Monetary Policy Report

(January 2001 ~ February 2002)

THE BANK OF KOREA

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Ⅰ. Overview

1 The Bank of Korea established an inflation target for the year 2001 of 3±1% in terms of core inflation. To maintain consistency in monetary policy and heighten its credibility, the medium term inflation target was kept unchanged at the previous year's level of 2.5%.

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

In February, consumer and business confidence evaporated and the growth rate of exports fell sharply in response to the U.S. economic slowdown. The Bank thus cut its target rate by 25 basis points(5.25% → 5.0%) to avoid an overly deep decline in business activity.

The target call rate was maintained at the 5% level right through until the end of June. The rationale for this decision was that consumer spending had shown stronger growth than expected, thereby lessening the speed of the economic slowdown, while the combination of higher oil prices, the weakness of the Korean won and rises in public service charges that had emerged from early in the second half of the preceding year, continued to drive inflation at a rate above the upper bound of its target range.

After having briefly shown an improved pattern of economic activity, real economic indicators began to deteriorate again from early in the second half. On the external front, concerns over a world-wide recession mounted amid a gradual increase in the obscurity surrounding the prospects for an early recovery of the U.S. economy. The rate of inflation, though still running slightly above the upper bound of its target range, began to ease from early June onwards and held out the prospect of a gradual return within its target range during the second half of the year. This was because the cost-push factors that had driven inflation in the first half of the year, such as the Korean won's depreciation and the rises in oil prices and public service charges, had weakened while demand side upward pressures remained virtually absent.

Taking into account this situation, the Bank brought down its target rate to the level of 4.5% in two consecutive reductions of 25 basis points each in July and August. In the case of the cut in August, the Bank also signalled the accentuation of its stance of monetary easing to the markets by lowering the Liquidity Adjustment Loans rates by 25 basis points(4.5% → 4.25%) at the same time.

Right after the September 11 terrorist attacks on the U.S., the Bank promptly announced plans to increase the supply of liquidity in order to secure financial market stability. Soon afterwards, an extraordinary meeting of the Monetary Policy Committee was convened on 19 September. At this a number of positive measures were taken, including an additional reduction of 50 basis points in the target call rate(4.5% → 4%) and the lowering of the interest rates on Liquidity Adjustment Loans and Aggregate Credit Ceiling Loans by a further 50 basis points, with a view to checking the spread of the malign influence of the terrorist attacks.

From then until the end of the year, the target call rate was maintained unchanged despite expectations of its further reduction in view of the uncertainties surrounding domestic and external economic conditions. The rationale for the Bank's stance was the improvement in external conditions such as the signs of a turnaround in the U.S. economy in response to the likelihood of an early conclusion of the Afghanistan campaign while the side effects of the "War against Terrorism" on the economy did not appear as large as had at first been feared. In addition, the level of confidence concerning economic recovery was heightened by the unexpectedly good showing of some leading domestic economic indicators, hikes in stock prices and increased activity in construction.

The trend of improvement in real economic activity was carried on into the year 2002. Consumer spending and construction investment continued buoyant and facilities investment shifted to an upward trend. Although there were factors present acting to destabilize prices, such as the Korean won's depreciation, from the second half of 2001 onwards, they exhibited downwardly stable trends. The Bank of Korea accordingly left its overnight call rate target unchanged at the level of 4 percent.

3 From the year 2001, broad money(M3), which had been hitherto employed as an intermediate target, was converted into a monitoring indicator of overall liquidity conditions. Liquidity was therefore supplied in response to the level of money demand, maintaining the overnight call rate at its target level. In the year 2001, the growth rate of M3 accelerated from the preceding year's 5.6% to 9.6% as a result of the recovery of the intermediary function of non-bank financial institutions including investment trust companies. This rate of increase was just inside its monitoring range established at the beginning of the year(6~10%).

The Bank of Korea handled abrupt changes in the financial market through the flexible supply of liquidity. In the case of the large redemption of investment trust companies' MMFs(Money Market Funds) in April, which threatened to destabilize the bond market, and immediately after the terrorist attacks on the U.S. in September, commercial banks were supplied with additional reserve money through open market operations. The scale and timing of issues of Monetary Stabilization Bonds(MSBs) were also flexibly adjusted at those times. In November, when bond rates rose sharply for a short period of time, early redemptions of MSBs and outright purchases of government and public bonds were carried out in order to soothe the market instability.

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

The Aggregate Credit Ceiling was raised by 2 trillion won in January 2001 and by a further 2 trillion won immediately after the terrorist attacks on the U.S., bringing the total size of the facility to 11.6 trillion won. The method of quota allocation under the facility was also changed to encourage banks to provide more funds to the corporate sector than to households. From March 2001, quota allocation methods were adjusted, for a period of one year only, so as to reflect performance in lending to large enterprises (excluding the top four business groups) and purchases of corporate bonds and commercial paper. From March 2002 onwards, the Bank augmented its preferential quota for credit-based lending to small and medium sized enterprises(SMEs) while reducing the quota for banks that had increased household lending.

From June 2001, exports of products in electronic form including those of software via the Internet also became eligible for trade finance support from the Bank. On the other hand, the Bank changed the rule for its post hoc management in maintaining the ratio of lending to SMEs, encouraging banks to expand their lending to entities involved in the construction of social overhead capital(SOC).

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

The amount of the Aggregate Credit Ceiling assigned to Corporate Procurement Loans was raised from 1 trillion to 3 trillion won during the year 2001 and it was lifted further to 4.3 trillion won from February 2002. This was done with a view to promoting advanced settlement practises in commercial transactions by reducing the use of commercial bills.

The Bank introduced a system of Electronically-processed Secured Receivables Loans in February 2001, which allows SMEs to receive settlement in cash for goods delivered to companies belonging to the top 30 business groups. To help this system come into active use at an early date, it was included among the items eligible for support under the Aggregate Credit Ceiling. In contrast, support for the discount of commercial bills is being gradually reduced. As a result, the total amount of loans designed to replace bill-based transactions, such as Corporate Procurement Loans, reached an amount equivalent to 77% of the total of commercial bills discounted. Judging from this, cash settlement appears to be rapidly replacing settlement by means of bills.

5 In January 2001, the Bank of Korea raised the maximum credit ceiling on its Liquidity Adjustment Loans by 1 trillion won(2 trillion won → 3 trillion won) to intensify the function of the central bank's loan system in securing financial stability. At the same time, the ceiling on Daylight Overdrafts was increased from 100% of a commercial bank's average current account balance held with the Bank to 200% thereof, and the range of securities eligible as collateral was widened to include government guaranteed bonds.

The Bank and the Financial Supervisory Service conducted joint examinations of fifteen banks from January 2001 through February 2002 to obtain information on the status of financial institutions and strengthen monitoring of their management.

6 The accommodating stance of monetary policy exemplified by the four successive reductions in target call rate contributed greatly to avoiding an economic recession in Korea during the year 2001.

Real GDP growth rate registered 3.7% in the first quarter but it declined subsequently to 2.9% in the second quarter and 1.9% in the third quarter, due mainly to the lacklustre performance of facilities investment and exports. In the fourth quarter, however, it stood at 3.7% owing to the large increase in consumer spending and construction investment. As a result for the year as a whole, GDP grew at a rate of 3%. In fact, the Korean economy recorded a relatively satisfactory growth performance in 2001, given that other Asian newly industrializing countries such as Taiwan and Singapore saw negative growth from the second quarter onwards.

Consumer prices rose rapidly during the early half of the year, but during the latter half their pace eased or showed a falling pattern. For the year as a whole they registered a relatively high rate of increase of 4.1%, principally as a result of increases in public service charges and the depreciation of the Korean won. Public service charges rose 7.5% for the year due to the sharp rise in health insurance fees and piped gas charges, which contributed 28% of the overall rise in consumer prices. The Korean won depreciated 14.2% against the U.S. dollar as compared to the previous year, which also put upward pressure on prices. The sharp rise in housing rental charges similarly acted as a major factor in the upward trend of consumer prices.

The inflation target established at the beginning of 2001 was based on the composition of the price index for the year 1995 and, on the basis of this, core inflation for the year under review registered 4.2%, above the 4% upper bound of its target range. The newly released statistics at the beginning of 2002, using the rebased year 2000 price index, however, show core inflation for the year as having recorded 3.6%, which was within its target range.

Exports declined because of the business slowdown in the advanced countries including the U.S. and the sharp fall in the prices of information technology(IT) related items. Imports, meanwhile, fell even more sharply in response to subdued domestic business activities and the drop in oil prices. As a net result, the current account registered a surplus of 8.6 billion dollars for the year.

In the financial market, interest rates fluctuated in line with changes in the business outlook, but generally maintained a downwardly stable course in view of the rather low level of corporate demand for funds and the absence of any major problems for companies in fund-raising.

As for the foreign exchange market, the net supply of foreign exchange continued for the year and the exchange rate of the Korean won against the U.S. dollar maintained its stable trend overall. From November onwards, however, the Korean won softened against the U.S. dollar, reflecting the weakening of the Japanese yen. Foreign currency reserves built up steadily throughout the year, despite the complete repayment in August 2001 of the borrowings from the IMF, and they stood at 105.1 billion dollars as the end of February 2002.

7 The Korean economy is expected to accelerate its pace of growth during the year 2002 along with the improvements in the external and internal environment. But there still exist uncertainties in external conditions in that the pace of recovery of the U.S. economy is expected to be rather flatter than that from other recent downturns and the anxieties over the Japanese economy have not completely disappeared.

On the prices front, despite the rise in business activity, the stable trend should be continued through the mid-part of the year because of the ample supply capacity, and for the year as a whole, inflation should be rather lower than in the preceding year. Factors still remain that make for price instability in the form of the rise in real estate prices, the possibility of the persistent weakness of the Japanese yen and a run-up in oil prices caused by the expansion of the “War against Terrorism”.

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 but imports are also likely to accelerate their expansionary trend and the services account will also deteriorate.

8 Taking overall account of these conditions, the Bank of Korea set its inflation target at 3±1% in terms of core inflation, the same level as in the previous year and maintained its medium term target at 2.5% with a view to ensuring the consistency of monetary policy.

Price rises are seen to remain stable within the target range, provided unexpected disequilibria do not arise. Every effort will be made to hold in check the latent factors that might disturb price stability, allowing this year's inflation target to be met and, from next year onwards, the inflation rate should converge rapidly on its medium term target of 2.5%.

While focusing on achieving the inflation target, the Bank will operate its interest rate policy instruments flexibly, responding to changes in domestic and external conditions. Particular care will be given to asset price movements, including those of real estate. 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.

The utmost efforts will also be made to ensure the stability of the financial markets. It is anticipated that financial market conditions will be better than last year's but that major financial variables may become more volatile as domestic and external conditions evolve. Appropriate market stabilization measures will be undertaken in the event of an abrupt and temporary shift in interest rates caused by the markets' over-reaction. Money will be supplied flexibly by, for example, providing appropriate liquidity in a timely manner to financial institutions should they face temporary liquidity problems in the course of financial restructuring. In this context, the Bank has established a monitoring range for M3(period-average basis) growth of 8~12%, somewhat higher than last year's 6~10%, in view of the likelihood of increased private-sector money demand with the recovery of business activity.

This year, endeavors will be continued to strengthen the incentives for financial institutions to expand credit-based corporate lending and improve settlement practises in commercial transactions between companies. This should allow SMEs to raise the funds they need without problems.

The Bank will make every effort to enhance the effectiveness and transparency of monetary policy, facilitating the prompter and more accurate transmission of its policy intentions to the real sector and the financial markets. The Bank will also augment its activities in checking and analyzing the soundness of financial institutions' management and make active use of the information thus obtained in its monetary policy.

Efforts will also be devoted to heightening the security and efficiency of the payments systems. To this end, BOK-Wire will be operated more efficiently and settlement risk managed more tightly. At the same time, a drive will be mounted to develop and generalize the use of electronic settlement systems.

Ⅱ. Economic and Financial Movements

1. Overseas Economy

A. Economic Growth and Trade

<Table Ⅱ-1>

Trends of Major Overseas Economic Indicators

(%, annual %)

	1998	1999	2000	2001e
Economic Growth[1]				
World	2.6	3.6	4.7	2.4
Industrialized nations	2.4	3.3	3.9	1.1
U.S.A.	4.4	4.1	4.1	1.2
Japan	-2.5	0.7	2.2	-0.5
Euro area	2.7	2.6	3.4	1.5
(Germany)	2.1	1.8	3.0	0.6
Asian emerging markets[2]	-2.3	7.9	8.2	0.4
Developing nations	3.5	3.9	5.8	4.0
Asia	4.1	6.2	6.8	5.6
(China)	7.8	7.1	8.0	7.3
Latin America	2.2	0.1	4.1	1.0
World trade growth[1]	4.3	5.4	12.4	1.0
Long-term interest rates[3]				
U.S.A.	4.65	6.44	5.11	5.05
Japan	2.22	1.65	1.64	1.37
Germany	3.87	5.35	4.84	5.00
Exchange rates[4]				
¥/U$	113.6	102.5	114.4	131.7
U$/euro	1.167	1.006	0.943	0.890
Prices of international raw materials				
Rise in crude oil prices[5]	-33.2	39.9	59.8	-14.4
Others[6]	-17.5	-14.0	1.9	-10.1

Notes: 1) Based on IMF statistics apart from the growth of the U.S., Japan, Germany and China, which are based on their respective statistics.
2) Korea, Taiwan, Singapore and Hong Kong.
3) Based on the yields of 10-year government bonds and on period-end figures.
4) Based on period-end figures.
5) Based on annual average of Brent oil prices.
6) Based on annual average of Reuters' Product Price Index.
Source: "World Economic Outlook" (Dec. 2001) by the IMF. Bloomberg, Reuters.

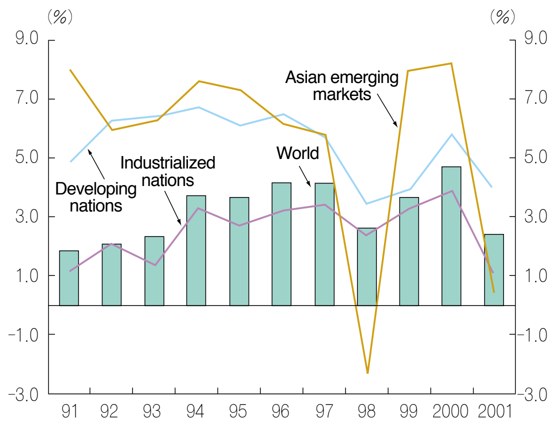
During the course of 2001 the world economy was unable to escape from the doldrums in which it was caught by the slowdown of U.S. economic growth. The impact of the terrorist attacks on the U.S. further depressed the already low growth. As a result, it registered the lowest growth rate since 1993 with the growth rate falling from the 4.7% of the year 2000 to a little over 2% in the year 2001.

The downturn in the U.S. economy, which had begun in the latter half of the year 2000, was continued in the first quarter of 2001 when its GDP growth stood at just 1.3%(annualized quarter-to-quarter change). During the second quarter, it slowed to near zero growth (0.3%), before moving into negative growth(-1.3%) in the third quarter. This was attributable to the depressed state of the information technology(IT) industry, sluggish exports and depressed investment and other such negative effects of the September 11 terrorist attacks. Although the impact of the terrorist attacks eased as the fourth quarter wore on and the business downturn moderated, fourth quarter growth was somewhat low(1.4%) and GDP growth for the year as a whole came in at just 1.2%.

The Japanese economy achieved a shift into positive growth during the final quarter of the year 2000 and the first quarter of 2001 thanks to the expansion of facilities investment in the IT sector and increasing exports. In

<Figure Ⅱ-1>

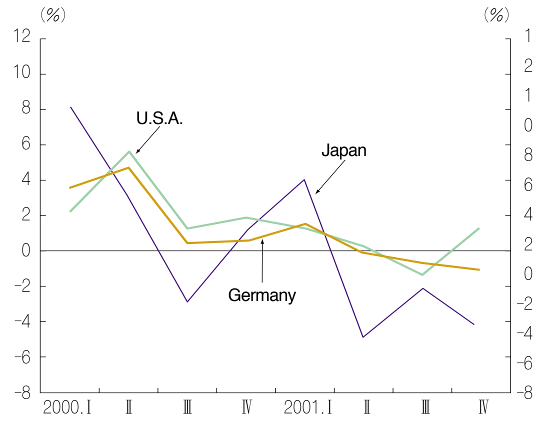
Trends of World Economic Growth



Source: "World Economic Outlook"(Dec. 2001) by the IMF.

<Figure Ⅱ-2>

Trends of Economic Growth in Major Industrialized Nations[1)]



Notes: 1) Annualized quarter-to-quarter changes.
2) Based on each country's respective statistics.

<Table Ⅱ-2>
GDP Growth and Percentage Shares in IT Export of Major Asian Countries

(%)

		Singapore	Malaysia	Taiwan	Korea	Hong Kong
Shares in IT Export[1)]		58.2	53.0	41.9	35.0	28.4
GDP Growth	2000	9.9	8.3	6.0	9.3	10.5
	2001	-2.0	0.4	-1.9	3.0	0.1

Note: 1) Based on 2000 statistics.
Source: The Bank of Korea.

the following three quarters, however, it registered continued negative growth as exports, investment and consumer spending all contracted amid the slowing of the global economy and worries over the soundness of the financial sector. In the second quarter of the year 2001, growth slid to -4.8%(annualized quarter-to-quarter change) and stood at -2.1% and -4.5%, respectively, in the third and fourth quarters. For the year as a whole, Japanese GDP growth marked just -0.5%. Under such as depressed economic conditions, Japan experienced deflation with the continual decline in consumer prices since February 1999 and unemployment rose to the level of 5.5% in December 2001, its highest figure in recent economic history.

In Euroland, GDP growth reached 2.4%(year-on-year basis) during the first quarter of 2001, but from the second quarter onwards it dipped sharply as exports and industrial production turned sluggish under the influence of the U.S. business slowdown, dragging down growth to just 1.5%, much lower than the previous year's performance(3.4%). In Germany, with the waning of the exceptionally high demand caused by reunification, construction investment contracted notably. The sluggishness of German exports brought about a slowing of facilities investment. During the latter half of the year, increased unemployment acted to reduce consumer spending. Under the combined influence of these malign factors, the German economy grew just 0.6% for the year 2001 as a whole.

In the Asian region, three Asian countries which have a particularly high dependence on IT exports, Singapore, Taiwan and Korea, experienced difficulties as a result of the slowdown of U.S. business activity. It was notable that Singapore and Taiwan, which have both been praised for their strong growth over the past few years, suffered negative growth during the year 2001.

In contrast, the Chinese economy with the vast scale of demand in its domestic market was able to achieve growth in 2001 at the level of 7%, following growth of 8.0% in the previous year, buoyed up by consumer spending and the brisk evolution of government investment, while it remained less affected by the downturn in global business activity. In the case of the countries of South and Central America, while Argentina registered negative growth for the third straight year, the GDP growth of Brazil, Mexico and other regional countries dropped sharply owing to slackened exports under the influence of the U.S. business downturn as well as the contagion effect of the Argentinian economic instability.

World trade during the year under review(on the basis of export and import volumes) grew at a rate of only around 1%, well below the level of the previous year and the lowest recorded since 1983. This was attributable to the fact that not only did the majority of countries see the scale of their exports and imports contract sharply as a result of the slowdown of demand caused by the worldwide economic downturn, but also the exports of Asian emerging markets, Mexico, Canada and so on to the U.S. shrank in response to the rapid deceleration of the U.S. economy.

B. International Interest Rates and Foreign Exchange Rates

Viewing interest rate movements, during the year 2001, most countries experienced a sharp fall in short-term interest rates as central banks around the world reduced their policy interest rates in order to counter the economic downturn. Long-term interest rates fluctuated in line with the interplay of the effects of the business slowdown and of anticipations of economic

<Table Ⅱ-3>

Trends of Short- and Long-Term Interest Rates[1] in Major Countries

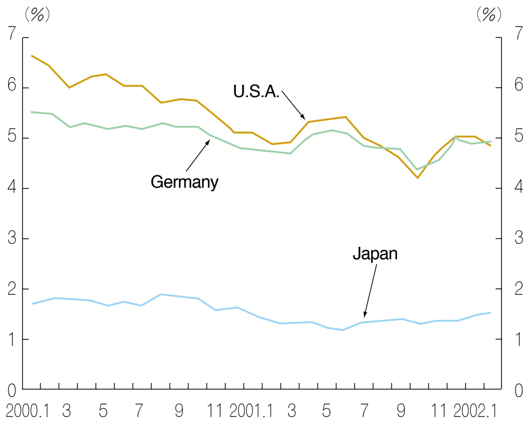
(annual %)

	2000	2001				2002	
	Dec.	Jan.	Mar.	Jun.	Dec.	Jan.	Feb.
Long-term[2]							
U.S.A.	5.11	5.11	4.91	5.41	5.05	5.03	4.88
Japan	1.64	1.50	1.27	1.19	1.37	1.49	1.53
Germany	4.84	4.79	4.68	5.09	5.00	4.91	4.96
Short-term[3]							
U.S.A.	5.87	4.96	4.28	3.63	1.72	1.75	1.75
Japan	0.40	0.33	0.05	0.01	0.01	0.001	0.001
Germany	5.15	4.63	4.54	4.51	3.29	3.29	3.29

Notes: 1) Period-end basis.
2) Based on yields on 10-year government bonds.
3) Based on yields on 3-month Treasury bills.
Source: Bloomberg.

<Figure Ⅱ-3>

Trends of Long-Term Interest Rates[1] of Major Countries



Note: 1) Based on yields on 10-year government bonds of each nation. Period-end basis.
Source: Bloomberg.

recovery. From the end of the year, as expectations of a worldwide economic recovery mounted and central banks of most individual countries desisted from any further lowering of their policy interest rates, the downward trend of short-term interest rates ceased and some long-term interest rates displayed an upward pattern of movements.

Seeking to ward off the economic downturn, the Federal Reserve Board in the U.S. lowered its Federal Funds target rate on 11 consecutive occasions during the year 2001, bringing it down by 4.75%p(6.5% → 1.75%). Three-month Treasury bills, the rate on which had come closer to the level of 6% towards the end of the year 2000, saw their yields slide to the level of 1.7% at the end of the year 2001, the lowest for 40 years. Long-term interest rates maintained their downward trend in the early part of 2001 in reaction to the economic downturn but from the second quarter onwards shifted to a mild upward trend, responding to anticipations of a pick-up in business activity thanks to the Federal Reserve's reductions in interest rates. Moving into the latter half of the year, however, the business downturn deepened and prospects of economic recovery became obscure in the aftermath of the terrorist attacks. This brought long-term rates down relatively sharply. From the fourth quarter onwards, anticipations concerning economic recovery gradually mounted, causing long-term rates to shift back to an upward trend. Meanwhile, moving into 2002, the downward trend of short-term interest rates came to a halt as the Federal Reserve held its Federal Funds target rate at its existing level. Long-term interest rates moved somewhat lower as investors' appetite for corporate bonds dried up in the wake of the Enron scandal, while that for government and public bonds increased.

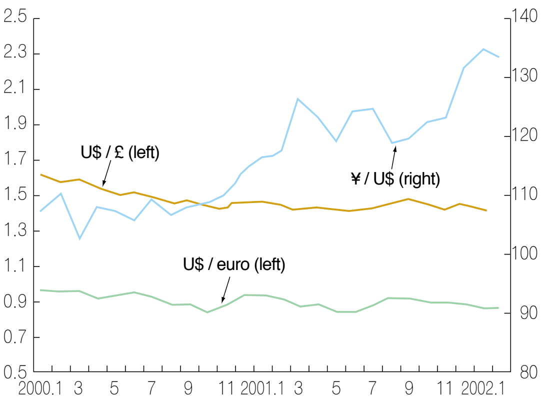
In Japan, short-term interest rates maintained a downward trend as the Bank of Japan, amid continuing deflation, intensified the easing of its monetary policy stance by expanding its supply of liquidity. This brought yields on three-month Treasury bills from 0.4% as of the end of 2000 to just 0.01% as of the end of 2001. Long-term interest rates moved smoothly upwards from the first half of 2001 onwards despite deflation, buoyed up by prospects of continued fiscal easing designed to counter the Japanese economic crisis. From early in the year of 2002, while the sense of crisis surrounding the Japanese economy mounted, banks tried to avoid the depletion of their capital anticipated from the introduction of market-based valuation of their share holdings as of the closing of their books at the end of March, by disposal of their bond holdings. This caused long-term interest rates to maintain their upward trend.

In the euro zone, short-term interest rates maintained a downward trend throughout 2001, responding to the European Central Bank's(ECB) decision to lower the interest rate on its open market operations on four occasions. Long-term interest rates moved downwards in the early part of 2001 with the weakening of inflationary pressures amid the business slowdown. They subsequently fluctuated in line with the strength of anticipations concerning economic recovery. In the early part of 2002, the downward trend of short-term interest rates came to a halt whereas long term rates showed a slightly upward pattern of movements.

Looking at the exchange rate movements of major currencies in the course of the year under review, the Japanese yen firmed temporarily against the U.S. dollar but subsequently its tone remained weak, reflecting the fragility of the Japanese economic

<Figure Ⅱ-4>

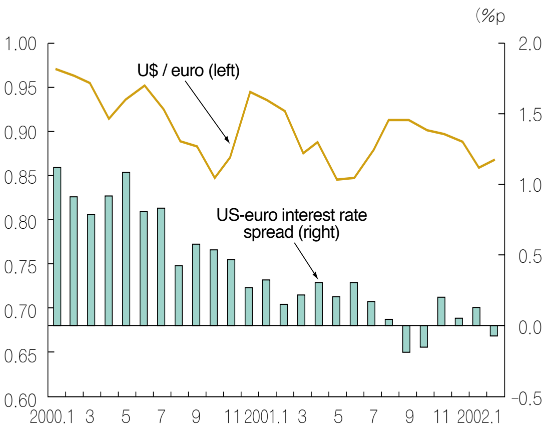
Trends of Major Exchange Rates[1]



Note: 1) Based on closing rates in local exchange markets. Period-end basis.
Source: Bloomberg.

<Figure Ⅱ-5>

Trends of Exchange Rates and Interest Rates Spreads between the US Dollar and the Euro[1]



Note: 1) Spread between the yields on 10-year government bonds of the U.S. and Germany. Period-end basis.
Source: Bloomberg.

situation. The euro also remained generally soft against the U.S. dollar.

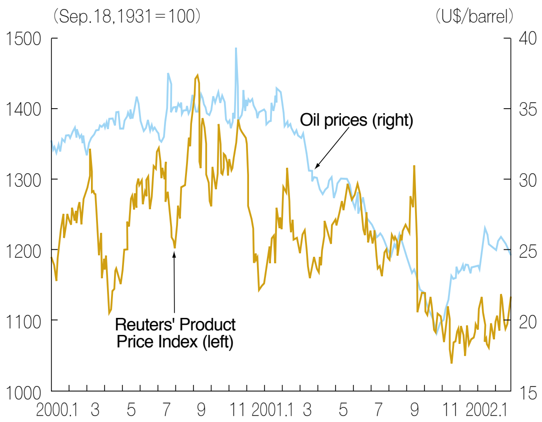
The Japanese yen, showing its weak tone against the U.S. dollar from the start of the year 2001, traded at 126 yen per dollar at the beginning of April. With Prime Minister Koizumi's formation of his cabinet during April, however, anticipations mounted concerning the pursuit of economic reform. As a result, the yen firmed against the dollar to stand at 119 yen per dollar as of the beginning of June. However, it subsequently shifted back to a softening trend in the absence of any visible efforts for specific structural adjustment, trading in a range of 120~125 yen per dollar until the beginning of September. Immediately after the events of 11 September, it strengthened to 116 yen per dollar but resumed its softening trend again after that. Particularly, as a sense of crisis concerning the Japanese economy built up from the end of November, the yen depreciated rapidly to stand at 134.7 yen per dollar on January 24, 2002, its lowest level since October 5, 1998(134.3 yen per dollar).

The euro also maintained a generally weak tone against the U.S. dollar until the beginning of July, reacting to a net outflow of funds in the form of foreign direct investment and portfolio investment while the euro zone economy performed more sluggishly than had been expected. As of July 2001, the euro, which had been trading at 0.94 dollar for 1 euro, was changing hands at 0.84 dollar per unit. It subsequently appreciated to above 0.92 dollar with the lack of visibility of the U.S. economic recovery and the widening of the spread between U.S and euro-area interest rates, before falling back below the 0.9 dollar level from October onwards as the euro-area economy also moved into recession. In the early part of 2002, the euro temporarily rallied on anticipations raised by its being put into physical circulation, before returning to its generally softer trend in response to comparatively weak economic indicators and the ECB's decision to keep interest rates unchanged.

C. Prices of International Raw Materials

<Figure Ⅱ-6>

Trends of Prices of International Raw Materials[1)]



Note: 1) International oil prices are based on annual average of Brent prices. Period-end basis.
Source: Reuters.

During the year 2001, international raw material prices generally exhibited a downward trend in response to the subdued demand in line with the worldwide economic downturn.

International oil prices rose sharply in line with the agreement among Oil Producing and Exporting Countries(OPEC) to reduce production at the beginning of the year 2001, climbing to above 30 dollars per barrel(Brent crude) during February. By the end of March, however the price fell to 23 dollars per barrel owing to the advent of spring when demand for oil is low and the general reduction in demand for it brought about by the worldwide economic downturn. Subsequently, OPEC undertook a second round of production cuts and, as the world's largest energy consumer, the U.S., increased oil imports to build up its stocks. As a result, prices rebounded to a level of 29 dollars per barrel as of the beginning of June. However, as demand remained low under the influence of the worldwide economic downturn and Iraq resumed its oil exports, which had been frozen for sometime, the price fell back to 23 dollars per barrel. Prices surged to 30 dollars per barrel for a brief period on the back of speculative demand immediately after the terrorist attacks on the U.S., but with the deepening of the worldwide economic downturn, the price fell steeply as OPEC lost its sway over the markets and from mid-October onwards, the price per barrel moved between 17 and 19 dollars. Early in 2002, the OPEC countries resolved to cut production, in spite of which international oil prices continued stable.

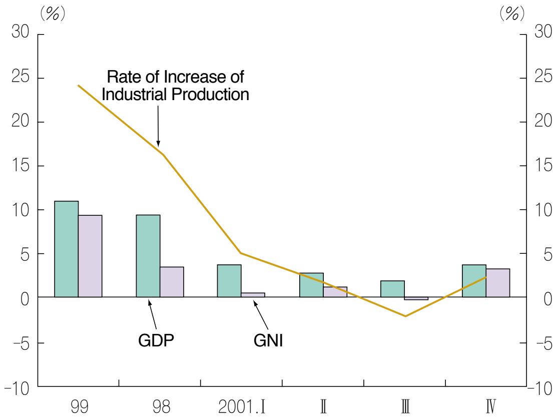
Other raw material prices had risen slightly during 2000, but for the year 2001 as a whole, the prices of the principal food grains generally held steady at the previous year's level whereas the prices of raw materials for use in manufacturing registered a steeply falling downward trend in response to the shrinking of demand worldwide. In the case of nonferrous metals, from November onwards, however, the prices of copper and aluminium shifted to a mild upward trend in response to the reduction of output by producers. Reuters Commodity Price Index stood at a level 14.2% lower at the end of January 2002 than at the end of the year 2000.

2. Economic Growth and Trade

A. Economic growth

<Figure Ⅱ-7>

Trends of Major Economic Growth[1] Indicators



Note: 1) Compared with the same period of the previous year.
Source: The Bank of Korea, Korea National Statistical Office.

