

## IV . Monetary Policy for 2001

### 1. Environment

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#### A. World Economy

Changes in the U.S. economy are expected to be the most influential factor during 2001 in determining economic conditions in Korea. After maintaining rapid growth for over a decade, the U.S. economy began to show signs of a serious slowdown from the third quarter of last year. In the fourth quarter, its GDP growth rate dropped to the lowest level since the second quarter of 1995 to stand at 1.1%(annualized quarter-to-quarter change). In 2001, with indicators continuing to predict a rapid downturn in the U.S. economy, the Federal Reserve lowered its target federal funds rate by a full percentage point in two stages in January(6.5% → 5.5%) and the Bush administration announced a ten-year plan to cut taxes by a total of 1.6 trillion US dollars in order to respond positively to the economic slowdown.

Although the forecast for the U.S. economy seems to be a mix of optimism and pessimism, the optimistic outlook seems to have the upper hand. In other words, the growth rate of U.S. economy is expected to be lower than initially expected, but not so slow as to push it into a recession. This forecast is based on the expectation that productivity will continue its healthy growth since the U.S. maintains unrivaled competitiveness in the information technology and telecommunications industries, and on the judgement that there still are many options left open in monetary and fiscal policies to spearhead an economic

recovery.<sup>1)</sup>

Despite such evidence against a recession, the high expectations of a “New Economy” born in the lengthy economic boom in the U.S. seem to have lost much of their steam. Hence, even if the U.S. economy does not take a track toward recession, it will be some time before we see the vitality of the 1990s again. This of course is expected to have a negative impact on Korea, whose economy is heavily dependent to that of the U.S.

Meanwhile, with the Japanese economy - which many had expected to shake off the lengthy economic recession by the first half of 2000 - recording negative GDP growth in the third quarter, the dominant opinion now seems to be that the Japanese economy will not be able to regain its vitality even in 2001. Moreover, Japan currently has almost no policy options left which it can use to stimulate economic recovery as it is burdened with a high national debt ratio and low policy-based interest rate. This means that unless the move toward a recovery comes from within the economy itself, it is difficult to expect its recovery.

The direction of international oil prices, which shot up in the latter half of last year, is another important factor for Korea, a country that imports all its oil needs.

<Table IV -1>

**Prospects for World Oil Demand and Supply**

(million barrels)

	2000	2001e				
		1/4	2/4	3/4	4/4	annual average
Demand(A)	75.6	77.7	75.6	77.0	79.8	77.5
Supply <sup>1)</sup> (B)	76.7	77.6	77.4	77.4	78.1	77.6
B-A	+1.1	-0.1	+1.8	+0.4	-1.7	+0.1

Note: 1) Assuming that Iraq increases crude oil production amounts to 2.2 million barrels for first quarter and 2.7 million barrels from the second quarter onwards. (Korea National Oil Corporation, Jan. 19, 2001)

Fortunately, in 2001, despite OPEC’s decision to cut production(January 17) and the looming possibility of further production cuts, increased exports from Iraq and lower demand owing to the worldwide economic

1) The U.S. Federal Reserve had raised the target rate for Federal Funds from the latter half of 1999 by 1.75% points, leaving room for an additional rate cut. The U.S. has also maintained a fiscal surplus since 1998. This means that the government could use increased fiscal expenditure to boost the economy.

slowdown are expected to make oil price fluctuations less of a threat to the global economy than last year. Many institutions predict that international oil prices (based on Brent crude oil) will move between 25 and 30 US dollars per barrel during the first quarter of 2001 before recording a steady fall to stay below around 25 dollars per barrel on an annual average.

The exchange rates of major currencies are expected to be largely swayed by changes in the real sector of their respective countries. Basically, delay in economic recovery is expected to keep the Japanese yen weak while the expected better performance of the European economy compared to that of U.S., is expected to keep the euro relatively strong - but the precise level will be determined by economic conditions in the U.S.

