

I . Overview

- 1 The Bank of Korea, in consultation with government, set an inflation target for the year 2002 of $3\pm 1\%$ in terms of core inflation, the same as in the previous year. The medium-term target was also maintained at 2.5%.
- 2 During the year 2002, interest rate policy was conducted with an emphasis on supporting the economic recovery while paying careful attention to price stability.

From early in the year, supported by the low interest rates, household loans increased at a rapid pace and housing prices rose steeply while business activity expanded relatively strongly. In order to preempt the possibility of internal and external disequilibria such as an increase in inflationary pressures and a deterioration of the current account position and thus preserve the basis for economic stability, the overnight call rate target, the central bank's policy rate, was raised by 25 basis points from 4% to 4.25% on May 7. In consequence, the rate of increase in household loans slowed down somewhat and the upward trend of housing prices was blunted.

The solid recovery of the real economy was subsequently maintained but, from the beginning of the third quarter, household loans rose steeply again with the upswing of housing prices. Meanwhile, affected by mounting

uncertainties over external conditions such as concerns over the delayed recovery of the world economy and the possibility of the outbreak of a war against Iraq, the stock market sank more deeply and economic actors were gripped by an increasingly intense mood of unease. To counter these trends, the Bank of Korea kept its policy rate target unchanged but from October it reduced the Aggregate Credit Ceiling somewhat with a view to reining in the strong monetary expansion pressures.

From October, housing prices regained their stability, influenced by the measures to stabilize the real estate market, and from November the scale of the increment of household lending contracted markedly in response to a broad spectrum of measures to bring it under control. Amidst these developments, the upward pace of the real economy showed signs of slowing down, reflecting the shrinking of consumer and business confidence in the face of the constantly rising tide of geopolitical uncertainty, most notably the threat of a war on Iraq and the North Korean nuclear issue. In this atmosphere, the Bank of Korea maintained its policy rate target unchanged at the 4.25 % level until February 2003.

- 3** Money supply was principally oriented to maintaining the call market interest rate at the target level with the flexibility over the short term in the light of financial market conditions.

The growth rate of M3 during 2002 registered 12.9%, which was higher

than the previous year's 9.6% mainly because of the sharp rise in household loans and lending to small and medium-sized enterprises (SMEs). It consequently slightly exceeded the upper bound of its monitoring range (8~12%) established as an information variable at the beginning of the year.

Efforts were directed toward maintaining financial market stability through normal open market operations. From early 2003, especially, the issue of long-term Monetary Stabilization Bonds (MSBs) was expanded in response to the market's oversensitive reactions, such as the rapid fall in bond yields that arose from the short-term mismatch between supply of and demand for bonds and the flight to quality in an environment characterized by increasing geopolitical risks.

- 4 In the operation of lending to financial institutions, the Bank of Korea sought to curb the excessive expansion of their household loans while constantly strengthening its inducement of their supply of corporate funds.

The weighting of the deduction made for household lending in calculating the Aggregate Credit Ceiling for each bank was adjusted upward in two steps, taken in March and May 2002, from 40% to 80%, so that banks that increased household lending excessively were treated with prejudice in the provision of loans bearing a low interest rate (2.5% p.a.) from the Bank of Korea. In a further move, from October 2002, the Aggregate Credit Ceiling, which had been raised to 11.6 trillion won immediately following the

terrorist attacks on United States in September 2001, was lowered to its previous level of 9.6 trillion won in order to draw off some market liquidity and prevent the inflationary expectations that might have been roused through the sustained run-up in housing prices. In spite of this reduction in the Aggregate Credit Ceiling, the size of the quotas made available to the Bank of Korea's regional branches for the support of regionally-based SMEs was increased by 600 billion won, so that lending by financial institutions to preferential support sectors and industries with a regional character could be expanded further.