Moving into 2001, the Korean economy, which had registered higher rates of growth in 1999~2000, saw its growth greatly subdued. During the year 2001, GDP growth remained at 3%, much lower than in the previous year(9.3%). Viewing GDP growth by period, during the first quarter it stood at 3.7%, before falling in the second and third quarters to 2.9% and 1.9% respectively; in the final quarter it picked up again to the level of 3.7%.

This rapid deceleration in the growth rate of the Korean economy was attributable to the ebbing of exports in response to the economic downturn in the U.S. and other major countries along with the lacklustre performance of the IT industry. Another major factor contributing to the slowdown was the large scale contraction of facilities investment in response to the murkiness of conditions at home and abroad. From early in the final quarter, however, the picture improved as domestic demand turned increasingly brisk, affected by the stimulation of domestic demand and by measures to revitalize the construction industry.

Meanwhile, real gross national income(GNI), which shows the real purchasing power of income derived from production activities, rose only 1.3%, much less than GDP did, following the trend of the preceding year, as a result of the worsening of the terms of trade with the fall in the prices of major export items such as semiconductors.

<Table Ⅱ-4>

Trends of Growth[1] by Expenditure Item

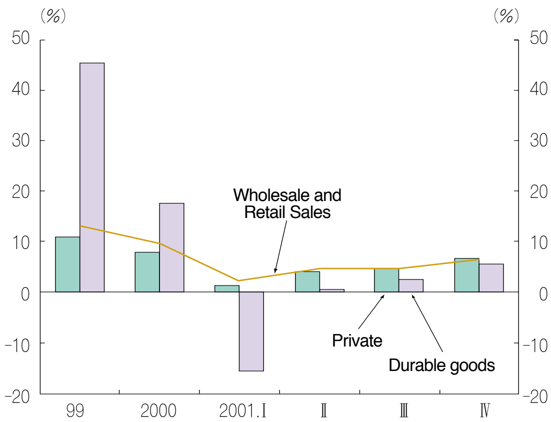
(%)

	1999	2000	2001P year	Ⅰ	Ⅱ	Ⅲ	Ⅳ
Final consumption expenditure	9.4	6.7	3.7	1.2	3.5	4.3	5.6
Private	11.0	7.9	4.2	1.5	4.1	4.8	6.6
Government	1.3	0.1	0.2	-0.7	-0.1	1.0	0.3
Gross fixed capital formation	3.7	11.4	-1.7	-4.0	-4.8	-3.1	4.9
Construction	-10.3	-4.1	5.8	1.5	1.1	8.2	10.7
Facilities	36.3	35.3	-9.8	-8.4	-11.2	-15.7	-3.1
Increase in inventories[2]	4.3	-0.2	0.0	-0.5	-0.1	0.3	0.1
Exports of goods and services	15.8	20.5	1.0	9.0	0.7	-4.1	-1.1
(Goods)	18.7	23.0	0.4	8.7	-0.1	-5.4	-1.1
Imports of goods and services	28.8	20.0	-2.8	0.2	-7.2	-5.5	1.1
(Goods)	32.8	21.0	-4.5	-0.1	-9.2	-7.9	-0.7
GDP	10.9	9.3	3.0	3.7	2.9	1.9	3.7

Notes: 1) Compared with the same period of the previous year.
2) Degree of contribution to GDP (percentage points).
Source: The Bank of Korea.

<Figure Ⅱ-8>

Trends of Major Consumption Growth[1] Indicators



Note: 1) Compared with the same period of the previous year.
Source: The Bank of Korea, Korea National Statistical Office

(Demand)

Viewing the trends of demand for the year by sector, whereas domestic demand witnessed continuing growth, especially in consumer spending and construction investment, the rate of increase of exports eased sharply and facilities investment declined from the previous year.

Consumer expenditure exhibited a moderate level of growth compared to the previous year, in spite of the continued acceleration of the expansion of private-sector consumption and the shift of government spending to an upward trend from the second half of the year. Private-sector consumption increased 4.2%. Viewed by quarter, its rate of increase marked only 1% during the first quarter because of the business slowdown, but from the second quarter onwards with the improvement of labour market conditions, consumer confidence gradually revived and, as the effects of the measures to stimulate domestic demand made themselves felt, its rate of increase also rose. More specifically, while the consumption of services appeared buoyant(7.2%) centering on communications services, medical treatment charges and eating out, consumption of semi-durables(-0.4%) and non-durables(0.7%) marked a low ebb. Although the consumption of durables, which is very sensitive to economic trends, contracted very sharply in the first quarter(-15.3%), leading it to register a decline for the year as a whole of 1.9%, it shifted to a modest rise from early in the second quarter onwards and then accelerated during the latter half of the year. Government spending, which had maintained a very mild pace of increase during the previous year, continued to exhibit a contractional trend during the first half of the year, but, moving into the second half of the year, with the compilation of two supplementary budgets, it shifted to an increasing trend, helped by the energetic disbursement of fiscal spending.

<Figure Ⅱ-9>

Trends of Major Investment Growth[1] Indicators

Note: 1) Compared with the same period of the previous year.
Source: The Bank of Korea, Korea National Statistical Office.

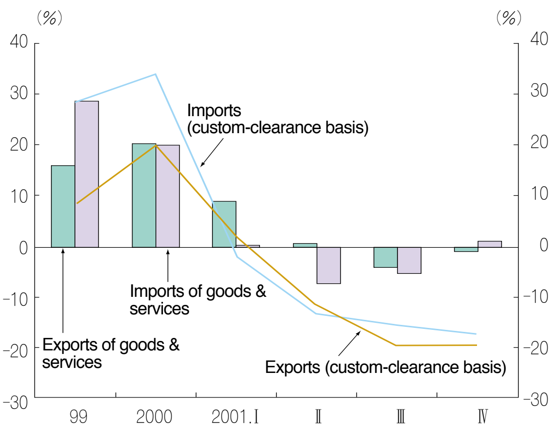
Looking at investment trends, fixed investment and inventories investment both showed a slight decrease. Fixed investment, which had raced ahead at a rate above the 30% level during 1999~2000, declined by 9.8% year on year in 2001. This contraction was attributable to the build-up of surplus capacity because of the reduction in demand in the midst of the business downturn from early in the year 2001. A further factor was the weakening of domestic and external conditions, which reduced business confidence and businessmen's willingness to invest. From the final quarter of the year, however, there was some slight improvement in business confidence with the favourable evolution of domestic demand, causing the scale of the decline in fixed investment to moderate greatly. Construction investment, which had shrunk in 1999~2000, showed a slight increase of above the 1% level during the first half of the year. However, from July onwards, its rate of increase accelerated greatly, as housing construction turned buoyant, especially in apartments and multi-unit, multi-household dwellings while infrastructure investment also increased.

Inventories continued to contract with those of agricultural and marine products and of imports being drawn down sharply, even though there was an increase in those of manufactured items.

The share in GDP of gross domestic investment (current-price basis) which had maintained an increasing trend(21.3%) since 1998, decelerated from the 28.3% of the previous year to 26.8% during the year 2001 in response to the large scale contraction in facilities investment. Even though the rate of increase of the growth of disposable income fell, the share in GDP of gross savings declined from the 32.4% of the previous year to 29.9% in reflection of consumption's robust pace of increase. There was, in consequence, a slight fall in the ratio of self-sufficiency in investment resources, which measures the extent to which gross domestic investment is covered by gross domestic savings, from 114.3% in the preceding year to 111.5%

<Figure Ⅱ-10>

Trends of Major Import and Export Growth[1] Indicators



Note: 1) Compared with the same period of the previous year.
Source: The Bank of Korea, Ministry of Commerce, Industry and Energy.

After registering a high rate of increase at the 20.5% level during the year 2000, the growth rate of goods and services exports(real basis) failed to rise above the 1.0% level during 2001. Viewed by period, while a mild increasing trend was exhibited in the first half of the year, from the third quarter onwards, a contractional trend was maintained. Affected by the worldwide depression of the IT industry, exports of goods including leading Korean export items such as semiconductors and computers experienced sharply reduced rates of growth; the exports of other sectors were also lacklustre at best, affected by the slowdown in business activities in the U.S. and other major countries. The overall growth rate of exports of goods consequently registered a mere 0.4% for the year as a whole. Service exports, in contrast, accelerated their pace of growth from the previous year to increase by 5.9%, thanks to augmented receipts from transport and communications services and to the larger number of foreign visitors to Korea.

Imports of goods and services(real basis) shifted from the high rate of growth of the previous year to a declining trend. Imports of goods declined by 4.5% over the year as a whole with a rise in those of consumer items being more than offset by a decrease in those of capital goods, raw materials and intermediate inputs, which together make up 88% of Korean imports. Service imports registered a modest rate of increase of 5.3%, lower than the preceding year's(15.0%), assisted by the expansion of royalty payments and of overseas travel by Korean residents.

<Table Ⅱ-5>

Trends of Growth Rate[1] by Economic Activity

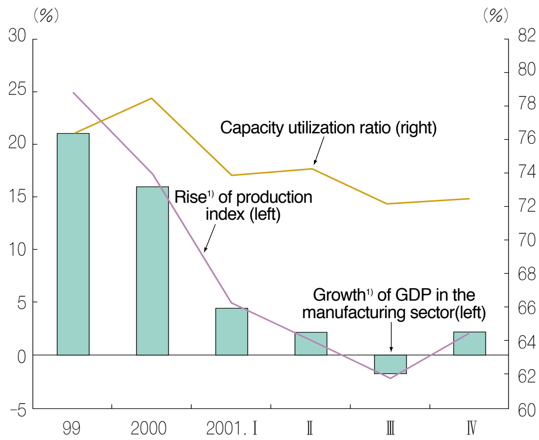
(%)

	1999	2000	2001ᴾ year	Ⅰ	Ⅱ	Ⅲ	Ⅳ
Agriculture, forestry & fishery	5.4	2.0	1.4	-4.1	3.5	1.3	1.5
Mining	5.3	2.5	0.5	-5.8	-0.1	10.8	-1.2
Manufacturing	21.0	15.9	1.7	4.5	2.2	-1.7	2.1
Electric, gas & piped water	10.4	14.0	5.7	7.5	4.7	4.3	6.0
Construction	-9.1	-3.1	5.6	2.4	1.5	7.6	9.5
Services[2]	11.9	9.5	4.1	3.9	4.0	3.8	4.7
Wholesale & retail, hotels & restaurants	14.1	9.8	4.0	3.4	3.8	3.8	5.1
Transport, storage & communications	14.5	17.9	7.3	8.2	6.8	7.7	6.8
Finance, insurance, real estate & business services	5.5	4.9	4.6	4.4	4.2	4.2	5.5
Social and private services	11.1	5.1	7.3	3.9	5.8	10.0	9.8
Government & private non-profit services[3]	1.2	0.3	0.9	1.2	1.0	0.8	0.6
GDP	10.9	9.3	3.0	3.7	2.9	1.9	3.7
GNI	9.4	3.6	1.3	0.5	1.0	-0.1	3.4

Notes: 1) Compared with the same period of the previous year.
2) Imputed bank service charge (less) and import duties included.
3) Includes household services.
Source: The Bank of Korea.

<Figure Ⅱ-11>

Trends of Production and Average Capacity Utilization Ratio in the Manufacturing Sector



Note: 1) Rates of change compared with the same period of the previous year.
Source: The Bank of Korea, Korea National Statistical Office.

(Production)

With the exception of the construction industry, most industrial sectors registered reduced growth in the course of the year 2001. Viewed by period, growth rates were mostly subdued up until the end of the third quarter, but exhibited a pattern of mild recovery in the final quarter.

Manufacturing, which had been the engine driving domestic business activities in the previous year with a growth rate of 15.9%, attained only a 1.7% rate of growth during the year 2001, thereby itself becoming a major contributor to the economic slowdown. The IT sector, embracing semiconductors, computers and communications equipment, which had achieved growth at the high level of 35.8% in the preceding year, saw its rate of growth greatly blunted. Another factor contributing to the slowdown was the shift of light industry, particularly textiles, apparel and footwear, to a declining trend.

Capacity utilization rates in manufacturing, which had reached 78.5% during the year 2000, fell sharply to 73.2% for the year 2001 as a result of the slowdown in business activities, which had begun during the latter half of the preceding year. Apart from a few sectors such as shipbuilding and non-metallic minerals, capacity utilization rates fell across manufacturing industry as a whole. The decline in those of the computer and semiconductor branches, in the aftermath of the depression of the IT sector, was particularly striking.

The electricity, gas and piped water sector grew by 5.7%, maintaining its increasing pace from the previous year thanks to the greater consumption of electricity and expansion of demand for piped natural gas. The construction sector, which had declined 3.1% in the year 2000, registered modest growth in the first half of the year at around the 2% level but its pace accelerated greatly during the latter half to reach 5.6% for the year as a whole. This upswing in the construction industry, which was centered on infrastructure projects such as roads and ports and on the housing sector such as apartments in particular came, in response to measures to revitalize construction activities, including the strengthening of financial and fiscal support for the additional construction of rented housing and for housing purchases.

The service industry continued to exhibit its relatively solid growth of the previous year, rising by 4.1% during 2001. The wholesale and retail, restaurants and hotels sector in particular maintained its incessant pace of growth, thanks to the buoyancy of the restaurants sub-sector in response to the increasing demand for eating out. Transport, storage and communications also continued its strong performance of the previous year, growing 7.3% for the year as a whole in line with the continuing briskness of communications centering on mobile phones and value-added communications services, whose effects more than offset the sluggishness of warehousing and storage. Growth at the level of 4%, similar to the previous year's, was exhibited by financial, real estate and business services, bolstered by financial institutions' earnings of interest and of fees and commissions and by the liveliness of real estate transactions. Another contributing factor was the continually upward trend of business services, most notably legal and accounting services. Social and personal services accelerated their pace of growth from the previous year in response to the buoyancy of private educational institutions, medical and public health services, and movies and other entertainment services.

The agriculture, forestry, and fishery industry achieved only modest growth, as it had done the previous year, rising by 1.4%. Even though forestry and fishery both shifted to a mild increase, shaking off their sharp falls in the previous year, the livestock business was badly affected by a panic over mad cow disease and agricultural production, particularly that of vegetables, declined.

B. Labor Market

The labour market situation maintained the improved picture of the previous year during 2001, and the rate of increase of nominal wages maintained a downwardly stable trend.

<Table Ⅱ-6>

Trends of Major Employment Related Indicators

(ten thousand, %)

	2000	2001					2002	
		year	Ⅰ	Ⅱ	Ⅲ	Ⅳ	Jan.	Feb.
Economically active population	2,195	2,218	2,143	2,247	2,243	2,240	2,185	2,190
(rate of growth)[1]	1.5	1.1	0.1	1.6	1.0	1.4	2.7	3.0
Economic participation rate	60.7	60.8	58.9	61.7	61.4	61.2	59.6	59.7
Number of persons employed	2,106	2,136	2,040	2,168	2,169	2,167	2,103	2,110
(rate of growth)[1]	3.8	1.4	0.4	1.9	1.4	1.9	3.6	4.5
Number of persons unemployed	89	82	103	79	73	73	82	80
Unemployment rate	4.1	3.7	4.8	3.5	3.3	3.2	3.7	3.7
(SA)	-	-	4.2	3.7	3.5	3.4	3.2	2.8

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

(Employment)

During the year the economically active population rose by 1.1% and despite the business slowdown, the number of persons employed increased by 1.4%, causing employment conditions to present a generally improved picture.

Because the rate of increase of the number of persons employed outstripped that of the economically active population, the unemployment rate fell from the 4.1% of the previous year to 3.7% and the number of persons unemployed declined from 890,000 to 820,000 during the year 2001. Viewed by period, the first quarter saw 1,030,000 out of work and the rate of unemployment at

<Figure Ⅱ-12>

Trends of Unemployment Rate and Number of Persons Unemployed

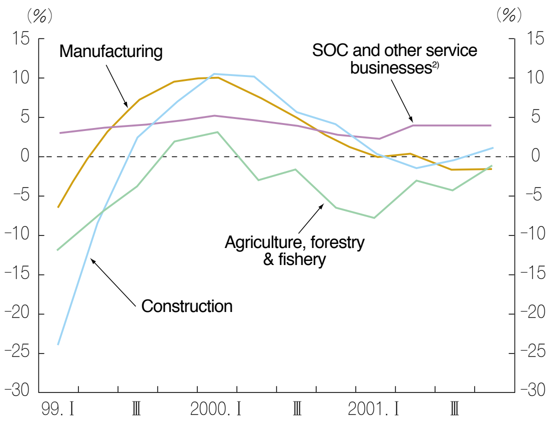
Source: Korea National Statistical Office

the 4.8 % level owing to the economic downturn and the increase in seasonal unemployment. From the second quarter onwards, however, the unemployment rate fell back to just above the 3% level and the number of persons unemployed declined greatly to around 700,000. In a notable development, unemployment eased to 3% in September, its lowest level since November 1997(2.6%). Moving into the final quarter, the number of persons employed in the agricultural and fishery industry decreased with the advent of the slack period of the farming year. Despite this and other seasonal factors, labour market condition remained favourable with the generally buoyant tone of business activities and the return of vitality to the construction sector in response to revival of real estate market activities. Moving into 2002, the number of persons out of work in the farming and fishing sector and in construction increased, as did the number of new graduates seeking employment, causing the rate of unemployment to rise to 3.7% in February and the number of persons unemployed to 800,000. After seasonal adjustment, the rate of unemployment(2.8%) and the number of persons out of work(630,000) both registered their lowest level since the outbreak of the currency crisis.

The reason that labour market conditions were favourable despite the overall slowdown in business activities seems to lie in the comparatively rapid rate of growth of the service sector, which has a high capacity for absorbing labour. An additional factor was that the decreases in manufacturing and especially in semiconductors, which spearheaded the economic decline, took place in the unit value of exports rather than in volume terms, meaning that the impact on employment was not particularly large. A further explanation was that companies responded to the contraction of demand not by reducing manpower, but

<Figure Ⅱ-13>

Trends of Growth[1] in the Number of Persons Employed by Industry



Notes: 1) Compared with the same period of the previous year.
2) Excludes construction.
Source: Korea National Statistical Office.

<Table Ⅱ-7>

Trends in the Structure of Employment and Working Hours

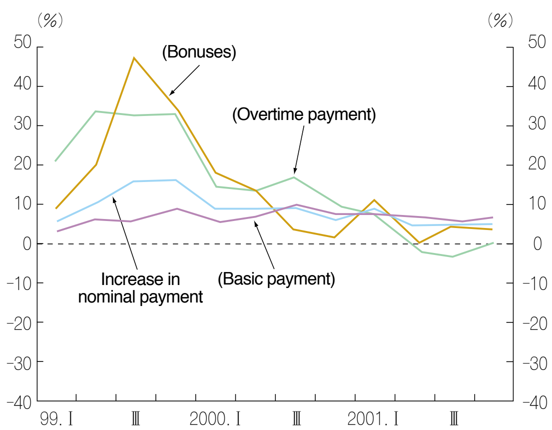
(%, hours)

	1999	2000	2001 year	Ⅰ	Ⅱ	Ⅲ	Ⅳ
Full time permanent[1]	48.3	47.6	48.7	49.5	48.7	48.6	48.1
Temporary and casual[1]	51.7	52.4	51.3	50.5	51.3	51.4	51.9
Monthly average working hours[2]	208	206	204	200	205	206	205
(overtime)	25	26	23	24	23	22	22

Notes: 1) Shares of total wage earners.
2) Based on businesses with 10 or more workers.
Source: Korea National Statistical Office, Ministry of Labor.

<Figure Ⅱ-14>

Trends in Wage Increases[1]



Notes: 1) Compared with the same period of the previous year.
2) Based on businesses with 10 or more workers.
Source: Ministry of Labor.

by restricting new hirings and the number of hours worked. Consequently the weakening of labour market conditions in response to the downturn was largely avoided.

Looking at employment trends by sector during the year, the downward trend of farming and fishing employment was maintained and the number of persons employed in manufacturing also decreased in response to lacklustre exports and facilities investment. In contrast, thanks to the convincing growth of domestic demand, the number of persons employed in the service industries greatly increased. In the case of the construction industry, the number of persons employed declined year-on-year on an annual average basis. Construction employment, nevertheless, shifted to an upward trend in the latter half of the year with a great expansion in the construction of apartments and multi-unit, multi-household dwellings in response to the government's concentration of its fiscal disbursements on the construction sector.

There was a moderate improvement from the preceding year in the structure of employment on an annual average balance, with the share of persons in full-time employment on the rise. However, total persons in full-time jobs(6.50 million) remained at around the level of 1998(6.48 million). Examining the trend by period, the share in total employment of those in full-time employment showed a reduction, whereas that of those employed on a temporary or casual basis exhibited an increasing trend.

(Wages)

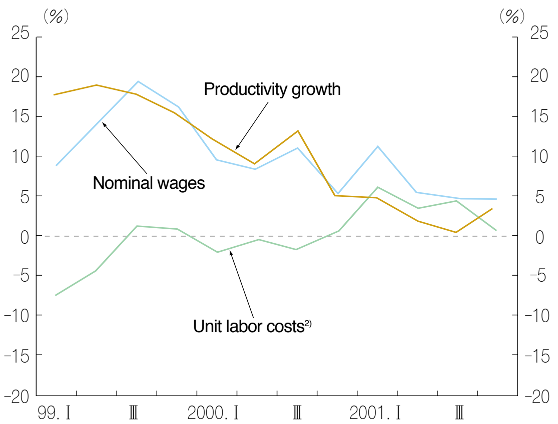
The rate of increase of nominal wages during the year 2001 decelerated from the previous year(8%) to stand at 5.6%. On the one hand, the weakening of corporate profitability as a result of the business downturn meant that companies' capacity to pay increased wages was limited while, on the other, with the progress of structural adjustment, workers sought security of employment rather than increased wages. The rate of increase of real wages, as represented by that of nominal wages adjusted for consumer price inflation, fell sharply from the 5.6% of the preceding year to 1.3%.

Looking at the make-up of nominal wages, the rate of increase of regular wages showed a slight deceleration from the previous year to stand at 6.5%, while overtime and special payments saw theirs drop to 0.3% and 5% respectively, reflecting the reduction in the number of hours worked across industry in view of the business slowdown and companies' lackluster performance. Rates of wage increases were lower than in the previous year across almost all branches of industry, but in the case of a few service sectors such as the wholesale and retail trade, wages rose slightly more rapidly than the year before, reflecting the continuing expansion of domestic demand.

Unit wage costs in manufacturing rose by 3.5% during the year 2001. This was a higher rate of increase than the previous year's because of the lower growth of labour productivity amid the business slowdown, which offset the effect of the reduction in the rate of increase of nominal wages.

<Figure Ⅱ-15>

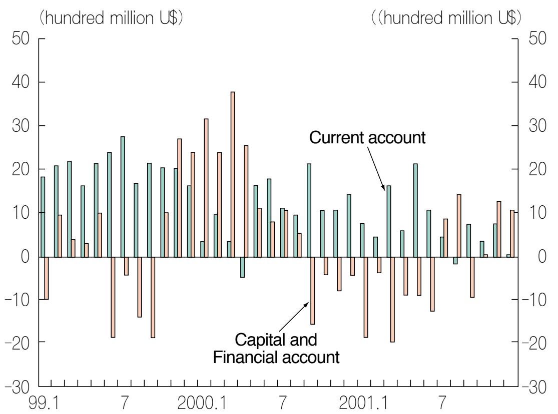
Trends of Increases[1] in Unit Labor Costs in the Manufacturing Sector



Notes: 1) Compared with the same period of the previous year.
2) Unit labor costs = nonimal wages/(constant GDP ÷ the number of persons employed).
Source: The Bank of Korea, Ministry of Labor.

<Figure Ⅱ-16>

Trends of Current, Capital and Financial Accounts



Source: The Bank of Korea

C. External Transactions

The current account registered a surplus of 8.6 billion dollars for the year 2001. This was the fourth straight year since 1998 that it had been in surplus, but its scale narrowed from the previous year(12.2 billion dollars), continuing its declining trend. The capital account shifted from the previous year's surplus of 12.1 billion dollars to a deficit of 3.6 billion dollars, as net inflows of direct and portfolio investment decreased whereas the deficit on the other income account was widened by the increased redemption of foreign loans. Meanwhile the Bank of Korea's external reserves rose by 7.7 billion dollars since the surplus on the current account more than offset the deficit on the capital account.

(Current Account)

<Table Ⅱ-8>

Balance of Payments

(hundred million U$)

	1999	2000	2001p
Current account	244.8	122.4	86.2
Goods & services	277.2	139.8	98.7
Goods	283.7	168.7	133.9
(exports)	1,451.6	1,759.5	1,513.7
(imports)	1,167.9	1,590.8	1,379.8
Services	-6.5	-28.9	-35.3
(credit)	265.3	305.3	296.0
(debit)	271.8	334.2	331.3
Income	-51.6	-24.2	-8.9
Current transfers	19.2	6.8	-3.6
Capital and financial account	20.4	121.1	-35.8
Financial account	24.3	127.3	-31.4
Direct investment	51.4	42.8	6.0
Portfolio investment	86.8	120.0	62.5
Other investment	-113.8	-35.6	-99.9
Other capital account	-3.9	-6.2	-4.4
Changes in reserve assets	-229.8	-237.7	-77.1
Errors and omissions	-35.3	-5.8	26.8

Source: The Bank of Korea.

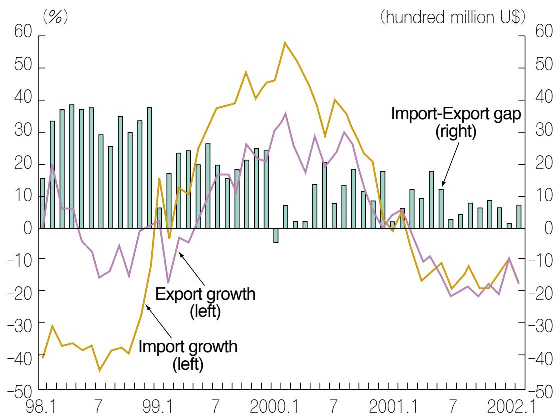
The scale of the current account surplus narrowed during the year 2001 from last year's 12.2 billion dollars to 8.6 billion dollars with the effect of the narrowing of the deficit on the income account being more than offset by that of the contraction of the goods account surplus and the shift into deficit on the current transfers account. Examining the figures by period, during the first half of the year, the goods account accumulated a large surplus, enabling the current account to register around 1.1 billion dollars in the black on a monthly average basis. The scale of the goods account surplus narrowed from early in the latter half of the year as exports turned lacklustre while the scale of the current transfers deficit enlarged. The effect of these movements was to narrow the scale of the average monthly current account surplus greatly to the 0.3 billion dollar level, scarcely one third that in the earlier half of the year. Strikingly, the current account registered a small deficit(-0.14 billion dollars) in August, the first for sixteen months since April 2000 (-0.49 billion dollars), as a result of the temporary widening of the travel account deficit as Korean residents took summer vacations abroad.

Viewed by component account, the surplus position on the goods account was maintained with the decrease in exports being largely counteracted by a matching decrease in imports centering on those of raw materials and intermediate inputs, but the scale of the surplus narrowed from 16.9 billion dollars to 13.4 billion dollars. The import export gap(customs clearance basis) during the first two months of the year 2002 witnessed a slight narrowing of its surplus from the same period of the previous year(0.84 billion dollars) to 0.72 billion dollars.

For the year 2001, exports(customs clearance basis) fell for the first time since 1958 with the sole exception of the year 1998, which was straight after the currency crisis. They contracted by 12.7% from the 172.3 billion dollars of the previous year to stand at 150.4 billion dollars. What caused this large decline in exports was the synchronized business downturn in major export destinations including the U.S., Japan and Southeast Asia. This was exacerbated by the worldwide depression in the IT sector, which caused exports of major Korean products such as semiconductors to tumble. Consequently most areas of industry apart from shipbuilding saw their performance decline from that of the previous year, the case of the electric and electronic appliances sector, which includes semiconductors, being particularly striking. Dividing the reduction in exports into changes in volumes and changes in unit prices, in the case of export volumes, the scale of the downturn is greatly reduced, with only a slight decrease being registered or even an upward trend maintained. It was in export unit prices that the downward trend of exports continued throughout the year on a large scale, and this acted as the main contributor to the decrease in the amount of exports in value terms. This fall in the unit value of exports was even more pronounced for IT products including semiconductors.

<Figure Ⅱ-17>

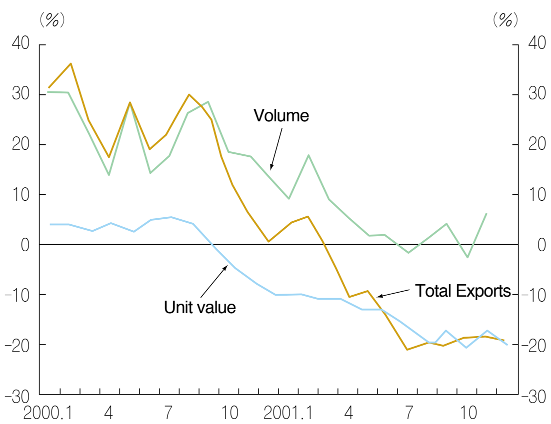
Trends of Import & Export Growth[1] and Import-Export Gap



Note: 1) Compared with the same period of the previous year.
Source: Ministry of Commerce, Industry and Energy.

<Figure Ⅱ-18>

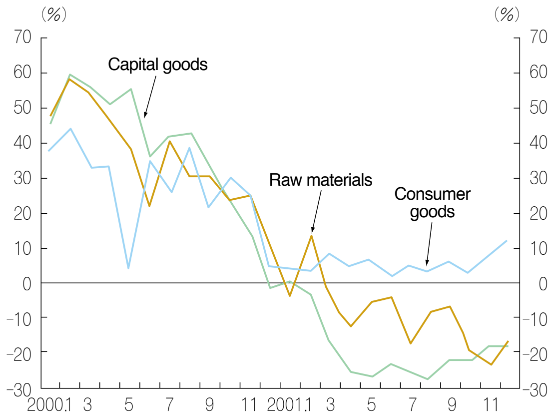
Trends of Volume and Unit Value of Exports



Note: 1) Compared with the same month of the previous year.
Source: The Bank of Korea.

<Figure Ⅱ-19>

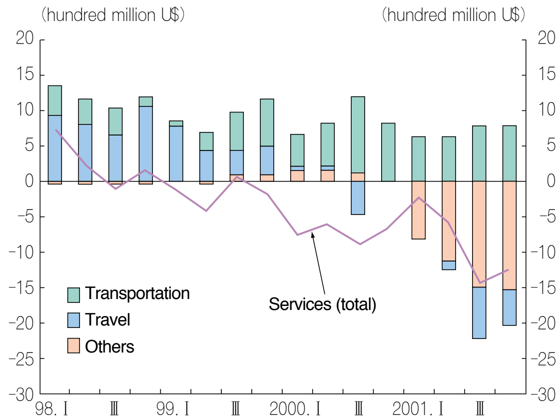
Trends of Imports by Use[1]



Note: 1) Compared with the same month of the previous year.
Source: Ministry of Commerce, Industry and Energy.

