Monetary Policy Report

(During the year 2003)

THE BANK OF KOREA

March 2004

This Monetary Policy Report is published in accordance with the provisions of Article 96 of the Bank of Korea Act, and with the resolution of the Monetary Policy Committee.

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Governor
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Monetary Policy Committee

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Member	Kim, Jong-Chang

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Ⅰ. Overview

1 The Bank of Korea set the inflation target for the year 2003, after consultation with the government, at 3±1% in terms of core inflation, the same as in the previous year. The medium-term inflation target was fixed as a range of 2.5~3.5%, in view of the medium-term trend of price increases in the Korean economy.

2 During the year under review, the Bank of Korea conducted monetary policy in such a way as to give support to a recovery of business activity while keeping a watchful eye on price stability.

During the first four months of the year, the call rate target was held at 4.25%, largely in consideration of the upward pressure on prices and the threat of a weakening of the current account position posed by the upswing in international oil prices, even though the economic growth rate slackened markedly in the wake of widespread uncertainties such as a possible war against Iraq.

Subsequently, while the outlook for prices and the current account improved as international oil prices shifted to a downward trend following the early conclusion of the war in Iraq, there were worries over an overly sharp contraction of economic activities in response to the negative influence of the spread of severe acute respiratory syndrome (SARS), the North Korean nuclear issue and the delayed recovery of the world economy. These were compounded by dulling of private consumption under the heavy burden of household-debt. The Bank of Korea acted on May 13 in response to these factors by lowering its policy rate target from 4.25% to 4%, following this up on July 10 with a further reduction to 3.75%, the lowest-ever level, and a downward adjustment of the interest rate applied on its Liquidity Adjustment Loans from 3.75% to 3.5%. Although there was rising concern over soaring housing prices, it was considered that the government's diverse anti-speculative measures would be more effective in restoring housing price stability.

From August onwards, the overseas environment improved markedly as the global economy, and notably the US economy, exhibited a rapid recovery. Meanwhile, the Korean economy continued to enjoy buoyant exports and construction investment despite the protracted sluggishness of private consumption and facilities investment. It was anticipated, in addition, that the effects of the two-step reduction of the call rate target and the government's execution of its supplementary budgets would gradually make themselves felt. The Bank of Korea accordingly decided not to make any further adjustments of the call rate target but to leave it on hold at 3.75%.

3 The Bank of Korea took several active steps to maintain financial market stability. As a result of the mounting uncertainties at home and abroad, there were, from the beginning of the year, some signs of financial market unrest: a sharp fall of benchmark yields in the bond market with a preference for assets perceived as safe, such as government and public bonds, increasing. To ensure the stability of market interest rates, the Bank resumed its over-the-counter sales of monetary stabilization bonds (MSBs), which had been suspended since April 2002, and stepped up the volume issued.

From early March, owing to concerns about the possible insolvency of several credit card companies and the SK Global accounting scandal, large-scale withdrawals took place from investment trust companies' money market funds (MMFs). The Bank's prompt supply of liquidity through open market operations made a major contribution to warding off market instability at an early stage. Subsequently, upon the outbreak of the war against Iraq, a 「Financial and Foreign Exchange Market Stability Package」, including prompt steps to expand the supply of liquidity, was unveiled in order to nip a mood of unease in the bud before it spread among financial market participants.

In June, Chohung Bank experienced a large volume of withdrawals around the time of a planned strike. As the lender of last resort, the Bank of Korea acted to secure the stability of the financial system by supplying needed liquidity to the bank in the form of Liquidity Adjustment Loans. It also strengthened its capacity to respond to financial institutions' shortages of liquidity from the third quarter onwards by raising the ceiling on its Liquidity Adjustment Loans from 3 trillion won to 5 trillion won.

4 Inducements for financial institutions' funding support to small and medium exporters and regional small and medium enterprises (SMEs) were constantly strengthened in the operation of the loans system.

In order to bring about an expansion on loans, especially those of trade finance, of banks to small and medium exporting businesses, which was experiencing difficulties due to the delayed world economic recovery, the Bank of Korea raised the General Ceiling, the sub-category of the Aggregate Credit Ceiling Facility which includes trade finance, in succession. First, in May, the Bank allocated the entire retained quota of 385 billion won, which was specially reserved for future contingencies under the facility, to the General Ceiling, with heightening it to 1.7 trillion won. It was followed up by raising it again in October to 2.7 trillion won. Besides this, the quota under the facility available to the regional branches of the Bank of Korea for the support of regionally-based SMEs was raised from 3.6 trillion won to 4 trillion won in August. Then in September, an additional amount of 85 billion won was made available to provide emergency support to SMEs that had suffered damage from Typhoon Maemi.

Efforts continued to be made to ensure that the practice of cash settlement in commercial transactions between businesses took firm hold. To bring about a contraction of settlement by means of bills, the recognition ratio for banks' performance in discounting them, which is used when calculating their individual quotas under the Aggregate Credit Ceiling, was sharply reduced in two steps in May and October from 50% to 20%.

5 The year under review saw the final completion of the process of interest rate deregulation embarked on under the 「Four-Stage Interest Rate Liberalization Plan」, announced in 1991, with the Bank of Korea's deregulation of interest rates on demand deposits. Also intensive endeavors were devoted to heightening policy transparency and credibility and to the more market-friendly operation of monetary policy instruments.

On December 24, the 「Regulation on the Deposit and Lending Rates of Financial Institutions」 was revised so as to abolish almost completely, with effect from February 2004, the remaining restrictions on demand deposits such as passbook deposits and temporary deposits along with company savings deposits of less than seven days, and also the remaining conditions imposed on deposits. In view, however, of the cost to banks of handling checks, the payment of interest on checking accounts remained prohibited. It is anticipated that this deregulation will amplify the transmission channels of monetary policy while bringing about a healthy competitive climate among financial institutions and spurring on product innovation. It should also make the use of financial services generally more convenient.

From January, the time of the announcement of plans for the competitive auction of MSBs was changed from the auction date itself to the immediately preceding business day so as to facilitate the more stable operation of financial institutions' funds and to heighten the predictability of the day-to-day interplay of the demand and supply of funds. From March onwards, information allowing an immediate check as to companies' eligibility as objects of support under the Aggregate Credit Ceiling Facility was put up on the Bank of Korea's web site for use by financial institutions in their credit screening. From September, for the greater convenience of exporters in their use of trade finance, electronic document interchange (EDI) was added to the existing method of submission of physical documents for the settlement of domestic letters of credit.

The channels of communication with the financial markets and the general public were constantly amplified in order to make the intentions of monetary policy clearly known and to facilitate the Monetary Policy Committee's accurate grasp of anticipations and reactions. Press conferences are held immediately after the monthly meeting of the Committee to set the direction of monetary policy. The decisions taken and the background to them are explained in full and minutes are made public in the 「Monthly Bulletin」 about two months later. Furthermore, in order to learn the opinions of external experts and gather on-the-spot information, the activities of the 「Economic Trends Discussion Meeting」 and the 「Financial Consultation Meeting」 were intensified, and, a 「Monetary Policy Contest」 was held for the first time in June, July and August, in which university students made presentations on monetary policy.

In order to capture the knock-on effects of policy and check up on the management status of financial institutions, joint on-site examinations were carried out on eleven banks with the Financial Supervisory Service during the year. The year also saw the launch of 「Financial Stability Report」, a publication containing overall analysis and evaluation of financial system stability and the financial servicing capacity of households and businesses.

In relation to the payment and settlement system, in a move to enhance the safety of the settlement of call transactions, from July banks were allowed to collect, through BOK-Wire, call-loan money offered to non-bank financial institution and foreign banks' branches. And in order to reduce banks' external foreign exchange settlement risk, construction was begun of Continuous Linked Settlement Bank's payment versus payment system in Korea with completion targeted for the end of 2004. In addition, ahead of the implementation of the revised Bank of Korea Act, overall preparations were made for the construction of an efficient oversight framework for the Bank of Korea's surveillance of the payment and settlement system by specifying the scope of that surveillance.

⑥ During the year under review, the Bank of Korea operated its call rate target at a lower level than in the previous year in consideration of the general state of the economy. Monetary policy thus provided a series of stepping-stones for domestic business activity to enter into a mild recovery phase from around the beginning of the fourth quarter thanks to buoyant exports by reacting flexibly to changes in the environment at home and abroad while containing the level of price increases within the range of the inflation target.

The real economy continued to wear a subdued aspect with private consumption and facilities investment both at a low ebb because of the general shrinking of confidence on the part of economic agents. The growth rate of real GDP fell, in consequence, to 3.1% from the previous year's 7.0%. Production activities, though, showed progressively livelier movements from September onwards helped by a sharp increase in exports.

Core inflation was held to 3.1% on a yearly average basis around the midpoint of its target range. This was attributable to the upward stability of the Korean won against the US dollar and the moderation of demand pressures resulting from the contraction of domestic demand even though these effects were partially offset by the continuing sharp upward trend in wages and rises in charges for public utilities and personal services. In contrast, the consumer price index showed an increase of 3.6% during the year, a more sharply upward trend than the preceding year's 2.7%. This was largely attributable to rises in the prices of petroleum products in response to the run-up in international oil prices. Housing prices, led by apartment prices in the metropolitan area, maintained their upward trend from the previous year, but shifted to a mild downward trend following the government's publication (October 29) of 「Comprehensive Package of Housing Market Stabilization Measures」.

The scale of the current account surplus widened greatly from the preceding year's 5.4 billion dollars to 12.3 billion dollars thanks to the sharp increase in exports mainly to China.

In the financial markets, though the growth rate of money supply decelerated sharply with the contraction of the supply of credit to the private sector, market liquidity conditions were relatively smooth: loans to SMEs increased steadily and overall corporate demand for funds remained low. But certain enterprises with a less than exemplary credit standing experienced difficulties following the financial institutions' strengthening of credit differentiation while the trouble of several ailing credit card companies at times proved to be a factor acting to destabilize financial markets.

Market interest rates and the deposit and lending rates of financial institutions showed a downwardly stable trend on the whole from the beginning of the year, but their movements from October onwards turned upward due to anticipations of a recovery of business activity at home and abroad. Share prices, showing synchronization with those of major advanced countries, shifted to an upward trend from the last week of March onwards to post a large-scale increase by the end of the year.

In the domestic foreign exchange market, the Korean won/US dollar exchange rate declined slightly on an annual average basis compared to the previous year as a result of the continued excess supply of foreign exchange. Until mid-April the won/dollar rate showed an upward trend due to the North Korean nuclear issue and the SK Global accounting scandal, but afterward marked a continued decrease thanks to the current account surplus and inflow of foreigners' portfolio investment, as well as comments hinting at toleration of a weak dollar at the G7 Meeting (September 20). However, the won weakened slightly against the dollar again from mid-October to the end of the year. The scale of the foreign exchange reserves rose constantly, bringing them to a total of 155.4 billion dollars as of year-end 2003, an increase of 33.9 billion dollars over the preceding year-end.

7 During 2004, the Korean economy is anticipated to move gradually into an upswing phase thanks to the knock-on effects of the wide-ranging measures to stimulate economic activity so far undertaken together with the acceleration of growth trends of major advanced economies including that of the US. During the first half of the year, the sharp upward trend of exports will be the principal contributor to economic growth, but during the latter half of the year there should also be an expansion of the upward trend of facilities investment and a gradual recovery of private consumption spending. It is therefore anticipated that the Korean economy

will see GDP growth rise to the 5% level during the year.

Core inflation is expected to remain stable on the whole during the year. This forecast is predicated on anticipations of the stabilizing effects of the continued weak underlying tone of the US dollar, combined with the mildness of upward pressures from the demand side as economic activity shows a smooth recovery. However, due to high international oil prices and the upward trend of international raw material prices, price instability cannot be ruled out.

The current account is projected to maintain its comparatively large-scale surplus thanks to a robust increase in exports, which will counteract the effects of an expansion of capital goods imports to feed the increase in facilities investment.

8 Taking this combination of domestic and external conditions into consideration, monetary policy will be operated in such a way as to keep core inflation within the medium-term inflation target range while paying careful attention so that no marked imbalances are allowed to arise during the year in terms of growth, prices or the current account. Monetary policy will support the domestic economic recovery and improvement of employment conditions but preemptive steps will be taken should domestic demand pressure intensify in the course of its recovery. In addition the effectiveness of monetary policy should be heightened through a harmonious policy mix with fiscal, exchange rate, and financial supervisory policies.

From the beginning of 2004, with the entry into effect of the revised Bank of Korea Act, the method of establishing the inflation target has shifted from the previous annual target system to a medium-term target system. The Bank of Korea has accordingly set the medium-term inflation target for the period 2004~2006 as a range of 2.5~3.5%, taking into consideration the transmission lag in the effects of monetary policy and so forth.

In this context, if the medium-term prospects for the price are anticipated to deviate from the target range, financial and economic conditions as well as the cause of its deviation will be taken into account in determining policy actions and the strength of such policy responses, so as to minimize the impact of the side effects on the real economy and the financial markets while seeking to converge upon the midpoint of the inflation target range from a medium-term perspective.

In keeping with the changes in the financial environment, the system of the Aggregate Credit Ceiling will be rearranged to emphasize support for small and medium exporters and the revitalization of regional economies. Meanwhile, to make active use of the interest rate announcement effect and liquidity control function, a careful review will be given to a possible change of the Liquidity Adjustment Loan system.

In addition, plans will be drawn up for the rationalization of the system of reserve requirements in reaction to the complete liberalization of interest rates, the expansion of electronic financial transactions and the diversification of the deposit products offered by financial institutions.

The unceasing strengthening of efforts for financial stability is also planned. A watchful eye will be constantly kept on latent factors that might bring market instability including the management status of credit card companies, and should there be signs of these factors' materializing, prompt action will be taken to counter them through, for example, open market operations. The Bank of Korea intends to make expanded use of joint examinations of banks in order to pick up promptly signs of instability within the financial system, to gather on-the-spot information necessary for the drawing up of policy and to check its actual transmission.

The revised Bank of Korea Act gives the central bank responsibility for the overall management and oversight of the payments and settlements system. In order to carry out these functions efficiently, policy initiatives are being pursued to put in place at an early date a framework for the surveillance and evaluation of the overall payments system and for the upgrading of each level sub-systems.

Ⅱ. Financial and Economic Trends

1. International Economies

A. International Economic Growth and Trade

In the early part of the year 2003, the world economy continued to exhibit the subdued pattern of activity that it had maintained in the preceding year, being influenced by the high level of geopolitical tensions and the spread of the severe acute respiratory syndrome (SARS). The economic environment showed a gradual improvement, however, as major economies sustained their pursuit of expansionary macro economic policies while oil prices fell back upon the declared prompt ending of the war against Iraq,[1] share prices rose, and consumer and investment confidence began to pick up again. From the beginning of the third quarter, recovery trend became evident centering on the US economy. Accordingly the growth rate of the global economy during the year 2003 is estimated to have shown a mild acceleration from the previous year's 3.0% to stand at 3.2% (IMF forecast).

The US economy exhibited a trend of rapid recovery from early in the latter half of the year, leading the global economic revival. During the first quarter of the year, despite a buoyant housing market, consumer and business confidence had contracted because of the heightened uncertainties surrounding the war against Iraq, and the hoped-for recovery was delayed. Share

<Table Ⅱ-1>

Trends of Major International Economic Indicators

(%, annual %)

	2000	2001	2002	2003
Economic Growth[1]				
World	4.8	2.4	3.0	3.2
Industrialized nations	3.9	1.0	1.8	1.8
US	3.7	0.5	2.2	3.1
Japan	2.8	0.4	-0.4	2.7
Euro area	3.5	1.6	0.9	0.4
(Germany)	2.9	0.8	0.2	-0.1
Asian emerging markets[2]	8.5	0.8	4.8	2.3
Developing nations	5.7	4.1	4.6	5.0
Asia	6.8	5.8	6.4	6.4
(China)	8.0	7.3	8.0	9.1
Latin America	4.0	0.7	-0.1	1.1
World trade growth[3]	12.1	0.1	3.4	4.0
Long-term interest rates[4]				
US	5.11	5.05	3.81	4.25
Japan	1.64	1.37	0.91	1.37
Euro area	4.85	5.00	4.20	4.29
Exchange rates[5]				
US$/€	0.943	0.890	1.049	1.260
¥/US$	114.8	131.4	118.7	106.9
Prices of international raw materials				
Rise in crude oil prices[6]	59.9	-14.7	2.5	15.2
Others[7]	1.9	-10.1	1.9	17.6

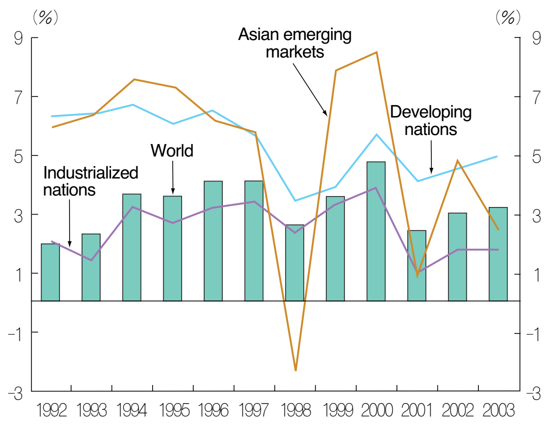
Notes: 1) Based on IMF statistics (the figures in 2003 are prospects) apart from certain individual countries which are based on their respective national statistics (including 2003).
2) Korea, Taiwan, Singapore and Hong Kong.
3) Based on OECD statistics (the figures in 2003 are prospects)
4) Based on the yields of 10-year government bonds and year-end basis.
5) US$/euro on New York market, ¥/US$ on Tokyo market, year-end basis.
6) Based on annual average of Brent crude prices.
7) Based on annual average of the Reuters' Commodity Price Index.

Sources: IMF, World Economic Outlook, Sep. 2003
OECD, Economic Outlook, Nov. 2003
Bloomberg, Reuters

1) Major dates: final US ultimatum to Iraq (March 18), US declaration of war (March 20), fall of Baghdad (April 9), US proclamation of the end of hostilities (May 1).