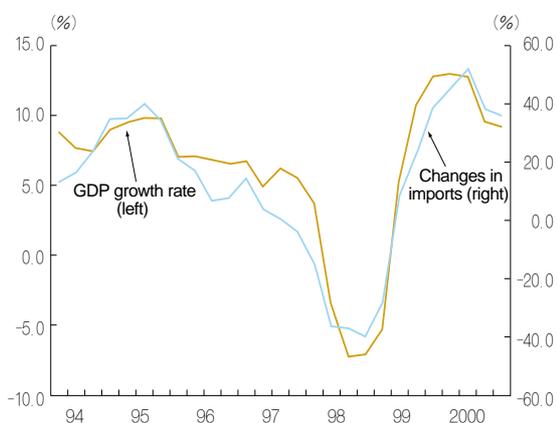
## **B. Domestic Economy**

The slowdown in the growth of the real sector economy since September last year seems to be continuing in 2001. Thus, the growth rate during the year is expected to be far lower than in 2000. However, recently, signs of an easing of the credit crunch have been appearing, and positive monetary and fiscal policies that aim to avert an excessive economic slowdown are being implemented. As such, in 2001, Korea is expected to register GDP growth slightly below its potential growth rate.

Prices are expected to rise at a level somewhat above 3%. In 2001, demand side inflationary pressure will be substantially weakened due to the slowdown in economic growth. But a disinflationary effect is not likely as the won is weaker than last year, and there are factors working to push prices higher including the impact of high oil prices and of hikes in public service

<Figure IV-1>

**GDP Growth Rate and Import Fluctuations**



charges. Furthermore, in the first two months this year, the rise in consumer prices reached 4.2% owing to a jump in prices of farm-livestock-fishery products and in public service charges such as medical insurance premiums. Added to this, the effect of lower prices in the base period of the first half of last year could push consumer price inflation above the 4% level. But in the latter half of the year, the slowdown in the economy and stable oil prices are expected to slow price rises to around the 3% mark.

As for the current account, despite the slow growth of exports, a larger drop in imports is expected to keep the account in surplus as it has been since 1998. The size of the surplus, however, is expected to be somewhat reduced.

In exports, the economic downturn in major export destinations, notably the U.S. and Japan, coupled with the possibility of increased trade frictions and weakened semiconductor prices are expected to keep export growth low. In particular, the economic slowdown in Korea's largest export destination - the U.S. (which took around 22% of overall exports in 2000) - will have a negative impact on main export items such as semiconductors, information technology and telecommunication equipment, and automobiles.

Import growth is expected to fall as the slowdown in the economy, lowers demand for imports. Another factor keeping imports low will be the decline in energy import costs resulting from the stabilization of oil prices within a lower range in 2001 after their sharp increase in 2000.

## 2. Monetary Policy Direction

In 2001, the highest priority in monetary policy will be placed on achieving the targets for price stabilization. The Bank of Korea will however, conduct its policy flexibly, taking account of the overall situation including economic trends and changes in the financial market.

### A. Inflation Target

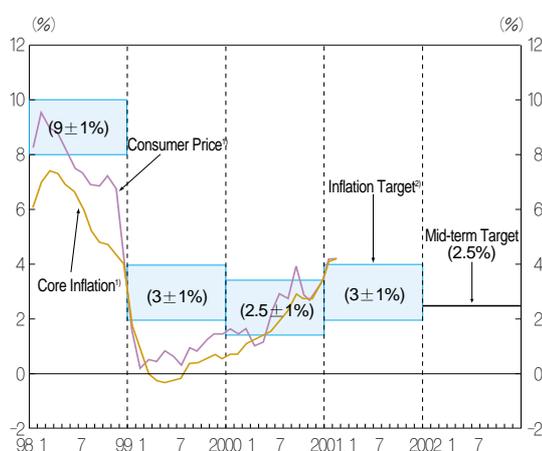
In consultation with the government, the Bank of Korea set its inflation target (based on core inflation) at  $3 \pm 1\%$  for the year 2001. Accordingly, the operation of monetary policy will primarily focus on the achievement of the inflation target.

Along with the annual target, the mid-term target, which was first announced last year, has been set at the 2.5% level (same as last year) to maintain the consistency and improve the credibility of monetary policy. With inflation expected to stand at around the 3% level in 2001, some argue that the mid-term target should be adjusted accordingly. However, as the mid-term target is a normative target indicator which the Korean economy needs to attain as a mid to long term goal, it is deemed more desirable to maintain it at the level initially announced. In the operation of monetary policy, the Bank of Korea will be mindful of the need to build a stable basis for price stability so as to induce inflation to converge on its mid-term target at the 2.5% level from next year onwards.