<Figure Ⅱ-20>

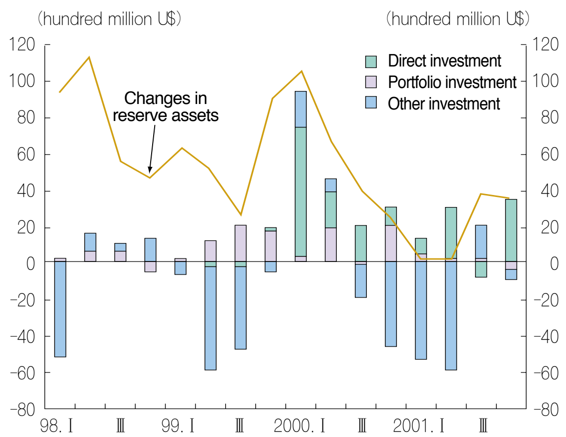
Trends of Service Account by Item



Source: The Bank of Korea.

<Figure Ⅱ-21>

Trends of Capital and Financial Account by Item



Source: The Bank of Korea.

For the year 2001, imports(customs clearance basis) fell by 12.1% from the previous year(160.5 billion dollars) to stand at 141.1 billion dollars. This was attributable to the large contraction of imports for export use such as those of raw materials and intermediate inputs because of lacklustre exports. Another contributing factor was the large scale reduction in capital goods imports because of the drying-up of facilities investment. The downward stability of internationally traded raw material prices including those of oil as a result of the worldwide economic recession also served as a factor in reducing imports.

The services account deficit expanded from the previous year's 2.9 billion dollars to 3.5 billion dollars as a result of increased overseas travel expenses, including those for foreign study and training, and the expanded payment of royalties and fees for the use of patents. In contrast, the income account registered a much reduced deficit of 0.9 billion dollars as against the previous year's 2.4 billion dollars, thanks to the heightened operating income from the expanded claims on the rest of the world generated by the accumulated current-account surplus.

The current transfers account shifted from the 0.7 billion dollar surplus of the year before to a deficit of 0.4 billion dollars in response to an expansion of overseas remittances by domestic residents.

(Capital Account)

The capital account shifted from a surplus of 12.1 billion dollars the year before to register a deficit of 3.6 billion dollars for the year 2001. This was mainly attributable to the large scale contraction of net inflows of direct and portfolio foreign investment and also to substantial redemptions of overseas loans.

Viewing capital transactions by category, the direct investment account saw the scale of its surplus narrow sharply from 4.3 billion dollars a year before to 0.6 billion dollars in the year 2001, with the effects of the contraction of outward direct investment by domestic residents being greatly exceeded by those of the decrease of inward direct investment by foreign residents. The portfolio investment account registered a level of surplus only about half that of the previous year. This was because of a large expansion of investment in overseas securities following an increase in domestic residents' purchases of medium and long-term foreign securities, together with the reduction in the scale of foreigners' inflow of portfolio investment funds, which had increased sharply in the year 2000. Meanwhile the scale of the deficit on the other investment account widened from 3.6 billion dollars to 10 billion dollars as a result of the redemption of foreign borrowings and the reduction of trade related credits in line with the sluggishness of exports.

3. Prices

<Table Ⅱ-9>

Trends of Growth[1] of Major Prices

(%)

	1998	1999	2000	2001	Jan.~Feb. 2002.
Consumer Prices	7.5	0.8	2.3	4.1	2.6
(Core Inflation)	(5.9)	(0.3)	(1.9)	(3.6)	(3.0)
Producer Prices	12.2	-2.1	2.0	1.9	-0.4
Import Prices	28.2	-12.1	7.6	4.9	-7.5

Note: 1) Compared with the same period of the previous year.
Source: Korea National Statistical Office, The Bank of Korea.

During the year 2001, the prices of imported goods rose 4.9% and of domestically produced items 1.9%, a lower rate of increase than in the preceding year. In contrast, consumer prices rose at a rate of 4.1%, accelerating their upward pace from the previous year.

In the case of import and producer's prices, there were factors present on both the demand and the supply-sides making for a reduction in prices, including the downward stability of raw material prices, oil in particular, and the downturn in business activities both at home and abroad, whose effects helped counteract those of the depreciation of the Korean won. In contrast, consumer prices, in which downwardly sticky service charges carry a large weight, was influenced by the sharp rises in charges for public services.

(Import and Export Prices)

<Table Ⅱ-10>

Trends of Movements[1] in Import and Export Prices

(%)

		2000	2001 year	2001 Ⅰ	2001 Ⅱ	2001 Ⅲ	2001 Ⅳ	2002 Jan.~Feb.
Import prices	Won-basis	7.6 (5.3)	4.9 (-6.2)	8.8 (-4.4)	11.3 (0.4)	4.9 (-3.0)	-4.6 (-7.6)	-7.5 (2.8)
	(raw materials)	11.1	4.5	9.6	11.9	4.2	-6.9	-9.1
	(capital goods)	-4.9	6.6	5.5	7.5	8.4	5.3	-1.1
	(consumer goods)	1.0	7.6	9.1	13.6	7.7	0.5	-2.1
	Contract currency basis	12.0 (0.5)	-6.1 (-9.9)	-1.7 (-0.9)	-2.5 (0.3)	-7.5 (-3.4)	-12.4 (-6.3)	-9.4 (1.2)
Export prices	Won-basis	-1.0 (4.2)	6.2 (-3.1)	7.9 (4.2)	9.8 (-1.5)	6.3 (-1.4)	0.9 (-4.2)	-4.3 (2.2)
	Contract currency basis	3.6 (-1.5)	-6.4 (-8.4)	-3.9 (-1.7)	-5.3 (-1.5)	-7.7 (-1.8)	-8.8 (-3.6)	-7.7 (0.3)
Exchange rates[2]		-4.9	14.2	13.0	17.0	16.0	11.0	4.4

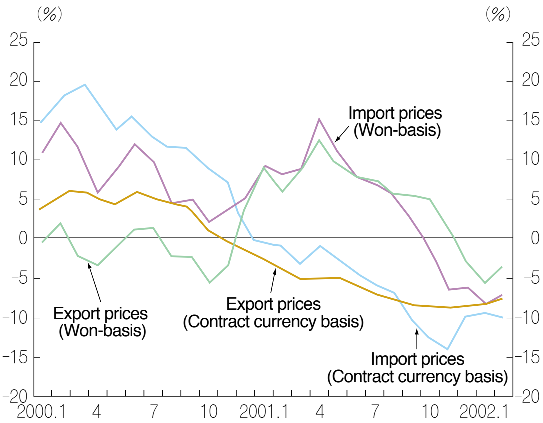
Notes: 1) Rates of change compared with the same period of the previous year.
2) Won/U$ basis.
3) Figures in parentheses refer to the rate of increase compared with the last month of the previous period.
Source: The Bank of Korea.

Import and export prices(Korean won basis) rose by a large margin during 2001, pushed up by the large scale of the depreciation of the Korean won. In terms of the contract currency, however, import prices fell 6.1%, limiting their increase in Korean won terms to 4.9% on an annual average, blunting the upward trend of the previous year (7.6%).

Looking at the movements of import prices by period, the rate of increase gradually steepened year-on-year from January to April, but from May onwards, they displayed a downwardly stable trend. On a contract currency basis, during the year to April, there was a modest decrease in import prices but, under the influence of the weakening of the Korean won, their upward trend steepened in local currency terms. The exchange rate maintained a more or less stable trend from early May and the price of oil and other international raw materials dropped sharply in response to the worldwide business slowdown, causing the upward trend of import prices in domestic currency terms to level off before shifting to a downward trend year-on-year in October. In the beginning of the year 2002, import prices rebounded slightly compared to the end of the previous year because of higher oil prices and the renewed weakness of the Korean won. On a year-on-year basis, in contrast, they fell on a larger scale.

<Figure Ⅱ-22>

Trends of Movements[1] in Import and Export Prices



Note: 1) Compared with the same period of the previous year.
Source: The Bank of Korea.

Export prices(Korean won basis), despite a 6.4% fall in contract currency terms, moved upwards as a result of the Korean currency's sharp loss of exchange value, registering a rate of increase of 6.2% averaged over the year as a whole, the first rise for the last three years.

Viewed by period, export price movements showed a similar pattern to those of import prices, rising more steeply year-on-year until the end of April but flattening their upward pace greatly from May onwards. It was noteworthy that during the second half of the year the export prices of electronic items such as semiconductors and of communications equipment fell by a large margin while the overall upward trend of export prices was greatly blunted as the exchange rate of the Korean won followed a more stable track. Export prices turned upward again in the early part of the year 2001 as compared to the end of the preceding year while continuing to fall year-on-year.

(Producer Prices)

Producer prices rose 1.9% on an annual average basis during the year 2001, a similar increase to that of the previous year(2.0%).

<Table Ⅱ-11>

Trends of Movements[1] in Producer Prices

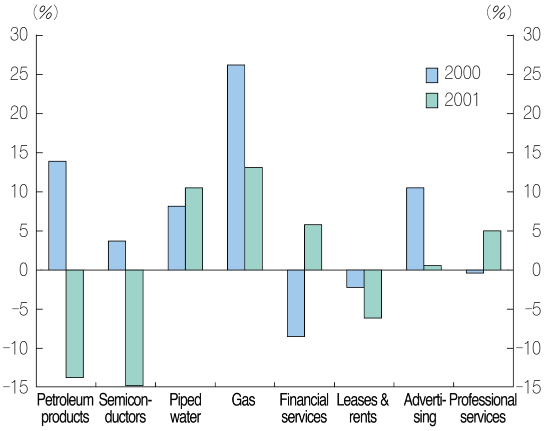
(%)

	2000	2001					2002
		year	Ⅰ	Ⅱ	Ⅲ	Ⅳ	Jan.~Feb.
Producer prices	2.0 (1.7)	1.9 (-0.7)	2.5 (1.1)	3.1 (0.2)	2.0 (-0.5)	0.0 (-1.4)	-0.4 (1.2)
Goods	2.2 (1.5)	1.8 (-1.3)	2.3 (1.2)	3.4 (0.2)	2.1 (-0.9)	-0.5 (-1.8)	-1.1 (1.1)
(agriculture, forestry & marine products)	-2.6 (-7.9)	1.0 (6.1)	-4.1 (9.7)	3.0 (0.4)	3.0 (-3.1)	2.4 (-0.7)	6.4 (5.0)
(industrial products)	2.4 (2.2)	1.5 (-2.3)	2.5 (0.2)	3.0 (0.2)	1.7 (-0.7)	-1.2 (-2.1)	-1.7 (0.9)
(electricity, piped water & gas)	8.5 (7.9)	7.3 (3.5)	8.5 (2.6)	8.5 (1.1)	8.0 (0.0)	4.7 (-0.3)	-2.0 (-2.8)
Services	1.5 (2.0)	2.4 (1.6)	3.2 (1.0)	2.9 (-0.2)	1.7 (0.6)	1.9 (0.2)	2.0 (1.2)

Notes: 1) Rates of change compared with the same period of the previous year.
2) Figures in parentheses refer to the rate of increase compared with the last month of the previous period.
Source: The Bank of Korea.

<Figure Ⅱ-23>

Movements of Producer Prices[1] in Major Businesses



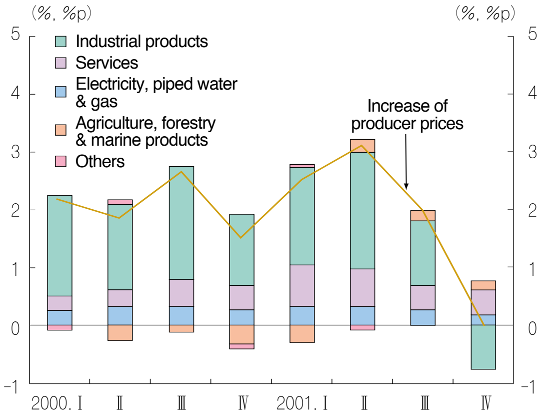
Note: 1) Compared with the last month of the previous year.
Source: The Bank of Korea.

Viewing producer price movements by period, their upward trend gradually accelerated during the first five months of the year, but from June onwards, they showed downward stability. The high rate of producer price inflation in the January to May period was attributable firstly to increases in the prices of agricultural and fishery products brought about by short-lived supply demand imbalances following heavy snows and a severe cold spell. Another major contributory factor was the increases of charges for utilities and services including piped gas, piped water, blueprint drafting and inspections. The downward stability of producer prices from early June onwards reflected the downward trend of prices for audio, visual and communications equipment including semiconductors, because of the weakening of demand in the wake of the downturn in business activity at home and abroad. The reduction of prices for petroleum products thanks to lower international oil prices was another major factor making for stability. The downward stability of producer prices on a year-on-year basis continued in the early part of the year 2002. Compared to the end of the year 2001, however, they showed an upward trend owing to seasonal price rises for vegetables and fruit, increased prices for petroleum products following the depreciation of the Korean won and the rise in oil prices and a hike in cigarette prices following the imposition of a public health levy.

Broken down by type of commodity, the prices of manufactured goods remained stable whereas prices in the electricity, water and gas sector staged a sharp rise. The prices of manufactures rose only 1.5% on an annual average basis, slackening their upward trend of the previous year because of reduced prices for petrochemical products and semiconductors. Following on from the year 2000, charges for electricity, water and piped gas were again raised steeply in the year

<Figure Ⅱ-24>

Degree of Contribution to the Rate of Increase of Producer Prices[1]



Note: 1) Compared with the same period of the previous year.
Source: The Bank of Korea.

<Table Ⅱ-12>

Trends of Movements[1] in Prices by Stage of Manufacturing

(%)

	2000	2001					2002
		year	Ⅰ	Ⅱ	Ⅲ	Ⅳ	Jan.~Feb.
Gross index	3.4 (4.2)	2.9 (-3.7)	4.3 (1.3)	5.5 (0.9)	3.3 (-1.0)	-1.5 (-2.6)	-2.7 (1.4)
Raw materials	22.7 (21.9)	3.7 (-18.7)	7.6 (-5.2)	13.0 (5.2)	6.3 (-1.5)	-10.3 (-8.7)	-6.4 (4.8)
Intermediate goods	4.1 (4.4)	3.3 (-3.6)	5.5 (1.8)	6.0 (0.6)	3.3 (-1.5)	-1.5 (-2.4)	-4.1 (0.4)
Final goods	-0.9 (0.3)	2.2 (0.0)	2.0 (2.0)	3.4 (0.4)	2.6 (-0.2)	0.8 (-1.4)	0.0 (1.8)

Notes: 1) Rates of change compared with the same period of the previous year.
2) Figures in parentheses refer to rates of increase compared with the last month of the previous period.
Source: The Bank of Korea.

2001, being increased by 7.3%. Meanwhile prices of agricultural and fishery products rose 1.8%, reflecting the poor yields brought about by adverse weather conditions in the form of heavy snows, a bitterly cold spell and a drought. Charges for services mounted 2.4%, led by higher fees for blueprint drafting, inspections and patent services and other expert services along with steep increases in charges for financial services.

As a consequence of these price movements, the contribution of manufactured products to the overall increase in producer prices stood at 1%p, lower than the previous year's(1.6%p). The contributions of agricultural and fishery products and services, in contrast, were larger than the previous year's(-0.2%p and 0.4%p each), registering 0.1%p and 0.5%p respectively.

Viewing manufacturing value added by stage in terms of sector weighted average for the goods price and the import price indices, the prices of raw materials and intermediate inputs decelerated their rate of increase while those of final goods shifted to a slight rise. Notably, the prices of raw materials, which had risen sharply the preceding year, slackened their upward pace greatly under the impact of the economic slowdown, increasing at a rate of 3.7% on an annual average basis.

(Consumer Prices)

During the year 2001, consumer prices rose at an annual average rate of 4.1%, accelerating their rate of increase from the previous year (2.3%).

Viewed by period, consumer price inflation continued to gather pace until May in comparison with the end of

<Table Ⅱ-13>

Trends of Movements[1] in Consumer Prices

(%)

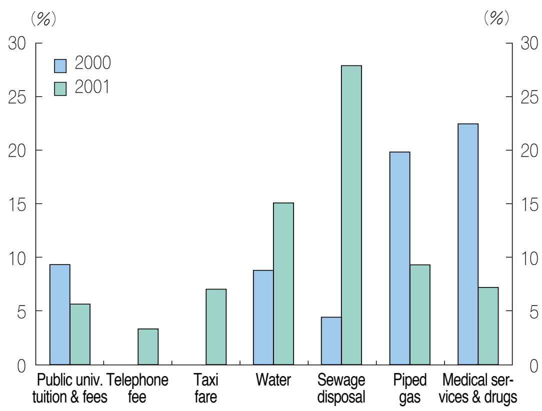
	2000	2001					2002
		year	Ⅰ	Ⅱ	Ⅲ	Ⅳ	Jan.~Feb.
Consumer Prices	2.3	4.1	3.6	5.0	4.2	3.4	2.6
	(2.7)	(3.2)	(2.5)	(0.6)	(0.5)	(-0.4)	(1.1)
Agriculture, livestock & marine products	1.9	6.3	1.0	8.8	8.1	7.4	9.8
	(-2.3)	(9.5)	(9.4)	(0.2)	(3.6)	(-3.5)	(7.2)
Industrial products	1.6	2.6	3.2	3.8	2.5	0.9	0.0
	(2.4)	(0.0)	(0.6)	(0.6)	(-0.3)	(-0.9)	(1.0)
(petroleum products)	11.0	4.2	9.9	11.1	2.9	-5.9	-7.0
	(9.3)	(-9.4)	(-1.1)	(-0.2)	(-2.6)	(-5.8)	(1.3)
Services	2.9	4.6	4.5	5.0	4.6	4.1	3.0
	(4.3)	(4.0)	(2.3)	(0.8)	(0.3)	(0.7)	(-0.1)
(public service charges)	7.1	7.5	8.8	9.4	7.0	4.5	0.0
	(9.0)	(3.7)	(3.6)	(0.5)	(-0.3)	(-0.1)	(-2.0)
(Rents)	-0.5	4.1	2.5	3.8	4.7	5.4	5.9
	(2.2)	(5.7)	(0.8)	(2.1)	(1.0)	(1.8)	(0.7)

Notes: 1) Rates of change compared with the same period of the previous year.
2) Figures in parentheses refer to the rate of increase compared with the last month of the previous period.
Source: Korea National Statistical Office.

the previous year. After maintaining a high level during the June to August period, it moved to a gradually easing track from September onwards. There was a build-up of upward pressures on prices during the year to May owing to the depreciation of the Korean won, increases in charges for public services such as medical treatment under public health insurance and piped gas, and hikes in prices of agricultural livestock and fishery products. From June through August the rate of increase in consumer prices recorded the high level of 4% year-on-year due to the sharp rise in prices of agricultural livestock and fishery products, and vegetables in particular, caused by a drought, and the acceleration of the rise in housing rents. From September onwards, however, the rate of increase in consumer prices lowered to around 3%. This was brought about the decreases in domestic fuel prices in line with lower international oil prices, reductions in agricultural prices for grains and vegetables thanks to good harvests and stability in public service charges due to the government's efforts to throttle back increases in them. The downward stability of consumer prices was prolonged into the early part of the year 2002.

<Figure Ⅱ-25>

Movements of Major Public Service Charges

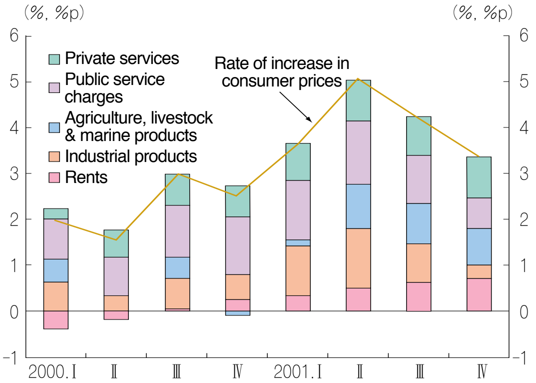


Note: 1) Compared with the last month of the previous year.
Source: Korea National Statistical Office.

Viewed by type of commodity, the prices of manufactured goods maintained a comparatively stable trend: services and agricultural, livestock and fishery products, in contrast, accelerated their upward trend. Helped by the large reductions in the prices of petroleum fuels including gasoline and heating oil during the latter half of the year, manufactured goods saw their rise in prices held to 2.6% on an annual average basis. Charges for services climbed 4.6% with those for public services, personal services and housing rentals all increasing. Most notably, charges for public services were raised by 7.5% as a result of the increased charges for treatment under public health

<Figure Ⅱ-26>

Degree of Contribution to the Rate of Increase of Consumer Prices



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

insurance, and for utilities including piped gas, water and sewage disposal. For their part, housing rental charges rose 4.1% following the increased in real estate prices. Apart from rice and other food grains, agricultural and animal husbandry products generally rose in price, bringing the price rise for the agricultural, forestry, livestock and fishery sector to 6.3%.

As a net result of these price movements, the ratio of manufactured goods' contribution to the total rise in consumer prices stood at 0.9%p, somewhat larger than the previous year's(0.6%p). Meanwhile the contribution ratios of services and of agricultural and fishery products expanded greatly compared to the previous year with the former rising to 2.5%p and the latter to 0.7%p(1.6%p and 0.2%p respectively). Remarkably, while the contribution ratio of services was augmented, that of charges for public services, which make up only 15% of the Consumer Price Index, continued last year's high level of contribution to the overall increase, being responsible for a 1.2%p rise in consumer price inflation. Personal services, meanwhile, pushed up inflation by 0.8%p, and housing rents did so by 0.5%p.

(Real Estate Prices)

<Table Ⅱ-14>

Trends of Movements[1] in Housing Prices and Rents

(%)

	2000	2001					2002
		year	Ⅰ	Ⅱ	Ⅲ	Ⅳ	Jan.~Feb.
Housing prices	0.4	9.9	0.8	2.2	4.8	1.7	5.2
(Apartment)	1.4	14.5	1.6	3.3	6.7	2.3	7.7
- Seoul	4.2	19.3	2.2	4.8	8.6	2.6	11.2
Housing rents	11.1	16.4	4.9	3.2	6.4	1.1	5.0
(Apartment)	12.2	20.0	5.7	3.7	7.7	1.7	6.6
- Seoul	12.1	23.4	6.8	5.2	9.7	0.1	7.6
Land prices	0.7	1.3	0.1	0.4	0.3	0.5	..

Note: 1) Compared with the end of the previous period.
Source: Kookmin Bank, Korea Land Corporation.

Over the course of 2001, housing prices increased by 9.9% and housing rents 16.4% over their level in the December of the preceding year, greatly accelerating their pace from that during the year 2000. A particularly sharp rise was exhibited in the selling prices of apartments and in the level of housing rents in the Greater Seoul area, which led the overall increase in prices in the housing market.

These steeply increased housing prices and rents were to a large extent the result of an imbalance between the demand and supply of housing. In terms of supply the number of new housing units fell, reduced by more frequent bankruptcies among construction companies following the currency crisis. At the same time, there was a leap in the demand for housing with demand for apartments scheduled for reconstruction expanding in anticipation of future price rises and speculative demand emerging for housing for rental. In the case of housing rents, the imbalances between supply and demand became evident as householders showed a preference for letting on a monthly rental basis and reconstruction work got underway for a number of large scale apartment complexes.

<Figure Ⅱ-27>

Trends of Movements[1] in Land Prices

Note: 1) Compared with the last month of the previous year.
Source: Korea Land Corporation.

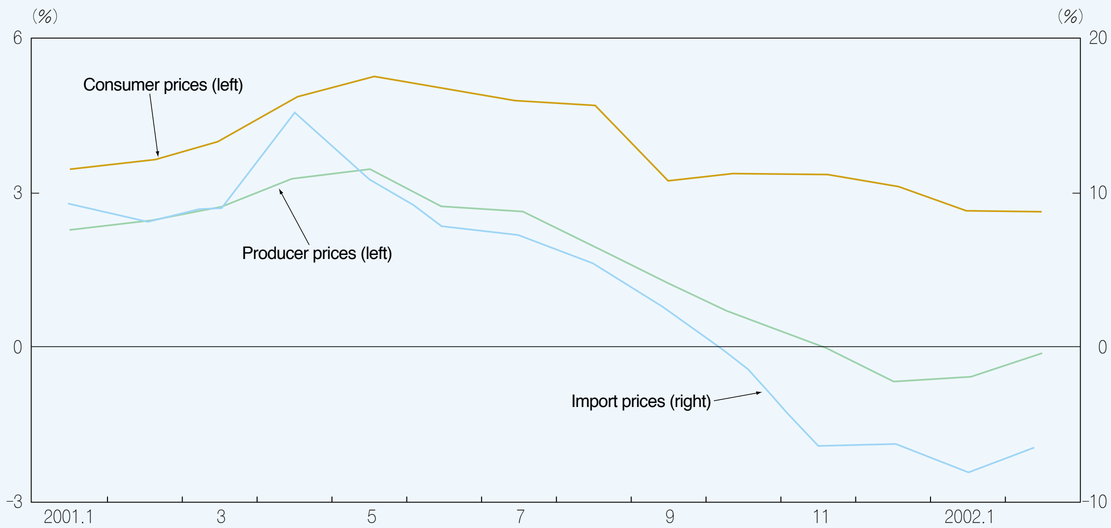
Nationwide land prices marked a 1.3% rise during the year 2001 from the level in the December of the preceding year, slightly increasing their pace of increase from the previous year(0.7%). It was apparent that this rise was greatly spurred by increased housing prices and the lifting of development restrictions in former green belt areas. Viewed by area land prices rose comparatively more rapidly in Seoul and surrounding suburban areas, where housing prices had greatly increased, and in small and medium-sized towns where zoning restrictions on development had been abolished.

<Box II-1>

Characteristics of Price Movements During the Year 2001

During the year 2001, prices rose steeply during the first half of the year and then their rate of increase slackened or they shifted to a downward track in the second half of the year. From early in the new year, an acceleration of price increases was observed across most categories of prices including consumer prices, producer prices and import prices, but the pace of increase peaked for import prices in April(15.1% year-on-year) and for consumer prices and producer prices in May(5.3% and 3.4% respectively). It then decelerated and, indeed, towards the end of the year, producer prices and import prices fell below their levels of a year earlier.

Trends of Movements[1] in Major Prices

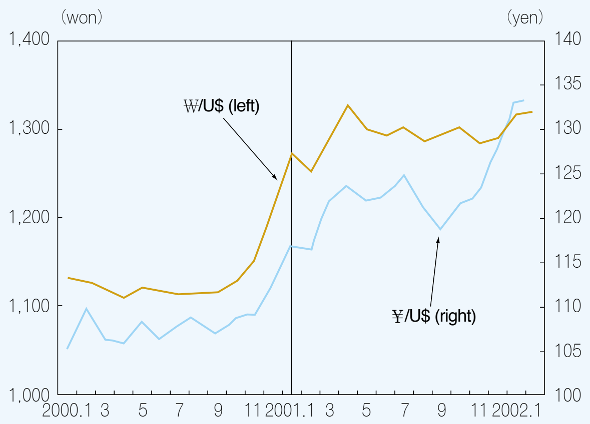


Note: 1) Compared with the same period of the previous year

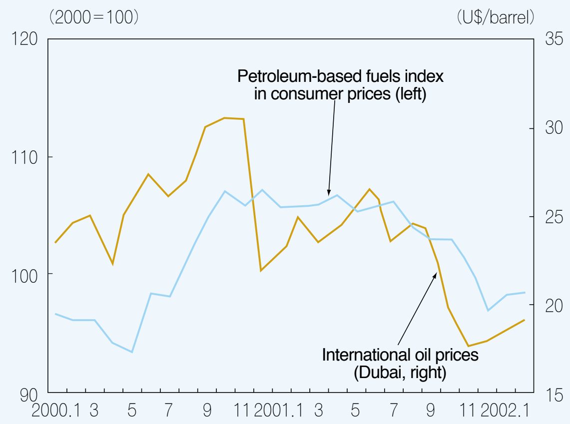
This pattern of price movements largely reflects the increase of prices during the year as a result of the Korean won's depreciation and the adjustment of charges for public services.

Most strikingly, the Korean won weakened sharply in the year 2001, with its exchange rate against the U.S. dollar, rising 14.2% on an annual average. By period, the Korean won dropped abruptly during the first 4 months of the year and subsequently maintained a generally stable pattern of movements. As a result, the effect of its depreciation fed through gradually into price rises during the first half of the year, causing them to maintain a brisk pace. For import items, prices rose 4.9% on an annual average basis in Korean won terms whereas they fell by some 6.1% on a contract currency basis, which strips out the effects of the Korean won's depreciation. From this it may be concluded that the softening of the currency was the leading factor in the rise in import prices. The upward trend of import prices caused by the weakening of the Korean won had a gradual knock-on effect on both producer and consumer prices. The results of the analysis of the 1998 input-output tables give an estimated effect from the depreciation of the currency on producer prices and the consumer prices of 4.0%p and 2.6%p respectively. In contrast, international raw material prices, and especially oil prices showed a sharp rise following the terrorist attacks on the U.S., but apart from that they maintained a downwardly stable trend, acting to blunt the pace of price increases.

Trends of Exchange Rates



Trends of International Oil Prices & Domestic Petroleum-based Fuels



The steep rises in the charges for public services also acted as a major contributory factor to price increases during the year 2001. With charges for water, sewage, piped gas and treatment under public health insurance being raised, electricity, water and gas charges were increased 7.3% on an annual average basis in terms of producer prices and public charges 7.5% in terms of consumer prices. The rises in charges for public services were notably concentrated in the latter half of the year 2000 and the first half of the year 2001. In the latter half of the year 2001, in contrast, the upward pressure in charges for public services eased in response to the government's efforts for price stability.

In addition, during the year 2001, the sharp rise in real estate prices made housing rents particularly high in terms of consumer prices, while fanning inflationary expectations. In the course of 2001, housing prices rose 9.9% and housing rents by 16.4% compared with the end of the previous year(Kookmin Bank survey of asking prices), because of which the resulting rise in housing rents among consumer prices stood at 4.1%. In consequence the contribution of housing rents to consumer prices, which had stood at -0.1%p in the preceding year expanded sharply to 0.5%p during the year 2001. The rise in housing rents accounted for 12.2% of the increase in consumer prices(annual average 4.1%).

During the latter half of the year, the slowdown of the pace of consumer price rises was much less sharp than that in the case of import and producer prices. This is because while public service charges and housing rents increased sharply, the share of the services sector, which displays downward rigidity, is 55.0% in the consumer price index as against only 26.5% for the producer price index. Import prices, meanwhile do not include the service sector.

4. Financial Markets

A. Price Indicators

(1) Interest Rates

During the year 2001, both long and short term market interest rates generally maintained a downward trend as a result of the Bank of Korea's conduct of its monetary policy with an emphasis on warding-off an economic recession. From early in the final quarter, however, interest rates shifted to an upward trend on expectations of a recovery of economic activity.

Financial institutions continually reduced lending and deposit rates in reflection of falling market interest rates, their ample liquidity and the reduced corporate demand for funds. From the beginning of the year 2002, though, the downward trend of these rates has evened out in response to the upturn in market interest rates.

<Table Ⅱ-15>

Trends of Major Interest Rates[1]

(annual %)

	Dec.2000	2001				2002	
		Feb.	Apr.	Sep.	Dec.	Jan.	Feb.
Call (one day)	6.0	5.1	5.0	3.9	4.0	4.0	4.0
CP (91 days)	7.3	6.2	6.2	4.7	5.1	4.8	4.6
Treasury bonds (3 yrs.)	6.7	5.4	6.8	4.5	5.9	6.0	5.7
Corporate bonds (3 yrs.)	8.1	6.8	8.1	6.0	7.0	7.0	6.7

Note: 1) Month-end basis.
Source: The Bank of Korea, Korea Securities Computer Corp.

