

III . Monetary Policy Operation

1. Inflation target

In accordance with Article 6 of the Bank of Korea Act, the Bank of Korea set 2001 inflation target, in consultation with the government, at $3.0\pm 1\%$ based on the average annual growth rate of core inflation. At the same time, the medium term inflation target was retained at the level of 2.5% originally established in December 1999.

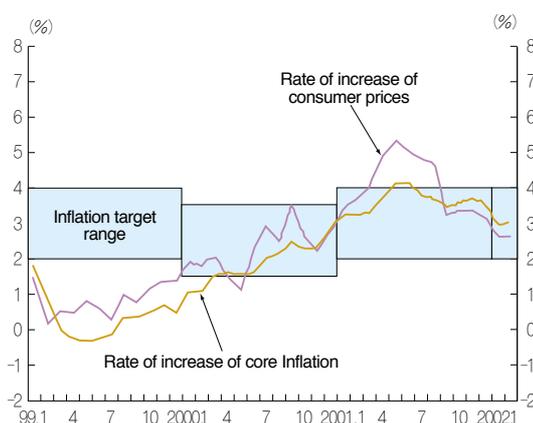
The index employed as the reference was core inflation, which strips out non grain farm products and petroleum based fuels from the Consumer Price Index (CPI), whose prices are subject to large temporary fluctuations depending upon changes in weather, harvests and international oil prices.

The inflation target was adjusted upward slightly from the previous year's level considering that consumer prices were expected to show an upward trend at around the 3% level in view of the anticipated increases in public service charges and the depreciation of the Korean won. In order to maintain consistency in monetary policy and heighten its credibility, the medium term inflation target was retained at the same level as in the year 2000 of 2.5%.

Core inflation continued to increase at a rapid pace during the first half of the year 2001 as a result of the depreciation of the Korean won and the hikes in charges for public services. With the easing of these factors during the second half of the year, the rate of price increases slackened. As a result, core inflation,

<Figure III -1>

Changes¹⁾ in Consumer Prices and Core Inflation



Note: 1) Rates of change compared with the same period of the previous year.

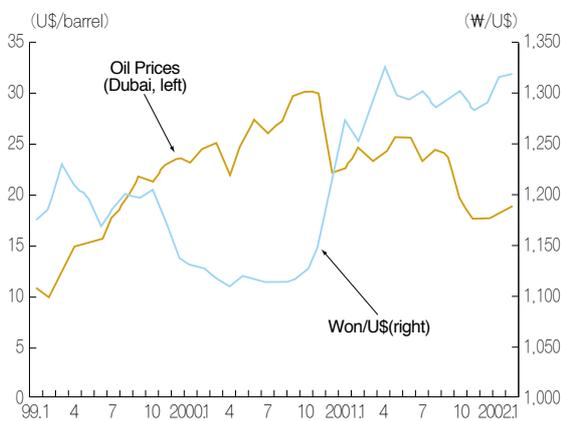
Source: Korea National Statistical Office.

when measured in terms of the 1995 based CPI used as a reference when it was established at the beginning of 2001, registered a level of 4.2%, which was above the 4% upper bound of its target range. Using the CPI rebased on the year 2000, which was announced by the National Statistical Office at the beginning of 2002, the rate of core inflation for the year 2001 stood at 3.6%, remaining within its target range. This large difference was caused by the adoption of a new base year for the CPI. The growth rate of public service charges showed a much lower level when it was adjusted to reflect the recent structural change of urban household expenditure based on the year of 2000 rather than that of on 1995.

The fact that core inflation temporarily rose above its target and, in terms of the 1995 based CPI, exceeded the upper bounds of its target range with price movements showing an unstable pattern, even though demand side price pressures were small and prices of raw materials including crude oil exhibited downwardly stable trends, is largely attributable to the substantial depreciation of the Korean won, the increases in charges for public services early in the year and the steep rise in housing rents.

<Figure III -2>

Trends of International Oil Prices and Exchange Rates¹⁾

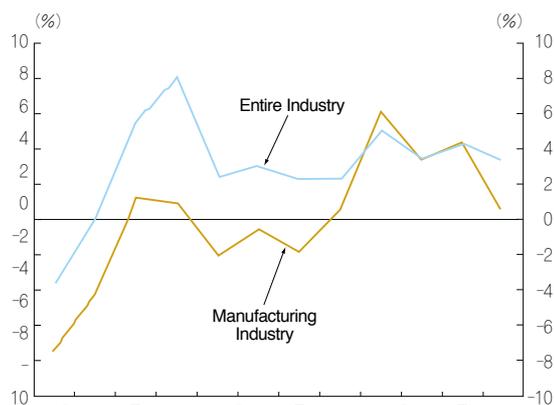


Note: 1) Monthly-Average Basis.
Source: The Bank of Korea, Bloomberg.

On the demand side, price pressures are estimated to have been minor because the rate of economic growth remained below the level of the potential growth rate. Apart from a short-lived spike following the terrorist attacks on the U.S., international oil prices maintained generally downwardly stable trends with the world economy including that of the U.S. stuck in the doldrums. The international oil prices(Dubai Light) fell by 13% on an annual average basis, and this is estimated to have pushed down consumer prices by 0.4%p based on the Input Output Analysis Table's estimation of cost pressures, an index that assumes the

<Figure III -3>

Growth Trends of Unit Labor Costs¹⁾



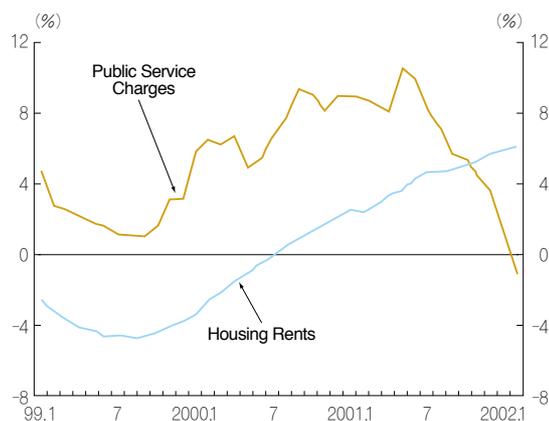
Note: 1) Unit labor costs = noninal wages/(constant GDP ÷ the number of persons employed).
Source: The Bank of Korea.

absence of economic structural changes. The general stability of other international raw material prices also served as a factor making for price stability.