In this context, let us examine more closely the prospects for price movements in 2002 and later years.

<Figure IV-2>

Trends of Inflation and Inflation Targets



Notes: 1) Rate increases compared with same month of the previous year.

2) Based on annual average growth rate.

As concerns the various factors expected to exercise a heavy influence on consumer prices in 2002: first, looking from the demand side, the Korean economy, which had started to show strong signs of a rapid downturn from the fourth quarter of the year 2000, is expected to show signs of a rebound from the latter half of 2001 and continue to get stronger from early 2002 onwards. This is not, however, anticipated to result in heavy inflationary pressure.

Cost factors are also expected to stay stable in 2002. The slowdown in world economic growth and seasonal factors are expected to stabilize oil prices after the second quarter of 2001 and these trends are expected to continue throughout 2002. Although the unemployment rate is expected to fall gradually from the latter half of 2001 with economic recovery, the increased flexibility in the labor market stemming from corporate and financial restructuring efforts will keep wage increases relatively low. Public service charges, however, are expected to continue to rise in 2002 and thus exert inflationary pressure.

Putting these all together, the rate of price increases will slow from the latter half of 2001 onwards and converge on its mid-term target range in the course of 2002.

## **B. Interest Rate Policy**

The Bank of Korea will operate the target call rate flexibly during 2001, paying close attention to changes in inflation as well as in the economic and financial market environments. While the emphasis will be placed on bringing about price stability, efforts must also be devoted to avoiding too deep an economic downturn and making sure that the basis is firmly

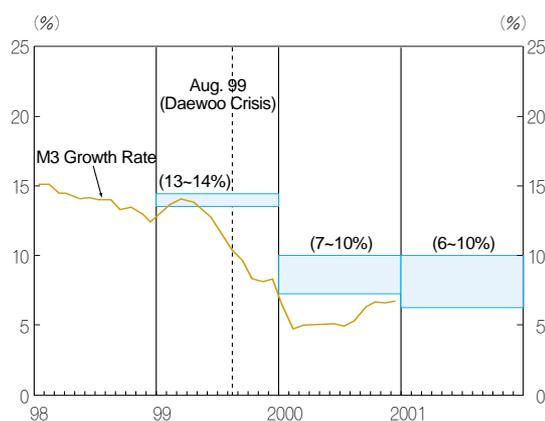
secured for the stability of the financial markets, which have recently started to show some signs of improvement. Moreover, capital flows are likely to become increasingly irregular with the heightened uncertainty of external conditions. Interest rate policy will thus also take movements of the exchange rate and the FX market into consideration.

In a situation of rising inflation amid a slowdown of the economy, the choice of policy options will be very difficult. Accordingly, a comprehensive overall picture will be built up for use in the operation of interest rate policy by grasping the scope and velocity of economic slowdown, the sources of inflationary pressure, money market trends and so forth.

### C. Money Supply

<Figure IV-3>

**Trends of M3 Growth Rate and Monitoring Ranges<sup>1)</sup>**



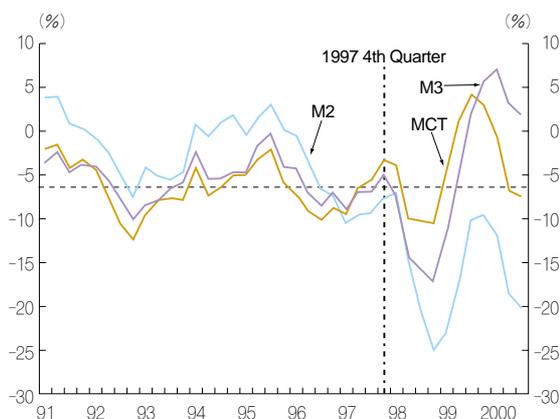
Note: 1) Intermediate target range for 1999 and 2000.

Money supply is expected to be conducted flexibly giving full consideration to the market situation. Although the growth rate of the broad monetary aggregate(M3) had been managed for some years through its use as the intermediate target, this has been changed to a monitoring range from this year onwards. For 2001, the monitoring range has been set at 6 to 10% in terms of the annual average rate based on the inflation target( $3 \pm 1\%$ ) and economic growth forecasts. If broad money supply deviates from its set range, we will not opt for an immediate response as when it formed the intermediate target, but conduct a detailed review on the reasons for the deviation and other factors in order to develop an appropriate response.

