



# **MONETARY POLICY IN KOREA**



**THE BANK OF KOREA**





# Monetary Policy in Korea

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# Foreword

The Bank of Korea (BOK), as the central bank of the Republic of Korea, has made every effort to ensure price and financial stability, thereby contributing to sustainable and stable economic growth. Toward this goal, the BOK has constantly refined its monetary policy framework, by way for example of developing new policy tools and improving relevant procedures to implement monetary policy more effectively.

In particular, the revision of the Bank of Korea Act after the Asian Currency Crisis of 1997 brought about a sea change in the overall environment for the operation of monetary policy in Korea, heightening both the Bank's independence and its accountability. The inflation targeting regime introduced at that time has been the basis of the monetary policy framework to this date. And since the introduction of inflation targeting, the Bank has continued its efforts to boost the effectiveness of its monetary policy. These endeavours, along with the experience acquired in the course of coping with crises, large and small, have markedly improved the Bank's crisis management capacity.

Reflecting the trend toward strengthening the central bank's financial stability role in the wake of the Global Financial Crisis, the Bank of Korea Act was revised in 2011 to give the BOK an explicit mandate for financial stability and equip it with the requisite tools. This has made the responsibilities entrusted to the Bank of Korea even more far-reaching.



This edition of 「Monetary Policy in Korea」, incorporating revisions and additions to the 2002 and 2008 editions, reflects the changes in monetary policy conditions at home and abroad during the time, as well as in the BOK's monetary policy framework and the related operating system.

It is my hope that readers will find this book useful in gaining a comprehensive understanding of monetary policy in Korea. I would like also to express my sincere gratitude to all those who have made such invaluable efforts for the publication of this book.

December 2012



Minho Kim

Director General

Monetary Policy & Markets Department



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# **I. Objectives of Monetary Policy**



# I

## Objectives of Monetary Policy

Like most other central banks, the Bank of Korea regards price stability as the most important objective of its monetary policy, in the awareness that price stability is critical in achieving stable and sustainable economic growth. This is because a central bank's management of the interest rate and money supply ultimately affect prices. Moreover, unstable prices raise uncertainties about the future and reduce economic activity, thereby not only distorting the distribution of resources, but also destabilizing livelihoods and eventually undermining stable economic growth. In line with this, the revised Bank of Korea Act of 1997 stipulated price stability as the purpose of the establishment of the Bank of Korea,<sup>1)</sup> specifying the objectives of monetary policy.

Korea had in the past experienced a high level of inflation and resulting macroeconomic unrest. In Korea, from 1965 onwards and

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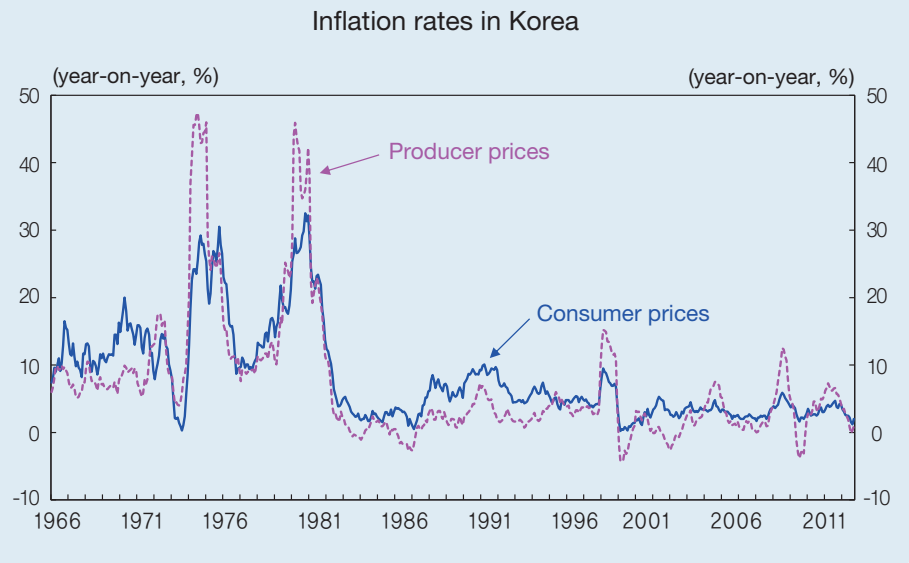
1) Under Article 1 (Purpose) of the Bank of Korea Act

(1) The purpose of this Act shall be to establish the Bank of Korea and to contribute to the sound development of the national economy by pursuing price stability through the formulation and implementation of efficient monetary and credit policies.

Prior to the revision of the Act of December 1997, the unamended Act provided that the purpose of the establishment of the Bank of Korea was to stabilize the value of money and ensure the soundness of the banking and credit systems for the development of the national economy.

throughout the 1970s during the period of rapid economic growth, the average annual increase in consumer prices stood at 14%. Then in the 1980s, as stabilization policies were resolutely pursued, annual inflation was brought down to single digits. During the 1990s, this pattern generally continued except in the aftermath of the currency crisis. In the early 2000s, consumer price inflation showed a stable pattern of movements within a range of 2~3%. It is more desirable to approach the issue of fulfilling inflation targets from a medium- to long-term perspective than from a short-term perspective, in consideration of long-term trends and cyclical fluctuations in prices as well as the time lag of effects of monetary policy. From this perspective, the Bank of Korea sets inflation targets for the medium-term time horizon after considering variables such as past inflation changes, and economic trends and forecasts at home and abroad, and strives to achieve such targets. Like other central banks under an inflation targeting regime, the Bank of Korea operates policy to bring about a convergence of the expected rate of inflation on the targeted figure, in the recognition that it is crucial to maintain stable inflation expectations in order to enhance the effectiveness and credibility of monetary policy.

<Figure I-1>



In the wake of the global financial crisis, there was vociferous criticism of the policy authorities' regulatory failure in respect of systemic risks. Based on the recognition that there had been inadequate containment of the macrofinancial imbalances accumulated over a long period through the linkages running between the financial sector and the real economy, which had resulted notably in asset bubbles, a number of countries including the US and UK started to strengthen the central bank's role of financial stability.

In response to this world-wide trend, it was advocated in Korea that the Bank of Korea's role of financial stability be enhanced to enable it to take more active measures to ward off and prevent another

financial crisis, and to maintain the stability of the financial system. Even before this, the Bank of Korea had long had the responsibility for maintaining financial stability as the lender of last resort. After the global financial crisis, however, the argument was put forward that the institutional foundation of the Bank of Korea needed to be consolidated to empower it to exercise its duty of maintaining financial stability. To this end, the revised Bank of Korea Act of 2011 explicitly specified achieving financial stability as well as price stability as the purpose of its establishment.<sup>2)</sup> Consequently, it was given the right to demand data and materials from non-bank financial institutions while being requiring it to compile biannually a report appraising the soundness of financial institutions in Korea and the macroprudential stability of the financial system as a whole and submit this to the National Assembly.

Under this brief, the Bank of Korea strives for price stability from a medium-term perspective while paying close attention to financial stability. It devotes its utmost efforts in its conduct of monetary policy to achieving the twin objectives of price stability and financial stability.

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<sup>2)</sup> Under Article 1 (Purpose) of the Bank of Korea Act

(2) The Bank of Korea shall pay attention to financial stability in carrying out its monetary and credit policies.



## **II. Monetary Policy Framework**



# II

## Monetary Policy Framework

Central banks operate monetary policy by firstly setting standard indices in order to stabilize prices. These indices consist of nominal variables considered to be closely linked to price stability, which are called nominal anchors. By its establishment and utilization of these nominal anchors, the central bank will be in a position to achieve price stability from two perspectives.<sup>1)</sup> First, when it maintains the nominal anchor at certain levels and prices fluctuate within a certain range around them, then inflation expectations are accordingly anchored. In addition, they reduce the possibilities of time-inconsistency caused by central bank's arbitrary policy operation, thereby increasing the possibility of price stability in the long run.

A nominal anchor is determined based on the economic structure and the extent of the development of financial markets, and the main nominal anchors include the exchange rate, money supply, and inflation. Accordingly, monetary policy regimes are classified as exchange rate targeting, monetary targeting, and inflation targeting. From 1957, the Bank of Korea implemented monetary policy with

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1) Mishkin, F., "International Experiences with Different Monetary Policy Regimes," *NBER Working Paper*, No. w6965, 1999.

## II. Monetary Policy Framework

money supply as a nominal anchor and, according to changing circumstances in the financial markets, the monetary indicator was shifted from M1 to M2 to MCT. However, as the effectiveness of monetary indicators was weakened by financial innovation and the revision of the Bank of Korea Act in 1997 stipulated price stability as the purpose of establishment of the Bank of Korea, the Bank introduced an inflation targeting regime, as an alternative to monetary targeting, which it has since continued to operate.

## 1. History

Due to the Korean War having broken out straight after the establishment of the Bank of Korea in June 1950, the Bank strove to support the smooth operation of the wartime economy and to curb inflation, by way of providing war expenses, restricting lending to financial institutions and implementing emergency currency exchange measures. Even after the Armistice was signed, the Bank of Korea continued to focus on curbing inflation in implementing its policy. Notably, following the entry into effect of the General Banking Act in 1954, the Bank of Korea reordered financial institutions' capital operations and lending management in order to promote the effective operation of financial funds and ensure the stability of monetary value.

The system for the operation of monetary policy in Korea began to take on its current form in 1957 with the creation of the Financial Stabilization Program. The program sought to hold down the deep seated inflation which had been caused by dramatic changes in the social and economic environments, and fiscal laxity since the foundation of the Republic of Korea. Under the program, a supply ceiling for money (M1) was set on either an annual or a quarterly basis; a ceiling was determined for each sector, i.e. the fiscal,

fertilizer (government agent), private, overseas and other sectors; and money supply was implemented only within the ceilings.

With the outbreak of the May 16th political upheaval in 1961, the program was suspended in 1961 and 1962. However, as the new government implemented its first Five-year Economic Development Plan, inflation accelerated and the foreign exchange reserves began to dry up, posing a threat to economic stability. Under these circumstances, the Financial Stabilization Program was revived in 1963 in close association with US financial assistance to Korea.

Then in March 1965, Korea signed a Stand-by Credit Agreement with the IMF in order to finance the chronic balance of payments deficit. In accordance with the Agreement, Korea had to set a specific target for the leading monetary indicator in consultation with the Fund. The monetary indicator chosen shifted from the initial M1 to the central bank's net domestic assets (1966~first half of 1969), reserve money (second half of 1969), domestic credit of financial institutions (1970~1982), and to net domestic credit (1983~1986). The Financial Stabilization Program was formulated and implemented based on these indicators.<sup>2)</sup>

From 1976 when signs of an improvement in the balance of payments began to emerge, Korea set and publicly announced an M1 growth target independently of the Agreement with the IMF. Due to

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<sup>2)</sup> The IMF Stand-by Credit Agreement was suspended during 1978~1979 when Korea's balance of payments improved before being resumed in 1980. Thanks to the shift in the balance of payments into surplus in the latter half of the 1980s, all outstanding borrowings from the IMF were fully redeemed by 1988.

irregular movements of M1, however, the gap between the actual figures and the target widened. Thus from 1979, M2 was substituted for M1 as the leading monetary indicator, and the monetary policy framework took on the characteristics of a fully-fledged monetary targeting regime.

Korea maintained monetary targeting up until the mid-1990s, even though many countries had abandoned it in the 1980s, with the relationship between monetary aggregates and inflation starting to break down. This was because interest rate deregulation commenced relatively late in Korea compared to the advanced countries and, accordingly, financial innovation, which curtails the effectiveness of a monetary targeting regime, occurred at a slow pace. M2 still continued to maintain a close relationship with prices, and in general it stayed within its target range, thanks to the appropriate conduct of monetary policy by the Bank of Korea.<sup>3)</sup>

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<sup>3)</sup> M2 did not achieve its target level on some occasions, for example, at the time of the Second Oil Shock in the early 1980s and of expanded money supply through the foreign sector in the late 1980s. Notably, in the late 1980s, the current account registered a large-scale surplus, fuelled by the so-called three-lows (low oil prices, low interest rates and low dollar or strong yen in international financial markets). As the economy showed a stable pattern of movements beginning from 1991, however, monetary growth stayed by and large within its target range.

<Table II-1>

M2 growth in Korea - target and actual figures

(%)

	Target	Actual figures	Computation
1979	25	24.6	based on year-end
80	20 (25)	27.0	"
81	25	25.2	"
82	20~22 (25)	27.0	"
83	18~20 (15)	14.7	based on average December balance
84	11~13	8.9	"
85	9.5	13.9	"
86	12~14(16~18)	17.4	"
87	15~18	22.5	"
88	15~18	18.8	based on average annual balance
89	15~18	18.4	"
90	15~19	21.2	"
91	17~19	18.3	based on average December balance
92	18.5	18.6	"
93	13~17	17.3	"
94	14~17	17.6	"
95	12~16	13.7	"
96	11.5~15.5	17.8	"

Note: Figures in parentheses are revised target figures.

The money supply target was set based on the European Community (EC) method.<sup>4)</sup> This method draws on the theoretical foundation of equation of exchange formulated by Irving Fisher as  $MV=PT$ (where M stands for money; V for velocity; P for the price

4) The method was called the EC method since the EC's Council recommended its adoption by all of its member countries in 1972.



level; and T for transactions). In other words, the Bank of Korea determined the money supply target, considering a number of expected economic conditions including economic growth, the rate of price increases, and changes in money velocity.

With the reorganization of the trust account system in April 1996, Korea's leading monetary indicator, M2, began to show unstable movements. The money-in-trust products that commercial banks handled tended to expand sharply compared to other products.<sup>5)</sup>

This expansion was attributable to banks' irregular operation of trust account products. The products were originally supposed to be long-term and performance-related. But they often had short maturities and low penalty charges for cancellation prior to maturity, and they were handled as if they were a fixed interest rate product. Furthermore, since they were not subject to reserve requirements, their yields were higher than those of other bank products. In view of this situation, the government reorganized the trust account system as a whole to restore the original function of money-in-trust. It extended the minimum maturity, raised the penalty charge for cancellation prior to maturity, and prohibited the handling of non-specific money-in-trust products, which had exhibited a sharply rising trend.<sup>6)</sup>

Accordingly, the pace of the upward trend of money-in-trust products decelerated greatly. Meanwhile, a sizable amount of the funds withdrawn from money-in-trust products flowed into banks'

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<sup>5)</sup> In the ten years from 1986 to 1995, deposits placed with commercial banks' trust accounts increased 33 times whereas there was only a six-fold expansion in deposits placed in regular bank accounts.

time & savings deposits, consequently pushing up the growth rate of M2. Looking at the figures, money-in-trust increased by 38.9 trillion won in the ten months from May 1995 to March 1996, just before the overhaul of the system. During the ten-month period from May 1996 to March 1997, it grew by 19 trillion won, less than half its increase during the same ten-month period a year earlier. On the other hand, time & savings deposits nearly doubled from 14.3 trillion won to 25.5 trillion won during the same period.

<Table II-2>

Scale of increase in money-in-trust and time & savings deposits before and after the reorganization of the trust system

(billions of won)

	May 95~Mar. 96 (A)	May 96~Mar. 97 (B)	B-A
Money-in-trust	38,851.2	19,082.2	-19,769.0
Time & savings deposits	14,347.7	25,511.0	11,163.3

6)

Reorganization of the trust system in 1996

	Previous	Revised
Minimum maturity	One year	One and a half year
Penalty charge for cancellation prior to contract maturity	0.5-1.75%	2.0-3.0%
Net increase ceiling for development trust products	5.6 trillion won	Frozen at the level of the previous year-end
Range of products eligible for trust principal guarantee	Personal pension, old age pension trust, household/business trust, installment fund	Personal pension, old age pension trust
General unspecified money trust funds	Allowed	Prohibited (starting January 1996)

With the expansion of time & savings deposits, M2 growth began to accelerate remarkably from May 1996. Having remained stable at around the 14% level until the first quarter of 1996, it registered 15.3% in May and 16.2% in June. Finally it rose to 18.3% in the fourth quarter of the year, well above the upper bound of the 1996 target range (11.5~15.5%). As a consequence, although the Bank of Korea maintained its monetary policy stance unchanged, monetary growth rose sharply, affected by the realignment of the financial system. This misled the general public into believing that the Bank was implementing an excessively accommodative monetary policy.

Under the circumstances, the Bank of Korea began to emphasize a new monetary indicator that counteracted the effects arising from flows of funds between financial assets. The new indicator was MCT, which included M2, certificates of deposit (CDs) and money-in-trust. Thus when funds moved from money-in-trust to time & savings deposits, MCT was not affected even if M2 growth accelerated. An examination of the time-series data of MCT proved that MCT satisfied the conditions<sup>7)</sup> necessary for a leading monetary indicator.

From 1997, the Bank of Korea introduced a dual monetary targeting system, using M2 and MCT as the target indicators, and set the M2 growth target (average December balance basis) at 14~19% and MCT growth target at 15~20%. In fact, the Bank placed more

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7) ① Stable relationship with real economic variables (nominal GDP and prices), ② high degree of controllability through reserve money manipulation, ③ exogeneity.

emphasis on MCT than on M2. Before long, however, another financial system realignment made MCT less useful. As a part of its realignment of the reserve requirement system undertaken in February 1997, the Bank of Korea imposed a 2% reserve requirement on CDs. Consequently, yields on CDs fell and at maturity CDs were redeemed on a large scale rather than being rolled over. Funds withdrawn from CDs flowed into cover bills that emerged as a new investment instrument following the scrapping of their issuance cap.<sup>8)</sup> This subsequently brought about a sharp decline in MCT growth. Cover bills, which had increased by only 236 billion won from February to April 1996, expanded by 5,508 billion won from February to April 1997. Meanwhile, CDs shifted from a 2 trillion won increase to a 2 trillion won decrease during the same period. In consequence, MCT growth, having accelerated to 19% during December 1996, dropped to 17.7% in March 1997 and 15.6% in May, approaching the lower bound of the growth target. Although the Bank did not change its monetary policy stance, the leading monetary indicator decreased very sharply as if the Bank of Korea were implementing an austere monetary policy.

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8) Previously, the ceiling on cover bills issuance was 50% of the amount of bank's discount performance of commercial and trade bills during the previous month. As of February 17, 1997, however the ceiling was scrapped and banks were able to issue cover bills up to their total holdings of bills outstanding.

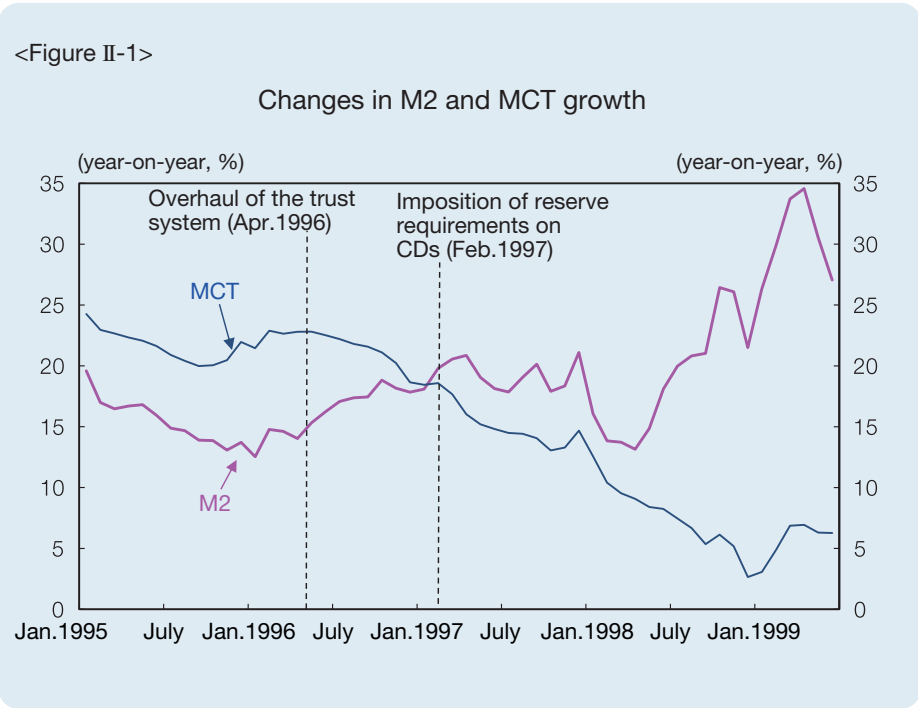
&lt;Table II-3&gt;

Changes in CDs and cover bills before and after the  
imposition of reserve requirements on CDs

(billions of won)

	Feb.-Apr. 96 (A)	Feb.-Apr. 97 (B)	B-A
CDs	1,984.5	-2,053.9	-4,038.4
Cover bills	236.0	5,507.8	5,271.8

Most advanced countries have experienced a similar phenomenon whereby the leading monetary indicator shows unstable movements when associated systems are rearranged, or financial innovation takes place, and its relationship with the final objective breaks down. Like other countries, the Bank of Korea then changed its leading monetary indicator, shifting from M2 to MCT, which covers a much broader range. But it soon had to decide whether it should maintain the entire system of monetary targeting, whose effectiveness had been cast into doubt.



With the decline in the effectiveness of monetary indicators, the introduction of inflation targeting as an alternative to monetary targeting came to be considered seriously from the mid-1990s. Inflation targeting was officially adopted in accordance with the revised Bank of Korea Act, which came into effect on April 1, 1998. The Act stipulated that the Bank of Korea should determine the annual inflation target in consultation with the government and make this target public. In accordance with this, the Bank set the 1998 inflation target at  $9.0\% \pm 1\%p$  based on consumer price inflation. In fact, however, it also followed the method of monetary operation recommended by the IMF as a part of the conditionality

attached to IMF credits.

This latter method was a form of monetary targeting in which a supply ceiling for reserve money was set as an indicative limit in proportion to the appropriate rate of M3 growth. First, based on the EC method, an appropriate rate of M3 growth was computed taking into account the GDP growth rate, the inflation target and money velocity; then the scale of reserve money was set, based on the M3 money multiplier. The supply channels of reserve money were divided into net international reserves (NIR)<sup>9)</sup> and net domestic assets (NDA)<sup>10)</sup>. After the lower limit of the target range for NIR was determined, NDA, which represented the reserve money target less NIR, was managed as the upper bound of the target range. The management of the lower bound of NIR was undertaken to maintain international reserves above a certain level while that of the upper bound of NDA sought to limit the domestic supply of money so as to achieve economic stability within a short period. This was the monetary management method customarily applied when the IMF carried out stabilization programs.

Every quarter, the IMF and the Bank of Korea consulted together and set these targets while keeping them under constant review. As foreign reserves grew rapidly, bolstered by a current account surplus, NIR stayed above the lower limit recommended by the IMF, and

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<sup>9)</sup> The Bank of Korea's disposable foreign reserves [total foreign reserves less foreign currency deposits placed in overseas branches of domestic banks] – external debts.

<sup>10)</sup> Reserve money - NIR

domestic credit also remained within its target range, largely because of high interest rates. Meanwhile, it was agreed during the fourth quarter consultation with the IMF in October 1998 that the indicative limit of reserve money should be removed. Thus only indicative target ranges for NIR and NDA continued to be recommended from 1999 until September 2000, when Korea graduated from the IMF's tutelage.

<Table II-4>

Status of the IMF monetary program's operation

		Lower limit of NIR (billions of dollars)	Upper limit of NDA (billions of won)
end of Dec. 1998	agreed	23.7	-5,170
	performance	31.2	-19,857
end of Mar. 1999	agreed	31.8	-17,341
	performance	39.2	-28,548
end of Jun. 1999	agreed	40.3	-25,787
	performance	48.4	-36,646
end of Sep. 1999	agreed	55.2	-42,540
	performance	58.5	-45,361
end of Dec. 1999	agreed	62.4	-47,917
	performance	67.0	-51,913
end of Sep. 2000	agreed	84.0	-71,794
	performance	86.5	-77,111

From 1999, it was no longer necessary to consult with the IMF concerning the appropriate level of M3. Even so, the Bank of Korea set an average growth target for M3 of 13~14% alongside the inflation target, an arrangement similar to the two-pillar system of the



European Central Bank. This was because the financial markets could have been thrown into confusion if the monetary targeting that had been utilized during the previous 30 years were to be scrapped all at once. In addition, considering the fact that inflation expectations were still affected by monetary indicators, it was judged desirable to lower them through the announcement of an appropriate growth rate for M3. It was also intended that both systems should be employed during the period of transition until inflation targeting took root.

For the year 2000, a target for M3 growth of 7~10% was established along with the inflation target, but from 2001 onwards its rate of growth was not taken as an intermediate target but as a monitoring variable. Accordingly, even if the broadest monetary aggregate did not stay within the surveillance range, measures were not taken immediately as they had been when it formed the intermediate target. The system of Korea's monetary policy operation had thus completed the transition to inflation targeting. This was further underlined with the use of M3<sup>11)</sup> growth solely as an information variable, with no monitoring range being set for it from 2003 onwards.

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11) From June 2006 the components of M3 (broad money) were realigned and it was reconstituted as Lf (financial institution liquidity).

## 2. Current Monetary Policy Framework: Inflation Targeting

At present, the Bank of Korea employs inflation targeting as its monetary policy framework.<sup>12)</sup> The Bank of Korea sets an explicit inflation target on a three-year basis in consultation with the government, and implements monetary policy (interest rate-based) to achieve this target by setting a policy rate, namely the ‘Bank of Korea Base Rate.’ Furthermore, the Bank of Korea forecasts the future inflation rate by making use of a wide range of information variables and operates monetary policy to achieve the convergence of the actual rate of inflation on the targeted inflation figure. In this process, the Bank strives to anchor inflation expectations to the target rate, since expectations exercise a great deal of influence on pricing decisions concerning wages and product/service costs.

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<sup>12)</sup> Under Article 6 (Setting of the Operational Direction for Monetary and Credit Policies) of the present Bank of Korea Act

- (1) The Bank of Korea shall set a price stability target in consultation with the government,
- (2) The Bank of Korea shall set and publish the operational direction for monetary and credit policies every year, and
- (3) The Bank of Korea shall do the best to achieve the price stability target as provided for in Clause (1).

