

IV . Monetary Policy for 2002

1. Environment

A. World Economy

In the course of the past year, the Korean economy experienced comparatively favourable growth thanks to domestic demand particularly in the form of consumer spending and construction investment, even though in common with the rest of the world it was affected by the slowdown of the global economy. However the recovery of overseas demand is very important for a small open economy like that of Korea if it is to enjoy sustainable economic growth. Fortunately, from the latter half of this year onwards, the world economy, and particularly the U.S., is expected to see a smooth recovery trend, which will, it is anticipated, have a positive effect on the Korean economy.

The principal U.S. economic indicators have exhibited an improved pattern since the beginning of the year, and anticipations of economic recovery have gradually mounted. In reflection of this, optimism prevails concerning the future of the U.S. economy. There is, however a mood of prudence evident in regard to the strength of that recovery. The optimism is fuelled by the increasingly evident signs that the expansionary macro-economic policies coordinated by the Federal Reserve and the U.S. Government are taking effect. It also appears likely that the IT sector's over-capacity will be resolved more quickly than expected thanks to the speed of technological innovation and the distinctively short product life cycle of IT sector

products. Since early this year all indicators relating to the real economy have shown a favourable evolution, and this provides evidence to support the optimism. The discontinuance by the Federal Reserve in January 2002 of its 12 month long course of continued interest rate reductions has also heightened anticipations of economic resurgence.

Cautious observers, however, point out that a full fledged recovery of the U.S. economy may be hampered by the over borrowing of the household sector, the weakening of corporate profitability and the loss of corporate credibility in the wake of the Enron scandal.

Putting these various prognoses together, we can say that there is a great likelihood of a gradual recovery of the U.S. economy, but that its speed and strength will be relatively modest compared to the long sustained economic boom of the 1990s.

After registering negative growth in the previous year, the Japanese economy has seen a turn for the better in several economic indicators since the beginning of the year 2002, but the factors making for instability have not yet been completely dealt with. Because of the protracted economic downturn, the number of corporate bankruptcies has increased, and consumer and business confidence remain at a very low ebb with the continuing instability of employment conditions. A latent mood of instability pervades the financial world as a consequence of the delay in tackling the most pressing question facing the Japanese economy, the resolution of the financial sector's bad loans. The fact that a number of macro economic stimulus packages have been almost without effect in their attempts to revitalize the economy by way of zero interest rates and deficit spending has also become a factor

increasing the uncertainty surrounding the Japanese economy.

The euro area economy appears to be gradually moving onto a recovery track, thanks to the lowering of interest rates and reductions in income tax together with the effect of the U.S. recovery. The pace of the recovery is expected to be rather gentle in view of the sluggishness of the German economy, the region's largest and most important.

The Chinese economy is gradually increasing its share in world trade, spurred on by the country's accession to the World Trade Organization(WTO). It is expected to maintain its robust growth trend during the year 2002 on the basis of domestic demand. China's entry to the WTO, it should be noted, implies the prospect of an expansion of market opening and a large increase in the scale of its trade.

International oil prices, meanwhile, are seen to remain comparatively stable in spite of the decision by the Organization of Petroleum Exporting Countries (OPEC) to reduce production. The demand for oil will expand with the recovery of the global economy, but the strength of the recovery of economic activity is not seen likely to be so high as to bring a large increase in oil prices. Major forecasting organizations predict that the price of oil will remain somewhere around 20 dollars per barrel. With the proposed escalation of the "War against Terrorism," the possibility has emerged of a sharp rise in oil prices.

The Japanese yen will show a pattern of fluctuations in line with anticipations of Japanese economic recovery, but it is expected to continue its generally weak tone in the absence of any major improvement in the macro-economic environment.

