed

The government shifted the procedure required in making overseas payments for current account transactions from a system of validation by foreign exchange banks to a notification system, and at the same time abolished the need for service transactions to receive authorization. Various other restrictions related to current account transactions were also relaxed including those concerning the payment of overseas emigration expenses, the obligation to collect and remit to Korea external claims outstanding, and the holding of foreign currency by overseas construction or other service companies.

#### B. Liberalization of Capital Transactions Further Widened

The government expanded the scope of liberalization for capital transactions, all of which had previously required, in principle, the approval of the Minister of Finance and Economy, by separating them into two groups: those still requiring approval and those for which notification or, alternatively, declaration subject to screening would now suffice. It also raised the ceiling on overseas deposits. In a similar move, restrictions were eased on institutional investors' foreign currency lending to nonresidents, foreign currency guarantees for both domestic and overseas payments, and foreign currency denominated transactions between residents. Furthermore, the government also relaxed its requirement for the submission of proof of underlying real demand when forward and financial futures transactions are conducted for hedging purposes.

#### C. Entry Barriers to Foreign Exchange Business Lowered

Obtaining a license to conduct foreign exchange business was made easier. Previously there had been a two-tier system whereby approval was needed for newly-established businesses and a declaration, whose acceptance was conditional upon its examination, for the expansion of existing facilities. This was replaced by a simple system of notification in both cases. For authorization to set up an overseas branch, the system was changed from an annual round of approvals to consideration for approval at any time. The scope for the business initiative of foreign exchange banks was meanwhile increased by lifting restrictions on their right to enter into foreign exchange trade contracts and removing restraints on the operations of their overseas branches and subsidiaries. The registered money changer business was opened to any person having an adequate amount of capital, manpower, and facilities.

#### D. Internationalization of the Won Pursued

The government allowed the overseas branches of domestic foreign exchange banks and their subsidiaries to hold Free-Won accounts, and permitted foreign exchange banks to lend up to 100 million Korean won to nonresidents. Also the amount of Korean won which can be carried out of the country was raised from 3 million Korean won to 8 million Korean won, within which residents may freely deposit won or exchange them into another currency abroad.

### (2) Improvement of the System for Current Account Transactions

#### A. Receipt Limit on Export Advances Raised and Period of Deferred Payments for Imports Extended

The ceiling on the receipt of export advances by large enterprises was raised on July 1 from 10% to 15% of their exports in the preceeding calendar year, and it was raised further to 20% thereof on October 21. Also the settlement periods for imports on a deferred payments basis of raw materials destined for export use were all lengthened by 30 days, giving a maximum of 180 days. Those for imports of crude oil including LNG were similarly extended by 30 days, bringing them into line with other general commodities.

#### B. Ex-post Management of Payments for Invisible Trade Reformed

The government tightened the ex-post management of the overseas use of credit cards and individual remittances on June 22. First, the amount of credit card payment subject to subsequent investigation was changed from over US$ 5 thousand per individual card and calendar month to the sum of all overseas credit card expenditures by one person per calendar month in excess of US$ 5 thousand. In regard to individual remittances abroad by Korean residents, although underlying documentation as to the purpose of the transfer is not required for sums of no more than US$ 5 thousand per transaction, if the total amount to be remitted by one person would exceed US$ 10 thousand per year, then the excess amount must now first be declared to the Bank of Korea. Moreover, the annual receipt of over US$ 20 thousand or the annual remittance of at least US$ 10 thousand for more than three years by any one person has to be notified to the National Tax Administration.

### (3) Advance of Capital Market Liberalization

#### A. Foreign Direct Investment by Nonresidents Promoted

Foreign direct investment in Korea has been actively promoted by the government since its announcement of the Five Year Plan for Foreign Direct Investment in June 1993, which was subsequently supplemented and revised in June 1994 and November 1995. But the need for a wider opening of business sectors was highlighted when Korea joined the OECD. A new Plan for the Expansion of Foreign Direct Investment was thus announced on May 14, with a view to broadening the opportunities for inward investment. It provided for the full opening, or the widening of the existing opening by the year 2000, of 47 business sectors out of the total of 81 that would remain prohibited to foreign direct investment as of January 1997. In particular, 28 business sectors were to be fully or partially opened in 1997.

The government revised the Foreign Capital Inducement Law on December 16, and announced it would come into force from February 1997, under the new title of the Foreign Investment and Foreign Capital Inducement Law. The revision was undertaken to induce larger inflows of foreign capital and bring the foreign investment system into conformity with international standards. Provision was made for the consolidation of the previous two-tier system involving either prior approval or notification for foreign direct investment projects into a notification system. It also abolished the need for approval when foreign enterprises receive loans with a maturity of more than 5 years from affiliated companies, classing this as a form of direct investment. Also mergers and acquisitions engineered by a foreign company were permitted if approved by the board of directors of the targeted enterprise. An exception, however, was made for enterprises having assets of at least 2 trillion Korean won in view of the potential impact on the national economy. In these cases the permission of the Minister of Finance and Economy must be obtained.