The effects of the price stability of raw materials, and especially of crude oil, were offset by the steep depreciation of the Korean won, which acted as a factor in pushing up prices on the cost side. The exchange rate(in terms of the base rate) rose by 14.2% in the year 2001 and is estimated to have acted to push up the rate of consumer price inflation by 2.6%p on the basis of the Input Output Analysis Table. On the wages front, unit wage costs rose at a rather higher level of 4% than that of preceding years(2.6%). Notably, that of the manufacturing field changed from the previous year's decrease(-0.8%) to an increase(3.5%), which have acted as a factor making for consumer price increases.

<Figure III -4>

Rates of Increase of Public Service Charges and Housing Rents¹⁾



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

In addition to that, the large rises in patient contributions following the reorganization of the public medical insurance system and the hikes in charges for piped gas and other public services, which all experienced unexpectedly high increases, pushed up consumer prices 1.2%p. Meanwhile housing rents, which are among the components of the CPI, sharply increased following the intensification of demand-supply imbalances in the housing sector. The rise in housing rents is estimated to have acted to push up consumer prices by 0.5%p.

Inflationary expectations became widespread following the steeply rising prices of the early part of the year, but they subsided somewhat with the blunting of the pace of prices increases from the second part of the year onwards.

<Box III-1>

Effects of the Revision of the Consumer Price Index(CPI)

In January 2002, the National Statistical Office changed the base year of the CPI from the year 1995 to 2000. This revision resulted in the omission of some 32 items including wireless pagers and the addition of some 61 new product categories including fees for the use of IT networks and charges for the use of PC rooms (cyber cafes). With the amalgamation or subdivision of existing product categories, the number of the product categories surveyed was increased by 7 from the previous 509 to 516. Adjustment was also made to the weights given product categories surveyed, so that for example the weighting given to charges for piped gas was raised from its previous 6.2 to 18.6 and to charges for mobile phones from the previous 2.2 to 23.7.

The Details of Changes in the Classification of Items and Weighting

	The number of items (units)			Weighting		
	1995	2000	Difference	1995	2000	Difference
Consumer prices	509	516	7	1,000.0	1,000.0	0.0
Agriculture, livestock and marine products	76	71	-5	144.8	107.4	-37.4
Industrial products	298	286	-12	369.2	342.9	-26.3
Services	135	159	24	486.0	549.7	63.7
(Housing rents)	2	2	0	127.5	131.4	3.9
(Public service)	47	45	-2	131.4	150.9	19.5
(Private service)	86	112	26	227.1	267.4	40.3
Core inflation	460	474	14	898.8	883.5	-15.3

Source: Korea National Statistical Office.

With this revision, consumer price inflation during the year 2001 was changed from 4.3% in terms of the previous 1995 based index to 4.1%, being reduced by 0.2%p. In terms of core inflation, the rate of price increases was dramatically reduced from 4.2% under the 1995 base year to 3.6% on the rebased index. In the past, with the revision of the base year of the CPI to a 1990 and a 1995 year basis, the effect had been to reduce consumer price inflation by 0.4 and 0.1%p respectively.

The principal reason that the revision of the CPI had the effect of reducing consumer price inflation last year

Difference between the New and Old Rates Caused by the Changes in the CPI

	(% , %p)		
	1991	1996	2001
New index (after revision)	9.3	4.9	4.1
Old index (before revision)	9.7	5.0	4.3
Difference (%p)	-0.4	-0.1	-0.2

Source: Korea National Statistical Office.

by such a large margin was its lowering of the increasing rate of charges for public services, which had contributed greatly to the rise in consumer prices, from its previous 9.2% to 7.5% because of the changes in

weights and product classifications. In particular, the weight on charges for medical services, traffic fares and refuse disposal services, which had been sharply raised during the year 2001, were reduced whereas weights of charges for mobile phones, wireless broadcasting fees and expressway tolls, which rose by a comparatively small margin, were increased. All of this had a great effect in reducing the increase in charges for public services. The inclusion as a new item of land to mobile(LM) telephone charges also contributed to reducing the increase in public services charges.

The effect of the changes in the weighting and classification of items for public services in reducing the rate of price increases was even larger in the case of core inflation. This is because among public service charges, piped gas, prices for which were sharply increased, is not included in core inflation and the resulting share of charges for public services in the composition of core inflation stands at 15%, being comparatively much greater than their 13.2 % share in the composition of the CPI.

Comparison between New and Old CPI

	Weighting			Rate of increase(%)			Degree of contribution(%)		
	Old index	New index	Difference	Old index	New index	Difference	Old index	New index	Difference
Consumer prices	1000.0	1000.0	0.0	4.3	4.1	-0.2	4.3	4.1	-0.2
(Public service)	131.4	150.9	19.5	9.2	7.5	-1.7	1.3	1.2	-0.2
- Piped gas	6.2	18.6	12.4	19.1	18.7	-0.4	0.2	0.4	0.2
- Others	125.2	132.3	7.1	8.6	5.9	-2.7	1.2	0.8	-0.4
Core inflation	898.8	883.5	-15.3	4.2	3.6	-0.6	4.2	3.6	-0.6
(Other public service charges)	125.2	132.3	7.1	8.6	5.9	-2.7	1.4	0.9	-0.5

Source: Korea National Statistical Office.

2. Interest Rate Policy

<Table III -1>

Monthly Stance of Interest Rate Policy and Market Interest Rate Trends

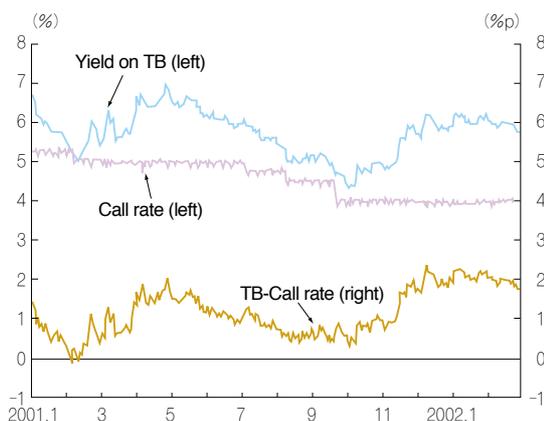
	Interest rate policy direction	Market interest rate movements ¹⁾
Jan. 2001	Maintain current level of overnight call rate (5.25%)	Decline
Feb.	Cut by 25 bp (5.00%)	Decline
Mar.~Apr.	Maintain current level	Increase
May~Jun.	Maintain current level	Decline
Jul.	Cut by 25 bp (4.75%)	Decline
Aug.	Cut by 25 bp (4.50%)	Decline
Sep. ²⁾	Cut by 50 bp (4.0%)	Decline
Oct.~Nov.	Maintain current level	Decline
Dec.	Maintain current level	Increase
Jan. 2002	Maintain current level	Increase
Feb.	Maintain current level	Decline

Notes: 1) Based on average monthly yield on three year Treasury bonds.
 2) Resolution at Monetary Policy Committee's sub-official meeting (Sep.19, 2001).