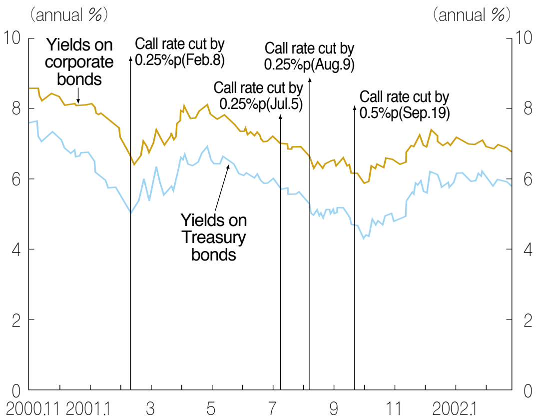
(Long-term Market Interest Rates)

Long-term market interest rates fluctuated under the influence of market anticipations of an economic recovery, the Bank of Korea's monetary policy stance, stock market movements, and so forth.

In the early part of the year 2001, business conditions weakened much more than had been expected, leading to widespread anticipations of easier money. Long-term market interest rates, meanwhile, fell sharply in response to the reduction in the Federal Funds rate and the Bank of Korea's downward adjustment of its call rate target(February 8). Yields on three-year Treasury bonds, after testing the 5% level in January, continued their underlying downward path. On February 6 yields dropped to 5.28% below the call rate(5.31%). Furthermore, they registered 5%, of their lowest ever, on February 12.

<Figure Ⅱ-28>

Trends of Major Long-term Interest Rates



Source: Korea Securities Computer Corp.

After this, long-term market rates shifted to an upward trend, rising sharply until late April in the following environment. Firstly, the perception among market participants gained ground that the scale of the fall of interest rates had been too large. Particularly, market participants began to share the understanding that the interest rate fall after the end of the year 2000 had been partially attributable to a tendency for some investors to engage in short term money plays in search of profits in view of the ample liquidity. Secondly, the real economy, which had been expected to slacken greatly, showed a brighter picture with a steady rise of consumer spending and construction investment. Inflation, meanwhile, had risen above its target level of 4% under the influence of the increased charges for public services and the sharp fall in the exchange value of the Korean won brought about by the weakening of the Japanese yen. In reflection of this, the Bank of Korea refrained from any further lowering of its target call rate while the hopes of an early economic recovery and rising prices acted to put upward pressure on long-term market interest rates. Thirdly, the rise in market interest rates sparked a large-scale redemption of money market funds(MMFs), which in turn itself acted to put further upward pressure on interest rates. Because of the large scale rise in market interest rates, the anticipated yields on MMF funds declined to the point where a large increase in their redemption took place.[1] This centered on institutional investors who

1) Funds under management in MMFs, which had increased by 3.4 trillion won during March, saw an outflow of 3 trillion won between April 1 and 21. The following week, the scale of the withdrawals expanded sharply with 0.23 trillion won on 23, Apr., 0.74 trillion won on 24, Apr., 1.51 trillion won on 25, Apr. and 2.58 trillion won on 26, Apr..

were concerned over the possibility of the loss of their principal.[2] In consequence, the upward pressure on interest rates intensified further as investment trust companies sold off the securities operated in their MMFs in order to have funds available for their redemption. Yields on Treasury bonds and corporate bonds, which had fallen to lows of 5% and 6.4%, respectively, rebounded to reach 6.9% and 8.2% as of 26 April under the influence of these factors.

Wishing to moderate the mood of instability gripping the financial markets following the sharp rise in market interest rates, the Bank of Korea announced a package of measures designed to stabilise the bond market; the flexible supply of high powered money, the cancellation of its offers of RPs, and the reduction in the volume of Monetary Stabilisation Bonds.

The upswing in long term market interest rates was checked by the Bank's announcement of measures to stabilise the bond market. Subsequently, they shifted to a downturn amid concerns over the unlikelihood of an early business recovery and in anticipation of a deceleration of consumer price inflation, which had risen sharply in the first half of the year. Furthermore, the Bank reduced its call rate target for three successive months, July, August and September. With the occurrence of the September 11 terrorist attacks on the United States, long-term market interest rates continued to fall in line with forecasts that the economic downturn would be prolonged. This caused yields on Treasury bonds to drop sharply to 4.3% and those on corporate bonds to 5.9% as of October 4.

2) MMFs are in principle valued at historic cost(book price) but if the market price is more than 1% lower than this or if there are fears that such a gap will develop, the underlying securities should be sold. Subsequently, this provision was made more restrictive(0.75% from July 2001, 0.5% from January 2002).

This situation underwent a change from early October. Additional cuts in the call rate were anticipated in the domestic financial market in the wake of repeated interest reductions by the Federal Reserve. Nevertheless, after careful examination of the overall domestic and international environments, the Bank of Korea left the call rate target unchanged at its existing level, considering that there was no great necessity for further interest rate reductions. In addition, the Korean stock market shifted to a sharp upward trend, buoyed by large scale foreign buying of shares. It was synchronised with a rapid rebound of the U.S. stock markets, which had fallen sharply in the wake of the terrorist attacks, on anticipations of an early end to the U.S. war on terror. The stock market rebound and the expectations of economic recovery acted to push up market interest rates, in consequence of which yields on Treasury bonds rose to 5.9% and those on corporate bonds to 7.2% as of November 22. In order to limit the scale of the rise in market interest rates, the Bank of Korea carried out a 1 trillion won retirement of MSBs and outright repurchase of Treasury bonds (announced on November 23 and carried out on the 26th).

Moving into the new year 2002, long term market interest rates exhibited a generally downward pattern, but fluctuated in accordance with the prevailing degree of uncertainty concerning the speed of economic recovery and the prospects of an improvement in the interplay of supply and demand for securities.

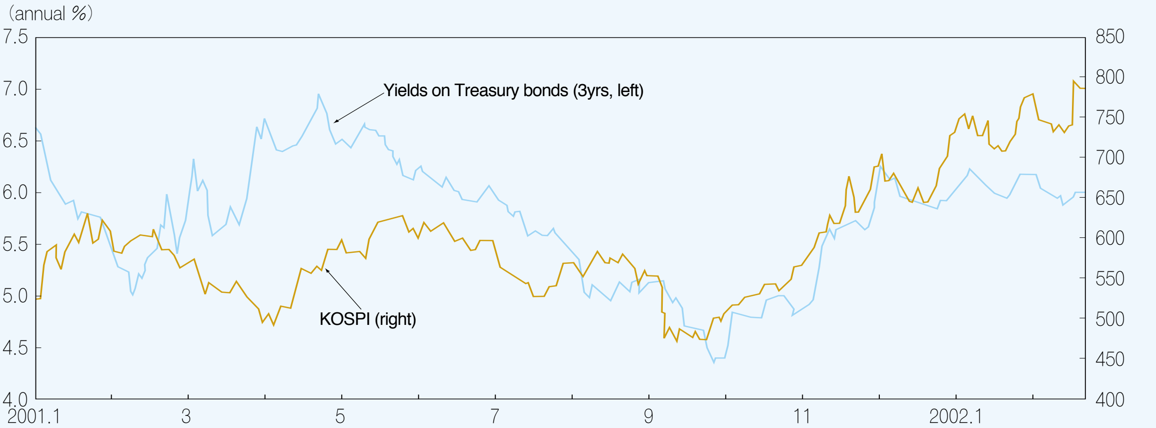
<Box II-2>

Synchronisation of Bond Market Rates and Share Prices in Late 2001

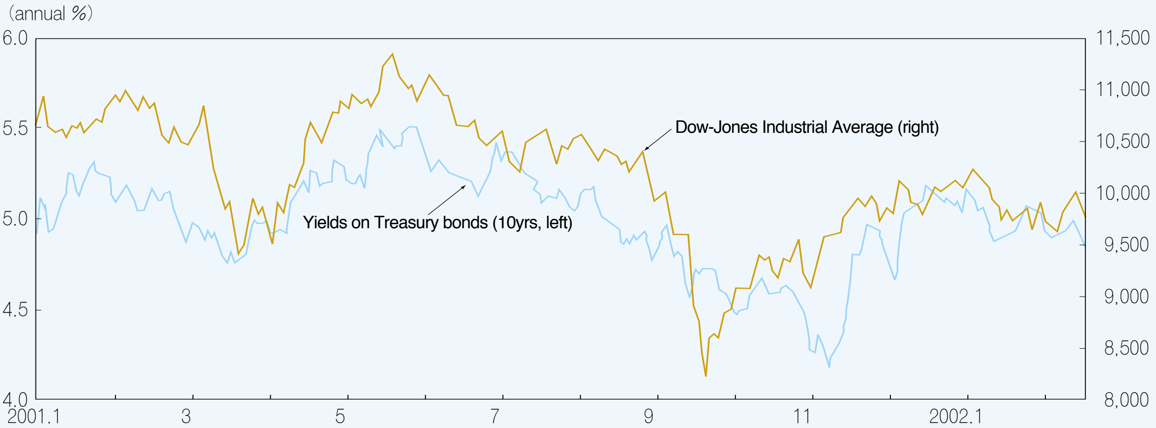
In the last six weeks of the year 2001, as anticipations of economic recovery quickened, share prices and the interest rates of long-term bonds quoted on the Stock Exchange both moved upward together, a phenomenon not confined to Korea but also observed in the United States.

Trends of KOSPI and Yields on Bonds

(Korea)



(America)



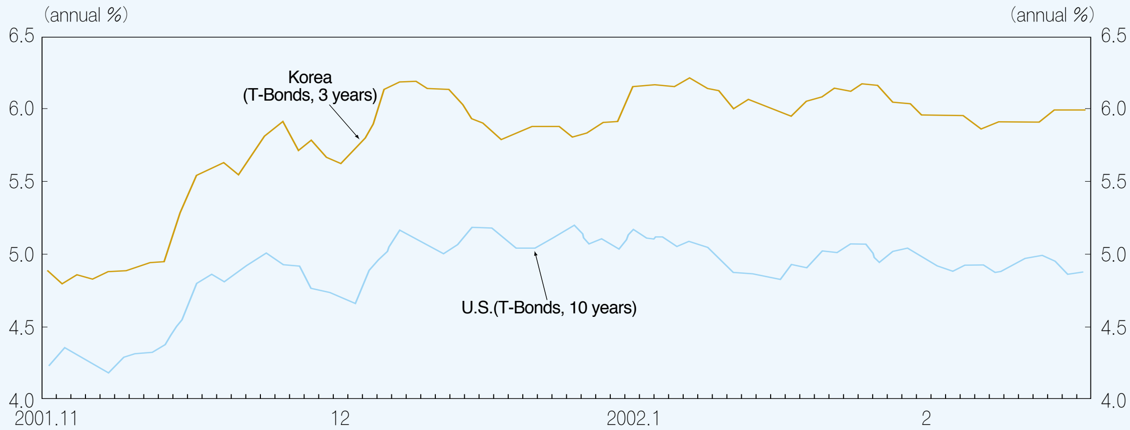
Source: Korea Securities Computer Corp., Reuters.

Conventional economic theory has it that interest rates and share prices normally move in opposite directions by way of the following mechanism. Initially, when interest rates drop, there is an improvement in firms' financial structure and profitability. On the other hand the demand for shares, as alternative investment instruments to debt securities, increases and share prices rise. Conversely, when share prices rise, firms' fund-raising through the stock market increases and their need to raise funds through the issue of debt securities declines, causing interest rates to fall. In addition, where the scale of the increase in share prices is so large that any further increase in earnings performance is considered difficult, the demand for bonds may increase, bringing a fall in interest rates. However, when the rise in share prices brings about a migration of funds from the bond market to the share market, there is the possibility that interest rates will rise as the demand for bonds shrinks.

It should nevertheless be pointed out that whereas share prices and interest rates moved in the same direction in late 2001, it was the expectations factor which impacted on them simultaneously since the power of its influence was greater than the mutually offsetting influence of these two variables on each other mentioned above. For example, where economic actors anticipate an improvement in the level of business activity, there is the prospect that listed firm's profitability will improve. This stimulates the purchase of their shares, causing share prices to rise. In the bond market, meanwhile, market interest rates rise on concerns about an acceleration in inflation accompanying the upturn in business activity. This influence of the expectations variable is greatly magnified because markets react very sensitively to even small signals indicating an economic upturn or recession where a high degree of uncertainty surrounds the economy. Furthermore, in the case of interest rates, a shift to an upward trend in interest rates could easily occur because the monetary authorities have already kept them at a low level under the low interest rate policy.

Towards the end of 2001, the rise in domestic bond market interest rates under the influence of the sharp rise in sovereign bond yield in the U.S. and other advanced countries showed that the phenomenon of synchronicity is not restricted to share prices but also applies in part to interest rates on debt securities.

Phenomenon of Synchronicity Between Yields on Korean and U.S. Bonds



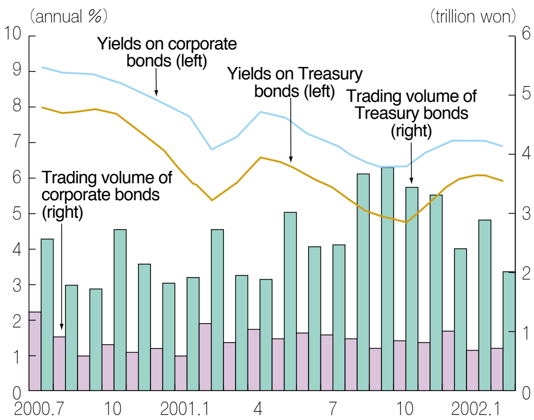
Source: Korea Securities Computer Corp., Reuters.

Average daily bond market turnover(based on Treasury and corporate bonds) expanded greatly during the year 2001, rising from 2.7 trillion won in the preceding year to 3.6 trillion won. This was attributable to brisk dealing activity in search of marginal profits which was fuelled by ample market liquidity, thanks to last year's four successive reductions in the call rate.

In the Treasury bonds market, the average daily volume of transactions expanded when their yields fell but contracted when yields on them rose. During January and February, amid falling yields, turnover expanded to an average daily of around 2.3 trillion won, showing an increase from the end of 2000. As yields rose in March and April, average daily turnover fell back to the 1.9 trillion won level. With the subsequent decline in yields, average daily transaction volume swelled greatly to 3.1 trillion won during the seven months from May to October, before contracting again to 2.8 trillion won following the shift of yields to an upward trend.

<Figure Ⅱ-29>

Trends of Yields on Corporate and Treasury Bonds and Trading Volumes



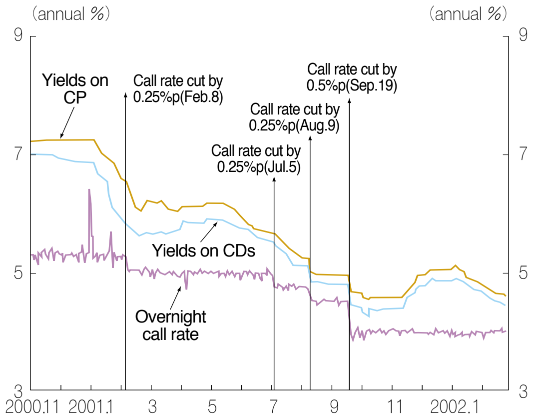
Source: Korea Securities Computer Corp.

The average daily volume of transactions in corporate bonds, which had contracted sharply from August 2000 onwards, expanded slightly early in the year 2001. This was attributable in part to the increased appetite for corporate bonds, which offered relatively higher yields, in a period of falling interest rates. Another contributing factor was the reduction in corporate credit risk as a result of progress in the disposal of insolvent firms. Having languished at 0.71 trillion won during the final quarter of the year 2000, the average daily turnover of the corporate bond market expanded to 0.84 trillion won in the first quarter of the year 2001 and to 0.96 trillion won in the second. Amid mounting concern in the market regarding the large scale of corporate bonds approaching maturity, the average daily transaction volume shrank slightly to 0.86 trillion won in the latter half of the year.

(Short-term Market Interest Rates)

<Figure Ⅱ-30>

Trends of Major Short-term Interest Rates



Source: The Bank of Korea, Korea Securities Computer Corp.

Short term market interest rates maintained a downwardly stable trend in accordance with the Bank of Korea's monetary policy stance.

The overnight call rate was maintained at the level of 5.25% from October 2000 until February 2001. On February 8, the Bank of Korea reduced its target interest rate by 25 basis points, bringing it down to 5%, in the face of an economic slowdown.

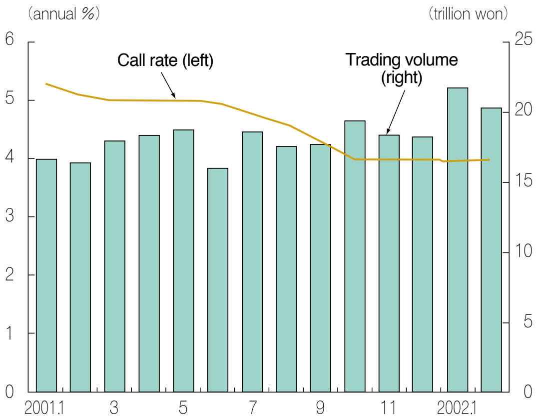
Afterwards, to ward off an economic recession, the target rate was again reduced on July 5 and on August 9, each time by 25 basis points, to stand at 4.5%.

In September, call rates fell to their lowest ever level of 4% following the Bank of Korea's 50 basis points cut in its target call market rate, which was made in order to soften the impact of the terrorist attacks on the United States.

The average overnight call rate moved smoothly downwards in response to these actions. Specifically, by period, it averaged 5.25% from January 1 2001 until February 7; 4.98% from February 8 until July 4; 4.75% from July 5 until August 8; 4.49% from August 9 until September 18; and 3.98% from September 19 until December 31.

<Figure Ⅱ-31>

Trends of Call Rate and Call Market Trading Volume



Source: The Bank of Korea.

Looking at the scale of call market transactions, average daily transaction volume during the year 2001 stood at 17.9 trillion won, an 11.1% increase over the previous year(16.1 trillion won). This was attributable to the great expansion of demand for call market loans as branches of foreign banks sought to adjust their positions arising from transactions involving non delivery forwards (NDF)[3] and the expansion of arbitrage exploiting the spread between long-term and short-term interest rates, which more than offset the reduction of the demand from securities companies for call funds due to the contraction of their unsold beneficiary certificates and the associated call loans.[4]

<Table Ⅱ-16>

Movements of Net Call Borrowings[1] in the Call Market by Major Participant

(daily average, hundred million won)

	2000			2001		
	Borrowing	Lending	Net borrowing	Borrowing	Lending	Net borrowing
Domestic banks	37,492	9,425	28,067	48,712	26,821	21,891
Foreign bank branches	25,518	1,278	24,240	54,918	1,353	53,565
Securities companies[2]	71,860	3,243	68,617	44,886	2,124	42,762
Trust accounts of banks	-	6,733	-6,733	-	11,279	-11,279
ITMCs	-	119,094	-119,094	-	112,693	-112,693

Notes: 1) Based on intermediary transactions.
2) Includes ITCs' own account before ITSCs' separation.
Source: The Bank of Korea.

Yields on 91-day commercial paper(CP) continued to fall throughout the year 2001. This was because of financial institutions' increased appetite for CP as a vehicle for the operation of their short-term funds in line with the concentration of market funds at the short term end of the yield curve. Remarkably, while the call rate target was reduced three times from June onwards, the uncertainty of economic prospects and the intensification of the phenomenon of the short-termism of market funds owing to long-term market interest rates' fall caused yields to fall to around 4.5% by mid-October. But from mid-November onwards, because long-term market interest rates rose and investment trust companies' demand for short term securities contracted due to the decline of capital inflows, yields on CP rose to the 5% level in December. Moving into 2002, however, they fell slightly below 5%.

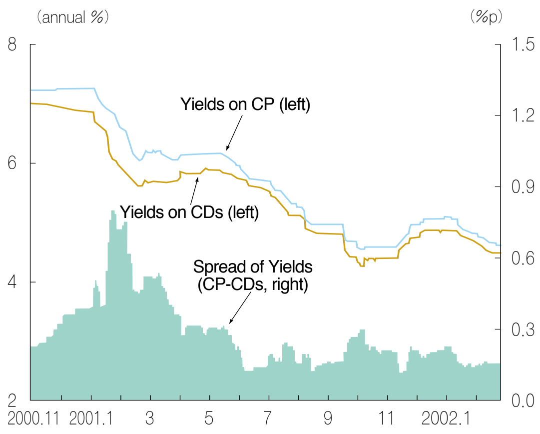
Yields on CDs(91 days) moved with a stable spread over those on CP because the issuer of CDs are banks,

3) Generally, branches of foreign banks hedge their exchange rate risk arising from NDF transactions through purchasing spot exchange while mainly sourcing the required Korean won funds through the call market.

4) Associated call is when an investment trust securities company (formerly an investment trust company's account) borrows funds through a call brokerage company from its subsidiary investment trust management company(formerly an investment trust company's trust account). Under the measures for promoting the stock market of December 1989, a scheme was put in place whereby investment trust companies' own accounts were able to borrow from their trust accounts in order to redeem loans taken out from banks for the purchase of shares, which were in default because of the fall in share prices. As of year end 2001, the outstanding amount of associated call had fallen by around 1 trillion won from the end of the preceding year to stand at 1.798 trillion won.

<Figure Ⅱ-32>

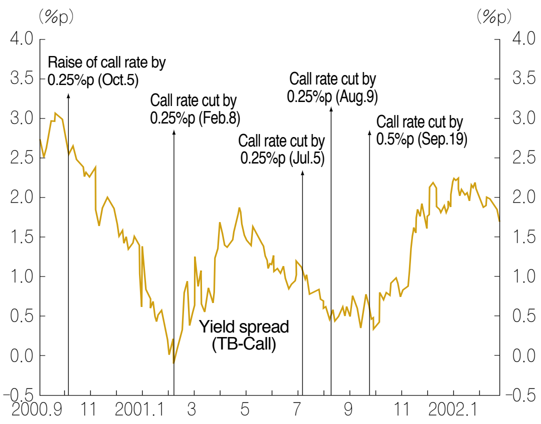
Yields on CDs & CP and Spread of CP over CDs



Source: Korea Securities Computer Corp.

<Figure Ⅱ-33>

Trends of Spread between Short- and Long-term Interest Rates



Source: The Bank of Korea, Korea Securities Computer Corp.

which have a comparatively higher credit standing and lower risk weighting than the companies which issue commercial paper. The spread enlarged to 80 basis points in early 2001, but it narrowed to 10 basis points in response to the easing of some companies's liquidity shortage, the ample liquidity available in the financial markets and the fall of market interest rates. Accordingly, yields on CDs continued to retreat from a level of around 6% at the beginning of 2001, falling to below 4.5% in October 2001. In recent months, yields rose slightly to around 4.5%.

(The Spread between Short- and Long-term Interest Rates)

The spread between short- and long-term interest rates, and especially between the overnight call and three year Treasuries, moved mainly according to the movements of yields on three-year Treasuries.

The spread, which had narrowed sharply from September 2000, fell to below 1%p reflecting the fall of long-term interest rates. In February, the spread inverted temporarily as long-term interest rates fell below than the short-term interest rates.

During the period from March to April, the spread, which had moved around below 1%p in February, widened to 2%p as the overnight call rate was maintained at its existing level by the Bank of Korea while long-term interest rates firmed due to the easing of the economic recession and concern over price instability. From May onwards, the spread showed a narrowing pattern as long-term interest rates began to sink. Particularly, when the Bank of Korea cut its call rate target by 25 basis points on July 5, long-term interests declined more sharply. Hence the spread contracted to below 1%p at the end of July. From

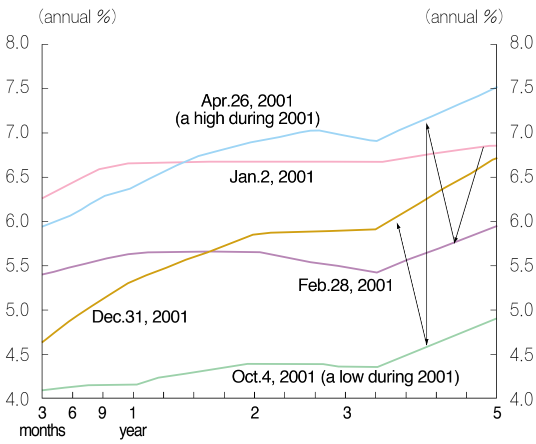
August onwards, although the Bank of Korea reduced the call rate in two successive months, the spread scarcely budged from its previous level, in contrast to the situation in July, because long-term interest rates had fallen on roughly the same scale as the call rate.

In the last quarter, short term interest rates showed only minor fluctuations as the Bank of Korea kept its call rate target unchanged. Long-term interest rates, on the other hand, shifted to an upward trend on the revival of the stock market and anticipations of economic recovery. As of the year-end, the spread between long-term and short-term rates had widened to as much as 2%p.

In early 2002, the call rate target was maintained at its existing level but long-term market interest rates eased slightly, causing the interest rates spread to narrow to between 1.5% and 2%.

<Figure Ⅱ-34>

Yield Curves of Treasury Bonds



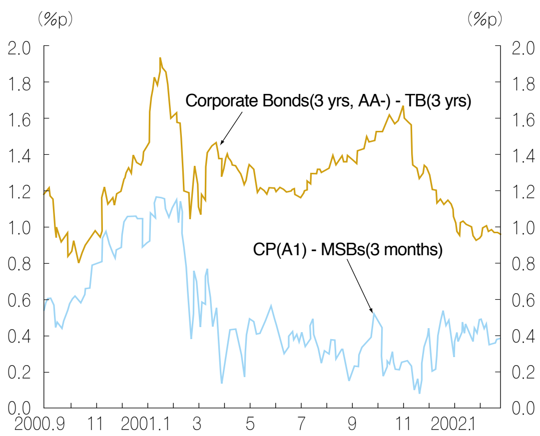
Source: Korea Securities Computer Corp.

Reflecting these movements of the spread between long-term and short-term interest rates, the yield curve on Treasury bonds showed repeated phases of steepening and flattening.

It flattened out during January and February and from May through September when interest rates were falling, but steepened during March and April and from October onwards when interest rates were again on the rise. The fact that the slope of the yield curve underwent repeated shifts on several occasions during the year appears to show that the depth of uncertainty concerning the prospects for the economy and prices was great.

<Figure Ⅱ-35>

Trends of Risk Premiums



Source: The Bank of Korea, Korea Securities Computer Corp.

(Risk Premiums)

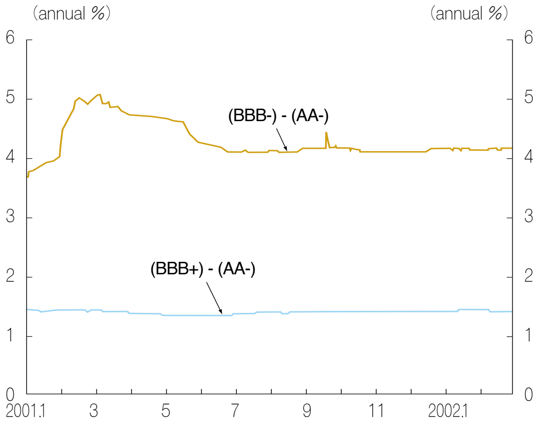
Risk premiums, spreads between the yields on risk-bearing and risk-free assets, exhibited a generally narrowing pattern during the year 2001. This narrowing reflected the fall in market interest rates, together with the easing of the flight to quality and the progress in the disposal of several insolvent companies, which acted to reduce corporate credit risk.

The long-term risk premium(yields on AA-rated three year corporate bonds as against yields on three year Treasury bonds) had continued to widen until the end of January 2001, but from February onwards, it narrowed as a result of the easing of investors' flight to quality caused by the progress in corporate restructuring and the reduction in market interest rates. From early July, a mood of instability in the markets nurtured by the bunching of maturities of corporate bonds during the second half of the year and the liquidity problems of Hynix Semiconductor. This led to a renewed widening of risk premiums. They narrowed again, however, from November thanks to the easing of corporate credit risk on the back of expectations of economic recovery and the soothing of market fears by the announcement of a plan to provide funding support to Hynix Semiconductor and the amelioration of the situation with regard to the concentration of corporate bond maturities.

The short-term risk premium(yields on A1 rated CP with a maturity of 91 days versus yields on MSBs with a maturity of 91 days) generally exhibited the same movements as the long term risk premium while responding sensitively to changes in investment trust companies' short-term deposit. With the large increase in their deposit-taking during the first quarter and in July and August, investment in higher yielding, risk bearing assets also expanded, causing the short-term risk premium to narrow. However, it widened again from early October as yields on risk bearing commercial paper rose sharply following the lessened demand for short-term assets due to the reduction in deposit-taking by investment trust companies and the rise in long term market interest rates.

<Figure Ⅱ-36>

Trends of Spread on Corporate Bonds by Credit Rating



Source: Korea Securities Computer Corp.

Spreads among the various levels of investment grade corporate bonds exhibited a largely stable pattern of movements. The benchmark spread between BBB- and AA-corporate bonds widened to reach 5%p at the end of February as yields on highly rated bonds dropped sharply in response to a sudden and abrupt expansion of demand for high-grade bonds generated by a decline in yields on Treasury bonds at the beginning of the year. In accordance with the continuing issuance of primary CBO(Collateralized Bond Obligations) and the smooth operation of the prompt underwriting scheme for corporate bonds, the market became more favourable for the issuance of lower grade corporate bonds and the spread gradually contracted to move stably in a range of between of 4%p and 4.5%p from the end of May onwards. The interest rates spread between corporate bonds rated BBB+ and those with an AA-grade moved with little variation during the year at around 1.4%p. It was noteworthy that when yields on AA-corporate bonds dropped sharply in early February, those on BBB+ corporate bonds followed them downwards in virtual lockstep.

<Table Ⅱ-17>

Trends of Spread Between CPs by Credit Rating
(month-end basis)

(annual %)

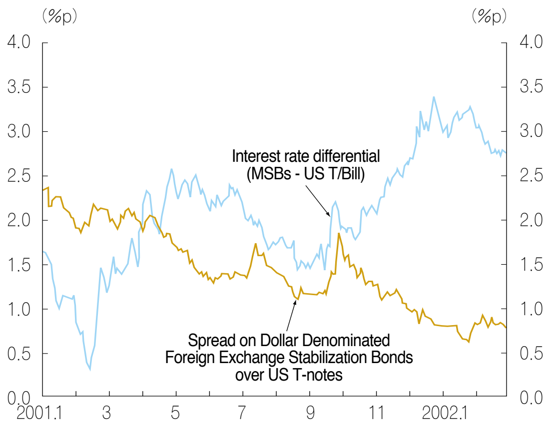
	2000	2001				2002	
	Dec.	Jan.	Mar.	Jun.	Dec.	Jan.	Feb.
A1-rated(a)	7.26	6.66	6.19	4.96	5.07	4.80	4.60
B-rated(b)	11.61	10.98	10.40	9.15	9.32	9.02	8.81
Spread(b-a)	4.35	4.32	4.21	4.19	4.25	4.22	4.21

Source: Korea Securities Computer Corp.

Meanwhile, the expansion of demand for commercial paper, generated by the market's preference for the operation of funds at the short term end, generally led the premium between B grade commercial paper and A1 grade to move stably in the region of 4.2%p during the year.

<Figure Ⅱ-37>

Trends of Interest Rate Differential and Spread of Dollar Denominated Foreign Exchange Stabilization Bonds over US T-notes



Source: The Bank of Korea, Federal Reserve Board.

(Domestic-Foreign Interest Rate Differential and Premiums on Dollar Denominated Foreign Exchange Stabilization Bonds)

The differential between foreign and domestic interest rates generally widened in response to the continued reduction of international interest rates.