**<Table IV -1>
Prospects for International Oil Prices in 2002**

| | (period average, U\$/barrel) | | |
|------------------------------|------------------------------|-------------|------|
| | first half | second half | year |
| U.S. EIA ¹⁾ | 18.6 | 21.3 | 19.9 |
| Morgan Stanley ²⁾ | 21.8 | 24.5 | 23.5 |
| EIU ²⁾ | 22.0 | 21.0 | 20.5 |
| OEF ²⁾ | 20.1 | 21.1 | 20.6 |

Notes: 1) Based on U.S. oil company import prices.

2) Brent crude.

Source: U.S. Energy Information Administration(EIA, Jan. 2002), Morgan Stanley(Nov. 2001), The Economist Intelligence Unit (Oct. 2001), Oxford Economic Forecasting(Dec. 2001).

The euro, whose entry into circulation as legal tender from January 1 this year passed off smoothly, may be expected to show a somewhat stronger trend in future, once signs of an economic recovery become evident.

B. Domestic Economy

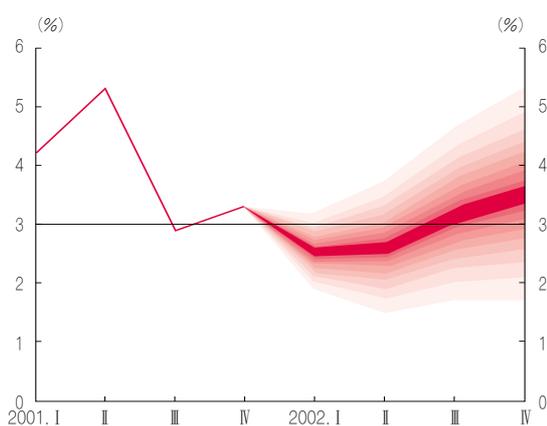
The Korean economy should see an acceleration of growth during the year 2002 on the basis of the improved conditions both at home and abroad. In December 2001 the Bank of Korea issued a forecast putting the GDP growth rate at 3.9% in view of the gradual recovery of the U.S. economy and the stability of international oil prices. But with the more rapid than expected recovery of domestic demand in the early months of this year and the stirrings of an early U.S. business recovery, there is the likelihood of economic growth coming in higher than the rate originally forecast.¹⁾

On the prices front, the rate of price increases is expected to be somewhat lower than last year's with the stable trend of prices being maintained until at least midway through the year thanks to the surplus in supply capacity, which should offset the effects of the economic upswing. It should also be pointed out that there are few factors present such as the sharp rise in charges for treatment under public health insurance and public utility charges, which were increased so steeply last year. Meanwhile the lowering of charges for mobile phones and the use of piped natural gas should serve as a factor acting to lower the rate of price increases. Nevertheless there are latent factors present making for an increase in prices. These include the run

1) Actually the Bank revised its economic forecast in April 2002 and it is expected that annual GDP growth will stand at around the 5.7 % level.

<Figure IV-1>

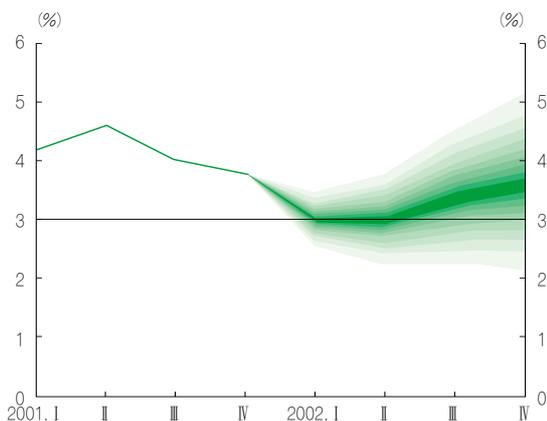
CPI Inflation Projection



Source: The Bank of Korea.

<Figure IV-2>

Core Inflation Projection



Source: The Bank of Korea.

up in real estate prices, the possibility of the Japanese yen’s weakness, the prospect of a surge in oil prices in the event of an escalation of the “War against Terrorism”, and a climate of social unrest generated by the holding of presidential and local elections and the staging of international sporting events.