From the beginning of the year 2001, monetary policy actions were needed to avoid an economic slowdown, given the accentuation of the subdued trend of most major economic indicators. During the first half of the year, however, the major emphasis was placed on price stability and monetary policy was conducted prudently as inflation rose a little above the upper bound of its target range; a modest cut(25 basis points) in the overnight call rate target was therefore undertaken. The economic slowdown gathered pace from the start of the second half whereas the rate of price increases gradually slackened. Besides this, domestic and international economic uncertainties deepened, so the focus of monetary policy was placed on economic recovery, and the target call rate was reduced on three occasions by a total of 100 basis points.

<Figure III -5>

Trends of Overnight Call Rate and Yields on Treasury Bonds¹⁾



Note: 1) Three year Treasury bonds, Overnight call rate.
 Source: The Bank of Korea, The Korea Securities Dealers Association.

On January 3, 2001 the U.S. Federal Reserve, in order to counter the rapid slowing of the U.S. economy, reduced its Federal Funds target rate by 50 basis points at an extraordinary meeting of the Federal Open Markets Committee. This spurred the central banks of individual countries around the world to take a close look at business conditions and to examine the desirability of reducing interest rates. In the case of Korea, the first signs of an economic downturn had emerged in November 2000, progressively becoming more strident as the year 2001 wore on. The Bank of Korea, however, did not lower its policy rate in January and left it unchanged at 5.25%, considering that the government was intensifying the loosening of its fiscal policy stance such as bringing forward its disbursement of planned budgetary expenditures. Instead, given the possibility of a recession of the real sector, the Bank resolved to keep a close watch on the state of the

economy and announced its intention to operate interest rate policy flexibly. The Bank reduced its call rate target on February 8 by 25 basis points to the 5% level. This decision was taken because there was increasing need for action to prevent an excessive slowdown of the economy. Real economic activity had deteriorated more quickly than they had been expected, with industrial production falling for the fourth straight month since September 2000 and the growth rate of exports greatly blunted, while all surveys of consumer and business confidence pointed to a rapid evaporation of confidence. Although the financial markets displayed a pattern of increasing stabilization helped by the continued downward trends of market interest rates and the partial easing of the corporate credit squeeze, the possibility emerged that corporate cash flows would weaken during the business recession and there were concerns about the credit risk of potentially insolvent companies. During January, however, consumer prices rose by 1.1% over the end of the previous month, showing a steeply increasing trend and it was recognised that could set a limit on additional interest rate reductions.

The Bank of Korea subsequently maintained the call rate at the 5% level until June. The rationale for not making any further reductions in target call rate was based on the points set out below. Although the economic slowdown had continued, consumer confidence took a favorable turn and consumer spending had shown a stable upward trend, which caused manufacturing production to increase, thereby slowing the pace of the economic downturn. The financial markets generally had shown stable trends since the beginning of the year as market interest rates remained at a low level in the absence of any strong demand for corporate funds and the fund raising environment had improved. On the other hand, the

inflation rate continued at a high, running above the 4% upper bound of its target range due mainly to the effects of high oil prices, the depreciation of the Korean won and hikes in public service charges including those medical treatment under public health insurance since the latter half of the year 2000. Summing up, while much of the uncertainty surrounding the real economy and the financial sector had dissipated, the intensity of the upward pressures on prices was closely reflected in decision-making on interest rate policy.

During the first half of the year 2001, meanwhile most central banks including the Federal Reserve repeatedly lowered their policy rates step by step. Notably, as the U.S. Federal Reserve reduced its Federal Funds rate on 6 consecutive occasions by a total of 275 basis points, the necessity for additional cuts in the policy rate was constantly advocated in Korea. But in comparison with the U.S., there were two major differences in the Korean situation. First there was comparatively little concern over the level of price increases in the U.S., whereas, in Korea, inflation had shown a steep upward trend since the beginning of the year and had risen above the upper bound of its target range. Secondly the U.S. and EU had repeatedly increased interest rates for some time whereas interest rates had been kept low in Korea for a considerable time in order to stabilize the financial markets.¹⁾

Moving into the latter half of the year, the economic conditions at home and abroad that had constituted the back-drop against which the call rate had been kept at its existing level from February onwards began to change. The business downturn in the U.S. and other

<Table III -2>

**Trends of Policy Rate Changes in
Major Countries During**

(%)

	US	UK	Euro-area	Canada	New Zealand
Dec. 2000	6.50	6.00	4.75	5.75	6.50
Jan. 2001	6.00 ¹⁾ 5.50 ²⁾			5.50	
Feb.		5.75			
Mar.	5.00			5.00	6.25
Apr.	4.50	5.50		4.75	6.00
May	4.00	5.25	4.50	4.50	5.75
Jun.	3.75				
Jul.				4.25	
Aug.	3.50	5.00	4.25	4.00	
Sep.	3.00	4.75	3.75	3.50	5.25
Oct.	2.50	4.50		2.75	
Nov.	2.00	4.00	3.25	2.25	4.75
Dec.	1.75				

Notes: 1) Jan.3. 2) Jan.31.

Source: Central banks of individual countries and the ECB.

1) As of the end of the year 2000, the U.S. Federal Reserves's Federal Funds target rate stood at the level of 6.5%, whereas in Korea, the call rate target was 125 basis points lower at 5.25%.

advanced countries had a knock on effect on the domestic economy by way of an acceleration of the downward trend of exports and facilities investment, while trends that had appeared to be on an improvement track for some time again showed a subdued pattern. On the external front, the likelihood of an early recovery of the U.S. economy gradually receded and the European economy, which had been showing comparatively robust movements, also slowed while the Japanese economy remained mired in recession. Concern therefore mounted over the possibility of a global recession. Meanwhile the rate of price increases, which had been running slightly above the upper bounds of the inflation target, began to decelerate from early June. The factors that had been the principal contributors to the increase in prices during the first half of the year, including the depreciation of the Korean won, the rise in oil prices and the hikes in charges for public services, also weakened while upward pressures on the demand side were virtually absent, opening up the prospect that inflation would return within its target range. On July 5, the Bank of Korea therefore decided, taking the above state of affairs into account, to reduce the level of its call rate target by 25 basis points to 4.75%.