The differential between them on the basis of paper with a maturity of 12 months(yields on MSBs vs. U.S. Treasury bills) narrowed greatly to 0.3%p during January and early February 2001 as yields on short term domestic paper fell steeply. It subsequently widened from mid-February, reaching 2.4%p at the end of April as several leading domestic interest rates shifted to an upward trend whereas U.S. bond rates fell in response to the Fed's lowering of interest rates. Thereafter, it moved undramatically within a range of 2 to 2.5%p as domestic and foreign interest rates fell on a similar scale.

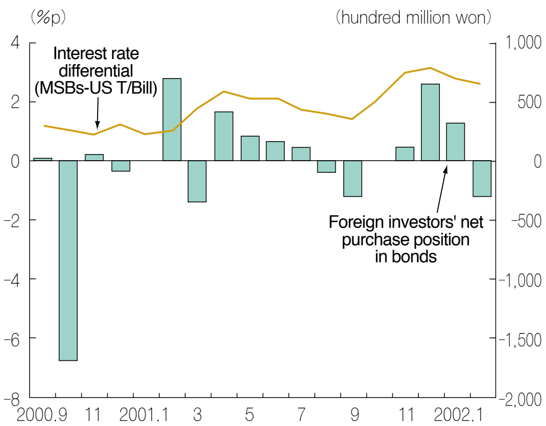
From July onwards, as the Bank of Korea lowered interest rates on two occasions, promoting a steep fall in domestic market interest rates, the differential narrowed to 1.7%p as of the end of August.

Following the events of 11 September, it widened somewhat as a result of the sharp decline in U.S. bond yields generated by the U.S. Federal Reserve's substantial reduction of interest rates. From October onwards, as MSB yields rose sharply on the possibility of an early recovery of the domestic economy whereas U.S. bond market rates staged only a slight rise, the differential between rates at home and abroad widened to the 3.2%p level toward the end of the year.

The scale of foreign net purchases of domestic bonds during the year 2001 stood at 0.15 trillion won, very

<Figure Ⅱ-38>

Trends of Interest Rate Differential and Foreign Investors' Net Purchase Position in Bonds



Source: The Bank of Korea, The Financial Supervisory Service, Federal Reserve Board.

much lower than the scale of foreign net purchases of shares(8.9 trillion won). Looking at the linkages between foreigners purchases of domestic bonds and the differential between domestic and foreign interest rates, as the differential widened during the first half of the year, foreign investors increased their purchases of short term securities such as MSBs which offer a high degree of security, maintaining a net buying position. During the third quarter when it narrowed, they preferred to run down their positions. As the differential between domestic and international interest rates widened again in the final quarter, they returned to a net purchase position.

The spread over U.S. Treasury notes on Dollar-denominated Foreign Exchange Stabilisation bonds fell steeply during the course of the year. This was attributable to the fact that, at a time when the international financial markets' appetite for Asian bonds was increasing, Korea's sovereign ratings was upgraded on the strength of its favourable economic performance.

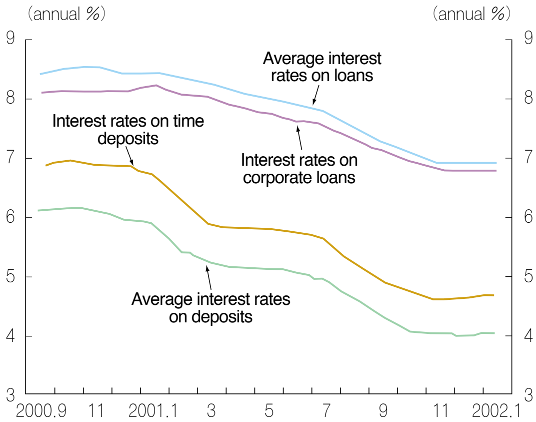
It was above all the Federal Reserve's interest rate reductions and the ensuing abundant international liquidity that brought about the high demand for the sovereign bonds of newly emerging market issuers. In addition to this, the Argentine debacle brought about the migration of funds away from the Latin American region to concentrate on Asian sovereign bonds, which appeared to offer stability and high yields. This contributed to the reduction of the premium on Asian bonds. The events of September 11 led to a temporary hike in the premium, but it quickly fell back again as the international financial markets regained stability thanks to the endeavors of central banks around the world with this end.

Furthermore, while in most Asian countries apart from China, economic activity was in the doldrums, Korea achieved a convincing performance with GDP growth of around 3%. The international financial markets also recognised Korea's relatively high degree of progress in comparison with Japan in the pursuit of financial and corporate restructuring. Reflecting these factors, the premium on Foreign Exchange Stabilisation Bonds narrowed from 235 basis points at the beginning of the year to 81 basis points as of the year-end. The Korea premium on Foreign Exchange Stabilisation Bonds, which had begun the year wider than that on Chinese, Malaysian and Thai sovereigns, narrowed to below the premium on those countries' bonds by the year end.

(Interest Rates on Deposits and Loans of Financial Institutions)

<Figure Ⅱ-39>

Trends of Interest Rates on Bank Deposits and Loans



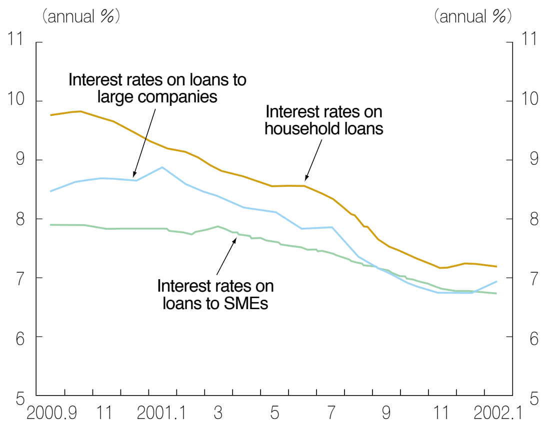
Source: The Bank of Korea.

Financial institutions' interest rates on deposits and loans fell continuously in the course of the year 2001 in view of the weakening of the demand for funds amid the business downturn, the drop in long-term and short-term market interest rates, and their abundant liquidity.

During January 2001, banks' average lending rate(on the basis of amounts newly extended) rose slightly from the previous month's 8.4% to 8.5% in response to an increase in overdraft lending, which carries a high interest rate. It subsequently fell to the 8.1% level by mid-April. This was attributable to two main factors. Backed by ample liquidity, banks followed a strategy of expanding loans to households centering on mortgage lending, which carries a low risk and a favourable risk weighting in the calculation of the BIS capital adequacy ratios. As a consequence, households' lending rates fell to a great extent. They also mounted a campaign to expand lending to outstanding small and medium enterprises in a situation where corporate demand for funds remained lacklustre as a result of the business slowdown. Therefore, corporate lending rates continued their downward path.

<Figure Ⅱ-40>

Trends of Interest Rates on Bank Loans by Borrower



Source: The Bank of Korea

Banks' lending rates eased to 7.3% in September, reflecting the constant downward path of market interest rates in view of the increased proportion of lending with floating rates tied to market interest rates. Even though market interest rates shifted to an upward trend from October onwards, fuelled by their ample liquidity, banks applied reduced premiums on lending to the household sector and to outstanding small and medium enterprises. Their average lending rate, in consequence, eased further to stand at 6.9% in December.

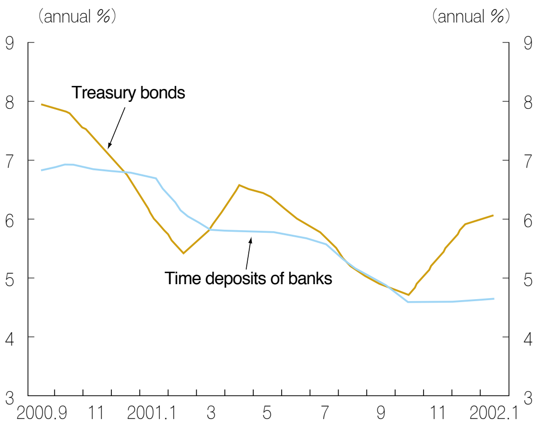
Viewed by borrower, banks' interest rates on lending to households fell by a large margin. Specifically, the average interest rate on such lending dropped from 9.88% during the year 2000 to 8.23% in 2001, a reduction of 1.65%p which was much larger than the 0.69%p decline in their corporate lending rate over the same period(8.18% in 2000 → 7.49% in 2001).

The average interest rate on bank deposits(on the basis of amount of new deposit-taking) pursued a generally downward path during the year in a situation in which, after the initially active migration of funds at the beginning of the year following their structural reform and the introduction of the system of only partial deposit insurance coverage, banks were able to focus on increasing profitability rather than attracting deposits, thanks to the fall in market interest rates and the ample liquidity available.

A reduction in deposit rates, which had begun in November 2000, accelerated in the early part of the

<Figure Ⅱ-41>

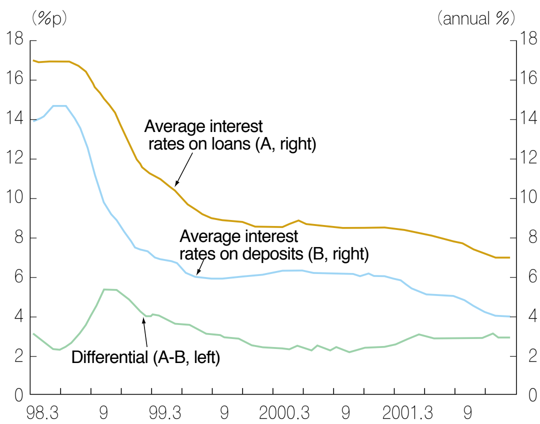
Interest Rates on Time Deposits of Banks and Yields on Treasury Bonds



Source: The Bank of Korea, Korea Securities Computer Corp.

<Figure Ⅱ-42>

Trends of Differential Between Interest Rates on Deposits and Loans of Banks



year 2001. Banks' deposit interest rates dropped 0.84%p from 6% at the end of 2000 to 5.1% in April. From early May, the downward course of banks' deposit interest rates was greatly eased. The explanation for this was that several banks expanded their practise of applying preferential interest rates to retain large value deposits while several of the more recently established nationwide commercial banks, whose reputation had increased since the currency crisis, set interest rates on time deposits at a slightly higher level than that offered by those banks that had received injections of public funds, in order to ward off any encroachment on their deposit base following the progressive easing of discrimination according to banks' credit standing.

From July onwards, however, against the backdrop of the Bank of Korea's three reductions of the target level of its call interest rate, banks adjusted deposit interest rates rapidly downward so that the average deposit interest rates reached 4% in October.

From November onwards, while market interest rates turned upward, some banks offered preferential interest rates on long-term time deposits to counter any consequent lowering of their liquidity ratios with the structure of deposits shifting towards the short term. This brought a levelling-off of the decline in the average deposit rate and its modest rise early in the new year.

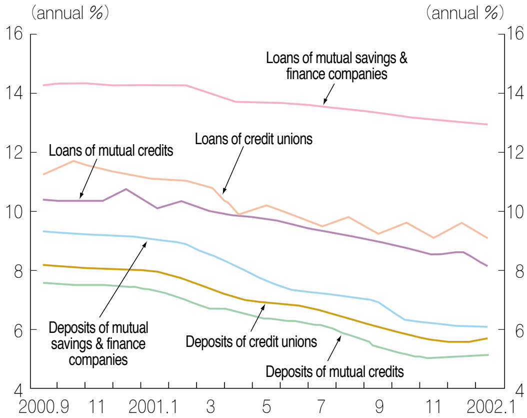
Banks' time deposit interest rates generally moved in line with the market based yields on Treasury bonds, but showed a somewhat different pattern in their response when market rates rose or fell. Specifically, when market rates were easing, banks adjusted their deposit interest rates downward by a corresponding margin, but when they were on the rise, banks reduced the scale of their interest rate reductions or carried out only a small-scale increase.

Meanwhile, the spread between banks' deposit and lending interest rates widened from 2.5%p as of the end of the year 2000 to 2.9%p at the end of December 2001. This was attributable to the fact that despite intense competition among financial institutions for lending to outstanding customers, banks boldly lowered their deposit interest rates by an even larger margin than the reduction of their lending interest rates.

The lending and deposit interest rates of non-bank financial institutions, meanwhile, saw a generally downwardly stable trend.

<Figure Ⅱ-43>

Trends of Interest Rates on Loans and Deposits of Non Bank Financial Institutions



Source: The Bank of Korea.

Their average lending interest rates(on the basis of amounts newly extended) declined constantly as a result of the overall slackness of the demand for funds and the decline in the cost of raising funds. Mutual savings & finance companies' lending interest rates(bill discount basis) declined to 13% during the December of the year 2001, a 1.2%p reduction from that prevailing in the same period of the preceding year. Those of credit unions fell by 1.7%p(11.3% → 9.6%) and those of mutual credits fell by 2.0%p(10.7% → 8.7%) over the same period.

The average deposit interest rates(on the basis of new deposits taken at fixed interest rates) fell even more steeply than the average lending interest rates in view of the lowering of deposit interest rates by banks, with which they are in competition, and the desirability of ensuring an appropriate spread. Mutual Savings & finance companies' deposit interest rates registered the largest reduction, falling by 3.1%p year on year to stand at 6.1% during December 2001. Those of credit unions and mutual credit both witnessed a 2.5%p reduction(8.0% → 5.5% and 7.4% → 4.9% respectively).

Looking at the spread between lending and deposit rates of these non-bank financial institutions in the last month of the year 2001, that of mutual savings & finance companies was the widest at 6.9%p as compared to credit unions' 4.1%p and mutual credit's 3.8%p. A major factor contributing to this was that mutual savings & finance companies, whose cost of funds is higher, expanded lending at high rates of interest to customers whose credit risk is relatively larger, amid the intensification of competition among financial institutions for lending to the best customers.

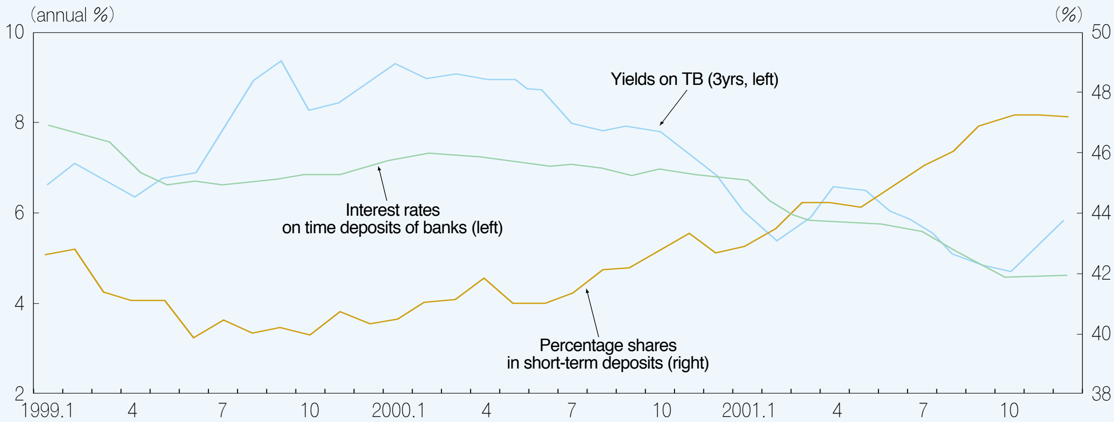
<Box II-3>

The Decline of Interest Rates and Changes in Financial Institutions' Deposit Structure

Examining the composition of long term and short term deposits in the deposit structure of the principal types of financial institutions(on an average balance basis of banks, trust accounts of banks, investment trust companies and merchant banking corporations), there was an intensification of the short-termism of financial institutions' deposit products, which had been evident since the latter half of 1999. The proportion of their short term deposit products(less than 6 months) climbed sharply from 42.7% at the end of the preceding year to 47.2% as of the end of the year 2001.

There are two main factors contributing to the shift toward the short term in the holding of financial institutions' deposit products. Firstly, there has been a high degree of uncertainty surrounding finance and the economy in the ongoing process of structural reforms. And there has also been a reorganization of all aspects of the financial system including the introduction of mark to market pricing for bonds and a system of only partial deposit insurance coverage. The general public have, therefore, looked not simply for high rates of return, but also security and liquidity when selecting financial assets. Secondly, expectations persisted of a rise in interest rates, especially among less sophisticated savers, in the course of the downward trend of both market interest rates and financial institutions' deposit interest rates. Taking last year as an example, the shift towards the short term became especially rapid in the months from May to September when interest rates fell sharply, but the phenomenon became less clearly marked from October onwards when interest rates shifted to an upward trend.

Trends of Market Rates and of Percentage Shares in Short-term Deposits of Financial Institutions



Source: The Bank of Korea, Korea Securities Computer Corp.

<Table Ⅱ-18>

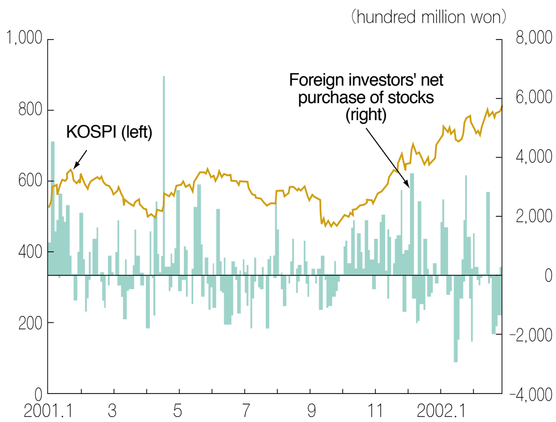
Stock Market Trends

	2000	2001		2002	
		first half	second half	Jan.	Feb.
KOSPI[1]	504.6 (-50.9)	595.1 (17.9)	693.7 (37.5)	748.1 (7.8)	820.0 (18.2)
Volume (ten thousand shares)[2]	30,614	41,830	52,726	71,614	64,048
Value (hundred million won)[2]	26,021	20,078	19,839	41,032	35,213
KOSDAQ Index[1]	52.6 (-79.5)	76.9 (46.1)	72.2 (37.3)	77.4 (7.1)	78.7 (9.0)
Volume (ten thousand shares)[2]	21,191	41,647	35,147	34,893	31,385
Value (hundred million won)[2]	24,005	21,072	13,556	14,913	13,497

Notes: 1) Based on period-end.
2) Daily average.
3) Figures in parentheses refer to percentage changes compared with the previous year-end.
Source: Korea Securities Computer Corp.

<Figure Ⅱ-44>

Trends of KOSPI and Foreign Investors' Net Purchase of Stocks



Source: The Financial Supervisory Service, Korea Securities Computer Corp.

(2) Stock Prices

Stock prices witnessed a pattern of repeated fluctuations in line with changing domestic and international conditions until the third quarter last year, but from the second half of September onwards, they rose by a large margin in response to heavy foreign buying and growing anticipations of economic recovery. This trend persisted into the early part of the year 2002.

(Korea Composite Stock Price Index)

Stock prices had fallen steeply during the year 2000 because of the deterioration of the market environment through a rise in international oil prices, prospects of an economic downturn and financial market instability. From early January 2001, however, they shifted to an upward trend, influenced by hopes for an improvement in the external environment following the U.S. Federal Reserve's reduction of interest rates and net purchases by foreign investors. The composite stock price index(KOSPI), which had registered 627 on January 22, soared 24% in just 3 weeks.

From mid-February, they, however, shifted to a downward trend amid growing signs of weakness including a mood of caution following an abrupt rise within a short period, the weakness of American share prices in line with the gathering slowdown of U.S. business activity, the depreciation of the Korean won and the liquidity problems of Hyundai Engineering & Construction. By early April, KOSPI had fallen back to the 500 point level.[5]

5) In order to stimulate stock market activity, the government announced a plan to expand the scale of share purchases by major pension funds including the National Pension Fund from the current 8 trillion won to the 25 trillion level within two to three years, and declared its intention to commence by raising the scale of such investment by 6 trillion won within the year 2001.

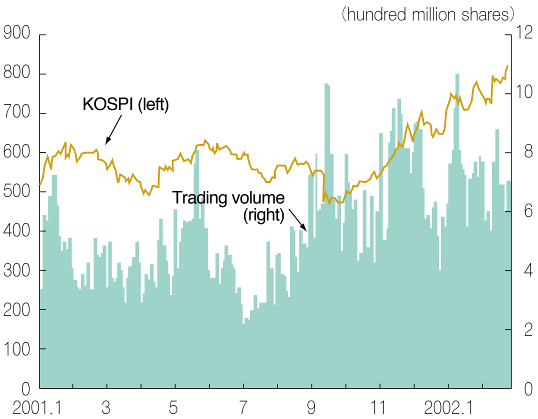
From mid-April until the end of May, stock prices climbed higher as foreign investors expanded their net purchase position under the influence of the more stable tone of the Korean won, the merger agreement between Kookmin Bank and Housing & Commercial Bank, the U.S. Federal Reserve's additional interest rate reductions and the expansion of the Korean weighting following the change in the composition of the MSCI (11.5% → 14.8%). Similarly, Korean investors increased their share buying activity backed by the continuing increase in customers' security deposit accounts. Together this enabled KOSPI to reach 632 on May 29.

Stock prices shifted back to a downward trend from early June. With the acceleration of the fall in semiconductor prices, financial markets showed signs of instability in the face of structural adjustment problems at several large companies, and especially Hynix Semiconductor, and the large scale of corporate bonds nearing maturity in the latter half of the year. The international financial markets were also troubled by the heightened risk of Argentina's default on its debts. This caused KOSPI to slide back below the 500 level again. In the wake of the events of September 11 and the imminent so called war on terror, there was widespread concern over the volatile global political situation and a long-lasting worldwide economic recession, prompting a renewed fall in KOSPI to 480 as of the end of September.

From the end of September, the fundamental trend of stock prices turned upward. Externally, foreign stock markets, and especially the U.S. markets, recovered rapidly on the prospect of an early conclusion of the war on terror. Internally, an early recovery of business activity was anticipated with a number of economic indicators giving a favourable picture. In addition, there was renewed recognition that the Korean economy was delivering a better growth performance than that of its rivals such as Taiwan and Singapore and Korea's credit standing saw a rapid improvement. In recognition, Standard and Poor's upgraded Korea's sovereign rating(BBB- → BBB+) on November 13. This coincided with the return to an upward trend of semiconductor prices, which had fallen sharply for some time, while prospects improved greatly for an early solution to the problems of Hynix Semiconductor that had acted to weaken the stock market. Buoyed by these factors, foreign investors began large scale purchases in response to which KOSPI surged 37.5% from its level at the end of the preceding year (504.6) to register 693.7 as of the end of December 2001.[6] With the large scale of the increase in the prices of listed shares, total market capitalisation expanded sharply from 188 trillion won as of the year end 2000 to stand at 256 trillion won as at the end of the year 2001.

<Figure Ⅱ-45>

Trends of KOSPI and Trading Volume



Source: Korea Securities Computer Corp.

In the early months of 2002, stock prices rose sharply thanks to anticipations of economic recovery, boosted by the favourable movements of economic indicators, and several blue-chip company's improved their profits. KOSPI thus registered an 18.2% rise from the level of the end of 2001 to reach 820 as of the end of February, the first time it had reached this level in the nineteen months since July 2000.

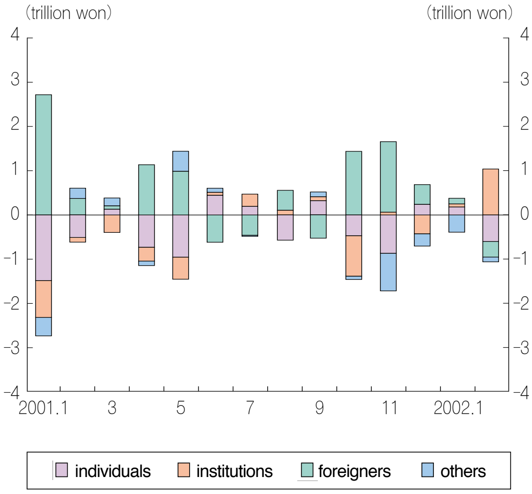
6) Viewing the increase rates of stock prices in several countries, stock prices declined in most of them, but rose sharply in Korea.

	end of yr.2000 (a)	end of yr. 2001 (b)	Increase rate of stock prices (b/a-1)×100
KOR(KOSPI)	505	694	37.5%
USA(DJIA)	10,787	10,022	-7.1%
UK(FTSE 100)	6,223	5,217	-16.2%
JPN(Nikkei 225)	13,786	10,543	-23.5%
HG(HangSeng Index)	15,096	11,397	-24.5%
Singapore(STI)	1,927	1,624	-15.7%

Stock trading volumes varied with the state of the stock market. Average daily turnover rose sharply from the 310 million shares of December 2000 to reach 510 million shares in January 2001 reflecting the rise of stock prices in January. In the February to April period, stock prices fell and the trading volume also shrank 370 million shares. With stock prices showing a recovery trend during May, share turnover again rose to the 530 million share level a day, and then fell back to the 360 million share level as stock prices fell in the June to August period. From mid-September onwards, however, stock prices showed an underlying upward trend and for the last four months of the year, the average daily share trading volume climbed steeply to 620 million shares. Stock prices held to their fundamental upward trend in the early months of 2002, generating brisk share trading activity and causing daily turnover to rise well above the previous year's level to reach 680 million shares.

<Figure Ⅱ-46>

Trends of Net Purchase and Sale of Stocks of the KSE Market by Investor



Source: Korea Securities Computer Corp.

Viewing stock transaction by class of investor, institutional investors, including investment trust management companies, non financial companies and individuals showed a net selling position whereas foreign investors were net purchasers.

Foreign investors' total net purchases on the course of the year 2001 registered 7.6 trillion won, with net buying on a much smaller scale than last year's(11.5 trillion won). For the first half of the year, their total net purchases reached 4.7 trillion won, since Korean shares were regarded as being undervalued and the interest rate reductions in the United States and Korea aroused expectations of a recovery of domestic business activity. In the third quarter, however, there were worries that the Korean economic recovery might be delayed while the international markets were disturbed as the risk of Argentina's default on its debt augmented. On top of this came the terrorist attacks on the United States. Foreign investors thus took a net selling position to the tune of 0.5 trillion won. From the beginning of the last quarter, as the international financial market became stable and the credit rating of Korea was also upgraded, foreign investors' net purchases again expanded sharply to 3.4 trillion won for the three-month period.

For the first and second quarters, the net inflow of foreign capital for portfolio investment reached 4.2 billion dollars, reflecting active share purchases, but for the third quarter, this shifted to a net outflow of 0.4 billion dollars. As share prices mounted rapidly in the final quarter, a total of 3.7 billion dollars flowed into the country to fund foreign portfolio investment in Korean shares. In the early part of the year 2002, foreign investors maintained their net purchase position in regard to Korean shares, resulting in an inflow of some 200 million dollars to the capital account.

<Table Ⅱ-19>

Trends of Foreign Investors' Net Purchase[1] and Net Inflow of Portfolio Funds
(based on changes)

	2001					2002	
	year	Ⅰ	Ⅱ	Ⅲ	Ⅳ	Jan.	Fab.
Net purchase (billion won)	8,908	3,406	1,733	-434	4,203	592	-257
Net inflow[2] (100M U$)	75.3	27.3	15.1	-3.8	36.7	5.6	-3.8

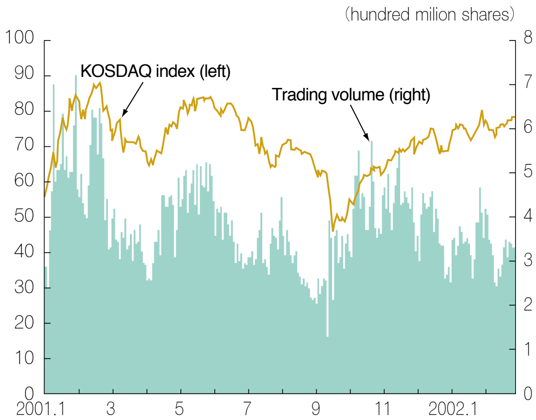
Notes: 1) Sum of net purchase in Korea Exchange Market and KOSDAQ market.
2) Preliminary figures.
Source: The Bank of Korea, Korea Securities Computer Corp.

(KOSDAQ Index)

The KOSDAQ index, which had fallen sharply during the year 2000 as a result of correction of the imbalance between of supply and demand following the massive expansion of share issuance and the emergence of debate over a bubble in information technology(IT) and Internet related businesses, followed a generally similar pattern of movements to that of KOSPI during the year 2001. As of the end of the year it had risen 37.3% from a year earlier to stand at 72.2.

<Figure Ⅱ-47>

Trends of KOSDAQ Index and Trading Volume



Source: Korea Securities Computer Corp.

From January to February, as the KOSDAQ market was influenced mainly by the pick-up of activity on the KSE even though the NASDAQ market showed a downward trend, the KOSDAQ index climbed steeply to reach its highest level for the year at 87.7 on February 20.

Amid concerns about overheating in a short period, the NASDAQ index's collapse below 2000 points and the depreciation of the Korean won, the index fell back to 68.4 by the end of March.

While rising from mid-April to May in sympathy with the NASDAQ market, the KOSDAQ index then followed a downward trend until September. What contributed to this slide was the expansion of the supply of newly issued shares as a result of rights offerings and initial public offerings(IPO) together with the likelihood of a long-term recession in the IT sector following the revelation of the weakening profitability of American IT businesses. It was, nevertheless, in the wake of the terrorist attacks on the United States of September11 that the KOSDAQ market tumbled to its lowest level for the year, registering 46.1 on September 17.

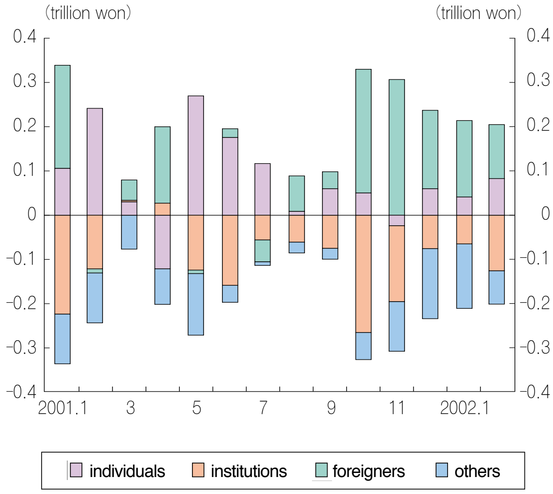
From October, with a spreading perception that the KOSDAQ' s correction had overshot, foreign and individual investors went on a buying spree, taking the KOSDAQ to 72.2 points at the end of the year, a 37% rise from a year earlier.

Moving into the year 2002, as investors' spirits were enhanced by the pick-up of activity on the KSE and the rise of semiconductor prices, the KOSDAQ market showed an upward trend.

Transaction volumes on the KOSDAQ market swelled greatly compared to the preceding year. This was attributable to the continual increase in the number of listed firms and to the expansion of transactions in search of marginal profits from the large fluctuations in the index. The average daily volume of share transactions rose from 210 million shares the previous year to 390 million shares in the year 2001. Moving

<Figure Ⅱ-48>

Trends of Net Purchase and Sale of Stock on the KOSDAQ Market by Investor



Source: Korea Securities Computer Corp.

into 2002, average daily turnover marked a level of around 330 million shares.

Examining the trend of KOSDAQ share transactions by investor, foreign and individual investors registered net purchases of 1.3 trillion won and 1.0 trillion won respectively. In contrast, institutional investors and non financial companies made net sales of 1.3 trillion won and 1.0 trillion won. These patterns were maintained in the early months of 2002.

B. Quantitative indicators

(1) Money

Non-bank financial institutions gradually recovered their intermediary function in the course of the year 2001 while banks' supply of liquidity was considerably reduced. Reflecting these trends the growth rates of the principal monetary aggregates showed a divergent pattern.