## (1) Establishment of Inflation Target

### Target Indicator

In the early stage of inflation targeting in Korea, i.e. during 1998 and 1999, the rate of increase in the Consumer Price Index (CPI) was used as the target indicator. This was mainly because of its familiarity to the general public. It was also considered that if another indicator were used, it could lead to public confusion in that the government also announced a forecast for rises in CPI in consultation with the IMF.

After a series of exhaustive studies on matters concerning the compilation of core inflation,<sup>13)</sup> this was adopted as the target indicator in 2000. Then the issue became that of which items should be excluded from the CPI to calculate core inflation. Following in-depth discussions, it was decided that those items whose prices were subject to very large short-lived shifts that resulted from unexpected external shocks regardless of the movements of other prices should be excluded from the CPI. Specifically, the items excluded consisted of certain non-grain agricultural products, whose prices are greatly affected by weather conditions, harvests and so forth. Also excluded were petroleum products, whose prices are likely to fluctuate

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<sup>13)</sup> Core inflation, or underlying inflation, is not a standardized concept but refers to the basic rate of inflation represented by the rate of price increases, after excluding the price volatility of items subject to generally unexpected temporary external shocks (such as surges in oil prices, abnormal weather conditions, and institutional changes).

depending on changes in international oil prices. This core inflation index was viewed as the most desirable indicator for the operation of monetary policy, since it represents the basic trend of changes in prices rather than wide short-term swings.

Core inflation is less subject than consumer price inflation to short-term volatility and it reacts sensitively to the adjustment of the policy rate. It does, however, suffer from the weakness of being estranged from the day-to-day life of the general public in that it excludes the prices of agricultural products and oil-based fuels that constitute major items in the cost of living. Besides this, most countries that have adopted inflation targeting employ the CPI as their target indicator and if the Bank of Korea had persisted with core inflation despite the government's use of the CPI as its price indicator in planning the management of the economy, this could have led to popular confusion in judging price levels. Taking all these points into overall consideration, the Bank of Korea shifted back to the CPI as its target indicator from 2007.

## **Inflation Target Level**

The target level is determined largely by normative and positive methods. The normative method is to set a target level that should be achieved over the long term. The positive method is to set an achievable target, based on price forecasts, taking into overall consideration the status of the financial markets, and domestic and overseas economic conditions. The latter is the method used by most

countries that have adopted an inflation targeting regime.

Korea has adopted the positive method. During 1998, the first year of the new regime, the inflation target was set at  $9.0\% \pm 1\%p$ , relatively high in terms of the rate of increase in the CPI (on a year-on-year basis) reflecting the sharp depreciation of the won following the outbreak of the currency crisis. Afterwards, it was adjusted downward to  $3.0\% \pm 1\%p$  in 1999 as prices stabilized. In 2000 when the inflation target indicator was altered, the target was set at  $2.5\% \pm 1\%p$  in terms of core inflation and  $3.0\% \pm 1\%p$  for each year from 2001 to 2003. For the period of 2004~2006 when the shift was made to a medium-term inflation targeting system, it was established as a range of 2.5~3.5% (annual average basis of the three years in terms of the rate of increase in the CPI) while the scale of the tolerated change within the target range was reduced from the previous two percentage points to one percentage point in order to minimize price volatility and build the foundation for medium and long-term price stability. For the period 2007~2009 when the CPI was reintroduced as the inflation target indicator, the medium-term inflation target was set at  $3.0\% \pm 0.5\%p$ <sup>14)</sup> in terms of the rate of increase in the CPI. From 2010 to 2012, it was set at  $3.0\% \pm 1\%p$  and the scale of the tolerated change was enlarged to a range of two percentage points, in

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<sup>14)</sup> The inflation target for 2004~2006 was expressed as a target range rather than as a midpoint as previously, but a target range midpoint was restored for the period of 2007~2009, to specify the tolerated target range of fluctuations. This change allowed the public to better understand the policy intentions of the Bank of Korea, as well as enabling the Bank of Korea to bring about a smoother convergence of public inflation expectations with the targeted level.

order to secure the scope to determine the policy direction from a medium- and long-term perspective, based on fundamental price trends under increased uncertainty concerning price levels in the aftermath of the financial crisis. In the meantime, the inflation target for the next three years (2013~2015) has been set at 2.5~3.5%,<sup>15)</sup> the target range having been narrowed by one percentage point in order to reflect the current price trends of—less inflationary pressure on the demand side for the time being due to the global economic slowdown—and increase the accountability of monetary policy.

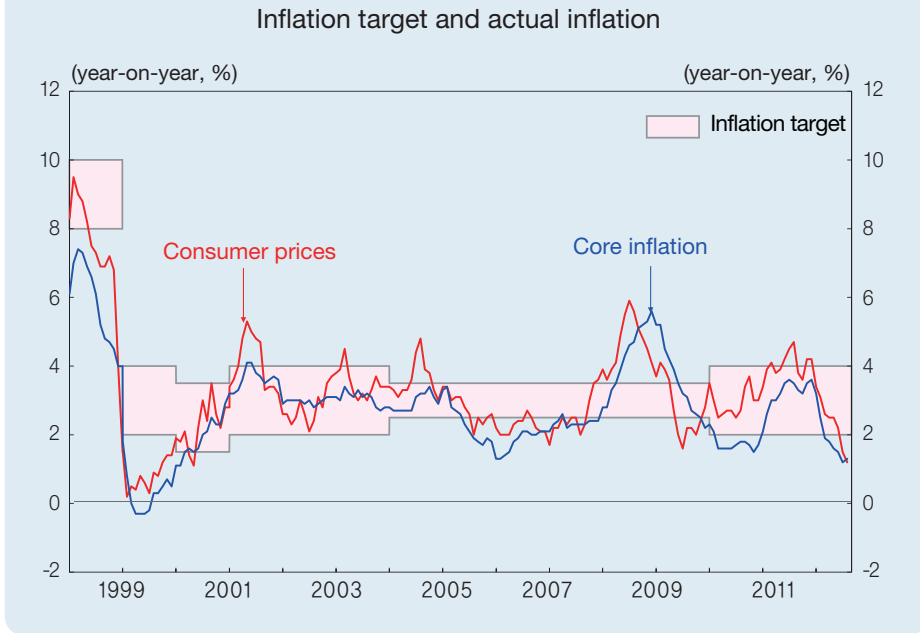
The actual rate of inflation in terms of the CPI registered 7.5% in 1998 and 0.8% in 1999, in both cases below the lower bound of the annual inflation target range as the exchange rate, wages and other production cost factors were more stable than had been expected. The rate of core inflation, which became the targeted index of the inflation target from 2000, was held generally stable within its target range. For the years of 2004~2006 when there was a shift to a medium-term targeting system, the annual average rate of core inflation remained at a level of 2.3%, slightly below the lower bound of its target range. This was because prices continued on a downwardly stable trend from 2005 onwards thanks to the weakness of the demand pressures and the appreciation of the Korean won. On

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<sup>15)</sup> With the expectation of the decreased level of global inflationary pressure in 2013, appropriate conditions were in place for lowering inflation expectations; however, considering the uncertainties in determining an appropriate inflation target, the policy of setting a midpoint was abolished. Furthermore, the Bank of Korea committed itself to holding the inflation rate below 3% from a medium- to long-term perspective in order to lower and stabilize inflation expectations.

the other hand, as seen from 2007 when the CPI was reintroduced as the inflation target indicator, the period from 2007 to 2009 showed that prices rose by an annual average of 3.3% within the inflation target range, but from December 2007 through April 2009, they exceeded the upper bound of the acceptable range of the inflation target in the aftermath of soaring international oil prices and the depreciation of the Korean won triggered by the global financial crisis. Despite the sharp rise in the prices of agricultural products in 2010, the inflation rate stood at its target midpoint of 3.0%, but in 2011 it was driven above the upper bound of the target range to stand at 4.0%, due to supply-side factors such as the sharp rise in international oil prices, coupled with demand-side pressure. From the beginning of 2012, however, the inflation rate quickly stabilized at below 2%, the lower bound of the target range, thanks to several factors, including the slowdown in the domestic economy and stable prices for both international raw materials and for agricultural, fishery, and livestock products.

<Figure II-2>



## Target Horizon

From 1998 until 2003, the Bank of Korea consulted with the government to determine the inflation target for the following year, to be announced along with the annual proclamation of monetary policy directions at the start of the year.<sup>16)</sup> However, annual inflation targeting of this kind had some problems.

<sup>16)</sup> Under Article 6 (Setting of the Operational Direction for Monetary and Credit Policies) of the Bank of Korea Act (Entry into force in April 1998)

(1) The Bank of Korea shall set an inflation target in consultation with Government.



First, there is a considerable time lag until monetary policy affects prices. When a central bank changes its policy rate, it takes around 6 to 24 months to have an effect. Suppose the time lag of policy transmission is twelve months. In this case, if the target achievement period is set for one year, then, theoretically, no policy options can be adopted to achieve the target in the year concerned since the current round of policy determination does not influence target achievement for the current year. To take this problem into account, the time horizon for target achievement should be longer. Most nations that adopted inflation targeting before Korea now announce only an inflation target that will form the basis for the operation of monetary policy for some years to come.

Second, there is a considerable degree of uncertainty surrounding price conditions. Prices in a small open economy such as Korea's are greatly affected by factors beyond domestic control such as changes in exchange rates and international raw material prices including oil. If inflation targets are pitched at different levels each year in line with the emergence of these factors, public confidence in the consistency of monetary policy naturally weakens. Therefore, it is desirable to propose a target to be maintained by the central bank for some years ahead, helping give it scope to operate policy on a consistent, and long-term basis despite price fluctuations that depend on uncertain factors.

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(2) The Bank of Korea shall set and publish the operational direction for monetary and credit policies every year.

(3) The Bank of Korea shall do its best to achieve the inflation target as provided for in Clause (1).

In order to make up for shortcomings in the method of setting an annual target every year in its inflation targeting, the Bank of Korea had, since 2000, set a medium-term target, announcing that it would strive to hold core inflation at the 2.5% level. This level was set considering the medium-term inflation target ought to be lower than the 3% level of inflation that was registered during those periods of the 1970s~1980s when prices<sup>17)</sup> were stable amid rapid economic growth. It was also born in mind that the inflation targets of other advanced countries that operated inflation targeting generally cluster around at level of 2~2.5%. From 2003, the medium-term inflation target changed from 2.5% to 2.5~3.5% to allow the operation of monetary policy in a more flexible manner.

But because this medium-term inflation target was only a declaration that lacked binding force, there was a limit to the extent to which it could resolve fundamentally the problems presented by the annual inflation targeting regime. Inevitably the question of whether the inflation target was being attained was couched simply in terms of the legally stipulated annual target rather than the medium-term target. The interest of the general public and the press focused on whether this annual target was achieved. The conduct of monetary policy was also liable to face problems because of

17) Consumer price inflation in the 1970s and the 1980s (annual average basis) (%)

	1970~79	1980~89
Throughout the period	15.1	8.1
Periods of price stability	3.3 <sup>1)</sup>	2.8 <sup>2)</sup>

Notes : 1) 1973 2) Average of 1983~1987.

differences in the policy response called for by each of the two inflation targets when both an annual and a medium-term target were set up, and confusion could arise among the general public in seeking to grasp the intention of the central bank's policies. Subsequently the medium-term target was adjusted from 2.5% to a range of 2.5~3.5% in 2003 but, although this declaration of intent was introduced to make up for the shortcomings of the annual targeting system, it failed to produce the hoped-for results and remained largely nominative in character, lacking binding force.

To this end, when the Bank of Korea Act was revised in August 2003, legal provision was made<sup>18)</sup> for the establishment of a 'medium-term inflation target' to replace the 'annual inflation target' and, from 2004 onwards, the annual inflation targeting system underwent a transition to a medium-term inflation targeting regime. In consideration of the time-lag in the transmission of monetary policy, the examples of foreign countries and a general recognition of what constitutes the medium term, the period of the achievement of this target has been set at three years and judgment as to whether the target was attained was based on an average of its annual inflation rates over the three years.

However, under an inflation targeting regime that assesses whether the target is achieved based on the average inflation rate over the particular period during which the target was applied, as the evaluation of policy operation is made after the end of the target

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18) The words 'every year' were deleted in the revised Bank of Korea Act in 2003.

achievement period, this disrupts the continuity of monetary policy featuring the alternation of implementation → evaluation → implementation. In particular, as it approaches the end of the target achievement period, the policy time horizon becomes shorter, which makes it difficult to implement forward-looking monetary policies in the medium term. To compensate for this problem, the system was restructured in 2010 to check price trends on a regular basis from a medium-term perspective, instead of determining at the end of the period whether the target had been attained. Accordingly, the Bank of Korea publishes a report examining the operation of inflation targeting every year (December), and from 2013, it will increase the frequency of its publication to twice a year (January and July), while providing more detailed and analytical information to make clear the medium-term character of the inflation targeting regime.

## **(2) Operation of Interest Rate-oriented Monetary Policy**

Under the monetary aggregate targeting regime in force up until 1997, monetary policy was operated making use of an intermediate monetary growth target and employing reserve money as the operating target to attain it. Specifically, under the assumption of a stable multiplier relationship between reserve money and the money supply, monetary policy was operated by converting the monetary target into reserve money and achieving the required scale through

open market operations. As has been described above, however, the chosen monetary aggregate gradually lost its effectiveness as an intermediate target, the Bank of Korea, in tandem with the introduction of an inflation targeting regime following the foreign currency crisis, shifted to an interest rate-oriented monetary policy; the Bank set its policy rate at a certain level and operated monetary policy with a focus on attaining this level. Accordingly, the Bank of Korea employed the call rate target as its policy rate from the introduction of the inflation targeting regime, and since 2008, this has been changed to the Bank of Korea Base Rate.

## **The Establishment and Operation of Call Rate Target**

Following Korea's receipt of an initial Stand-by Credit from the IMF in early December 1997, the Bank of Korea induced a dramatic hike in the call rate, acting in close consultation with the Fund, paying attention to the role of interest rates as a means of bringing stability to the foreign exchange market. The Bank of Korea raised the interest rate offered in its open market operations and pushed up the overnight call rate to the upper limit of 25% specified in the Enforcement Decree of the Interest Restriction Act.<sup>19)</sup> Subsequently,

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<sup>19)</sup> The Interest Restriction Act stipulated the upper limit of interest rates at 40%, and its Enforcement Decree set the upper limit of legal interest rates within the stipulated upper limit of the Act. From December 22, 1997, the upper limit of legal interest rates under the Enforcement Decree was raised from 25% to the maximum permissible 40%, and the Act itself was repealed on January 13, 1998. Subsequently, the provisions of the Interest Restriction Act were

when the upper limit of interest rates was adjusted upwards to 40%, the overnight call rate rose above 30%. Accordingly, both yields on corporate bonds and banks' lending & deposit rates registered sharp increases. As a period of high interest rates had arrived, their movements attracted much closer popular attention. Although not explicitly stating so, the Bank of Korea made it clear that it would operate monetary policy with a focus on interest rates, unlike its still-existing monetary policy framework, as it began to present the operational direction of interest rates in its 'The Direction of Monetary Policy for the Quarter' from July 1998.<sup>20)</sup>

As the domestic foreign exchange market quickly regained stability, the Bank of Korea progressively eased its tight monetary policy. As a result, the overnight call rate and other interest rates showed simultaneous declines. The reduction of the call rate target on

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reintroduced in March 2007, in connection with monetary transactions between individuals and those of unregistered money lenders. The new Act stipulates that the maximum interest rate under a loan contract should be prescribed by the Enforcement Decree of the Act to an extent that does not exceed 40% per annum and the Enforcement Decree set the maximum of legal interest rates at 30% per annum. The Interest Restriction Act was revised on October 26, 2011, but the upper limit of legal interest rate prescribed in the Act remains at 30% per annum. Interests related to monetary transactions of registered money lenders and credit financial institutions, not subject to the Act, are applied by the Act on the Registration of Credit Businesses, etc. and the Protection of Financial Consumers. The maximum of legal interest rates under the Act is set at 39% per annum. Interest rates related to banks and mutual savings banks are subject to the acts relevant for their authorization and permission.

20) "...During the third quarter, the downward stability of interest rates will be pursued insofar as this does not detract from the stability of the foreign exchange market..." (July 3, 1998)

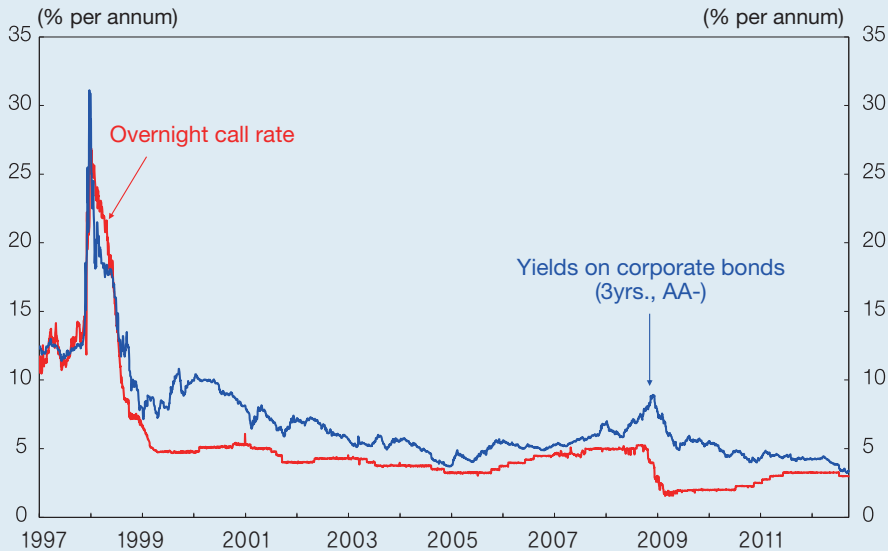
September 30, 1998<sup>21)</sup> was the first instance of the Bank's making use of the interest rate as its official operating target. To revive the subdued real economy and to ease the severe credit crunch, the Bank announced that it would cut the interest rate offered in its open market operations to the 7% level from the previous 8.1%, in keeping with the interest rate reductions announced by the central banks of the US and other advanced nations. This was viewed as a fundamentally new departure in that a specific interest rate target was announced. Taking into account the fact that the overnight call rate closely tracks the rate applied in open market operations, this measure represented a big step toward a monetary policy regime employing the overnight call rate as its operating target.

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21) "The Bank of Korea resolved to reduce the interest rate offered in its open market operations and pushed down the overnight call rate from its previous level of 8% to around 7%." (September 30, 1998)

<Figure II-3>

Interest rates following the currency crisis



From early 1999, the position of the overnight call rate was consolidated as the operating target of monetary policy. More stress began to be placed on the level of the overnight call rate in the Monetary Policy Direction, which was decided at the monthly policy-setting meeting of the Monetary Policy Committee. Furthermore, a specific figure for the overnight call rate began to be suggested as a target from May 1999 onwards. Hitherto, a vague expression such as “the downward stability of the call rate is to be induced” had normally been employed. However, a clearer statement that “the call rate will be stably operated at around the present



level”<sup>22)</sup> was made at the Monetary Policy Committee Meeting in May 1999. That statement meant that the call rate target was set at 4.75%, because the call rate had been moving at around the 4.75% level. Subsequently, as the degree of adjustment of the call rate target was explicitly announced, a method of operating monetary policy in which the call rate target is established as the policy rate and monetary policy is operated with a focus on this became firmly entrenched. Therefore, the call rate target functioned as the policy rate up until the time when it was replaced by the Bank of Korea Base Rate in January 2008.

## **Shift to the Bank of Korea Base Rate**

Call rate targeting, under which a target level was set each month, greatly contributed to the stabilization of the macroeconomy even when considering the unstable relationship between monetary aggregates and the real economy, by allowing the Bank of Korea to stabilize prices and underpin the economic recovery. In particular, compared to the past when monetary policy was operated based on monetary aggregates, the introduction of the call rate target framework widened the scope for the flexible adjustment of liquidity, and this served as an institutional foundation to enable the Bank of

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<sup>22)</sup> “In view of the fact that the effects of policy of the downward stabilization of interest rates, pursued as part of the efforts for the recovery of the real economy, are becoming evident, the overnight call rate needs to be operated at the current level and the pace of real economy recovery should also be closely watched.” (May 7, 1999)

Korea to actively respond to financial tensions such as the Daewoo scandal and the credit card debacle.

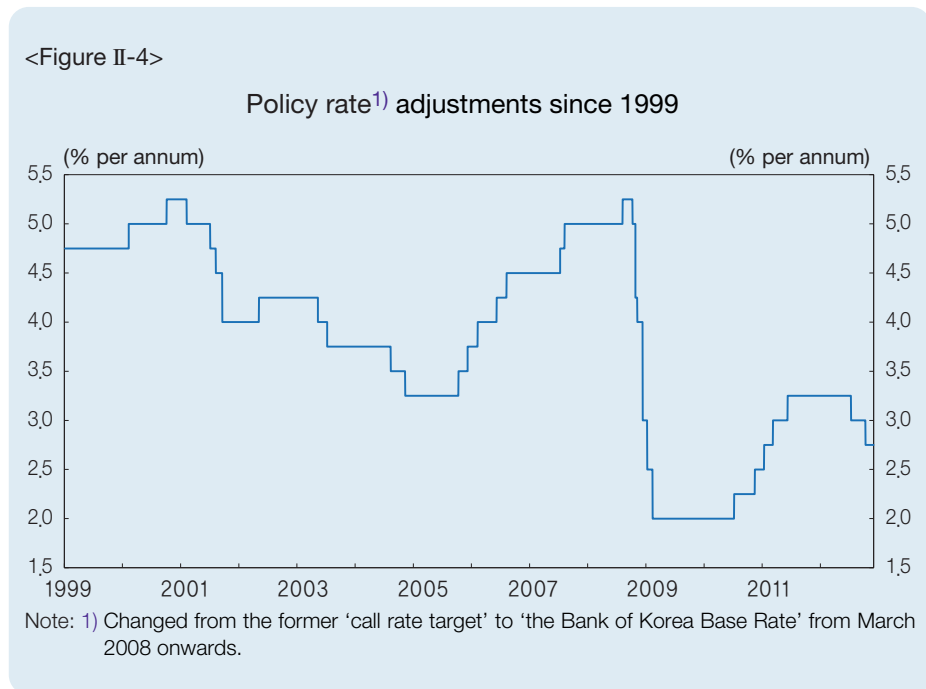
However, once the call rate became adopted as the operating target, it stayed virtually fixed at the target level set by the Bank of Korea regardless of liquidity or supply-and-demand conditions in the reserve market. This meant that its functions of funds allocation was greatly weakened, while because of this constraint on its movements of the call rate, short-term fund transactions came to be excessively concentrated in the call market, thereby detracting from the development of other short-term financial markets, including the repo (RP) market. The consequence was a restriction of the seamless working of the monetary policy transmission channel running from the adjustment of the policy rate to the real economy through the adjustment of long-term interest rates.

In order to address the problems associated with its existing system of monetary policy operation, including this drawback of call rate targeting, the Bank of Korea reorganized the system,<sup>23)</sup> changing its policy rate from the ‘call rate target’ to the ‘Bank of Korea Base Rate’, and began to operate monetary policy within the new framework from March 2008. The Base Rate is the reference rate applied in transactions such as RPs between the Bank of Korea and

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<sup>23)</sup> The restructuring of the monetary policy operating framework not only heightened the market character of the call rate, but also took into consideration the fact that the existing reserve system together with the lending and deposit facilities of the Bank of Korea retained the basic framework of the previous monetary targeting regime, meaning that neither could operate properly under an orientation toward interest rates.

its financial institution counterparts, functioning both as the fixed rate for its sales of securities to absorb excess liquidity and as the minimum tender rate for its purchases to provide liquidity. Nevertheless, as the call rate continues to serve as the market interest rate that is the point of departure for the transmission channel of monetary policy, the Bank still makes efforts to prevent the call rate from deviating greatly from the level of the 'Base Rate.'<sup>24)</sup>



<sup>24)</sup> The reason the Bank of Korea finds it rational to maintain the transaction rate of 7-day RPs at levels close to the overnight call rate is that the credit risk of an unsecured call transaction is offset by the duration risk of a secured transaction of RPs.

## II. Monetary Policy Framework

<Table II-5>

### Policy rate<sup>1)</sup> adjustments since 1999

	Policy direction	Size of adjustment	Policy rate level
1999 Jan.-Apr.	Downward stability	–	–
May	Maintaining current level	–	4.75%
2000 Feb.	increase	+0.25%p	5.00%
Oct.	increase	+0.25%p	5.25%
2001 Feb.	decrease	-0.25%p	5.00%
July	decrease	-0.25%p	4.75%
Aug.	decrease	-0.25%p	4.50%
Sep.	decrease	-0.50%p	4.00%
2002 May	increase	+0.25%p	4.25%
2003 May	decrease	-0.25%p	4.00%
July	decrease	-0.25%p	3.75%
2004 Aug.	decrease	-0.25%p	3.50%
Nov.	decrease	-0.25%p	3.25%
2005 Oct.	increase	+0.25%p	3.50%
Dec.	increase	+0.25%p	3.75%
2006 Feb.	increase	+0.25%p	4.00%
June	increase	+0.25%p	4.25%
Aug.	increase	+0.25%p	4.50%
2007 July	increase	+0.25%p	4.75%
Aug.	increase	+0.25%p	5.00%
2008 Mar. <sup>1)</sup>	–	–	5.00%
Aug.	increase	+0.25%p	5.25%
Oct.	decrease	-0.25%p	5.00%
Oct.	decrease	-0.75%p	4.25%
Nov.	decrease	-0.25%p	4.00%
Dec.	decrease	-1.00%p	3.00%
2009 Jan.	decrease	-0.50%p	2.50%
Feb.	decrease	-0.50%p	2.00%
2010 July	increase	+0.25%p	2.25%
Nov.	increase	+0.25%p	2.50%
2011 Jan.	increase	+0.25%p	2.75%
Mar.	increase	+0.25%p	3.00%
June	increase	+0.25%p	3.25%
2012 July	decrease	-0.25%p	3.00%
Oct.	decrease	-0.25%p	2.75%

Note: 1) Changed from the former 'call rate target' to 'the Bank of Korea Base Rate' in March 2008.

