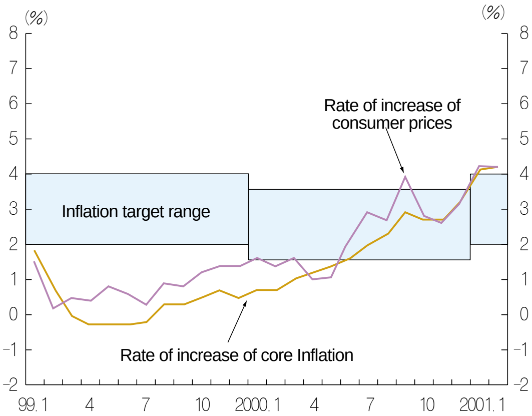
Ⅲ. Monetary Policy Operation

1. Inflation Target

In accordance with Article 6 of the Bank of Korea Act, the Bank of Korea set the 2000 inflation target, in consultation with the government, at 2.5±1% based on the average annual growth rate of core inflation. At the same time, the Bank set the mid-term inflation target at 2.5%.

<Figure Ⅲ-1>

Changes[1] in Consumer Prices and Core Inflation Rates



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

Unlike 1998 and 1999 when the inflation target was set in terms of on the Consumer Price Index(CPI), the Bank of Korea decided to make use of core inflation as the price index for the inflation target from the year 2000. This excludes non-cereal agricultural products and petroleum-based fuels from the CPI since these are subject to wide short-term price fluctuations, largely influenced by weather, harvests, and international oil prices. Meanwhile, the Bank also announced a mid-term inflation target. Its decision to do so was based on the consideration of the substantial time lag before a change in monetary policy works through to affect consumer prices, and of the help of public confidence in the consistency of the central bank's anti-inflationary monetary policy stance which will suppress the emergence of inflationary expectations.

The CPI posted a rise of around 1% compared with same period of previous year until the end of May 2000, backed by the appreciation of the Korean currency and the stable interplay of supply and demand for farm-livestock-fisheries products. However, with the surge of domestic petroleum-based product prices influenced by the dramatic rise in international oil prices and the concentration of hikes in medical insurance fees and public service charges including transportation costs, the CPI showed a steeper rise starting from early June to post a 3.0% increase during the second half of 2000. Accordingly, 2000 saw an average annual consumer inflation rate of 2.3%, up 0.8% from the preceding year.

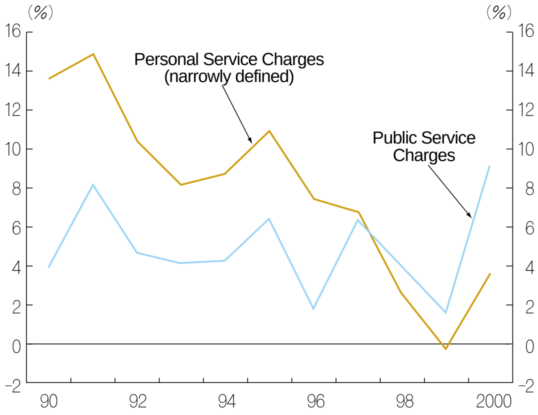
Core inflation showed a generally similar pattern of movements to that of consumer prices, showing a stable rise of 1.1% during the first half of 2000. From the second half of the year, core inflation too maintained a more steeply upward trend. It continued to fluctuate around the middle of its target range from September onwards, but registered a rise of 2.6% for the latter half. Accordingly, the annual average core inflation rate registered 1.8%, which was within the bounds set by the inflation target range.

The fact that core inflation stabilized within its target range despite international oil price hikes and the nation's rapid economic growth is considered to have been attributable to the lingering effects of the won's appreciation in suppressing inflationary pressure, the wider market opening for imports, the improvement of the structure of distribution, and the intensification of price competition.

It is problematic to estimate potential GDP accurately due to structural changes in the economy in the wake of the nation's financial crisis and the rapid progress in information technology and telecommunications. However, the annual GDP gap(the difference between real and potential GDP) ratio is estimated to have been positive, considering the continuance of rapid economic growth in 2000 following on from the previous year. Judging from the estimated gap ratio, demand-side pressures pulling prices upwards seem to

<Figure Ⅲ-2>

Rates of Increase[1] of Public and Personal Service Charges



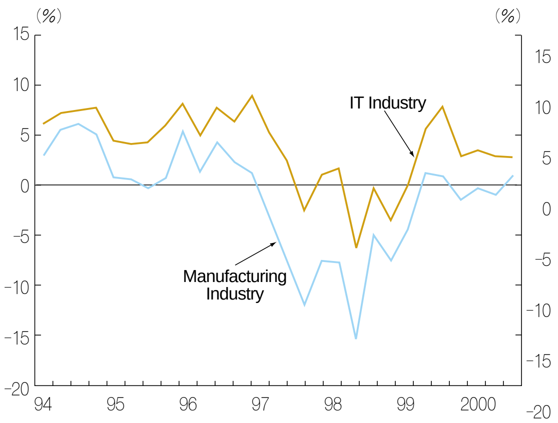
Note: 1) Compared with the last month of the previous year.