The real economy continued to deteriorate even more rapidly despite the one-time reduction in the call rate. U.S. business activity, and especially that of the information technology sector, remained in the doldrums. The accompanying economic downturn in the economies of other advanced countries and of the South East Asian countries gathered intensity. All of this caused exports and facilities investment to contract sharply in Korea. In the financial markets, although the supply of corporate funds was smooth, and market interest rates and deposit and loan rates maintained a low level, concerns over the uncertainty linked to the

structural reform of several large companies and a weakening of profitability of firms in the course of the business downturn acted as factors making for instability. The upward trend of consumer prices continued to slacken and the major factors that had a direct impact on prices, including oil prices and the exchange rate, remained stable.

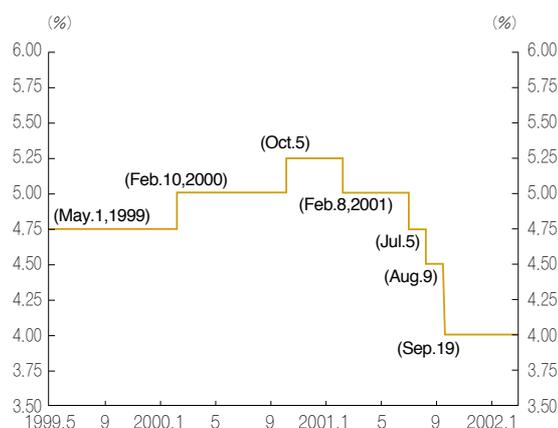
The Bank of Korea, having cut its call rate target in July, accordingly reduced it again in August by a further 25 basis points(4.75 → 4.5%). Notably, together with the call rate reduction, it lowered the Liquidity Adjustment Loans rates by 25 basis points(4.5% → 4.25%) in order to signal the accentuated action of its stance of monetary easing to the markets.

After the two consecutive cuts of target call rate in July and August, the Monetary Policy Committee decided to leave the call rate target unchanged at 4.25% at the scheduled policy meeting on September 6. In justifying its decision to do so, it pointed to the strengthening of fiscal policy measures to assist an economic recovery and to the desirability of assessing the effects on the economy of the three successive reductions in interest rate already undertaken.

With the occurrence of the terrorist attacks on the U.S. on September 11, a mood of crisis prevailed that the world economy would slide even more deeply into recession. World financial markets including the New York Stock Exchange were thrown into turmoil and central banks around the world reduced interest rates and expanded liquidity in order to assist a recovery from the crisis. The Bank of Korea announced a package of emergency measures on September 12, immediately after the tragic events, and announced its intention to deal strongly with problems that might

<Figure III -6>

Trends of Changes in Overnight Call Rate Target



Source: The Bank of Korea.

arise in the domestic financial and foreign exchange markets. On September 19, the first extraordinary meeting of the Monetary Policy Committee was convened since the 1998 revision of the Bank of Korea Act. It was resolved to reduce the call rate target by 50 basis points to 4%, and to lower the interest rate charged on its Liquidity Adjustment Loans and Aggregate Credit Ceiling Loans by 50 basis points in each case.²⁾ The Bank's 50 basis point reduction in target call rates was the largest scale adjustment since it began the active use of call rates as an operating target.

As the U.S. started raid on Afghanistan on October 7, expectations of a further reduction of the target call rate by the Bank of Korea were formed in the markets considering the uncertainty in domestic and external environments. But the Bank decided to maintain its target call rates at the 4% level on October 11. The rationale for the Bank's decision was that it had already cut target call rates several times to cope with uncertainties and that there was a need to observe closely the impact of the U.S. "War against Terrorism" on the domestic and world economy.

After the decision to maintain the target call rates unchanged at its existing level in October, certain positive changes had started to make themselves felt amid the worldwide economic depression that accompanied the "War against Terrorism". Industrial production had shifted to an upward trend and, on the demand side, consumer spending and construction investment showed continued convincing growth, while exports and facilities investment experienced a moderate narrowing of the scale of their contraction. Together with the prospect of an early conclusion of

2) Liquidity Adjustment Loans rate : 4.25% → 3.75%; Aggregate Credit Ceiling Loans rates : 3.0% → 2.5%.

the Afghanistan campaign,³⁾ business and consumer confidence, which had contracted steeply, began a gradual improvement. Consumer price inflation, which had retreated to the 3% level in September, stabilized at that level. Taking comprehensive account of these changing conditions, the Bank of Korea maintained the call rate unchanged at 4% during November and December.

Moving into 2002, exports were still subdued but consumer spending and construction investment continued their increasing trend. Meanwhile facilities investment which had contracted for 12 straight months, shifted to an upward trend. The real economy showed relatively clear signs of improvement. In addition to that, as anticipations of the likelihood of a U.S. economic recovery mounted, it was perceived that provided no unexpected calamity occurred, any further deepening of the economic recession could be avoided.

Despite factors making for price instability in the form of the rise in the exchange rate of the Korean won on the heels of the weakening of the Japanese yen, inflation fell to the central point of its target range due to the reduction in oil prices and the stability of charges for public services. In the financial markets, corporate funding conditions were comparatively calm and the markets continued to show generally stable trends. The Bank of Korea, taking these developments into consideration, decided to leave the target call rates unchanged at the 4% level in January and February 2002

3) On December 11, Al Qaeda, which had been extremely influential in the Taliban's government of Afghanistan, declared its surrender.

<Box III-2>

Operating Conditions of Interest Rate Policy During 2001

During a downturn phase of the business cycle, demand pressures remain modest and, with plenty of spare supply capacity, prices should fall. In this case a central bank normally has few worries about rising prices and can stimulate aggregate demand by lowering interest rates. During the year 2001, however, inflation rates in the Korean economy exceeded the upper bound of their target range and the downturn in business activity persisted at the same time. This created a situation in which it was very difficult to achieve the two policy goals of price stability and preventing an economic recession at the same time.