## **III. Implementation of Monetary Policy**



# III

## Implementation of Monetary Policy

### 1. Monetary Policy Decision-making

The Monetary Policy Committee, the supreme policy-setting body of the Bank of Korea, deliberates and decides Korean monetary policy at the highest level. As explained in Chapter 2, the inflation target is set every three years by the Committee in consultation with the government, and in principle, the policy rate, or the Base Rate, is decided at the monthly meetings of the Committee.

#### **Composition and Operation of the Monetary Policy Committee**

It is the general practice that authority and accountability regarding monetary policy decision-making are granted to a committee comprising a number of members, rather than to anyone individual.<sup>1)</sup>

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<sup>1)</sup> Considering that monetary policy is a macroeconomic policy that widely

Examples are the Federal Open Market Committee (FOMC) of the US Federal Reserve, the Governing Council of the European Central Bank, the Monetary Policy Committee (MPC) of the Bank of England, and the Policy Board of the Bank of Japan.

The policy setting body of the Bank of Korea before April 1998 was the Monetary Board, which was made up of the Minister of Finance and Economy and the Governor of the Bank of Korea *ex-officio*; plus seven appointed members. This composition made it difficult for the central bank to carry out its monetary policy independently. Above all, since the Minister of Finance and Economy served as the chairman, most decisions on policy matters were greatly influenced by the Ministry of Finance and Economy. Furthermore, of the seven appointed members, five were selected on government recommendation,<sup>2)</sup> which also acted to restrict the Monetary Board's independence in setting policy.

Under the revised Bank of Korea Act that came into force in April 1998, however, there were considerable changes in the composition of the policy-setting body. Its name was changed to the Monetary Policy Committee with the word 'operation' being omitted from the Korean version of its name (directly translated as the 'Monetary

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influences the economy, the committee system, where individuals with various forms of expertise and experience participate in the decision-making process, can reduce errors and enhance the efficacy of policies through the members' information sharing and mutual learning.

- <sup>2)</sup> One member was appointed on the recommendation of the Minister of Finance and Economy, two on that of the Minister of Agriculture, Forestry and Fisheries and two on that of the Minister of Trade, Industry and Energy.



Policy Operation Committee’), which had given the impression that it was a passive agent, and the Governor of the Bank of Korea took over chairmanship of the Committee. The number of members making up the Committee was reduced to seven, and as part of efforts to lessen governmental influence, the number of members recommended by the government was reduced to two among the six recommended members.<sup>3)</sup> Members who had been previously able to serve part-time, were now required to serve full time so as to heighten policy accountability and expertise. Following these changes, the Monetary Policy Committee acquired the institutional foundation to determine monetary policy in a much more independent and neutral manner, than in the past. Furthermore, under the revision of the Bank of Korea Act in September 2003 (entry into effect, January 2004), the Senior Deputy Governor of the Bank additionally serves as an ex-officio member of the Monetary Policy Committee,<sup>4)</sup> thereby enhancing the independence of the Bank of

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<sup>3)</sup> The Governor of the Bank of Korea, the Minister of Finance and Economy (currently the Minister of Strategy and Finance), the Chairman of the Financial Supervisory Commission (currently Financial Services Commission), the Chairman of the Korea Chamber of Commerce and Industry, the Chairman of the Korea Securities Dealers Association and the Chairman of the Korea Federation of Banks each recommend one member of the Monetary Policy Committee.

<sup>4)</sup> It is generally the case in major countries that the senior deputy governor participates as an ex-officio member in the highest decision-making body. Notably, in the US, the UK, Japan, Canada and other advanced countries, between two to five senior executives of the central bank, including the senior deputy governor, serve as members of the supreme decision-making organ. In the meantime, under the revised Bank of Korea Act, the membership of the

Korea. The members of the Committee are appointed by the President and serve terms of four years.<sup>5)</sup>

A regular meeting takes place on the Thursday of the second and fourth weeks of each month, with exceptions only for unavoidable reasons. An exceptional meeting is called if the chairman deems it necessary or it is requested by at least two members. For such meetings, the agenda is drawn up by the chairman or at least two members, and the decisions made at the meeting are adopted through a simple majority with at least five members attending<sup>6)</sup> unless otherwise specified.<sup>7)</sup>

## **Decision-making Process of Monetary Policy**

The decision-making process of the Monetary Policy Committee, for example, in its decision of the Base Rate, is as follows. In principle, the meeting for resolution of the monetary policy direction is held on the Thursday of the second week of each month. Although

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Monetary Policy Committee remained unchanged at seven, with the addition of the Senior Deputy Governor of the Bank and exclusion of the one member previously recommended by the Korea Securities Dealer Federation.

5) Nevertheless, the term of the Senior Deputy Governor of the Bank of Korea is three years.

6) Previously, in the event of a tied vote, the chairman had casting vote, but this was removed in the revision of the Bank of Korea Act in December 1997.

7) At least four members are required to be present for emergency credit to banking institutions and credit to for-profit enterprises (Articles 65 and 80 of the Bank of Korea Act); at least five for the decision on a matter whose reconsideration has been requested by the Minister of Strategy and Finance (Article 92 of the Bank of Korea Act).

the date of a meeting may be changed according to circumstances,<sup>8)</sup> the annual schedule for the Committee's policy-setting meetings is set and released in advance, thereby minimizing market uncertainties concerning the day of the decision of the Base Rate. The monetary policy direction is made public without delay.

A week before the monthly meeting to decide the Base Rate is held, committee members and those involved in major departments of the Bank of Korea have an informal meeting to review the economic situation; on the day before the meeting, a meeting takes place to report economic trends under the auspices of the Monetary Policy Committee. At that time, each department briefs the committee members on economic and financial conditions at home and abroad, and they then discuss these issues in depth. Unless there is an extraordinary situation, the policy-setting meeting takes place at nine in the morning; the Base Rate is determined after considering various factors, including domestic prices, markets conditions, financial and foreign exchange markets, and the trends of the global economy; and a statement is drawn up on the monetary policy direction. After the meeting, a press release of the statement is made available and the Governor of the Bank of Korea holds a press conference to explain the details and the background to the decision. The minutes detailing

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<sup>8)</sup> Article 9 (2) of the Bank of Korea Act limits the change of the day for the meeting by prescribing, "If the day designated for a regular meeting falls on a legal holiday or it is deemed that unavoidable circumstances exist, the Monetary Policy Committee shall meet on the day preceding the designated day, or on the day decided at its previous meeting."

the discussion at the meeting are made public after a certain length of time (currently set at two weeks).

## **Considerations in Monetary Policy Decision-making**

In the process of making decisions on monetary policy, the Monetary Policy Committee comprehensively takes into account economic circumstances at home and abroad. The Bank of Korea's purpose is stipulated as being to contribute to the sound development of the national economy by striving for price stability through formulation and implementation of monetary policy while paying close attention to financial stability. Therefore, in setting the Base Rate, it is important to judge the effect exercised on the real economy in terms of, say, prices and economic growth of a possible change in interest rates and the scale of any such change. However, this is by no means easy to assess accurately, since monetary policy is transmitted through various channels and has a time lag involved. The Monetary Policy Committee bears in mind the uncertainties associated with policy transmission channels as well as changes in external conditions such as international oil prices when deliberating on monetary policy, making decisions largely based upon these following considerations.

First, it should forecast what effects the change in various conditions will have on inflation. To this end, an econometric model is initially employed. If such a model, composed of numerous variables and equations, is used, it allows influences on prices to be

calculated with relative ease. But the problem lies in the credibility of the model. Estimations of econometric models based on past data do not accurately reflect changes in the economic structure, which is subject to constant variation over time. In addition, because the patterns of the past do not necessarily repeat themselves in the present where numerous uncertainties exist, it is difficult to be confident in the figures generated by such a model. Hence, to make up for these shortcomings, central banks use various indicators that signal inflationary pressures, rather than being wholly dependent on econometric models. The Bank of Korea also utilizes primary data that are considered to be closely linked to future inflation as well as many other indicators compiled by processing statistics.<sup>9)</sup> This is dubbed the “look-at-everything approach” where as many indicators as possible are used to measure inflationary pressure.

Second, even if expected inflation is judged to exceed the target level, should there be problems with the real economy or the financial markets, the central bank must decide whether it ought to raise interest rates solely for the sake of price stability. Although the central bank’s fundamental task is clearly that of ensuring price stability, that does not mean that it can ignore other policy goals. Even if future price increases are expected to be high, provided they remain within the target range, the central bank may not need to raise interest rates, basing its decision rather on the state of the financial

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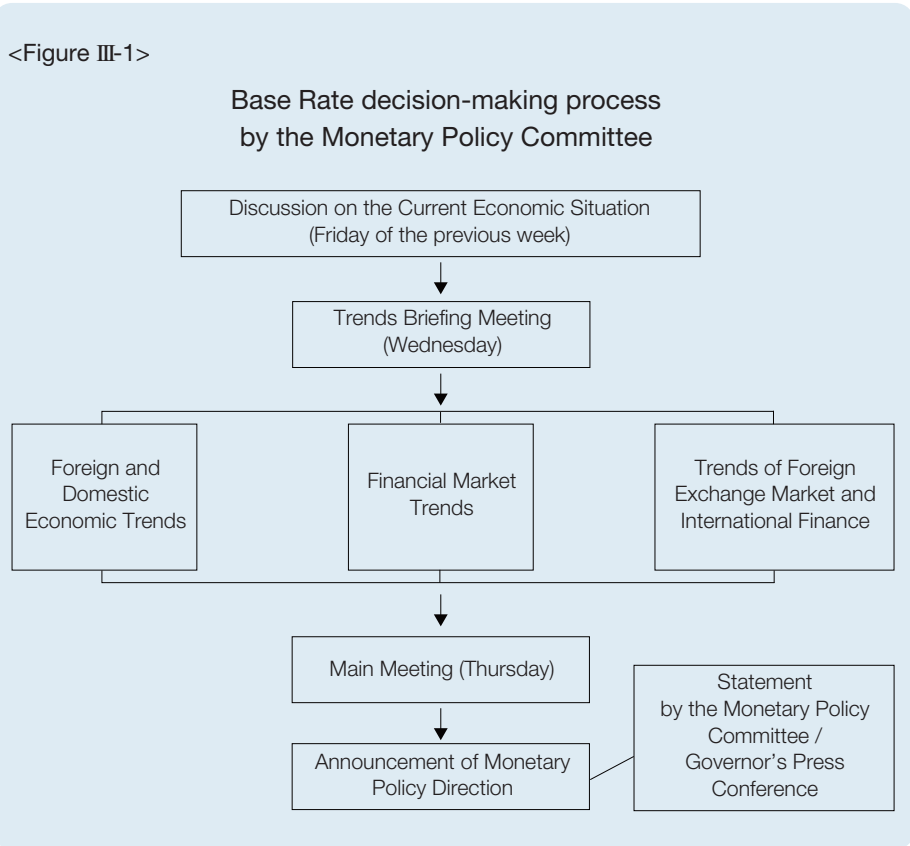
<sup>9)</sup> They include the GDP gap, the non-accelerating inflation rate of unemployment (NAIRU), spreads between long- and short-term interest rates, surveys of inflation expectations and so forth.

markets or the real economy. However, if prices are expected to exceed the target range, and at the same time, an economic slowdown or financial market instability occurs, the central bank will face difficulties in selecting the appropriate policy direction. In such a scenario, since interest rate adjustment is the central bank's only policy option, it should set up an order of priorities among its multiple goals to cope with the situation.<sup>10)</sup>

Third, once it decides to adjust the policy rate, the central bank should determine the scale of the adjustment. For this, the econometric model is also employed to calculate the appropriate scale, but unless there are special circumstances, such as a crisis situation, most central banks prefer a gradual approach. From the beginning of the 1990s, the US Federal Reserve adjusted the policy rate in quarter of a percentage point steps, termed 'Greenspan's babysteps', after the then chairman of the Federal Reserve.

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<sup>10)</sup> Appropriately, this is called taking an "eclectic approach", in which choosing policy direction depends wholly on the central bank's judgement of the economic situation.



## 2. Instruments of Monetary Policy

The monetary policy instruments that can be used by central banks are largely divided into those for indirect and direct adjustment. Indirect adjustment instruments, which are market-friendly in that they correspond to the spontaneous movements of the market, include open market operations, lending and deposit facilities and reserve requirements. Direct adjustment instruments are employed under the regulatory powers granted to the authorities, rather than by making use of the market mechanism. The setting of commercial banks' deposit and lending rates and the control of the scale of their lending fall into this category.

From the time of its establishment in 1950, the Bank of Korea was legally endowed with indirect adjustment instruments, but in practice it long had to rely on direct regulatory instruments because direct regulation was more effective in adjusting the money supply in a situation in which the financial markets remained underdeveloped and there was chronic excess demand for funds. In this respect, direct regulation was to some extent inevitable.

From the early 1980s, however, as the scale of the Korean economy expanded and its structure became even more complex, there was a growing need for it to operate on the basis of the market principle.



Accordingly, a wide-ranging easing of regulations was undertaken, and the operation of policy on the basis of the market mechanism began to take hold. In this vein, the gradual deregulation<sup>11)</sup> of interest rates was pursued along with the securing of greater managerial independence for financial institutions, while monetary policy shifted to a reliance on indirect adjustment instruments. In the late 1980s, as money supply expanded through the foreign sector following the shift of the current account into surplus, orthodox monetary policy instruments, including open market operations, lending facilities and reserve requirements came to be widely used to sterilize the monetary expansion. In particular, the revised Bank of Korea Act, which came into effect in April 1998, stipulates<sup>12)</sup> that the Bank is basically duty-bound to implement monetary policy in a market-friendly manner. At the present time, the Bank of Korea relies on indirect adjustment instruments in implementing monetary policy.

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11) From the mid-1980s, the regulation of interest rates began to be gradually eased in Korea. In December 1988, the deregulation of most lending rates and some long-term time & savings deposit rates was carried out. Subsequently, however, overall economic conditions worsened amid rises in prices and market interest rates, labor disputes, and lackluster export growth. Under these circumstances, interest rate controls were reimposed through the use of moral suasion from the latter half of 1989. Then, in August 1991, a four-stage interest rate deregulation plan was initiated and pursued. Following the first stage of deregulation launched in November 1991, the second and the third stages were completed in November 1993 and 1995, respectively. In July 1997, some elements of the fourth stage of interest rate deregulation were put in place. Interest rate deregulation was completed in February 2004 with the freeing up of interest rates on banks' demand deposits.

12) Article 4 (2) of The Bank of Korea Act stipulates that, in implementing monetary and credit policies, the Bank of Korea shall emphasize the market mechanism.

## (1) Reserve Requirements

The reserve requirement system obliges financial institutions to hold a certain ratio of their liabilities subject to reserve requirements in their accounts with the central bank.

Financial institutions operate funds raised from their customers in the form of many types of assets, reducing their holdings of low-yielding liquid assets as much as possible to raise profits. Therefore, it is necessary for a minimum ratio of liquid assets to be legally stipulated so that banks can comply appropriately with demands for withdrawal. The minimum level of required liquid assets is referred to as reserves, and the ratio of reserves to the liabilities subject to reserve requirements is called the reserve requirement ratio. Reserves consist of funds that the financial institutions deposit with the central bank and vault cash held by the institutions.

### History

The passage of the Bank of Korea Act in 1950 introduced the reserve requirement system, although it initially played only a limited role as a supplement to direct controls. Following the September 1965 measures to promote more realistic interest rates,<sup>13)</sup> however,

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<sup>13)</sup> In order to bring about a considerable expansion of savings and rein in inflationary pressures, the Interest Restriction Act was revised on September 24, 1965 and the upper limit of legal interest rates was raised from 20.0% per annum to 36.5%. On September 30, the upper limit of interest rates on time

foreign capital inflows increased due to the interest rate differential and exports surged rapidly, and pressures for expansion of currency issuance as a result increased. In response, the Bank of Korea raised the reserve requirement ratio sharply to absorb liquidity. On this occasion, the reserve requirements began to be used as a full-fledged monetary policy instrument.

From the mid-1980s, when the shift of current account into surplus led to monetary expansion through the foreign sector, reserve requirements were actively employed as a major instrument to control liquidity. Since the early 1990s, however, following financial liberalization and the rapid development of financial markets, open market operations have emerged as the main monetary policy instrument, and the role of reserve requirements as a means of liquidity adjustment has declined. However, the reserve requirements still take an important place as an instrument of monetary policy. This was demonstrated when the reserve requirement ratio was raised in November 2006 in an effort to boost the effectiveness of interest rate policy by controlling the rapid credit expansion of financial institutions, and the reserve requirement system was realigned under the amended Bank of Korea Act of December 2011 to deal effectively with financial innovation and to improve the

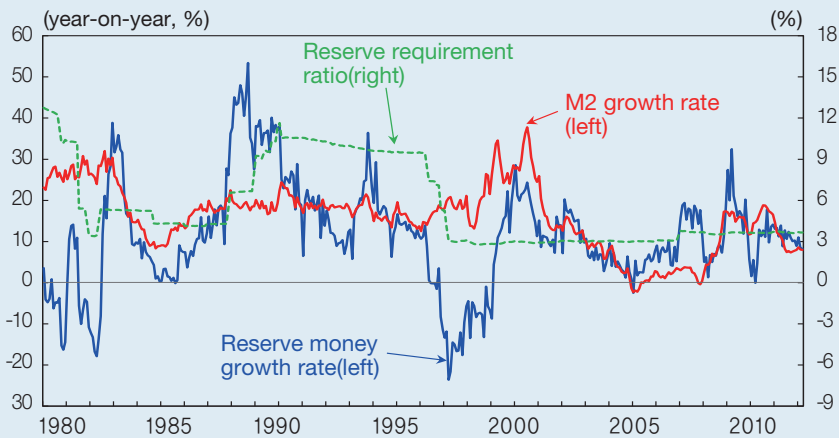
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deposits was raised from 15.0% per annum to 30.0%, and that of lending rates on general loans from 15.0% per annum to 26.0%. As the high interest rate policy weakened the competitiveness of export industries and hindered the development of the securities market, however, the upper limits on financial institutions' lending and deposit rates were adjusted downward on several occasions from April 1968.

efficacy of monetary policy.

<Figure III-2>

Average reserve requirement ratio<sup>1)</sup> and money supply since 1980



## Current System and Operation

Current system of reserve requirements reflects the amendment of the Bank of Korea Act in December 2011. This added certain financial debentures,<sup>14)</sup> to the existing deposit liabilities subject to reserve requirements. This change was made because an excess of

<sup>14)</sup> Specifically, they refer to won-denominated bonds with a maturity of less than 2 years, including (1) financial debentures that are issued under Article 19 of the Enforcement Decree of the Banking Act during a period which the Monetary Policy Committee recognizes as one of pronounced monetary expansion or showing signs of a pronounced monetary expansion and requires reserves to be

financial debentures had been issued during the 2000s, due to their low funding costs and marketability. This overhang led to difficulties in their rollover following the collapse of Lehman Brothers in 2008, posing liquidity risk to financial institutions and undermining foreign investors' confidence in domestic banks.

Under the amended Bank of Korea Act, the Monetary Policy Committee is to set the method of maintaining reserve requirements. Furthermore, different reserve requirement ratios may now be applied to liabilities based on their scale, while the previous system allowed this only on the basis of the type of liability. The amendment also changed the reserve calculation period to a monthly basis, in keeping with the monthly Base Rate decision (normally the Thursday of the second week of each month), and allowed the Monetary Policy Committee to decide the relevant reserve maintenance period. Sanctions imposed on financial institutions for a reserves shortfall were accordingly modified to reflect the change in the reserve calculation period.

The current reserve requirement system that incorporates the above-mentioned changes can be summarized as follows. The

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set aside; (2) bonds (e.g. Agricultural Finance Bonds prescribed in Article 153 of the Agricultural Cooperatives Act; Fishery Finance Bonds prescribed in Article 156 of the Fisheries Cooperatives Act; Small and Medium Business Financial Bonds prescribed in Article 36-2 of the Industrial Bank of Korea Act; Industrial Finance Bonds prescribed in Article 25 of the Korea Development Bank Act) issued during a period set by the Monetary Policy Committee in consultation with the government regarding the necessity of reserve maintenance and the period of maintenance during a pronounced monetary expansion (Article 12-2 of the Enforcement Decree of the Bank of Korea Act).

Monetary Policy Committee decides the minimum ratio of reserves to be held by each financial institution<sup>15)</sup> within a range not exceeding 50%. However, in periods of pronounced monetary expansion, the Committee can impose a marginal reserve requirement ratio of up to 100% on the excess of liabilities subject to reserve requirements over those on a specific date.

Reserve requirement ratios cannot differ among financial institutions, but can vary according to type and size of pertinent liabilities. Currently, however, different reserve requirement ratios are set out based only on the type of liabilities, not on the size, as shown in <Table III-1>.

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<sup>15)</sup> Financial institutions refer to banks under Article 2 of the Banking Act and bank holding companies under the Financial Holding Company Act. The fact that non-bank financial institutions including mutual savings banks are not subject to reserve requirements detracts from the fairness of the law. Meanwhile, non-bank financial institutions also have to hold a certain ratio of their deposit liabilities as reserves under the legislation providing for their establishment. However, these are held against ordinary withdrawal demands unrelated to the central bank's monetary policy, and are usually held in the form of profit-bearing assets.

&lt;Table III-1&gt;

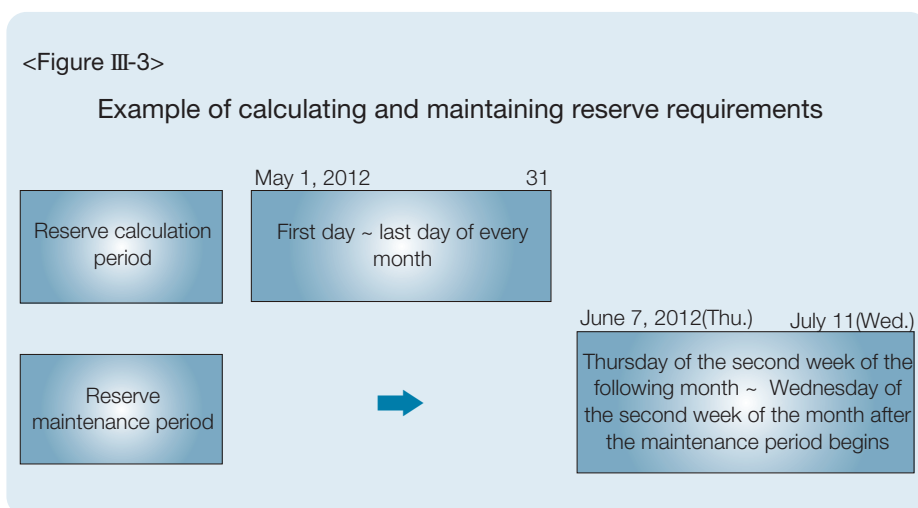
**Reserve requirement ratios**  
(as of the end of November 2012) (%)

Type of liabilities	Reserve requirement ratio
<ul style="list-style-type: none"> <li>• Workers' property accumulation savings, workers' long-term savings, long-term house-purchasing savings, workers' house-purchasing savings, households' long-term savings, workers' preferred savings</li> </ul>	0.0
<ul style="list-style-type: none"> <li>• Time deposits, installment deposits, mutual installment deposits, housing installment deposits, CDs<sup>1)</sup></li> </ul>	2.0
<ul style="list-style-type: none"> <li>• Other deposits</li> </ul>	7.0

Note: 1) CDs issued to financial institutions subject to the reserve requirements are excluded.

Liabilities subject to reserve requirements include deposits and some financial debentures. For financial debentures, however, reserve requirement ratios are not set, because they are subject to reserve requirements only in periods of pronounced monetary expansion or periods when pronounced monetary expansion is expected.

As for the method of maintaining reserves, each financial institution calculates and maintains its required reserves on a monthly basis after a certain period. The reserve calculation period is from the first day to the last day of every month, and the reserve maintenance period is from the Thursday of the second week of the following month to the Wednesday of the second week of the month after the following month.



Each financial institution must hold its reserves in its current deposit with the Bank of Korea or in its own vault cash. A financial institution is allowed to hold up to 35% of its required reserves as vault cash, the amount of which is calculated based on the amount held during the reserve calculation period.

If a financial institution fails to hold a sufficient balance to meet its reserve requirements during the reserve maintenance period, it has to pay a penalty of 2% of the average balance of the deficiency. If its actual reserves fall short for three periods in a row, it may be forbidden to make new loans, investments, or pay dividends to shareholders until it maintains the required reserves for more than a month.

In principle, no interest payments are made on reserve deposits with the central bank. However, if necessary, reserve deposits can be remunerated as decided by the Monetary Policy Committee.



&lt;Table III-2&gt;

**Reserve requirement system  
(as of the end of November 2012)**

Classification	Key contents
• Reserve requirement ratios	Differ according to type of pertinent liabilities
• Financial institutions subject to reserve requirements	Banks, bank holding companies
• Liabilities subject to reserve requirements	Deposit liabilities and some financial debentures
• Method of calculating and maintaining reserves	Calculation and maintenance on a monthly basis (more than 1 month deferred maintenance)
• Method of holding reserves	Reserve deposits with the central bank, vault cash (up to 35% of required reserves)
• Sanctions in case of a shortfall in reserves	(Penalty) 2% of average deficiency (Ban on new lending, etc.) If the reserve shortfall continues for three months in a row, the ban may be continued until required reserves are met for more than a month.
• Interest payment	Can be made, if necessary

## (2) Open Market Operations

Open market operations are the policy instrument through which central banks purchase or sell securities including government and public bonds with financial institution counterparts in open markets such as money or bond markets, and accordingly change these counterparts' funding conditions, thereby adjusting reserve money stock <sup>16)</sup> or the short-term interest rate.<sup>17)</sup>

<sup>16)</sup> Reserve money is the sum of currency in circulation, which represent the central

Financial institutions buy and hold bonds with the intention of operating their funds. If a financial institution needs to convert bonds into cash to meet withdrawal demands from its customers, it has to sell them in the financial market to secure liquidity. Since the cash balance of the counterpart who purchases the bonds is reduced by the same amount, however, the amount of liquidity in the entire financial institutions remains unchanged. Where there is a flight to liquidity due to the financial market instability or where banks as a whole are suffering from a shortage of reserves, a financial institution attempting to sell bonds for liquidity will find no willing takers. Under these conditions, since the supply of liquidity does not meet the demand for it, the central bank supplies fresh liquidity by purchasing bonds in the financial markets. On the contrary, in a situation in which the demand for bonds exceeds their supply, the central bank absorbs the excess liquidity by selling bonds in the financial markets. In this way, the central bank buys and sells bonds in the open markets to control market liquidity.