have been stronger in 2000 than the previous year. Meanwhile, international oil prices(Dubai light) rose 52.4% on an annual average basis and this is estimated to have pushed up consumer prices by 1.4 percentage points based on the Input-Output Analysis Table, an index that assumes the absence of economic structural changes and the downward stickiness of prices. The international oil price hike is considered to have exerted an influence even on core inflation, by way of increases in related public service charges such as transportation, electricity and city gas and the subsequent hikes in private service charges.

However, the average annual exchange rate(in terms of the base rate) fell 4.9% in 2000 on a year-on-year basis, which served as a significant factor in stabilizing consumer prices. Analyzed on the basis of the Input-Output Analysis Table, the exchange rate seems to have served as a factor reducing the annual CPI growth rate by 0.8 of a percentage point. Meanwhile, in terms of labor costs, the growth rate of labor unit costs based on that of all industries remained at a relatively higher level(3.2%) than that of the preceding year(2.4%), serving as a cost-push factor. However, as labor unit costs in the manufacturing sector registered a decrease in 2000 following that in 1999, industrial products, unlike services, are deemed to have been under relatively low upward pressure on their prices from the labor cost-side.

<Figure Ⅲ-3>

Growth Trends of Unit Labor Costs[1]

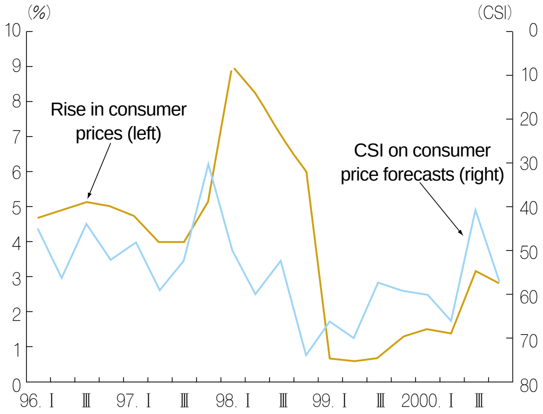


Note: 1) Nominal wage of full time permanent employment/(real GDP÷number of employees)

In addition to broader market opening following the establishment of the World Trade Organization(in 1995) and the scrapping of the regulation concerning the diversification of sources of imports(at the end of 1998 and in June 1999), the improvement of the structure of distribution including the rapid spread of discount stores after the opening of the domestic distribution market(in 1996) are judged to have served

<Figure Ⅲ-4>

Trends of the CSI on Consumer Prices Forecasts



as factors making for the stability of consumer prices. Coupled with such factors, the heightening of consumers' price sensitivity after the nation's financial crisis also seems to have served as a factor in stabilizing consumer prices.

Although consumers' inflationary expectations were somewhat higher in 2000 than in 1999, they appear to have subsided from earlier years, except during the third quarter of 2000 when they rose temporarily due to several factors including concentrated hikes in public service charges and a steep surge in international oil prices. This relatively low level of inflationary expectations on the part of consumers also seems to have contributed to price stability.

2. Interest Rate Policy

<Table Ⅲ-1>

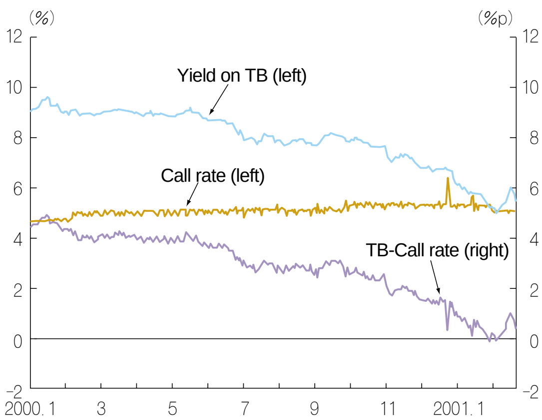
Monthly Stance of Interest Rate Policy and Market Interest Rate Trends

	Interest Rate Policy Direction	Market Interest rate movements[1]
Jan. 2000	Maintain current level of overnight call rate (4.75%)	Increase
Feb.	Increase by 25 bp (5.00%)	Decline
Mar.	Maintain current level	Increase
Apr.	Maintain current level	Decline
May	Maintain current level	Stable
Jun.~Aug.	Maintain current level	Decline
Sep.	Maintain current level	Increase
Oct.	Increase by 25bp (5.25%)	Decline
Nov.~Dec.	Maintain current level	Decline
Jan. 2001	Maintain current level	Decline
Feb.	Cut by 25bp (5.00%)	Decline

Note: 1) Based on average monthly yield on three year Treasury bonds.