This year’s expected inflation channel is depicted in the form of a fan chart of Figures IV-1 and IV-2 in which not only the inflation forecast but also the degree of uncertainty associated with it are shown. In this year’s forecasts for consumer prices and core inflation, upward bias is apparent along with the basic forecast.

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

Exports have continued to slow for some time in view of the worldwide economic downturn. Aided by the upward trend of the prices of major export items, and especially semiconductors, the signs of an improvement in the IT industry, and anticipations of an economic recovery in major countries including the U.S., exports appear set to move to a gradually increasing trend early in the second half of the year. There are nevertheless factors present which are expected to act to restrict exports. These include the possibility of additional weakening of the Japanese yen, the U.S. decision to impose a high rate of tariffs on imports of steel products, and the recent intensification of competition between Korean products and those of other East Asian countries.

During the first half of the year, imports are seen to decrease, but from July onwards with the recovery of domestic and export demand, they are likely to show a comparatively steep rate of increase, driven by imports of capital goods such as machine tools. Oil imports, however, are expected to fall in value terms compared to last year in view of the reduction in unit values brought about by the downward stability of oil prices.

<Box IV-1>

What are Inflation Fan Charts and How are They Drawn?

1. Meaning of inflation fan charts

In the last few years, the central banks of the UK, Sweden and other major inflation targeting countries have compiled and published fan charts* that present in an objective manner not just inflation forecasts but the degree of uncertainty associated with them, expressed in the form of a probability distribution. The purpose of presenting fan charts is to dispel market uncertainty concerning the future course of monetary policy and to build up its credibility by providing a clearer and more detailed explanation of the monetary authority's view concerning the outlook for inflation, which is selected as the policy target.

* The Bank of England first began to publish its forecast path for inflation in the form of a fan chart in February 1996. Subsequently, Sweden, Brazil, Chile, Thailand and the central banks of other countries that have adopted inflation targeting have begun to present their forecasts for the course of inflation and GDP growth in the form of a fan chart.

2. How fan charts are drawn

In order to construct a fan chart showing the probability distribution concerning the inflation forecast, it is first necessary to decide the central projection(central forecast), the range of the probability distribution (dispersion of the degrees of uncertainty) and the degree of asymmetry(direction of the uncertainty).

It is first assumed that the monetary policy stance remains unchanged from its current position. The forecast level of inflation which has the greatest chance of being attained(the mode) is then established using a variety of forecasting techniques including statistical models of the economy(econometric models) to incorporate all types of information concerning domestic and external economic conditions.

An overall assessment is then arrived at for the range of the probability distribution of the inflation forecast using stochastic simulation of the econometric model in an iterative procedure to obtain the forecast error, which is then compared with previous actual forecast errors and the future degree of uncertainty compared with that in the past.

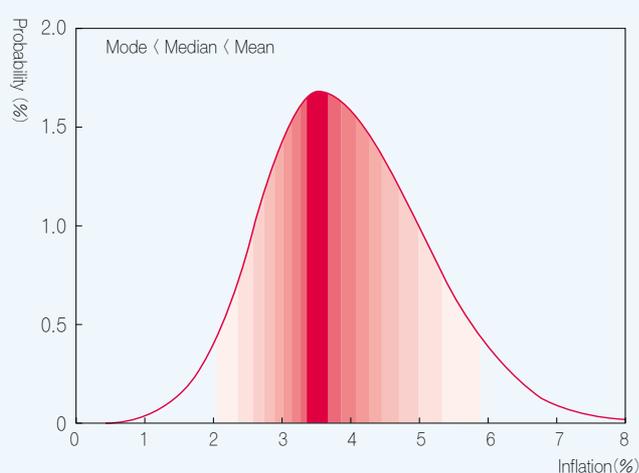
A judgment must then be made as to the degree to which the possibility that inflation will be higher than its central projection is greater than the possibility that it will be lower, so that it can be decided whether the distribution of forecast probabilities is symmetrical or whether it is skewed upward or downward. For example in this year's inflation forecast it was assumed that the world economy would show an improvement during the latter half of the year while there was still the possibility of an earlier economic recovery. If the possibility of