<Figure Ⅱ-1>

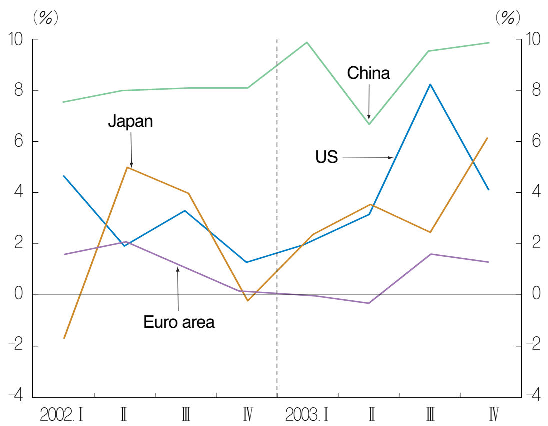
Trends of World Economic Growth



Source: IMF, World Economic Outlook, Sep. 2003

<Figure Ⅱ-2>

Trends of Economic Growth[1] by Major Economies



Note: 1) Annualized quarter to quarter changes, apart from China for which the figures are year-on-year.

prices shifted to an upward trend, however, upon the outbreak of the war against Iraq and the early conclusion of hostilities while the macro economic stimulation measures including interest rate cut[2] and tax reduction[3] began to take effect. Consumer and investment confidence turned the corner while the housing market remained brisk, so that it became clear that the economy was on the mend. The speed of the recovery picked up its pace further from early in the latter half of the year, bringing GDP growth in the third quarter (annualized quarter to quarter change) to 8.2%, its highest level since the first quarter of 1984 (9.0%). Consequently, US GDP growth for the year as a whole rose from the preceding year's 2.2% to stand at 3.1%.

The Japanese economy also showed signs of breaking free from its protracted recession. Although the recovery of consumer spending remained conspicuously weak, exports rose strongly fueled by the expansion of import demand from China and other countries in the Asian region and the pickup in the US economy. Investment showed briskness on rising anticipations of a coming upswing in business activity. Consequently GDP, which had displayed negative growth (-0.4%) during 2002, shifted to positive growth at the comparatively high level of 2.7%.

In the economy of the euro zone, the subdued pattern of the previous year persisted with a reduction of investment and the unemployment rate remaining at a high level. Strikingly, during the first half of the year the growth rate of GDP (compared to the previous period) registered a negative figure for two straight

2) The Federal Open Market Committee (FOMC) lowered its policy Federal Funds rate from the previous 1.25% by 25 basis points to 1.00% on June 25, bringing it to its lowest level since 1958 (0.68%).
3) The Upper and Lower Houses of the US Congress on May 23 approved a plan for tax reductions amounting to some 350 billion dollars in all.

quarters as exports and investment shrank. For the year as a whole, therefore, GDP growth is estimated to have marked a level of 0.4%, rather lower than the preceding year's performance (0.9%). In the latter half of the year, nevertheless, exports showed an upswing in line with the US recovery and there were signs of improvement in the confidence of economic agents.

The Chinese economy maintained its high rate of economic growth despite the negative impact of SARS. Second quarter's GDP growth (year-on-year basis) fell from the preceding quarter's 9.9% to stand at 6.7% as consumption and production activities shrank following the spread of SARS. Even so, exports and investment both maintained their rapid growth and with consumption again rising sharply after shaking off the impact of SARS from June onwards, the growth rate of GDP for the year as a whole reached 9.1%[4], outpacing that of the previous year (8.0%).

Other economies in the Asian region were unable to break free of their downturn during the first half of the year because of the delayed recovery of the global economy and the spread of SARS, but from the beginning of the second half of the year a pattern of recovery gradually emerged with the increase of domestic demand and exports. Specifically, Taiwan and Singapore, which suffered a high incidence of SARS showed subdued pattern, while other countries generally saw an acceleration of growth in comparison to the previous year.

The economies of the Central and South American region showed a somewhat improved performance with the financial unrest soothed. Argentina registered substantial positive growth, shaking off the negative

4) The GDP growth rate of 9.1% for the year 2003 was the highest level registered since that of 9.6% in 1996.

growth of the preceding few years thanks to favorable investment and consumption. Brazil, too, showed a relatively buoyant tone with the current account showing a large-scale surplus and share prices on the rise. In the case of Venezuela, however, the economic stagnation intensified amid the financial market unrest generated by the strike action by staff of the Venezuelan National Petroleum Company that continued until the beginning of the year.

For the year 2003 as a whole, the growth rate of global trade (volume basis) is estimated to have stood at 4.0% (OECD forecast), slightly higher than the previous year's level (3.4%). During the first half of the year, world trade decreased under the influence of the heightened geopolitical tensions and the spread of SARS. From the beginning of the latter half of the year, however, the growth rate of world trade showed expansionary movements in line with the economic recovery of major countries.

B. International Financial Markets

During the year 2003, international financial markets turned gradually brisker with the early conclusion of the war against Iraq.

International interest rates showed a generally downward trend from the beginning of the year that reflected the reductions in the policy rate in major countries and the uncertain economic prospects. They shifted to an upward trend, however, from the end of June amid spreading anticipations of business recovery.

US long-term interest rates (ten-year Treasury bond yields) maintained a downward trend amid a marked flight to asset quality, which resulted from the

<Table Ⅱ-2>

Trends of Short- and Long-term Interest Rates[1] in Major Economies

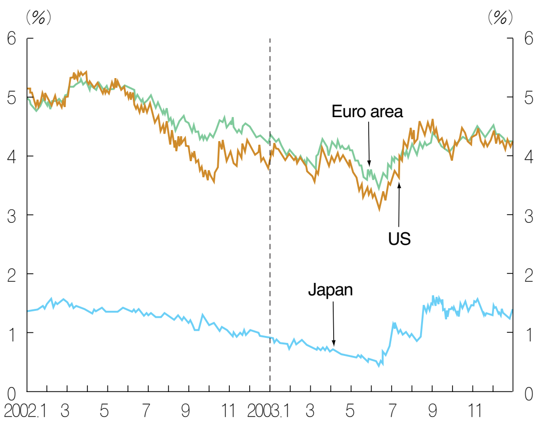
(annual %)

	2001 Dec.	2002 Dec.	2003 Mar.	2003 Jun.	2003 Sep.	2003 Dec.
Long-term[2]						
US	5.05	3.81	3.80	3.51	3.94	4.25
Japan	1.37	0.91	0.71	0.85	1.39	1.37
Euro area	5.00	4.20	4.04	3.80	4.00	4.29
Short-term[3]						
US	1.73	1.19	1.10	0.85	0.94	0.92
Japan	0.01	0.00	0.01	0.01	0.01	0.00
Euro area	3.29	2.87	2.52	2.15	2.13	2.12

Notes: 1) Month-end basis.
2) Based on yields on 10-year government bonds.
3) Based on yields on 3-month Treasury bills, apart from Euro area, which is based on yields on 3-month EURIBOR.
Source: Bloomberg.

<Figure Ⅱ-3>

Trends of Long-term Interest Rates[1] of Major Economies



Note: 1) Based on yields of each country's 10-year government bonds.
Source: Bloomberg.

uncertainty of domestic and external economic conditions, and anticipations of additional interest rate reductions by the Federal Reserve. They registered a historic low level of 3.1% on June 13. However, amid mounting anticipations of economic recovery and the increased volume of Treasury paper issued because of the expansion of the fiscal deficit, they shifted back to an upward trend to reach their highest point during the year of 4.6% on September 2. They subsequently fell back to remain in the 4~4.5% range during the remainder of the year. Short-term interest rates held stable at the low level of around 1% in line with the Federal Reserve's reduction of its policy rate to 1% (June 25), the lowest level since 1958 (0.68%).

Japanese interest rates, meanwhile, continued to exhibit a downward trend influenced by the protracted business recession, so that long-term interest rates (ten-year government bond yields) eased to their lowest-ever level of 0.435% on June 12. They subsequently edged upward to record their highest level for the year of 1.66% on September 2 affected by the shift of funds from bond investments under the influence of a rise in share prices in line with mounting expectations of economic recovery. During the fourth quarter, they showed generally stable movements at around the 1.4% level. Short-term interest rates held steady at the 0% level, reflecting the Bank of Japan's continued accommodating monetary stance.

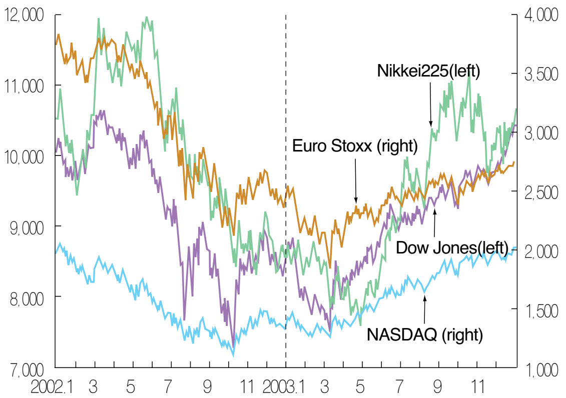
In Euroland, interest rates showed similar movements to those in the US and Japan. During the first half of the year, they displayed a downward trend in response to worries about an economic recession, the European Central Bank's (ECB) reduction of its policy rate[5], and

5) The European Central Bank (ECB) reduced its policy rate on two occasions during 2003, from 2.75% to 2.5% on March 6 and from 2.5% to 2% on June 5.

the decline in US interest rates. From early in the latter half of the year, however, they turned to an upward trend, affected by portfolio shifts out of bond investments as share prices rose, the spreading mood of anticipation concerning the recovery of the US economy, and concerns over a deterioration of fiscal deficits in several euro zone member states.

<Figure Ⅱ-4>

Trends of Share Prices Indices[1] in Major Economies



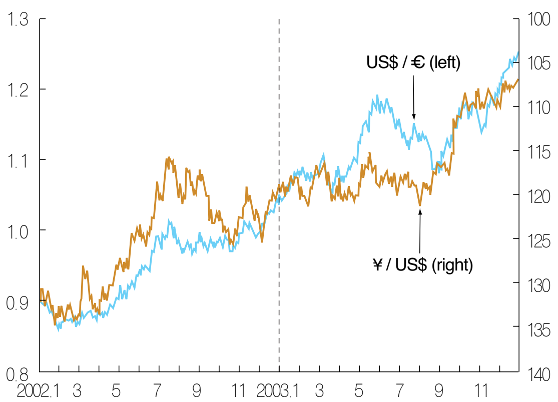
Note: 1) Spot market stock price basis.
Source: Bloomberg.

During the year 2003, share prices in major industrialized countries initially exhibited a downward trend, but turned upward after the outbreak of the war against Iraq. Amid brighter economic prospects, they subsequently showed gains on a larger scale.

In the United States, share prices started off the year on a downward trend as uncertainty ran high over the looming war against Iraq, but they shifted to an upward trend in mid-March on rampant expectations of an early conclusion of hostilities once war broke out. With businesses reporting more favorable results and mounting expectations of economic recovery, share prices maintained a sharply upward trend, leading the Dow Jones Industrial Index to finish the year with a 25.3% rise and the NASDAQ Index with a 50% rise. In Japan and the euro zone, share prices by and large showed similar movements to those in the US, with the Nikkei Index posting a rise for the year of 24.5% and the Euro Stoxx Index one of 15.7%.

<Figure Ⅱ-5>

Trends of Major Exchange Rates[1]



Note: 1) US$/€ on New York market, ¥/US$ on Tokyo market.
Source: Bloomberg.

Looking at exchange rate trends during 2003, the US dollar showed a weakening trend against other major currencies. This was attributable to rising concerns over the accumulated US budget and current account deficit and to the US administration's perceived willingness to tolerate a weaker dollar in contrast to its previous position.

Turning to the movements of individual currencies

<Table Ⅱ-3>

Changes in Major Exchange Rates[1)]

(%)

	Euro	Japanese yen	UK pound	Taiwanese dollar	Singapore dollar	Thai baht
2002	+18.0	+10.7	+11.3	+0.7	+6.3	+2.3
2003	+20.0	+11.0	+10.5	+2.3	+2.2	+8.9

Note: 1) The appreciation(+) or depreciation(-) rate of each currency against the US dollar. Based on the Tokyo market, apart from the euro which is based on the New York market.
Source: Bloomberg.

against the US dollar, the greenback continued weak against the euro from the beginning of the year and on May 29, it had fallen to 1.19 dollars per euro. It later picked up to show a mildly strengthening trend against the euro until early September, influenced by the weakness of the euro zone economy. The exchange value of the US dollar subsequently fell back rapidly again following confirmation of the US weak dollar policy at the G-7 meeting of finance ministers on September 20, together with signs of a recovery of the euro zone economy. Consequently, the euro appreciated by 20% against the US dollar during the year under review, so that the exchange rate stood at the level of 1.26 dollars per euro as of the end of the year 2003.

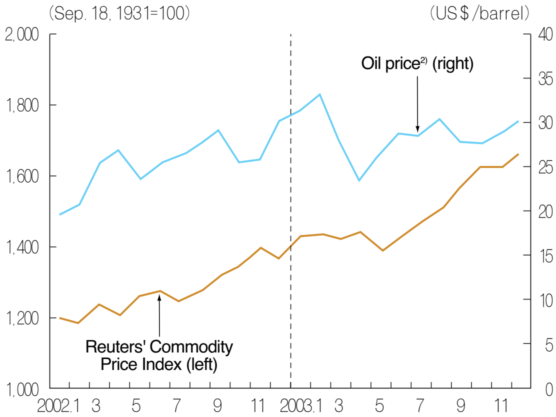
Against the Japanese yen, with the US dollar showing a pattern of repeated fluctuations the scale of depreciation of the greenback remained minimal until August in view of large-scale intervention by the Japanese foreign exchange authorities. From September onwards, however, the dollar displayed a rapidly weakening trend against the yen affected by mounting expectations of the Japanese economic recovery and the outcome of the G7 meeting of finance ministers. As of year-end 2003, the Japanese yen had appreciated by 11% against the greenback over the course of the year to stand at 106.9 yen per US dollar.

C. International Raw Material Prices

International oil prices were heavily influenced by the political situation in the Middle East during the first half of the year and, after showing repeated wide fluctuations, they maintained a comparatively high level until the end of the year.

<Figure Ⅱ-6>

Trends of Prices[1] of International Raw Materials



Notes: 1) Month-end basis
2) International oil prices are based on Brent crude price.
Source: Reuters.

From the beginning of the year, international oil prices maintained a steep upward trend, affected by the geopolitical tensions surrounding the looming war against Iraq and the continuation from the previous year of strike action by staff of the Venezuelan National Petroleum Company. The price of Brent crude oil rose to 34.9 US dollars a barrel by March 10. Following the actual outbreak of hostilities with Iraq, international oil prices shifted to a sharply downward trend amid growing anticipations of an early end to the war, dropping to the lowest level for the year of 23.2 dollars a barrel on April 29. Subsequently, however, they showed a pattern of movements within a range of 27~30 dollars. This was attributable to the changes in the interplay of supply and demand factors including the level of US oil reserves, the possibility of a resumption of Iraqi crude oil production, the adjustment of production volumes by OPEC, world economic prospects and seasonal variations in demand. It also reflected the weak underlying term of the US dollar.

Apart from oil products, international raw materials generally saw their prices on a rising trend during the year. The prices of raw materials for industrial use rose by a larger margin from the beginning of the second half of the year with the increase of demand generated by the recovery of the world economy. Grain prices also displayed an upward trend from early in the second half of the year affected by poor harvests of corn and wheat. As a net consequence, by the end of the year, the Reuters' Commodity Price Index had risen 21.1% compared with the end of the previous year.

<Reference Ⅱ-1>

Background to the Weakness of the US Dollar

The US dollar maintained its weak tone of the preceding year against other major currencies throughout the year 2003. It depreciated by 20% against the euro, 11% against the Japanese yen and 10.5% against the pound sterling, and it also showed a pattern of large-scale depreciation against almost all other currencies.

Appreciation(+) or Depreciation(-) of Major Currencies[1] against the US Dollar

(%)

	Korea won	Euro	Japanese yen	UK pound	Australian dollar	Taiwanese dollar	Singapore dollar	Thai baht	Brazilian real	Argentinean peso
During the year 2002	+10.7	+18.0	+10.7	+11.3	+10.7	+0.7	+6.3	+2.3	-34.1	-70.4
During the year 2003	-0.6	+20.0	+11.0	+10.5	+33.0	+2.3	+2.2	+8.9	+22.0	+15.5

Note: 1) Based on Tokyo market, apart from euro which based on New York market
Source: Bloomberg.

The background to this weak trend of the dollar was provided by the expansion of the US current account and budget deficits and the US administration's perceived tolerance of a weaker dollar.

During the year 2003 the US current account deficit widened to the equivalent of 5% of GDP with having already accumulated a deficit of some 2 trillion dollars during the previous five years. These large-scale current account deficits served as the direct cause of the dollar's weakness, bringing about outflows of capital. Besides in line with the spreading of a climate in which further weakness of the greenback was seen as inevitable in order to reduce the scale of that deficit, it actually hastened its depreciation still further. Meanwhile, the fiscal deficits, which has shifted deeply into the red since the Bush administration took office, served as a factor fanning import demand, thereby also widening the current account deficit and acting to accentuate the dollar's weakness.

Trends of the US Current and Fiscal Accounts

(billion dollars)

	1996	1997	1998	1999	2000	2001	2002	2003
Current GDP(A)	7,817	8,304	8,747	9,268	9,817	10,101	10,481	10,986
Current account(B)	-117	-128	-205	-291	-412	-394	-481	-542
Fiscal account(C)	-111	-2	54	157	255	92	-230	-375
B/A(%)	-1.50	-1.54	-2.34	-3.14	-4.20	-3.90	-4.59	-4.93
C/A(%)	-1.42	-0.02	0.62	1.69	2.60	0.91	-2.19	-3.41

Sources: US Department of Commerce, US Treasury

Another factor in the rapid loss of the exchange value of the US dollar was a shift in the US government's stance away from a strong dollar policy toward one of tolerating a weak dollar. In May, 2003, US Treasury

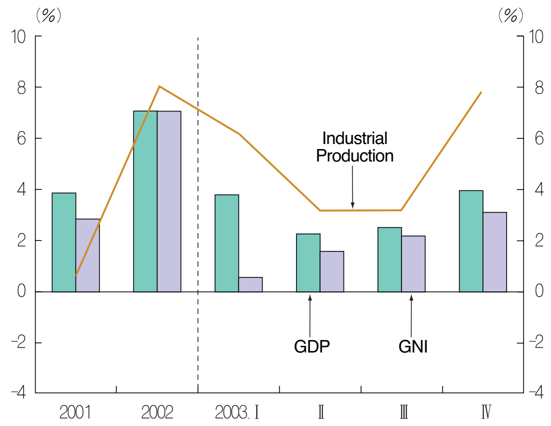
Secretary John Snow declared: “When the dollar is at a lower level, it helps exports, and I think exports are getting stronger as a result.” (May 11) and “We want the currency set through a regime of open, competitive markets with interventions kept to a minimum.” (May 13) His comments served to make this policy shift evident, and US economic policy makers subsequently continued to declare their toleration of the dollar’s weakening. Most notably, the communiqé issued following Dubai meeting of G-7 countries’ finance ministers and central bank governors read: “calling for greater flexibility in exchange rate policy as the most suitable method of inducing the smooth adjustment of imbalances within the international financial system”. This reasserted the previous position that exchange rates should reflect underlying economic conditions. Other countries were perceived as aligning themselves with the US position that through such exchange rate adjustment the problem of current account disequilibria among major countries could be resolved. The weakening of the US dollar promptly accelerated thereafter.