<Figure Ⅲ-5>

Trends of Overnight Call Rate and Yields on Treasury Bonds[1]



Note: 1) Three year Treasury bonds.

Following the eruption of Daewoo Group's problems in July 1999, the Monetary Policy Committee(MPC) had set the overnight call rate target at a relatively low 4.75% and maintained it at this level until January 2000, emphasizing the stabilization of the domestic financial market.

However, on February 10, 2000, the MPC decided to increase the overnight call rate target by 25 basis points to 5%. The decision was intended to ease the tendency of a bunching of funds at the short-term end of the market by narrowing the wide gap between long-term and short-term interest rates, which resulted from the target rate having been kept at a low level despite the rise of long-term interest rates. The decision was also intended to enhance the effectiveness of interest rate policy by strengthening the linkages between long-term and short-term interest rates. By raising the overnight call rate, the gap between them(i.e. the yield on three-year Treasury bonds versus the overnight call rate) was effectively reduced. The decision to raise the overnight call rate was possible at that time since it was considered that the fears of financial market unrest roused by the overhang of bonds issued by the distressed Daewoo Group had subsided somewhat.

Despite the rise in the overnight call rate, the domestic financial markets showed a relatively stable pattern of movements until early April owing to the effects of the ample market liquidity and the easing of financial market uncertainties associated with the redemption of beneficiary certificates by investment trust companies. As evidenced by the nation's GDP growth rates which marked 12.6% during the first quarter of 2000, the real sector economy was on a rapid upswing. Although the inflation rate remained relatively stable despite the economic upturn, the MPC paid keen attention to the possibility of internal and external imbalances that might arise, particularly due to a more rapid narrowing of the current account surplus. However, the MPC deemed that the situation was not so grave as to necessitate an interest rate hike at that stage.

Moreover, the desirability of the stable operation of interest rate policy was heightened as the financial markets, having remained stable for some time, were rattled from late May by the Saehan Group being put under a workout program and Hyundai Engineering & Construction facing a liquidity crisis. Accordingly, the MPC resolved to maintain the overnight call rate stable at around 5% until it convened for its regular monthly policy meeting in June.

Consumer prices surged sharply from June onwards, breaking away from the stable trend they had maintained for some time and presenting a new angle for the deliberation of the MPC in their policy-setting session.[1)] The CPI, which had risen only 0.4% during the year to May, moved upward more steeply, increasing 0.5% in June, 0.3% in July, and 0.8% in August. In addition, as the GDP growth rate registered 9.7% during the second quarter, concerns arose that too much capacity might have been stripped out of the economy and that the pressures of excess demand would gradually emerge. Under the circumstances, the MPC recognized the necessity of rising the call rate in order to deal preemptively with inflationary pressure.

1) During the first half of the year 2000, the MPC paid keen attention to the contraction of the current account surplus, a malign effect of the nation's rapid economic recovery. However, from May onwards, the scale of the current account surplus was no longer deemed a problem as it held generally steady at over 1 billion US dollars every month.

Moving into August, however, the domestic financial market witnessed increasing uncertainties as Hyundai Engineering & Construction suffered another liquidity crisis. At the same time, the domestic stock market remained bearish due to a decline of semi-conductor prices, a dramatic surge in international oil prices and the deterioration of external confidence in the economy, most particularly because of the complications involved in the sale of Daewoo Motor Company. Accordingly, the MPC decided to maintain the overnight call rate at its existing level(5%) in its periodic meetings until September, placing the focus of its policy on the stabilization of the financial market.

At the October 5 meeting, the MPC decided to adjust upwards the overnight call rate target by 25 basis points from 5.0% to 5.25%, a shift from its stance maintained since March of that year.

The MPC arrived at its decision as anxieties over inflation were translated into reality as was evident from the sharp rise in consumer prices from June onwards and their 1.5% increase in September over the preceding month, a level not seen since February 1998. Some pointed out the inappropriateness of dealing with rapidly rising consumer prices through an aggregate-demand management oriented monetary policy, as they stemmed not from demand-side factors but from cost-side factors resulting from a surge in international oil prices. Being aware that a high level of consumer price increases might trigger the public's inflationary expectations, however, the MPC judged that it would be necessary to nip them in the bud by sending a signal to the public that it would respond fully and adequately to consumer price increases. In addition, the Committee judged that the financial sector could accomodate the relatively small increase of the overnight call rate without any difficulty as public misgivings were somewhat mitigated after the government's announce-ment of a plan to accelerate corporate and financial restructuring(October 4).

From October onwards, consumer prices shifted to a declining trend. Since the real sector of the economy, having been on a rapid growth track since early 2000, had begun to show signs of a slowdown, demand-pull inflationary pressure was judged to have moderated somewhat. Meanwhile, despite the announcement of the results of credit risk assessments for potentially non-viable companies(November 3), the uncertainties surrounding the financial markets had not dispelled significantly. In November, particularly, the exchange rate began to show an unstable pattern of movements. Under the circumstances, the Committee decided to maintain the overnight call rate at the current level at its regular policy meetings in November and December 2000.