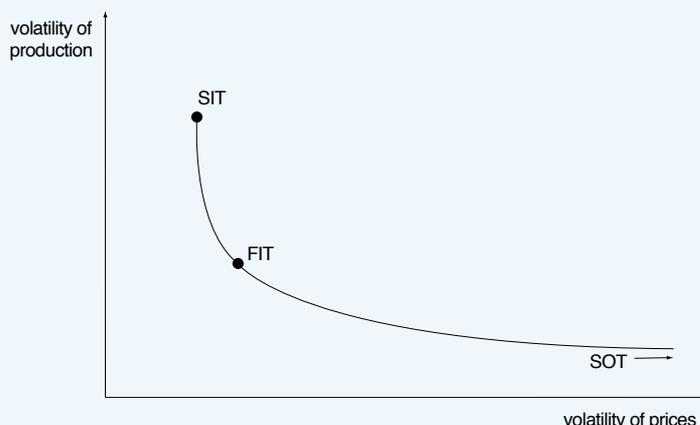
Interest Rate Policy Reaction to Economic Situations

Economic situation		Policy reaction
Economic growth	Prices	
Increasing	High	Interest rate ↑
Increasing	Low	Neutral
Decreasing	High	Dilemma
Decreasing	Low	Interest rate ↓

Confronted with conflicting policy goals, a monetary authority has to make efforts to attain the best policy option, taking into account the estimated degree of uncertainty and ensuing damage through not achieving one of its goals. Inflation targeting central banks are not exempt from this dilemma and rather than concentrating on prices alone, they struggle to achieve a reasonable compromise between prices and the level of economic activity. The rationale for this policy action is that there exists a trade-off between the volatility of price and economic activity movements, at least in the short run. So whenever the monetary authority is trying to achieve only one goal strictly, the volatility of the other goal tends to increase. On the basis of this recognition, inflation targeting central banks generally adopt flexible inflation targeting(FIT) which takes the volatility of these two variables into account appropriately, rather than strict output-gap targeting(SOT) or strict inflation targeting(SIT).*

* Independent Review of the Operation of Monetary Policy in New Zealand: Report to the Minister of Finance, Lars E.O. Svensson, February 2001.

Trade-off between Volatilities of Prices and Economic Activities



During the year 2001, the inflation targeting central banks of major countries including the European Central Bank, Australia, New Zealand and Canada placed their main focus on economic recovery and lowered their policy rates even in a situation where the inflation rate temporary exceeded its target range on the basis of this perception.

Trends of Inflation¹⁾

		(%)													
	Inflation target	Indicator	Inflation rate 2001												
			Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	year
Euro	2%이하	HICP	2.4	2.6	2.6	2.9	3.4*	3.0	2.8	2.7*	2.5*	2.4	2.1*	2.1	2.6
Australia	2~3%	CPI	-	-*	6.0*	-*	-	6.0	-	-	2.5*	-	-	3.1*	4.4
New Zealand	0~3%	CPI	-	-	3.1*	-*	-*	3.2	-	-	2.4*	-	-*	1.8	2.6
Canada	1~3%	CPI	3.0*	2.9	2.5*	3.6*	3.9*	3.3	2.6*	2.8*	2.6*	1.9*	0.7*	0.7	2.5

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

2) * indicates the month when policy rates were reduced.

Source: Individual central banks.

3. Money supply

From 2001 onwards the Bank of Korea changed its use of the monetary aggregate from the intermediate target, as which it had been managed for some considerable time, to a monitoring indicator.⁴⁾ In accordance with this change, liquidity was supplied at that level consistent with money demand that would maintain the call rate at its target level. Flexible adjustment was however made to the supply of liquidity where necessary in consideration of changes in the corporate demand for funds and portfolio shifts within the financial sector.

The growth of the reserve base(on an annual average basis) which had reached 20% during the year 2000, slowed relatively sharply to stand at 11.5%. The reasons for this were that the demand for funds was not particularly substantial as the business slowdown and the rate of increase of banks' payment reserve deposits were curbed due to a larger migration of funds into non-bank financial institutions' products whose yields were based on actual performance as bank deposit rates fell in contrast to the previous year.

The growth rate of broad money(M3) had stood at only 5.6% in the year 2000, but with the recovery of the role of non-bank financial institutions such as investment trust companies in the intermediation of funds, it rose to the 8% level in the first half of the year and to the 10% level during the latter half, registering 9.6% for the year as a whole. It showed a comparatively stable range of movements within its established monitoring range(6%-10%).

4) In the event of the monetary aggregate exceeding its target range, the Bank of Korea will not act immediately, as it would have done when it was employed as its mid-term target, but instead examine carefully the reason for its acceleration beyond its target range.

<Table III -3>
Trends of Base Money¹⁾

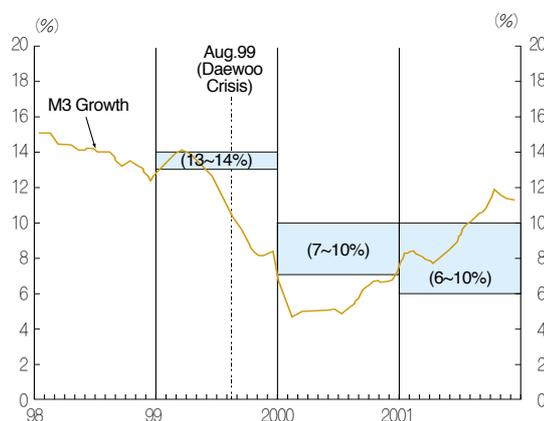
	(hundred million won, %)		
	2000	2001	2002.Jan.~Feb.
Base money	263,570 (20.0)	293,759 (11.5)	330,087 (13.5)
Currency in circulation	149,950 (12.2)	163,835 (9.6)	184,962 (10.5)
Total reserve deposits	113,620 (32.1)	129,924 (14.0)	145,125 (17.6)

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

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

Source: The Bank of Korea.

<Figure III -7>
Trends of M3 Growth Rate and Monitoring Ranges¹⁾



Note: 1) Intermediate target range for 1999 and 2000.

Source: The Bank of Korea.

The Bank of Korea adjusted market liquidity appropriately by way of routine open market operations and acted firmly to counter the emergence of factors making for financial market instability. In April when the bond market was disturbed by the sharp increase in the redemption of MMFs, it cancelled its scheduled sale of maturing RPs(4.6 trillion won) and took positive action to stabilize the market through the net redemption of Monetary Stabilization Bonds(MSBs, 3.7 trillion won). Immediately after the events of September 11, it ensured that banks had surplus payment reserves through open market operations and moved swiftly to counter any seizing-up of the financial markets by, for example, flexibly adjusting the scale and timing of its issue of MSBs with an eye to market conditions. Additionally from mid-November onwards as the markets became increasingly unsettled with bond market interest rates shooting up sharply in the short period of time, it carried out a redemption of MSBs before their maturity to the value of 1 trillion won and engaged in outright purchases of government and public bonds.