2. The Real Economy

A. Economic Growth

<Figure Ⅱ-7>

Trends of Major Economic Growth[1] Indicators



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

During the year 2003 economic growth (real GDP basis) fell sharply from the previous year's 7.0% to 3.1%. During the first quarter, GDP growth marked a rate of 3.7% in view of the contraction of domestic demand resulting from the heightened uncertainties including the US-led war against Iraq and the North Korean nuclear issue. In the second quarter, it fell further to 2.2% as the problems of credit card companies served to compound the negative economic effects of SARS. From July onwards a recovery trend became evident in the global economy, particularly in the United States, and GDP growth rose slightly to stand at 2.4% during the third quarter and 3.9% during the fourth quarter.

The rate of increase of gross national income (GNI) was slipped from the previous year's 7.0% to 1.8% in response to the deterioration of the terms of trade and the reduction in GNP growth.

<Table Ⅱ-4>

Trends of Growth[1] by Expenditure Item

(%)

	2001	2002	2003P year	I	II	III	IV
Final consumption expenditure	4.9	7.6	-0.5	0.9	-0.8	-0.9	-1.1
Private	4.9	7.9	-1.4	0.3	-1.8	-1.9	-2.2
Government	4.9	6.0	3.7	4.0	3.7	3.5	3.5
Gross fixed capital formation	-0.2	6.6	3.6	4.6	3.7	2.6	3.6
(Construction)	6.0	5.3	7.6	8.0	7.3	7.9	7.4
(Facilities)	-9.0	7.5	-1.5	1.9	-0.6	-5.0	-2.4
Increase in inventories[2]	0.0	-0.2	-0.6	0.8	-1.3	-1.1	-0.8
Exports of goods and services	-2.7	13.3	15.7	15.9	8.4	14.9	23.1
(Goods)	-4.4	16.5	18.7	20.1	10.6	18.4	25.3
Imports of goods and services	-4.2	15.2	9.7	14.2	5.2	7.7	11.7
(Goods)	-5.9	15.6	10.8	16.3	6.1	8.2	12.9
GDP	3.8	7.0	3.1	3.7	2.2	2.4	3.9
GNI	2.8	7.0	1.8	0.5	1.5	2.1	3.0

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

(Domestic Demand)

Looking at demand trends over the year, exports retained a strong expansionary trend and construction investment showed a dynamic tone but private consumption and facilities investment remained in the doldrums.

Among consumption expenditures, private sector expenditures shifted from the preceding year's 7.9% increase to a decline of 1.4% because of a combination of factors including a deterioration of the financial soundness of households, the problems of credit card companies and the weakening of employment conditions. By type of spending, the consumption of durables, which is highly sensitive to economic fluctuations, decreased on a large scale while that of semi-durables and non-durables was also below the previous year’s level. The consumption of services showed just a little increase compared with the previous year’s. Government consumption, however, accelerated its pace of increase to 3.7%, influenced by active pump-priming policies including the drawing up of supplementary budgets.

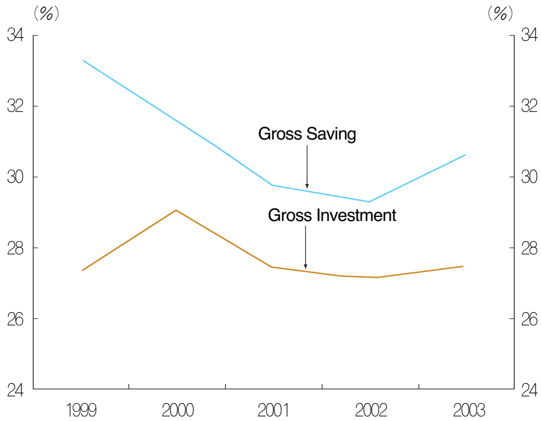
Turning to investment trends, the briskness of exports failed to spark a revival of investment confidence and facilities investment shifted from the preceding year’s 7.5% increase to mark a decrease of 1.5%. In contrast, construction investment rose from the preceding year’s 5.3% to stand at 7.6% in line with the buoyancy of building construction thanks to the upswing in housing prices.

Exports of goods and services (real term basis) maintained their liveliness from the previous year, rising from the previous year’s 13.3% to stand at 15.7%. Goods exports grew 18.7% with a particularly buoyant tone shown by those of semiconductors, mobile phone handsets, computers and other IT items, spurred on by the rapid growth of the Chinese economy and the global recovery. Those of services, on the other hand, continued on a downward path with the contraction, for example, of foreigners’ spending on travel expenses in Korea.

Imports of goods and services (real term basis) saw their rate of increase dip from the previous year’s 15.2% to stand at 9.7%. Goods imports rose by 10.8%, centering on those of capital goods and raw materials for export use. Service imports decelerated their rate of

<Figure Ⅱ-8>

Trends of Gross Investment and Gross Saving Ratios



<Table Ⅱ-5>

Trends of Growth[1] by Economic Activity

(%)

	2001	2002	2003^P year	Ⅰ	Ⅱ	Ⅲ	Ⅳ
Agriculture, forestry & fisheries	1.1	-3.5	-7.1	-5.1	-1.3	-9.1	-9.1
Mining	-0.1	-7.7	3.0	7.3	-1.1	2.4	4.0
Manufacturing	2.2	7.6	4.8	5.1	2.6	3.3	8.0
Electricity, gas & piped water	7.2	7.7	5.7	7.1	8.9	3.1	3.7
Construction	5.5	2.8	8.1	8.4	7.7	8.1	8.4
Services[2]	4.8	7.8	1.8	1.9	1.1	1.6	2.4
Wholesale & retail, hotels & restaurants	4.6	5.4	-2.3	-0.6	-3.9	-3.0	-1.8
Transport, storage & communications	14.9	9.2	3.7	3.8	3.3	3.1	4.5
Finance, insurance, real estate & business services	3.0	8.3	2.6	2.2	2.1	2.7	3.2
GDP	3.8	7.0	3.1	3.7	2.2	2.4	3.9

Notes: 1) Compared with the same period of the previous year.
2) Less imputed bank service charges but including import duties.

growth somewhat from the previous year's 13.5% to show a 4.8% increase, as SARS had a negative impact on overseas travel spending by Korean residents.

The gross saving ratio (current price basis) rose by 1.3 percentage points from the preceding year's 31.3% to stand at 32.6%, while the gross domestic investment ratio registered 29.5%, rising slightly by 0.4 percentage point from the preceding year's 29.1%. Accordingly, the share of gross domestic saving to gross domestic investment, which measures the self-sufficiency of investment resources, rose slightly from the previous year's 107.3% to 110.6%.

(Production)

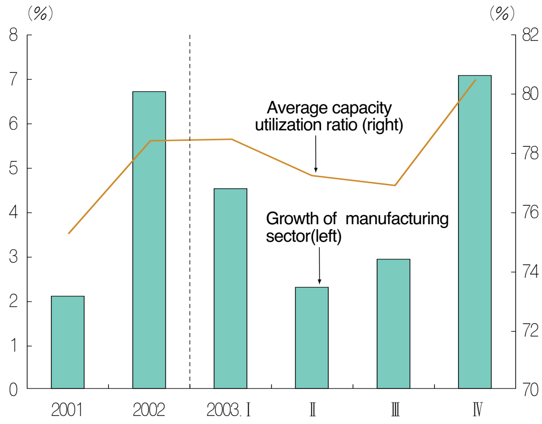
Looking at production activities by sector during the year, manufacturing and services saw a slowdown in their rate of growth while construction experienced an expansion.

In manufacturing, the growth rate slipped from the previous year's 7.6% to stand at 4.8%, dragged down by the sluggishness of businesses focusing on domestic demand, which contrasted with the buoyancy of export-oriented businesses including automobiles, semiconductors and communications devices. Despite this slackening of production activity, the capacity utilization rate in manufacturing stood at 78.3%, a very similar level to the previous year's 78.4%. This was attributable to the limits imposed on the growth of production capacity by the contraction of facilities investment.

The electricity, gas and piped water sector grew at a rate of 5.7%, below the previous year's level of 7.7% owing to the deceleration of expanding trend in electricity as a result of the sluggishness in electricity consumption.

<Figure Ⅱ-9>

Trends of Growth[1] and Average Capacity Utilization Ratio in the Manufacturing Sector



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

In the case of the construction sector, private construction activity increased greatly centering on that of buildings for housing and commercial use. This led to an acceleration in the growth of the production of the sector as a whole from the previous year's 2.8% to 8.1%.

Services saw their rate of expansion dropped sharply from the previous year's 7.8% to stand at 1.8%. Broken down by subsector, wholesale and retail, hotels and restaurants saw negative growth of 2.3%, influenced by the lackluster consumption. Transport, warehousing and communications, meanwhile, slowed from the preceding year's 9.2% to 3.7% because of the sluggishness of transport and warehousing business, which offset the effects of the buoyancy of communications. Financial, insurance, real estate and business services also saw their rate of growth fall back sharply under the impact of the business downturn.

Farming, forestry and fishing, showed an expansion of their declining trend from the previous year's -3.5% to stand at -7.1%, with the reduction in output volumes from cultivation and animal husbandry, which were badly affected by typhoons and inclement weather.

B. Employment and Wages

During the course of the year 2003 employment conditions were more difficult than in the previous year and the growth rate of nominal wage declined slightly.

(Employment)

Amid the continued economic downturn, the rate of increase of the economically active population fell sharply to just 0.2% and the number of people in

<Table Ⅱ-6>

Trends of Major Employment Related Indicators

(million, %)

	2001	2002	2003 year	2003 Ⅰ	2003 Ⅱ	2003 Ⅲ	2003 Ⅳ
Economically active population	22.4	22.9	22.9	22.4	23.1	23.1	23.1
(rate of growth)[1]	1.6	2.1	0.2	0.4	-0.2	-0.1	0.6
Economic participation rate	61.3	61.9	61.4	60.3	61.8	61.6	61.7
Number of persons employed	21.6	22.2	22.1	21.6	22.3	22.3	22.3
(rate of growth)[1]	2.0	2.8	-0.1	0.6	-0.5	-0.5	0.0
Number of persons unemployed	0.85	0.71	0.78	0.81	0.75	0.76	0.79
Unemployment rate	3.8	3.1	3.4	3.6	3.3	3.3	3.4
(SA)	-	-	-	3.1	3.4	3.5	3.6

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

<Table Ⅱ-7>

Trends in the Structure of Employment and Working Hours

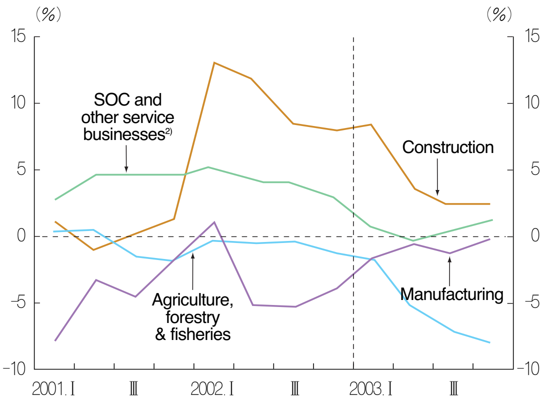
(%, hours)

	2001	2002	2003 year	2003 Ⅰ	2003 Ⅱ	2003 Ⅲ	2003 Ⅳ
Full time permanent[1]	49.2	48.4	50.5	50.6	50.0	50.6	50.6
Temporary or casual[1]	50.8	51.6	49.5	49.4	50.0	49.4	49.4
Monthly average working hours[2]	204	201	199	197	200	195	205
(overtime)	23	20	20	19	20	19	20

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

<Figure Ⅱ-10>

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



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

employment fell by 0.1%, the first decline registered since 1998.

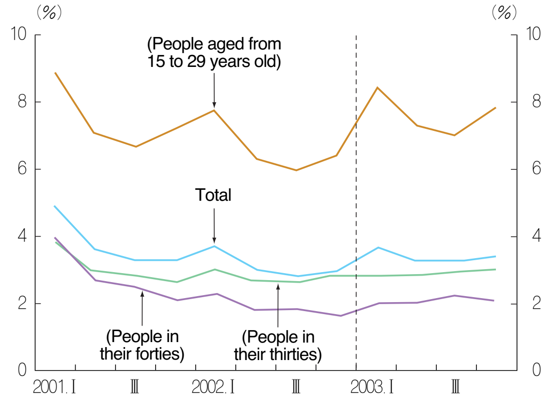
In consequence, the number of people unemployed increased from the previous year's 708 thousand to 777 thousand and the unemployment rate rose from 3.1% to 3.4%. Seen by quarter, the unemployment rate rose to 3.6% in the first quarter as the number of the unemployed increased to 806 thousand for seasonal reasons. From the second quarter onwards, together with the decline in the number of people out of work, the unemployment rate eased to around 3.3%. The seasonally adjusted unemployment rate rose steadily to 3.1% in the first quarter, to 3.4% in the second, to 3.5% in the third and to 3.6% in the fourth quarter.

Viewing employment trends by industry over the course of the year, the reduction in the number of persons employed in agricultural, forestry and fisheries, continued as a result of migration to the cities. The number of persons employed in manufacturing also continued to decline with the continuation of the business downturn and the reorganization of the industrial structure toward the information and communications sector, which has a low employment generating effect. The service sector, which has a large capacity for absorbing labor, experienced only a slight increase in employment from the previous year because of the depressed state of consumer spending and other domestic consumption. The construction sector, which had seen a sharp rise in employment the previous year, registered a deceleration of the increase in the number employed.

Breaking down unemployment by age brackets, the unemployment rate among adolescents and young people (15~29 years old) increased on a large scale from 6.6% during 2002 to 7.7% during 2003. This was

<Figure Ⅱ-11>

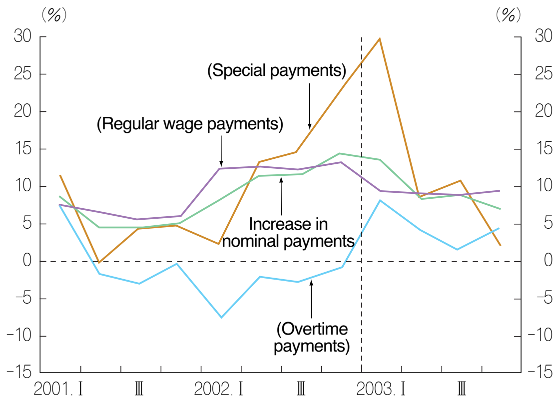
Trends of Unemployment by Age Brackets



Sources: Korea National Statistical Office.

<Figure Ⅱ-12>

Trends of Wage Increases[1]



Note: 1) Compared with the same period of the previous year.
Source: Ministry of Labor.

largely attributable to the decrease in the demand for fresh human resources affected by economic sluggishness and the change to an employment structure based primarily on experience and career record.

In relation to the type of employment, there was a decline from the previous year's 51.6% to 49.5% in the share among waged employees of those working on a casual or temporary basis, largely because of the sharp contraction of those working on a casual basis in the service sector. Meanwhile, average working hours per month declined by two hours from the previous year, but overtime hours worked remained unchanged.

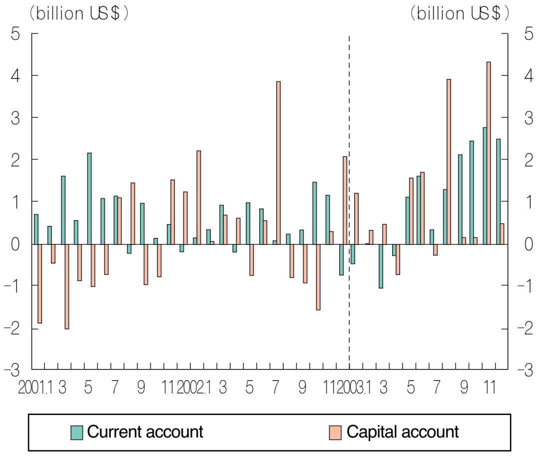
(Wages)

During the year 2003, the all industry nominal wage (based on businesses with 10 or more workers) rose 9.4%, which was lower than the 11.6% increase of the previous year. Deflating nominal wages by the rise in the Consumer Price Index (CPI), the rate of increase of real wages fell from the previous year's 8.9% to stand at 5.8%.

Looking at the composition of nominal wages, the rate of increase of regular wage payments declined from the previous year's 12.7% to register 9.2%, and the rate of increase of special payments also dropped, moving down from the preceding year's 13.5% to 11.9%, whereas that of overtime marked a level of 4.4% increase, outpacing the previous year's 3.4% decline. Viewed by industry, rates of wage increases were relatively subdued across almost all branches of industry compared to the preceding year, especially centering on those of the financial, insurance, real estate and business services, and for the social and private service sectors.

<Figure Ⅱ-13>

Trends of Current and Capital Accounts



C. External Transactions

In the course of the year 2003, the current account and the capital account both exhibited a substantial surplus. The current account registered a surplus of 12.3 billion dollars thanks to the buoyancy of exports while the capital account surplus stood at 13.1 billion dollars, largely owing to the inflow of foreign capital for investment in stocks. Consequently, reserve assets as recorded in the international balance of payments statistics increased by 25.9 billion dollars in the course of the year.

(Current Account)

The current account of the balance of payments saw its largest surplus since 1998, largely centering on the goods account. The scale of the surplus widened greatly from the previous year’s 5.4 billion dollars to stand at 12.3 billion dollars. Viewed by period, during the first four months of the year apart from February the current account exhibited a deficit because of the run-up in oil prices precipitated by the looming war against Iraq. From May onwards, however, exports turned lively and a pattern emerged of a widening surplus. From September, the monthly surplus continued to exceed 2 billion dollars.