The decision to change monetary aggregate from being an intermediate target, which had been used since 1979, to being a monitoring range was made because

<Figure IV-4>

**Fluctuations in Velocity of Money**



the financial deregulation and liberalization of the 1990s, followed by the financial crisis in 1997 and subsequent restructuring efforts had continued to weaken the usefulness of monetary aggregates. That situation is not expected to improve in 2001. With the deepening fluctuations of the real economy, the velocity of money supply, through which the money supply is linked to the real economy, has been presenting a highly unstable pattern with its trends subject to wide variations. The ongoing financial restructuring and the implementation of the partial guarantee system for deposits from 2001 onwards are another factors that increase this instability.

Even after shifting to a monitoring range for money supply, the Bank of Korea will still maintain policies aiming to keep liquidity at an appropriate level to realize its set inflation target.

**D. Credit Policy**

<Table IV-2>

**Trends in Corporate Lending**  
(based on changes)

(hundred million won)

	2000			2001		
	year	Oct.	Nov.	Dec.	Jan.	Feb.
Large companies	72,498	13,646	-1,391	-34,863	30,831	-6,342
SMEs	162,042	14,323	9,640	-4,757	8,045	-1,034
<b>Total<sup>1)</sup></b>	<b>234,540</b>	<b>27,969</b>	<b>8,249</b>	<b>-39,620</b>	<b>38,876</b>	<b>-7,376</b>

Note: 1) Includes trust account loans and CLOs, but excludes changes in book value due to such as clearing of ailing loans.

In addition to the Bank of Korea’s supporting facilities for SMEs such as Aggregate Credit Ceiling, as commercial banks actively seek out high-quality customers, the growth of lending to SMEs is continuing to evolve favorably in 2001 as it did in 2000. The Bank of Korea plans to exert efforts to facilitate fund supply to the overall corporate sector including SMEs.

Above all, like last year, the Aggregate Credit Ceiling system will continue to offer the incentives needed to maximize the flow of funds from financial institutions to corporations and ensure the expansion of financial support to SMEs in regional areas.

As it did last year, in a bid to promote the expansion of corporate funding by financial institutions, the Bank

will absorb excess funds from banks with higher volumes of retail financing transactions through routine open market operations and use these funds to help increase the liquidity of those banks which handle a greater volume of corporate credits but suffer from a funds shortage.

At the same time, to avoid pitfalls arising from settlement by means of post-dated promissory notes and to improve commercial transaction settlement practice among companies, the Bank will exert efforts to promote the wider use of Corporate Procurement Loans, and the system of Electronically-processed Secured Receivables Loans, so that the financial expenses of companies can be effectively reduced.

To consolidate the stability of the financial market, the Bank of Korea will focus on the flexible supply of liquidity and on correcting imbalances in fund distribution among banks. In order to assure the systemic health of the financial system, those financial institutions which experience temporary liquidity shortages due to portfolio shifts during financial restructuring can look to the support of timely fund injection through liquidity adjustment loans.

## **E. Others**

With the introduction of a monitoring range for the monetary aggregate from 2001, the sole basis for monetary policy operation will be inflation targeting. The Bank of Korea plans to improve its capabilities of policy operations accordingly. To this end, it will concentrate on enhancing its inflation analysis and forecasting skills while increasing policy transparency and reliability further. In particular, considering that under an inflation targeting regime, the efficacy of

monetary policy is determined by the public's trust in the announced policies, the Bank will exert active efforts to build a social consensus on the importance of price stability by strengthening its provision of public information regarding the direction of monetary policy and the detailed framework involved.

The Bank of Korea will also step up its efforts to capture accurately the financial information needed to gain a clear picture of the status of financial institutions and to carry out monetary policy. With the objective of collecting more market information and obtaining a detailed understanding of the management of financial institutions, the Bank will expand the number of bank examinations conducted jointly with the Financial Supervisory Service. It will also improve its capacity for analyzing the management status of financial institutions by, among other things, developing analytical techniques for financial holding companies, whose establishment is expected shortly. The Bank will also expand its information provision function by improving its delivery of the collected financial information and relaying details of the difficulties faced by financial institutions to the relevant organizations.