<Table III -4>

MSB Issuance · Interest Payments · Base Money Supply from Foreign Sector

	(billion won)				
	1997	1998	1999	2000	2001
MSBs outstanding ¹⁾	23,475	45,673	51,489	66,378	79,121
(Changes)	(-1,555)	(22,198)	(5,816)	(14,889)	(12,743)
MSB interest payment ²⁾	2,725	4,841	3,799	4,666	4,873
Base money supply from foreign sector ¹⁾	15,241	38,139	73,711	110,179	131,408

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

With the continuance of a surplus position on the current account and inflows of foreign funds for direct and portfolio investment during the year 2001, the foreign sector again served as a conduit of money supply, the greater part of which was absorbed through the issue of MSBs. It should also be pointed out that it was highly desirable to manage at an appropriate level the expansion of liquidity supplied through the Bank of Korea's raising of the Aggregate Credit Ceiling(4 trillion won) and the government's disbursement of its additional budgets. As a result of these exercises, as of the end of the year 2001, MSBs outstanding rose by 12.7 trillion won from the end of the year 2000 to reach 79.1 trillion won. Interest expenses on them consequently stood at around 5 trillion won for the year 2001.

4. Credit Policy

(Strengthening Incentives for Banks to Expand Credit to the Corporate Sector)

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

Initially, the size of the Aggregate Credit Ceiling, which had been set at 7.6 trillion won from September 1998, was increased by 2 trillion won to 9.6 trillion won from January 2001. This action was undertaken with a view to resolving the bottleneck in fund-raising being experienced by SMEs following measures to close down the operation of some mutual credit facilities at a time when several leading enterprises were still experiencing a credit squeeze, despite the announcements of the findings of the credit assessment of potentially insolvent enterprises on November 3, 2000.

In September 2001, the Aggregate Credit Ceiling facility was increased by an additional 2 trillion won(9.6 trillion won → 11.6 trillion won) to counter worries of a reduction in financial institutions' supply of corporate credit following the events of September 11. The loan rates on this facility were also reduced by 50 basis points(3% → 2.5%) with a view to lessening the burden of companies' financial expenses.

As well as expanding the scale of its Aggregate Credit Ceiling facility, the Bank changed the method of its quota allocation in order to encourage banks to provide more funds to the corporate sector than to households.

<Table III -5>

Trends of Aggregate Credit Ceiling and its Interest Rates

(trillion won, annual %)

	Dec.97~	Mar.98~	Sep.98~	Jan.2001~	Sep.2001~
Credit ceiling	4.6	5.6	7.6	9.6	11.6
Interest rates	5.0	5.0	3.0	3.0	2.5

Source: The Bank of Korea.

This was because during 2001 banks were accelerating the operation of their funds with a focus on expanding household lending, the credit risk on which is comparatively low.

In this connection, from March 2001, quota allocation methods were adjusted so as to reflect the performance in lending to large enterprises(excluding the top four business groups) and purchases of corporate bonds and commercial paper. Considering, nonetheless, the desirability of limiting the scope of eligibility for lending under this facility to SMEs the revised method of allocation was made effective for a period of one year only. In line with these guidelines, the revised method was terminated from March 2002, but banks' perform in purchasing the corporate bonds and commercial paper issued by SMEs continued to be reflected in allocation. On the other hand, from March 2002 onwards, the Bank heightened its preferential quota for credit based lending to SMEs whereas it reduced the quota for banks that increased household lending.⁵⁾

The Bank of Korea also sought to heighten industrial competitiveness through the efficient operation of the Aggregate Credit Ceiling Loans scheme. From June 2001, exports of products⁶⁾ in electronic form via the Internet also became eligible for trade finance support from the Bank. In addition to that, from August, the Bank changed its post hoc management basis for maintaining the ratio of lending to SMEs, encouraging banks to expand their lending to entities involved in construction of social overhead capital(SOC).

5) The preferential weight given to credit based loans to SMEs was increased from its previous 30% to 40% while the negative weight given to household sector loans was increased from 40% to 60%.

6) Software, entertainment and leisure items(games, animation cartoons, characters), sound, audio products, electronic books, databases, etc.

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

(Encouraging the Use of the Bill Substitution Scheme)

Efforts were continued to promote advanced settlement practises in commercial transactions by reducing the use of commercial bills in the form of post-dated promissory notes.

Positive action was taken to encourage the more widespread use of the Corporate Procurement Loans system, use of which had already been increasing rapidly since its introduction in May 2000. In this context, from April 2001, the amount set aside under the Aggregate Credit Ceiling for banks providing loans for corporate procurement was increased by 0.5 trillion won (2 trillion won → 2.5 trillion won) and in July, it was increased by an additional 0.5 trillion won to a total of 3 trillion won. As the operating performance of financial institutions in extending Corporate Procurement Loans continued to improve, following the series of increments in the provision for them under the Aggregate Credit Ceiling, the Bank raised its allocation for their support step by step so as to provide refinancing funds against 50% of financial institutions' extension of such loans. From February 2002, an amount of 4.3 trillion was established under the Aggregate Credit Ceiling for the support of Corporate

Procurement Loans and, within this overall ceiling, quotas were allocated to individual banks.

The major drawback to the scheme was that companies belonging to the top 30 business groups had difficulties in making use of the Corporate Procurement Loans system because of the prudential regulation ceiling on credit to a single borrower(or single business group). In recognition of this the Bank introduced in February 2001 a system of Electronically-processed Secured Receivables Loans. A supplier takes out a loan secured against sales on credit receivables, enabling it to receive the proceeds of the sale in cash, with the loan being redeemed by the supplier. In addition, in order to encourage the adoption of the system it was included among the objects eligible for refinancing support under the Aggregate Credit Ceiling.