Generally when the central bank increases liquidity supply, financial institutions use the increased liquidity for making loans to companies or households, leading to an increase in money supply through the multiplier process and thus putting downward pressure on interest rates.

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bank's monetary liability, plus the reserves held by financial institutions.

17) In general, this refers to the interest rate on overnight funds transactions among financial institutions.

Open market operations emerged as a major instrument of monetary policy in the 20<sup>th</sup> century. Particularly since the 1980s, as financial liberalization and innovation facilitated the development of financial markets, many countries adopted open market operations as their main monetary policy instrument.

However, open market operations do not allow the central bank to meet its targets for both the reserve money<sup>18)</sup> and the very short-term (overnight) interest rate simultaneously. In other words, only one of the two targets can be met through open market operations.<sup>19)</sup> Currently, the Bank of Korea and central banks in major advanced countries use these open market operations as their main monetary policy instrument and adjust the amount of reserve money (high-powered money) so that the overnight call interest rate can approach its policy rate target.

## History

Open market operations in Korea were launched with the first issuance of Monetary Stabilization Bonds (MSBs) in November 1961. Operations involving the purchases and sales of government

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<sup>18)</sup> Specifically, it refers to the reserve supply.

<sup>19)</sup> For example, when the central bank sets and attempts to meet a reserve money target, if banks' demand for reserves change due to reasons such as unexpected changes in bank deposits, changes in interest rates are not avoidable. In contrast, when the central bank seeks to keep the very short-term interest rate constant, it has to adjust reserves supply if there are changes in banks' demand for reserves.

and public bonds with bank counterparts became possible from February 1969; non-bank financial institutions were included as counterparts eligible for these operations from 1977, when the methods of open market operations were divided into repurchase agreements (RPs) and outright transactions. From 1986, in order to absorb excess liquidity supplied through the foreign sector following the shift of the current account into surplus, open market operations began to be employed on a substantial scale.

Since the early 1990s, the system has been improved so that open market operations based on market principles have taken firm root. In March 1993, a competitive tender method was introduced for transactions of government and public bonds under RPs which had formerly been conducted by compulsory assignment. This move was intended to pave the way for open market operations based on prevailing market interest rates. From February 1997, the bonds that failed to attract successful bid at auctions for sales of RPs or issuance of MSBs were no longer absorbed by direct sale to financial institutions. With this, the conversion of open market operations to fully competitive bidding was effectively completed. With the inauguration of electronic bidding through BOK-Wire, the Bank of Korea's RTGS (Real Time Gross Settlement) system, in August 1997, open market operations based on the market mechanism became firmly established.

Since the 2000s, efforts have been made to relieve the burden of roll-over and the accumulation of MSBs and make open market operation system more market-friendly and efficient. For example, a

regular timetable<sup>20)</sup> was instituted for the auction of MSBs based on maturity;<sup>21)</sup> the minimum bid price and minimum successful bid price were adjusted upwards, reflecting common transaction practice in the bond market; and the subscription, fungible issue, and early redemption<sup>22)</sup> of MSBs were introduced. Meanwhile, the method of conducting RP transactions with financial institutions was changed from the ‘borrowing and lending of funds using securities as collateral’ to the ‘buying and selling of securities.’<sup>23)</sup> With the reform of the monetary policy operational framework in March 2008, RP transactions came to be undertaken on a regular basis and fixed-rated tenders were introduced. In October 2010, alongside the

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20) MSBs have been issued on a regular basis since January 2003. The types of MSBs issued regularly and issuance schedules have subsequently been changed several times according to policy objectives. To strengthen the role of MSB rate as the short-term benchmark rate, 91-day MSBs have been issued every week and 182-day MSBs in the first and third week of every month since September 2010. Meanwhile, 2-year MSBs (long-term MSBs) are issued in the first and third week of every month; and 1-year MSBs (also long-term MSBs) are issued in the second and fourth week of every month.

21) In June 2002, the minimum amount of bids and successful bids for competitive auctions of MSBs were adjusted upward from 100 million won to 5 billion won. In August 2004, they were adjusted upward again to 10 billion won.

22) The subscription to MSBs and the fungible issue of 2-year MSBs were introduced in June 2009. The fungible issue of 1-year MSBs was also adopted in June 2010. To reduce the maturity concentration of 2-year MSBs issued under the fungible issue system, a system of redemption prior to maturity was introduced.

23) This change was introduced in April 2006. By allowing RP buyers to freely dispose of the securities within the maturity period, it sought to encourage financial institutions to conduct RP transactions with the central bank, boost the liquidity of RPs and arbitrage transactions, and eventually vitalize RP markets and bond markets.

existing compulsory deposit requirement, a market-friendly system of competitive bidding was adopted for deposits with the Bank of Korea's Monetary Stabilization Account (MSA). In December 2011, securities lending & borrowing and intraday RP systems were introduced, which strengthened the role of open market operations for financial stability.

## **Current System and Operation**

### *Liquidity Adjustment Method*

The usual aim of open market operations by the Bank of Korea is to keep the call rate<sup>24)</sup> from deviating sharply from the Base Rate set by the Monetary Policy Committee. The call rate is significantly affected by the amount of bank reserves, because banks attempt to deal with a shortage or surplus of reserves through the call market, where short-term funds are traded (typically overnight loans). Therefore, a further task of open market operations can be said to be adjusting the amount of banks' reserves appropriately.

The demand for reserves is equivalent to the required reserves<sup>25)</sup>

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<sup>24)</sup> Specifically, this refers to the unsecured overnight call rate.

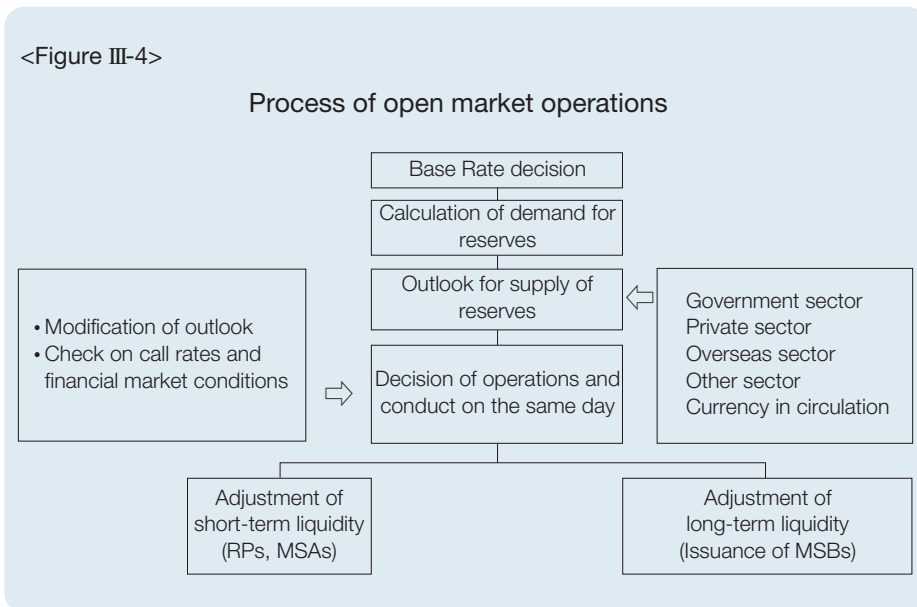
<sup>25)</sup> Reserves consist of required reserves and surplus reserves. Required reserves are the amount of money that banks must hold under the Bank of Korea Act. Surplus reserves are the amount of money that banks maintain in excess of required reserves for various reasons (e.g. for payments or against uncertainties). Although the Bank of Korea Act provides for interest payments on reserves, they are usually not remunerated except in special cases (such as a crisis). Therefore, banks try to minimize their surplus reserves.

that a bank has to hold for a certain period. The required amount is calculated every month based on a bank's liabilities subject to reserve requirements, and the bank must hold it from the Thursday of the second week of the following month to the Wednesday of the second week of the month after that. The supply of reserves takes place through various sectors and varies on a daily basis. When the government collects taxes from the public, people pay them using cash or bank deposits. Since taxes collected by the government are to be deposited in the government account with the Bank of Korea, banks' reserves are commensurately reduced. Conversely, if the government makes payment for a construction project to a private contractor, new funds are supplied, and in consequence, bank reserves increase. When the Bank of Korea pays Korean won for the purchase of US dollars from commercial banks, reserves are supplied. Likewise, when the Bank extends loans to banks, reserves also increase.

If the supply of reserves far exceeds the demand for reserves, banks will try to operate their non-profit surplus reserves (actual reserves minus required reserves) on the call market, leading to a large supply of call money and downward pressure on call rates. In contrast, if actual reserves fall short of required reserves, banks will borrow more money from the call market, leading to upward pressure on call rates.

The Bank of Korea predicts the supply of reserves by reflecting various factors affecting reserves, compares it with the demand for reserves, and calculates the amount of reserve surplus or deficit. If a

deficit is expected, the Bank of Korea will inject liquidity, and if a surplus is expected, it will absorb liquidity. In this way, it conducts open market operations so that call rates do not deviate significantly from the Base Rate.



### ***Operational Instruments***

The main instruments of open market operations include the issuance of MSBs, transactions of securities, and deposits with the MSA.

MSBs, issued only by the Bank of Korea, originated as a major tool of monetary policy during the period when there was an insufficient volume of the government and public bonds that are essential for



open market operations. These central bank obligations have relatively long maturities, and once issued, they are not, in principle, redeemable prior to maturity. Thus, they are used as a major structural adjustment tool with long-lasting policy effects. A ceiling on the issuance of MSBs is set by the Monetary Policy Committee every quarter. By maturity, there are 13 types<sup>26)</sup> of MSBs varying from 14-day MSBs to 2-year MSBs. Currently, however, only 91-day, 182-day, 1-year, and 2-year MSBs are issued regularly through competitive bidding. The fungible issue<sup>27)</sup> period for 1-year and 2-year MSBs is one month and two months, respectively, and subscription is held once a month. Twice in every odd month (Jan., Mar., May etc.), the Bank of Korea repurchases 2-year MSBs with remaining maturities of 3, 5, 7, and 9 months in order to ease maturity concentration and boost liquidity.

Securities transactions are used to supply or withdraw funds by buying or selling government and public bonds. Eligible securities are confined to government bonds, government-guaranteed bonds, and MSBs in consideration of the efficiency of open market

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26) MSBs comprise discount bonds and coupon bonds. Discount bonds include 14-day, 28-day, 63-day, 91-day, 140-day, 182-day, 364-day, 371-day, 392-day, and 546-day bonds, while coupon bonds include 1-year, 1.5-year, and 2-year bonds.

27) In the fungible issue system, the same issue terms and conditions (e.g. coupon rate and maturity) are applied to all the bonds issued during a certain period, and thus they are regarded as the same bond. In respect of Treasury bonds, the fungible issue periods for 3-year and 5-year bonds are units of six months, those for 10-year bonds units of one year and those for 20-year and 30-year bonds every other year, respectively.

operations and the credit risk of the relevant securities. However, if necessary, those bonds specifically determined by the Monetary Policy Committee can be included.

<Table III-3>

Securities eligible in open market operations

Outright transactions	RP transactions
Government bonds Government-guaranteed bonds	Government bonds Government-guaranteed bonds MSBs <sup>1)</sup>

Note: 1) Limited to RP purchases.

Securities transactions consist of outright transactions and RP transactions. Designed to absorb liquidity, outright sales have found little use since they have the same effect as the issuance of MSBs. Outright purchases are not frequently used to supply liquidity, because market liquidity is generally in surplus. Hence outright purchases are utilized only when there is a need to secure Treasury bonds for RP sales or to stabilize the financial market.

Accordingly, most securities transactions are RP transactions. In RP transactions, the Bank of Korea sells (or buys) its Treasury bonds to financial institutions and repurchases (or resells) them upon maturity, so it can absorb (or supply) funds until the end of the maturity date. The longest RP maturity is 91 days, but the majority of RP transactions involve 7-day RPs, whose interest rate is the Base Rate of the Bank of Korea. Since the reserve maintenance period was

lengthened from half a month to a month from 2012, 14-day and 21-day RPs have occasionally been used. In addition, the Bank of Korea can conduct an intraday RP transaction with an institution that is a member of BOK-Wire to help it to tackle a temporary shortage of settlement funds. Meanwhile, if the Bank of Korea lacks sufficient Treasury bonds for the RPs that it needs to sell, it may borrow<sup>28)</sup> them from financial institutions.

The Monetary Stabilization Account (MSA), a term-based deposit facility, is one of the open market operation instruments that the Bank of Korea uses to control short-term liquidity. In normal times, the Bank of Korea accepts deposits from financial institutions in a process of market-friendly competitive bidding. However, it can also oblige financial institutions to make deposits with the MSA in exceptional situations, including rapid credit expansion. The maturity period of deposits with the account is less than 91 days, but the Bank of Korea largely accepts deposits to the MSA with a less than 1 month maturity<sup>29)</sup> such as 28-day deposits, in order to ensure the

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28) Securities lending and borrowing by the Bank of Korea has been allowed since the amendment of the Bank of Korea Act on December 17, 2011. Ordinarily, the central bank uses this method to borrow Treasury bonds from financial institutions for the sale of RPs. However, it can also use the method to support financial institutions having difficulty in raising funds such as in the case of a bond market contraction owing to a financial crisis. In this case, the central bank lends Treasury bonds, which usually have good liquidity, against credit securities, etc. held by financial institutions as collateral.

29) This practice is related to the fact that the deposits in the MSA with a more than 1-month maturity are not included in the current assets when calculating the won currency liquidity ratio (=current assets with a remaining maturity of less than 1 month/current liabilities x 100).

flexible operation of funds by financial institutions. Early withdrawal of MSA deposits is restricted,<sup>30)</sup> and the amount deposited is not regarded as reserves.

<Table III-4>

Instruments of open market operations

		Type of operation	Eligible securities
Long-term adjustment	Withdrawal	Issuance of long-term MSBs	—
		Outright sales of securities	Government bonds and government-guaranteed bonds held by the Bank of Korea
	Supply	Repurchases of MSBs with long-term remaining maturities	—
		Outright purchases of securities	Government bonds and government-guaranteed bonds held by institutional counterparts
Short-term adjustment	Withdrawal	Sales of RPs	Government bonds and government-guaranteed bonds held by the Bank of Korea
		Acceptance of MSA deposits	—
		Issuance of short-term MSBs	—
	Supply	Purchases of RPs	Government bonds, government-guaranteed bonds, and MSBs held by institutional counterparts
		Early withdrawal of MSA deposits	—
		Repurchases of MSBs with short-term remaining maturities	—

The balance of MSBs issued and outstanding was 162.2 trillion won on an average balance basis during the period of January to

<sup>30)</sup> Early termination of MSA deposits is allowed only for cases deemed unavoidable by the Governor of the Bank of Korea. As such, MSA deposits have less liquidity than MSBs, which can be sold in the secondary market.

November 2012. Of this amount, 2-year MSBs accounted for 67.9%; 1-year MSBs, 16.5%; 182-days MSBs, 3.8%; and 91-days MSBs, 9.6%. During the same period, outstanding RP sales stood at 14.7 trillion won, mostly made up of the sales of 7-day RPs (77.2%). There were no purchases of RPs. The average balance of the MSA, which has been actively employed since October 2010, has increased rapidly, standing at 6.8 trillion won during the said eleven-month period.

&lt;Table III-5&gt;

## Performance by instrument of open market operations

(average balance basis, trillions of won, %)

		2009	2010	2011	Jan. ~ Nov. 2012
Outstanding MSBs <sup>1)</sup>		152.0 <62.5>	161.9 <67.2>	166.2 <70.6>	162.2 <67.9>
RPs	Sales <sup>2)</sup>	13.3 <100.0>	12.7 <100.0>	13.1 <99.6>	14.7 <77.2>
	Purchases	2.8	1.8	1.3	—
Balance of MSAs		—	0.4	3.3	6.8

Notes: 1) <> means the share of 2-year MSBs, 2) <> means the share of 7-day MSBs

### ***Operational Methods***

The Bank of Korea conducts most of its open market operations through online public offerings (BOK-Wire<sup>31)</sup>), and if necessary, it also makes bilateral transactions with individual financial institutions.

The public offerings are divided into subscriptions and competitive auctions. When the Bank of Korea undertakes securities transactions or issues/repurchases MSBs, it allocates the securities or MSBs among institutional bidders according to their bidding amount by applying a fixed interest rate set by the Bank. This method is called subscription. Meanwhile, in a competitive auction, the central bank allocates securities, etc. according to bid rates. The subscription method is used for regular subscriptions to MSBs<sup>32)</sup> and the sale of 7-day RPs, while the competitive auction method is used for other types of operations.

In a competitive auction, there are two methods for determining interest rates for transactions; the single rate method (Dutch method) and multiple rate method (conventional method). The former applies the highest rate among those offered by successful bidders, while the latter applies the rate that each bidder offers. The Bank of Korea uses

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31) A series of procedures, including bidding announcement, implementation of bidding, notification of successful bids and settlement, are carried out through the online computer network established between the Bank of Korea and its trading counterparts.

32) Using this subscription method, the Bank of Korea issues 1-year and 2-year MSBs once a month (typically, the last Friday of a month).

the single rate method to absorb liquidity and the multiple rate method to supply liquidity. For instance, to absorb liquidity, if the Bank of Korea issues MSBs or sells RPs through a competitive auction, any financial institution that offers the lowest rate (or the highest price) will be at the top of the allocation order. Subsequently, the highest successful bid rate is applied to all successful bidders. In contrast, if the Bank of Korea seeks to supply liquidity by repurchasing MSBs before maturity or buying RPs in a competitive auction, the financial institution that offers the highest rate (or the lowest price) will be at the top of the allocation order. The bid rate that each successful bidder offers will become a successful bid rate—in other words, successful bid rates will vary among successful bidders. Meanwhile, if the bid rate of more than two successful bidders is the same, the amount allocated will be in proportion the amount bid for (at that price).

Other than public offerings, the Bank of Korea can repurchase MSBs prior to maturity or sell/lend securities to specific financial institutions through bilateral transactions. However, the use of bilateral transactions is limited to some exceptional cases: for example, to support a financial institution suffering liquidity problems, or to conduct an intraday RP transaction to help address a temporary shortage of settlement funds.

### ***Eligible Financial Institution Counterparts***

Once every year, the Bank of Korea selects its financial institution counterparts<sup>33)</sup> for transactions—such as MSB transactions and securities selling and buying/lending and borrowing—based on its selection criteria that take into consideration the efficiency of open market operations and the asset and financial soundness of eligible financial institutions. As of November 2012, there are 35 financial institution counterparts, including banks. Specifically by operational instrument, there are 20 institutional counterparts (7 domestic banks, 4 foreign bank branches, and 9 securities companies) for MSB transactions and outright transactions for securities; 29 institutional counterparts, including 14 domestic banks, for RP transactions and deposits with MSA; and 15 institutional counterparts, including 7 domestic banks, for securities lending and borrowing.

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<sup>33)</sup> The selection of financial institution counterparts has to be made based on comprehensive considerations, for example, whether it is better to have various financial institutions participate or to just maintain a special relationship with certain market makers so as to boost market development and reduce the risk potentially faced by the central bank. An example of the latter is the US Federal Reserve Bank, which makes transactions with a few primary dealers. An example of the former is the European Central Bank whose auctions are open to all financial institutions subject to its reserve requirements.



### (3) Lending and Deposit Facilities

Lending and deposit facilities are operated by central banks to control the supply and demand for funds by extending loans to or receiving deposits from individual financial institutions. Central banks' lending and deposit facilities first took the form of a system of commercial bill rediscounts, before developing into liquidity adjustment loans and standing facilities, and they still assume a critical function in implementing monetary policy as a means of injecting liquidity into the financial market and serving as the lender of last resort.

For some time after its adoption, the central bank's rediscount system of commercial bills was utilized by banks as a means to raise general operational funds from the central bank. With the development of the financial market, however, the system gradually faded, and liquidity adjustment loans were later introduced as more emphasis began to be placed upon the function of interest rate disclosure, to notify the markets of changes in the central bank's monetary policy stance. After a series of systemic changes, central banks of most major countries introduced standing facilities as a policy instrument in order to rein in the excessive volatility of money market interest rates, while implementing interest rate-oriented monetary policy to enhance the market character of the money market rates. Under the standing facilities, liquidity is supplied and absorbed without limit within a certain margin around the policy rate, thereby determining the upper and lower limits of the overnight call

rate, which contributes to the formation of money market interest rates.

Meanwhile, the central bank's lending facilities supply financial institutions with the liquidity required for lending. This function, however, has gradually declined in conjunction with the development of the financial market, and is not used much in advanced countries. The central bank's lending facilities also function as the lender of last resort. That is, in the event of individual financial institutions facing temporary fund shortages, the central bank swiftly provides them the required funds to contain the spread of financial unrest at an early stage. In addition, the lending facilities contribute to smooth payments and settlements. For example, intraday overdrafts provide real-time support to cover temporary fund shortages suffered by financial institutions during the course of a day, thereby ensuring the smooth settlement of payments and the stable operation of the payment and settlement system, which makes up an essential element of the financial infrastructure.

## **History**

During the period of rapid economic growth, the lending facilities of the Bank of Korea were used as a means of policy financing to support particular industries, rather than as a tool for liquidity adjustment. In other words, when banks provided financial support for a strategic industry amid the chronic excess demand for funds, the Bank of Korea refinanced a certain ratio (30~60%) of the funds

extended at rates lower than market interest rates. This system led to an oversupply of liquidity, bringing about inflation. It also made it difficult for the Bank's lending facilities to play an active role as an instrument of monetary policy, because interest rates stayed at a low level for long periods and the amount of lending was decided irrespective of its policy intentions. Furthermore, as the Bank absorbed excessive liquidity by issuing Monetary Stabilization Bonds (MSBs), an overhang of MSBs resulted.

&lt;Table III-6&gt;

## Loans of the Bank of Korea until 1993

(billions of won)

Year-end	Rediscounts of commercial bills	Loans against bills				General loans	Total
		Trade financing	Agriculture, fisheries and livestock	Defense industry	Other bills		
1980	297.4	1,291.3	121.1	16.7	267.4	451.0	2,445.0
1985	1,320.8	2,039.2	173.6	6.3	67.9	5,463.2	9,071.0
1990	3,819.6	891.9	348.2	6.3	0.4	5,968.4	11,034.8
1993	5,178.1	1,054.9	507.8	5.8	1.1	9,170.2	15,917.8

As the deregulation of interest rates and financial market openness progressed rapidly from the early 1990s, management of the money supply using indirect methods of adjustment based on market principles emerged as an important task. The Bank of Korea completely reorganized its lending facilities in March 1994, by reducing policy financing and strengthening its function of

management of the money supply. To summarize the changes, an Aggregate Credit Ceiling System was introduced and the rediscounts of commercial bills, trade financing, and loans for the production of basic materials and parts were incorporated into this system. Most policy funds, meanwhile, were either shifted over onto the fiscal budget or were discontinued. The Aggregate Credit Ceiling System, under which the Bank of Korea sets a ceiling on its overall refinancing provided to banks, is meaningful in that it is not a system of automatic rediscounts. Thus, the Bank of Korea was able to take the lead in determining the amount of the credit supplied in the form of Aggregate Credit Ceiling Loans and the objects eligible for refinancing. This represented a large step forward from the Bank's previous practice of passively supplying funds.

&lt;Table III-7&gt;

**Reorganization of the Bank of Korea's rediscount system  
(March 15, 1994)**

Before	After
<ul style="list-style-type: none"> <li>• Rediscounts of commercial bills</li> <li>• Trade financing</li> <li>• Loans for the production of basic materials and parts</li> <li>• Funds for small and medium-sized enterprises (SMEs) in the provinces</li> </ul>	<p>Absorbed by the newly introduced Aggregate Credit Ceiling System</p> <ul style="list-style-type: none"> <li>• Rediscounts of commercial bills, trade financing, and loans for the production of basic materials and parts, operated within the Aggregate Credit Ceiling quotas for individual financial institutions</li> <li>• Funds for small and medium-sized enterprises (SMEs) in the provinces operated within the quotas set for BOK regional branches</li> </ul>
<ul style="list-style-type: none"> <li>• Loans to meet temporary shortages of funds</li> <li>• Loans for agriculture, fisheries and livestock</li> </ul>	<p>Operated as before</p> <p>Gradually transferred to the fiscal budget</p>
<ul style="list-style-type: none"> <li>• Equipment funds for export industries</li> <li>• Funds for the technology development of SMEs, equipment funds for pollution prevention for SMEs, procurement loan facilities for enterprises buying goods manufactured by SMEs</li> <li>• Loans for the defense industry</li> <li>• Funds for liquidity adjustment</li> <li>• Loans whose fresh extension was discontinued: industrial structural adjustment funds, funds for energy-saving equipment, and industrial rationalization funds</li> <li>• Funds for management stabilization of investment trust companies</li> </ul>	<p>Discontinued</p> <p>Reviewed every 6 months for rollover</p>

Besides the Aggregate Credit Ceiling Loans, the Bank of Korea also introduced Liquidity Adjustment Loans in June 2000 to stabilize the financial market by providing prompt access to funds for applicant banks facing temporary shortages of liquidity. Another purpose of the loans was to enable the central bank to publicly signal its monetary policy stance to the financial markets through the flexible adjustment of lending rates, as is the norm in advanced countries. Lending performance was, however, conspicuously weak because financial institutions sought to avoid borrowings in fear of a reduction of their credit standing through a stigma effect. In September 2000, Intraday Overdrafts were adopted to provide financial support to banks experiencing short-lived shortages of funds for payment-settlements within the course of the day.