### B. Internationalization of Domestic Securities Market Expanded

Domestic portfolio investment opportunities for nonresidents were greatly expanded during the year as part of the thrust toward a revitalized and internationalized Korean capital market.

The aggregate ceiling for the purchase of stocks listed on the Korea Stock Exchange was raised on April 1 from 15% to 18% of the outstanding stocks issued by a listed firm, and from 10% to 12% for those issued by a public corporation. The ceiling on holdings by an individual foreign investor was raised from 3% to 4% of a firm's outstanding stocks. On October 1, the general ceiling was further raised to 20% for a firm, and to 15% for a public corporation. The individual ceiling was at the same time increased to 5%.

On April 1, stocks listed on the over-the-counter(OTC) market were included among eligible objects of investment for stock-type country funds. The government allowed funds to invest up to 25% of their net assets in stocks listed on the OTC market and up to 5% of them in any of such issue.

Nonresidents were allowed to trade stock index futures on the Korea Stock Exchange starting May 3 within 3% of the individual ceiling or 15% of the aggregate ceiling on the basis of the preceeding three months' daily average total open interest. These limits were raised to 5% for the individual ceiling and to 30% for the aggregate ceiling on November 1.

As of May 1, nonresidents were allowed to purchase and trade bonds with warrants. A system for the disclosure of OTC transactions by nonresidents was introduced that same day along with a system of consignment guarantee deposit in foreign currency. It was further announced that foreign companies with good credit standing would be able to issue and trade their shares on the Korea Stock Exchange in the form of depository receipts.

### C. Domestic Bond Investment by Nonresidents Liberalized

In accordance with the plan announced on December 29, 1995, the Korea Bond Fund, capitalized at US$ 100 million, was listed on the London Stock Exchange on October 1. The government also announced on March 13 plans for the establishment of a Korea Europe Bond Fund of US$ 100 million to diversify fund-raising areas and widen the opportunities for indirect investment by foreigners in Korean bonds.

In addition, it was announced that, with effect from January 3, 1997, the overall limit on nonresidents' investments in convertible bonds issued by small and medium-sized enterprises would be increased from 30% to 50% of the total listed amount, and that the individual limit would be raised from 5% to 10% of that amount. Listed small and medium-sized enterprises with a credit rating better than BB from at least one credit rating institution were also allowed to issue non-guaranteed company bonds with subscription limited to nonresidents as of January 3, 1997.

### D. Restrictions on Direct Investment Overseas Eased

With effect from June 1, in a move to support firms' overseas operations, the government lifted the restrictions on outward investment in three real-estate related sectors, namely, real-estate leasing service, real-estate sales service, and the laying out and operation of golf courses, and extended the scope of investment for individuals or an entrepreneur without a record of sales from US$ 500 thousand to US$ 1 million. Also it was announced that when investing in countries with an A credit rating from the Export-Import Bank of Korea, approval was to be granted as a matter of course.

Residents intending to sojourn abroad for more than two years were allowed to purchase real-estate abroad for residential purposes within a limit of US$ 300 thousand, loosening the criteria of a three-year stay and US$ 100 thousand.

### E. Overseas Portfolio Investment Liberalized

Having liberalized institutional investors' overseas portfolio investment on February 13, 1995, the government abolished the investment ceiling on foreign securities and the system of designated securities trading offices for individual investors and general corporations on April 1. It also expanded eligible investment objects from stocks, bonds, and beneficiary certificates that were listed or soon-to-be listed in designated securities trading offices, widening their scope to securities including unlisted foreign stocks traded in foreign authorized OTC markets, commercial paper issued by foreign enterprises, and certificates of deposit sold by foreign financial institutions. Additionally, securities companies and general investors were permitted to buy and sell in the domestic OTC market any securities in which overseas investment could be made.

### F. Restrictions on Commercial Loans from Abroad and the Issue of Foreign Currency Securities Greatly Eased

With effect from October 1, the government dismantled most restrictions on direct foreign borrowings, enabling non-manufacturing small and medium-sized firms, except for those in sectors to which credit is prohibited under Regulations on Credit Operation of Banking Institution, to receive loans from abroad for the import of production facilities. It also readjusted the borrowing terms from at or below LIBOR+1% to a more realistic level of within LIBOR+2%.

It was also announced that from January 1997, for social overhead capital projects conducted in line with the Private Capital Inducement Act whose net construction cost was over 500 billion Korean won, foreign borrowings of up to 20% of the annual net cost per project (subject to a ceiling of US$ 50 million ; for those with a net cost of over 1 trillion Korean won, a ceiling of US$ 100 million) would be permitted to finance the domestic part of the infrastructure project.