Viewed by component account, the surplus of the goods account widened greatly from the previous year’s 14.8 billion dollars to 22.2 billion dollars, thanks to the swelling export-import gap. The income account also recorded a surplus, albeit only slight (0.6 billion dollars), which centered on income from salaries and wages. In contrast, the service account ran up a deficit of 7.6 billion dollars, owing to the decline in earnings from inbound tourism, increased spending on study and training abroad and an expansion of royalty payments

<Table Ⅱ-8>

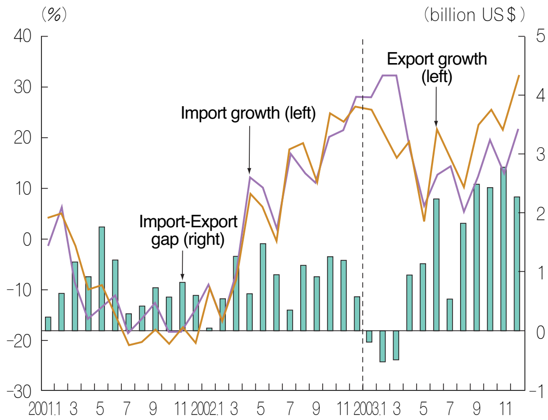
Balance of Payments

(billion US$)

	2001	2002	2003p
Current account	8.0	5.4	12.3
Goods	13.5	14.8	22.2
(exports)	151.5	163.4	197.6
(imports)	138.0	148.6	175.5
Services	-3.9	-8.2	-7.6
(credits)	29.1	28.4	32.7
(debits)	32.9	36.6	40.3
Income	-1.2	0.4	0.6
Current transfers	-0.4	-1.6	-2.8
Capital account	-3.4	6.3	13.1
Financial account	-2.7	7.3	14.5
Direct investment	1.1	-0.2	-0.2
Portfolio investment	6.6	0.7	18.0
Other investment	-10.4	6.9	-3.2
Other capital account	-0.7	-1.1	-1.4
Changes in reserve assets	-7.6	-11.8	-25.9
Errors and omissions	2.9	0.2	0.4

<Figure Ⅱ-14>

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



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

and patent fees.

During the year 2003, exports (customs clearance basis) rose 19.3% over the previous year (162.5 billion dollars) to chalk up a figure of 193.8 billion dollars, boosted by the sustained rapid growth of the Chinese economy and the economic recovery in major advanced countries including the US and Japan.

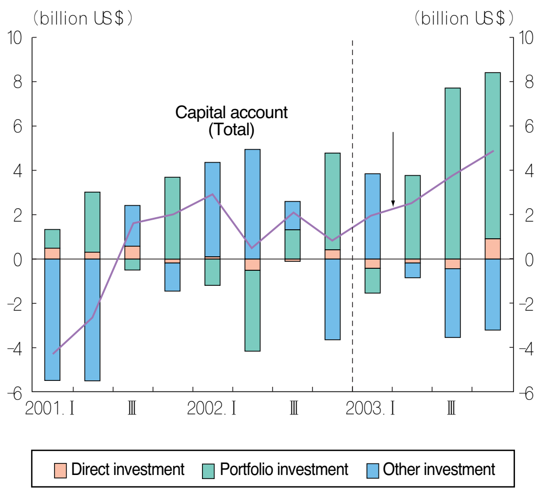
Breaking down exports by major product group, those of semiconductors, mobile phone handsets, computers and other IT related items sustained their brisk tone while those of automobiles and steel witnessed a sharp acceleration of their upward trend. Splitting the expansion of exports into volume factors and price factors, the shift in the unit price of exports from the previous year's downward trend to an upswing served as a factor accelerating the growth of exports.

Imports (customs clearance basis) during the year 2003 rose 17.6% over the previous year (152.1 billion dollars) to reach 178.8 billion dollars.

Broken down by major product group, those of raw materials such as oil, iron and steel rose sharply along with those of capital goods for use in the processing of export items. Imports of consumer goods shrugged off the generally subdued tone of consumer spending to rise by a wider margin, centering on those of durables, particularly household electrical appliances and automobiles. Besides this, with the freeing of imports of gold bullion from value-added tax early in the latter half of the year, imports of gold saw a sharp acceleration of their upward trend. Looking at the growth of imports in terms of prices and volumes, the rise in the unit value of imports outpaced that of their volume growth.

<Figure Ⅱ-15>

Trends of Capital Account by Item



(Capital Account)

The capital account registered a surplus of 13.1 billion dollars for the year 2003 that was primarily driven by foreign stock market investment funds. This represented a large-scale increase over the surplus exhibited the previous year (6.3 billion dollars).

Viewed by component account, the direct investment account registered a 0.2 billion dollar deficit, the same figure as the previous year. Inward and outward foreign direct investment both saw a sharp acceleration of their upward trend.

The portfolio investment account saw a massive increase in the scale of its surplus from 0.7 billion dollars the previous year to 18 billion dollars, which reflected the sharp increase in the scale of foreigners' investment in Korean securities at a time when overseas securities investment by Korean residents remained flat.

The other investment account shifted from the previous year's surplus of 6.9 billion dollars to a deficit of 3.2 billion dollars, led by a large increase in lending by financial institutions to non-residents.

3. Prices

<Table Ⅱ-9>

Trends of Movements[1] of Major Prices

(%)

	1999	2000	2001	2002	2003
Consumer Prices	0.8	2.3	4.1	2.7	3.6
(Core Inflation)	(0.3)	(1.9)	(3.6)	(3.0)	(3.1)
Producer Prices	-2.1	2.0	-0.5	-0.3	2.2
Import Prices	-12.1	7.7	3.5	-6.2	1.8

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

During the year 2003, prices showed a steeper upward trend than in the preceding year owing to the large-scale of the rise in prices of internationally traded raw materials and agricultural products. The annualized average rate of increase in the Consumer Price Index (CPI) rose from 2.7% the year before to 3.6% while the Producer Price Index (CPI) shifted from a decline of 0.3% the previous year to a rise of 2.2%. Core inflation, nevertheless, exhibited a rate of increase of 3.1%, similar to that of the previous year's 3%.

(Consumer Prices)

<Table Ⅱ-10>

Trends of Movements[1] in Consumer Prices

(%)

	2001	2002	2003				
			year	Ⅰ	Ⅱ	Ⅲ	Ⅳ
Consumer Prices	4.1	2.7	3.6	4.1	3.4	3.2	3.5
	(3.2)	(3.7)	(3.4)	(2.4)	(-0.6)	(1.3)	(0.4)
Agriculture, livestock & marine products	6.3	6.2	5.9	6.1	2.7	3.5	11.3
	(9.5)	(6.9)	(8.9)	(6.6)	(-5.9)	(10.3)	(-1.6)
Industrial products	2.6	1.7	2.3	4.5	2.5	1.8	0.8
	(0.0)	(4.1)	(1.4)	(1.7)	(-1.1)	(-0.2)	(1.0)
(Petroleum products)	4.2	-0.8	6.0	13.8	4.5	4.2	1.9
	(-9.4)	(10.5)	(4.3)	(6.9)	(-6.6)	(0.6)	(3.9)
Services	4.6	2.8	3.6	3.4	3.9	3.9	3.6
	(4.0)	(2.8)	(3.5)	(1.9)	(0.7)	(0.4)	(0.4)
(Public service charges)	7.5	-1.3	2.5	1.1	3.1	3.5	2.4
	(3.7)	(-0.8)	(2.0)	(2.0)	(0.6)	(-0.5)	(-0.2)
(Rents)	4.1	5.8	3.5	4.4	3.8	3.2	2.9
	(5.7)	(4.8)	(2.8)	(0.7)	(1.0)	(0.6)	(0.4)
(Private services)	3.1	3.7	4.5	4.3	4.4	4.6	4.7
	(3.4)	(3.9)	(4.7)	(2.7)	(0.6)	(0.6)	(0.7)

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

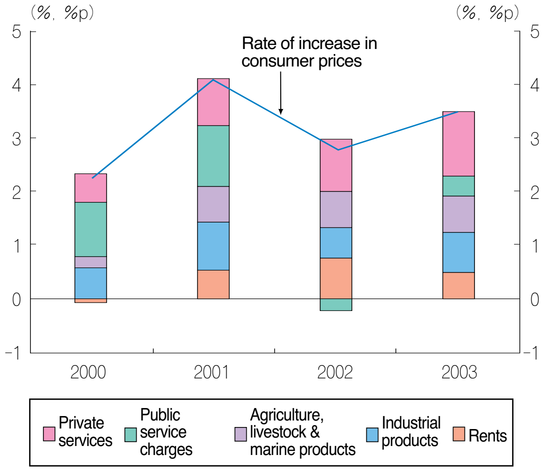
In the course of the year 2003, the CPI rose at an annualized average rate of 3.6%, showing a steeper upward trend than the previous year's 2.7%. This was largely because oil prices and private service charges sustained their elevated levels of the first quarter throughout the rest of the year. In addition, the prices of agricultural, livestock and fishery products rose sharply under the impact of typhoons in the last quarter.

Viewed by commodity group, the prices of agricultural and fishery products increased by 5.9%, centering on vegetables and fruits, while the prices of industrial goods rose 2.3%, led by those of petroleum products. For services, the rise was 3.6%. Although there was a reduction in the scale of increase of housing rents, this was more than offset by the rise in charges for private services including those for eating-out and for tutoring institutes and the effects of heights in the charges for public utilities and services such as railway fares and health insurance contributions.

Looking at the contribution to the rise in the CPI by

<Figure Ⅱ-16>

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



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

<Table Ⅱ-11>

Trends of Movements[1] in Producer Prices

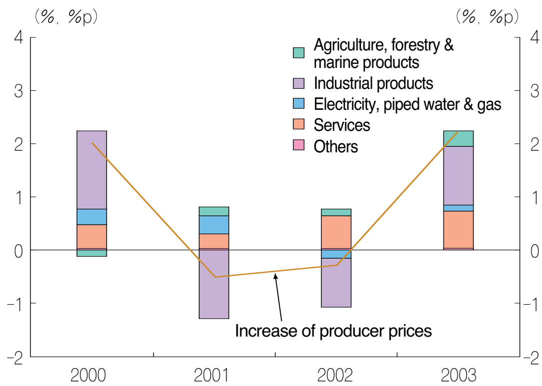
(%)

	2001	2002	2003 year	2003 Ⅰ	2003 Ⅱ	2003 Ⅲ	2003 Ⅳ
Producer prices	-0.5 (-2.5)	-0.3 (2.3)	2.2 (3.1)	3.0 (2.3)	1.3 (-1.6)	1.9 (1.0)	2.6 (1.4)
Goods	-1.1 (-4.2)	-1.2 (2.2)	2.0 (3.2)	3.1 (2.9)	1.1 (-2.4)	1.5 (1.2)	2.7 (1.5)
(Agriculture, forestry & marine products)	3.7 (6.7)	2.5 (4.9)	5.7 (12.1)	2.6 (3.9)	0.6 (-4.9)	5.3 (11.0)	14.6 (2.3)
(Industrial products)	-2.1 (-5.6)	-1.5 (2.2)	1.8 (2.7)	3.3 (2.9)	0.9 (-2.3)	1.1 (0.6)	1.8 (1.5)
(Electricity, piped water & city gas)	8.4 (4.0)	-3.2 (-1.8)	3.0 (0.6)	3.4 (2.4)	4.4 (-0.1)	3.3 (-1.9)	0.9 (0.2)
Services	1.0 (1.4)	2.1 (2.4)	2.3 (2.9)	2.3 (1.0)	1.8 (0.4)	2.3 (0.3)	2.6 (1.2)

Notes: 1) Compared with the same period of the previous year.
Figures in parentheses refer to rates of increase compared with the last month of the previous period.

<Figure Ⅱ-17>

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



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

product group, that of agricultural, livestock and fishery stood at 0.7 percentage point similar to the previous year's figure, that of industrial goods expanded from the previous year's 0.5 percentage point to 0.8 percentage point and that of services enlarged from 1.5 percentage points the previous year to 2.1 percentage points. Within the services group, the contribution of housing rents declined from the preceding year's 0.8 percentage point to 0.5 percentage point. In contrast, that of individual services enlarged from the previous year's 1.0 percentage point to 1.2 percentage points and that of charges for public utilities shifted from a negative contribution of 0.2 percentage point to a positive contribution of 0.4 percentage point.

(Producer Prices)

During the year 2003, the PPI showed a rise on a similar scale to that of the CPI during the first and final quarters, shifting to an increase of 2.2% on an annual average basis compared to its decrease in both 2001 and 2002.

Viewed by commodity group, the prices of agricultural and fishery products rose 5.7% as a result of the reduced volume of output brought about by unfavorable weather conditions including typhoons and a particularly heavy rainy season. The prices of industrial products, meanwhile, rose 1.8%, led by those of petroleum products and primary metals. Charges for electricity, piped water and city gas moved up 3.0%, driven by an increase in the city gas tariff. For their part, service charges showed a mild acceleration of their upward trend that centered on ocean shipping and airfreight charges.

Turning to contribution to the rise in the PPI by commodity group, that of industrial products showed a

<Table Ⅱ-12>

Trends of Movements[1] in Stage-of-Processing Prices

(%)

	2001	2002	2003 year	2003 Ⅰ	2003 Ⅱ	2003 Ⅲ	2003 Ⅳ
Gross index	0.2 (-5.4)	-2.7 (2.4)	1.9 (4.1)	3.3 (3.8)	0.4 (-3.4)	1.5 (0.5)	3.1 (3.4)
Raw materials	2.3 (-7.9)	1.3 (18.3)	6.4 (9.1)	16.4 (7.4)	-1.0 (-7.3)	3.7 (-0.8)	7.3 (10.5)
Intermediate goods	-0.4 (-7.1)	-3.9 (0.8)	2.2 (4.9)	2.5 (4.7)	0.8 (-3.6)	2.0 (0.6)	3.3 (3.3)
Final goods	0.5 (-2.3)	-2.0 (0.9)	0.7 (1.7)	1.1 (1.7)	0.0 (-2.2)	0.1 (0.7)	1.4 (1.5)

Notes: 1) Compared with the same period of the previous year. Figures in parentheses refer to rates of increase compared with the last month of the previous period.

<Table Ⅱ-13>

Trends of Movements[1] in Import and Export Prices

(%)

		2001	2002	2003 year	2003 Ⅰ	2003 Ⅱ	2003 Ⅲ	2003 Ⅳ
Export prices	Won-basis	-3.8 (-11.6)	-7.0 (-1.1)	-2.2 (3.3)	-3.9 (4.6)	-4.5 (-5.7)	-0.7 (-1.2)	0.6 (6.0)
	Contract currency-basis	-15.2 (-16.3)	-4.2 (4.5)	1.3 (2.9)	4.0 (2.1)	-1.1 (-3.2)	0.2 (1.4)	2.3 (2.6)
Import prices	Won-basis	3.5 (-8.5)	-6.2 (2.9)	1.8 (6.5)	3.5 (6.3)	-1.6 (-6.4)	1.4 (-1.1)	4.0 (8.2)
	(raw materials)	2.5	-6.4	2.5	5.6	-1.5	1.8	4.3
	(capital goods)	7.3	-6.3	-1.8	-5.7	-2.1	-1.1	2.0
	(consumer goods)	10.6	-3.1	-0.6	-3.9	-2.6	1.3	3.3
	Contract currency-basis	-7.7 (-12.2)	-3.1 (8.3)	5.0 (5.5)	11.1 (3.6)	1.7 (-3.6)	2.5 (1.0)	5.1 (4.6)
Exchange rates[2]		-12.4	3.2	4.9	9.8	5.0	1.9	3.3

Notes: 1) Compared with the same period of the previous year. Figures in parentheses refer to the rates of increase compared with the last month of the previous period.
2) Won/US$ basis, average rate of increase during the given period.

large transformation from the previous year's 0.9% decrease to a 1.1% increase. Enlarged contributions to the rise in the index were also made by agricultural and fishery products, electricity, water and city gas, and by the service sector.

Meanwhile, looking at the stage-of-processing prices[6], the scale of the rise in those of raw materials expanded greatly while that of intermediate imports and of final products shifted from the previous year's decline to a rise, centering on petroleum and chemical products, primary metals and agricultural and fishery products.

(Import and Export Prices)

During 2003, export prices (Korean won basis) saw a 2.2% decrease. This was ascribable to the 4.9% appreciation of the Korean won against the US dollar, which more than offset the effects of the 1.3% rise in the contract currency price of exports brought about by rising demand in line with the recovery of the global economy.

Viewed by period, up until the end of the third quarter, export prices (Korean won basis) moved downward led by audio, visual and communication equipment, and by textiles and apparel in a development that reflected the US dollar's weakness and the intensification of competition between producers both at home and abroad. From the beginning of the final quarter, however, they shifted to an upward trend as the upsurge in the price of imported raw materials put increased pressure on Korean won prices while the Japanese yen and the euro strengthened against the dollar.

6) Producer prices of goods in terms of sector-weighted average of the PPI of commodities and import price index.

Even though the Korean won appreciated in dollar terms during the year 2003, import prices (Korea won basis) shifted from the previous year's 6.2% decline to a rise of 1.8%, led by a 5% rise of the contract currency price of imports.

Viewed by period, the rise in import prices showed a particularly pronounced pattern of upward movements during the first and the fourth quarters, largely influenced by movements in the prices of international raw material prices and especially those of oil.

(Real Estate Prices)

Housing prices during 2003 showed a rise of 5.7% on the basis of the final month of the previous year. This was a milder upward trend than that of the previous year, but it still outpaced the rate of increase in the CPI. Prices of apartments in the Gangnam area of Seoul continued to spearhead the upward movement of housing prices in general. On the other hand, leasehold deposits showed a 1.4% decline on the basis of the last month of the previous year.