From March 2008, as part of the reform of the monetary policy operational framework, the Bank of Korea introduced new Liquidity Adjustment Loans and Deposits on the model of major countries' standing facilities with adjustments for conditions in Korea. The object of their adoption was to heighten the stability of money market interest rates and secure a further policy tool available in the event of a financial crisis. Meanwhile, Loans to Meet Temporary Shortages of Funds and the former Liquidity Adjustment Loans, whose functions duplicate those of the new facilities, were abolished.

## Current System and Operation

The Bank of Korea's credit operations with financial institutions<sup>34)</sup> are subdivided into rediscounts on bills, loans against securities collateral, and loans against assets as temporarily acceptable collateral pursuant to Articles 64 and 65 of the Bank of Korea Act.<sup>35)</sup> In addition, when severe impediments, such as credit contraction, to obtaining funds from financial institutions arise, or are strongly likely to arise, the Bank of Korea may, upon the approval of at least four members of the Monetary Policy Committee, render credit to any for-profit, non-bank financial institutions.

In the meantime, the Bank of Korea may accept and hold deposits from financial institutions pursuant to Article 54 of the Bank of Korea Act, and pursuant to Articles 79 and 82, it may accept deposits

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<sup>34)</sup> Under Article 11 (Scope of Financial Institutions) of the Bank of Korea Act

(1) The term 'financial institutions' in this Act means banks referred to in Article 2 of the Banking Act and bank holding companies referred to in the Financial Holding Companies Act.

(2) The credit and banking sector of the National Federation of Fisheries Cooperatives shall be deemed a financial institution.

(3) Insurance companies and companies which engage exclusively in mutual savings bank business or in trust business shall not be deemed financial institutions.

<sup>35)</sup> The Korea Development Bank and the Industrial Bank of Korea belong to those financial institutions with which the Bank of Korea may engage in credit operations under the Bank of Korea Act, pursuant to the Korea Development Bank Act and the Industrial Bank of Korea Act, respectively. The Bank of Korea, however, does not provide credit to the Export-Import Bank of Korea since the Bank of Korea Act is excluded from application to it under the legislation providing for its establishment (the Export-Import Bank of Korea Act).

### III. Implementation of Monetary Policy

from judicial persons other than financial institutions in cases determined by the Monetary Policy Committee.

As provided for under this legislation, the lending and deposit facilities of the Bank of Korea available to financial institutions consist of Aggregate Credit Ceiling Loans, Intraday Overdrafts, Liquidity Adjustment Loans and Deposits, and special loans. In addition, the Bank of Korea operates current deposits for the acceptance of reserves as well as settlement accounts for transactions between financial institutions.

<Table III-8>

#### The Bank of Korea's lending and deposit facilities (as of November 2012)

Category	Function	Ceiling	Rates	Maturity
Aggregate Credit Ceiling Loans	Inducing banks to expand loans to small and medium-sized enterprises	9 trillion won	1.25% per annum	One month
Liquidity Adjustment Loans and Deposits	Constraining excessive volatility of money market interest rates by enabling financial institutions to borrow shortages of funds from the Bank of Korea or deposit surplus funds at an interest rate level within a certain margin above or below the Base Rate	–	The Bank of Korea Base Rate ±100bp	Overnight
Intraday Overdrafts	Supporting banks facing temporary shortages of funds for payment and settlement in the course of a day	–	Yield on three year Treasury bond—Call rate	Close of the business day
Special loans	Extension of loans as the lender of last resort	Determined in each case		



### ***Aggregate Credit Ceiling Loans***

Aggregate Credit Ceiling Loans were adopted in March 1994 to reform the traditional lending facilities of automatic rediscounts in order to reduce policy funds and reinforce the liquidity adjustment function. Under the Aggregate Credit Ceiling System, the Bank of Korea provides loans to financial institutions within a certain ceiling set by the Monetary Policy Committee, in consideration of their individual performance in lending to small and medium enterprises. Such loans are given within a pre-determined aggregate ceiling of refinancing credits, allocating quotas to individual banks in accordance with prescribed criteria. Banks may then borrow funds from the Bank of Korea within their quotas.

This represents a transitional stage in the evolution of the central bank's lending facilities from its former function of policy financing to the function of liquidity adjustment alone. Considering the fact that the Bank is able to set a ceiling, this system clearly represents a step toward advanced lending practices. However, the fact that allocation criteria are linked to commercial banks' lending to SMEs, and that lending rates are lower than market interest rates, still echoes previous policy financing arrangements. This halfway house status came about because preferential support for SMEs could not be rolled back all at once under the financial and economic conditions prevailing in Korea. Thus, until the Asian currency crisis, the medium- and long-term goal of the Bank of Korea in regard to its lending facilities was to normalize its function by gradually

ratcheting down the Aggregate Credit Ceiling and adjusting interest rates on its credit to a realistic level. In fact, the Aggregate Credit Ceiling was lowered steeply from 8.8 trillion won in March 1994 when the system was adopted to only 3.6 trillion won, in keeping with the reductions of reserve requirement ratios undertaken in November 1996 and February 1997.

Subsequently, however, Aggregate Credit Ceiling Loans were extensively used as a means to overcome large-scale domestic economy and liquidity issues, as well as credit crunches resulting from financial and economic events in Korea and abroad, such as the 1997 currency crisis, the September 11 incident in the United States, and the 2008 global financial crisis. Consequently, in addition to the Aggregate Credit Ceiling Loans and lending rates, fund allocation criteria for the Aggregate Credit Ceiling were also adjusted to correspond to the policy conditions at the time. As a result, Aggregate Credit Ceiling Loans have served more as a microeconomic policy tool than an orthodox instrument for liquidity adjustment.

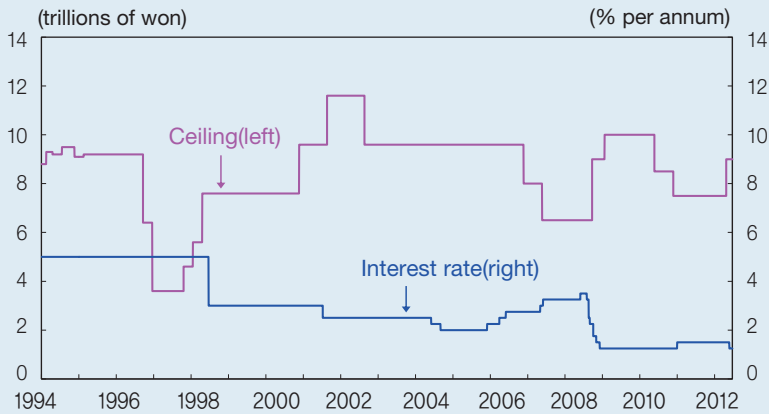
The Aggregate Credit Ceiling is set for each quarter by the Monetary Policy Committee in consideration of monetary trends and the financial conditions of small and medium enterprises and regional financing. As of November 2012, the Aggregate Credit Ceiling stood at 9 trillion won. The ceiling underwent a significant increase (from 6.5 trillion won to 10 trillion won) after the bankruptcy of Lehman Brothers in 2008, but as financial and economic conditions improved, it was then gradually reduced (cut by 1.5 trillion won in July 2010

and 1 trillion won in January 2011). In September 2012, the Bank of Korea raised the Aggregate Credit Ceiling by 1.5 trillion won in order to give financial support to small self-employed business owners.

The Bank of Korea had set the lending rate at 5% per annum after the adoption of Aggregate Credit Ceiling Loans, but adjusted it as necessary in consideration of financial and economic conditions and changes in the Base Rate. The lending rate on them as of the end of November 2012 was 1.25% per annum.

<Figure III-5>

Changes in Aggregate Credit Ceiling and its interest rate



### III. Implementation of Monetary Policy

The Governor of the Bank of Korea allocates the Aggregate Credit Ceiling by dividing it into two separate ceilings, which are applied in the form of monthly quotas for individual financial institutions and for the regional branches of the Bank of Korea, within the amount set by the Monetary Policy Committee. The Governor may also set aside up to 10% of the Aggregate Credit Ceiling set by the Monetary Policy Committee and operate this reserve in the event of emergencies such as natural disasters.

<Table III-9>

#### Allocation of Aggregate Credit Ceiling (as of November 2012)

(trillions of won)

	Quota	Entitled funds
• Ceiling for individual financial institutions	4.0	
• Ceiling for three types of funds	1.5	Corporate Procurement Loans, Electronically Processed Secured Receivables Loans, and trade finance
• Special support ceiling linked to credit loans to small and medium-sized enterprises	1.0	Credit loans to small and medium-sized enterprises
• Special support ceiling linked to loans to small self-employed business owners	1.5	Loans to small self-employed business owners
• Ceiling for BOK regional branches	4.9	Determined by each regional branch in consideration of regional characteristics, etc.
• Ceiling for reserves	0.1	–
Total	9.0	

The ceiling for individual financial institutions is 4 trillion won in total as of November 2012. This ceiling is allocated by dividing it up among the three types of funds, the special support linked to credit loans to SMEs and another special support linked to loans to small self-employed business owners. The ceiling for three types of funds is allocated to financial institutions, based on their performances in lending to SMEs for corporate purchases to improve corporate bill use practices and support export financing, electronic ARC loans and trade financing. As of November 2012, the ceiling for three types of funds was 1.5 trillion won -- divided up into a corporate paper replacement fund (for corporate procurement loans and electronically processed secured receivables loans, 0.75 trillion won) and a trade financing fund (0.75 trillion won) and allocated to financial institutions based on their loan performances. The introduction of the corporate paper replacement fund is believed to have contributed to improving the existing practices of using bills, for example, the amount of cash settlement for corporate commercial transactions has expanded.

In the wake of the collapse of Lehman Brothers', the Bank of Korea introduced a special support ceiling to enable the flexible adjustment of eligibility for Aggregate Credit Ceiling in line with financial and economic conditions.<sup>36)</sup> At the time of this ceiling's introduction, the

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<sup>36)</sup> In October 2008, the Bank of Korea revised 「the BOK Regulation of Lending to Financial Institutions」, and the 'Other Credit Operation Performances of Financial Institutions Selected by the Governor' was added to the criteria for determining financial institution eligibility under the ceiling for individual financial institutions.

Bank also launched and operated a ‘Special Support Ceiling linked to the SME Fast-Track Program’ based on financial institutions’ fund management performances under the ‘SME Fast-Track Program’. However, the special support ceiling linked to the SME Fast-Track Program was terminated in March 2012,<sup>37)</sup> and a 1 trillion won ‘Special Support Ceiling linked to SME Credit Loans’ was established from April 2012. This ceiling is allocated and operated based on financial institutions’ performances in extending unsecured loans to SMEs. The Bank of Korea also launched a 1.5 trillion won ‘Special Support Ceiling linked to Small Self-employed Business Owners’ in September 2012, to enhance these borrowers’ access to financial institutions within the system.<sup>38)</sup> The Bank of Korea will use this ceiling for five years, to support banks’ performances in handling refinancing loans to small self-employed business owners with high interest rate debts.<sup>39)</sup>

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<sup>37)</sup> This ceiling was raised by 1 trillion won in March 2009, due to financial institutions’ increased operation of relevant funds and then cut by 1 trillion won in January 2011 given the improvements in financial and economic conditions.

<sup>38)</sup> The Bank of Korea devised measures to provide financial support to this group, given the need for efforts to prevent systemic risk and economic recession with the worsening of debt problems of small self-employed business owners, as well as that of central bank to join in efforts for financial inclusion of the vulnerable, whose importance has been highlighted through the G20 Summits since the global financial crisis.

<sup>39)</sup> Banks contribute their funding cost savings from the low interest rate of Bank of Korea loans to the KAMCO Credit Recovery Fund and, based upon these resources and its existing assets, the KAMCO Credit Recovery Fund provides full guarantees for the refinancing loans extended to small self-employed business owners.

The ceiling for BOK regional branches, currently standing at a total of 4.9 trillion won, is divided into a strategic support ceiling and a general support ceiling. For the strategic support ceiling, the specific support ceiling for each bank is first determined in consideration of its lending plans, and then 50% of the amount of loans handled by the bank concerned is supported. In the case of the general support ceiling, the remaining funds of the total ceiling for BOK regional branches after provision of those under the strategic support ceiling are allocated in proportion to banks' performance in handling loans to firms other than those with high credit ratings.

### ***Liquidity Adjustment Loans and Deposits***

Together with the realignment of the monetary policy operational framework from March 7, 2008, Liquidity Adjustment Loans and Deposits were adopted with modifications corresponding to the domestic situation from the standing facilities of central banks of major countries including the Bank of England and the ECB. Liquidity Adjustment Loans allow financial institutions to borrow from the Bank of Korea to adjust the supply of and demand for funds, and as standing facilities they represent a major monetary policy tool, along with Liquidity Adjustment Deposits, which allow banks to freely deposit surplus funds with the Bank of Korea. Liquidity Adjustment Loans and Deposits contain the volatility of money market interest rates within a certain range (Liquidity Adjustment Loan and Deposit rates set the upper and lower bounds of money market interest rates).

The operational method of Liquidity Adjustment Loans and Deposits was improved in 2009 and 2011. In February 2009, it became possible for the maturity of Liquidity Adjustment Loans to be extended by up to one month so as to allow them to be used flexibly as a tool for stabilizing the financial market, and the restrictions for interest rate adjustment were eased so that they can be decreased/increased to the level of the Bank of Korea's Base Rate. In 2011, as the amended Bank of Korea Act changed the reserve maintenance period of financial institutions from a half-monthly to a monthly basis, the Bank of Korea adjusted the interest rates of



Liquidity Adjustment Loans and Deposits on the last business day of the reserve maintenance period to the same level as on other business days, in order to discourage financial institutions from delaying the adjustment of reserve overs or shorts until the last business day of the reserve maintenance period.<sup>40)</sup> This measure was designed to prepare against the possibility of violent fluctuations in the overnight call rate arising from significantly increased amounts of fund excesses or deficits to be adjusted around the last business day of the maintenance period, although it was also expected to allow financial institutions to increase flexibility and autonomy in terms of their fund management.

Financial institutions eligible to make use of these standing facilities are those required to hold reserves. The use of Liquidity Adjustment Loans by financial institutions whose financial soundness is weak may be restricted so that they do not become a tool for the support of troubled financial institutions. Liquidity Adjustment Loans and Deposits carry overnight maturities. But if the Monetary Policy Committee recognizes that it is necessary for smooth working of the financial markets, tenor for Liquidity Adjustment Loans may be extended by up to one month. The interest rate for Liquidity Adjustment Loans is 1% point higher than the Base Rate of the Bank of Korea, and should the Base Rate be below 1%, the rate becomes twice the Base Rate. Meanwhile, the rate for Liquidity Adjustment Deposits is 1% point lower than the Base Rate, and should the Base

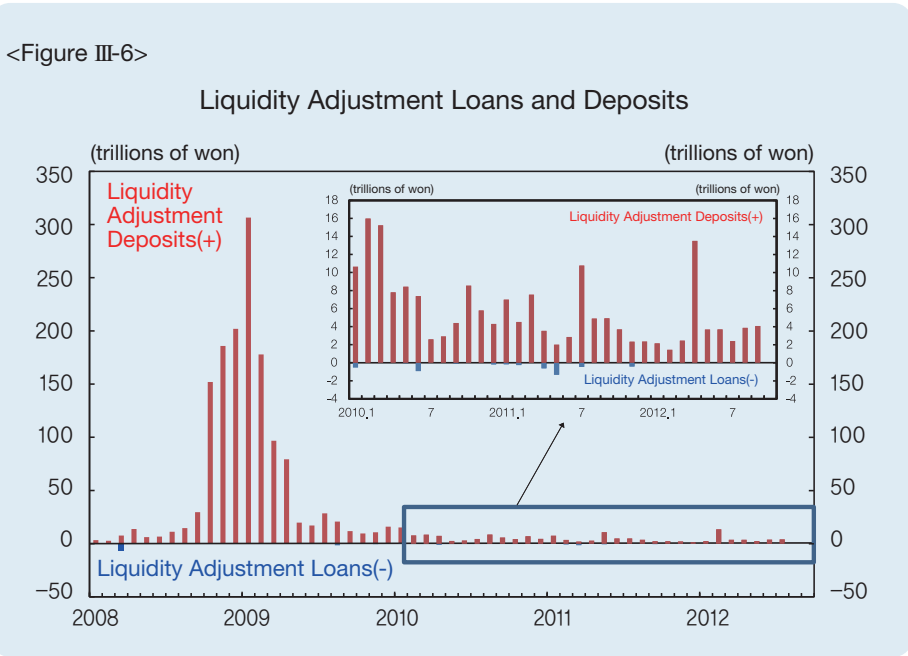
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<sup>40)</sup> Before the system was reformed, a rate of Base Rate  $\pm 0.5\%$ p had been applied on the last business day of the reserve maintenance period.

Rate be below 1%, the lower limit becomes 0%.

The performance of Liquidity Adjustment Loans suggests that banks do not routinely access this facility even when faced with temporary fund shortages and, when it is used on intermittent occasions, this is due to their predictions as to their funding conditions going temporarily awry. This is probably because, when banks experience temporary fund shortages, it is more advantageous for them to borrow money from the call market at a low interest rate than to use the Liquidity Adjustment Loans, which impose a rate 1% point higher than the Base Rate, and also because those banks that do so risk a stigma effect from a reputation for being unable to raise funds in the financial market.

In the case of Liquidity Adjustment Deposits, it has been observed that more banks have come to prefer depositing surplus funds in the facility since credit risk intensified in the wake of global financial crisis. The crisis led to an increased volume of the Liquidity Adjustment Deposits, which exceeded 300 trillion won during March 2009 before decreasing again when the crisis subsided.



### *Intraday Overdrafts*

Intraday Overdrafts were introduced in September 2000 to extend financial support to banks experiencing transient shortages of settlement funds in the course of a day. They thus serve to stimulate fund transactions between financial institutions and, as a result, between corporations using those institutions. Their adoption came about because of the increasing incidence of payment settlement being temporarily delayed, a situation that frequently occurs as the scale of settlement between financial institutions increases.

The Bank of Korea provides automatic real-time support in the form of Intraday Overdrafts within the amount of the collateral, when

the payment or settlement funds required during the day exceeds the balance of the current deposits held with the Bank of Korea by individual financial institutions. During the initial adoption stage in 2000, the Bank set the ceiling on Intraday Overdrafts at the equivalent of a bank's average current deposit balance, but raised the ceiling in July 2001 to double the previous amount before abolishing it entirely in September 2006. Subsequently, however, the Bank resolved to levy interest to deter financial institutions from excessive reliance on them. As a result, the Bank collects interest each business day by applying an interest rate on loans in excess of 25% of a financial institution's equity capital equivalent to the spread between the three-year Treasury bond yield and the call rate. This interest rate is changed each quarter, and calculated based on the average spread between the three-year Treasury bond yield and the call rate during the last month of the immediately preceding quarter.

The eligible collateral for the loans includes Treasury bonds, government-guaranteed bonds, Monetary Stabilization Bonds, bills acquired by financial institutions through loans, and other credit securities (limited to those that have a remaining maturity of less than one year from the date of acquisition by the Bank of Korea), and the institutions entitled to use Intraday Overdrafts are limited to financial institutions that must deposit reserves with the Bank of Korea and have joined New BOK-Wire (BOK-Wire+). If banks fail to redeem their borrowings by the close of the business day, the Bank of Korea converts Intraday Overdrafts to Liquidity Adjustment Loans. Financial institutions whose use of Liquidity Adjustment Loans is

restricted may also be limited in their access to Intraday Overdrafts. As of November 2012, the daily average balance of Intraday Overdrafts stood at 2.02 trillion won.

&lt;Table III-10&gt;

## Utilization of Intraday Overdrafts

(daily average balance, billions of won)

	Dec. 2006	Dec. 2007	Dec. 2008	Dec. 2009	Dec. 2010	Dec. 2011	Nov. 2012
Nationwide commercial banks	404.8	232.9	404.2	952.3	607.7	550.8	676.3
Local banks	1.2	1.5	1.8	2.9	0	2.8	0.3
Specialized banks	190.2	119.2	191.6	576.6	493.6	708	706.3
Branches of foreign banks	73	152.7	226	459.2	568.3	482.3	637.2
Total	669.2	506.3	823.6	1,991	1,669.6	1,743.9	2,020.1

**Special Loans**

Special loans are those that the Bank of Korea extends as the lender of last resort in order to secure financial market stability, after obtaining special approval from the Monetary Policy Committee. The Bank of Korea provided a total of 10.8 trillion won in special loans during the latter half of 1997 when the financial market was

extremely unstable. These loans, extended to resolve financial institutions' liquidity shortages, differed from previous low-interest rate special loans to make up for balance sheet losses in that they were provided at market interest rates.<sup>41)</sup>

Viewing these special loans in detail, the Bank of Korea provided 1 trillion won in September 1997 to Korea First Bank, which was suffering a shortage of liquidity. The interest rate was 8% per annum, the level of the average cost of funds for commercial banks.<sup>42)</sup> In October 1997, the Bank also extended, through their creditor banks, a total of 1 trillion won at 8% per annum to 16 merchant banks whose credits to corporations under the Bankruptcy-Prevention Accord exceeded 50% of their equity capital. In December of that year, the financial markets faced a crisis, including the lackluster state of fund transactions through the call market following the suspension of business by 14 merchant banks and securities companies. The Bank of Korea provided 6.8 trillion won to banks at a rate one percent lower than the overnight call rate, and then 1.1 trillion won to

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41) The Bank of Korea extended a total of 1.7 trillion won at 3% per annum during 1985~1987, in the process of industrial rationalization relating to the overseas construction and the shipping industry. This was to boost these sectors, which had weakened following the Second Oil Crisis and the slowdown of construction business in the Middle East. Meanwhile, the Bank provided 250 billion won in March 1987 to agricultural, livestock and fishing cooperatives at 3% per annum, so that they could extend long-term loans to low-income farming and fishing households at very low rates. In August 1992, the Bank of Korea also extended a total of 2.9 trillion won at 3% per annum to investment trust companies (ITCs) that were experiencing financial difficulties.

42) Although the loan fell due in September 1998, the Bank of Korea re-extended it at the overnight call rate, taking the view that Korea First Bank, which faced the prospect of disposal to a foreign buyer, was experiencing shortages of liquidity.

securities companies and 0.9 trillion won to merchant banks at the overnight call rate through the Korea Securities Finance Corporation and the Korea Non-Bank Deposit Insurance Corporation, respectively. Once the financial market had largely begun to regain stability from the latter half of 1998, however, the Bank of Korea progressively called in these loans.

Meanwhile, in order to prepare against the possibility of banks' shortages of settlement funds due to the Y2K problem, the Bank of Korea put in place a Y2K Special Lending Facility for the six months from November 1999 to April 2000. However, since the much-feared Y2K problem passed without major incident, no special loans were extended under this facility. Additionally, in accordance with the government's 'Credit Recovery Support Program for Those Unable to Meet the Financial Expenses for Their Financial Livelihood', a special loan was extended through Korea Development Bank to the Korean Asset Management Corporation (KAMCO) to support the restructuring of debts of those receiving basic public livelihood support. The amount of the loan was 446.2 billion won and it carried an interest rate of 2% per annum with the outstanding balance being repaid at the end of 2006.

In response to the global financial crisis, the Bank of Korea subscribed 3,299.6 billion won to the Bank Recapitalization Fund in March 2009<sup>43)</sup> through the Korea Development Bank, in order to

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43) The Bank Recapitalization Fund raised funds from the Bank of Korea and Korea Development Bank to support bank recapitalization by purchasing banks' subordinated debt and hybrid bonds.

facilitate an expansion of credit supply and a smooth business restructuring process by recapitalizing banks. The subscription to the Bank Recapitalization Fund was repeated in three tranches over the period between 2010 and 2012, and the balance outstanding was 493.6 billion won as of November 2012 after 2,803 billion won had been collected since the initial funding.

With regard to special loans, the amendment of the Bank of Korea Act in 2011 eased the requirements for emergency credit. This move has granted more leeway to the Bank of Korea to provide special loans for financial stability. Along with easing requirements for emergency credit the amended Bank of Korea Act extended the scope of eligible collateral so that the Bank can perform its role as the lender of last resort in a preemptive and flexible manner should any emergency situation occur that might jeopardize financial stability. In addition, the Bank of Korea may now extend credit to for-profit enterprises even when severe impediments arise to obtaining funds, as the amended Act eased the strict requirements on specific conditions such as at times of serious monetary contraction.



&lt;Table III-11&gt;

**Amendments of the Bank of Korea Act in 2011,  
related to Special Loans**

	Before amendment	After amendment
Easing requirements for emergency credit	May handle emergency credit in the event of grave emergency situations that directly threaten the stability of currency and banks	May conduct emergency credit operations with financial institutions whose liquidity conditions have deteriorated due to imbalances between fund raising and use of funds
Easing requirements for credit to for-profit enterprises	May extend credit to for-profit enterprises at times of severe monetary contraction when financial institutions are calling in existing loans and restricting new loans	May grant credit to any for-profit enterprise when severe impediments arise to obtaining funds from financial institutions including a severe contraction of credit or when there is a strong likelihood of their arising

### III. Implementation of Monetary Policy

<Table III-12>

#### Loans of the Bank of Korea (since 1994)

(billions of won)

Loan type	End of 1994	End of 1997	End of 2000	End of 2005	End of 2010	End of 2011	End of Nov. 2012
Aggregate Credit Ceiling Loans	8,832.1	4,266.4	7,360.1	9,371.7	7,936.2	7,399.6	7,188.9
(New) Liquidity Adjustment Loans	-	-	-	-	-	-	-
Loans to the Bank Recapitalization Fund	-	-	-	-	2,793.6	493.6	493.6
Agriculture, fisheries and livestock funds	467.7	115.5	-	-	-	-	-
Balance management loans <sup>1)</sup>	2,855.4	496.0	25.8	-	-	-	-
Funds to stabilize management of investment trust companies	1,300.0	-	-	-	-	-	-
Special loan to Korea First Bank	-	1,000.0	-	-	-	-	-
Special loans to merchant banks	-	1,000.0	-	-	-	-	-
Funds for financial market stabilization measures	-	5,938.9	-	-	-	-	-
Liquidity Adjustment Loans	-	-	270.0	-	-	-	-
Total	13,455.2	12,816.8	7,655.9	9,371.7	10,729.8	7,893.2	7,682.5

Note: 1) This refers to previous general loans, the new issuance of which was terminated at the time the rediscount system was reformed in March 1994. (being collected at maturity with the outstanding balance of existing loans remaining under management).