(Monetary Aggregates)

<Table Ⅱ-20>

Growth Rate[1] of Major Monetary Aggregates

(%)

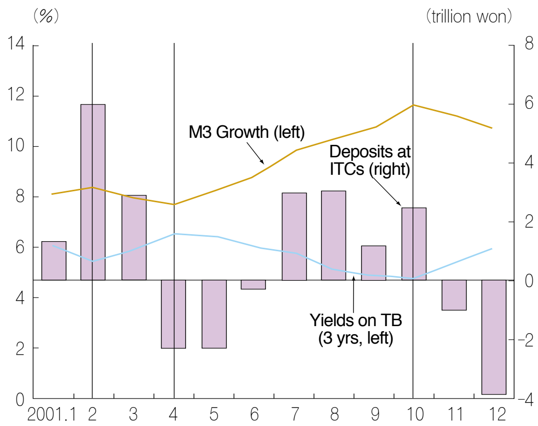
	2000	2001				2002	
	Dec.	Mar.	Jun.	Sep.	Dec.	Jan.	Feb.
M1	11.8	13.2	12.6	14.9	18.7	16.7	28.9
M2	24.5	18.1	13.9	12.8	13.7	12.5	14.7
MCT+	14.1	11.7	11.3	12.6	13.6	12.3	13.9
M3	6.7	7.9	8.8	10.7	11.3	..	..
RB	11.3	11.4	9.6	7.2	14.0	7.1	20.3

Note: 1) Based on daily average, compared with the same period of the previous year.
Source: The Bank of Korea.

During the year under review the growth rates of both M2 and MCT+ lowered while that of M3 continued its smooth upward trend. This was attributable to the contraction of banks' supply of liquidity resulting from the reduction of firms' reliance on them for financing because of the revival of the corporate bond market together with their reduced demand for funds in the course of the economic downturn. It was also attributable to non-bank financial institutions' expanded supply of funds to the private sector, buoyed by an increase of deposits attracted by the relatively high anticipated yields on investment trust companies' performance-based products at a time when market

<Figure Ⅱ-49>

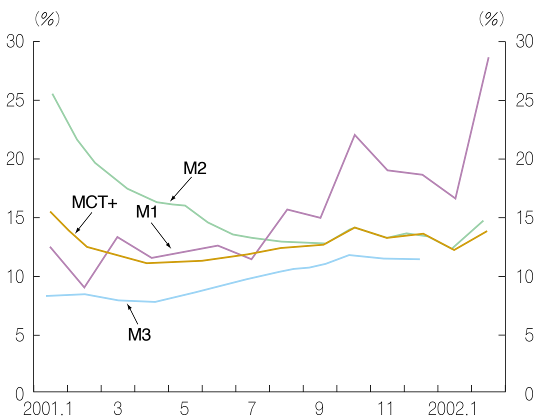
M3 Growth · Market Interest Rates · Deposits at Investment Trust Companies



Note: 1) Based on bond type product, Based on changes.
Source: The Bank of Korea.

<Figure Ⅱ-50>

Growth Rates of Major Monetary Aggregates



Source: The Bank of Korea.

interest rates and bank deposit rates were both continuing to fall.

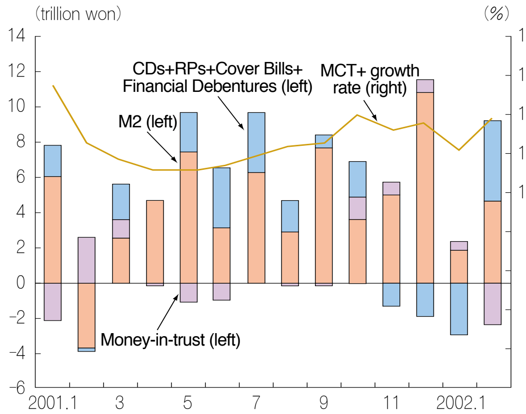
Broad money (M3), which had stayed at around the 5-6% level during the year 2000, saw its growth rate(average balance basis) move smoothly upward during the year under review. During March and April nevertheless, its growth rate dipped for a while as investment trust companies faced redemption of their money market funds amid worries over sagging yields following the jump in market interest rates. From May onwards the upward trend resumed and accelerated to 11.3% during December. During the year the growth rate of M3 varied distinctively by month in line with the movement of market interest rates and the fluctuating inflow of deposits to performance-based products offered by investment trust companies. Specifically, during March, April and again from early October when yields on government bonds rose, deposit taking by investment trust companies slowed and the growth rate of M3 fell. When yields on Treasury bonds showed a downward trend during the May to September period, however, there was an increased flow of funds into investment trust companies and the growth rate of M3 also showed a rising pattern.

M2 growth differed from that of M3 in showing a continued deceleration. Among the reasons for this is that the rate of increase of the supply of liquidity through banks slowed as conditions for direct financing improved and business activity contracted while there was a migration of market funds to banks in response to the flight to quality subsequent to the financial market instability of the preceding year. After registering a rate of 24.5% during December 2000, M2 growth(average balance basis) continued to decelerate so that in January 2002, it had halved to the level of

12%. However from October 2001 until the end of that year it moved slightly in a contrary direction mainly because the funds which had moved out of investment trust companies and cover bills upon their maturity flowed into bank deposits.

<Figure Ⅱ-51>

MCT+ Growth Rate and Fluctuation by Component[1)]

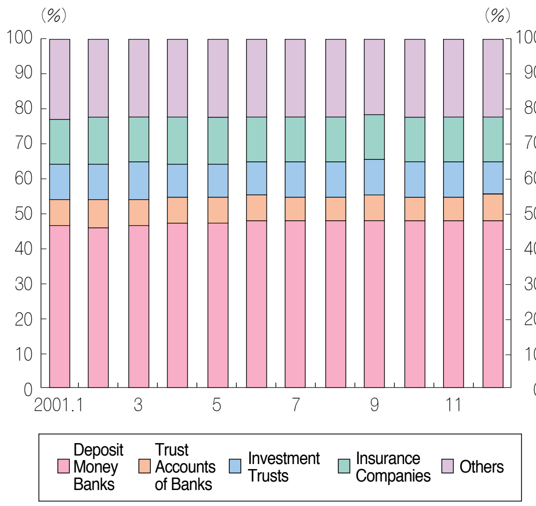


Note: 1) Based on daily average, compared to the same period of the previous year.
Source: The Bank of Korea.

MCT+(M2 plus CDs plus cover bills plus money in trust plus RPs plus financial debentures), which incorporates all the deposit products of banks, like M2 saw a continued reduction of its growth rate(average balance basis) but one which was comparatively less pronounced in view of the expansion of short-term marketable deposit products and the increased issuance of financial debentures. Specifically, after standing at 15% at the beginning of the year its growth rate slowed to between 11% and 12% from March onwards; its rate of growth, from October onwards, shifted to an upward trend along with that of M2, accelerating to a level of between 13% and 14%. In the first two months of 2002, it fell back to between 12% and 13%.

<Figure Ⅱ-52>

Shares of M3 by Financial Institution Type



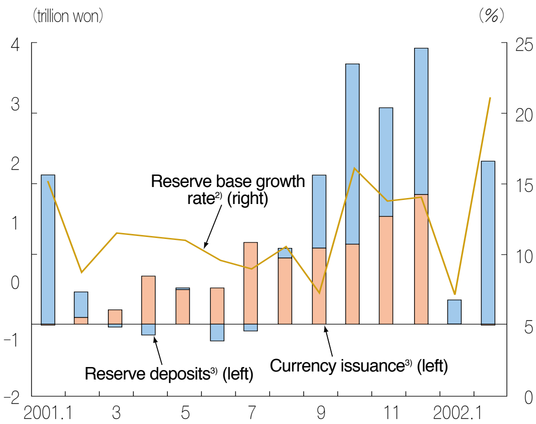
Source: The Bank of Korea.

Viewing the composition of M3 by the weight of each type of financial institution, in the case of bank accounts, their share rose from 46.4% at the end of January 2001 to reach 48.5% by the end of the year, reflecting their more active deposit taking. Accordingly, in spite of a contraction of the weight of banks' trust accounts(7.4% → 7%) the combined weight of banks' deposits(bank accounts and trust accounts) rose from 53.8% at the end of January 2001 to 55.6% at the end of December. From October onwards, there was a contraction of the volume of deposit taking by investment trust companies, which caused their share of M3 to fall slightly from 10.3% at the end of January to 9% at the end of December.

The growth rate of reserve money which had been in the region of 20% throughout the year 2000 dropped to

<Figure Ⅱ-53>

Reserve Base Growth Rate and Changes by Component[1]



Notes: 1) Based on daily average.
2) Compared to the same period of the previous year.
3) Compared to the end of the previous year.
Source: The Bank of Korea.

<Table Ⅱ-21>

M3 Supply by Sector[1]

(hundred million won)

	2000	2001
M3 changes	608,140	1,060,735
Government	22,272	119,878
Public sector	90,451	172,128
Private sector	-158,873	747,455
(Loans & discounts)	229,104	455,767
(Securities)[2]	-377,749	226,930
(Loans in foreign currency)[3]	-47,586	-45,438
Foreign sector	472,122	215,181
Others	182,168	-193,907

Notes: 1) Changes based on year-end balance.
2) Securities such as coporate bonds, CP, etc.
3) Advanced payment against foreign currency payment guarantees, foreign currency credits, etc.
Source: The Bank of Korea.

around 11% during 2001. This large reduction in its growth rate was attributable to the contraction of banks demand for reserves following the deceleration of the increase of those deposits which are subject to reserve requirements. During September and October as a result of a base effect caused by the Chuseok festival falling in different months in the two years[7], causing changes in the amount of cash in circulation, the growth rate of the reserve base surged from 7.2% to 16.1%. In December, the growth rate of the reserve base rose to 14.0% because, under the influence of the migration of market funds to the short term end of the yield curve, there was a large increase in the attraction of deposits to instant access accounts, which carry a comparatively high reserve requirement(5%). In January 2002, it fell back again to 7.1% due to the sharp decline of the rate of increase of cash in circulation as a result of the Lunar New Year festival falling in a different month from the previous year.

Viewing the differences in the volume of the supply of reserve base by its individual components, reserve deposits contributed an increase of 1.8 trillion won and the volume of currency issue expanded by 2.1 trillion won, prompted by the increasing demand for settlement balances amid signs of improvement in economic activity from the latter half of the year under review.

(Fund Supply Structure)

If we examine the structure of the supply of broad money(M3) during the year 2001, it is striking that the private-sector shifted from being a net absorber to a large supply position and that the supply of money through the government sector also expanded. In contrast, the scale of supply through the foreign sector

7) September 12, 2000 ; October 1, 2001

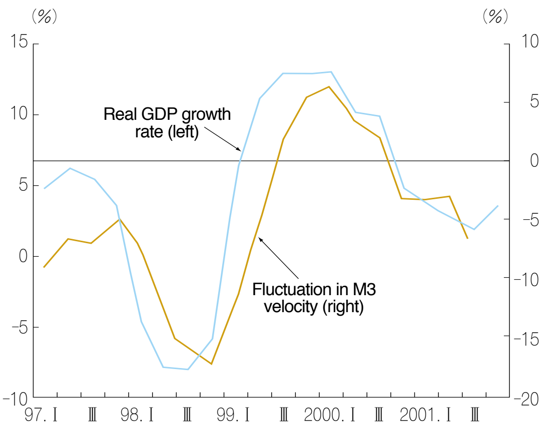
was diminished compared to the previous year.

In the case of the private sector, the turnaround in its position from absorption to a large supply position took place through a shift to the supply of funds from purchases of securities such as CP and corporate bonds with the recovery of the direct financing market(year 2000: -37.8 trillion won → year 2001: 22.7 trillion won). Another contributory factor was the large increase in loans(year 2000: 22.9 trillion won → year 2001: 45.6 trillion won). The supply of funds through the government sector increased from 2.2 trillion won in the preceding year to 12 trillion won during the year under review as a result of the expansion of fiscal expenditures from the second quarter onwards. The public sector increased its supply of funds from the 9 trillion won of the previous year to 17.2 trillion won by way of the purchases of Deposit Insurance Fund bonds. The foreign sector, meanwhile, saw a reduction of its net supply from the previous year to 21.5 trillion won in response to the narrowing of the current account surplus and the dulling of foreign investors' introduction of funds for the purchase of securities.

(Money Velocity)

<Figure Ⅱ-54>

M3 Velocity Fluctuations and Real GDP Growth Trends



Source: The Bank of Korea.

A gradual blunting of the upward trend in the velocity of money on an M3 basis had begun from early in the year 2000, and from the fourth quarter of that year onwards a shift to a downward trend in money velocity took place, which persisted on into the year 2001. This is attributable in part to the slowing of the level of real economic activity but also to the abundance of market liquidity.

M3 velocity, which had decelerated by 4% in the final quarter of the year 2000, registered a rate of decrease of around the 3% level, similar to the preceding quarter's, during the first and second quarters of the year under review. As from August onwards the growth rate of M3 rose above 10% reflecting the investment trust companies' buoyant deposit taking, the scale of the decrease in M3 velocity widened to register a fall of 7% in the third quarter.

(2) Deposits at Financial Institutions

In 2001, investors began to demand not just security but profitability as financial market uncertainties had been resolved to a considerable degree with the introduction of the partial deposit insurance scheme and the completion of the principal elements of financial restructuring. Banks accordingly saw a major slowdown in the rate of increase in their deposit taking whereas deposit taking by money in trust and investment trust companies shifted to an increase in view of the comparatively higher yields on offer given the decline in market interest rates. Mutual credit facilities also saw a favourable turn in their deposit taking thanks to interest rates that were higher than banks'. Meanwhile with the wider fluctuations of interest rates and the emerging signs of a recovery of real economic activity, the phenomenon of a migration of market funds towards the short term end became evident.

<Table Ⅱ-22>

Trends in Deposits of Financial Institutions

(Changes during the period, trillion won)

	2000	2001					2002
		year	Ⅰ	Ⅱ	Ⅲ	Ⅳ	Jan.~Feb.
Deposit money banks	92.0	54.6	2.4	21.9	25.7	4.6	15.3
Real demand	4.1	6.2	−2.7	4.1	2.7	2.1	1.7
Time & savings	76.8	44.8	2.9	12.6	20.2	9.0	9.7
(Time)	56.0	9.9	0.2	1.8	7.6	0.3	7.3
<over 1 year>	51.4	2.8	0.1	−1.7	1.3	3.2	1.1
(Instant access)	15.3	26.1	−1.5	6.9	9.2	11.6	2.7
<MMDA>	3.3	8.5	−1.3	3.5	2.6	3.7	0.6
CDs+RPs	4.8	10.5	3.8	6.1	3.3	−2.7	4.0
Cover bills	6.3	−6.9	−1.7	−1.0	−0.4	−3.8	−
Money-in-trust	−42.2	2.7	3.5	−2.8	−0.4	2.4	−4.2
Additional	4.7	0.7	3.8	−2.9	0.1	−0.3	−0.7
New silver years life pension	1.4	7.9	5.4	0.8	0.8	1.0	−1.9
Unit	−11.9	0.6	−0.4	−0.2	0.4	0.8	0.1
New installment	−11.0	−5.7	−2.4	−1.3	−1.0	−0.9	−0.8
Specific	4.9	5.1	−0.1	1.6	0.6	3.1	0.2
Investment trust companies	−50.2	14.0	17.9	−8.8	26.0	−21.1	10.5
Short term bond	−23.1	8.8	3.2	1.5	7.8	−3.6	0.5
Long term bond	−26.1	−1.1	3.2	0.6	1.7	−6.6	−4.2
MMF	4.2	8.5	16.5	−10.9	12.7	−9.9	10.3
Stock[1]	−5.2	−2.2	−5.1	−	3.9	−0.9	3.9
Merchant banks	−8.5	−1.7	−0.6	−0.1	−	−1.1	1.4
Bills issued	−5.9	−1.6	−0.6	−0.1	−	−1.0	1.0
CMA	−2.6	−0.1	−	−	−	−0.1	0.4
Post office	7.6	5.7	3.3	1.2	0.6	0.6	−0.2
Mutual savings & finance companies	3.8	4.7	2.1	0.7	0.8	1.1	0.6

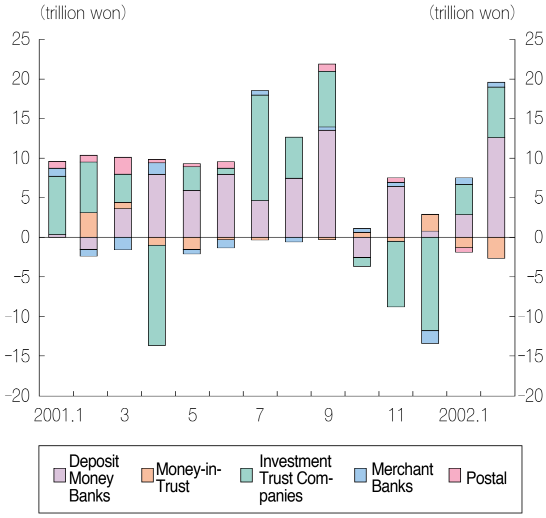
Note: 1) Includes mixed investment trusts.
Sources: The Bank of Korea, Representative associations.

(Deposit Money Banks)

In 2001, deposit money banks saw an increase in their deposits of 54.6 trillion won. This was the largest increase among financial institutions but represented a sharp contraction from the scale of the previous year's expansion(92 trillion won). By type of deposit product, instant access deposits and RPs, CDs and other types of short term marketable deposits were considerably boosted in reflection of the migration of funds toward the short term end of the market. In contrast long term deposits saw their rate of increase greatly blunted in view of the continuing downward trend of interest rates. In the early part of 2002, the scale of the growth in the taking of deposits expanded thanks to the return of funds that had been withdrawn at the year end for the redemption of borrowings and settlement purposes.

<Figure Ⅱ-55>

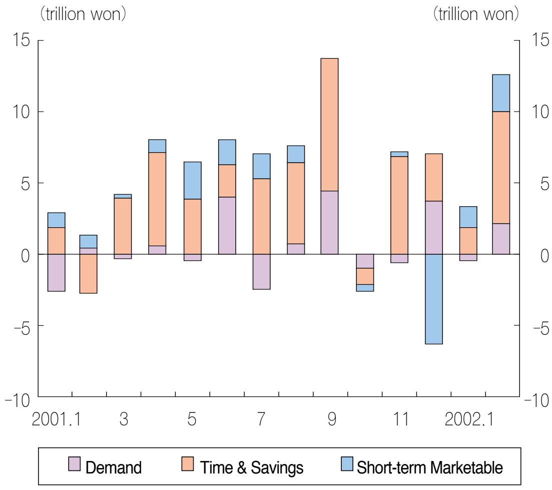
Deposits at Financial Institutions[1)]
(based on changes)



Note: 1) Based on changes.
Sources: The Bank of Korea, Representative associations.

<Figure Ⅱ-56>

Deposits at Deposit Money Banks by Product[1)]



Note: 1) Based on changes.
Source: The Bank of Korea.

Time & savings deposit registered an increase of 44.8 trillion won in 2001. This expansion was headed by the increase of 26.1 trillion won in short-term, instant access deposit. It was due to the great increase in floating funds searching for opportunities for increased yields as well as the general decrease in deposit rates and to the subsequent reduction in differentials based on the period of deposit. In addition the government's release of funds by way of the expansion of fiscal expenditures was also a factor increasing the demand for deposit for settlement purposes such as instant access deposits. Long-term time deposits, which in the preceding year had expanded greatly(56 trillion won) in line with the preference for asset security, saw an increase of only 9.9 trillion won in 2001. The fall in the taking of time deposits with a maturity of one year and over fell especially sharply(36.2 trillion won → 2.5 trillion won). From October onwards, the differential between interest rates on long-term and short-term deposits widened slightly, prompting a modest increase in longer-term time deposits. This was however small in scale and they have been unable to shake off their subdued trend since early 2001.

Affected by the placement in them of the proceeds from the maturity of long-term time deposits,[8)] CDs and

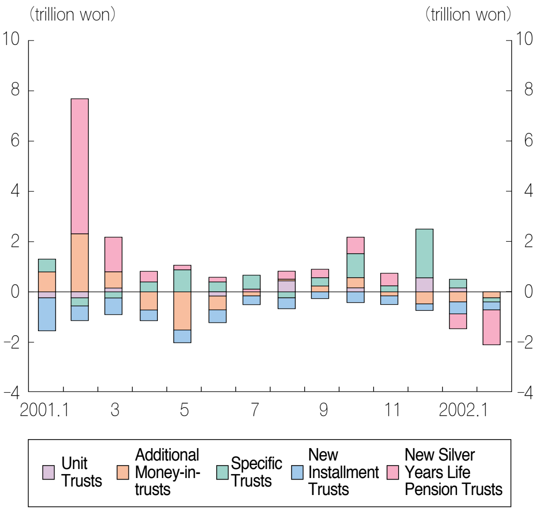
8) In the case of RPs, the cost of funds is approximately 20 basis points lower than that of the time deposit with an equivalent maturity in view of the absence of the deposit insurance levy and of a reserve requirement. Some banks, therefore, applied a preferential interest rate of around 10 basis points to attract the deposit of funds from maturing time deposits.

RPs, which are short-term marketable products, registered an increase of 10.5 trillion won in 2001 but in view of the contraction of 6.9 trillion won in the funds attracted to cover bills,[9] the overall increase in such products stood at only 3.6 trillion won

(Money-in-Trust)

<Figure Ⅱ-57>

Deposits at Money-in-Trust by Product[1]



Note: 1) Based on changes.
Source: The Bank of Korea.

Money-in-trust had continued to contract by a large margin for several years but the trend shifted to register an increase of 2.7 trillion won in 2001. Broken down by product, new silver years life pension trusts, which offer relatively high yields, witnessed an expansionary trend. Specific money trusts also met a favorable buying response thanks to the increase of their own companies' shares purchase trusts[10] and the less than three month maturity short term trust products[11] that were newly offered. In contrast, new capital accumulation trusts and additional money trusts witnessed continual withdrawals. From early in the year 2002, withdrawals at maturity persisted for tax exempt household trusts and new capital accumulation trusts with the blunting of the increase of short term specific money trusts, the taking of deposits by the trust accounts of banks decelerated.

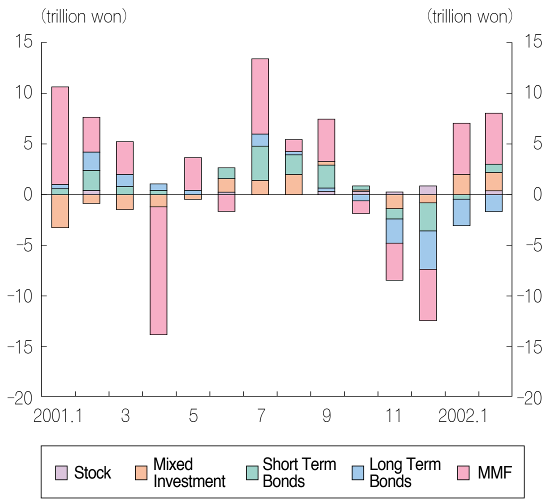
9) The normal maturity of cover bills is 3 months but around the end of the year 2000, cover bills with a maturity of 1 year, known as new cover bill, were sold as a product offering tax incentives(as cover bills were sold on a discount basis, they were exempt from the comprehensive tax on financial income), which made them very popular. There was a big contraction in cover bills when these products reached maturity at the end of the year 2001

10) Money-in-trust companies invest funds for the purpose of purchasing their own shares so as to manage their prices.

11) Following the abolition of the regulation on the minimum maturity of trusts accepted by bank trust accounts(9 November 2001), from November 26, short term(less than three month maturity) special money-in-trust products were offered for sale.

<Figure Ⅱ-58>

Deposits at Investment Trust Companies by Product[1)]



Note: 1) Based on changes.
Source: Investment Trust Association.

(Investment Trust Companies)

Investment trust companies, whose deposits had shrunk by 50.2 trillion won in 2000, saw a shift in their deposit taking to an increase of 14 trillion won in 2001. The rationale for this is that the strength of investors' flight to quality weakened with the restoration of stability in the financial markets and the competitiveness of investment trust companies' products was relatively heightened by the reduction of banks' deposit interest rates. In view of the uncertainty of prospects concerning future interest rates movements, however, the increase was principally led by short-term products such as MMF(+8.5 trillion won) and short term bond investment trusts(+8.8 trillion won). Long-term bond investment trusts(-1.1 trillion won) and stock investment trusts(-2.2 trillion won), in contrast, experienced a contraction.

Viewing deposit taking by investment trust companies by period, it rose by 17.9 trillion won during the first quarter led by MMF(+16.5 trillion won). During April with the sharp rise in market interest rates(the sharp fall in bond prices) anticipated yields fell and, prompted also by seasonal factors such as the need to meet tax payments, the net redemption of MMF expanded greatly, becoming a further factor threatening market stability. Following the unveiling of the Bank of Korea's bond market stabilisation measures(April 27), market interest rates returned to stability and from May onwards, MMF shifted back to an expansionary trend. During the third quarter, market interest rates responded to the Bank of Korea's lowering of the call rate by falling, causing operating yields to rise. This created a relatively large increase for short term bond investment trusts and mixed investment trusts[12)] as well

12) The increase was spearheaded by the tax-exempt, high risk, high-yield funds, subscription to which was launched on 14 August 2001.

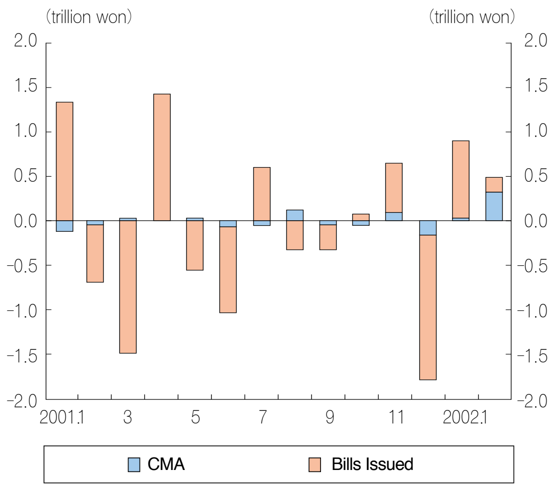
as for MMF. But in the final quarter, as expectations of an early economic recovery mounted, market interest rates shifted to an upward trend while the inflow of funds was also affected by seasonal factors including financial institutions' year-end management of their BIS capital adequacy ratios, and companies' year-end settlement and reduction of their debt ratios. In consequence, deposits at investment trust companies contracted by 21.1 trillion won.

In the early months of the year 2002, despite the continued shrinking of long term bond investment trusts, investment trust companies' deposit taking shifted back to an upward trend. This was because MMF attracted a large volume of funds and mixed investment trusts, which had seen a downward trend since the previous October, also shifted back to a rising trend in a climate of high-yield anticipations.

(Merchant Banks)

<Figure Ⅱ-59>

Deposits at Merchant Banks by Product[1)]



Note: 1) Based on changes.
Source: The Bank of Korea.

Merchant banks' deposits had fallen by 8.9 trillion won in 2000 and in 2001 they were also unable to shake off their sluggishness due to factors such as the reduction in their numbers.[13)] Nevertheless, the scale of the contraction in their deposits was smaller than that of the preceding year(-8.9 trillion won → -1.7 trillion won). For settlement purposes and in order to reduce their debt ratios, companies had withdrawn funds at the end of the previous year and some of these flowed back in early in the new year, and a similar pattern was repeated during July following the half-yearly closing at the end of the preceding month. This and other seasonal factors led to a slight rise in deposits. In addition, in response to the influence of interest rates'

13) With the merger of Regent Merchant Bank into Tongyang Investment Bank, the number of merchant banks was reduced from 4 to 3.

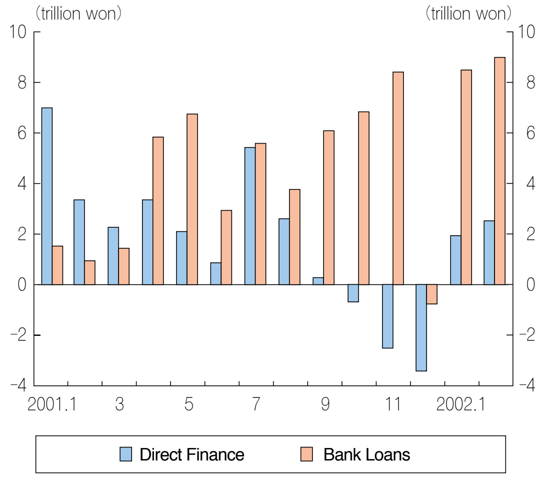
rising in April and November, funds which had migrated out of MMFs moved in some cases into fixed interest rate products such as bills issued, causing merchant banks' deposits to record a temporary upward trend. These remained the sole exceptions to their otherwise contraction throughout the year.

(Mutual Savings & Finance Companies)

Thanks to a constant inflow of market funds, deposits at mutual savings & finance companies accelerated the scale of their increase during the preceding year(+3.8 trillion won) to stand at 4.7 trillion won. This was attributable to the fact that certain mutual savings & finance companies had emerged from the process of structural adjustment with a heightened credit rating, and that their products were given relatively strong interest rate competitiveness by the fall in banks' deposit rates. In the early months of 2002, the upward trend of their deposits was maintained, owing to the increase of deposit interest rates by some mutual savings & finance companies in view of their expansion of small credit loans at high lending rates.

<Figure Ⅱ-60>

Corporate Finance[1)]



Note: 1) Based on changes.
Source: The Bank of Korea.

(3) Corporate Finance

Corporate funding conditions were generally ameliorated in 2001. This can be explained as follows: Given the murkiness of business prospects, corporate investment demand was restrained while with the easing of the stance of monetary policy, ample liquidity prevailed in the markets, allowing market interest rates and financial institutions' deposit and lending rates to continue to fall. The government, for its part, continually pursued measures to ensure the stability of the markets in which funds are raised by, for example, the issue of Primary CBOs.

Viewing the supply of funds by channel, bank lending expanded on a scale similar to the previous year, headed by the lending to households and small and medium enterprises. Thanks to the improvement of fund-raising conditions in the direct financial market, corporate bond and commercial paper shifted to a net issuance. This trend continued on into early 2002.

(A) Bank Lending

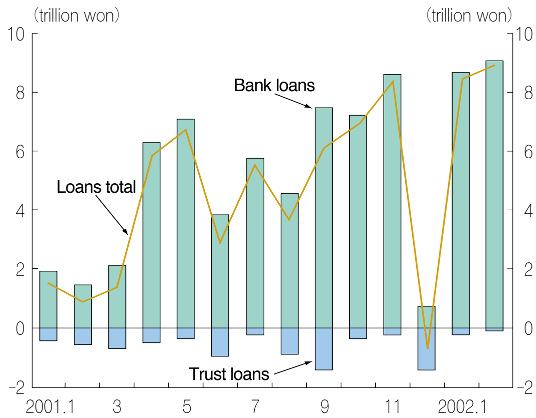
In 2001, aggregate lending by banks(including trust account loans) expanded by 49 trillion won, maintaining the trend of increase of the previous year(+57.7 trillion won). By type of accounts, loans from the bank accounts experienced a strong increase(+57 trillion won) whereas those from the trust accounts contracted following on from the previous year(-7.9 trillion won) owing to lackluster deposit-taking by money-in-trust. Bank lending as a whole continued to increase in the early months of 2002.