With the turn of the year, the environment surrounding interest rate policy changed rapidly. Most notably, the Federal Reserve Board(FRB) adjusted its target federal funds rate downwards by 50 basis points on January 3, 2001, to guard against the possibility of a rapid slowdown of the U.S. economy. Although the domestic financial markets expected that the Bank of Korea would lower its target overnight call rate following the lead of the FRB, the MPC decided to keep the movements of the real economy under close observation for a further time due to the high degree of uncertainty surrounding the domestic and international environment. At its monthly policy meeting on February 8, 2001, the MPC decided to cut its target overnight call rate by 25 basis points and operate with a rate of around 5%.

This decision was seen as essential to ward off a excessive slowdown for the real sector of the economy as real sector economic indicators were falling faster than had been anticipated, and the findings of a number of surveys pointed to a sharp contraction of consumption and weakened business confidence. On the other hand, the CPI posted a large increase of 1.1% in January on a month-on-month basis. This was attributable to price hikes for farm-livestock-fisheries products and increases in public service charges such as medical insurance fees. But demand-pull pressures on inflation were not considered to be strong because of the business downturn. Moreover, the Committee also took it into consideration that the corporate sector might experience a deterioration of cash flow amid the economic slowdown despite the continued downwardly stable trend of market interest rates and the partial easing of the corporate credit crunch. The lingering concerns about the credit risks of potentially non-viable companies were also taken into account in the MPC's decision to cut the overnight call rate.

3. Money Supply

The Bank of Korea supplied liquidity in a flexible manner, placing a focus on the stability of the domestic financial market.

From early in the year 2000, there was a large increase in demand for bank loans as corporations found it difficult to mobilize funds through direct financing. In this situation, the Bank of Korea supplied base money to meet the funding demand so that corporate financing via banks could be effected smoothly. From early May, due to the aggravation of the liquidity crunch at some medium and large corporations, banks began to differentiate more strongly in their lending policies among companies. The Bank of Korea responded by heightening the flexibility of its liquidity supply in order to avoid this situation triggering an overall credit crunch.

As a result, the reserve base grew 20.0%(on an annual average balance) in 2000, higher than the 12.1% growth in 1999. M2 and MCT+ also posted high growth rates of 30.2% and 15.1%, respectively, in terms of annual balance, which reflected wider credit extension to the private sector by the banking industry. In view of this high growth of the monetary aggregates and of the draw-down ratio of overdrafts remaining at a low level, market liquidity was deemed to be ample.

The Bank of Korea also sought to improve the flow of funds through routine open market operations. Last year, market funds flowed toward banks with a heavy reliance on retail banking in the course of restructuring, leading to a contraction of the supply of funds channeled to the corporate sector. As part of its efforts to alleviate this situation, the Bank of Korea absorbed

<Table Ⅲ-2>

Trends of Base Money Supply and Liquidity Control Volume
(Changes in average balances)

(hundred million won, %)

	1999	2000	2001.Jan.~Feb.
Base Money	47,830 (12.1)	28,223 (20.0)	4,414 (11.9)
Liquidity adjustment	94,908	112,028	32,065
(MSBs)	66,775	146,515	60,042
(RPs)	28,133	-34,487	-27,977

Note: 1) Figures in parentheses refer to growth rates against the corresponding period of the preceding year.

<Table Ⅲ-3>

Trends in Draw-down Ratio of Overdrafts[1]

(%)

2000						2001	
Jan.	Mar.	May	Jul.	Sep.	Nov.	Jan.	Feb.
19.4	19.3	21.6	20.4	18.8	19.9	17.7	17.6

Note: 1) From commercial banks as of the end of each month.

surplus liquidity through open market operations with the retail oriented banks while providing funds to banks that relied heavily on corporate banking but had insufficient funds.

In addition, the Bank provided a total of 1.5 trillion won of liquidity to the Korea Development Bank and the Industrial Bank of Korea via open market operations during the period from June to September 2000 to enable them to provide financial support to the Korea Deposit Insurance Corporation(KDIC). This had been the vehicle for the KDIC's injection of public funds to the Korea Investment Trust Management & Securities Company and Daehan Investment Trust Securities Company in order to facilitate the restructuring of the domestic investment trust industry. Through repurchase agreements(RPs), the Bank of Korea also provided 1.5 trillion won to Kookmin Bank and the Housing & Commercial Bank of Korea, which faced a temporary outflow of deposits due to strike action at the end of last year.

