

## I . Overview

**1** The Bank of Korea set the inflation target for the year 2003, after consultation with the government, at  $3 \pm 1\%$  in terms of core inflation, the same as in the previous year. The medium-term inflation target was fixed as a range of 2.5~3.5%, in view of the medium-term trend of price increases in the Korean economy.

**2** During the year under review, the Bank of Korea conducted monetary policy in such a way as to give support to a recovery of business activity while keeping a watchful eye on price stability.

During the first four months of the year, the call rate target was held at 4.25%, largely in consideration of the upward pressure on prices and the threat of a weakening of the current account position posed by the upswing in international oil prices, even though the economic growth rate slackened markedly in the wake of widespread uncertainties such as a possible war against Iraq.

Subsequently, while the outlook for prices and the current account improved as international oil prices shifted to a downward trend following the early conclusion of the war in Iraq, there were worries over an overly sharp contraction of economic activities in response to the negative influence of the spread of severe acute respiratory syndrome (SARS), the North Korean nuclear issue and the delayed recovery of the world economy. These were compounded by dulling of private consumption under the heavy burden of household-debt. The Bank of Korea acted on May 13 in response to these factors by lowering its policy rate target from 4.25% to 4%, following this up on July 10 with a further reduction to 3.75%, the lowest-ever

level, and a downward adjustment of the interest rate applied on its Liquidity Adjustment Loans from 3.75% to 3.5%. Although there was rising concern over soaring housing prices, it was considered that the government's diverse anti-speculative measures would be more effective in restoring housing price stability.

From August onwards, the overseas environment improved markedly as the global economy, and notably the US economy, exhibited a rapid recovery. Meanwhile, the Korean economy continued to enjoy buoyant exports and construction investment despite the protracted sluggishness of private consumption and facilities investment. It was anticipated, in addition, that the effects of the two-step reduction of the call rate target and the government's execution of its supplementary budgets would gradually make themselves felt. The Bank of Korea accordingly decided not to make any further adjustments of the call rate target but to leave it on hold at 3.75%.

**3** The Bank of Korea took several active steps to maintain financial market stability. As a result of the mounting uncertainties at home and abroad, there were, from the beginning of the year, some signs of financial market unrest: a sharp fall of benchmark yields in the bond market with a preference for assets perceived as safe, such as government and public bonds, increasing. To ensure the stability of market interest rates, the Bank resumed its over-the-counter sales of monetary stabilization bonds (MSBs), which had been suspended since April 2002, and stepped up the volume issued.

From early March, owing to concerns about the possible insolvency of several credit card companies and the SK Global accounting scandal, large-scale withdrawals took place from investment trust companies' money market funds (MMFs). The Bank's prompt supply of liquidity through open market operations made a major contribution

to warding off market instability at an early stage. Subsequently, upon the outbreak of the war against Iraq, a 「Financial and Foreign Exchange Market Stability Package」, including prompt steps to expand the supply of liquidity, was unveiled in order to nip a mood of unease in the bud before it spread among financial market participants.

In June, Chohung Bank experienced a large volume of withdrawals around the time of a planned strike. As the lender of last resort, the Bank of Korea acted to secure the stability of the financial system by supplying needed liquidity to the bank in the form of Liquidity Adjustment Loans. It also strengthened its capacity to respond to financial institutions' shortages of liquidity from the third quarter onwards by raising the ceiling on its Liquidity Adjustment Loans from 3 trillion won to 5 trillion won.

**4** Inducements for financial institutions' funding support to small and medium exporters and regional small and medium enterprises (SMEs) were constantly strengthened in the operation of the loans system.

In order to bring about an expansion on loans, especially those of trade finance, of banks to small and medium exporting businesses, which was experiencing difficulties due to the delayed world economic recovery, the Bank of Korea raised the General Ceiling, the sub-category of the Aggregate Credit Ceiling Facility which includes trade finance, in succession. First, in May, the Bank allocated the entire retained quota of 385 billion won, which was specially reserved for future contingencies under the facility, to the General Ceiling, with heightening it to 1.7 trillion won. It was followed up by raising it again in October to 2.7 trillion won. Besides this, the quota under the facility available to the regional branches of the Bank of Korea for the support of regionally-based SMEs was raised from 3.6 trillion won to 4 trillion won in August. Then in September, an additional amount of 85 billion won was made available to

provide emergency support to SMEs that had suffered damage from Typhoon Maemi.

Efforts continued to be made to ensure that the practice of cash settlement in commercial transactions between businesses took firm hold. To bring about a contraction of settlement by means of bills, the recognition ratio for banks' performance in discounting them, which is used when calculating their individual quotas under the Aggregate Credit Ceiling, was sharply reduced in two steps in May and October from 50% to 20%.