## **3. Monetary Policy Communication**

Monetary policy communication refers to a series of activities whereby central banks communicate with markets and economic agents such as households, enterprises, government and so on. The content of such communication is not limited to conveying information related to monetary policy, but also spans all the various feedback processes encompassing the market perception of the business cycle, responses of economic agents to monetary policy, and the sharing of information and opinions with the government.

The strategy for monetary policy communication involves, in broad terms, a process of deciding the combination of subjects, times and principal agents to be employed in communication with the aim of achieving monetary policy objectives. The accumulated research findings have given rise to a tacit consensus as to many aspects of the optimal central bank communication strategy, but no generally applied principles have yet emerged. So central banks around the world draw up and implement the communication strategy best suited to their particular circumstances.

Upon the extensive revision of the Bank of Korea Act at the end of 1997, the Bank of Korea switched its method of monetary policy operation from a money supply orientation to an interest rate

orientation. With this shift in focus, building up trust with the financial markets and managing the expectations of economic agents started to take on an added importance as tasks to be handled by the Bank of Korea in striving for its policy goals. From the normative aspect, it is required that the Bank of Korea clearly demonstrate its accountability in keeping with the authority bestowed upon it so that its conduct of policy carries democratic legitimacy. In line with this, the Bank of Korea is making considerable efforts to heighten transparency through communication so that economic agents gain a better understanding of how monetary policy is devised and conducted.

## **Announcement of Targets of Monetary Policy and Policy Decision**

Having adopted inflation targeting as a framework for the operation of its monetary policy, the Bank of Korea consults with the government<sup>44)</sup> every three years to set and announce a medium-term inflation target.<sup>45)</sup> In addition, the Bank produces a comprehensive

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<sup>44)</sup> Under Article 6 of the Bank of Korea Act (Establishment of Operational Direction of Monetary and Credit Policy) (1) the Bank of Korea shall, in consultation with the Government, set an inflation target.

<sup>45)</sup> The inflation target for the period from 2013 to 2015 was set at 2.5-3.5% in terms of consumer price inflation (year-on-year) (resolution of the Monetary Policy Committee on October 11, 2012). The narrowing of the target range compared to that for the period from 2010 to 2012 (3% ± 1%p) represents a step by the Bank of Korea to enhance the accountability and transparency of monetary policy, along with more frequent public explanation of the state of the operation of the inflation target (once a year → twice a year).

report on the inflation twice a year, explaining inflation trends and the inflation environment and outlook.

Monthly monetary policies enacted by the Monetary Policy Committee in pursuit of monetary policy objectives are also subject to public scrutiny and transparent disclosure. To begin with, the Monetary Policy Committee is in charge of deliberation and resolution on monthly directions of monetary policy and announces the monetary policy direction immediately, while the governor offers a detailed explanation about the policy decision and its background at a press conference. Every decision on the movement of the policy rate including maintaining (or freezing) it at the previous level as well as of course changing it is subject to this procedure. This is because a lack of change in policy (inaction) is also an important policy decision activity whose meaning needs to be clarified. And minutes detailing the debate by members of the Monetary Policy Committee during the monetary policy-making process are released on the website of the Bank of Korea on the first Tuesday (in the case of holidays, the next business day) falling after two weeks have passed from the date of the meeting.<sup>46)</sup>

Meanwhile, the Bank of Korea is making continuous efforts to

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<sup>46)</sup> Until March 2005, minutes had been made public by publication in the Monthly Bulletin for the month after two months had passed following the date of the Monetary Policy Committee meeting. Starting from April of that year, the interval between the date of meeting and the release time of minutes was greatly shortened from about 3.5 months to six weeks. The further curtailment of the interval before the release of the minutes starting from the meeting in September 2012 meeting seeks to narrow the information gap between the Bank of Korea and markets.

enhance the policy signaling effect of the ‘Statement of Monetary Policy Direction.’ While the statement was originally confined to a description largely focused on explanation in regard to economic developments, its content was improved starting from July 2007 by adding an assessment of overall economic conditions and, if necessary, a judgment on the underlying policy stance. In a further addition, risk factors related to the domestic economy were included in statements issued from November of that year. Moreover, in 2008, the price outlook began to be incorporated in the statement from July and the future monetary policy stance was presented from October. Such comprehensiveness in the descriptive content of the statement is motivated by the need for the Bank of Korea to communicate more closely with economic agents so as to heighten the predictability and transparency of monetary policy, and avoid herd behavior on the part of economic agents. Similarly, in 2010, came the addition of the outlook for the domestic economy including prices (January), and of an assessment of the state of the world economy (April). Besides this augmentation of the statement’s content, since October 2010, in a bid to further enhance transparency and the signaling effect of monetary policy the statement has been followed by an announcement as to whether members of the Monetary Policy Committee reached a unanimous decision on the policy rate.

&lt;Table III-13&gt;

## Changes in the Statement of Monetary Policy Direction

June 2007	December 2012
<p data-bbox="238 720 559 859">□ In the real economy, while exports continue to show steady growth, facilities and construction investment maintain robust paces of increase, and private consumption appears to be recovering.</p> <p data-bbox="257 870 559 986">Meanwhile, the current account has recorded a deficit recently owing mainly to the narrowed goods account surplus and the repatriation of dividends.</p> <p data-bbox="238 998 559 1091">□ Consumer price inflation and core inflation both remain stable. The upward pace of real estate prices has slowed down significantly.</p> <p data-bbox="238 1245 559 1361">□ In the financial markets, overall liquidity conditions are favorable and financial institutions' lending has increased sharply, led by loans to small and medium-sized enterprises.</p>	<p data-bbox="588 472 1097 709">□ Based on currently available information, the Committee considers the moderate economic recovery in the US to have continued, but the sluggishness of economic activities in the euro area to have persisted. Economic indicators in emerging market countries have shown signs of gradual improvement. The Committee expects the global economy to exhibit a modest recovery going forward but judges the downside risks to growth to be large, owing chiefly to the euro area fiscal crisis and to the fiscal consolidation issue in the US.</p> <p data-bbox="588 720 1097 956">□ In Korea, the Committee appraises economic growth to have remained at a weak level, with exports improving but the sluggishness in domestic demand continuing. On the employment front, the number of persons employed has shown a trend of increase above its average pre-global financial crisis level, led by the higher age groups. Going forward, the Committee anticipates that the negative output gap in the domestic economy will persist for a considerable time, due mostly to the prolongation of the euro area fiscal crisis and to the delay in recovery of world economic growth.</p> <p data-bbox="588 998 1097 1234">□ Consumer price inflation fell to 1.6% in November, from 2.1% the previous month, a result mainly of declines in agricultural and petroleum product prices, and core inflation excluding the prices of agricultural and petroleum products continued to run at a low level at 1.3%. The Committee forecasts that inflation will remain low for the time being, owing primarily to the easing of demand-side pressures. As for housing prices, those in Seoul and its surrounding areas continued their downtrend and those in the rest of the country their uptrend.</p> <p data-bbox="588 1245 1097 1384">□ In the financial markets, stock prices and long-term market interest rates rose, due mostly to international financial market stability and improvements in economic indicators in major countries, and the Korean won appreciated against the US dollar owing chiefly to the continued surplus in the current account.</p> <p data-bbox="588 1395 1097 1560">□ Looking ahead, the Committee will closely monitor external risk factors and the consequent changes in financial and economic conditions at home and abroad, and conduct monetary policy so as to stabilize consumer price inflation at the inflation target over a medium-term horizon while continuing its efforts to lower inflation expectations and ensuring that the growth potential is not eroded.</p>

## Direct Communication with the Public and the National Assembly

The Bank of Korea Act stipulates that the Bank of Korea shall prepare and submit to the National Assembly both a report on the implementation of its monetary and credit policies and a report on macro-financial stability conditions at least twice every year.<sup>47)</sup>

This requirement arises in fulfilling the duty of accountability to the public under the authority bestowed upon it as the central bank responsible for price stability and for giving its attention to financial stability. As a statutory report, the Monetary Policy Report explicitly states whether the inflation target has been achieved and the underlying rationale for this, along with specific details of monetary policy implementation and performance, and the future policy directions. The Financial Stability Report,<sup>48)</sup> also now a statutory report, provides an assessment of the stability of the Korean financial

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47) Under Article 96 of the Bank of Korea Act (Reports to National Assembly)

- (1) The Bank of Korea shall prepare a report on the execution situations of monetary and credit policies and evaluation of conditions of macro-financial stability at least twice every year and submit it to the National Assembly.
- (2) The Governor shall attend and reply when the National Assembly or any its committees requests him to attend in connection with a report submitted pursuant to paragraph (1).

48) The Financial Stability Report had been published previously as a voluntary report. As the revision of the Bank of Korea Act in September 2011 (enforcement in December) imposed the duty of paying attention to financial stability on the Bank of Korea, the Report has been submitted to the National Assembly as a statutory report starting from April 2012.



system and the direction of the Bank of Korea's policy for financial stability. Both of these two statutory reports are currently published twice a year. With regard to the publication of these reports, the Governor of the Bank of Korea upon request from the National Assembly attends its competent standing committees to provide testimony about the operational directions of monetary policy and the economic outlook.

Additionally, the Bank of Korea Act requires the publication of an annual report describing the business status of the Bank of Korea, its monetary policy, and the government's foreign exchange policy.<sup>49)</sup> Besides these statutory reports, the Bank of Korea issues detailed business reports such as *Annual Report on the Payment and Settlement System* (annual) and *Bank of Korea Inflation Report*<sup>50)</sup> (semi-annual; January and July), and provides a diverse range of information and analysis on the financial and economic conditions at home and abroad through quarterly (January, April, July and

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<sup>49)</sup> Under Article 102 of the Bank of Korea Act (Publication of Annual Report)

(1) The Bank of Korea shall within three months after the end of every fiscal year submit to the Government and publish its annual report, outlining its business status and government foreign exchange policy during the fiscal year and analyzing the country's financial and economic conditions during that fiscal year.

(2) The annual report referred to in paragraph (1) shall be approved by a decision by the Monetary Policy Committee.

<sup>50)</sup> Inflation Report was previously distributed in the form of an annual press release, but has been published as a booklet twice a year from 2012. The Bank of Korea Inflation Report contains analysis and assessments of the inflationary situation, an examination of inflation conditions, the presentation of its outlook for inflation and risk factors, and an analysis of price stability issues.

October) publications such as *Economic Outlook*<sup>51)</sup> and *Economic Analysis*, as well as *Monthly Bulletin* (monthly) and *Global Economics Focus* (weekly). It constantly endeavors to expand both the types of such reports and the scope of information made public.

Meanwhile, besides the Bank of Korea's communication efforts through the announcement of the policy decision and the publication of reports, the Governor and other members of the Monetary Policy Committee as well as senior executive level staff of the Bank of Korea go to a great deal of effort to apprise the public of current monetary policy issues and the future policy direction by actively engaging in a range of activities including public addresses, lectures, interviews, and academic conferences. In addition, with a view to widening the understanding of experts in diverse fields and major market participants, a number of monthly meetings presided over by the Governor are held.

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51) The Bank of Korea increased the frequency of release of its economic outlook from three times a year (April, July, December) to four times a year starting from October 2012. Also the release date, which used to be the day following the policy setting meeting, has been moved forward to be the same day as this meeting.

## 4. Transmission of Monetary Policy

The Bank of Korea's monetary policy affects the real economy, including consumption, investment, production and prices, through various transmission channels, such as the interest rate channel, the asset price channel, the exchange rate channel, the expectations channel, and the credit channel. Among these channels the interest rate and expectations channels are gaining increasing importance, mainly because the central bank has focused on inflation targeting and interest rates in its monetary policy operation. In addition, Korea's monetary policy transmission lags are analyzed to be similar to those of the U.S. and other major countries. According to research on monetary policy implemented during the 1980s and the 1990s, the transmission of monetary policy to real production activity becomes evident no later than two quarters out and reaches its strongest effect four to six quarters out. The transmission of monetary policy to inflation, meanwhile, starts to take effect from the third quarter out and reaches its strongest effect eight to nine quarters out.<sup>52)</sup> Empirical research for the period of 1999~2008 also shows that the effects of monetary policy on real production reach their peak three to six

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<sup>52)</sup> Kim, Hyun Euy, "The Lag in the Effect of Monetary Policy," *Monthly Bulletin*, Bank of Korea, Jan. 2000.

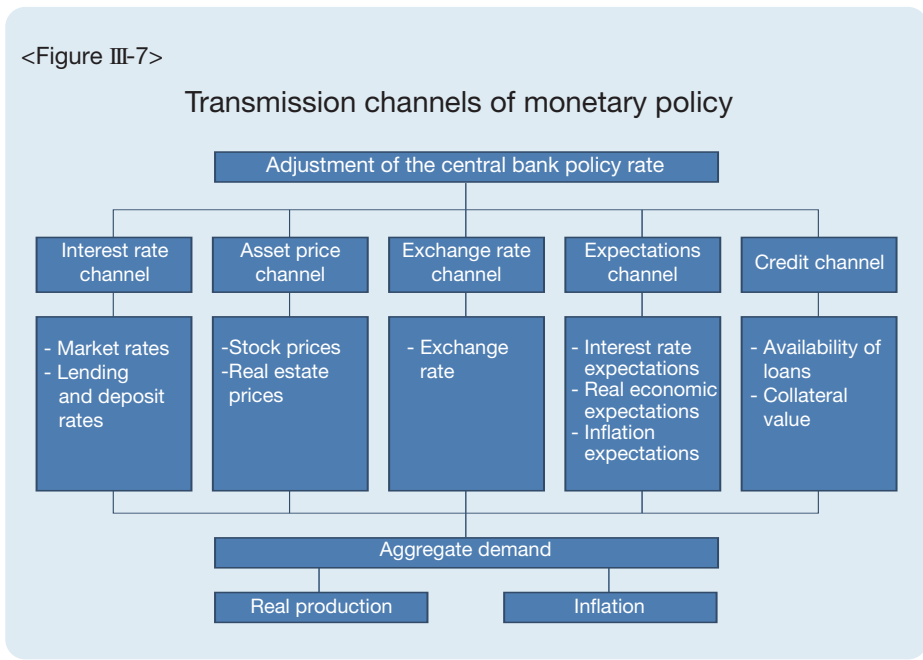
quarters later.<sup>53)</sup> However, there is a possibility that monetary policy transmission lags have shortened as economic agents have become more sensitive to monetary policy, affected chiefly by a system of monetary policy operation focusing on interest rates with inflation targeting having been put in place.

Meanwhile, the influence of monetary policy on the real economy can be asymmetric depending upon the direction of monetary policy (tightening or easing), economic phase (contraction or expansion), etc. A comparison of the effects of monetary tightening and easing in Korea finds that the production reduction effect of monetary tightening is greater than that of monetary easing. Furthermore, in terms of economic phase, monetary policy is seen to be more effective during an economic contraction phase than during an economic expansion phase, regardless of the direction of policy rate adjustment.<sup>54)</sup> In major countries, meanwhile, policy rate adjustment at times of liquidity shortage in the financial markets is seen to have a greater impact on the real economy than policy rate adjustment at times of ample liquidity. Korea's monetary policy transmission channels are more closely examined below, centering around empirical analyses.

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<sup>53)</sup> Kim, Hyun Euy and Sang Min Aum, "The Role of Money and Banking in Monetary Policy: Does It Matter Quantitatively for the Korean Economy?," *Economic Analysis*, No. 17-1, Bank of Korea, Mar. 2011.

<sup>54)</sup> Kim, Ki Hwa, "Asymmetric Effects of Monetary Policy over the Business Cycle Phases," *KYONG JE HAK YON GU*, No. 58-1, The Korean Economic Association, 2010.



## (1) Transmission Channels of Monetary Policy

### Interest rate channel

An adjustment of the Base Rate affects interest rates in the financial markets as a whole, including short-term and long-term interest rates, and deposit and lending rates. For example, if the Bank of Korea raises its Base Rate, short-term interest rates such as the overnight call rate rise immediately, deposit and lending rates show an underlying upward tendency, and long-term interest rates come under upward pressures. Such movements of various interest rates affect

aggregate demand in the form of both consumption and investment. For instance, a hike in interest rates leads to a curb on borrowings, an increase in savings, rises in interest remuneration on deposits and on loans, and ultimately a decline in household consumption. This also applies to businesses. *Ceteris paribus*, an increase in interest rates raises financial expenses and accordingly reduces investment.

Given that monetary policy affects the real economy through the system of financial institutions and financial markets, the effectiveness of monetary policy transmission channels is dependent upon the changes in the financial environment represented by financial regulation and financial innovation.

The very real progress made in the full-scale deregulation of interest rates during the 1990s allowed Korea to satisfy all the basic preconditions for the operation of the interest rate channel, as the price function of interest rates showed substantial improvement. In addition, the Bank of Korea's utilization of the call rate as its operation target from 1998 substantially raised economic agents' interest rate sensitivity. As is the case with advanced countries, these environmental changes indicate the increasing transmission effect of monetary policy through the interest rate channel in Korea. Moreover, it seems that the enormous broadening and deepening of short- and long-term financial markets has enhanced the interconnectedness of individual markets by way of interest rates, and established a mechanism for incorporating market expectations and responses into interest rates.

Studies on the interest rate channel report the seamless working of

the channel running from ‘the policy rate of the Bank of Korea → money market interest rates → interest rates of banks.’<sup>55)</sup> Analysis of the effect of raising the policy rate after 2000<sup>56)</sup> on market rates and bank rates reveals that the transmission rate to the 91-day CD stood at 91% (based on the period from July 2010 to June 2011, the same hereafter) and the rate to 1-year financial debentures marked 42%, while the transmission rates to banks’ deposit and lending interest rates exhibited 63% and 43%, respectively.

The transmission ratio of the channel running from the policy rate to long-term market rates is shown to be significantly smaller. This is due to the fact that unlike money market interest rates directly affected by the policy rate, long-term market rates are strongly influenced by diverse factors such as the economic situation at home and abroad, conditions in the financial market, and supply and demand of bonds. In particular, the increasing foreign investment in bonds amid the gradually decreasing uncertainty in the financial market after 2010 has sharply driven down long-term rates with a rapid reduction in the term premium, which appears to be underlie the flattening of the yield curve.<sup>57)</sup>

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<sup>55)</sup> Bank of Korea, Monetary Policy Report (September 2011)

<sup>56)</sup> Since 2000 to date, there have been two major periods of policy rate increases in Korea. The first extended from October 2005 to August 2006, and the second from July 2010 to June 2011. During both of these periods, the policy rate was raised on five occasions, 0.25%p at each step for a total rise of 1.25%p.

<sup>57)</sup> Kim, Jun-tae, Du-kyung Kim and Il-dong Jung, “Analysis of Factors Affecting the Changes in the Term Structure of Interest Rates,” *Bank of Korea Economic Brief*, No. 2011-2, Bank of Korea, 2011.

<Table III-14>

Policy rate pass-through into short- and long-term market rates<sup>1)</sup> and bank rates<sup>2)</sup>

(%, %p)

		Oct. 2005 ~ Aug. 2006				July 2010 ~ June 2011			
		Sep.'05 (A)	Sep.'06 (B)	Change (B-A)	pass- through <sup>3)</sup>	June'10 (C)	July'11 (D)	Change (D-C)	pass- through <sup>3)</sup>
Policy rate <sup>4)</sup>		3.25	4.50	1.25		2.00	3.25	1.25	
Short-term	91-day CDs	3.70	4.64	0.94	75.2	2.45	3.59	1.14	91.2
	1-year financial debentures	4.27	4.72	0.45	36.0	3.31	3.83	0.52	41.6
At banks	Deposit rates	3.80	4.57	0.77	61.6	3.00	3.79	0.79	63.2
	(Time deposits)	3.70	4.56	0.86	68.8	3.00	3.79	0.79	63.2
	Lending rates	5.61	6.13	0.52	41.6	5.32	5.86	0.54	43.2
	(Household lending)	5.50	5.90	0.40	32.0	5.15	5.46	0.31	24.8
	(Corporate lending)	5.67	6.21	0.54	43.2	5.40	5.98	0.58	46.4
Long-term	3-year Treasury bonds	4.52	4.69	0.17	13.6	3.75	3.77	0.02	1.6
	5-year Treasury bonds	4.81	4.76	-0.05	-0.04	4.41	3.98	-0.43	-34.4

Notes: 1) Based on the monthly average. 2) Newly-handled amount basis.

3)  $(\text{Changes in market rates and deposit rates} / \text{Changes in the Base Rate}) \times 100$

4) Based on the end of the quarter, call rate target before March 2008, and the Bank of Korea Base Rate thereafter.

Sources: Bank of Korea, Korea Financial Investment Association

## Asset price channel

A change in the Base Rate also influences prices of assets including stocks, bonds and real estate. For instance, if the Base Rate rises, the present value of future profits to be gained through assets such as



stocks, bonds and real estate declines, and asset prices accordingly go down. This leads to a decrease in households' assets, or wealth, serving as a factor in bringing down household consumption (wealth effect). In addition, if the Base Rate goes down, the market value of a company rises relatively more than the replacement cost of real capital due to the increase in the stock prices. This leads to an increase in investment of the company (Tobin's  $q$ ).

A substantial body of research has shown that asset prices such as stock prices and housing prices are by and large immune to the influence of Bank of Korea policy rate adjustments.<sup>58)</sup> This seems attributable to the growing influence of external variables, as the foreign share of stock market capitalization has risen,<sup>59)</sup> and to the constraints on funding availability imposed by government measures to stabilize housing prices including the regulation of the loan to value (LTV) ratio of mortgage loans.<sup>60)</sup>

In contrast, changes in asset prices have an influence on the real economy to some extent through the wealth effect.<sup>61)</sup> Examining the

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58) Son, Jongchil, "Dynamic Analysis of Correlations among Monetary Policy, Real and Financial Variables and Housing Prices," *KYONG JE HAK YON GU*, No. 58-2, The Korean Economic Association, 2010.

Lee, Keunyeong, "The Effects of Monetary Policy on Financial Asset Prices: The Case of Korea," *Applied Economics*, No. 9-1, Korean Association of Applied Economics, 2007.

59) The foreign share of Korean stock market capitalization increased from 14.6% at the end of 1997 to 32.9% at the end of 2011.

60) The introduction of a loan to value (LTV) ratio for mortgage loans was made in September 2002 and that of a debt-to-income (DTI) ratio in August 2005.

61) As the facilities investment of Korean companies have been mostly funded internally rather than by issuing stocks since the Asian currency crisis, it is unlikely that the channel of Tobin's  $q$  will operate properly.

wealth effect indicates a greater impact of changes in real estate prices than in stock prices.<sup>62)</sup> This may largely arise from Korean households' tendency to hold assets preponderantly in the form of real estate<sup>63)</sup> and the disparity between the ownership structure of houses and stocks.

Meanwhile, some studies have produced the results of empirical analysis suggesting that the effectiveness of the asset price transmission channel through real estate may come under constraint when the scale of household debts is very large.<sup>64)</sup> To put it more concretely, with respect to housing assets the higher the ratio of debt to assets, the less the elasticity of consumption. This indicates a strong possibility that households with a relatively larger ratio of debts to assets will set aside the increased wealth from higher asset prices for debt redemption rather than directly making use of it for consumption.

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62) Kim, Young-il, "Asset Prices and Consumption Dynamics in Korea," *Policy Research Series*, No. 2009-08, Korea Development Institute, Dec. 2009.

Kang, Huidon, "Fluctuations in Real Estate Prices and Monetary Policy Countermeasures," *Monthly Bulletin*, Bank of Korea, July 2006.

Choi, Yo-chul and Eunyoung Kim "Analysis of the Effect of Changes in Households," *Monthly Bulletin*, Bank of Korea, Oct. 2007.

63) Real estate assets account for 73.6% of the total assets owned by households in Korea, exponentially higher than stocks (2.2%). (2011 Household Finances Survey)

64) Lee, Hangyong "Changes in House Prices and the Wealth Effect," *Finance and Economics Working Papers*, No. 181, Bank of Korea, July 2004.

## Exchange rate channel

A change in the Base Rate affects the foreign exchange rate as well. For instance, if the Base Rate rises in Korea while rates in other countries remain unchanged, returns on Korean won-denominated assets will increase relatively, which will attract foreign capital. As the number of persons hoping to purchase Korean won-denominated assets grows, the won will appreciate. Its appreciation will bring down prices of imported goods and services and demand for them will accordingly grow. This will in turn push up prices of export goods denominated in foreign currency, which will lead to a decline in overseas demand for Korean goods and services.

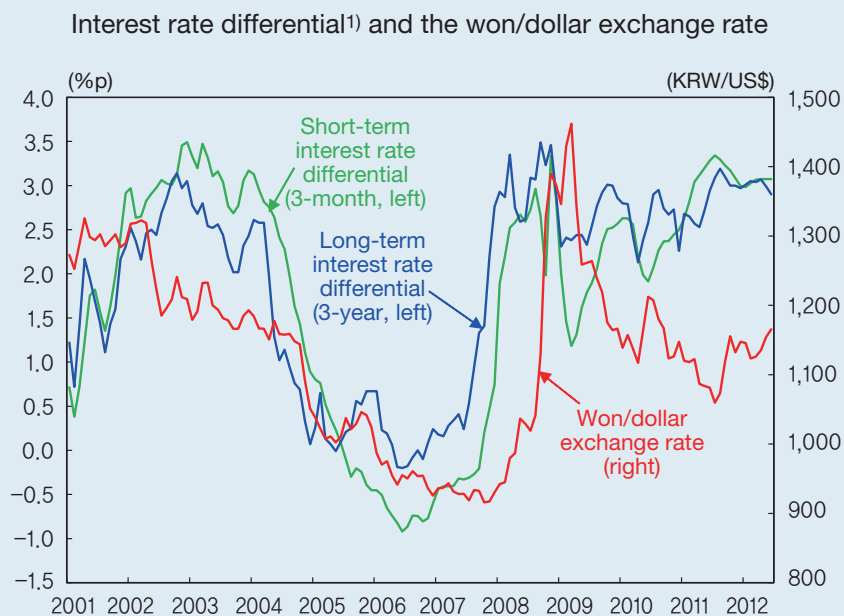
For the effect of monetary policy to be transmitted to the real economy through changes in exchange rates first calls for the exchange rate to respond to a significant degree to changes in domestic interest rates, and, moreover, for that response to be in a consistent direction. In Korea, however, the exchange rate does not show a significant response to changes in the differential between domestic and international interest rates, and there are frequent cases in which the direction of the change fails to match theoretical predictions.<sup>65)</sup>

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<sup>65)</sup> Park, Chanho and Aleum Kim, "An Analysis of the Relation between the Korea-U.S. Policy Rate Gap, and the KRW/USD Exchange Rate," *Monthly Bulletin*, Bank of Korea, Feb. 2008.