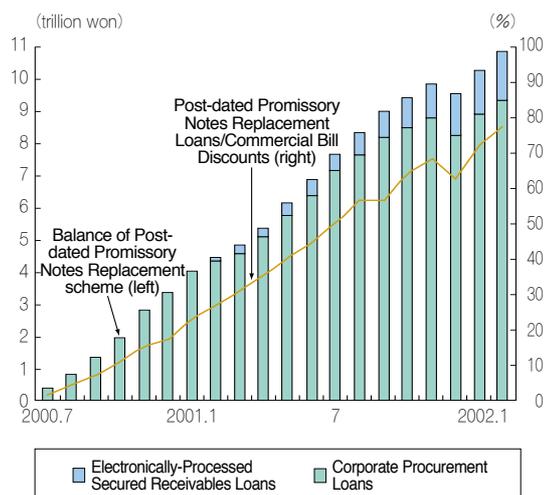
In parallel with its introduction of the loan systems to reduce the use of bills, the Bank gradually phased back its support under the Aggregate Credit Ceiling for the discount of commercial bills. Specifically, from July 2001, it reduced from 100% to 80% the performance recognition ratio for the discount of commercial bills when calculating individual banks' quotas under the Aggregate Credit Ceiling and from February 2002, this figure was further reduced to 70%.

In order to spread public awareness of the loan systems to replace bills, the Bank stepped up its public information activities. During July and August 2001, the Bank's regional branches held forums to explain the workings of the new loan systems in replacement of corporate bills. These were held in 13 districts with the participation of 874 companies. In January and February 2002, public information activities concerning the details of the systems were staged in principal cities across the country at joint forums also

held to explain the government’s support measures for SMEs.

<Figure III -8>

Trends in Post-dated Promissory Notes Replacement Loans¹⁾ Extension



Note: 1) Corporate procurement loans plus electronically-processed secured receivables loans.

Source: The Bank of Korea.

Thanks to these initiatives, there has been a large increase in the use of the systems of Corporate Procurement Loans and Electronically-processed Secured Receivables Loans. Meanwhile, the discount of commercial bills has seen a continuing downward trend. The amount of outstanding commercial bills dropped from 18.5 trillion won in June 2000, when the bill substitution scheme was introduced, to 14.1 trillion won in February 2002. In contrast as of the end of February 2002, the total amount of outstanding loans under the scheme to phase out bills stood at 10.9 trillion won, equivalent to 77.4% of total discounts of commercial bills. It is considered that corporate cash flow will be improved through the advances in settlement practises for commercial transactions between companies by virtue of the rapid advance in the substitution of cash settlement for settlement by means of bills.

5. Monetary Policy Instruments

The Bank of Korea intensified its endeavors to consolidate the role of the central bank lending system in promoting financial stability while at the same time heightening the transparency and credibility of monetary policy. It also increased its efforts in the gathering and checking of on-the-spot information about financial institutions.

(Strengthening the Role of the Central Bank's Lending System in Supporting Financial Stability)

The system of Liquidity Adjustment Loans, which was introduced in June 2000, as well as increasing the central bank's ability to give appropriate signals to the market concerning the direction of monetary policy, has the function of assisting financial stability by way of the prompt provision of credit to temporarily illiquid banks. In the course of the year 2001, emphasis was placed on the active employment of the signalling functions of the Liquidity Adjustment Loans system and giving force to its role in financial stability.

From January 2001 the overall ceiling on Liquidity Adjustment Loans was raised by 1 trillion won (2 trillion won → 3 trillion won). In the course of the year, moreover, along with the four reductions in the target call rate, the interest rate on this facility was lowered on two occasions (August and September), signalling even more clearly the central bank's easing of its monetary policy stance to the financial markets.

With a view to enhancing the stability and efficiency of the payments system, the ceiling on Daylight Overdrafts was raised and the range of securities eligible as collateral was enlarged. From June 2001 the

<Table III -6>

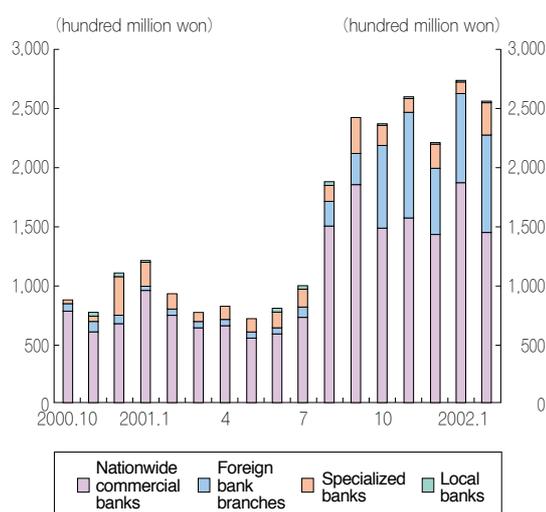
Status of Loan System of the Bank of Korea

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

Source: The Bank of Korea.

<Figure III -9>

Use of Daylight Overdraft Loans¹⁾



Note: 1) Based on daily average balance.
Source: The Bank of Korea.

ceiling on the Daylight Overdraft facility was raised from 100% of a commercial bank’s average current account balance held with the Bank of Korea to 200% of it, with an additional special ceiling also being set in the light of the applicant’s loan history. The range of securities eligible as collateral was widened to include government guaranteed bonds in addition to the existing government and public bonds and MSBs in a move intended to assist the frictionless operation of the payment and settlement systems.

Looking at the operating performance of Daylight Overdrafts, from 110 billion won in December 2000 just after the system’s introduction, the daily average performance more than doubled to reach 221 billion won in December 2001. In addition the number of banks placed in a queue for settlement almost halved on a daily average basis from 10 just prior to the system’s introduction(September 2000) to 5.2 during the year 2001.

(Heightening the Transparency and Credibility of Monetary Policy)

The Bank of Korea strove to augment the credibility and transparency of its monetary policy and to broaden popular understanding of its conduct of policy.

A press conference is held every month just after the policy setting meeting of the Monetary Policy Committee and briefing materials are distributed so as to provide a succinct explanation of the details of the policy decisions taken and the background to them.

From the year 2001, an English language version of the “Monetary Policy Report” presented to the National Assembly has been published and distributed to relevant institutions abroad with a view to widening the

understanding of Korean monetary policy. In a similar move, a book entitled “Monetary Policy in Korea” was published in Korean and distributed. This work was written to foster a clearer grasp and more detailed understanding among the general public and those operating in the financial industry of the changes that have taken place in monetary policy since the currency crisis, including the adoption of an inflation targeting system and employment of market-oriented methods of policy operation that give emphasis to interest rates.