While supplying money flexibly to stabilize the domestic financial market, the Bank of Korea collected 500 billion won in June and another 500 billion in September from Korea First Bank, which had received an emergency loan of 1 trillion won in September 1997. In a parallel move, foreign-currency funds which had been placed on deposit with banks were also collected by the Bank to a total of 9.04 billion US dollars in 2000 and of 1.81 billion dollars in January and February 2001. As of the end of February 2001, the Bank of Korea's total foreign exchange still placed on deposit with banks totaled 6.62 billion dollars.

As the Bank of Korea saw a large-scale expansion of money supply through the foreign sector due to the current account surplus and both direct and indirect

<Table Ⅲ-4>

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

(billion won)

	1996	1997	1998	1999	2000
MSB outstanding[1]	25,030	23,475	45,673	51,489	66,378
(Changes)	(-795)	(-1,555)	(22,198)	(5,816)	(14,889)
MSB Interest payment[2]	2,855	2,725	4,841	3,799	4,666
Base money supply from foreign sector	28,148	15,241	36,266	73,522	110,143

Notes: 1) End of year outstanding. 2) During the year.

foreign investment, the Bank absorbed a substantial amount of it by issuing Monetary Stabilization Bonds(MSBs). As a result, the balance of Monetary Stabilization Bonds outstanding rose to 66.4 trillion won as of the end of 2000, up 14.9 trillion won from the end of 1999. The interest paid on them totaled 4.7 trillion in 2000. This surge in interests payments on MSBs further hardened the rigidity of the supply structure of base money, acting as an obstacle to the implementation of efficient monetary policies.

In January 2000, the Bank of Korea set the M3 growth rate target for the year in line with with the inflation target at 7~10% in terms of annual average balance. However, the growth rate of M3(in terms of average balance) declined markedly from 11.3% in 1999 to 5.6% in 2000, far below its target range. This was attributable to a marked contraction of the financial intermediation function of the nonbank financial sector including investment trust companies, merchant banks, and the trust accounts of banking institutions. Another cause of the slow M3 growth in 2000 was that its balance at the beginning of the year had been exceptionally low as corporations had repaid their loans to financial institutions at the end of 1999 in a concentrated manner so as to reduce their debt ratios at year-end closing. However, as described earlier, despite the low growth rate of M3, market liquidity was deemed ample in consideration of the fact that the growth rates of the narrower and more liquid M2 and MCT+ aggregates remained at high levels.

4. Credit Policy

(Increase of the Aggregate Credit Ceiling and Improvement in the Method of its Operation)

The Bank of Korea increased the Aggregate Credit Ceiling and significantly improved its method of operation to ensure that corporations, particularly small and medium sized enterprises(SMEs), which were having difficulty in financing themselves in the course of domestic corporate and financial restructuring, could secure financing from banks.

<Table Ⅲ-5>

Trends of Aggregate Credit Ceiling and its Interest Rates

(hundred million won, annual %)

	Dec.97~	Mar.98~	Sep.98~	Dec.98~	Aug.99~	Jan.2001~
Credit ceiling[1]	46,000 (12,543)	56,000 (12,543)	76,000 (17,543)	76,000 (19,543)	76,000 (21,543)	96,000 (26,543)[2]
Interest rates	5%	5%	3%	3%	3%	3%

Notes: 1) Figures in parentheses refers to the Aggregate Credit Ceiling allocated to provincial branches of the BOK.
2) Increased from Dec 2000.

The Bank of Korea increased the Aggregate Credit Ceiling by 2 trillion won to 9.6 trillion won from January 2001. The Aggregate Credit Ceiling, i.e. the Bank's policy loan refinancing facility at a low interest rate(3% per annum), had been maintained at 7.6 trillion won since September 1998. The Bank raised the ceiling substantially despite its difficulties in monetary management because of the pressing need to ease the corporate credit crunch. In fact, credit crunch had not greatly alleviated centering on large mainstay corporations even after the results of the credit assessment of potentially non-viable corporations were announced in November 3, 2000. On top of this, the compulsory suspension of the business operations of savings and finance companies aggravated the credit crunch for minor small and medium corporations.

Coupled with the increase in the Aggregate Credit Ceiling, the Bank changed the method of allocating refinancing under the facility to induce a normalization of the flow of funds in the market. Most banks concentrated on expanding relatively low-risk household lending in 2000 out of concern over corporate credit risk. This strategy contracted the supply of funds to corporations, which acted as an obstacle to the easing of the credit crunch.

As part of its efforts to alleviate this problem, in September 2000, the Bank changed its method of assessing the performance of banks in terms of financing SMEs, one of the criteria used in allocating refinancing under the Aggregate Credit Ceiling to banks. The purpose of this change is to provide a larger allocation of credit to those banks that provide corporate financing than to those specializing retail and consumer financing. Subsequently, the Bank also raised the credit ceiling allocations to its regional branches by 500 billion won (2,154.3 billion won to 2,654.3 billion won) in December 2000 in a move to encourage the expansion of funding to regional SMEs suffering difficulties during the corporate restructuring process. Furthermore, the Bank adjusted upwards the percentage of the funds operated flexibly at the discretion of its branches so as to take account of the particular characteristics of the regional economies, raising it from 50% to 70% of the allocated amount. At the same time, it expanded the scope of the Aggregate Credit Ceiling to cover all working-capital loans to SMEs in the provinces.