an earlier recovery of the world economy was greater than the possibility that the economic recovery might be delayed, then this would create greater upward pressure on prices than originally expected and, taking this into account, the distribution of probabilities for inflation would be biased upward in an asymmetric pattern. The degree of this asymmetry(skewness)* denotes the upside or downside risk that it was decided from an overall assessment that the principal factors influencing inflation represented. As shown below <Figure 1> where the central inflation forecast(mode) is lower than the mean, the fan chart <Figure 2> shows a wider upward scatter of probabilities.

* Skewness, which shows the degree of asymmetry of the probability distribution of inflation, can be expressed as follows; skewness = (mean - mode) / standard error

<Figure 1>

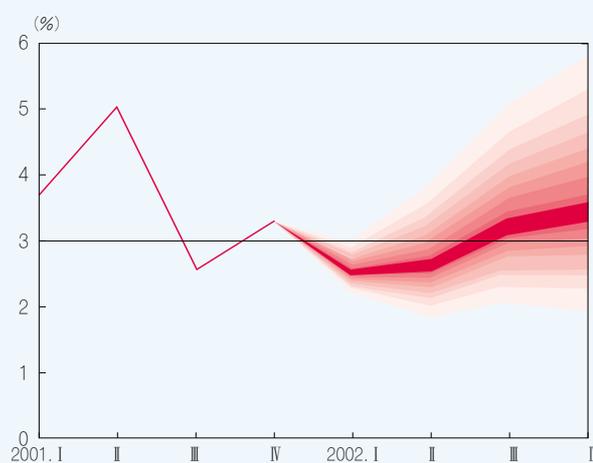
Probability Distribution of Inflation¹⁾ (example)



Note: 1) Probability distribution of inflation forecasts for 2002 IV

<Figure 2>

Inflation Projection (example)



3. Interpreting fan charts

Just as contour lines and shading on the map show height, the density of the probability range concerning the inflation forecast is shown by the darkness of the bands on a fan chart. The central projection for inflation is included in the middle band. Above and below this, the shading lightens, with the range of probabilities being divided into 9 patterns of shading and 17 bands. The fan chart as a whole covers 90% of the probability range. Each pair of bands with the same density of shading represents a 10% probability that the actual inflation rate will be within them.

2. Monetary Policy Direction

During the course of 2002 monetary policy will be conducted flexibly, taking care that upward pressures on prices do not become too large, and taking into overall account the trend of economic recovery and the status of financial markets.

A. Inflation Target

For the year 2002 the inflation target(annual average basis in terms of core inflation) was established in consultation with government, and set at the same level as the previous year at $3\pm 1\%$. Furthermore, in order to restrain inflationary expectations and heighten the consistency of monetary policy, the medium term inflation target was maintained at 2.5%.

Provided no unforeseen factors arise, price rises should remain stable within the target range. Thoroughgoing measures will however be needed to keep in check potential pressures making for price instability, including the rise of some real estate prices.

In consideration of this point the Bank of Korea will devote its policy endeavors to ensuring that the annual inflation target is achieved and, moreover, that from next year onwards, the rate of price increases converges on the medium term inflation target. It is meanwhile considered desirable for the effectiveness of monetary policy to improve the method of operation of the inflation targeting system from the current method of setting a target annually. This is because it is not reasonable to establish and seek to achieve an annual inflation target within a one year policy horizon in view of the considerable time lag before the effects of

changes in monetary policy feed through to prices and the level of business activity. It has become general for most inflation targeting countries to opt to achieve it over the medium term.