In June 2001 the “Bank of Korea Museum” was opened with a view to encouraging a greater understanding among the general public of monetary policy and the cultural features of currency, along with the importance of price stability for the development of the national economy. In the period from its opening to the end of February 2002, the museum was visited by a total of 32,600 people(daily average 185 persons). Apart from this, the Bank provided up-to-date information on materials concerning monetary policy and the general economy by means of its Internet homepage and its economic tutorials. Since its Internet homepage was first put up(December 1997) it has received a total of 4.5 million hits as of February 2002. In all, 82 economic tutorials have been held since the first in May 1995.

(Strengthening Examination of the Management Performance of Financial Institutions)

For the more efficient conduct of monetary policy and stable financial markets, that Bank of Korea strengthened its efforts to gather on site information concerning financial institutions and to check their management performance.

In this connection, the number of financial institutions that underwent joint examinations was greatly

<Table III -7>

Status of Implementation of Joint Examinations

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

Source: The Bank of Korea.

expanded. In the course of the year 2000, these were held at only three banks, but this number was increased to thirteen in the course of the year 2001,⁷⁾ and branches of foreign banks were also the object of examinations. By these means, detailed and accurate on-site information was gathered for use in the conduct of monetary policy. At the same time, it can be confirmed that various monetary policy measures have been carried out appropriately. In the case of banks that were not the subject of joint examinations, the policy was put in place of receiving regular reports on examination findings from the Financial Supervisory Service.⁸⁾

The Bank endeavors to carry out rigorous analysis of the management performance of financial institutions, and the results of this analysis serve as a reference for the formulation and conduct of its monetary policy. It evaluates the management status of individual banks and forecasts the soundness of their management in future. A quarterly survey is held on banks' loans status, and information is gathered and analysed concerning future lending attitudes, the demand for loans and the possibility of a credit squeeze arising.

The Bank participated actively in the task of setting common international supervisory standards such as the new BIS capital adequacy standards. These are expected to be introduced in the year 2005. The Bank has forcefully stated its opinion that efforts should be made to avoid domestic financial institutions losing out because of differences between the financial environments of various countries.

7) In January and February 2002 joint examinations were carried out on two banks (Korea First Bank and Tokyo Mitsubishi).

8) In the course of 2001 reports on examination findings of 12 banks were received from the Financial Supervisory Service and these were put to use.

(Spread of Electronic Payment systems and the Strengthening of Security)

With the spread of electronic transactions the Bank of Korea sought to develop and popularise electronic payment and settlement systems. At the same time, it strove to augment the security and efficiency of payments and settlement systems.

The Bank extended the range of uses of electronic currency, K-CASH. In addition to that, from April 2001, an “Electronic Banking System” was newly introduced by which payment transfers can be made through phone or Internet 24 hours a day. In June 2001, an “Electronic Bill Presentment and Payment System” was also constructed that allows the electronic collection of taxes and other public levies. Meanwhile, work is proceeding on the development and widespread entry into general use of similar electronic payment and settlement systems.

In March 2001 with the improvement of the system of adjustment of funds between banks using the Interbank CD · Funds Transfer · Shared Network System,⁹⁾ the credit risk arising from net settlement was reduced while at the same time the burden on banks of raising funds for settlement was eased. From August, in order to reduce settlement risk arising from interbank net settlements, the value of securities collateral that banks participating in net settlement systems had to deposit with the Bank of Korea was adjusted upwards.¹⁰⁾ In October with the expansion¹¹⁾ of DVP(Delivery Versus

<Table III -8>

Settlements Handled by BOK-Wire

(Unit, billion won)

	2000 (a)	2001 (b)	changes(%) (b/a - 1) × 100
<Volume>			
Domestic Currency Funds Transfers	4,093 (85.8)	4,521 (85.8)	10.5
(Gross Settlement)	3,300 (69.2)	3,727 (70.7)	12.9
(Net Settlement)	793 (16.6)	794 (15.1)	0.1
Treasury Funds Transfers	625 (13.1)	702 (13.3)	12.3
BOK Loans and Discounts	37 (0.8)	35 (0.7)	-5.4
Government and Public Bonds	13 (0.3)	11 (0.2)	-15.4
Total	4,768(100.0)	5,269(100.0)	10.5
Foreign Currency Funds Transfers	10 (-)	9 (-)	-10.0
<Value>			
Domestic Currency Funds Transfers	61,077 (95.6)	72,504 (96.0)	18.7
(Gross Settlement)	48,962 (76.7)	60,047 (79.5)	22.6
(Net Settlement)	12,115 (19.0)	12,457 (16.5)	2.8
Treasury Funds Transfers	1,459 (2.3)	1,636 (2.2)	12.1
BOK Loans and Discounts	637 (1.0)	796 (1.1)	25.0
Government and Public Bonds	694 (1.1)	612 (0.8)	-11.8
Total	63,867(100.0)	75,548(100.0)	18.3
Foreign Currency Funds Transfers (million US)	97 (-)	113 (-)	16.5

Notes: 1) Daily Average.

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

Source: The Bank of Korea.

9) The method of adjusting funds for net settlement was improved from that of adjusting the disparity between the cumulated outstanding of funds to that of the calculation of the interest.

10) Raised from 10% to 20% of the net debit cap.

11) To the previous DVP transactions involving the settlement of over-the-counter bonds and bonds that are the object of RP transactions were added those between institutional investors arising from share transactions on the Korea Stock Exchange and the KOSDAQ market.

Payment) transactions involving the payment and simultaneous delivery of securities through BOK Wire, settlement risk arising from securities settlement transactions was greatly reduced. In November, a backup centre was constructed for the BOK-Wire to deal with emergencies such as system failures or disasters, thus reinforcing the security of the large value gross payments system. Apart from this, the Regulation on the Operation and Management of Payments Systems was established (with effect from February 2002), providing a basis for the Bank to give directions or make recommendations to institutions of operating payment systems and their participant institutions.

In order to raise the efficiency of payment systems, from July 2001, the period allowed for queuing for the transfer of payment between financial institutions through BOK-Wire was shortened to one hour in order to achieve seamless settlement of large value fund transactions. From February 2002 customers of small-scale financial institutions such as mutual credit facilities, credit cooperative associations, credit unions and New Community credit cooperative associations were allowed to make use under the same conditions as bank customers of the Giro System and Interbank CD · Funds Transfer · Shared Network System, as part of efforts to heighten the efficiency of small value payment systems.