In February 2001, the Bank of Korea again revised the method of allocating the Aggregate Credit Ceiling to expand the allocation to financial institutions that expand their purchases of corporate bonds and CP, and, of course, corporate loans to large mainstay corporations(excluding the affiliates of the top four business groups). This revision of the allocation method was undertaken after the Bank took into consideration the financial institutions' reluctance to provide loans to large mainstay corporations with low credit ratings, causing such entities to face difficulties in redeeming or issuing CP and corporate bonds.

However, considering the appropriateness of restricting the beneficiaries of the Aggregate Credit Ceiling to small and medium enterprises, the Bank decided to maintain the revised allocation method for a limited period of one year.

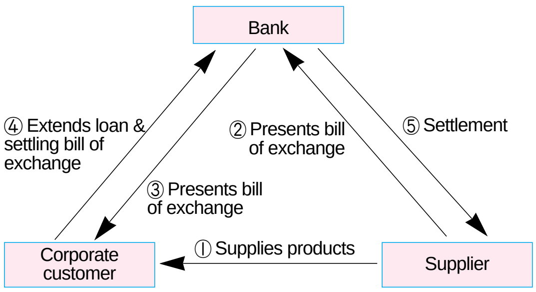
(The Introduction of Corporate Procurement Loans)

Commercial transactions between corporations had customarily been mostly settled by means of post-dated promissory notes. However, this practice had created a number of negative side-effects, imposing a heavy financial burden on small and medium enterprise beneficiaries due to the long period of time required for settlement, and triggering chain bankruptcies in the case of default by an issuer. Criticism of it had mounted, with a call for the abolition of the practice, citing the side-effects.

As a sudden scrapping of the bill-based settlement practice would invite the emergence of major problems such as wholesale confusion in commercial transactions, the Bank of Korea introduced Corporate Procurement Loans in May 2000 in order to discourage bill-based settlement and phase in cash settlement gradually.

<Figure Ⅲ-6>

Transaction Flow of Corporate Procurement Loans



This loan system represents a new method of settling commercial transactions whose flow is as follows: supplier(A) delivers the products to corporate customer(B), and issues and presents to a bank a bill of exchange whereby B undertakes to pay A the supply price. B is notified of the bill of exchange by its bank from which B may take out a Corporate Procurement Loan if it lacks cash to settle the bill of exchange.

As an incentive to stimulate a wider use of the Corporate Procurement Loans, the Bank provides refinancing at a low-interest rate (3% per annum) under the Aggregate Credit Ceiling to cover up to 50% of Corporate Procurement Loans extended by banks. The Bank also streamlined the loan procedure in order to enhance the ease of use by corporations and financial institutions. In addition, the Bank increased the amount of the Aggregate Credit Ceiling to be allocated to cover Corporate Procurement Loans from 1 trillion won at the time of their introduction to 2 trillion won in January 2001.

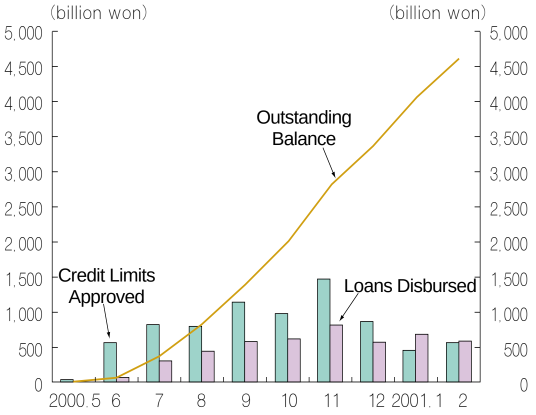
Corporate Procurement Loans have rapidly been taking firm root backed by the Bank's positive inducements and their favorable reception by companies and financial institutions. As of the end of February 2001, Corporate Procurement Loans outstanding had surged to 4,616 billion won as aginst 65.1 billion won at the end of June 2000. The number of corporations making use of the facility increased to 6,813 from 135 over the same period.

While the use of the Corporate Procurement Loans has been growing on a large scale, the discount of commercial bills has declined steadily. As of the end of February 2001, the amount of Corporate Procurement Loans was equivalent to 28.2% of the total of commercial bills discounted. It is considered that cash settlement via Corporate Procurement Loans is rapidly replacing the discount of commercial bills for commercial transaction settlements.