Continuing efforts were also devoted to further galvanize the Bill Substitution Scheme introduced for the expansion of cash-based settlement practices in commercial transactions between enterprises. From January 2002, the Aggregate Credit Ceiling allocated on the basis of banks' performance in providing Corporate Procurement Loans was raised from its previous 3 trillion won to 4.3 trillion won. Meanwhile, the ratio for the performance in commercial bill discounts applied in the allocation of the Aggregate Credit Ceiling was reduced in two steps, taken in April and October 2002, from 80% to 50%, with the resources thus freed up being used to support other forms of funding for SMEs. In consequence, as of the end of February 2003, the total amount of lending designed to replace commercial bill transactions such as Corporate Procurement Loans reached 123% of commercial bill discounts, reflecting the fact that cash-based settlement was rapidly replacing bill-based settlement.

- 5 Endeavors were also heightened toward improving the instruments of monetary policy to allow their operation in a more market-friendly manner and toward enhancing the transparency and credibility of policy formulation and implementation.

In June 2002, the minimum amount and the unit of transactions in competitive bidding for MSBs were both raised from the previous 100 million won to 5 billion won in consideration of the trends toward the increased scale of issuance of MSBs and the enlargement of the size of transactions, as well as the convenience of financial institutions in making transactions. From January 2003, in order to improve financial institutions' ability to forecast their day-to-day fund supply and demand situation, and therefore operate their funds with greater stability, the timing of the announcement of MSBs' competitive bidding was altered from the date of auction itself to the immediately preceding business day.

Mutual feedback between the central bank and the financial markets was greatly fortified by its making known to the markets the background and details of monetary policy decisions and in return grasping and analyzing closely their anticipations and reactions. In this connection, monthly meetings were newly introduced such as 「Economic Trends Discussion Meeting」, whose participants are drawn from major economic research institutes and academic circles and 「Financial Consultation Meeting」, bringing together the heads of financial institutions. Through these channels,

the opinions of outside experts can make themselves heard and a wide range of on-the-spot information can be gathered for effective use in policy formulation.

Additionally, in order to check the transmission effects of monetary policy and the business status of financial institutions, during the year 2002, joint inspections of 13 banks were held together with the Financial Supervisory Service.

- 6** During the year under review, the Bank of Korea reacted flexibly to changes in the domestic and the external environment while maintaining its call rate target at a low level. This policy stance contributed greatly to the recovery of business activity by underpinning a solid increase in domestic demand in forms such as private consumption while keeping prices stable within their target range.

The real economy showed a convincing upward trend despite the persistent overall sluggishness of global economic activity. In the first half of the year, the recovery was driven by consumption and construction investment while, in the latter half, exports evolved favorably. Consequently, real GDP growth rate, which had remained at only 3.1% during 2001, rose to 6.3% during 2002.

The rise in consumer prices was limited to an annualized rate of 2.7%

thanks to the lack of demand-pull pressures, the appreciation of the Korean won and the stabilization of charges for public services, which together more than offset the effects of the upswing in housing rents and wages and the higher prices of agricultural products as a result of exceptionally severe weather conditions. Core inflation was held to 3%, which is the mid-point of its target range of $3\pm 1\%$ and lower than its 3.6% of the previous year.

The current account maintained an annual surplus, mainly thanks to the large-scale increase of exports centering on IT products. Nevertheless, the scale of the surplus decreased from 8.2 billion dollars of the previous year to 6.1 billion dollars during 2002 because of the greatly widened service account deficit as a result of increased spending on overseas travel and so forth.

In the financial markets, interest rates continued their downward movement amid ample liquidity thanks to the sustained easy stance of monetary policy. Corporate funding conditions were smooth owing to the improvement in profitability and cash flow generated by the economic upswing. For its part, however, the stock market shrugged off the business recovery and the favorable evolution of companies' operating performance. Investors' spirits were chilled by the high degree of uncertainty surrounding domestic and external conditions, so that from late April onwards, like the stock markets of major advanced countries, it was unable to pull out of the doldrums.