<Table Ⅱ-14>

Trends of Movements[1] in Housing Prices and Leasehold Deposits

(%)

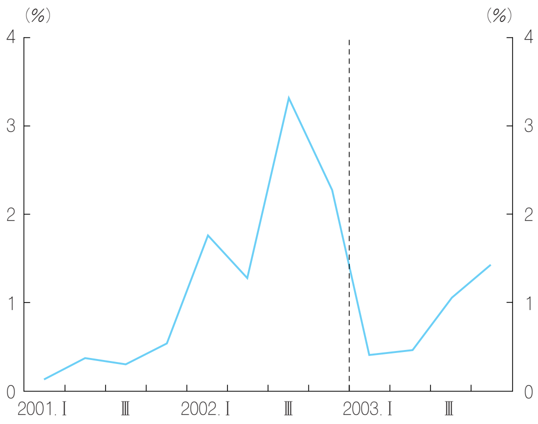
	2001	2002	2003				
			year	Ⅰ	Ⅱ	Ⅲ	Ⅳ
Housing prices	9.9	16.4	5.7	1.2	3.3	1.4	-0.2
(Apartments)	14.5	22.8	9.6	1.3	4.7	2.4	0.9
- Seoul	19.3	30.8	10.2	-0.8	5.4	4.4	0.9
<Gangnam>	22.0	35.2	14.3	-0.8	7.1	6.6	0.8
Leasehold deposits	16.4	10.1	-1.4	1.4	-0.7	-0.3	-1.8
(Apartments)	20.0	12.2	-0.4	2.0	-1.3	0.0	-1.1
- Seoul	23.4	11.4	-3.2	1.3	-2.4	-0.5	-1.6
Land prices	1.3	9.0	3.4	0.4	0.5	1.1	1.5

Note: 1) Compared with the last month of the previous period.
Sources: Ministry of Construction and Transportation, Kookmin Bank.

Looking at the movements of housing prices during the year, they showed a stable pattern during the first quarter in line with the heightened uncertainties overshadowing the economy as a whole including the looming war against Iraq and the North Korean nuclear issue. The scale of their upward movement expanded greatly from early in the second quarter and on through into the third quarter. It was stirred by speculative demand for apartments slated for reconstruction in the Gangnam district, and spread to its neighborhoods centering on large and medium sized apartments, new satellite cities around Seoul, and on areas reported as possible sites for the construction of the new administrative capital in the Daejeon and Chungcheong

<Figure Ⅱ-18>

Trends of Movements[1] in Land Prices



Note: 1) Compared with the last month of the previous quarter.
Source: Ministry of Construction and Transportation.

regions. During the fourth quarter, they shifted to a downward trend, albeit in a minor key, following the government's unveiling of its 「Comprehensive Package of Housing Market Stabilization Measures」 (October 29), designed to tackle the protracted sharp rise in housing prices.

In the case of housing leasehold deposits, although prices rose temporarily at the beginning of the new school year in February and March, and again in August and September, stable trends were maintained, largely as a result of the improved interplay of supply and demand thanks to an increase in the completion of new apartments.

Land prices showed a rise of only 3.4% from the previous year's 9.0% upswing. From the third quarter onwards, however, there were signs of an acceleration of the upward trend of land prices in districts in which development restrictions were abolished, in suburban areas surrounding Greater Seoul in connection with the planned development of satellite cities, and in the Chungcheong region in response to the decision to move Korea's administrative capital.

4. Financial Markets

A. Price Indicators

(1) Interest Rates

<Table Ⅱ-15>

Trends of Major Market Interest Rates[1]

(annual %)

	2001 Dec.	2002 Dec.	2003 Mar.	2003 Jun.	2003 Sep.	2003 Dec.
Call (one day)	4.00	4.52	4.25	4.09	3.75	3.95
CD (91days)	4.86	4.90	4.70	4.30	3.89	4.36
CP (91days, A1)	5.07	5.03	5.27	4.67	4.11	4.55
Treasury bonds (3yrs.)	5.91	5.11	4.62	4.16	4.11	4.82
Corporate bonds (3yrs., AA-)	7.04	5.68	5.38	5.45	5.05	5.58

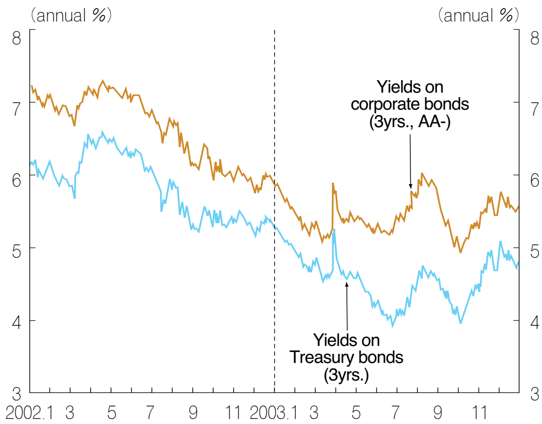
Note: 1) Month-end basis
Sources: The Bank of Korea, Korea Securities Computer Corp.

In 2003, long-term interest rates initially fell steeply during the first half of the year owing to the worries about the delay of economic recovery and the imbalance between the supply and demand of bonds, moving below the level of short-term market interest rates for a while. From early in the latter half of the year, they shifted to an upward trend and, in line with the brightening of prospects for a recovery of business activity, showed a progressive expansion in the scale of their rise. Interest rates on financial institutions' deposit and loans showed a small-scale decrease affected by the downward adjustment of the overnight call rate target.

(Long-Term Market Interest Rates)

<Figure Ⅱ-19>

Trends of Major Long-term Market Interest Rates

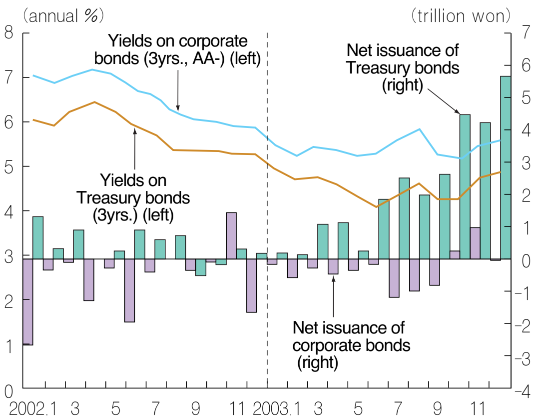


Source: Korea Securities Computer Corp.

A downward trend was exhibited from the beginning of the year in the movements of long-term interest rates owing to the worries about the delay of economic recovery generated by the geopolitical tensions surrounding the looming war against Iraq and the North Korean nuclear issue. Another factor acting to pull down long-term rates was the increased buying demand from financial institutions resulting from the strengthened preference for asset quality and increased deposit-taking by investment trusts at a time when the scale of the supply of long-term bonds, including both Treasury and corporate bonds, was on the decline. In consequence, secondary market yields on three-year Treasury bonds dropped to 4.57% (February 27).

<Figure Ⅱ-20>

Trends of Yields[1] on Corporate and Treasury Bonds and Net Issuance



Note: 1) Monthly average.
Source: Korea Securities Computer Corp.

The financial unrest precipitated in mid-March by the revelation of accounting malpractice at SK Global and concerns over possible defaults on credit card companies' paper led to a sharp temporary rise in yields on three-year Treasury bonds, bringing them to their highest level for the year (March 13, 5.24%). Helped by the steps to stabilize the financial markets taken by the Bank of Korea and the government, though, they swiftly returned to their previous level. They subsequently maintained this downward trend on growing anticipations that the Bank of Korea would lower its call rate target in response to the protraction of the downturn of the real economy under the impact of the spread of SARS and so forth. Notably, on June 18, yields on three-year Treasury bonds dropped below the overnight call rate to register their lowest-ever level of 3.95%. Three-year corporate bond yields showed similar movements to those on three-year Treasuries, but from March onwards the scale of their decline was relatively narrower owing to the heightened risk premium on them.

In the last days of June, long-term interest rates shifted from their long sustained downward trend to an upswing. As the revival of the US economy gathered momentum from early in the latter half of the year, they showed a rapid upward trend amid a growing mood of optimism about economic recovery thanks to pump-priming measures including the Bank of Korea's further reduction of its call rate target and the government's drawing-up of a supplementary budget. Secondary market yields on three-year Treasuries consequently moved up to 4.75% by August 1, at which date those on three-year corporate bonds (AA-) registered their highest level for the year as a whole of 6.01%.

After this rally, long-term yields retreated to their downward trend owing to the persistent sluggishness of domestic business activity, which contrasted with the recovering movements of the world economy and particularly those of the US economy. Yields on three-year Treasuries slipped back to 3.98% (October 2) as the domestic real economy ran into heavier difficulties due to the faltering of production in response to strikes at some large enterprises and fears mounted over further delay in the recovery given the strength of the Korean won against the US dollar.

Long-term yields shifted back to an upward trend, however, from October onwards with the further acceleration of the US economic recovery and the forming of expectations of an expanded supply of government bonds following the compilation of a second supplementary budget. At the same time, optimism concerning domestic economic recovery was becoming widespread in view of the buoyancy of exports. The upward trend of secondary market yields persisted on into early December when they eased back slightly so that yields on three-year Treasuries ended the year at 4.82% and those on three-year corporate bonds (AA-) at 5.58%, down respectively 29 basis points and 10 basis points from their level at the end of the previous year.

Looking at the interplay of the supply and demand for major types of bonds during the year under review, net issuance volumes contracted from the previous year in a movement centering on short-term issuance. At the same time, financial institutions, with investment trusts to the fore, reduced the scale of their purchases.

In the case of long-term bonds, those of the Deposit Insurance Fund (DIF) and the Non-performing Loans Management Fund (NPLMF) saw a large-scale net redemption, as did those of corporate bonds and

<Table Ⅱ-16>

Trends of Issuance[1] of Major Bonds

(trillion won)

	2001	2002	2003
Government bond	11.2	15.9	37.5
(Treasury bond)	8.4	4.7	25.9
Corporate bond[2]	8.2	-8.1	-4.0
Financial debenture[3]	4.7	27.4	8.5
ABS[4]	19.2	6.7	-1.9
Special bond[5]	30.5	8.4	-27.2
MSB	12.7	5.2	21.2
Total	86.5	55.5	34.1

Notes: 1) Based on the value of net issuance.
2) Excludes those issued by companies under court receivership in process of mediation or workout.
3) Industrial Finance bonds, SMEs' Finance bonds, Kookmin Bank's bonds, etc.
4) Secondary CBO, CLO, ABS of receivables loans, etc.
5) DIF bonds, NPLMF bonds, Credit card bonds, Installment bonds, Leasing bonds, etc.

<Table Ⅱ-17>

Status of the Changes of Holding Bonds by Institutions

(trillion won)

	Banks	(Branches of foreign banks)	Banks' trust	Investment trust	Pension funds	Insurance companies
2002	12.2	6.8	-4.0	-4.4	18.3	16.4
2003	6.4	5.4	-7.1	-13.4	26.1	11.2

Source: Korea Securities Depository

asset-backed securities (ABS). In contrast, there were large increases in the issue of Treasury bonds including those for foreign exchange market stability[7], because of the need to finance the two supplementary budgets, and of Monetary Stabilization Bonds consequently the supply of long-term bonds showed an overall increase from the previous year. In contrast, the volume of supply of short-term bonds shrank considerably with a decrease in the scale of net issuance of bank debentures and a sharp contraction in the issue of credit card company paper in response to fears over the precarious state of credit card companies' management.

In terms of the demand for bonds, pension funds and insurance companies maintained their buying position and banks, led by the branches of foreign banks, built up the scale of their bond holdings. Meanwhile, investment trust companies and banks' trust accounts expanded the scale of their disposal of bonds holdings in view of their reduced deposit-taking.

(Short-Term Market Interest Rates)

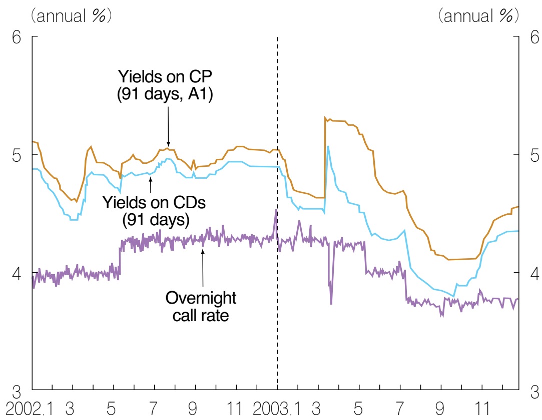
Short-term market interest rates, taking their cue from the adjustment of the call rate, exhibited smooth downward trend during the year to September, apart from a sudden spike in March. From the beginning of the fourth quarter, however, they shifted to an upward trend.

They showed a comparatively sharp fall during January, influenced by the decline of long-term market rates and the expanded demand for short-term financial assets following increased deposit-taking by investment trust companies. Thereafter they exhibited

7) From the November 10, 2003, the domestic issue of Foreign Exchange Stabilization Fund bonds was replaced by the issue of Treasury bonds for foreign exchange market stability.

<Figure Ⅱ-21>

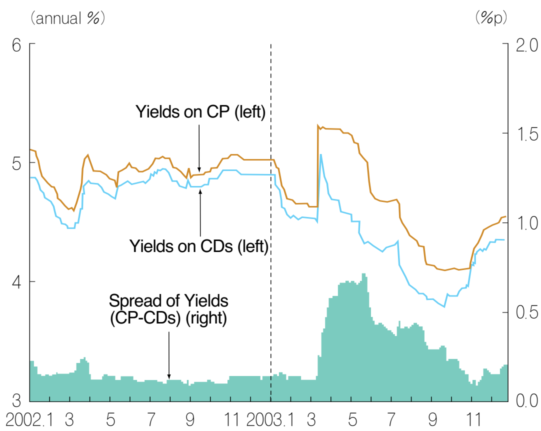
Trends of Major Short-term Market Interest Rates



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

<Figure Ⅱ-22>

Yields on CDs & CP and Spread of CP over CDs



Source: Korea Securities Computer Corp.

stable movements until the early part of March with secondary market yields on CDs (91 days) around the 4.5% level and those on A1-rated commercial paper (CP, 91 days) at 4.6%.

There was a sharp rebound of short-term interest rates in mid-March when the revelation of the accounting scandal at SK Global coincided with large-scale withdrawals from investment trust companies' money market funds (MMFs). There was a particularly large-scale increase in CP yields, which involve comparatively high risk, with financial institutions becoming increasingly sensitive to the degree of risk. After the spike, short-term market rates quickly regained their stability thanks to the measures taken to counter the financial market instability. They then moved steadily downward until late September, reflecting the Bank of Korea's reduction of its policy rate target on two occasions.

From October onwards, short-term market interest rates shifted to an upward trend, tracking the similar movements of long-term market rates, as the appetite for short-term financial assets dried up following the contraction of investment trust companies' MMFs deposits. In particular, yields on CDs showed a comparatively steep rise as banks increased their sales of CDs in order to bring up their liquidity ratios at year-end. As of the end of 2003, yields on 91-day CDs stood at 4.36% and those on the same maturity CP (A1) at 4.55%, respectively 54 basis points and 48 basis points lower than at the end of the preceding year.

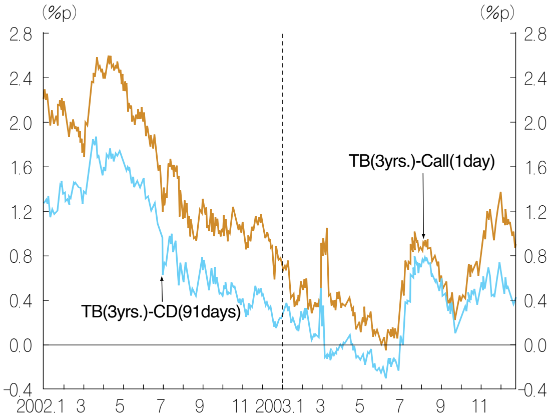
The differential between CD and CP yields widened greatly from early March, but gradually narrowed from mid-May, before opening up again somewhat around the year-end.

Overnight call rates were generally formed at the level of the Bank of Korea's call rate target. After running at a level of around 4.25% from May 2002, they eased to the 4% level in line with the Bank of Korea's downward adjustment of its call rate target by 25 basis points on May 13, 2003, and subsequently formed at around the 3.75% level after a second 25 basis-point cut in the policy rate on July 10.

(Spread between Long- and Short-Term Interest Rates)

<Figure Ⅱ-23>

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



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

The spread between long- and short-term interest rates continued to narrow and, during the second quarter, there was an inversion of the yield curve. From the beginning of the latter half of the year, however, the term structure of interest rates returned to normal with the rise in long-term interest rates.

The spread between long- and short-term interest rates maintained in the early part of the year its narrowing trend of the previous year as long-term market interest rates continued their downward trends. Notably from mid-March, secondary market yields on Treasuries (3 years) began to form below those on CDs (91 days) in a period when short-term market interest rates were rising steeply because of the financial market unrest generated by the SK Global accounting scandal and so forth. This phenomenon of an inverted yield curve persisted on through the second quarter so that, by mid-June, yields on three-year Treasury bond were running for a while below the overnight call rate.

After the late June, long-term market interest rates shifted to an upward trend whereas short-term market rates maintained their downward trend, influenced by the reduction of the call rate target. The phenomenon of an inverted yield curve began to disappear from early

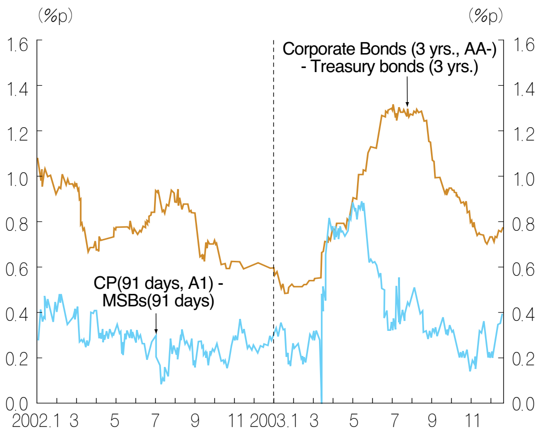
July onwards and, by early August, the differential was rapidly widening. Subsequently, the spread between long- and short-term interest rates, after narrowing a little in response to the movements of long-term market rates, opened up again somewhat. From mid-October, the spread between Treasuries (3 years) and CDs (91 days) was of the order of 0.5 percentage point. As of the end of December 2003, the spread between the two interest rates stood at 0.46 percentage point (previous year-end 0.21 percentage point).

(Risk Premium)

The risk premium, which is the difference between assets deemed to carry a high risk and those judged as having little or no risk, widened greatly during the first half of the year in line with the accelerated preference for asset quality, but from the beginning of the second half of the year it showed a narrowing pattern.

<Figure Ⅱ-24>

Trends of Risk Premiums



Source: Korea Securities Computer Corp.