The use of Corporate Procurement Loans is expected to expand further in the years to come as more and more corporations recognize the benefits of the loan system and, in the wake of the implementation of the 'Special Tax Treatment Control Law' revised in October last year, under which corporations are expected to receive substantial corporate tax(or income tax) benefits[2].

<Figure Ⅲ-7>

Trends in Corporate Procurement Loan Extension



<Table Ⅲ-6>

Trends of Corporate Procurement Loans and Commercial Bill Discounts

(billion won)

	2000			2001	
	Jun.	Oct.	Dec.	Jan.	Feb.
Corporate Procurement Loans(A)	65	1,990	3,359	4,040	4,616
Commercial bill discounts(B)[1]	18,454	18,336	19,567	17,438	16,368
A / B (%)	0.4	10.9	17.2	23.2	28.2

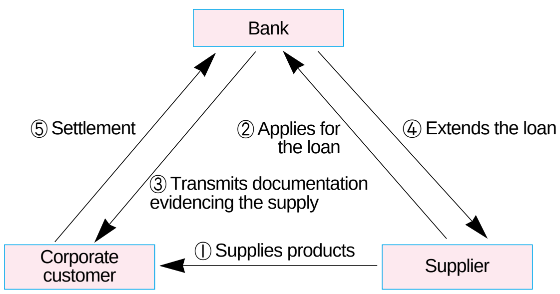
Note: 1) Based on commercial bill discounts of small and medium sized corporations.

(Introduction of Electronically-Processed Secured Receivables Loans)

Despite the rapid spread of Corporate Procurement Loans, most companies affiliated with the top 30 business conglomerates were effectively restricted in access to them due to the prudential regulation ceiling on lending to a single borrower(or single business group) although these companies issue a large volume of commercial notes. Accordingly, the Bank of Korea introduced "Electronically-Processed Secured Receivables Loans" in February 2001, under which affiliates of the top-thirty business conglomerates no longer issue promissory notes to settle their commercial transactions with suppliers, but suppliers receive their proceeds in cash at an early stage.

<Figure Ⅲ-8>

Transaction Flow of Electronically-Processed Secured Receivables Loans



Electronically-Processed Secured Receivables Loans scheme is a new commercial transaction settlement system whose flow is as follows: A supplier takes out a loan secured against sales-on-credit receivables from a corporate customer from a bank, enabling it to collect the supply price in cash at an early stage. Rather than issuing bills in settlement, the purchaser repays the loan on behalf of the supplier after a certain time has elapsed.

All procedures involved in these new loans ranging from loan applications to loan repayments are processed electronically via dedicated lines or the internet without involving the issuance of promissory notes, enabling both buyers and suppliers to save on transaction expenses. Small and medium enterprises supplying large companies, can collect the proceeds in

2) Tax-deduction Amount : (Bill amount of exchange settlement for purchases + Amount of purchase-only card settlements – Amount of notes issued) × 0.5%.
Deduction Limit : 10% of tax-deduction amount

cash at an early stage by borrowing against the collateral of sales-on-credit receivables from a bank, backed by the credit standing of the large company, thus improving the cash flow and cutting financing expenses.

The Bank provides support by having the new Electronically-Processed Secured Receivables Loans qualify for refianncing under the Aggregate Credit Ceiling in order to stimulate the utilization of the new loan system at an early stage.

In combination with the Corporate Procurement Loans already in use, Electronically-Processed Secured Receivables Loans are expected to reduce the negative effects arising from settlement via commercial bills and contribute significantly to the advancement of commercial transaction settlement practice in future.

5. Monetary Policy Instruments

The Bank of Korea reinforced its efforts to improve the way it extends loans and inspects the management performance of financial institutions in its quest to put in place an advanced system for the operation of monetary and credit policy.

(Introduction of a Liquidity Adjustment Loan)

Recently the loan policy of the central banks have tended to emphasize its public disclosure function of signalling the fundamental direction of monetary policy through the adjustment of loan interest rates (i.e. the rediscount rate), and its function of being a lender of last resort to inject sufficient liquidity into the financial market at times of financial panic, rather than on its function of serving as the liquidity supply channel for financial institutions at all times.

However, as the Bank of Korea used the Aggregate Credit Ceiling System as a tool to allay the credit crunch following the nation's currency crisis, it has been difficult to carry out the full-fledged operation of this distinctive loan policy. Taking the situation into consideration, the Bank introduced a Liquidity Adjustment Loan System in August 2000, keeping it separate from the Aggregate Credit Ceiling.