Set out below is a discussion of the prospects for price movements from the year 2003 onwards, in relation to the establishment and operation of the medium term target.

First of all, in the year 2003, the recovery trend of the global economy that should set in from the summer of 2002 is expected to become more clearly marked, with rates of growth and of the expansion of world trade both increasing more rapidly. Providing the world economy shows this pattern of recovery, the Korean economy should see an acceleration of the growth of exports, together with the continued expansion of domestic demand. Together these should almost completely solve the problem of surplus capacity, and there is a possibility of excess demand pressures emerging.

On the cost front, the prices of oil and other raw materials are expected to be higher than in the current year because of the increase in world demand. Domestically, there is the possibility of a renewal of the high pace of increases in charges for public services while wages may show an upward trend amid the recovery in business activity.

Taking overall account of these domestic and overseas conditions, if the current stance of monetary policy is maintained, the upward trend of prices that is likely to become evident in the latter half of the year 2002 will be continued in the year 2003. There are therefore grounds for concern that the annual average rate of inflation may be higher in the year 2003 than in the current year 2002.

<Box IV-2>

Time Horizon of Inflation Targeting

For those countries that have selected a system of inflation targeting, the length of the time horizon that should be established is very important for the success of that system. Among the 19 countries from around the world that have opted for inflation targeting, only six countries including Korea operate under a short term time horizon of one year. Such a system has several shortcomings which are described below.

Central banks that target the monetary aggregate or the exchange rate have a comparatively high degree of control over these variables. In the case of the inflation target, control of prices is very difficult because there is a considerable time lag before the effects of monetary policy can be confirmed through price movements, quite apart the great variability of the lag involved. Where there is only a short term time horizon for the inflation target, the central bank's capacity to control prices is limited as, in many cases, price movements within in this term are not always seen as a result of the operation of monetary policy within it. In addition, in the case of a small open economy such as Korea's, changes in oil prices and the exchange rate and other external shocks translate on the cost side into very large pressures for price rises without any time lag, which makes it very difficult for the central bank to achieve an inflation target operated under a short term time horizon. Accordingly, even though ongoing monetary policy is operated appropriately with a view to the medium to long-term horizon it fails to achieve the short term inflation target, which may harm the credibility of central bank's monetary policy among general public.

A number of economists point out that another shortcoming of inflation targeting is that it calls for rigid application of rules for the monetary authority to follow, which may restrict its flexible policy reactions to counter with future uncertainties. For example, economic uncertainties are realized when, as last year, there is a worldwide economic recession along with the occurrence of events such as the terrorist attacks on the U.S., which cannot be predicted beforehand. Even though the monetary authority needs to act flexibly to counter the problem in such a situation, because it is bound by its fundamental rule of achieving the inflation target that has been established, there is a high probability that it will operate monetary policy in a rigid fashion. The shorter the time horizon of inflation targeting, the more likely is such a scenario.

What is more, even when the inflation target is achieved under a short term time horizon the instruments of monetary policy including the policy interest rate and the exchange rate will be highly unstable. In particular, in a small open economy which establishes and operates a short term inflation target, there is a high possibility of reliance on short term exchange rate manipulation because of the greater ease with which the inflation target can be achieved by adjusting import prices through exchange rate manipulation rather than by changes in interest rates.

In order to overcome the problems posed by the operation of the inflation target under a short term policy horizon, four alternatives can be proposed: ① An exemption clause waiving sanctions on the monetary authority in the event of failure to achieve the inflation target; ② Widening the range of the inflation target; ③

Establishing the target in terms of core inflation; or ④ Extending the time horizon of the target to the medium or long-term. With a view to the credibility and accountability of monetary policy, extending the time horizon to a period approaching that of the time lag during which the effects of monetary policy are transmitted to prices and the rest of the real economy is considered to be the optimum method.*

* Mishkin · Schmidt-Hebbel, “One Decade of Inflation Targeting in the World”, NBER Working Paper, No. 8397, July 2001.