Up until mid-March, a relatively stable pattern of movements was exhibited by the risk premium on corporate bonds (3 years, AA-) over Treasury bonds (3 years), which remained at around 0.5 percentage point as yields on the two types of asset both declined at a similar pace in view of the prevailing uncertainty of economic prospects. After that time, however, a heightened preference was observed for asset quality amid worries over the fragility of credit card companies and the SK Global accounting scandal. While yields on Treasuries continued to fall by a large margin, the scale of the decline in corporate bond yields was limited. This led to a sharp widening of the risk premium between them, so that it reached 1.2 percentage points in mid-June. It persisted at this high level until the early part of August but then settled down to reach a level of 0.7 percentage point at year-end as the credit risk of large enterprises declined in response to the buoyancy of exports and the improved prospects for economic recovery.

The short-term asset risk premium for CP (91 days, A1) over Monetary Stabilization Bonds (91 days) widened greatly during March in consequence of the sharp rise in CP yields. From early June, however, it narrowed to a considerable degree. Subsequently, although showing mild fluctuations, it generally moved within a range of 0.2~0.4 percentage point.

(Interest Rates on Financial Institutions' Deposits and Loans)

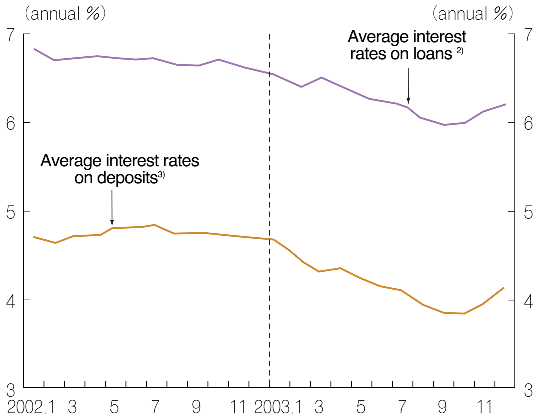
Interest rates on the deposits and loans of financial institutions maintained a downward trend during the first three quarters, influenced by the subdued demand for funds and the Bank of Korea's reduction in its policy rate along with the consequent fall in short-term market interest rates. They shifted to a mild upward trend, however, from the beginning of the fourth quarter.

The average deposit rate on the Bank deposits (newly-extended deposit basis) maintained a continuing decline, repeatedly touching new historic lows. The factors putting downward pressure on deposit rates included the difficulties that banks experienced in the operation of their funds from early in the year because of the policy authorities' guidelines on reining in household credits and the subdued demand for corporate funds in view of the economic downturn. This was exacerbated by the Korea Deposit Insurance Corporation's imposition of a special insurance premium on deposits.

In April deposit interest rates rose briefly, centering on those on short-term marketable financial products such

<Figure Ⅱ-25>

Trends of Interest Rates[1] on Bank Deposits and Loans



Notes: 1) Based on newly extended loans and deposits.
2) Excludes overdrafts and minus account loans.
3) Excludes demand deposits and savings deposits with instant access.

as CDs. This came in response to the sharp rise in market interest rates following the financial market turmoil of the previous month. Subsequently, however, as banks continued to experience difficulties in their use of funds while short-term market interest rates declined under the influence of the two-step cut in the policy rate, deposit interest rates repeatedly tested new lows each month, dropping to 3.81% in October.

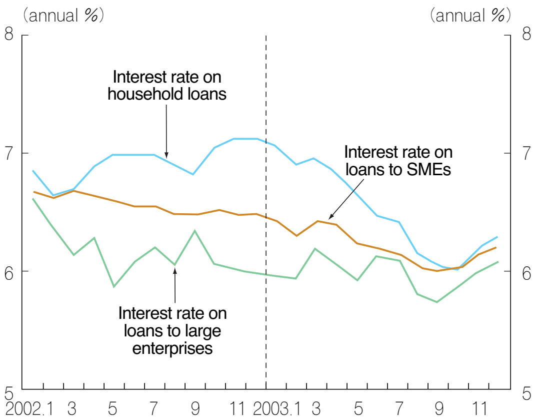
Rates paid by banks on deposit products eventually shifted to an upward trend from November onwards, as banks raised their rates on long-term deposits in line with the need to achieve their desired liquidity ratios at year-end, while interest rates on marketable financial products were also pushed up by rising market interest rates. In consequence, the average deposit rate moved up to 4.12% in December, but this level was still 0.57 percentage point lower than that a year earlier.

Banks' average lending interest rate (newly-extended lending basis) showed a similar downward trend, repeatedly touching new lows from the beginning of the year, in line with the backdrop of subdued corporate demand for funds and the downward trend of market interest rates. There was a short-lived hike in March amid increased demand for borrowings following the rise in market interest rates and the contraction of the bond market, but lending rates swiftly returned to a downward trend. Once again from May onwards they repeatedly touched new lows, and the average lending rate eased to 5.97% in September.

From early October onwards, though, the average lending rate shifted to an upward trend centering on floating-rate products linked to market interest rates such as loans secured against houses, and in December registered 6.20%, which was 0.38 percentage point lower than its level a year before.

<Figure Ⅱ-26>

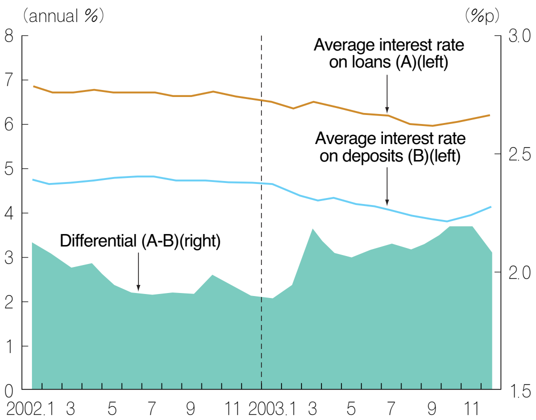
Trends of Average Interest Rates[1] on Bank Loans by Borrower



Note: 1) Based on newly extended loans.

<Figure Ⅱ-27>

Trends of Spread Between Interest Rates[1] on Deposits and Loans of Banks



Note: 1) Based on newly extended loans and deposits.

Looking at bank loans rates by type of borrower, those on households loans, linked mainly with market interest rates, fell steeply compared to those on corporate loans. Among types of loans to businesses, those to small and medium enterprises (SMEs) witnessed a comparatively large-scale decline amid banks' efforts to expand lending to SMEs. Loans rates on lending to large businesses showed a pattern of iterative fluctuations around the 6% mark, influenced by the high interest rates imposed on a number of enterprises with less than distinguished credit standing.

The spread between banks' interest rates on deposits and loans (newly-handled amount basis) widened from 1.89 percentage points as of the last month of the previous year to stand at 2.08 percentage points in December 2003. The widened spread reflected the rather greater fall in deposit rates than in loan rates.

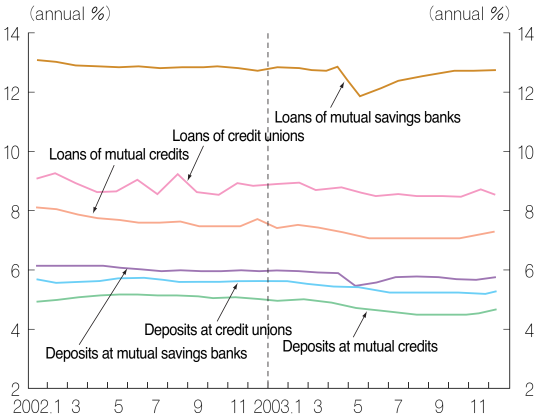
The deposit and lending rates of non-bank financial institutions exhibited downward trends more or less similar to those of banks during the year.

The average deposit rate paid by non-bank financial institutions (newly-extended deposits basis), while differing across the various types of institutions, evidenced an underlying downward trend during the first ten months of the year in line with the generally subdued character of the demand for funds and the decline of market interest rates, although it showed a mild upward trend from November onwards. The deposit rates paid by mutual savings banks, which handle various distinctive products paying relatively high interest rates; maintained the highest level among non-bank financial institutions, and the scale of their decline remained minor.

The average loan interest rate of non-bank financial

<Figure Ⅱ-28>

Trends of Interest Rates[1] on Loans and Deposits of Non-Bank Financial Institutions



Note: 1) Based on newly extended loans and deposits.

<Table Ⅱ-18>

Trends of the Major Indicators of Stock Market

	2001	2002	2003
KOSPI[1]	693.7 (+37.5)	627.6 (-9.5)	810.7 (+29.2)
Volume (million shares)[2]	473	857	542
Value (billion won)[2]	1,997	3,042	2,217
KOSDAQ Index[1]	72.2 (+37.3)	44.4 (-38.6)	44.9 (+1.1)
Volume (million shares)[2]	384	320	408
Value (billion won)[2]	1,728	1,205	1,079

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

institutions (newly-extended loan basis) also showed a generally downward trend until October, shifting to an upward trend thereafter. The lending rates of mutual savings banks showed a comparatively rapid upward pace, propelled by their expansion, from early in the second half of the year, of lending to SMEs with low credit ratings.

(2) Stock Prices

Korean stock prices showed a pattern of movements during the course of the year under review that was closely synchronized with those of stock markets in the US and other major countries. They started off the year on a downward trend, but upon the outbreak of the war against Iraq shifted to an upswing, thereafter maintaining a comparatively steep rising trend up until the end of the year.

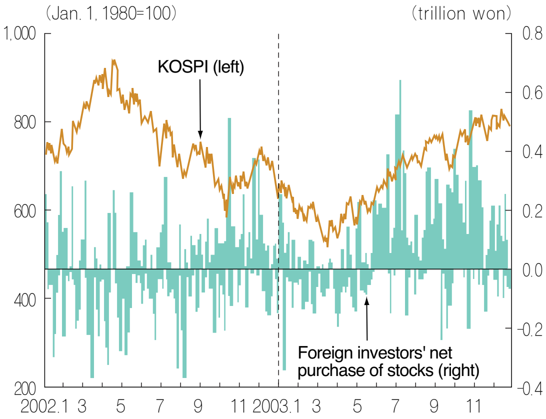
(Korea Stock Price Index)

The Korea Stock Price Index (KOSPI) started off the year on a downward trend that reflected the heightening of concerns over the delay in economic recovery as consumer and business confidence shrank amid mounting uncertainties concerning the North Korean nuclear issue and the looming war against Iraq. What is more, major domestic companies had shown disappointing business performance the previous year and foreign investors maintained a net selling position. The stock market adhered to its downward trend until mid-March, with KOSPI reaching its bottom for the year of 515.24 on March 17, following the emergence of widespread accounting malpractice at SK Global and the threat of default on credit card companies' bonds.

Around the time of the outbreak (March 20) of the US-led war against Iraq, however, as much of the uncertainty over the war was dispelled and the anticipations of an early ending of hostilities mounted, KOSPI began to rise, keeping pace with US share prices. Notably, they maintained a steep upward trend once financial market unease had been soothed by the announcement (April 3) of measures to appease the credit card companies' woes, and rising expectations of a peaceful settlement of the North Korean nuclear question.

<Figure Ⅱ-29>

Trends of KOSPI and Foreign Investors' Net Purchase of Stocks



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

In the last week of April, amid the spreading of the SARS epidemic and its negative influence, share prices briefly showed a steep decline as the North Korean nuclear issue was complicated by the North's declaration (April 25) of its holdings of nuclear weapons. However, KOSPI once again staged a large-scale rally with the assuaging at an early date of much of the concern over SARS and the North Korean nuclear issue, which coincided with the sustained upward trend of US share prices and the progressive spread of a mood of anticipation concerning an economic recovery in the latter part of the year. Notably, foreign investors shifted to a net buying position from around the end of April and greatly stepped up the scale of their net purchases thereafter, so that KOSPI's upward pace accelerated, setting a trend that was maintained until mid-September.

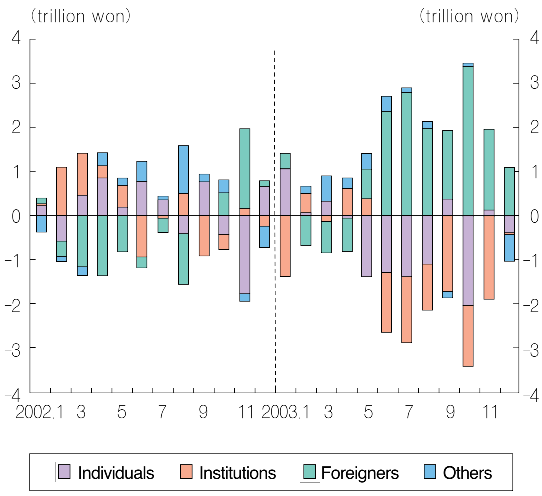
Share prices briefly retreated to a downward trend in mid-September. This was attributable to the worsening for a while of the economic environment at home and abroad as Typhoon Maemi caused widespread damage, oil prices rose in reaction to OPEC's decision (September 24) to reduce production, and the Korean won strengthened against the US dollar just after the G-7 meeting (September 20). Worse still, US stock prices entered on a correction phase and foreign investors, who had driven the upswing in Korean share prices for several months, moderated their net buying position.

In the early part of October, with the recovering movements of the US economy becoming more evident, US stock prices shifted back to an upward trend and major Korean companies reported greatly improved business performance during the third quarter. What is more, foreign investors, after briefly scaling back their purchases during September, greatly expanded their net buying position. As a result of these developments, KOSPI shifted back to a steep upward path, achieving a month-on-month rise of 12.16%, its largest since November 2001 (19.72%). In the last two months of the year, while showing temporary fluctuations, share prices maintained a smooth underlying upward trend that brought KOSPI to a level of 810.71 at the year-end, which represented a 29.2% rise over the previous year-end.

This large-scale rise in share prices led to a 37.4% (96.7 trillion won) expansion of market capitalization, so that the total value of shares listed on the Korean Stock Exchange registered 355.4 trillion won at the year-end.

<Figure Ⅱ-30>

Trends of Net Purchase of Stocks on the KOSPI Market by Type of Investor



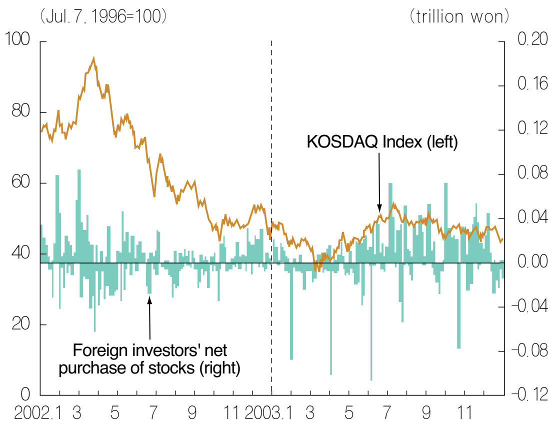
Source: Korea Securities Computer Corp.

Looking at transaction trends by category of investor during the year 2003, foreign investors who had shown a net selling position (2.9 trillion won) during the year 2002 for the first time since the opening of the stock market (1992) were the biggest buyers, registering net purchases of 13.8 trillion won for the year as a whole. In contrast, domestic institutional and individual investors recorded net sales of 9.0 trillion won and 5.9 trillion won respectively.

If we examine the trends of foreign investors' share trading by quarter, we see that a relatively large-scale net selling position was maintained by them from mid-January up until late April in consequence of the obscurity of the conditions shrouding stock markets at home and abroad. From around the end of April, however, there was a shift to a net buying trend and the scale of purchases progressively increased so that, for the six-month period from June to November, monthly average purchases were running at 2.5 trillion won, leading the rise in share prices. During December, although share prices showed a short-lived correction phase, foreign investors still registered net sales of more than one trillion won.

<Figure Ⅱ-31>

Trends of KOSDAQ Index and Foreign Investors' Net Purchase of Stocks



Source: Korea Securities Computer Corp.

(KOSDAQ Index)

The Korea Securities Dealers Association Automated Quotation (KOSDAQ) Index[8] displayed similar movements to those of KOSPI during the first half of the year. From early in the year it maintained a downward trend to reach 34.64 on March 17, its historically lowest level. But then it shifted to a sharp upward trend, keeping pace with that of KOSPI, which brought it to stand at 53.50, its highest level for the year, on July 9.

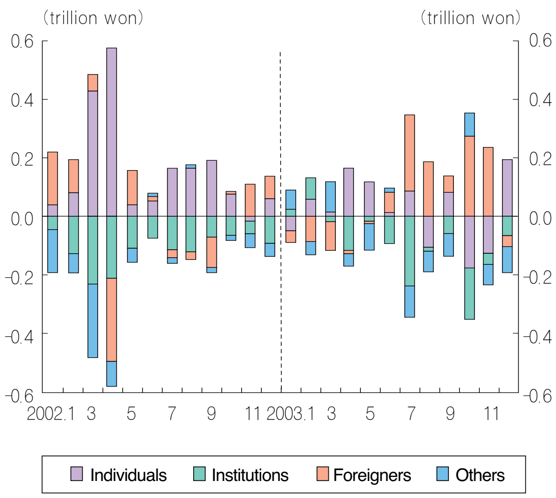
In mid-July, however, it shifted to a downward trend as it emerged that major Internet-related businesses' second-quarter business performance fell far short of expectations. Notably under the influence of suspicions of illicit internal transactions and the window dressing of accounts on the part of certain Internet-related businesses, the KOSDAQ Index, contrary to KOSPI's upward path, showed an uninterrupted downward trend centering on IT companies until the end of the year. As

8) Figures for the KOSDAQ Index shown in this report take the base value of 100 with the base date of July 1, 1996, although, on and from January 26, 2004, the KOSDAQ Index has been rebased from 100 to 1000.

a consequence, the KOSDAQ Index finished the year standing at 44.87, a rise of just 1.1% over the previous year-end. The total market capitalization of the KOSDAQ market, meanwhile, did not budge from the previous year's 37.4 trillion won.

<Figure Ⅱ-32>

Trends of Net Purchase of Stock on the KOSDAQ Market by Type of Investor



Source: Korea Securities Computer Corp.

Looking at the trends of transactions by type of investor during the year under review, foreign investors and domestic individual investors had net purchasing positions of 0.8 trillion won and 0.3 trillion won respectively whereas domestic institutional investors, including investment trust companies and securities companies, had a net selling position to the tune of 0.7 trillion won. From early in the year foreign investors maintained a net selling position, but after shifting to a net buying position in June, they chalked up net purchases of more than one trillion won by the end of the year, helping to limit the scale of the decline in the index.