(Lending by Sector)

Lending to households registered an increase of 44.8 trillion won, which was much larger in scale than that of the previous year(26.4 trillion won). This resulted from banks' aggressive efforts to expand retail banking through the expansion of housing mortgage lending and of credit based lending, along with the lowering of interest rates on household loans. Banks concentrated on mortgage lending, which composed the major part of household loans, but as profit margins gradually weakened in this area because of the intensification of competition among banks,[14] they also laid stress on expanding their credit based lending, targeting those

<Figure Ⅱ-61>

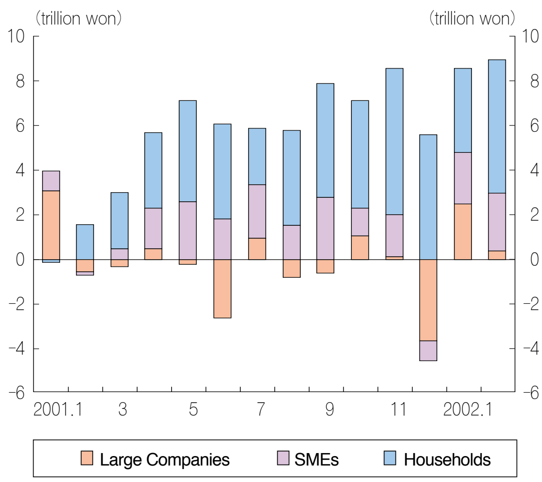
Total Bank Lending[1]



Note: 1) Based on changes.
Source: The Bank of Korea.

<Figure Ⅱ-62>

Bank Lending by Sector[1]



Note: 1) Based on changes.
Source: The Bank of Korea.

14) In the case of mortgage lending, loan interest rates are comparatively low and banks additionally assumed the mortgage arrangement fees. So banks' actual loan margins were greatly reduced.

not presenting a serious credit risk such as persons in secure employment or with an outstanding record in running their own small business. In addition industrial premises, agricultural land(paddy and dry field), and woodlands were also increasingly accepted as eligible loan collateral and interest rates on overdraft loans(negative accounts) were also lowered, together generating new demand for loans. Around the turn of the year, at which time BIS capital adequacy ratios are calculated, banks greatly increased their mortgage loans, which carry a low risk weighting. This caused the scale of the increase in household lending to register its highest level for the year(November to December monthly average was 6 trillion won ; monthly average for the year as a whole was 3.7 trillion won). Despite seasonal factors such as the redemption of outstanding loans using bonuses received at the year end / new year period, in January 2002, the increase in household lending chalked up the very large figure of 3.8 trillion won.[15] It was attributable to the renewed intensification of banks' competition for household lending through, for example, the continued easing of conditions on mortgage loans.

Lending to small and medium enterprises posted an increase of 16.4 trillion won in 2001, slightly larger than that in the previous year(16.2 trillion won). This was partly attributable to the increased incentives for the extension of such loans through the raising of the Bank of Korea's credit ceiling but it was also due to the banks' active efforts[16] to develop new credit lines and to lure promising small and medium companies whose growth and profitability were anticipated by lowering

15) January totals for household lending over the past 3 years: +200 billion won in 2000, -200 billion won in 2001, +3.8 trillion won in 2002.

16) Some banks put in place a low interest rate loan scheme whose rates floated with market interest rates and established specialist sections to handle SME credits.

interest rates in order to make use of banks' funds. However SME lending contracted slightly in February 2001, when the large volume of commercial bills issued at the end of the previous year[17] reached maturity, and again in December that year, as a result of the strengthening of controls over the BIS capital adequacy ratios. Moving into 2002, it expanded on a large scale owing to the re-extension of loans that had been temporarily redeemed at the previous year end, and to the emergence of demand for loans for the payment of value added tax.

<Table Ⅱ-23>

Bank Lending[1] by Sector

(trillion won)

	2000	2001					2002p
		year	Ⅰ	Ⅱ	Ⅲ	Ⅳ	Jan.~Feb.
Large companies	7.2	-3.4	2.1	-2.4	-0.4	-2.7	2.8
SMEs	16.2	16.4	1.2	6.1	6.7	2.4	5.0
Households	26.4	44.8	3.8	12.3	11.7	17.0	9.7
Others[2]	7.9	-8.8	-3.3	-0.6	-2.7	-2.2	-0.1
Total	57.7	49.0	3.8	15.4	15.4	14.5	17.4

Notes: 1) Includes Trust Accounts lending (except discount of CP). Based on changes.
2) Lending to public and other legal entities.
Source: The Bank of Korea.

Amid the continuing economic downturn, large enterprises by and large had only modest demand for funds, and with the favourable evolution of their fund-raising conditions in the direct financial market through the issue of corporate bonds and commercial paper, their borrowings from banks shifted from an increase of 7.2 trillion won in the previous year to a contraction of 3.4 trillion won in 2001. Notably in the case of large enterprises with a high credit standing, borrowings from banks carrying relatively high interest rates were redeemed using funds obtained through the issue of corporate bonds and commercial paper. Some companies, which could not easily gain access to the direct financial market due to their relatively low credit standing, raised required funds through bank lending and so forth. At the beginning of the year 2002 bank lending to large enterprises exhibited an upward trend with the partial reextension of some of the loans that had been temporarily redeemed in order to reduce debt ratios at the end of the previous year.

17) In advance of the closing of their books at year end 2000, companies seeking to reduce their debt ratios had, instead of redeeming general loans, expanded their discounting of commercial bills.(Where discounts of commercial bills are increased, cash on hand is increased but receivables are decreased, Thus the overall scale of assets and liabilities is not influenced.)

<Table Ⅱ-24>

Bank Lending by Product[1)]

(trillion won)

	2000	2001					2002
		year	Ⅰ	Ⅱ	Ⅲ	Ⅳ	Jan.~Feb.
Commercial bill discounts	1.5	-6.4	-5.6	-0.6	0.1	-0.3	-1.5
Overdrafts	0.3	-1.5	1.3	-0.9	-0.8	-1.0	0.8
Foreign trade loans	2.1	0.1	0.7	0.2	0.1	-0.8	0.6
Corporate procurement loans	3.4	4.9	1.3	1.8	1.8	-	0.7
Electronically-processed secured receivables loans	-	1.3	0.2	0.2	0.3	0.5	0.1
General loans	44.5	45.6	2.9	13.3	13.9	15.5	6.1

Note: 1) Based on bank-account lending. Based on changes.
Source: The Bank of Korea

(Lending by Type)

Discounts on commercial bills shifted from an increase of 1.5 trillion won in 2000 to a massive contraction of 6.4 trillion won in 2001. This was largely because of the continuing substitution of cash settlement for the use of commercial bills with the Bank of Korea's introduction and inauguration, of the system of electronically-processed secured receivables loans in February 2001 in adition to corporate procurement loans.[18)] These actions were undertaken to reduce the use of bills for the settlement of commercial transactions between companies and to encourage the use of cash settlement.

General loans rose on a larger scale(+45.6 trillion won) than in the previous year(+44.5 trillion won) owing to the continued increase on lending to households and SMEs. Foreign trade loans saw the scale of its increase (100 billion won) narrow from that of the previous year(2.1 trillion won), reflecting the subdued state of exports. Overdraft loans contracted(-1.5 trillion won), as companies chose to redeem overdraft loans at high interest rates in view of benign funding conditions.

Corporate procurement loans registered a sharply increasing trend, rising by 4.9 trillion won, following the 3.4 trillion won in the previews year. This was because, firstly, the Bank of Korea provided preferential support at low interest rates(2.5% p.a.) for half of the total amount of banks' loans of this type under its Aggregate Credit Ceiling and, secondly, the

18) Corporate procurement loans represent an arrangement whereby a purchasing company take out a bank loan to meet the funds required to effect cash settlement with the supplier. Electronically-processed secured receivables loans work as follows: using as collateral receivables from sales on credit to a corporate customer, a supplier receives a loan from a bank. Instead of settling the purchasing account, the corporate purchaser redeems the supplier's loan from the bank.

government granted various tax incentives for their use. Electronically-processed secured receivables loans which were introduced in February 2001 continued to take firm root, registering 1.3 trillion won up until the end of 2001.

(B) Direct Financing

<Table Ⅱ-25>

Trends in Corporate Fund Raising by Direct Financing[1]

(trillion won)

	2000	2001					2002[p]
		year	Ⅰ	Ⅱ	Ⅲ	Ⅳ	Jan.~Feb.
Corporate bond issuance (net)[2]	-8.5 (-15.8)	8.3 (1.0)	5.6 (1.9)	5.2 (3.9)	3.8 (2.4)	-6.4 (-7.3)	-2.6 (-2.2)
CP issuance (net)[3]	-0.6	7.8	7.0	0.2	3.4	-2.7	7.0
Stock issuance[4]	13.2	4.6	0.4	0.9	1.0	2.3	0.5
Direct finance total	4.0	20.7	12.8	7.0	8.2	-6.8	4.9

Notes: 1) Based on changes.
2) Excludes those issued by companies under court receivership, in process of mediation or workout and ABS. Includes primary CBO and the share of new bond quickly underwritten by Korea Development Bank (KDB).
3) Based on CP discount by securities companies, merchant banks and bank trusts accounts.
4) Based on companies listed on the Korea Stock Exchange or KOSDAQ, but excludes financial institutions.
Sources: The Bank of Korea, The Financial Supervisory Service, Representative associations.

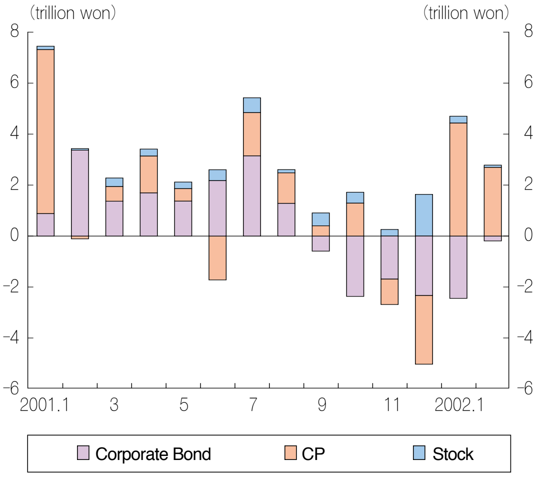
In 2001, corporate fund-raising through direct financing, which had been in the doldrums for some considerable time, expanded on a relatively large scale. In the case of corporate bonds, which had recorded a net redemption the year before, net issuance of 8.3 trillion won was chalked up in 2001 and commercial paper witnessed a similar turnaround from a contraction to an expansion of 7.8 trillion won. Fund-raising through stock issuance, in contrast, saw an increase of only 4.6 trillion won, considerably less than that of 13.2 trillion won the year before. As a result of these development, the total amount of fund raising through direct financing increased by 20.7 trillion won, as against 4 trillion won in the previous year. In the early months of 2002, there emerged a wave of net redemptions of corporate bonds led by highly-rated companies but the issuance of commercial paper and stock made good headway.

(Issuance of Corporate Bonds)

The issuance of corporate bonds showed a pattern of brisk activity in 2001, shifting from the previous year's net redemption(-8.5 trillion won) to net issuance of 8.3 trillion won(net issuance of 1 trillion won through general public flotations, excluding that through Primary CBOs and the Korea Development Bank's prompt underwriting scheme). During January corporate bonds registered a net issuance position for the first time since the preceding October, and in

<Figure Ⅱ-63>

Trends in Corporate Fund Raising by Direct Financing[1)]



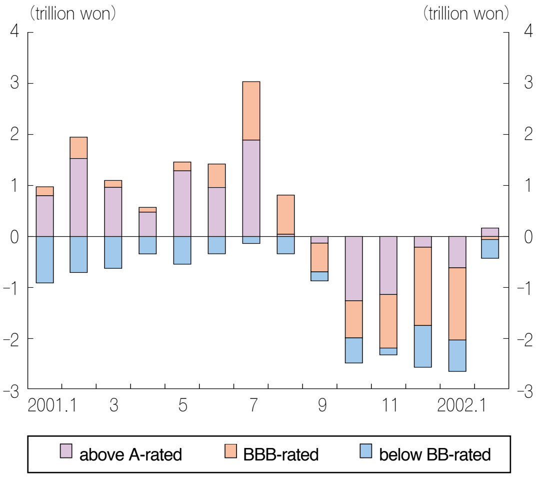
Note: 1) Based on changes.
Sources: The Bank of Korea, The Financial Supervisory Service, Representative associations.

February this expanded to 3.4 trillion won, the largest since November 1998. This trend continued until August(January to August +15.3 trillion won)

The reasons for the galvanization of the corporate bond market are as follows. First of all, on the demand side, non-bank financial institutions, and particularly investment trust companies, which have the largest appetite for corporate bonds, saw a recovery of their deposit-taking, enlarging their buying capacity. In addition, preference for corporate bonds as alternative investment instruments rose strongly, in the quest for opportunities for additional profit after the sharp fall of yields on government bonds. On the supply side, the volume of corporate bonds expanded with their acquisition by Primary CBOs thanks to the putting in-place of the government's plan to reinvigorate the issuance of corporate bonds.[19)] With benign conditions prevailing in the issue market, an increase in issuance began, led by highly rated large companies seeking to refinance themselves by redeeming existing corporate bonds and borrowings carrying high interest rates through new corporate bonds at low interest rates.

<Figure Ⅱ-64>

Trends in Net Issuance of Corporate Bonds by Credit Rating[1)]



Note: 1) Based on changes.
Source: The Bank of Korea.

While the scale of issuance increased, there was a waning of concern over corporate credit risk and a moderation of investors' risk aversion. This made lower rated corporate bonds see brisk issuance activity, with, for example, corporate bonds carrying a rating of BBB, whose issuance had contracted the previous year, achieving an increase in net issuance of 3.3 trillion won during the first eight months of 2001.

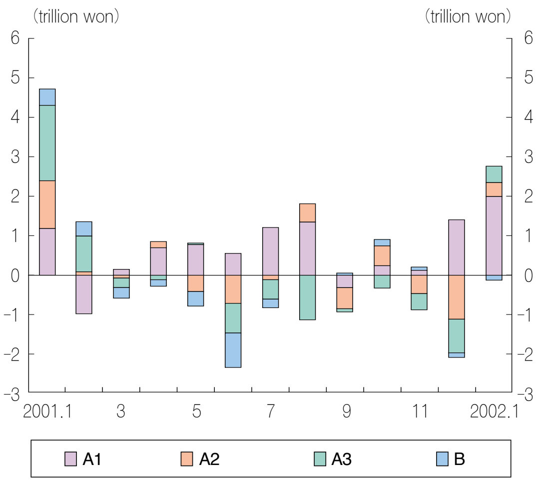
19) On December 26, 2000, the government announced a plan to galvanise the corporate bond market through credit guarantees from the Credit Guarantee Fund and the introduction of a prompt underwriting scheme for corporate bonds (temporarily illiquid companies with many corporate bonds reaching maturity underwrite 20% of the rolled over issue themselves and the remaining 80% is underwritten by financial institutions) in order to support companies' roll-over of their maturing corporate bonds.

From September onwards although the scale of corporate bonds reaching maturity expanded and the question of whether the companies involved would be able to raise to obtain the requisite resources seamlessly came to the fore, in actual fact there were no major problems. Highly rated companies redeemed bonds reaching maturity for themselves from funds which had already been acquired through advance-issues in preparation for the maturity. In addition, less well rated companies, for whose corporate bonds investors' appetite had waned, were able to handle the redemption of maturing issues through bank loans or the issue of Primary CBOs. In the early months of 2002, most companies were in a position to redeem maturing corporate bonds from their own resources or by means of the issue of asset backed securities, which presented few major problems.

(Issuance of Commercial Paper)

<Figure Ⅱ-65>

Trends in Net Issuance of CP by Credit Rating[1)]

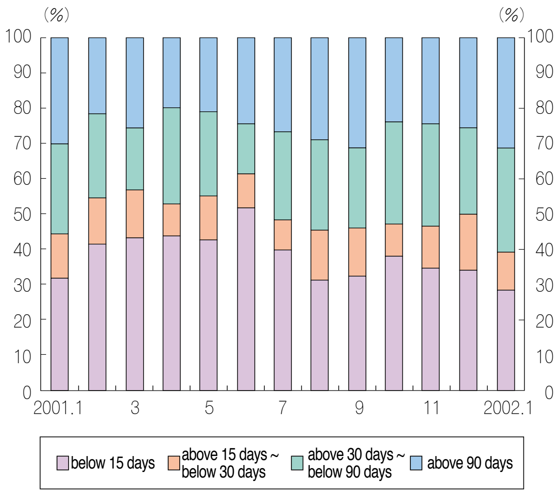


Note: 1) Based on changes.
Source: The Bank of Korea.

Having fallen by 600 billion won in 2000, net issuance of commercial paper(CP) shifted to record a large scale net increase of 7.8 trillion won in 2001. One reason for this was that with the continuing short-termism of market funds, institutional investors such as investment trust companies expanded their purchases of commercial paper for the operation of their short term funds. A further reason was that companies concentrated on the issue of commercial paper for the raising of short-term funds at a time when interest rates were on the decline. Reflecting the short-termism of market funds, there was a change in the maturity structure of commercial paper, causing the proportion of that in the shortest maturity range of less than 15 days to rise to 51.4% in June.

In addition, whereas in the previous year, the issuance of CP had been limited to blue chip companies(A1 grade), from the early months of 2001 it expanded to embrace those companies with a somewhat lower rating(A3 grade) and issuance by companies with a speculative grade(B grade) also took place to a certain extent.

<Figure Ⅱ-66>
Percentage Shares in CP Total by Maturity[1)]

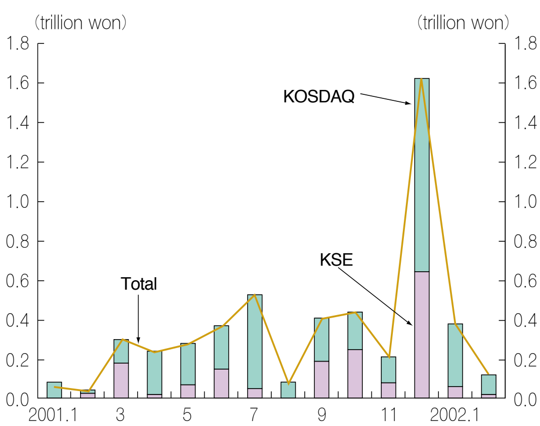


Note: 1) Period-end basis.
Source: The Bank of Korea.

Viewed by period, during the first ten months of the year, companies by and large continued their net issuance of CP, apart from June when they executed a short-lived redemption of their commercial paper in order to bring their debt ratios under control for semi-annual closing.(In July there was a rebound.) Following the events of September 11 in the United States, airlines and companies with low credit ratings experienced difficulties in issuing CP. From November CP issuance shifted to a net redemption position. In November the appetite for CP was slackened in response to a fall in deposit-taking by investment trust companies, and in December, highly rated large companies retired their paper ahead of the year-end closing of accounts. Whereas these two months normally see a net redemption of CP, some less well-rated companies which had been experiencing difficulties in rolling over retiring corporate bonds, resorted to the issuance of CP in order to raise the necessary funds. In early 2002, CP issuance witnessed a large scale increase, with the return to the market of issuers who had redeemed outstanding paper at the end of the previous year and investment trust companies' increased appetite for paper owing to the sharp increase in funds attracted to MMF.

<Figure Ⅱ-67>

Trends in Stock Issuance[1)]



Note: 1) Based on companies listed on the KSE or KOSDAQ, excludes those issued by financial institutions.
Source: The Financial Supervisory Service.

(Stock Issuance)

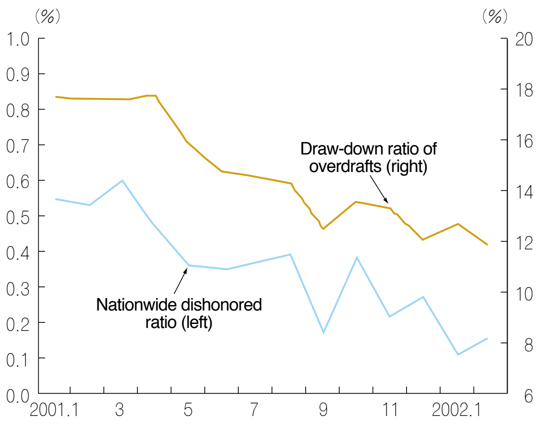
In 2001, companies' fund raising through the stock issuance contracted sharply from 13.2 trillion won in 2000 to 4.6 trillion won. This was because the stock market remained in a depressed phase for a considerable period of time while corporate demand for funds was limited as a result of the business slowdown. More specifically, thanks to the increase in venture start-ups' initial public offerings(IPO), fund-raising through the KOSDAQ market registered 2.9 trillion won over the year, surpassing the figure raised through the Korea Stock Exchange(KSE)(1.7 trillion won).[20] Moving into the year 2002, stock issuance performance maintained a comparatively brisk pace thanks to the liveliness of the stock market.

(C) Corporate Funding Conditions

In 2001, the demand for funds was subdued whereas the supply of funds continued smoothly, so that corporate funding conditions were generally perceived as favourable. Reflecting this conjuncture, major indicators of corporate funding conditions including the default ratio of bills & checks and the ratio of the draw-down of overdraft facilities remained benign.

<Figure Ⅱ-68>

Nationwide Dishonored Ratio and Draw-down Ratio of Overdrafts



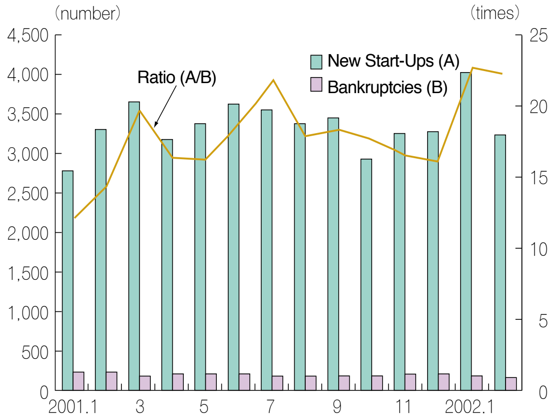
Source: The Bank of Korea

The nationwide bills & checks default ratio eased from the 0.55% of January 2001 to 0.17% in September. In October it climbed back to 0.38%, however, as the amount in default rose greatly upon the maturity of corporate bonds issued by companies belonging to the Daewoo Group, before returning to the 0.2% level in November and December. In addition, the draw-down ratio of overdraft facilities, which indicates urgent corporate demand for funds, eased persistently during the year from the 17% level at the outset to 12.1% in December. The monthly average number of corporate bankruptcies, which stood at 23 in January 2001, contracted gradually until September(15 instances),

20) Looking at the performance of corporate public offerings during 2001, only 3 were held on the Korea Stock Exchange for a total value of 218 billion won whereas there were 166 public offerings on the KOSDAQ market which raised a total value of 1.3 trillion won.

<Figure Ⅱ-69>

No. of New Corporate Start-Ups and Corporate Bankruptcies in Eight Major Cities[1]



Note: 1) Seoul, Busan, Daegu, Incheon, Gwangju, Daejeon, Suweon, Ulsan.
Source: The Bank of Korea

after then showing an increasing trend with 18 corporate bankruptcies registered in December.

The ratio of new start-ups to corporate bankruptcies in Seoul and seven other major cities continued to show an upward trend in view of the increasing trend of new start-ups until July, when it reached its highest level for the year of 21.8. After then, with the slight falling off in the pace of increase of new start-ups amid prospects for a delay in economic recovery, the ratio followed a smooth downward path. Nevertheless, for the ten months period from March until December it maintained a high level of above 16 except in January and February when there occurred a comparatively large number of corporate bankruptcies(11.9 and 14.1, respectively).

<Box II-4>

Sharp Increase in Household Lending: Background and Appraisal

Looking at the environment surrounding the sharp increase in household lending from the demand side and from the supply side, we note the following points. Firstly, on the demand side, households increased their demand for loans in order to purchase real estate with the formation of anticipations of rising asset prices in view of the continuance of low interest rates. In a survey covering 1,500 adult men and women held by Korea Gallup in December 2001, it was found that the preference for bank accounts had fallen compared to the same period of the previous year(73.6% → 58.7%), whereas the preference for real estate had risen(13.6% → 26.1%). Secondly in the course of the increase in individual businesses run by people who had lost their employment in the process of structural adjustment after the currency crisis, a considerable proportion of these business funds seems to have been raised in the form of household loans owing to the simplicity of the loan procedures. Surveys report that the share of business funds in total uses of household lending stands above 20%. Thirdly, with the increase in unemployment and the changes in the wage and employment structure such as the larger proportion of people working on a temporary basis and for performance-based wages, the volatility of the flow of household incomes has greatly increased, which has also acted as a factor increasing household demand for loans.

Survey Result of Household Lending Usages

(%)

	General living expenses	Business funds	Debt consolidation	Housing funds
Korea National Statistical Office (1999)	23.3	38.8	(interest payment, 6.3)	31.6
Korea Exchange Bank (Dec.1999)	52.6	42.8	36.2	35.4
Hyundai Research Institute (Sep.2001)	··	22.3	30.3	33.1

On the supply side, it can be pointed out that with the maintenance of ample market liquidity while corporate demand for funds was blunted by the economic downturn, financial institutions' availability of resources for household lending was greatly expanded. Moreover, after the currency crisis, financial institutions shifted their business strategy from an emphasis on growth to a focus on profitability and security, which also served as an element in the environment acting to increase household credit. Compared to corporate lending, household lending consists of loans that are generally small in amount and the associated credit risk is low while interest rates are comparatively high, thus being favorable in satisfying both security and profitability. In addition, the increasing proliferation of internet banking is also serving to reduce operational handling expenses.

Apart from such supply and demand factors, the growth of installment financing has also contributed to the rise in household lending through the use of a wide ranging system of redemption by installment of household consumer spending from houses(housing installment finance) to smaller value consumer items(card installment sales). In the past, consumers would accumulate a substantial sum by setting aside regular installments and then purchase a house, but recently it is increasingly common to first purchase a house using a loan and to pay-off the principal and interest over a long period through redemption by installment, which has led to a rapid increase in mortgage lending. Even though there has been a rapid rise in household lending, it does not seem to give rise to any particular concern at the present stage, considering the overall status of the servicing burden on households, the ratio of delinquencies and the level of asset holdings. In spite of the increase in the scale of liabilities, the burden of servicing interest payments was not that large given the decline in lending rates and the ratio of delinquencies in bank lending remains at the low level of around 1%. The ratio of private sector held financial assets to private-sector financial liabilities rose to 2.5 at year-end 1998 and since then it has declined slightly, standing at 2.5 recently but this is still a high level compared to that of the years before 1997(around 2.1). More than 60% of private-sector financial assets are held in deposit accounts with a high degree of liquidity, and the value of private-sector loan collateral is also relatively stable in the light of the recent buoyant trend of real estate and stock market prices.

Trend in Financial Assets and Liabilities of the Private Sector[1]

(trillion won)

	95	96	97	98	99	2000p	Sep.2001p
Assets(A)	467.1 (17.9)	537.0 (15.0)	619.3 (15.3)	673.9 (8.8)	731.4 (8.5)	799.5 (9.3)	858.6 (7.4)
Liabilities(B)	214.6 (16.3)	253.7 (18.2)	300.1 (18.3)	269.9 (-10.1)	293.0 (8.6)	329.7 (12.5)	371.6 (15.2)
Net assets(A-B)	252.5	283.4	319.1	404.0	438.4	469.9	487.0
Assets/Liabilities (time, A/B)	2.18	2.12	2.06	2.50	2.50	2.42	2.31

Notes: 1) Period-end basis. Figures in parentheses refer to % changes compared with the previous year.
Source: The Bank of Korea.

Having said this, nevertheless it should be pointed out that if financial institutions maintain their strategy of expanding credit to the retail sector beyond its present status, which has already undergone a great expansion, problems may arise should economic conditions change. First, if market interest rates shift to an upward trend, the burden of servicing principal and interest payments will increase and difficulties may be experienced in the redemption of loans. Since there has been a big increase in mortgage lending, there is a possibility that the problem of collateral fragility may arise should real estate prices fall. Above all, the comparative contraction of corporate lending may bring to the fore the question of a lowering of the Korean economy’s medium and long term growth potential. For this reason, financial institutions should continue to expand corporate lending and household debt should not be increased excessively compared with incomes.

5. Foreign Exchange Markets

(Foreign Currency Supply & Demand)

Supply and demand conditions in the foreign exchange market were characterized by a prevailing over supply position during the year 2001 that was the result of the sustained current account surplus and net inflow of funds for direct and portfolio investment from foreign investors.

During the course of the year 2001, the scale of the surplus narrowed year on year as a result of lacklustre exports, but since imports contracted greatly, the surplus position was maintained. In addition, foreign investors somewhat reduced the scale of their inflow in response to the global economic downturn and the depression of the IT sector. Nevertheless, the net inflow position was maintained owing to the relatively favourable state of the Korean economy. Large inflows of foreign investment funds had been continued from the beginning of the year but the zeal for investment waned during the third quarter particularly with the terrorist attacks on the U.S., which prompted a temporary shift to a net outflow position. From October onwards, however, with anticipations of economic recovery and the upgrading of Korea's sovereign rating, there was a return to heavy net inflows, setting the tone which prevailed on into the early months of the year 2002.

<Table Ⅱ-26>

Foreign Exchange Reserves[1]

(hundred million U$)

	1999	2000	2001				2002
			Mar.	Jun.	Sep.	Dec.	Feb.
FX Reserve	741	962	944	943	990	1,028	1,051

Note: 1) Period-end basis.
Source: The Bank of Korea.

Together with this continuing net excess of foreign exchange supply, the foreign exchange reserves witnessed a steady expansion, rising from 96.2 billion dollars at year end 2000, to 102.8 billion dollars at the end of 2001, and to 105.1 billion dollars at the end of February, 2002.

<Table Ⅱ-27>

Foreign Credit & Debt[1)]

(hundred million dollars)

	1999	2000(A)	2001(B)	Change (B-A)
Credit	1,454	1,647	1,619	-28
Debt	1,371 (100.0)	1,317 (100.0)	1,199 (100.0)	-118
Long term	979 (71.4)	838 (63.6)	810 (67.6)	-28
Short term	392 (28.6)	479 (36.4)	389 (32.4)	-90
Net foreign credit	83	330	420	90

Notes: 1) Year-end basis.
2) Figures in parentheses refer to shares in total (%).
Source: The Bank of Korea.

(Foreign Credit & Debt)

As of the end of the year 2001, Korea had total foreign indebtedness of 119.9 billion dollars, which represented a contraction of 11.8 billion dollars from the previous year end. Claims on the rest of the world declined by 2.8 billion dollars compared to the previous year end to stand at 161.9 billion dollars. As a consequence of these movements Korea, which has been a net creditor nation since September 1999, saw the scale of its net credit position rise by 9 billion dollars to stand at 42 billion dollars as of the end of the year 2001. In the course of the year the scale of net foreign indebtedness narrowed, an increase in the private sector's external payment burden notwithstanding, because of the large scale redemption of borrowings by the government sector and the financial sector.

The net redemption of foreign liabilities continued during the year 2001, centering on short term foreign liabilities, the proportion of which contracted greatly, falling from 36.4% of the end of the preceding year to stand at 32.4% as of the end of the year 2001.

<Figure Ⅱ-70>

Trends of Exchange Rates

Source: The Bank of Korea.