Although it is true that it is desirable to set a medium to long-term time horizon for the inflation target, in countries that are experiencing a high rate of inflation, a target in terms of one year units may be established. As the level of the target is ratcheted down and prices stabilize to some degree, the time horizon is lengthened.

Operations of Inflation Targeting

| Country | Date of adoption | Indicator | Target range ¹⁾ | Target horizon |
|--------------|------------------|--------------------|---|--|
| New Zealand | Mar.1990 | CPI | <ul style="list-style-type: none"> • end of 1992 : 0~2%(Mar.90) • end of 1993 : 0~2%(Dec.90) • Aug. 1998 : 0~2%(Dec.92) • Aug. 1998 : 0~3%(Dec.96) • Aug. 2003 : 0~3%(Dec.97) • Aug. 2003 : 0~3%(Dec.99) | medium-term |
| Canada | Feb.1991 | CPI | <ul style="list-style-type: none"> • end of 1995 : 2±1%(Feb.91) • end of 1998 : 2±1%(Dec.93) • end of 2001 : 2±1%(Feb.98) | medium-term |
| UK | Oct.1992 | RPIX ²⁾ | <ul style="list-style-type: none"> • After Jun.1997 : 2.5%(Jun.97) | medium-term |
| Sweden | Jan.1993 | CPI | <ul style="list-style-type: none"> • After 1995 : 2±1%(Jan.95) | medium-term |
| Australia | 1993 | CPI | <ul style="list-style-type: none"> • 2~3%(1993) | medium-term |
| Finland | Feb.1993 | CPI | <ul style="list-style-type: none"> • After 1995 : 2%(Feb.93) • After 1999 : below 2%(Jan.99) | medium-term |
| Spain | Nov.1994 | CPI | <ul style="list-style-type: none"> • end of 1997 : below 3%(Nov.94) • end of 1998 : around 2%(Dec.97) • After 1999 : below 2%(Jan.99) | medium-term |
| Israel | Dec.1991 | CPI | <ul style="list-style-type: none"> • 1992 : 14~15%(1991) • 1993 : 10%(1992) • 1994 : 8%(1993) • 1995 : 8~11%(1994) • 1996 : 8~10%(1995) • 1997 : 7~10%(1996) • 1998 : 7~10%(1997) • 1999 : 3~5%(1998) • 2000~2001 : 3~4%(1999) • end of 2003 : 1~3%(2000) | 1992~99 : annual 2000 : medium-term |
| South Africa | Feb.2000 | CPI | <ul style="list-style-type: none"> • After 2003 : 3~6%(Feb.2000) | medium-term |
| Poland | Oct.1998 | CPI | <ul style="list-style-type: none"> • 1998 : below 9.5%(Oct.98) • 1999 : 6.6~7.8%(Mar.99) • 2000 : 5.4~6.8%(Sep.99) • 2001 : 6~8%(Sep.2000) • 2002 : 5±1%(Sep.2001) | Annual and medium-term ³⁾ |

Notes: 1) Figures in parentheses are date of setting months.

2) Retail prices excluding mortgage interest payments.

3) After 2003, below 4%.

Source: Mishkin · Schmidt-Hebbel, “One Decade of Inflation Targeting in the World”, NBER Working Paper, No. 8397, July 2001.

B. Interest Rate Policy

The operating conditions for interest rate policy during the year 2002 are likely to be improved, with the economy growing rather faster than last year, whereas the rate of price increases should be lower. The domestic and external environments surrounding business activity and prices, however, are still attended by a considerable degree of uncertainty. Interest rate policy will consequently be conducted placing the principal emphasis upon the attainment of the inflation target, while dealing flexibly with the economic situation at home and abroad. It is expected, in addition, that a cautious eye will be kept on the movements of asset prices, including those for real estate, and that appropriate policy steps will be taken.