B. Quantitative Indicators

(1) Money

<Table Ⅱ-19>

Growth Rate[1] of Major Monetary Aggregates

(%)

	2001 Dec.	2002 Dec.	2003 Mar.	2003 Jun.	2003 Sep.	2003 Dec.
M3	11.3 (9.6)	13.3 (12.9)	11.7	9.1	7.5	5.0 (8.8)
M2	8.3 (6.9)	14.1 (11.5)	11.9	7.9	5.8	3.0 (7.9)
M1	25.0 (18.0)	15.2 (22.5)	7.8	5.9	6.8	5.4 (6.9)
RB	14.0 (11.5)	9.7 (14.3)	6.0	8.6	6.8	6.6 (6.5)

Notes: 1) Based on monthly average, compared with the same period of the previous year.
Figures in parentheses refer to yearly average basis.

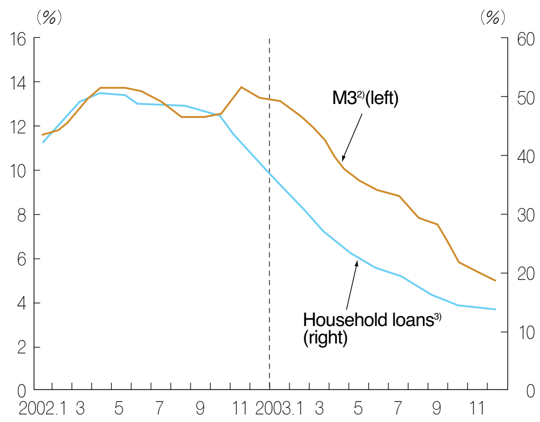
During 2003, the growth rate of the monetary stock decelerated greatly owing to financial institutions' reduction of the supply of credit to the private sector, notably households, compared to the previous year, which more than offset the government's expansion of fiscal spending.

(Monetary Aggregates)

The annual growth rate of M3 (average balance basis), the broad money aggregates encompassing overall liquidity, declined from the preceding year's 12.9% to 8.8%.

<Figure Ⅱ-33>

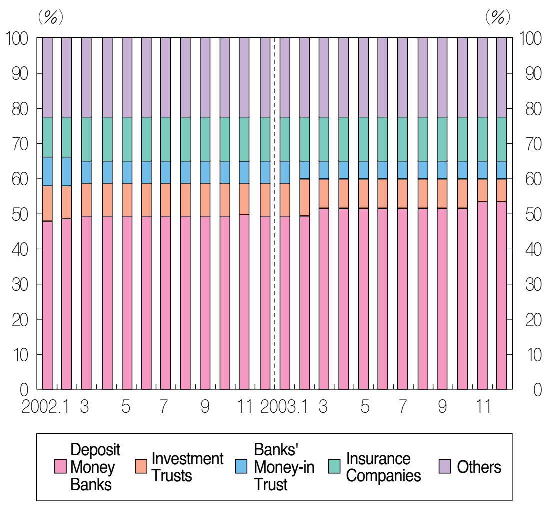
Trends of the Growth Rate[1] of M3 and Household Loans by Banks



Notes: 1) Compared with the same period of the previous year.
2) Monthly average basis.
3) Period-end basis.

<Figure Ⅱ-34>

Shares of M3 by Financial Institution Type



The growth rate of M3 showed a downward trend from early in the year owing to the shrinkage of the supply of the credit to the private sector by banks. This contraction was largely attributable to the government's guidelines on reining in household loans along with a base period effect from their sharp rise a year earlier, which more than offset the relative buoyancy of corporate lending as financial institutions endeavored to step up their lending to SMEs. Strikingly, despite the government bringing forward its disbursement of the budget to stimulate the economy, the downward trend in the growth rate of M3 accelerated from early in the second quarter as the financial intermediation function contracted centering on non-bank institutions, for example, large-scale withdrawals from investment trusts' MMFs.

During the latter half of the year, the growth rate of M3 sustained its downward trend, dropping to the level of 5% in December. This occurred despite the further expansion of fiscal spending brought about by the government's complication of two supplementary budgets on two occasions, and was ascribable to the slowdown in household loans and companies' reduced demand for funds as a result of the delay in economic recovery.

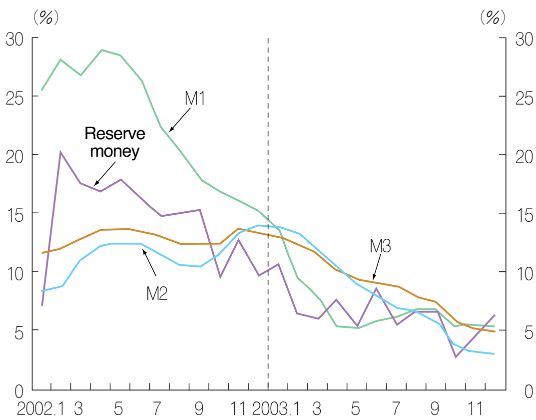
Looking at the composition of M3 in terms of the deposits of the various categories of financial institutions, the share of bank accounts rose from the previous year's 50% to 52.5% as of year-end 2003 thanks to their absorption from March onwards of funds that had previously migrated to investment trust companies. In contrast, the weight of investment trust companies in M3 slipped from 9.8% to 7.3% as a result of the contraction of their MMFs and the share of banks' trust accounts also saw a reduction, declining from 5.5% to 4.1% in a move centering on specific money trusts.

For its part, M2 (average balance basis) also maintained a downward trend from the beginning of the year and saw its growth rate fall sharply from 11.5% the year before to stand at 7.9% during 2003. Most notably, from early in the fourth quarter, its rate of growth slid to the 3% level.

The growth rate of M1 (average balance basis), narrow money, fell back dramatically from 22.5% the previous year to stand at 6.9%.

<Figure Ⅱ-35>

Growth Rates[1] of Major Monetary Aggregates



Notes: 1) Based on monthly average.
Compared with the same month of the previous year.

Viewed by period, M1 growth tumbled by almost 10 percentage points within a four-month period from 15.2% in the December of the preceding year to 5.3% in April 2003. This was attributable to the subdued demand for transaction balances during the year 2003 owing to lackluster business activity, base-period effects resulting from the sharp increase in demand for short-term funds a year earlier, and the large-scale redemption of investment trust companies' MMFs.

Later in the year, the downward trend of M1 growth began to show signs of faltering as instant-access account products turned buoyant and some of the funds from the redemption of MMFs flowed back in thanks to the early stabilization of financial market. Indeed, from June onwards, it shifted to a mild upward trend. Notably, during the third quarter, there was a concentration into short-term financial assets of market funds waiting for appropriate investment opportunities, and the growth rate of M1 rose to above 6.5% level.

With the onset of the fourth quarter, however, the growth rate of M1 resumed its downward trend amid large-scale withdrawals of funds from financial institutions associated with the redemption of Deposit Insurance Fund (DIF) and Non-performing Loans Management Fund (NPLMF) bonds. In particular, the growth rate of M1 fell to 5.4% in December because of the redemption of MMFs prompted by the liquidity crisis of credit card companies and seasonal factors including, for example, businesses' withdrawal of short-term deposits in banks to meet their year-end demand for funds.

The growth rate of reserve money (average balance basis), which had risen sharply by 14.3% the previous year, dropped back steeply, largely because of the subdued demand for transaction balances owing to lackluster business activity.

(Money Supply Structure)

Looking at the supply of money by sector during the year 2003 on the basis of M3, money supply through the private sector shrank greatly compared with the previous year whereas supply through the government sector expanded. The foreign sector, meanwhile, shifted from a channel of absorption to one of supply.

The overall supply of M3 through the private sector shrank greatly from 149.1 trillion won in 2002 to 60.0 trillion won in 2003. This decline was led by the slowdown of the growth of loans from 115.4 trillion won the previous year to 76.6 trillion won in a movement centering on household loans. Meanwhile, securities including corporate bonds and CP shifted from a supply of 13.8 trillion won to a net absorption of 18.1 trillion won.

The public sector expanded its scale of absorption from the preceding year's 7.0 trillion won to 19.7 trillion won in line with the large-scale redemption of DIF and NPLMF bonds. For its part, the government sector expanded the scale of its supply of money from 2.5 trillion won the previous year to 11.2 trillion won,

<Table Ⅱ-20>

M3 Supply[1] by Sector

(trillion won)

	2001	2002	2003
M3 changes	106.1	138.0	54.0
Government	12.0	2.5	11.2
Public sector	17.2	-7.0	-19.7
Private sector	74.7	149.1	60.0
(Loans & discounts)	45.6	115.4	76.6
(Securities)[2]	22.7	13.8	-18.1
(Loans in foreign currency)[3]	-4.5	17.5	2.9
Foreign sector	21.5	-10.4	31.8
Others	-19.4	3.9	-29.3

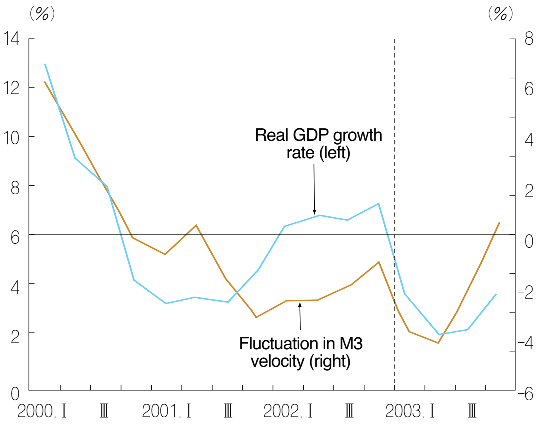
Notes: 1) Changes based on year-end balance.
2) Securities such as coporate bonds, CP, etc.
3) Advanced payment against foreign currency payment guarantees, foreign currency credits, etc.

owing to the increased fiscal spending resulting from its compilation on two occasions of supplementary budget as a pump-priming measure.

The foreign sector, meanwhile, shifted from a net absorption of 10.4 trillion won the previous year to a supply of 31.8 trillion won as a result of the greatly expanded current account surplus and large-scale inflows of foreign capital for portfolio investment.

<Figure Ⅱ-36>

M3 Velocity Fluctuations and Real GDP Growth Trends[1)]



Notes: 1) Compared with the same period of the previous year.

(Monetary Velocity)

Despite the sharp fall in the growth of money supply, monetary velocity on an M3 basis decelerated only slightly during the year under review. Its movements reflected the maintenance of price stability amid a swift cooling of business activity.

<Reference Ⅱ-2>

Judgment Concerning the Decline in Money Supply Growth and Market Liquidity Conditions

From the early part of 2003, the growth rates of the major money supply aggregates such as M3 decelerated rapidly as the government's expansion of fiscal spending was more than counteracted by the generally subdued demand for corporate funds and the sharp decline in the rate of increase in household loans.

Growth Rates[1)] of Major Monetary Aggregates

(%)

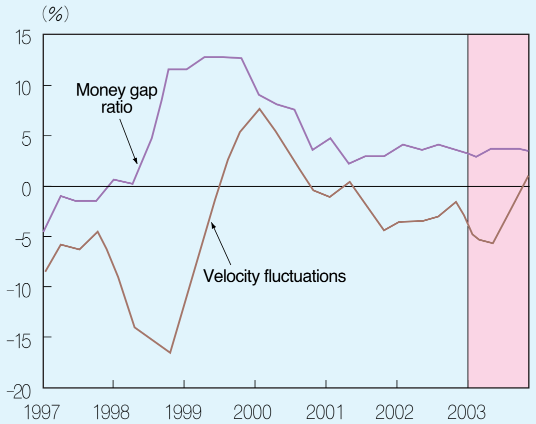
	2001	2002	2003				
			year	Ⅰ	Ⅱ	Ⅲ	Ⅳ
M3	9.6	12.9	8.8	12.4	9.6	8.1	5.4
M2	6.9	11.5	7.9	13.1	9.1	6.5	3.3
M1	18.0	22.5	6.9	10.3	5.5	6.6	5.5

Notes: 1) Compared with the same period of the previous year.
Average balance basis.

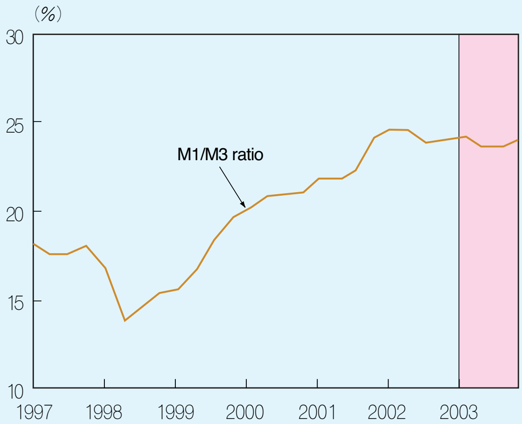
Nevertheless market liquidity conditions are judged to have been generally smooth in view of the fact that the M3 money gap (the gap between current real M3 stock and that consistent with long-run equilibrium) estimated through the long-term money demand function remained positive and monetary velocity continued the slackening trend during the year.

This is because the decline in monetary growth rates was ascribable not so much to money supply factors but to the subdued money demand of households and companies resulting from the downturn in business activity. In fact, the Bank of Korea continued its accommodating monetary stance during the year 2003, lowering, for example, its call rate target on two occasions by a total of 50 basis pionts. At the same time, financial institutions, with holding ample overall funds, experienced difficulties in operating them. In addition, from the aspect of the composition of monetary aggregates, the ratio of M1, which has a high degree of moneyness, to M3 remained at an elevated level during the year. This is served as a factor making for ample liquidity conditions by offsetting to a considerable extent the influence of the decline in the growth rate of M3.

Trends of Money Gap and Velocity Fluctuations of M3



Trends of M1/M3 Ratio



<Table Ⅱ-21>

Trends in Deposits[1] of Financial Institutions

(Changes during the period, trillion won)

	2001	2002	2003 year	Ⅰ	Ⅱ	Ⅲ	Ⅳ
Deposit money banks[1]	54.6	64.9	39.9	8.4	14.6	-1.5	18.4
Real demand	6.2	8.6	1.4	-5.4	2.7	-0.3	4.4
Time & savings	44.8	43.1	29.3	11.2	5.5	-2.7	15.3
(Time)	9.9	31.7	14.7	2.9	5.9	-0.3	6.2
<over 1 year>	3.6	46.5	30.9	8.1	10.0	5.1	7.7
(Instant access)	26.1	10.1	15.7	7.9	-0.6	-2.8	11.2
<MMDA>	8.5	-0.1	14.6	9.8	1.7	-3.5	6.5
CDs+RPs	10.5	12.9	9.3	2.6	7.1	1.6	-1.9
Cover bills	-6.9	0.3	-0.2	0.1	-0.6	-0.1	0.5
Banks' trust account	2.7	-8.0	-15.7	-2.2	-7.0	-3.2	-3.2
Specific money trust	5.1	10.9	-6.7	0.3	-4.4	-1.4	-1.2
Investment trust companies	14.0	16.3	-28.6	-8.1	-9.1	6.3	-17.8
Short-term bond type	8.8	10.6	-3.5	2.7	-1.9	-1.4	-3.0
Long-term bond type	-1.1	-14.5	-3.7	-0.3	1.9	-1.5	-3.8
MMFs	8.5	14.0	-7.2	-9.6	-2.7	11.3	-6.1
Stock type	2.6	2.7	-1.0	1.4	-0.4	-1.0	-0.9
Mixed type	-4.8	3.6	-13.1	-2.2	-6.0	-1.1	-3.9
Merchant banks	-2.1	0.0	-0.7	2.7	-1.0	-0.8	-1.5
Bills issued	-1.9	0.0	-1.1	2.2	-0.7	-0.9	-1.7
CMA	-0.2	0.0	0.4	0.4	-0.3	0.1	0.2
Mutual savings banks	4.7	3.0	4.5	0.9	0.6	0.9	2.0

Note: 1) Includes due from governments and excludes deposits of the Korea Development Bank.
Source: Representative associations.

(2) Deposit at Financial Institutions

In the course of the year under review the growth rate of deposits at deposit money banks (bank account only basis) decelerated and the level of deposits at investment trust companies and in banks' trust accounts contracted absolutely.

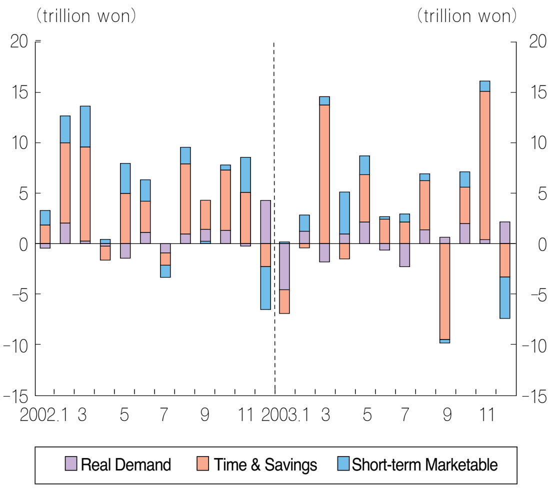
(Deposit Money Banks)

Deposit money banks received a constant influx of market funds owing to the continued preference for asset quality and showed relatively convincing growth, but their total increase during the year of 39.9 trillion won represented a reduction compared to that of the previous year's 64.9 trillion won.

Broken down by type of deposit product, demand deposits marked a small increase of 1.4 trillion won over the year. Instant access accounts enjoyed buoyant growth centering on money market deposit accounts (MMDA), attracting funds away from investment trust companies and the banks' own trust accounts. Time deposits experienced a sharp fall in their rate of increase, influenced by the withdrawal of funds by the Korea Deposit Insurance Corporation (KDIC) and the Korea Asset Management Corporation (KAMCO) for the redemption of respectively DIF and NPLMF bonds. In consequence, there was a sharp decline in the growth of time and savings deposits as a whole, and their overall increase fell from that of the previous year's 43.1 trillion won to 29.3 trillion won during the year under review. Meanwhile short-term marketable products such as CDs and RPs maintained a relatively sharp pace of expansion from the previous year to register an increase of 9.3 trillion won, profiting from the contraction in the issue of CP, with which they compete.

<Figure Ⅱ-37>

Deposits[1] at Deposit Money Banks by Product



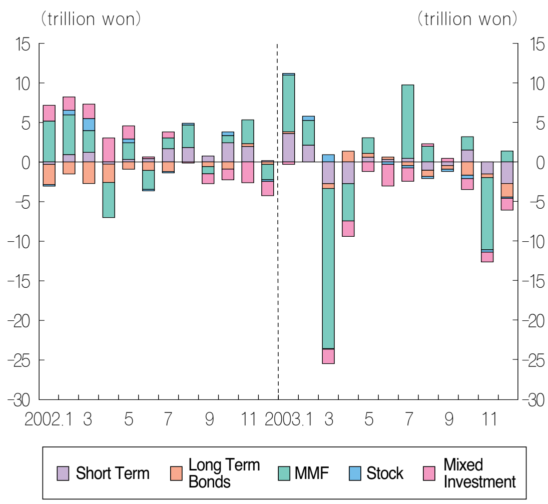
Note: 1) Based on changes during the month.