5 The year under review saw the final completion of the process of interest rate deregulation embarked on under the 「Four-Stage Interest Rate Liberalization Plan」, announced in 1991, with the Bank of Korea's deregulation of interest rates on demand deposits. Also intensive endeavors were devoted to heightening policy transparency and credibility and to the more market-friendly operation of monetary policy instruments.

On December 24, the 「Regulation on the Deposit and Lending Rates of Financial Institutions」 was revised so as to abolish almost completely, with effect from February 2004, the remaining restrictions on demand deposits such as passbook deposits and temporary deposits along with company savings deposits of less than seven days, and also the remaining conditions imposed on deposits. In view, however, of the cost to banks of handling checks, the payment of interest on checking accounts remained prohibited. It is anticipated that this deregulation will amplify the transmission channels of monetary policy while bringing about a healthy competitive climate among financial institutions and spurring on product innovation. It should also make the use of financial services generally more convenient.

From January, the time of the announcement of plans for the competitive auction of MSBs was changed from the auction date itself to the immediately preceding business day so as to facilitate the more stable operation of financial institutions' funds and to heighten the predictability of the day-to-day interplay of the demand and supply of funds. From March onwards, information allowing an immediate check as to companies' eligibility as objects of support under the Aggregate Credit Ceiling Facility was put up on the Bank of Korea's web site for use by financial institutions in their credit screening. From September, for the greater convenience of exporters in their use of trade finance, electronic document interchange (EDI) was added to the existing method of submission of physical documents for the settlement of domestic letters of credit.

The channels of communication with the financial markets and the general public were constantly amplified in order to make the intentions of monetary policy clearly known and to facilitate the Monetary Policy Committee's accurate grasp of anticipations and reactions. Press conferences are held immediately after the monthly meeting of the Committee to set the direction of monetary policy. The decisions taken and the background to them are explained in full and minutes are made public in the 「Monthly Bulletin」 about two months later. Furthermore, in order to learn the opinions of external experts and gather on-the-spot information, the activities of the 「Economic Trends Discussion Meeting」 and the 「Financial Consultation Meeting」 were intensified, and, a 「Monetary Policy Contest」 was held for the first time in June, July and August, in which university students made presentations on monetary policy.

In order to capture the knock-on effects of policy and check up on the management status of financial institutions, joint on-site examinations were carried out on eleven banks with the Financial Supervisory Service during the year. The year also saw the

launch of 「Financial Stability Report」, a publication containing overall analysis and evaluation of financial system stability and the financial servicing capacity of households and businesses.

In relation to the payment and settlement system, in a move to enhance the safety of the settlement of call transactions, from July banks were allowed to collect, through BOK-Wire, call-loan money offered to non-bank financial institution and foreign banks' branches. And in order to reduce banks' external foreign exchange settlement risk, construction was begun of Continuous Linked Settlement Bank's payment versus payment system in Korea with completion targeted for the end of 2004. In addition, ahead of the implementation of the revised Bank of Korea Act, overall preparations were made for the construction of an efficient oversight framework for the Bank of Korea's surveillance of the payment and settlement system by specifying the scope of that surveillance.

**6** During the year under review, the Bank of Korea operated its call rate target at a lower level than in the previous year in consideration of the general state of the economy. Monetary policy thus provided a series of stepping-stones for domestic business activity to enter into a mild recovery phase from around the beginning of the fourth quarter thanks to buoyant exports by reacting flexibly to changes in the environment at home and abroad while containing the level of price increases within the range of the inflation target.

The real economy continued to wear a subdued aspect with private consumption and facilities investment both at a low ebb because of the general shrinking of confidence on the part of economic agents. The growth rate of real GDP fell, in consequence, to 3.1% from the previous year's 7.0%. Production activities, though, showed

progressively livelier movements from September onwards helped by a sharp increase in exports.

Core inflation was held to 3.1% on a yearly average basis around the midpoint of its target range. This was attributable to the upward stability of the Korean won against the US dollar and the moderation of demand pressures resulting from the contraction of domestic demand even though these effects were partially offset by the continuing sharp upward trend in wages and rises in charges for public utilities and personal services. In contrast, the consumer price index showed an increase of 3.6% during the year, a more sharply upward trend than the preceding year's 2.7%. This was largely attributable to rises in the prices of petroleum products in response to the run-up in international oil prices. Housing prices, led by apartment prices in the metropolitan area, maintained their upward trend from the previous year, but shifted to a mild downward trend following the government's publication (October 29) of 「Comprehensive Package of Housing Market Stabilization Measures」.

The scale of the current account surplus widened greatly from the preceding year's 5.4 billion dollars to 12.3 billion dollars thanks to the sharp increase in exports mainly to China.