There is the possibility of a high degree of volatility for price variables including interest rates, share prices and the exchange rate as a result of sharp swings in the exchange rate of the Japanese yen and erratic flows of international capital. It is also expected that the role of fiscal policy in boosting the economy will be continued for a while. In these respects, interest rate policy should be implemented taking close account of foreign exchange market movements and the status of fiscal disbursements.

C. Money Supply

Money will be supplied flexibly in consideration of the state of the economy including financial markets.

The monitoring range for the growth of M3(average basis) during the year 2002 was established at a rate of

8~12%,²⁾ rather higher than last year's range(6~10%). This is because, during the current year, private sector money demand and market interest rates will increase in response to the recovery of business activity, while the foreign sector will continue to supply liquidity through inflows of foreign direct and portfolio investment and so forth.

In carrying out its monetary policy with regard to interest rates, the Bank of Korea establishes a monitoring range for the growth of money supply. It does this because, although in the short term the relationship between inflation and the monetary stock may be unstable, from the long-term point of view inflation is indubitably always a monetary phenomenon. In other words in order to build a foundation for price stability in the medium and long term, it is essential to maintain careful continuing observation of the movements of the monetary stock.

Furthermore, the Bank will from this year construct a new monetary indicator for the level of overall liquidity of financial assets without dividing them into banking and non-banking financial institutions. It intends to make use of this indicator as an important information variable for monetary policy.

<Table IV-2>

**Comparison between Previous
and New Monetary Aggregates**

(hundred million won)

| Old Monetary Aggregates | New Monetary Aggregates |
|--|---|
| M1 = Currency in circulation + Demand deposits | New M1 = Currency in circulation + Transferable deposits + MMFs |
| M2 = M1 + Time & savings deposits + Residents' foreign currency deposits | M2 = New M1 + Other deposits (non transferable deposits, term deposits, installment savings deposits, residents' foreign currency deposits, CMAs, money in trusts, securities investment savings) + Securities other than shares (CDs, RPs, bills sold, bills issued, financial debentures, beneficial certificates) |
| M3 = M2 + CDs + Money in trust + RPs + CMAs + Bills sold + Bills issued + Financial debentures + Beneficial certificates + Securities investment savings + Reserves of life insurance | Unchanged (As on the left) |

D. Financial Market Stability

Financial markets are expected to show an improved pattern compared to the previous year. Thanks to the recovery of business activities, corporate profits and cash flow should be improved and credit risk reduced.

2) Looking at the provisional calculations for the growth rate of M3 this year, it is estimated at around the 10% level through the employment of the money demand function which is based on the projections for the inflation target, the GDP growth rate and market interest rates.

Meanwhile, the volume of maturing bond issues, and particularly of corporate bond issues, will contract. On the other hand with the large degree of uncertainty surrounding domestic and external conditions, it is likely that major financial price variables will show a high degree of volatility.

Accordingly, the Bank of Korea will put in place appropriate measures for market stability in the event of an abrupt high degree of interest rate volatility caused by the markets' overreaction. In addition, the Bank stands ready to provide liquidity in appropriate amounts for financial institutions experiencing temporary shortages of liquidity in the process of financial restructuring. This is to prevent a liquidity crisis at an individual financial institution spreading to embrace the whole financial system.

E. Supply of Corporate Funds

To enable enterprises to raise the funds they need seamlessly with the resurgence of business activity, incentives for the expansion of the supply of corporate funds are to be continually strengthened.

It will be made more attractive for financial institutions to expand lending to enterprises and credit based lending through changes in the method of allocation of loans under the Aggregate Credit Ceiling. Efforts will also be continued to upgrade settlement practises³⁾ in commercial transactions between enterprises.

3) The cash flow of SMEs will be improved and their burden of financial expenses reduced by improving the settlement practises from bills(post-dated promissory notes) to a cash basis through the use of the Corporate Procurement Loans. On the other hand, settlement practises will also be developed that are appropriate for electronic commercial transactions through the use of the system of Electronically-processed Secured Receivables Loans.