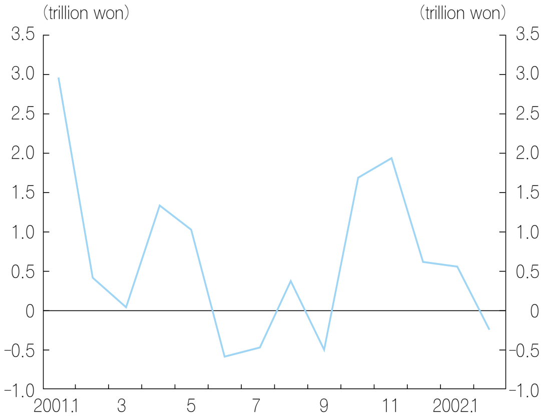
(Foreign Exchange Rate)

During the year 2001 the exchange rate of the Korean won against the U.S. dollar moved in a very similar pattern to that of the Japanese yen, showing a strongly rising trend from March to early April, followed by a generally stable trend until October and a subsequent steep rise with the rapid weakening of the Japanese yen.

Looking at these movements more closely by period, early in the year foreign investors greatly increased capital inflows for securities investment in Korea at a

<Figure Ⅱ-71>

Trends of Net Inflow of Portfolio Funds



Source: The Financial Supervisory Service.

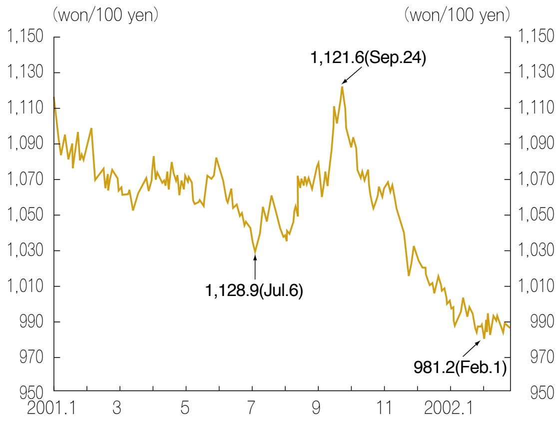
time when the Japanese yen showed a stable range of movements against the U.S. dollar. The Korea won consequently generally exhibited upward stability and reached its highest value against the U.S. dollar for the year in February when it traded at 1,236 won per dollar. But with the emergence of the weakness of the Japanese economy in early March, the yen dollar exchange rate rose steeply, causing the exchange value of the Korean won to fall to 1,365 won per dollar in early April. In this situation, the Korean policy authorities expressed their will to stabilize the exchange rate while the Japanese yen recovered some of its lost ground. In addition to that, the net inflow of foreign portfolio funds continued and the Korean won maintained a stable trend, trading within a range of 1,235 to 1,313 won per dollar. With the beginning of December, however the yen dollar exchange rate again climbed steeply and the Korean won again showed a synchronized pattern of movements with the Japanese yen, with the scale of net inflows of foreign portfolio investment narrowing sharply. The exchange rate of the Korean won against the U.S. dollar rose sharply and it closed the year 3.9% higher than the previous year at 1,314 won per dollar.

Just after the new year, the exchange rate of the Korean won showed a repeated pattern of large scale fluctuations in line with flows of foreign portfolio investment funds and the Japanese yen, rising to 1,331 won per dollar in late January. After showing these unstable movements, the exchange rate registered 1,324 won per dollar as of the end of February.

In view of the phenomenon of the synchronization of the Korean won and the Japanese yen exchange rates against the dollar, the won-yen exchange rate generally exhibited a stable pattern, moving within a range of 1,030 won to 1,120 won per 100 Japanese yen. From

<Figure Ⅱ-72>

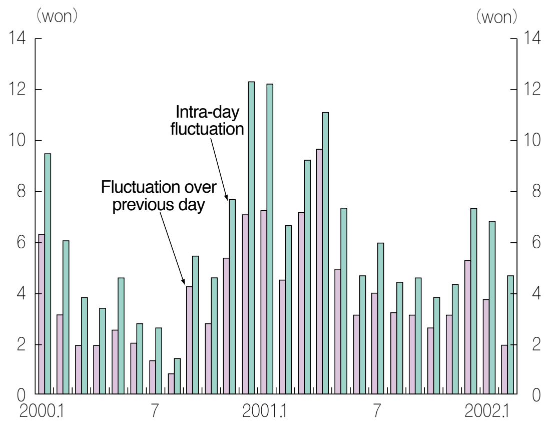
Trends of Won/Yen



Source: The Bank of Korea.

<Figure Ⅱ-73>

Trends of Won/U$ Fluctuations



Source: The Bank of Korea.

early December, however, even though both the Korean won and the Japanese yen rates rose against the U.S. dollar, the Korean won rose on a comparatively smaller scale than the Japanese yen. The Korean won strengthened against the Japanese yen, trading at the 1,000 won level at the end of the year 2001, reflected the apprehensions about a protracted recession of Japanese economy and the relatively good performance of the Korean economy. This trend continued in the beginning of the year 2002, and the Korean won rose to its highest level against the Japanese yen for the thirty months since November 1998 to stand at 980 Korean won per 100 Japanese yen.

Over the course of the year 2001 the exchange rate showed somewhat greater volatility than the previous year, with the scale of the day-to-day variation widening from 3.3 won to 4.8 won and that of the intraday variation from 5.3 won to 6.7 won. Viewed by period, during the first four months of the year, when the exchange rate of the Japanese yen against the U.S. dollar showed great volatility, the range of movements of the Korean won exchange rate also expanded. From May through November, the range of movements progressively diminished, only to expand again during December when the Japanese yen exchange rate showed renewed instability. In January and February 2002, the day-to-day fluctuation range narrowed from 5.3 won in December 2,001 to 2.8 won and the intraday fluctuation range from 7.3 won to 5.8 won.

(Foreign Borrowing Environment)

Korea's sovereign rating maintained its investment grade during the year 2001. In November S&P upgraded the country's sovereign rating by one grade (November 13, BBB → BBB+), making a positive assessment of the progress of corporate and financial

<Table Ⅱ-28>

Trends of Changes in Korea's Sovereign Rating

	S&P	Moody's	Fitch IBCA
1997	A+(Oct.24) A-(Nov.25) BBB-(Dec.10) B+(Dec.22)	A3(Nov.27) Baa1(Dec.10) Ba1(Dec.21)	A+(Nov.18) A(Dec.3) BBB-(Dec.11) B-(Dec.23)
1998	BB+(Feb.17)	-	BB+(Feb.2)
1999	BBB-(Jan.25) BBB(Nov.11)	Baa3(Feb.12) Baa2(Dec.16)	BBB-(Jan.19) BBB(Jun.24)
2000	-	-	BBB+(Mar.30)
2001	BBB+(Nov.13	-	-

Note: 1) Figures in parentheses refer to the date of release.

<Table Ⅱ-29>

Spread[1] on Foreign Exchange Stabilization Fund Bonds

(bp)

	2000	2001				2002
	Dec.	Mar.	Jun.	Sep.	Dec.	Feb.
Stabilization bonds (2003)	165	132	112	115	30	35
(2008)	240	174	136	145	81	60[2]
Industry & financial bonds (2004)	235	209	180	185	139	105

Notes: 1) Spread over US T-notes. Period-end basis.
2) Yield 7.04%(9.08% at the point of issuance)

<Table Ⅱ-30>

Spread on Short-term Borrowings of Domestic Banks

(bp)

	2000	2001				2002
	Dec.	Mar.	Jun.	Sep.	Dec.	Feb.
Spread[1]	76	53	45	38	32	25
Libor[2]	6.55	4.96	3.83	3.03	1.92	1.90

Notes: 1) Spread over Libor. Period-end basis.
2) 3 months, period average, (%).

restructuring. Other major international credit rating agencies meanwhile made upward adjustments on several occasions of domestic banks' ratings, taking into consideration the continuing reduction of non-performing assets, and the improvement of their management performance. This trend was continued on into the year 2002 and additional upgrades were made on several banks.

The premium on Foreign Exchange Stabilisation Fund(FESF) bonds continued to narrow. It widened again for a short lived period in the aftermath of the terrorist attacks on the U.S.(September 11), but resumed its narrowing trend thanks to S&P's upward adjustment of Korea's sovereign rating and expanded purchases by international institutional investors of Asian region government bonds. As a result of these developments it closed the year at 81 basis points, a 159 basis point reduction from the end of the previous year. In the year 2002, reflecting the economic recovery and Moody's upgrading of Korea's sovereign rating, the Korea premium narrowed further and by the end of February, it stood at 60 basis points, the lowest level since FESF bonds were issued in April 1998.

The spread over Libor on domestic banks' short term borrowings eased sharply thanks to the improvement in their external credit standing and the improved environment pertaining in international financial markets. It fell by 44 basis points in the course of the year to stand at 32 basis points at the end of 2001. It declined further to reach 25 basis points as at the end of February 2002, in response to the continued upgrading of domestic financial institutions' credit ratings by international credit rating agencies.

Ⅲ. Monetary Policy Operation

1. Inflation target

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

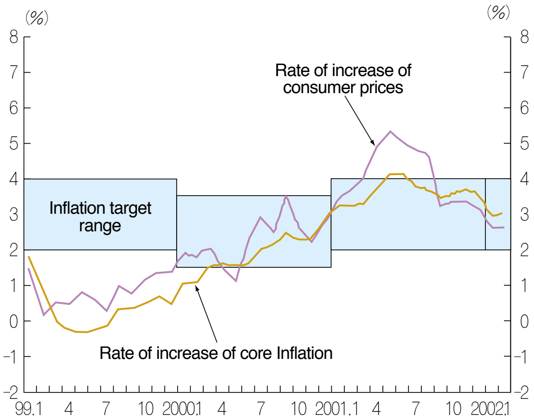
The index employed as the reference was core inflation, which strips out non grain farm products and petroleum based fuels from the Consumer Price Index (CPI), whose prices are subject to large temporary fluctuations depending upon changes in weather, harvests and international oil prices.

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

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

<Figure Ⅲ-1>

Changes[1] in Consumer Prices and Core Inflation



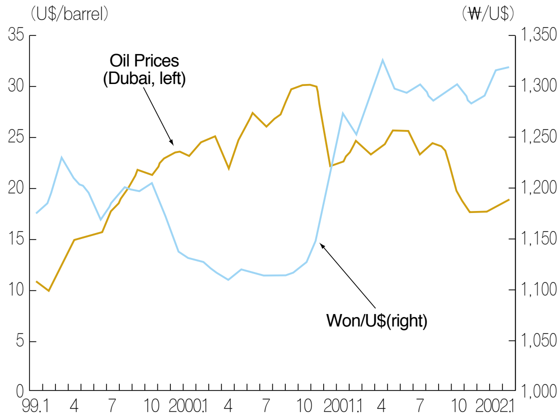
Note: 1) Rates of change compared with the same period of the previous year.
Source: Korea National Statistical Office.

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

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

<Figure Ⅲ-2>

Trends of International Oil Prices and Exchange Rates[1)]

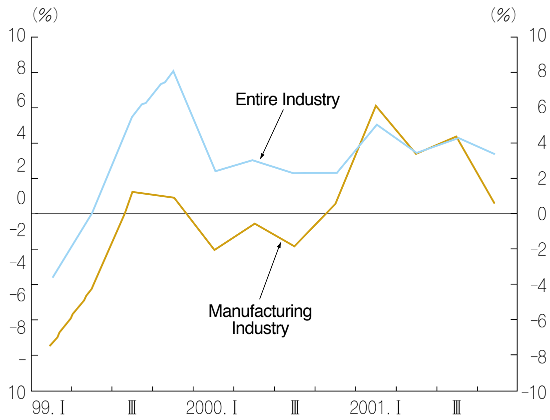


Note: 1) Monthly-Average Basis.
Source: The Bank of Korea, Bloomberg.

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

<Figure Ⅲ-3>

Growth Trends of Unit Labor Costs[1)]

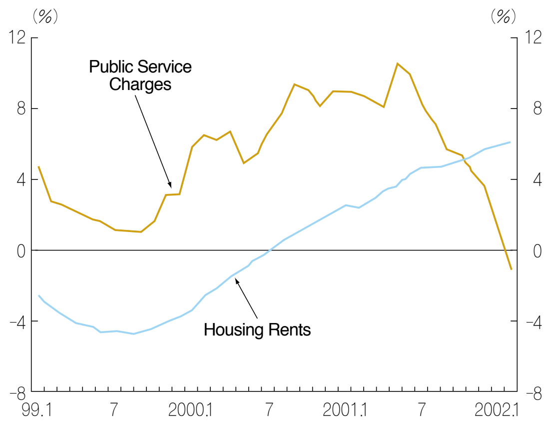


Note: 1) Unit labor costs = noninal wages/(constant GDP ÷ the number of persons employed).
Source: The Bank of Korea.

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

<Figure Ⅲ-4>

Rates of Increase of Public Service Charges and Housing Rents[1)]



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

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

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

<Box III-1>

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

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

The Details of Changes in the Classification of Items and Weighting

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

Source: Korea National Statistical Office.

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

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

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

(%, %p)

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

Source: Korea National Statistical Office.

by such a large margin was its lowering of the increasing rate of charges for public services, which had contributed greatly to the rise in consumer prices, from its previous 9.2% to 7.5% because of the changes in weights and product classifications. In particular, the weight on charges for medical services, traffic fares and refuse disposal services, which had been sharply raised during the year 2001, were reduced whereas weights of charges for mobile phones, wireless broadcasting fees and expressway tools, which rose by a comparatively small margin, were increased. All of this had a great effect in reducing the increase in charges for public services. The inclusion as a new item of land to mobile(LM) telephone charges also contributed to reducing the increase in public services charges.

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

Comparison between New and Old CPI

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

Source: Korea National Statistical Office.

2. Interest Rate Policy

<Table Ⅲ-1>

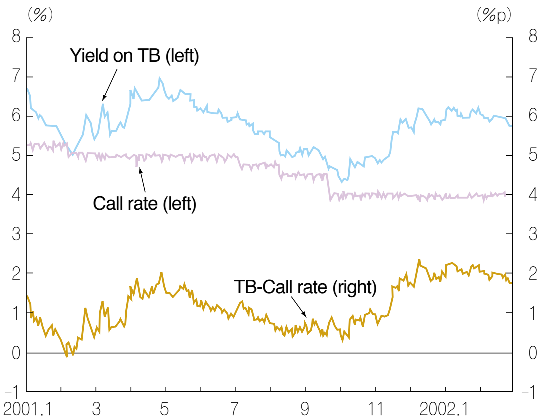
Monthly Stance of Interest Rate Policy and Market Interest Rate Trends

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

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

<Figure Ⅲ-5>

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



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

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

On January 3, 2001 the U.S. Federal Reserve, in order to counter the rapid slowing of the U.S. economy, reduced its Federal Funds target rate by 50 basis points at an extraordinary meeting of the Federal Open Markets Committee. This spurred the central banks of individual countries around the world to take a close look at business conditions and to examine the desirability of reducing interest rates. In the case of Korea, the first signs of an economic downturn had emerged in November 2000, progressively becoming more strident as the year 2001 wore on. The Bank of Korea, however, did not lower its policy rate in January and left it unchanged at 5.25%, considering that the government was intensifying the loosening of its fiscal policy stance such as bringing forward its disbursement of planned budgetary expenditures. Instead, given the possibility of a recession of the real sector, the Bank resolved to keep a close watch on the state of the economy and announced its intention to operate interest rate policy flexibly. The Bank reduced its call rate target on February 8 by 25 basis points to the 5% level. This decision was taken because there was increasing need for action to prevent an excessive slowdown of the economy. Real economic activity had deteriorated more quickly than they had been expected, with industrial production falling for the fourth straight month since September 2000 and the growth rate of exports greatly blunted, while all surveys of consumer and business confidence pointed to a rapid evaporation of confidence. Although the financial markets displayed a pattern of increasing stabilization helped by the continued downward trends of market interest rates and the partial easing of the corporate credit squeeze, the possibility emerged that corporate cash flows would weaken during the business recession and there were concerns about the credit risk of potentially insolvent companies. During January, however, consumer prices rose by 1.1% over the end of the previous month, showing a steeply increasing trend and it was recognised that could set a limit on additional interest rate reductions.

The Bank of Korea subsequently maintained the call rate at the 5% level until June. The rationale for not making any further reductions in target call rate was based on the points set out below. Although the economic slowdown had continued, consumer confidence took a favorable turn and consumer spending had shown a stable upward trend, which caused manufacturing production to increase, thereby slowing the pace of the economic downturn. The financial markets generally had shown stable trends since the beginning of the year as market interest rates remained at a low level in the absence of any strong demand for corporate funds and the fund raising environment had improved. On the other hand, the inflation rate continued at a high, running above the 4% upper bound of its target range due mainly to the effects of high oil prices, the depreciation of the Korean won and hikes in public service charges including those medical treatment under public health insurance since the latter half of the year 2000. Summing up, while much of the uncertainty surrounding the real economy and the financial sector had dissipated, the intensity of the upward pressures on prices was closely reflected in decision-making on interest rate policy.

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

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

<Table Ⅲ-2>

Trends of Policy Rate Changes in Major Countries During

(%)

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

Notes: 1) Jan.3. 2) Jan.31.
Source: Central banks of individual countries and the ECB.

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

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

The real economy continued to deteriorate even more rapidly despite the one-time reduction in the call rate. U.S. business activity, and especially that of the information technology sector, remained in the doldrums. The accompanying economic downturn in the economies of other advanced countries and of the South East Asian countries gathered intensity. All of this caused exports and facilities investment to contract sharply in Korea. In the financial markets, although the supply of corporate funds was smooth, and market interest rates and deposit and loan rates maintained a low level, concerns over the uncertainty linked to the structural reform of several large companies and a weakening of profitability of firms in the course of the business downturn acted as factors making for instability. The upward trend of consumer prices continued to slacken and the major factors that had a direct impact on prices, including oil prices and the exchange rate, remained stable.

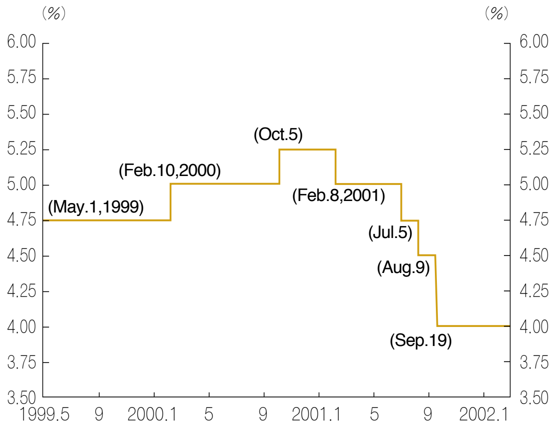
The Bank of Korea, having cut its call rate target in July, accordingly reduced it again in August by a further 25 basis points(4.75 → 4.5%). Notably, together with the call rate reduction, it lowered the Liquidity Adjustment Loans rates by 25 basis points(4.5% → 4.25%) in order to signal the accentuated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

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

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

<Figure Ⅲ-6>

Trends of Changes in Overnight Call Rate Target



Source: The Bank of Korea.

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

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

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

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

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

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

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

3) On December 1l, Al Qaeda, which had been extremely influential in the Taliban’s government of Afghanistan, declared its surrender.

<Box III-2>

Operating Conditions of Interest Rate Policy During 2001

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

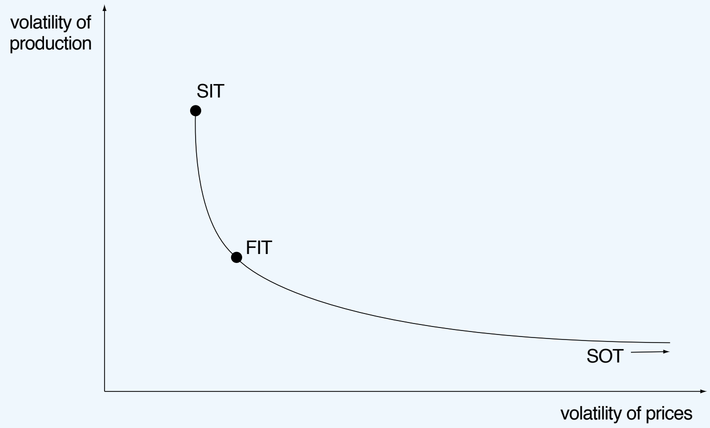
Interest Rate Policy Reaction to Economic Situations

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

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

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

Trade-off between Volatilities of Prices and Economic Activities



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

Trends of Inflation[1)]

(%)

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

Notes: 1) Compared with the same period of the previous year.
2) * indicates the month when policy rates were reduced.
Source: Individual central banks.

3. Money supply

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

<Table Ⅲ-3>

Trends of Base Money[1]

(hundred million won, %)

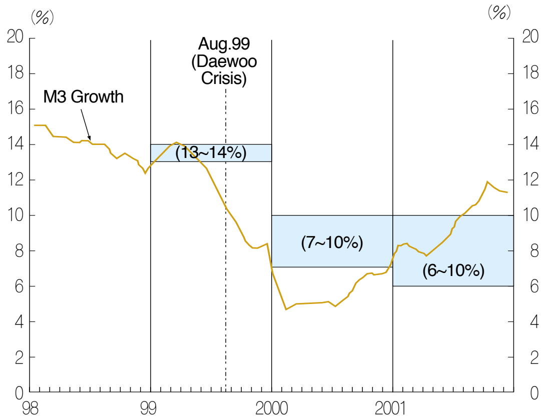
	2000	2001	2002.Jan.~Feb.
Base money	263,570 (20.0)	293,759 (11.5)	330,087 (13.5)
Currency in circulation	149,950 (12.2)	163,835 (9.6)	184,962 (10.5)
Total reserve deposits	113,620 (32.1)	129,924 (14.0)	145,125 (17.6)

Notes: 1) Changes in average balances(based on daily average balance).
2) Figures in parentheses refer to growth rates against the corresponding period of the preceding year.
Source: The Bank of Korea.

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

<Figure Ⅲ-7>

Trends of M3 Growth Rate and Monitoring Ranges[1]



Note: 1) Intermediate target range for 1999 and 2000.
Source: The Bank of Korea.

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

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

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

<Table Ⅲ-4>

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

(billion won)

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

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

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

4. Credit Policy

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

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

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

<Table Ⅲ-5>

Trends of Aggregate Credit Ceiling and its Interest Rates

(trillion won, annual %)

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

Source: The Bank of Korea.

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

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

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

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

The Bank of Korea also sought to heighten industrial competitiveness through the efficient operation of the Aggregate Credit Ceiling Loans scheme. From June 2001, exports of products[6)] in electronic form via the Internet also became eligible for trade finance support from the Bank. In addition to that, from August, the Bank changed its post hoc management basis for maintaining the ratio of lending to SMEs, encouraging banks to expand their lending to entities involved in construction of social overhead capital(SOC).

5) The preferential weight given to credit based loans to SMEs was increased from its previous 30% to 40% while the negative weight given to household sector loans was increased from 40% to 60%.
6) Software, entertainment and leisure items(games, animation cartoons, characters), sound, audio products, electronic books, databases, etc.

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

(Encouraging the Use of the Bill Substitution Scheme)

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

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

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

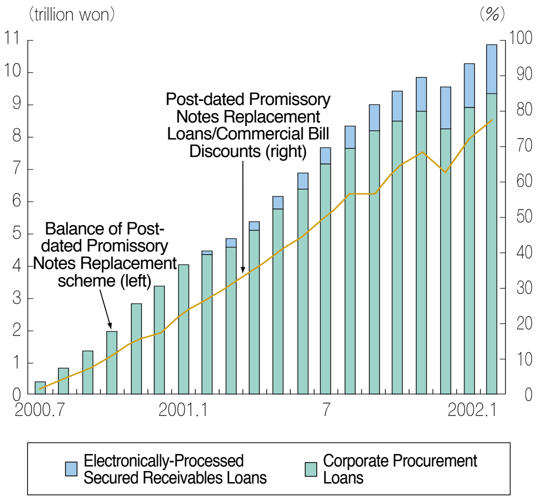
The major drawback to the scheme was that companies belonging to the top 30 business groups had difficulties in making use of the Corporate Procurement Loans system because of the prudential regulation ceiling on credit to a single borrower(or single business group). In recognition of this the Bank introduced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

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

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

<Figure Ⅲ-8>

Trends in Post-dated Promissory Notes Replacement Loans[1] Extension



Note: 1) Corporate procurement loans plus electronically-processed secured receivables loans.
Source: The Bank of Korea.

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

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

5. Monetary Policy Instruments

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

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

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

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

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

<Table Ⅲ-6>

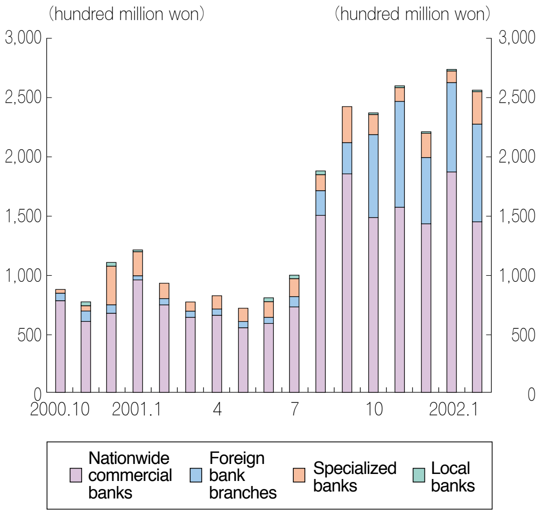
Status of Loan System of the Bank of Korea

	Function	Limits	Interest rate
Liquidity Adjustment Loan	· Signal the direction of interest rate policy through adjustments of loan interest rates in line with the direction of monetary policy · Pursue stabilization of the financial market through prompt supply of funds to banks facing temporary liquidity shortages that apply for the loan	3 trillion won	3.75% p.a. (4.75% p.a. when borrowing for three or more consecutive months)
Aggregate Credit Ceiling Loan	· Induce banks to expand loans to SMEs	11.6 trillion won	2.5% p.a.
Temporary Loan	· Supply funds to banks facing fund shortage for settlement (or reserve requirements)	Within amount of liquidity shortage	Overnight call rate +2%p
Daylight Overdraft	· Provide settlement funds to banks facing temporary settlement funds shortages during a given day	200% of average balance of current account	Interest-free

Source: The Bank of Korea.

<Figure Ⅲ-9>

Use of Daylight Overdraft Loans[1)]



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

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

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

(Heightening the Transparency and Credibility of Monetary Policy)

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

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

From the year 2001, an English language version of the "Monetary Policy Report" presented to the National Assembly has been published and distributed to relevant institutions abroad with a view to widening the understanding of Korean monetary policy. In a similar move, a book entitled “Monetary Policy in Korea” was published in Korean and distributed. This work was written to foster a clearer grasp and more detailed understanding among the general public and those operating in the financial industry of the changes that have taken place in monetary policy since the currency crisis, including the adoption of an inflation targeting system and employment of market-oriented methods of policy operation that give emphasis to interest rates.

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

(Strengthening Examination of the Management Performance of Financial Institutions)

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

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

<Table Ⅲ-7>

Status of Implementation of Joint Examinations

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

Source: The Bank of Korea.

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

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

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

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

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

<Table Ⅲ-8>

Settlements Handled by BOK-Wire

(Unit, billion won)

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

Notes: 1) Daily Average.
2) Figures in parentheses refer to shares in total (%).
Source: The Bank of Korea.

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

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

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

In March 2001 with the improvement of the system of adjustment of funds between banks using the Interbank CD · Funds Transfer · Shared Network System,[9] the credit risk arising from net settlement was reduced while at the same time the burden on banks of raising funds for settlement was eased. From August, in order to reduce settlement risk arising from interbank net settlements, the value of securities collateral that banks participating in net settlement systems had to deposit with the Bank of Korea was adjusted upwards.[10] In October with the expansion[11] of DVP(Delivery Versus

9) The method of adjusting funds for net settlement was improved from that of adjusting the disparity between the cumulated outstanding of funds to that of the calculation of the interest.
10) Raised from 10% to 20% of the net debit cap.
11) To the previous DVP transactions involving the settlement of over-the-counter bonds and bonds that are the object of RP transactions were added those between institutional investors arising from share transactions on the Korea Stock Exchange and the KOSDAQ market.

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

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

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.

<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).

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.

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.

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.

<Figure Ⅳ-1>

CPI Inflation Projection

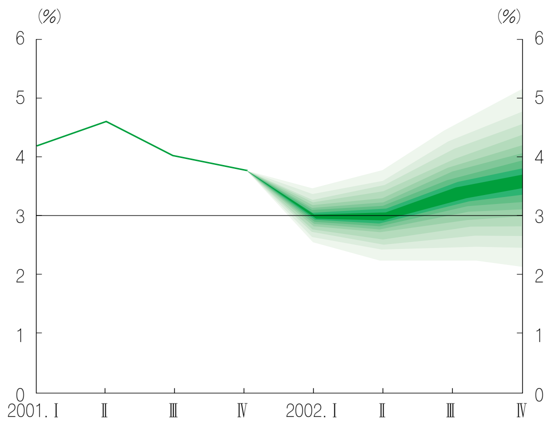
Source: The Bank of Korea.

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.

<Figure Ⅳ-2>

Core Inflation Projection



Source: The Bank of Korea.

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.

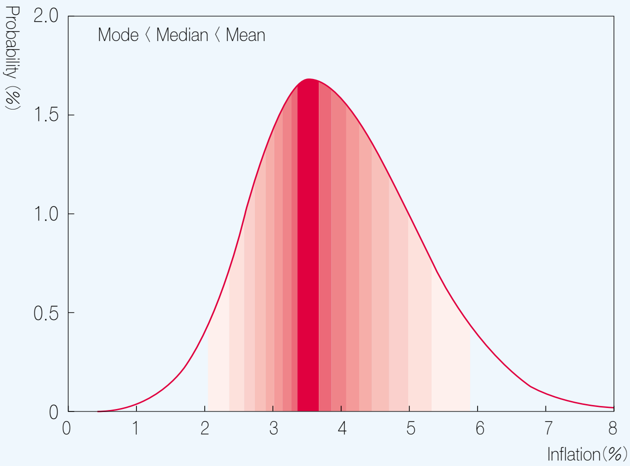
An overall assessment is then arrived at for the range of the probability distribution of the inflation forecast using stochastic simulation of the econometric model in an iterative procedure to obtain the forecast error, which is then compared with previous actual forecast errors and the future degree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

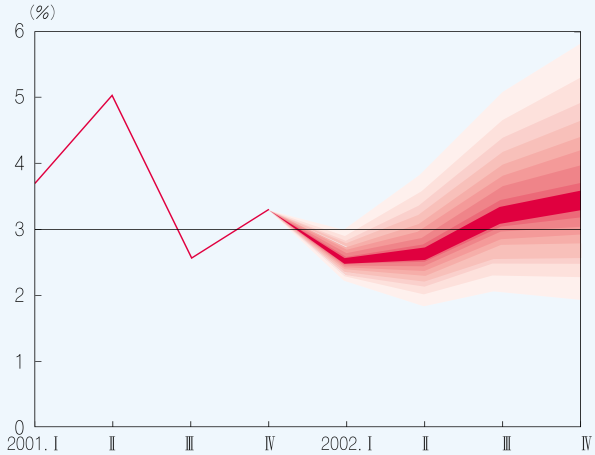
Probability Distribution of Inflation[1] (example)



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±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	• 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	• 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]	• After Jun.1997 : 2.5%(Jun.97)	medium-term
Sweden	Jan.1993	CPI	• After 1995 : 2±1%(Jan.95)	medium-term
Australia	1993	CPI	• 2~3%(1993)	medium-term
Finland	Feb.1993	CPI	• After 1995 : 2%(Feb.93) • After 1999 : below 2%(Jan.99)	medium-term
Spain	Nov.1994	CPI	• 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	• 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	• After 2003 : 3~6%(Feb.2000)	medium-term
Poland	Oct.1998	CPI	• 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 insurence	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 practises[3] 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.