In the financial markets, though the growth rate of money supply decelerated sharply with the contraction of the supply of credit to the private sector, market liquidity conditions were relatively smooth: loans to SMEs increased steadily and overall corporate demand for funds remained low. But certain enterprises with a less than exemplary credit standing experienced difficulties following the financial institutions' strengthening of credit differentiation while the trouble of several ailing credit card companies at times proved to be a factor acting to destabilize financial markets.

Market interest rates and the deposit and lending rates of financial institutions showed a downwardly stable trend on the whole from the beginning of the year, but their movements from October onwards turned upward due to anticipations of a recovery of business activity at home and abroad. Share prices, showing synchronization with those of major advanced countries, shifted to an upward trend from the last week of March onwards to post a large-scale increase by the end of the year.

In the domestic foreign exchange market, the Korean won/US dollar exchange rate declined slightly on an annual average basis compared to the previous year as a result of the continued excess supply of foreign exchange. Until mid-April the won/dollar rate showed an upward trend due to the North Korean nuclear issue and the SK Global accounting scandal, but afterward marked a continued decrease thanks to the current account surplus and inflow of foreigners' portfolio investment, as well as comments hinting at toleration of a weak dollar at the G7 Meeting (September 20). However, the won weakened slightly against the dollar again from mid-October to the end of the year. The scale of the foreign exchange reserves rose constantly, bringing them to a total of 155.4 billion dollars as of year-end 2003, an increase of 33.9 billion dollars over the preceding year-end.

**7** During 2004, the Korean economy is anticipated to move gradually into an upswing phase thanks to the knock-on effects of the wide-ranging measures to stimulate economic activity so far undertaken together with the acceleration of growth trends of major advanced economies including that of the US. During the first half of the year, the sharp upward trend of exports will be the principal contributor to economic growth, but during the latter half of the year there should also be an expansion of the upward trend of facilities investment and a gradual recovery of private consumption spending. It is therefore anticipated that the Korean economy

will see GDP growth rise to the 5% level during the year.

Core inflation is expected to remain stable on the whole during the year. This forecast is predicated on anticipations of the stabilizing effects of the continued weak underlying tone of the US dollar, combined with the mildness of upward pressures from the demand side as economic activity shows a smooth recovery. However, due to high international oil prices and the upward trend of international raw material prices, price instability cannot be ruled out.

The current account is projected to maintain its comparatively large-scale surplus thanks to a robust increase in exports, which will counteract the effects of an expansion of capital goods imports to feed the increase in facilities investment.

**8** Taking this combination of domestic and external conditions into consideration, monetary policy will be operated in such a way as to keep core inflation within the medium-term inflation target range while paying careful attention so that no marked imbalances are allowed to arise during the year in terms of growth, prices or the current account. Monetary policy will support the domestic economic recovery and improvement of employment conditions but preemptive steps will be taken should domestic demand pressure intensify in the course of its recovery. In addition the effectiveness of monetary policy should be heightened through a harmonious policy mix with fiscal, exchange rate, and financial supervisory policies.

From the beginning of 2004, with the entry into effect of the revised Bank of Korea Act, the method of establishing the inflation target has shifted from the previous annual target system to a medium-term target system. The Bank of Korea has accordingly set the medium-term inflation target for the period 2004~2006 as a range

of 2.5~3.5%, taking into consideration the transmission lag in the effects of monetary policy and so forth.

In this context, if the medium-term prospects for the price are anticipated to deviate from the target range, financial and economic conditions as well as the cause of its deviation will be taken into account in determining policy actions and the strength of such policy responses, so as to minimize the impact of the side effects on the real economy and the financial markets while seeking to converge upon the midpoint of the inflation target range from a medium-term perspective.

In keeping with the changes in the financial environment, the system of the Aggregate Credit Ceiling will be rearranged to emphasize support for small and medium exporters and the revitalization of regional economies. Meanwhile, to make active use of the interest rate announcement effect and liquidity control function, a careful review will be given to a possible change of the Liquidity Adjustment Loan system.

In addition, plans will be drawn up for the rationalization of the system of reserve requirements in reaction to the complete liberalization of interest rates, the expansion of electronic financial transactions and the diversification of the deposit products offered by financial institutions.

The unceasing strengthening of efforts for financial stability is also planned. A watchful eye will be constantly kept on latent factors that might bring market instability including the management status of credit card companies, and should there be signs of these factors' materializing, prompt action will be taken to counter them through, for example, open market operations. The Bank of Korea intends to make expanded use of joint examinations of banks in order to pick up promptly signs

of instability within the financial system, to gather on-the-spot information necessary for the drawing up of policy and to check its actual transmission.

The revised Bank of Korea Act gives the central bank responsibility for the overall management and oversight of the payments and settlements system. In order to carry out these functions efficiently, policy initiatives are being pursued to put in place at an early date a framework for the surveillance and evaluation of the overall payments system and for the upgrading of each level sub-systems.