In the foreign exchange markets, the supply of foreign exchange continued to exceed the demand and thus the Korean won showed a generally stable trend of mild appreciation against the US dollar. The foreign exchange reserves saw constant expansion, mainly thanks to earnings from the management of foreign currency asset holdings. As of the end of February 2003, they stood at 124 billion dollars, the fourth largest in the world after those of Japan, China and Taiwan.

- 7** Moving into 2003, the uncertainty in the external environment has been increasing such as the geopolitical risks including a war on Iraq and the North Korean nuclear issue, and the possibility of a further delay in the recovery of the world economy. However, this fog of uncertainty is anticipated to gradually recede in the future. Provided this is indeed the case, serious disequilibria in terms of growth, prices and the current account are unlikely to arise.

The rate of economic growth for 2003 is anticipated to stay at a level lower than that of last year mainly because of the slowdown in consumer spending that will more than offset the continuing buoyant growth of exports. Despite little demand-pull pressures, the rate of increase in prices is seen to be higher than that of last year as a result of the sharp rise in international oil prices, the increase in unit labor costs stemming from the high level of wage rises, and the imposition of higher charges for public services. It is foreseen that the current account position will deteriorate in view of high

international oil prices, the widening of the deficit on the services account and so on.

- 8** Taking these conditions into account, the Bank of Korea established its 2003 annual inflation target at $3\pm 1\%$ in terms of core inflation, the same level as in the previous year and set its medium-term target as a range of 2.5~3.5%.

For the current year, in the absence of any unanticipated external shock, the level of price rises is seen as likely to remain within its target range. The utmost efforts will, however, be devoted to achieving this year's target while holding the level of price increases stable within the medium-term target range from next year onwards by keeping an eye on the potential factors bringing about price instability.

It is intended that interest rate policy should be operated flexibly with the medium time horizon in such a way as to maintain the balance between growth and stability by paying careful attention to changes in domestic and external conditions. Should worries arise over the slowdown of business activity because of a more serious than expected deterioration of the economic environment, a flexible response will be taken, insofar as this would not undermine price stability.

Meanwhile, as the practice of monetary policy operation that puts emphasis on interest rates has become firmly established, a monitoring range for M3

will no longer be established and announced from this year onwards, although, in the course of the conduct of the monetary policy, the movements of quantitative indicators including M3 will continue to be carefully tracked as information variables.

In view of the possibility that the operating environment of SMEs, which are heavily dependent on domestic demand, will be relatively worsened by the shrinking of consumer confidence, it is intended to provide positive support so that they do not experience serious difficulties in fund raising. Efforts will be particularly directed toward raising the effectiveness of support to regionally-based SMEs in accordance with the policy of stimulating regional economies. Apart from this, for the soft-landing of the household debt problem, the trends of the increase and roll-overs in banks' household lending will be carefully monitored and appropriate measures to deal with the problem are expected to be sought.

Plans will also be deliberated to promote the rediscount system's orthodox functions of signalling monetary policy stance and adjusting liquidity by, for example, realigning efficiently the Aggregate Credit Ceiling System in line with recent changes in the financial environment, and galvanizing the use of the Liquidity Adjustment Loan System. At the same time, it is planned to put in place a more practical system of reserve requirements to induce financial institutions to maintain well-balanced term structures of deposits and to prepare for the expected expansion of the use of electronic money.

While keeping an eye on overall conditions in the financial markets, it is intended to complete the final stage of the 「Four Stage Interest Rate Deregulation Plan」, whose implementation began in 1991, by liberalizing interest rates on demand deposits. The dismantling of the remaining interest rate regulation is not considered likely to give rise to any particular side effects in view of the great improvement in banking profitability brought about by the sustained structural adjustment and the fact that the low interest stance has taken firm root.

So as to maximize the effects of monetary policy, efforts will be devoted to promoting confidence and understanding on the part of the general public concerning monetary policy while the function of policy inspection of financial institutions will be intensified.

In order to heighten the safety and efficiency of the payments and settlements system, endeavors will be made to upgrade the operating system of BOK-Wire, augment settlement risk management and bring about the continuing development and expansion of the electronic payments system.