Kim, Geun-Young, "Expectations regarding Exchange Rate Dynamics and the Effectiveness of Monetary Policy," *Finance and Economics Working Papers*, No. 436, Bank of Korea, Oct. 2010.

<Figure III-8>



Note: 1) For the short term, the spread between secondary market yields on CDs and 3-month LIBOR, and for the long term, between yields on 3-year Treasury bonds of Korea and the U.S.

Much of this pattern is attributable to the composition of inflows and outflows of foreign currency funds to and from Korea, much of which normally takes the form of portfolio investment funds targeting stocks and bonds, and of foreign currency borrowings and loans. The response to changes in interest rates therefore tends to run in opposite directions depending on the type of funds concerned. That is, if the interest rate spread widens due to a rise in domestic interest rates, the expected increase in investment yields tends to attract more money for investment in bonds and inflows of foreign

currency borrowings, but the fear of a slowdown in the economy following higher interest rates is likely to reduce the inflow of stock investment funds or even reverse their trend to an outflow. Therefore, net inflows and outflows of foreign funds in response to the change in domestic interest rates are supposed to move in the direction decided by the relative strength of these two effects.

For Korea, it is estimated that there are repeated instances of the exchange rate rising when the interest rate spreads widens, contrary to the prediction of theory, by virtue of the fact that stock investment funds are relatively larger than other funds.<sup>66)</sup>

On the other hand, a change in the exchange rate affects the real economy quite markedly due to the high degree of export dependence. As regards how a change in the exchange rate affects the current account, a rise of the exchange rate appears to improve both the goods account and the services account. However, for the trade balance, the analysis indicates the growing importance of non-price factors amid intensifying global competition, which will gradually weaken the effect of the changes in the exchange rate on exports and imports. Meanwhile, floating exchange rates have direct and indirect effects on consumer prices through changes in import prices. The recent run-up in international commodity prices has led to a greater share of commodity imports, which show a higher pass-

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<sup>66)</sup> Based on International Investment Position (IIP), foreign investment in Korea saw a continuing rise in the share of equity securities, peaking at 48.6% in 2005. Even though the proportion has fallen somewhat in the wake of the 2008 global financial crisis, it still hovers at a high level of over 30%.

through of the exchange rate to import prices, leading to a stronger effect of the exchange rate on prices than previously.<sup>67)</sup> Recent studies reveal that exchange rate pass-through to import prices has become close to unity since the 2000s, meaning an almost direct incorporation of exchange rate changes into domestic prices.

## Expectations channel

An adjustment of the Base Rate leads to a change in inflation expectations, consequently affecting prices. For example, an increase in the Base Rate is interpreted as showing the Bank of Korea's resolve to reduce price inflation, which brings inflation expectations down. This consequently influences firms' setting of their product prices and wages, as a result pulling real price inflation down.

The expectations channel has become more important as the expectations of economic agents have come to have a broad-spectrum effect embracing not just the real economy but also the financial markets, thanks to the active communication between the monetary authorities and market participants along with the development of the financial markets. Other factors behind the higher

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67) Yun, Seonghun and Guijeong Kim, "The Effects of Exchange Rate on the Trade Balance under the Incomplete Pass-through of the Exchange Rate," *Finance and Economics Working Papers*, No. 351, Bank of Korea, Nov. 2008.

Kim, Yongbok and Beobjun Gwak, "The Effects of Changes in the Exchange Rate on the Real Economy," *Finance and Economics Working Papers*, No. 378, Bank of Korea, Apr. 2009.

Choi, Youngil and Jaerim Choi, "Impact of Exchange-Rate Fluctuations on Trade in Goods and Services," *Monthly Bulletin*, Bank of Korea, Sep. 2009.

role of expectations in the financial and the real markets include the growing interest of economic agents in whether the monetary policy stance will change, along with the introduction of inflation targeting and interest rate-oriented monetary policy.

According to a research using a Dynamic Stochastic General Equilibrium (DSGE) model, expectation shocks with regard to a change in the Bank of Korea's policy rate are found to affect the price variables such as wage and stock prices as well as real economic variables, prior to the fulfillment of expectations.<sup>68)</sup> Such analysis indicates the need for the monetary authority, in deciding a policy direction, to devote efforts for the efficient conduct of monetary policy by taking account of the process whereby expectations of economic agents are formed, realized or ended.

## **Credit channel**

An adjustment of the Base Rate also influences banks' lending behavior (bank lending channel). For example, if there is a Base Rate hike, banks may become even more prudent than before in lending, concerned about the redemption capacity of borrowers. This dampens both investment by businesses raising funds through bank loans and credit-based consumption by households.

Changes in interest rate also affect the net worth of households and

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<sup>68)</sup> Kang, Huidon and Joongshik Lee, "Analysis of the Impacts of Changes in Expectations of Economic Agents on Domestic Economy and Monetary Policy," *Monthly Bulletin*, Bank of Korea, July 2008.

firms (balance sheet channel). For example, an increase in interest rates will lower the net worth of firms, leading to a lower collateral value and thus a reduction of the ability to borrow.

Although both the bank lending and balance sheet credit channels remain in operation, their effectiveness appears to have diminished as companies have become less dependent on bank loans and their financial health has been improved since 1998.

The bank lending channel is working, but its transmission effects are not estimated as being very large. Especially after the Asian currency crisis, transmission through the bank lending channel is found to have a smaller effect than before.<sup>69)</sup> This appears to have been caused by the reduced role of banks as financing channels for firms compared to the past. After the currency crisis, banks and companies embarked on the expansion of revenue through issuing finance debentures or corporate bonds, becoming less dependent on deposits or loans. Conversely, the balance sheet channel is found to be in effective operation.<sup>70)</sup> However, given the current corporate management stance of emphasizing the soundness of company finances, the channel may have less influence than before.

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<sup>69)</sup> Kim, Junhan and Myungsoo Yie, "Corporate Finance and Lending Channel," *Journal of Money & Finance*, Korea Institute of Finance, Sep. 2009.

<sup>70)</sup> Shin, Hyunul, "The Influence of Monetary Policy on Facilities Investment through the Credit Channel," *Monthly Bulletin*, Bank of Korea, Feb. 2010.



## **IV. Conduct of Monetary Policy**



# IV

## Conduct of Monetary Policy

### 1. Post-Currency Crisis~2004

In the immediate aftermath of the 1997 currency crisis, the Bank of Korea, acting under its agreement with the IMF, raised the interest rate applied in its open market operations as high as 35% per annum so as to stabilize the exchange rate. The exchange rate having stabilized, there was then thought to be scope for action to ward off an overly deep business downturn.<sup>1)</sup> In 1998, during the course of the contraction in business activity after the currency crisis, a credit crunch emerged as banks cut back their lending. Thus, the Bank of Korea sought to bring about conditions conducive to the early relief of the credit crunch by lowering interest rates and providing inducements for banks to expand their lending. In addition, it was

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1) At that time, the direction of monetary policy was largely subordinated to foreign exchange market trends. Because the focus was placed, above all, on exchange rate stability under the IMF program, it would have been difficult to ease the high interest rate policy unless the exchange rate had stabilized.

thought desirable to make active use of the credit guarantee system to disperse banks' credit risk burden. In this aspect, the government played a leading role.

The measures taken by the Bank of Korea and the government to ease the credit crunch gradually began to bear fruit, with bank lending shifting to an upward trend from February 1999 onwards. At the same time, many indicators of real economic activity including industrial output, consumption, and exports began to exhibit a clearly marked upward trend. Nevertheless, the Bank of Korea continued to maintain its stance of favoring the downward adjustment of interest rates for some time, considering that a somewhat longer period of observation was needed in order to judge whether the trend of recovery in business activity would prove to be sustainable. Reflecting the central bank's stance, the overnight call rate, which had fluctuated at around the level of 6% per annum at the beginning of the year, had fallen to a little below the level of 5% by mid-April.

In May, the Monetary Policy Committee decided not to lower its target for the call rate any further as the domestic economy appeared to be sustaining its recovery trend and there was concern about the generation of external imbalances. In addition, in July, the financial markets were thrown into turmoil with long-term interest rates on the rise due mainly to the Daewoo Group restructuring problem and the large scale redemptions of the beneficiary certificates of investment trust companies. Consequently, so that financial market instability did not detract from the pace of real economic recovery, the Bank of Korea and the government cooperated to keep the call

rate stable and inject sufficient liquidity in line with market conditions, while making efforts to address financial market disruptions by establishing a Bond Market Stabilization Fund<sup>2)</sup> to make up for a shortfall of demand in the bond market and by implementing a partial repurchase system<sup>3)</sup> in order to curb the run on investment finance companies' bond-type beneficiary certificates.

Influenced by such policy efforts, long-term interest rates seemed to have regained stability, but then rose sharply again as more people expected that inflation would go up in future due mainly to the continuation of the economic recovery and cost-push price hikes with factors causing financial market instability not completely resolved. A sharp rise in long-term interest rates in a situation in which the BOK's target for call rate was maintained at 4.75% per annum led to the widening of the gap between long- and short-term interest rates. Since a widening of the gap could act to limit the smooth implementation of monetary policy, the narrowing of the gap became an important objective of monetary policy.

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2) This fund whose ceiling was 30 trillion won, was operated from September 1999 until March 2000 in order to deal with a sharp rise in market interest rates following the Daewoo crisis. And in actual fact, around 25 trillion won was raised. Mainly banks and insurance companies subscribed to the Fund which was used mostly for purchasing sovereign debt securities, Monetary Stabilization Bonds and prime corporate bonds.

3) Repurchases were allowed for beneficiary certificates excluding Daewoo Group bonds. However, this was an emergency measure whereby 50% repurchase of the book value of Daewoo bonds was guaranteed if an application for repayment was made within 90 days, 80% repurchase was guaranteed if the application was made within 180 days, and 95% repurchase for the application was made after 180 days had passed.

If the call rate target were raised in consideration of economic conditions amid financial market instability, however, there was a possibility that market rates could climb excessively, and so it was necessary to raise the target at a time when financial market instability had become minimal. Hence, the Bank of Korea decided to increase the call rate target by 0.25%p to 5% per annum on February 10, 2000, after determining the financial market instability related to Daewoo Group bonds to be manageable.<sup>4)</sup>

In 2000, with the trend of an increase in economic activity seen in 1999 continuing, consumer prices bolted from their previous stable trend and rose sharply from June onwards. Against this backdrop, the Bank of Korea adjusted its call rate target upward by 0.25%p from 5.0% to 5.25% per annum on October 5 in order to respond preemptively to the inflationary pressure. Meanwhile, the financial markets, which had stabilized on the resolution of the Daewoo bond repurchase problem, started to show instability again from May onwards since some large corporations faced a liquidity crunch. Against this backdrop, the government and the Bank of Korea on June 19, 2000 announced a measure to facilitate friction-free business financial conditions with a focus on expanding demand for corporate bonds. In addition, the Bank of Korea created an environment conducive to ensuring financial market stability by maintaining flexibility in the injections of liquidity.

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<sup>4)</sup> This was the first hike in the rate since it had started to be used as an operational target in 1998.

Monetary policy conditions changed rapidly from early 2001. First, as the US economy, which had been experiencing a prolonged economic boom, started to show clear signs of slowdown and remained subdued from the latter half of 2000, the US Federal Reserve lowered the target for the federal funds rate in six steps by a total of 2.75%p in the first half of 2001. Major central banks around the world also started to lower their policy rates in line with the US Fed's reduction of its rate in a bid to curb the economic decline. The Bank of Korea, similarly, decided to cut its call rate target by 0.25%p in February 2001 amid signs of an economic slowdown materializing. However, conscious of upward price movements, it did not carry out any further downward adjustment until June.

From the beginning of the latter half of 2001, US economic growth remained virtually stagnant, in consequence of which the possibility of a global recession gradually loomed larger. To add to this, the ramifications of the events of September 11 and the ensuing outbreak of war against Afghanistan further depressed economic activity, dashing hopes of an early recovery for the global economy. In the aftermath, while the US Fed continued to lower interest rates, other major central banks around the world greatly expanded their supply of liquidity and cut interest rates in order to avert turmoil in financial markets and simultaneously provide the impetus for a recovery of business activity.

In July and August 2001, the Bank of Korea undertook interest rate reductions in two successive months, bringing the call rate target down by 50 basis points in all. In response to the events of September

11, which increased the prospect of a protracted downturn in business activity, the call rate target was brought down by a further half a percentage point later that month to stand at 4% per annum. In an additional move designed to ease the shock of these events, the interest rate on Aggregate Credit Ceiling Loans was lowered by half a percentage point to 2.5% per annum and the total size of the facility was increased by 2 trillion won. This was done in order to encourage banks' corporate lending and help lighten the burden of companies' financial expenses. The reasons why the Bank of Korea was better placed to ease its monetary policy boldly from July 2001 were that, although prices had risen sharply in the first half of the year, their upward trend was anticipated to flatten out moving into the latter half, with demand-pull pressures virtually absent amid the business downturn and few factors making for an increase in international oil prices or charges for public services.

From the early part of 2002, the Korean economy showed a clearly-marked recovery trend. In this process, prices showed signs of moving upward rapidly because demand-pull pressures had increased greatly and international oil prices were surging. Besides this, as real estate prices rose at a fast pace with household loans expanding by a large margin, concerns arose that this might lead to a rise in inflation expectations among the general public. Accordingly, the Bank of Korea adjusted the policy rate upward by a quarter of a percentage point from 4.0% to 4.25% per annum in May in order to deal preemptively with the various types of imbalances apt to arise in the course of a business recovery.



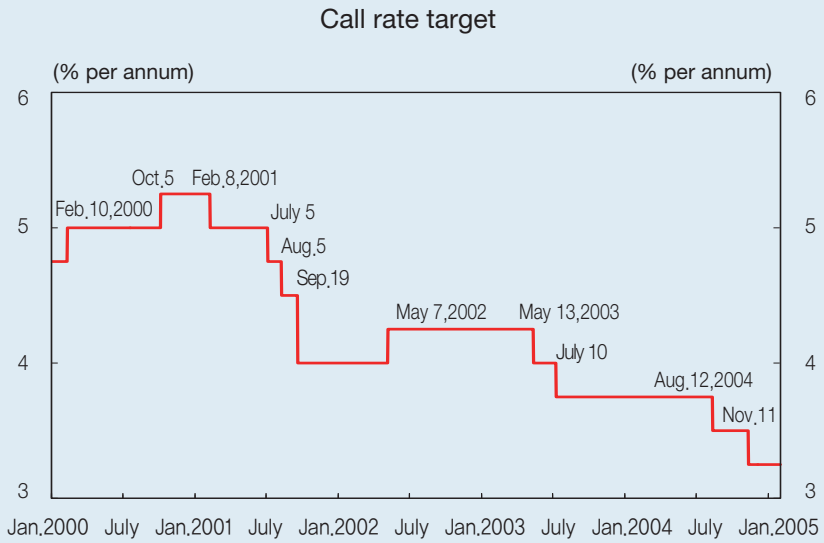
The call rate target had been kept on hold at 4.25% per annum for a year from May 2002 onwards, but the Bank of Korea started to lower it from May 2003, undertaking further reductions in July that year and again in August and November 2004, bringing it down in a four-step process to its then lowest-ever level of 3.25%. The reason for this continued accommodative monetary policy stance by the Bank of Korea was that the real economy showed signs of falling into a protracted depression due to extremely lackluster domestic demand including both private consumption and facilities investment,<sup>5)</sup> having begun to show a downward trend from early 2003. Stable prices helped the Bank of Korea's monetary easing on several occasions to tackle subdued domestic demand in 2003~2004. Core inflation remained stable at around 3%, the midpoint of its target range (3% ± 1%p in 2003 and 2.5~3.5% in 2004~2006), running at 3.1% in 2003 and 2.9% in 2004. This stability was ascribable to the slackening of demand pressures amid the protracted downturn of domestic demand and to the stabilization of import prices thanks to the sharp appreciation of the Korean won, which offset the effects of the sharp run-up in the international oil price.

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5) Private consumption registered negative growth for six straight quarters from the second quarter of 2003 until the third quarter of 2004, while facilities investment was similarly depressed for four quarters in a row from the second quarter of 2003 until the first quarter of 2004 (year-on-year basis). This was the first time that private consumption had been in negative territory since 1980, apart from just after the foreign currency crisis. Moreover, it was very exceptional for both private consumption and facilities investment to contract for several quarters in succession.

IV. Conduct of Monetary Policy

<Figure IV-1>

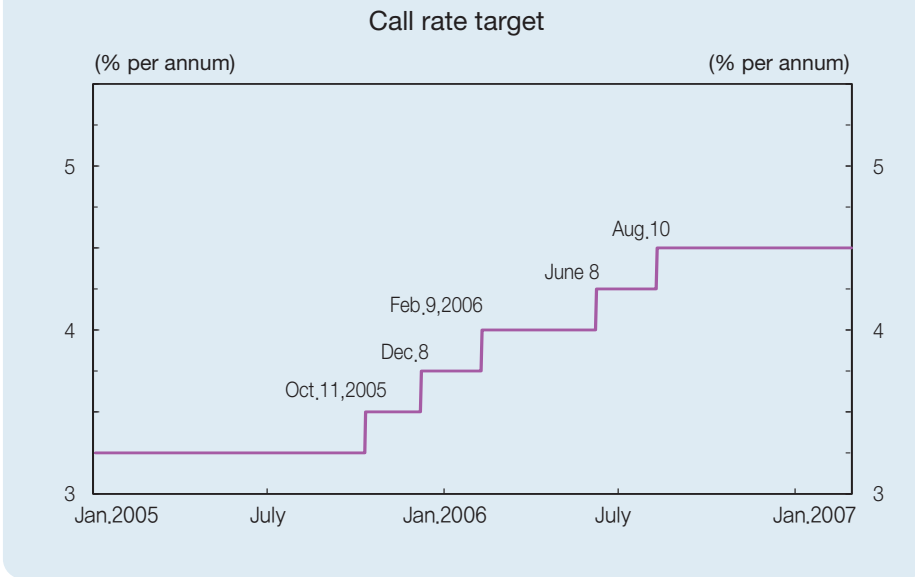


## **2. 2005~Prior to Global Financial Crisis**

### **2005~2006 : Gradual Reversal of Accommodative Stance amid Economic Recovery**

From the latter half of 2005, the Bank of Korea shifted its policy stance toward gradually reducing the degree of monetary accommodativeness in response to the improving trend of the real economy, while paying careful attention to price stability. Consequently, the Bank of Korea raised the call rate target by a quarter of a percentage point each time in a series of five steps, between October 2005 and August 2006, bringing it up from 3.25% to 4.5% per annum.

<Figure IV-2>



The gradual increase in the call rate target by the Bank of Korea was based on its judgment that as the upswing in domestic business activity had continued since the second quarter of 2005, backed by robust exports and the recovery of domestic demand, it was desirable to gradually resolve the side effects arising from a protracted period of low interest rates, including the heightened upward pressure on asset prices and the concentration of financial institutions' funds at the short-term end of the market, as well as to cope preemptively with the upward pressure on prices anticipated in the course of the future business recovery.

As for domestic business activity, the GDP growth rate was bolstered by continuous double-digit growth in exports and a steady

recovery of domestic demand including private consumption and facilities investment. The GDP growth rate rose from 2.7% in the first quarter of 2005 to 3.3% in the second quarter, and then accelerated further to 5.3% in the fourth quarter. The upswing continued even in 2006 and in particular, despite changes in the economic environment such as a sharp rise in international oil prices and a North Korean missile test, the domestic economy maintained a moderate upward pace owing to buoyant exports and the consistent steady growth of domestic demand.

Meanwhile, it was true that the low interest rate stance up to that point had formed the basis for the economic recovery by reducing the burden of economic agents' financial expenses. A number of malign side effects, though, had arisen from the maintenance of low interest rates for a considerable length of time. Among other things, it had led to the phenomenon of a herd-like rush of market funds to gain even a slightly higher profit. This was particularly prominent in the housing market. Although the government implemented real estate market stabilization measures on several occasions, the phenomenon was one of the reasons why the sharp run-up in real estate prices was never fundamentally solved. In addition, the short-termism of market funds, in which market funds concentrate on short-maturity products, became more pronounced as funds needed to be kept quasi-liquid for rapid shifts in quest of high-yields. Where fund-raising was short-term, the operation of those funds also had to be kept short-term to avoid a mismatch of maturities, which brought in its train the accompanying problem of difficulty in securing the stable and long-

term supply of funds to financial institutions. Accordingly, there was a growing need to gradually lessen the degree of the accommodative policy stance to eliminate the effects arising from a low interest rate policy as the recovery trend of the real economy became more evident.

The pace of the upward trend of lending by financial institutions decelerated from June 2006 onwards as a result of the Bank of Korea's rise in its call rate target. The government's various real estate market stabilization packages also began to bite, easing the upward movement of housing prices from June onwards. In addition, short-termism in the deposit structure of major financial institutions also saw improvement, with the share of short-term deposits with a maturity of less than six months declining from 52.6% in August 2005 to 50.3% in August 2006.

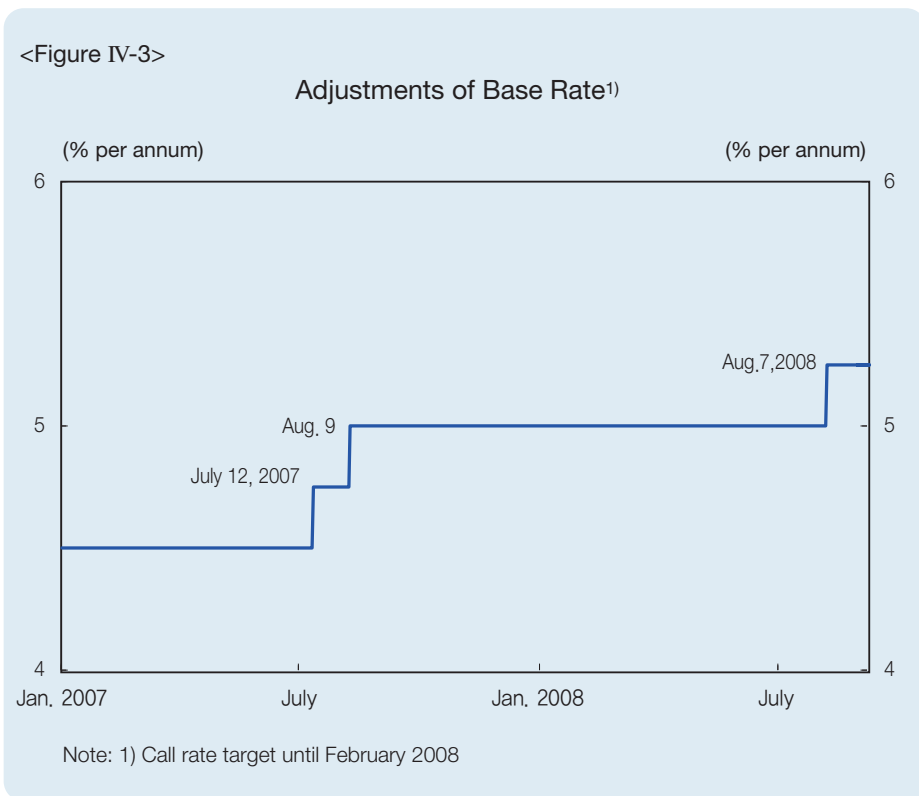
With domestic economic activity maintaining a modest upturn, however, expectations of real estate price increases had spread, driven by the hikes in leasehold deposit fees and apartment sales prices from September, and apartment prices in Seoul and the surrounding metropolitan areas rose steeply. Therefore, the Bank of Korea decided to hold the call rate target at 4.5% per annum from September 2006, judging it necessary to observe economic developments at home and abroad given the increased level of uncertainty. The Bank also took into account the possibility that the heightening of geopolitical risks including those from the North Korean rocket launch and armed conflict in the Middle East could dampen economic agents' sentiment.

Meanwhile, despite the series of increases in the call rate target, there was a rapid acceleration in the growth of monetary aggregates led by a surge in private credit. This rapidly swelling market liquidity resulted from a sharp expansion in the demand for loans owing to heated competition among financial institutions to expand their loan books and mounting anticipations of higher housing prices. It also reflected the greatly enlarged lending capacity of financial institutions through the inducement of overseas borrowings. The Bank of Korea adjusted the reserve requirement ratios for Korean won and foreign currency deposits in November and December 2006 in order to improve the effectiveness of interest rate policy by restraining the sharp increase in bank credit. The reserve requirement ratios were adjusted such way as to increase the average reserve requirement ratio, while expanding the difference between the reserve requirement ratios on long-term and on short-term deposits. As a result, the average reserve requirement ratio rose from 3.0% to 3.8% on Korean won deposits and from 3.6% to 4.8% on foreign currency deposits.

### **2007 ~ Prior to Global Financial Crisis (September 2008): Strengthening Foundation for Medium and Long-term Price Stability**

After maintaining its call rate target at 4.5% per annum from August 2006 onwards, the Bank of Korea adjusted the target upward in a series of three 25-basis point rises undertaken in July and August

2007 and August 2008, bringing it to 5.25% per annum. The Bank's tightening of monetary policy was intended to prevent the foundation of medium- and long-term price stability from being weakened by factors placing upward pressures on prices such as the possibility of demand pressures materializing amid the stronger upward trend of domestic business activity, swelling market liquidity, and the steep rise in the international prices of raw materials including crude oil.