Accordingly, the Bank acquired an instrument allowing it to supply the needed funds in a timely manner to banks facing a temporary liquidity shortage while conveying the Bank's underlying policy intention to the financial market more clearly and to fine-tune the overnight call rate target through adjustment of the interest rate on Liquidity Adjustment Loans in line with its monetary policy direction. With the

<Table Ⅲ-7>

Status of Loan System of the Bank of Korea

	Function	Limits	Interest rate
Liquidity Adjustment Loan	· Publicly disclose the direction of interest rate policy through adjustments of loan interest rates in line with the monetary policy direction · Pursue stabilization of the financial market through prompt supply of funds to banks facing temporary liquidity shortage that apply for the loan	3 trillion won	4.5% p.a. (5.5% p.a. when borrowing for three or more consecutive months)
Aggregate Credit Ceiling Loan	· Induce banks to expand loans to small and medium corporations	9.6 trillion won	3.0% p.a.
Temporary Loan	· Supply funds to banks facing fund shortage for settlement (or reserve requirement)	Within liquidity shortage	Overnight call rate +2%p
Daylight Overdraft	· Provide settlement fund to banks facing temporary settlement fund shortage during a given day	100% of average balance of deposit for requirements	No interest

introduction of Liquidity Adjustment Loans, the Bank initiated a new lending system enabling it to fulfill its pubic disclosure function as well as its function of stabilizing the financial market.

As of the end of February 2001, the interest rate on the Liquidation Adjustment Loans stood at 4.5% per annum. The total lending limit was increased to 3 trillion won in January 2001 from its initial 2 trillion won at the time of the introduction of the loan system as part of efforts to deal with potentially destabilizing factors in the financial market amid financial restructuring.

(Introduction of Daylight Overdraft System)

The Bank of Korea in September 2000 introduced a Daylight Overdraft System to enhance the stability and efficiency of the payment and settlement system.

This new loan system is intended to deal with the increasing incidence of temporary delays by financial institutions in payments and settlements in the wake of the marked expansion of in interbank settlements due to the increase in the scale of the national economy and surge in financial transactions.

With the introduction of Daylight Overdraft, the Bank could automatically provide the funds needed within a certain limit on a real time basis to financial institutions that find themselves unable to make settlement due to a temporary liquidity problem during a given day. The ceiling of the Daylight Overdraft is the average balance of current deposits placed by each bank with the Bank of Korea. Daylight Overdraft loans carry no interest in consideration of the fact that banks deposit their reserve requirements with the Bank at no interest and that the drawn-down portion of the overdraft facility is

<Table Ⅲ-8>

Introduction of Daylight Overdraft and the Queuing for Settlement in BOK Wire

		Pre-introduction		Post-introduction			
		2000		2000			2001
		Aug.	Sep.	Oct.	Nov.	Dec.[1]	Jan.[1]
The queuing rate for settlement (%)	No. of cases	21.3	24.1	20.8	20.6	21.6	22.4
	Amount	31.3	34.9	24.9	24.5	30.1	31.7
Daily average No. of banks queuing for settlement		12.0	12.8	4.9	4.6	6.7	7.5

Note: 1) Growth in the queuing rate for settlement and the number of banks queuing during the period from Dec. 2000 to Jan. 2001 was attributable to strikes within the banking industry, the liquidity shortage of some banks, a temporary increase in the volume of settlements at 2000 year-and and early 2001, etc.

<Table Ⅲ-9>

Trends of Foreign-Currency Deposit Reserve Requirement Ratio

(%)

	~Feb. 1990	Mar. 1990	Apr. 1996	Nov. 1996	Apr. 2000
Residents account	4.5	11.5	9	7	2[1] 5[2]
Other accounts[3]	1	1	1	1	1

Notes: 1) Savings deposits.
2) Demand deposits.
3) Bank account, External account and Overseas emigrant account, etc.

collected in full by the closing of the business day.

After the introduction of the Daylight Overdraft System, the proportion of banks queuing for settlement due to a shortage of settlement funds and their overall number both declined markedly.

(Reduction of the Foreign-Currency Deposit Reserve Requirement Ratio)

The Bank of Korea cut the foreign-currency deposit reserve requirement ratio for Korean residents in April 2000.

The move was designed to facilitate an increase of the foreign-currency deposits of corporations and individuals by inducing a hike in the effective interest rate on deposits while ‘leveling the playing field’ between foreign-currency and local-currency deposits in terms of the reserve requirement ratio. Accordingly, the reserve requirement ratio for foreign-currency deposits dropped from the previous flat 7% to 2% for savings deposits and to 5% for demand deposits.

(Examination of the Management Performance of Financial Institutions)

The Bank of Korea maintained its efforts in 2000 to examine the management performance of financial institutions in order to collect relevant informations necessary for the efficient implementation of its monetary policies.

As part of such efforts, on a quarterly basis, the Bank undertook *inter alia* management performance analysis of financial institutions in terms of income and asset quality, and a loan practice survey. In addition, the Bank conducted joint examination of commercial banks in collaboration with the Financial Supervisory Service in 2000 for the first time since the revision of the Bank of Korea Act in 1998. Joint examinations were held on three banks (Hanvit Bank, KEB and Daegu Bank) in 2000, and on one bank (Citibank) during the period of January and February in 2001.