Banks are to be encouraged to expand their supply of funds to enterprises by giving much larger allocations of funds at low interest rates (2.5% p.a.) under the Aggregate Credit Ceiling to those that expand credit based lending to SMEs rather than household lending. Support from the Aggregate Credit Ceiling for the discount of commercial bills is to be reduced while that for trade finance and Electronically-processed Secured Receivables Loans is to be increased so as to ameliorate still further commercial settlement practises between companies through the prioritization of cash settlement. More intensive public information activities are planned so that many more enterprises can access the new loan systems, such as Corporate Procurement Loans, that are designed to phase out the use of commercial bills.

Efficient operation of the allocation of quotas to the Bank's regional branches under the Aggregate Credit Ceiling is planned this year by tailoring them to the actual conditions prevailing in each specific region, so that SMEs based in the regions can obtain trouble-free support.

F. Effectiveness and Transparency of Monetary Policy

The Bank of Korea will heighten the effectiveness and transparency of its monetary policy so as to enable its policy stance to be perceived more promptly and accurately by the real economy and the financial markets.

Efforts will first of all be directed toward ensuring the smooth operation of the transmission channels of monetary policy. Banks will be given positive encouragement to improve the method of operation of

their loan interest rates so that these can respond more rapidly to adjustments in the level of the target call rate. The feedback linkages between the central bank and the financial markets are also to be strengthened, so that the financial markets are informed more promptly and in greater detail of the background to monetary policy decisions and their content, while financial market information is reflected more closely in the drawing up of policy. Public information activities directed towards the general public are to be intensified, so that the man or woman in the street can be fully informed concerning the workings and advantages of the inflation targeting system, thus enabling it to take firm root. The Bank will greatly augment the monitoring of prices and the status of business activities by its branches so that these can participate more fully in the life of their regional economies, and play a more positive role in decision-making concerning the direction of monetary policy.

Further improvements are to be made in the running of the Bank of Korea's Internet home page and its economic tutorials. It is also planned to attract even more visitors to the "Bank of Korea Museum". It is hoped that these activities will heighten the transparency of monetary policy.

G. Soundness of Financial Institutions' Management

The Bank's oversight and analysis of the soundness of financial institutions' management are to be intensified.

To this end, on site information gathering activities are to be stepped up through the holding of joint examinations with the Financial Supervisory Service. Such information will then be incorporated in the

formation and execution of monetary policy.

Efforts are now being made to construct a system for the surveillance of the financial system's stability. The stability of the financial system will be analysed periodically and, in addition, a risk management model is to be developed to evaluate its capacity to absorb external shocks.

Apart from this, substantive progress is being made in the analysis of financial institutions' management status and the holding of surveys of banks' attitude toward lending on a quarterly basis. The information thus acquired will be put to positive use in the drawing up and carrying out of monetary policy.

For these purposes, efforts will also be made for the development and employment of techniques for financial analysis and assessment, such as the construction of a programme to assess the level of individual banks' soundness and of their risk management.

H. Payment System's Security and Efficiency

The Bank of Korea is engaged in vigorous efforts to upgrade the efficiency and security of the payments system.

As major elements in this, it will strive for the efficient operation of BOK-Wire and the strengthened control of settlement risk by, for example, avoiding the risk arising from large value interbank fund transfers.

A number of electronic payment systems are being developed and brought into operation. Examples of this are the pursuit of the introduction of an "Individual

Purchasing Card System” for use on the Internet and of a “B2B Electronic Payments System for Commercial Transactions.”

Apart from this, it will seek to carry out efficiently its oversight function in regard to payment and settlement systems. As part of this, it engages in the assessment, on the basis of international standards, of the security and efficiency of major payment systems, and seeks to introduce improvements for shortcomings that are observed.