From the beginning of 2007, the upward pace of the domestic economy gradually accelerated, bolstered by sustained strong exports



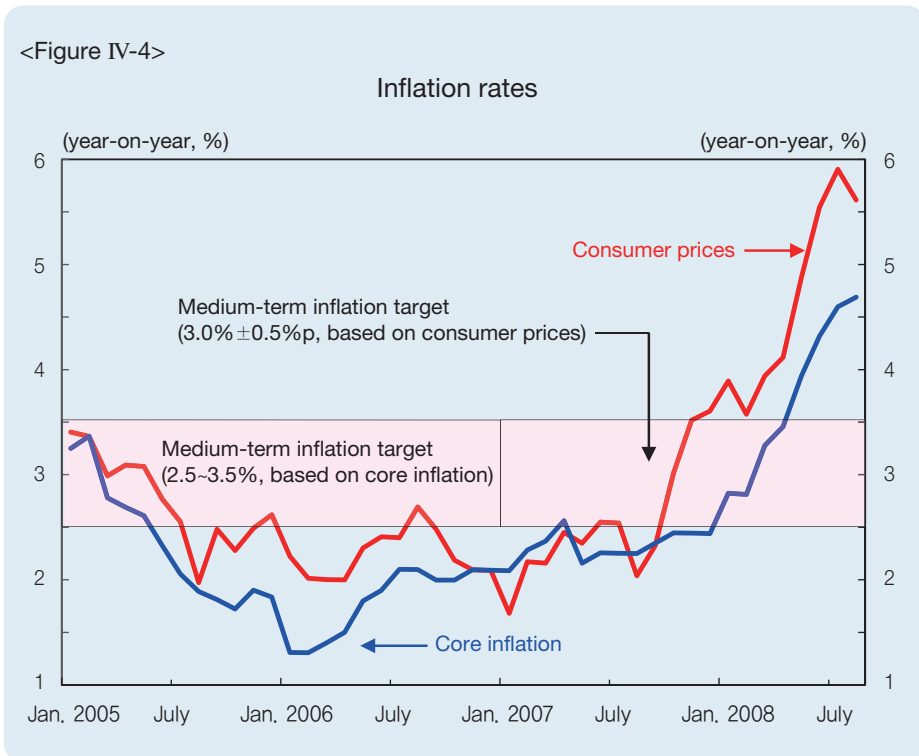
and a steady increase in domestic demand. GDP growth (year-on-year) rose significantly from 4.0% in the first quarter to 5.0~5.7% from the second to fourth quarters. Accordingly, the Bank of Korea judged that the upward pressure on prices from demand side factors would gradually grow from the latter half of 2007 onwards. From the beginning of 2008, though, the business upswing was weakened with domestic demand in the form of private consumption and facilities investment at a low ebb, offsetting the export buoyancy.

In the financial markets, household lending centering on credit-based lending grew rapidly from the latter half of 2007; and loans to small and medium-sized enterprises also increased on a large scale, influenced by banks' active cultivation of loan demand and the business upswing. Consequently, liquidity remained ample with monetary growth running at a persistently high level.

Meanwhile, the international oil price continued its steep upward trend until the first half of 2008, owing to a combination of several factors such as deepening concerns over unstable demand-supply conditions for crude oil arising from geopolitical risks, the expansion of demand led by emerging markets, the weakening of the US dollar, and increased speculative demand from the beginning of 2007. Consequently, the international oil price, which had remained below 50 US dollars (Brent crude basis) in mid-January 2007, subsequently climbed rapidly to near 150 US dollars per barrel in early July 2008.

Closely monitoring these changes in financial and economic conditions and judging that upward pressure on prices would gradually build up from the latter half of 2007, the Bank of Korea

had raised the call rate target by a quarter of a percentage point in both July and August 2007, bringing it up to 5.0% per annum.<sup>6)</sup>



<sup>6)</sup> Meanwhile, from late July 2007, influenced by concerns over the credit crunch arising from US sub-prime mortgage defaults, the volatility of price variables such as market interest rates and stock prices increased greatly in financial markets in Korea and a number of countries around the world. Although concerns arose that the international financial market unrest would continue for a considerable period of time and drag down global economic growth, it was predicted that its effects on domestic economic activity would be limited. In addition, it was judged that there was a need to further consolidate the foundation for economic stability by raising the call rate target, so that the economy could adequately cope with the high degree of uncertainty shrouding the knock-on effects arising from external destabilizing factors.

And, in actual fact, prices did exhibit a steep upward trend from October 2007. Consumer price inflation, after registering an increase of 3.6% (year-on-year) in December 2007, continued running at a high level well above the upper bound of the medium-term inflation target range ( $3.0\% \pm 0.5\%p$ ).

Despite the constant upward trends of business activity and prices, the Bank of Korea maintained the call rate target (Base Rate of the Bank of Korea from March 2008) at 5.0% per annum from September 2007 to July 2008. This policy was conducted against the backdrop of mounting macroeconomic uncertainty from September 2007, such as the international financial market unrest triggered by sub-prime mortgage defaults and the sharp run up in the international oil price. From the beginning of 2008, the Bank of Korea paid close attention to the gradually more evident signs of a slowdown in business activity because of the instability of international financial markets and sluggish domestic demand, even as the upward trend of prices accelerated.

In August 2008, though, the Bank of Korea adjusted its policy rate upward to 5.25% per annum due to its concern that inflation expectations might be kindled as the rising trend of prices become further consolidated, with consumer price inflation having approached 6% in that June and July.

### **3. Post-Global Financial Crisis**

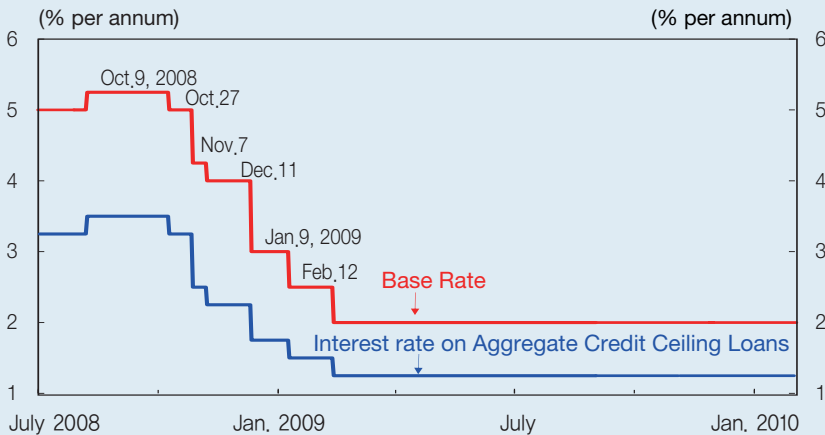
#### **September 2008~2009: Minimizing Negative Effects of the Crisis**

The Bank of Korea conducted monetary and credit policies with a focus on minimizing the negative effects on the domestic financial markets and the real economy arising from the global financial crisis and economic downturn, which spread out massively following Lehman Brothers' filing for bankruptcy protection in September 2008.

In accordance with this policy stance, the Bank of Korea lowered its Base Rate in six steps, from October 2008 to February 2009, resulting in a total cut of 3.25 percentage points. As a result, the Base Rate fell from 5.25% per annum to its lowest level of 2.0% per annum since May 1999 when the Bank had started to announce a policy rate target.

&lt;Figure IV-5&gt;

## Base Rate and interest rate on Aggregate Credit Ceiling Loans



In addition, to secure the stability of financial and foreign exchange markets, the Bank of Korea expanded the supply of Korean won and foreign currency liquidity by making use of open market operations and foreign currency loans. Above all, by its active use of open market operations, the Bank of Korea provided total liquidity of 18.5 trillion won<sup>7)</sup> between September 2008 and February 2009 to encourage the smooth flow of funds into long-term and short-term financial markets including the financial debenture and CP markets.

<sup>7)</sup> A total of 16.8 trillion won was supplied by means of long-term and unscheduled ad hoc RP purchases and 1.7 trillion won by means of the redemption of Monetary Stabilization Bonds prior to maturity and the outright purchase of Treasury bonds.

Furthermore, it widened the scope of the securities eligible for use in its open market operations<sup>8)</sup> and greatly increased the number of securities firm counterparts for its RP transactions. The Bank raised the Aggregate Credit Ceiling by a total of 3.5 trillion won, in October 2008 and March 2009, while lowering the interest rate on loans under it to 1.25% per annum. In November 2008, it supplied liquidity of 2.1 trillion won to financial institutions subscribing to the Bond Market Stabilization Fund. It also made a one-off interest payment of 500.2 billion won on reserve deposits to improve banks' capacity of credit supply by improving their BIS capital adequacy ratios in December 2008. Moreover, in March 2009, it provided 3.3 trillion won to the Bank Recapitalization Fund to increase banks' equity capital to facilitate the expansion of credit supply and the smooth implementation of corporate restructuring. For the stability of the foreign exchange market, the Bank provided foreign currency liquidity of 22.37 billion dollars (period-average basis) to financial institutions in the first quarter of 2009 by way of swap transactions and foreign currency loans using the proceeds of currency swaps with

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<sup>8)</sup> Financial debentures and some special bonds were included among the securities eligible for use in open market operations in order to induce the flow of funds into the market for securities carrying credit risks.

&lt;Table IV-1&gt;

Liquidity provision by the Bank of Korea after the collapse of Lehman Brothers  
(Sep. 2008 ~ Mar. 2009)

① Open market operations		<ul style="list-style-type: none"> <li>Expand of liquidity supply to financial market</li> <li>Diversify the liquidity provision channels and instruments</li> <li>Restore the interest rate mechanism 「lower the Base Rate → decrease short-term market interest rate like CDs → decrease long-term market interest rate like corporate bonds and banks' deposit and lending interest rate」</li> <li>Improve the conditions for issuance of credit securities, including corporate bonds and CPs</li> </ul>
① Purchase of long-term and nonregular RPs and reduction of regular RP sales(16.8trillion won)	Sep.18, 2008 3.5trillion won (decrease RP selling) Oct.24 2trillion won(28-day) Oct.31 1trillion won(91-day) Nov.11 1trillion won(63-day) Nov.21 2trillion won(28-day) Dec.16 2trillion won(91-day) Dec.19 2trillion won(28-day) Jan.13, 2009 1trillion won( 91-day) Jan.16 1.4trillion won(21-day) Feb. 6 0.9trillion won(14-day)	
② Outright purchase of Treasury bonds and Buy-back of MSBs (1.7trillion won)	Oct.23, 2008 Buy-back of MSBs, 0.7trillion won Nov.19 Outright purchase of Treasury bonds, 1trillion won	
③ Expansion of eligible securities and counterparts	Oct. 27, 2008 Included bank bonds and some special bonds Dec.23 Included bonds issued by Korea Housing Finance Corp. Dec.12 Added 12 securities companies	
② Lending facilities	Oct. 23, 2008 Expanded the total Aggregate Credit Ceiling (6.5trillion won → 9trillion won) Mar.23, 2009 Expanded the total Aggregate Credit Ceiling(9trillion won → 10trillion won) as of the end of Mar. 2009, provide 2.6trillion won	<ul style="list-style-type: none"> <li>Induce expansion of bank lending to SMEs</li> <li>Enlarge lending capacity by improving bank balance sheets and financial soundness</li> </ul>
③ Reserve requirements	Dec. 3, 2008 Paid interest on reserve deposits (0.5trillion won)	<ul style="list-style-type: none"> <li>Improve funds flow in direct financial markets, including those for corporate bonds and CPs</li> </ul>
④ Other supply	Nov.24, 2008 Announced the support for Bond Market Stabilization Fund(2.1trillion won) Mar.26, 2009 Announced the support for Bank Recapitalization Fund (3.3trillion won)	

Source : Annual Report, the Bank of Korea, 2008, 2009.

The rationale for its dramatic lowering of Base Rate within a short period and expansion of liquidity supply was its judgment that the Korean economy was vulnerable to extremely negative effects, given that the global financial crisis and the world economic recession had destabilized domestic financial and foreign exchange markets and sharply contracted the real economy, on top of the strong likelihood that a considerable amount of time would be needed before the global economy's recovery from its massive downturn.

Domestic business activities declined rapidly from the fourth quarter of 2008 as domestic demand in terms of consumption and investment shrank further and exports also fell sharply. Consequently, GDP growth (year-on-year) plunged from 3.1% in the third quarter of 2008 to -3.4% in the fourth quarter. The upward trend of prices flattened out remarkably from the latter half of 2008 as the effects of business activity weakness were added to those of the drop in the international prices of oil and other raw materials. The financial markets exhibited an unstable pattern of movements as shown by the massive outflow of foreign investment funds due to the international financial market turmoil, banks' conservative operation of their funds, and a severe credit crunch. Consequently, with stock prices falling sharply, the KOSPI index fell to as low as 939 in late October 2008. Looking at market interest rates, yields on credit securities carrying credit risks including corporate bonds and CP rose sharply and spread of yields of the credit securities over Treasury bonds widened greatly. Meanwhile, the Korean won/US dollar exchange rate soared from mid-September 2008, owing to the



outflow of foreign portfolio investment funds and worsening for foreign currency borrowings conditions stemming from the international financial market turmoil.

Immediately after the outbreak of the global financial crisis, the Bank of Korea implemented a bold and resolute monetary policy. The government, for its part, took active steps to counter the economic slowdown by drawing up a large-scale revised supplementary budget and the front-loading of its fiscal expenditures. Accordingly, from mid-March 2009, market interest rates maintained a stable trend, while stock prices rebounded and the Korean won/US dollar exchange rate showed downward stability. The real economy also evidenced a gradual improvement as exports recovered steadily and domestic demand revived, albeit at a modest pace.

Subsequently, despite continued improvement in the financial and economic situation, the Bank of Korea kept the Base Rate at its record low of 2.0% per annum in consideration of the high degree of uncertainty remaining over the economic environment at home and abroad. Above all, it was judged necessary to maintain the stance of financial easing to ensure that domestic business activity in the private sector recovered through its own dynamism, rather than from the effects of government policy. In addition, the Bank of Korea also took into consideration several factors such as concerns over the delayed economic recovery in major advanced countries, the unstable international financial markets and the sovereign debt crises in some countries in the euro zone.

However, while maintaining its stance of financial easing, the Bank

of Korea also continued its efforts to withdraw the liquidity that it had provided to cope with the financial crisis, in keeping with the recovery trends in the financial and foreign exchange market situation. As one element in this, the Bank started to ratchet down the Korean won liquidity supplied by purchasing long-term RPs. In August and December 2009, it also collected the entire amount of the foreign currency liquidity supplied through swap transactions and through foreign currency loans from the proceeds of its currency swap with the US Federal Reserve. In addition, the temporary measure under which risk-bearing securities including bank debentures and certain special bonds had been included among securities eligible for use in open market operations was terminated as scheduled on November 6, 2009. At the end of March 2010, 0.2 trillion won of the 3.3 trillion won provided to the Bank Recapitalization Fund at the end of March 2009 was also withdrawn.

### **2010~2011 : Gradual Lessening of Degree of Financial Easing**

During the first half of 2010, the Bank of Korea maintained the Base Rate at 2.0% per annum, the level to which it had been dramatically reduced in response to the financial crisis. This policy stance was adopted after taking it into due consideration that prices were showing generally stable movements, as the pressures on the demand side were not very great in spite of the continuous upward trend of domestic business activity, and the Korean won/US dollar

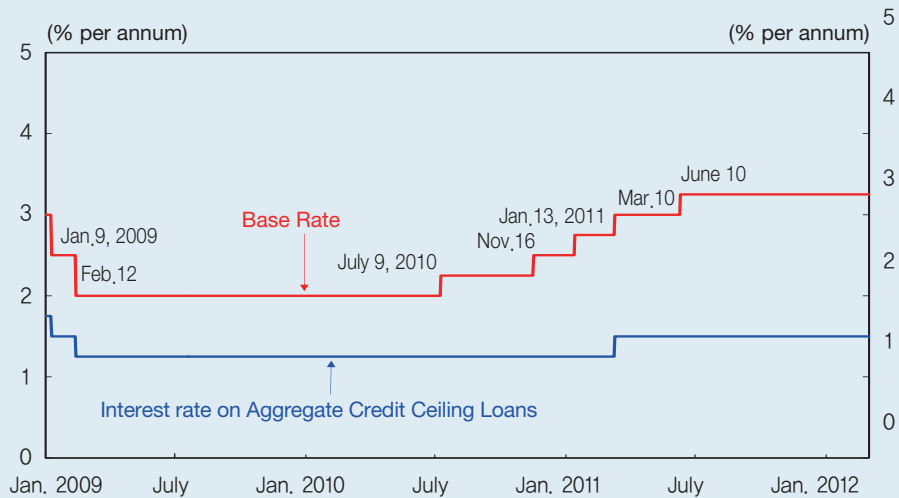
exchange rate had eased below its level of the previous year. In addition, it was also considered that the future economic prospects were highly uncertain owing to the inadequacy of the economic recovery in major advanced countries and the frequent reemergence of international financial market unrest.

From the latter half of 2010, however, in keeping with the increase in upward price pressures as the economy continued its upswing trend, the Bank of Korea conducted monetary policy in such a way as to gradually reduce the degree of financial easing and normalize interest rates.

In accordance with this policy stance, the Bank of Korea adjusted the Base Rate upward on five occasions, raising it by quarter of a percentage point steps in July and November 2010 and in January, March and June 2011, bringing it from 2.0% per annum to 3.25% per annum. However, despite the increase in the Base Rate, the interest rate on Aggregate Credit Ceiling Loans had been left unchanged at 1.25% to bring about favorable financial conditions for small and medium-sized enterprises and encourage banks to lend to them. Then, in March 2011, the interest rate on these loans was raised by a quarter of a percentage point to 1.50% per annum. The Bank, meanwhile, continued to strive to withdraw the liquidity provided in response to the global financial crisis.

<Figure IV-6>

Base Rate and interest rate on Aggregate Credit Ceiling Loans



<Table IV-2>

Supply of liquidity to counter the global financial crisis, and its withdrawal

Type		Scale	Withdrawal
Korean Won liquidity (trillions of won)	• Bank Recapitalization Fund	3.3(0.5) <sup>1)</sup>	Support still provided
	• Aggregate Credit Ceiling Loans	3.5(1.0) <sup>1)</sup>	
	• Bond Market Stabilization Fund	2.1(0.0) <sup>1)</sup>	Full amount withdrawn
	Sub-total	8.9(1.5) <sup>1)</sup>	-
	• Unscheduled ad hoc RP purchases	16.8	Full amount withdrawn
	• Other Korean won liquidity <sup>2)</sup>	2.3	One-off support
	Total	28.0	-
Foreign currency liquidity <sup>3)</sup> (billion dollars)		267.7	Full amount withdrawn

Notes: 1) Figures in parentheses are end-August 2011 basis.

2) Outright purchases of Treasury bonds, repurchases of MSBs prior to maturity, etc.

3) Foreign currency swaps, foreign currency loans.

The background to the gradual normalization of the Base Rate by the Bank of Korea was, first of all, that the world economy was maintaining its recovery trend led by emerging markets and that the upswing in domestic business activity continued, boosted by the consistent expansion of exports and the steady growth of domestic demand mainly driven by private consumption.

From the latter half of 2010 onwards until the latter half of 2011, prices continued on an upward trend as cost-side factors such as the sharp rise in prices of agricultural, livestock and marine products and an increase in international prices of raw materials were compounded by demand pressures driven by the economic upswing. Consumer price inflation (year-on-year) continued to exceed 3.0%, mid-point of the medium-term inflation target from September 2010 onwards and reached 4.7% in August 2011. Thereafter, it slowed down to some degree, but was still running at elevated rate of around 4% until the end of 2011.

During the latter half of 2011, the Base Rate was held at 3.25% per annum even despite continued high rate of increase in consumer prices. The rationale for keeping the Base Rate unchanged was that while the upward pressures on prices were expected to ease somewhat in 2012, the downside risks to growth and volatility of domestic financial and foreign exchange markets had been heightened by the sovereign debt problems in Europe, the economic slowdown in major countries and the international financial market unrest. In actual fact, during the latter half of 2011, growth slowed down with both exports and domestic demand declined, due to an

uncertain external environment as the negative impact on the real economic activity amid the continued deterioration of the European sovereign debt problems spread out to engulf even the emerging market countries, and the waning of economic agents' consumption and investor confidence. Real GDP growth fell from 3.6% in the third quarter to 3.3% in the fourth quarter.

Meanwhile, the Bank of Korea devoted multi-faceted efforts to minimize the influence of destabilizing factors in the financial and foreign exchange markets such as the expanded volatility of capital flow, the spread of the eurozone sovereign debt crisis, and uncertainties related to North Korea. As an initial step, the Bank strove to enhance the effectiveness of foreign exchange macro-prudential policy in concert with the government. It came up with a number of supplementary measures including lowering the ceilings on foreign exchange banks' FX-forward positions<sup>9)</sup> and restricting their investment in foreign currency-denominated bonds issued domestically for the purpose of Korean-won financing.<sup>10)</sup> At the same time, it adopted measures to facilitate the seamless implementation

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<sup>9)</sup> According to the joint foreign exchange probe of six banks carried out with the FSS from April to May 2011, foreign exchange forward long positions had increased and foreign currency-denominated bonds issued in Korea were being used as means of sidestepping the measures limiting the usage of foreign currency loans. To respond to these problems, the BOK reduced the ceiling on foreign exchange banks' foreign exchange forward positions by 20% from July 1, 2011, in consultation with the MOSF, the FSC and the FSS.

<sup>10)</sup> By revising the 「Detailed Working Rules on Dealing with Foreign Currency Transactions」, from July 25, 2011, the Bank of Korea restricted investment in foreign currency-denominated bonds issued in Korea for domestic use by financial institutions involved in foreign exchange business.

of the Macroprudential Stability Levy.<sup>11)</sup> Constantly monitoring Korean won and foreign currency liquidity conditions and the movements of price variables, the Bank promptly brought into operation a system of emergency responses arrangements such as the formation of the ‘Monetary and Financial Action Task Force,’ upon the emergence of factors making for market instability, including the downgrade of the US sovereign credit rating and the death of the North Korean leader. Moreover, to enhance the Bank’s capacity for responding to external shocks, the Bank arranged to enlarge the size of its currency swap lines with Japan and China.<sup>12)</sup>

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11) The Macroprudential Stability Levy was implemented from August 1, 2011 in order to reduce excessive foreign currency borrowings by banks. It involves the imposition of levies on foreign exchange banks’ balances of non-deposit foreign currency liabilities (total foreign currency liabilities - foreign currency deposits - tunnel accounts). The Bank of Korea overhauled the related regulations, for example, by revising the ‘Detailed Working Rules on Dealing with Foreign Currency Transactions’ and enacting ‘Procedures for Dealing with the Macroprudential Stability Levy’, and strove for their firm establishment by setting up a computerized system and holding meetings with financial institutions.

12) In October 2011, the Bank of Korea and the Bank of Japan agreed to expand the size of their existing \$13 billion bilateral currency swap to a total size of \$70 billion. The won/yen currency swap arrangement with the BOJ was increased from \$3 billion to \$30 billion, and in a joint effort with the government the Bank of Korea concluded a new US dollar/local currency swap deal worth \$30 billion with the Ministry of Finance of Japan and also agreed on extending the maturity of the countries’ existing CMI bilateral currency swap (\$10 billion). The BOK meanwhile also doubled the size of its won/yuan currency swap agreement with the PBC from the existing 180 billion yuan (38 trillion won) to 360 billion yuan (64 trillion won).

## **2012 : Reduction of Base Rate in View of Domestic Economic Slowdown and Financial Stability**

The Bank of Korea maintained the Base Rate at 3.25% per annum during the first half of 2012. Above all, even with the presence of the downside risks to growth generated by the sovereign debt crisis in Europe, it was forecast that the domestic economic growth rate would recover, albeit at a moderate rate, to the level of its long-term trend. Moreover, although consumer price inflation had fallen to a level of around the mid-2%, there were potential destabilizing factors such as high inflation expectations.

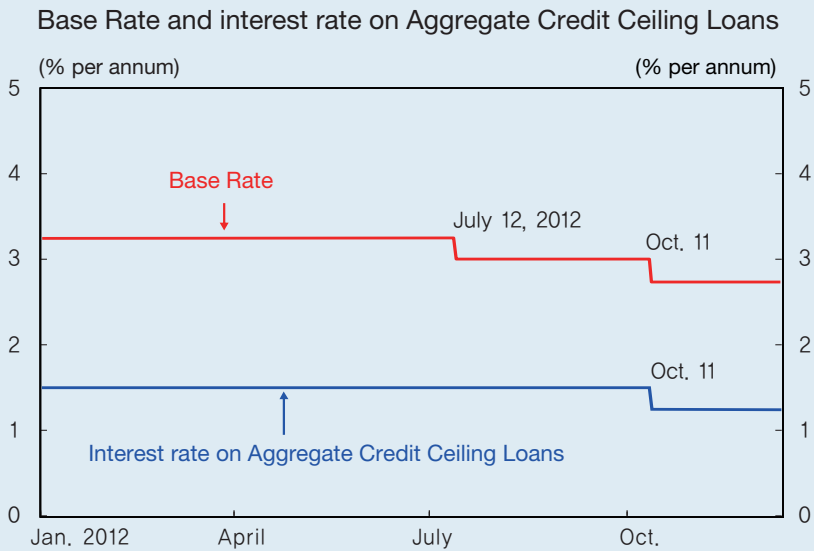
However, from July, as the domestic economy became more sluggish than had been initially anticipated, it was expected that the negative output gap would linger on for some time to come. On the other hand, consumer price inflation was expected to move below the mid-point of the inflation target for the time being. Accordingly, the Bank of Korea cut the Base Rate by a quarter of a percentage point in July and again in October, bringing it down to 2.75% per annum. Additionally, in October it lowered its interest rate on Aggregate Credit Ceiling Loans, which had remained unchanged since March 2011, from 1.5% to 1.25% per annum.

The benchmark rate cuts on two occasions led to sharp declines in market rates and bank lending and deposit rates. Corporate bond spreads also continued to narrow, albeit modestly, and bank lending kept increasing. The rate cuts were therefore deemed to have contributed to stopping financial conditions from worsening due



to economic recession in the second half of 2012. Meanwhile, the policy rate cuts were expected to affect, with some time lag, investment and growth in 2013 in earnest and to work toward relieving the debt servicing burden of highly indebted households.

<Figure IV-7>





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