All enterprises were allowed to receive commercial loans for the import of production facilities with effect from January 1997, and the total of all such loans was set at US$ 1 billion for 1997. The government also permitted firms the ratio of whose domestic-made machinery use for plant investment was at least 50% and also fifteen local governments to raise funds overseas through commercial loans or the issue of foreign currency securities.

### G. Swap System for Foreign Portfolio Investment Introduced

On April 8, the Bank of Korea introduced a foreign currency swap system for foreign portfolio investment by securities companies, insurance companies, and investment trust companies. In doing so it sought both to relieve the increasing pressure on money supply through the foreign sector associated with the active pursuit of capital liberalization, and to galvanize the international financial banking operations of domestic financial institutions.

Financial institutions may freely select the duration of the swap contract from terms of 3 months, 6 months, or 12 months and they may roll them over at the end of the term. The repurchase rate at the end of the term is set to maintain the difference between the yield on Monetary Stabilization Bonds and LIBOR. The securities in which swapped funds can be invested are confined to those open to institutional investors, such as foreign government and public bonds, bearer certificates of deposit, stock-related futures, and to short-term overseas deposits associated with such placements. These swapped funds cannot be invested in Korean paper issued by residents, international beneficiary securities issued by domestic investment trust companies for the purpose of investing in domestic listed stocks, or in securities issued by nonresidents for domestic portfolio investment.

### (4) Foreign Exchange Market Developed

**A. Won/Yen Market Opened**

A Korean won-Japanese yen market for spot and forward transactions was established on October 1 in order to promote the development of the foreign exchange market and heighten the convenience of foreign currency transactions through the diversification of the domestic foreign exchange market. The won-yen rate is arrived at by arbitrating between the yen-dollar rate in the Tokyo foreign exchange market and the market average rate of the Korean won against the US dollar as before. No limits are imposed on the degree of daily fluctuation of the consequent won-yen rate.

**B. Settlement Method for Spot Transactions Changed**

With effect from February 1, the spot transaction system for foreign exchange was brought into conformity with customary international practice by extending the coverage of the transaction to include 'value spot', which had previously been classified in Korea as futures trades. This move was designed to expand the volume of trading in the spot foreign exchange market, and build up the linkages between the domestic and international foreign exchange markets.

### C. Foreign Exchange Position Management System Improved

The government improved the overall position management system of foreign exchange banks to encourage them to manage their foreign exchange assets and liabilities soundly and to invigorate the domestic foreign exchange market. First, their overall position management system was consolidated on an equity capital basis whereas previously both the average balance of foreign exchange purchases and equity capital had been employed as bases. The limits on the composite over-bought position and the composite over-sold position were set respectively at 15% and 10% of the equity capital as of the end of the preceding month. The limit on the spot over-sold position was increased from the higher of 2% of equity capital or US$ 3 million to the higher of 3% of equity capital or US$ 5 million.

## (5) Foreign Exchange Related Measures Following Entry to the OECD and Reform of Foreign Trade System

### A. Foreign Exchange Related Follow-up Measures upon Joining the OECD

The government adopted a negative-list system in regard to conditions for foreign currency securities issuers, and such qualifications as credit ratings and amount of equity capital were abolished. The procedure to be followed in issuance was switched from a declaration to the Minister of Finance and Economy, whose acceptance of it was conditional upon its examination, to simple notification. Also not only international financial institutions but also governments, local governments, public institutions, financial institutions, and enterprises of foreign countries were given the right to issue Korean won-denominated securities in Korea, and up to 50% of the total issue were allowed to be sold overseas.

Sales of foreign investment trust securities in Korea through domestic sales representatives such as securities companies or investment trust companies were permitted. Approval by the Minister of Finance and Economy for the opening of branches by foreign companies involved in securities-related business was no longer required, and it was announced that the procedure had been replaced by acceptance through examination.

In connection with entry to the OECD, the government amended the Foreign Exchange Reform Plan originally published on December 2, 1995 and announced the Plan for Capital Market Liberalization and Opening of the Financial Industry on September 20. The plan provides for the complete removal of the overall ceiling on nonresidents' investment in domestic stocks and on their purchase of stock-type beneficiary certificates by the year 2000. It also envisages that bonds investment by nonresidents, loans in cash, and the issuance of securities overseas will all be completely liberalized, provided stable macroeconomic conditions are maintained or the differential between Korean and international interest rates falls below 2%.

### B. Measures Following Changes in Trade System

Following the abolition of the formal procedures for the authorization and ex-post management of exports and imports under the revised Foreign Trade Act, it was announced that foreign exchange banks would, from January 1, 1997, confirm whether a particular payment method for imports was allowed. Import transactions through an Air-Way Bill(AWB) would be subject to ex-post management which would involve establishing the receipt period of shipping documents and the settlement period for payment in a similar procedure to that adopted for imports on the basis of the issue of a Letter of Guarantee(L/G). For receipts from exports, foreign exchange banks would confirm whether or not a particular receipt from exports was permitted and that export performance in fact took place where the advance exceeded US$ 30 thousand.