Viewed by period, during January and February, demand deposits and instant access accounts displayed a subdued pattern owing to seasonal factors, including the strong demand for money in circulation around the Lunar New Year holiday period. From early in March, however, there were large portfolio shifts out of investment trust companies and banks' trust accounts into MMDAs, leading to brisk deposit-taking by banks. Subsequently, too, the preference for asset quality was maintained with banks, sustaining a convincing rate of deposit growth centering on time deposits and CDs until the year-end. In September, though, the KDIC and the KAMCO withdrew funds on a large-scale for the redemption of their maturing bond issues, bringing about a very large reduction in deposits centering on time deposits with a maturity of less than six months. From early December, there was again a considerable reduction, this time prompted by seasonal factors, particularly firms' demand for funds over the year-end.

(Investment Trust Companies)

<Figure Ⅱ-38>

Deposits[1] at Investment Trust Companies by Product



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

Deposits at investment trust companies, which had seen a 16.3 trillion won increase the previous year, shifted to a 28.6 trillion won decrease during the year under review. Their MMFs contracted particularly sharply under the influence of scrambles on two occasions, in March and November, to withdraw funds from them. At the same time, their bond-type and composite-type beneficiary certificates also presented a lackluster pattern.

Viewing their deposit-taking by period, a buoyant tone was evident in January and February with the inflow of short-term funds to MMFs in particular. From mid-March, however, concerns over the SK Global accounting scandal and the threat of default on credit card companies' bonds led to a large-scale migration of funds out of MMFs, and consequently to a sharp fall in deposits. During May some of the funds pulled out of MMFs flowed back into them again and there was a slight increase in deposits, but in June they shrank again as composite-type beneficiary certificates continued sluggish because of anticipations of an upturn in long-term market interest rates.

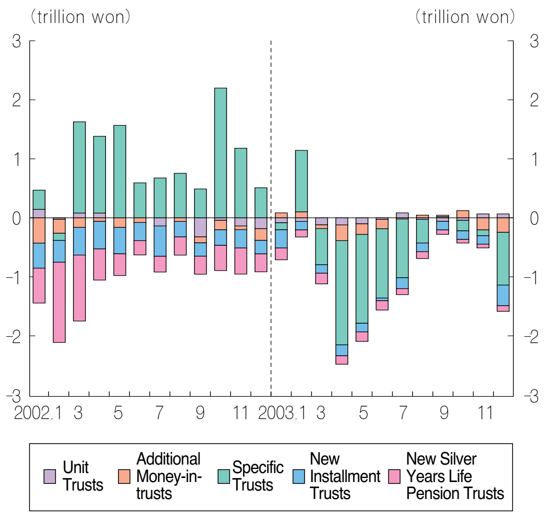
Over July and August, while the phenomenon of the short-termism of market funds intensified, the reduction by banks of interest rates on their MMDAs led to a big increase in deposits for the rival MMFs offered by investment trust companies. However, investment trust companies' deposits subsequently shifted back to a contraction amid the continued sluggishness of sales of bond-type and composite-type beneficiary certificates. From early November onwards, this declining trend gathered pace following renewed mass redemption of MMFs, this time as a result of the LG Card debacle.

(Banks' Trust Accounts)

Banks' trust accounts saw deposits shrink by 15.7 trillion won during 2003, representing an acceleration of their declining trend compared to the previous year's reduction of 8 trillion won. This was mainly attributable to a large-scale contraction of specific money trusts, which had shown strong growth during the previous year, due to an increase in the risk on CP, the principal vehicle for the operation of this type of trust, prompted by worries over the SK Global accounting scandal and the possibility of defaults on credit card companies' bonds. This situation was worsened by the continued exit at maturity of funds from tax-exempt household trusts and new installment trusts, new offers of which ceased.

<Figure Ⅱ-39>

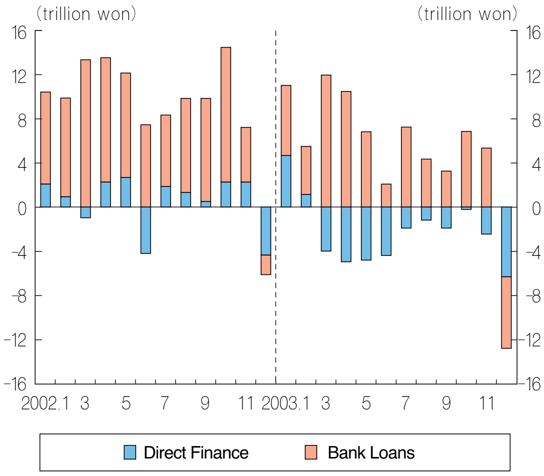
Deposits[1] at Banks' Trust Accounts by Product



Note: 1) Based on changes during the month.

<Figure Ⅱ-40>

Corporate Finance[1]



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

(3) Corporate Financing

Corporate financing conditions presented a comparatively smooth picture over the course of the year 2003: cash flow improved particularly for large companies thanks to the influence of buoyant exports while there was a contraction of demand for investment funds owing to the delay of domestic economic recovery. There was, nevertheless, a strengthening of credit differentiation with some deterioration of funding conditions in the case of SMEs with sub-optimal credit standing.

Looking at the channels of external corporate fund-raising, the bank lending channel maintained a robustly increasing trend that centered on SMEs, but the direct financial markets channel was sluggish owing to the lackluster demand for long-term investment funds and the heightened credit risk.

(A) Bank Loans

<Table Ⅱ-22>

Bank Lending[1] by Sector

(trillion won)

	2001	2002	2003				
			year	Ⅰ	Ⅱ	Ⅲ	Ⅳ
Large Enter-prises	-12.0	0.1	-2.9	1.8	-1.0	0.1	-3.8
SMEs	11.9	37.1	35.0	14.7	11.9	7.3	1.1
Households	45.0	61.6	30.6	4.8	9.1	8.7	7.9
Others[2]	-7.2	-0.2	-0.5	1.1	-0.9	-1.2	0.4
Total	37.8	98.6	62.2	22.4	19.2	15.0	5.7

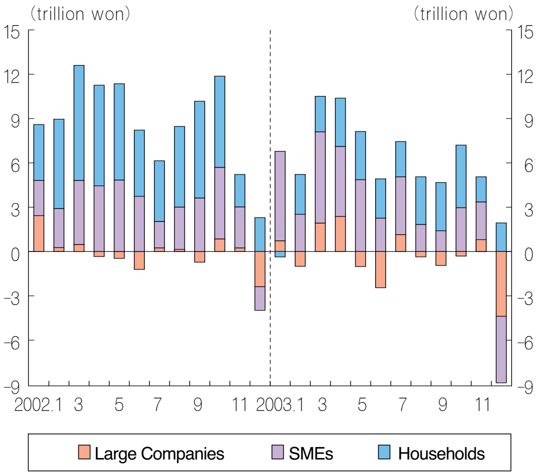
Notes: 1) Includes trust account lending (except discount of CP). Based on changes during the period.
2) Lending to public and other legal entities.

During the year 2003, bank loans (including those from banks' trust accounts) rose by 62.2 trillion won, showing a considerably smaller-scale increase than the previous year's 98.6 trillion won.

Viewed by sector, loans to large companies declined by 2.9 trillion won during the year. They had relatively little demand for borrowings owing to the postponement of facilities investment decisions while prospects for business remained obscure and to the comparatively favourable state of their cash flow thanks to strong business performance driven by a continuing export boom. In contrast, lending to SMEs sustained its strongly increasing pace of the previous year (37.1 trillion won), registering an increase of 35.0 trillion won during the year. This reflected companies'

<Figure Ⅱ-41>

Bank Lending[1] by Sector



Note: 1) Based on changes during the month.

need for short-term working capital because of lackluster domestic sales amid the contraction of domestic demand. At the same time, banks expanded their efforts to make loans to SMEs in response to the government's issue of guidelines on reining in household loans and subdued demand for borrowings on the part of large companies. A further factor in this expansion was that SMEs had become relatively more dependent on borrowings from banks in view of the worsening of conditions in the corporate bond and CP markets. Because SMEs are largely dependent on domestic demand, banks, nevertheless, increasingly fretted over the possibility of their loans to them turning sour as the economic recovery receded. The consequent progressive strengthening of their credit screening caused a decline in the growth of their lending to SMEs as the year-end drew near.

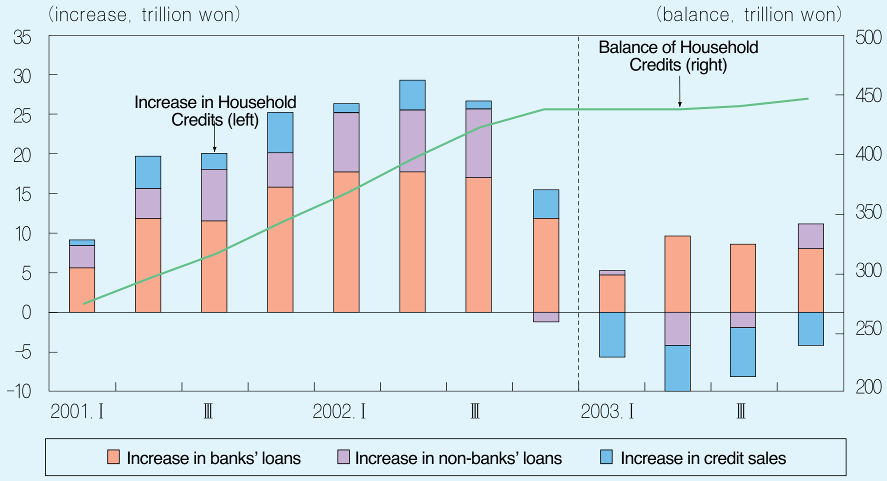
Meanwhile lending to households registered an expansion of some 30.6 trillion won, less than half the scale of that the year before (61.6 trillion won). This slowdown reflected the government's moral suasion on banks to rein in their credit to households and the increased credit risk of such lending because of the domestic economic downturn. Strikingly the growth of loans secured against housing collateral (excluding trust account loans) contracted sharply from 45.5 trillion won the previous year to 20.7 trillion won. Minus account loans also saw their growth reduced from 24.1 trillion won to 16.1 trillion won.

<Reference Ⅱ-3>

Impact of the Deterioration of Household Credit

Household credits had increased greatly during 2001 and 2002, giving rise to concerns both about their deterioration and a run-up in real estate prices. This prompted the government to issue guidelines on reining in such credits and the financial institutions to strengthen their risk management. From the beginning of 2003, in consequence, there was a sharp contraction of household credits. The rate of increase in household loans slackened considerably and credit card sales shrank on a large-scale.

Trends of the Amount of Increase and the Balance of Household Credits



Such a contraction of household credits became a principal factor in the slowdown of domestic economic activity by giving rise to an abrupt shriveling of private consumption. During the year 2003, private consumption shifted from the previous year's increase of 7.9% to register a decline of 1.4%, which caused the contribution rate of private consumption to GDP growth to shift from its positive 61.8% the previous year to a negative contribution of 25.4% during the year under review.

Trends of Growth[1] in Real GDP and Private Consumption

(%)

	2002					2003				
	Ⅰ	Ⅱ	Ⅲ	Ⅳ	year	Ⅰ	Ⅱ	Ⅲ	Ⅳ	year
Real GDP	6.5	7.0	6.8	7.5	7.0	3.7	2.2	2.4	3.9	3.1
Private consumption	9.8	8.7	7.8	5.5	7.9	0.3	-1.8	-1.9	-2.2	-1.4

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

Along with the contraction of household credits, delinquency rates on banks' household loans and on credit cards rose steeply from the beginning of 2003 as the latent problem of their deterioration, which had been present for some time, materialized. The number of people blacklisted as credit defaulters also increased rapidly to encompass 3.7 million people, emerging as a serious social issue.

Trends of Delinquency Ratios and Number of Credit Defaulters

(year-end basis, %, thousand)

	2002				2003			
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
Delinquency rates on banks' household loans[1]	1.43	1.30	1.61	1.50	2.06	2.01	2.27	1.78
Delinquency ratios on credit cards[2]	2.9	3.8	5.1	6.6	9.6	9.5	11.2	14.3
Number of credit defaulters	2,455	2,260	2,455	2,636	2,957	3,225	3,502	3,720

Notes: 1) Deposit money bank basis (includes banks trust account)
2) Based on management assets over 30 days of eight specialized credit card company, but excludes Korea Exchange Bank Credit Company in Dec. 2003, which was affected by a strike.
Sources: The Bank of Korea, The Financial Supervisory Service.

Meanwhile, the deepening spiral of management failure of credit card companies acted as a destabilizing factor on financial markets. Credit card companies had expanded their business excessively by the issue of cards without adequate credit screening procedures and the overextension of cash advances and add-on services. They had also greatly increased the scale of their liabilities involving notably short-term debt instruments such as bonds, asset backed securities (ABS) and CP. Thus, when the government put in place measures to control household credit and households' capacity to redeem their outstanding debts declined amid the economic downturn, credit card companies saw their net profit move deeply into deficit from the fourth quarter of 2002. On top of these problems, turmoil erupted in the financial markets when fears spread about the possibility of default on credit card companies' paper together with the revelation of the accounting scandal at SK Global (March 11). There were large-scale withdrawals from banks' specific money trusts and investment trust companies' MMFs, which had been heavy buyers of credit-card companies' paper. Credit card companies' liquidity position worsened greatly as they found difficulty in issuing new paper including ABS and CP and, amid renewed turmoil from early November, several of them were hit by a severe liquidity crisis, forcing them, for example, to suspend their cash advance services. Fortunately, calm was restored at an early stage in the financial markets, thanks to the swift action of the Bank of Korea and the government on the two occasions in taking appropriate countermeasures.

Trends of Major Indices Related with Credit Card Companies[1]

(period-end basis)

	2000	2001	2002			2003		
			first-half	second-half	year	first-half	second-half	year
Number of cards issued (million)	57.9	89.3	98.0	104.8	-	101.2	95.2	-
Amount settled with credit card (during the period, trillion won)	224.9	443.4	324.1	356.7	680.8	290.2	227.2	517.3
(ratio of cash advances to toal)[2] (%)	66.3	63.5	63.8	57.6	60.6	55.1	51.4	53.5
Net profit[3] (during the period, trillion won)	1.1	2.6	0.9	-0.5	0.5	-2.8	-7.7	-10.5

Notes: 1) Based on the all credit card companies (including both specialized card companies and bank-linked card companies)
2) Includes card loans.
3) Based on specialized credit card companies, and excludes the Kookmin Credit Card Company in 2002 and 2003.
Source: The Financial Supervisory Service.

(B) Direct Financing

<Table Ⅱ-23>

Trends in Corporate Fund Raising[1) by Direct Financing

(trillion won)

	2001	2002	2003 year	2003 Ⅰ	2003 Ⅱ	2003 Ⅲ	2003 Ⅳ
Corporate bond issuance (net)[2)	8.2 (0.9)	-8.1 (-1.5)	-4.0 (-1.8)	-1.0 (0.7)	-1.0 (-0.3)	-3.1 (-2.7)	1.2 (0.5)
CP issuance (net)[3)	8.1	10.9	-22.6	2.3	-13.3	-2.5	-9.1
Stock issuance[4)	4.2	4.0	2.8	0.6	0.4	0.8	1.1
Direct financing total	20.5	6.8	-23.8	1.8	-13.9	-4.8	-6.9

Notes: 1) Based on changes during the period.
2) Excludes those issued by companies under court receivership, in process of mediation or workout. Figures in parentheses exclude those incorporated into primary CBOs and new bonds promptly underwritten by Korea Development Bank (KDB).
3) Based on CP discounts by securities companies, merchant banks and bank trusts accounts.
4) Based on companies listed on the Korea Stock Exchange or KOSDAQ, but excludes fund-raising by financial institutions and debt for equity swaps by creditor financial institutions for the purpose of structural adjustment of corporations.
Sources: The Financial Supervisory Service, Representative associations.

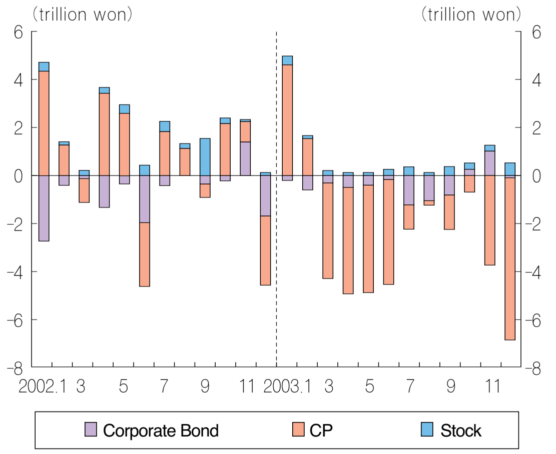
During the year under review, companies' fund-raising through the direct financial market was greatly reduced. Companies' demand for funds was generally subdued in view of the sluggish pace of business activity and there was a large net redemption of CP because of the worsening of the conditions for its issue. At the same time, corporate bonds maintained their net redemption trend from the previous year and fund-raising through the stock market shrank a little in spite of its buoyancy. In consequence, last year's amount of 6.8 trillion won raised through the direct financing market turned to a massive redemption of 23.8 trillion won.

(Issue of Corporate Bonds)

Corporate bonds saw a net redemption during the year of 4.0 trillion won, retaining the pattern of the previous year. This was ascribable both to businesses' diminished demand for long-term investment funds amid uncertain economic prospects and to the reduced scale of their bond issuance thanks to the relatively healthy flow of funds from their operations. Another factor behind the net redemption of corporate bonds was that financial institutions grew increasingly sensitive to credit risk, meaning that companies with undistinguished credit ratings found difficulty in issuing bonds; meanwhile, a large volume of the corporate bonds that had been incorporated into primary collateralized bond obligations (CBO) fell due at maturity. From early in the fourth quarter, however, there was a shift to a net issuance position as companies stepped up their sale of corporate bonds both to impose a longer term structure on their liabilities and to secure long-term investment funds at an early stage in line with indications of an upswing in

<Figure Ⅱ-42>

Trends in Corporate Fund Raising[1) by Direct Financing



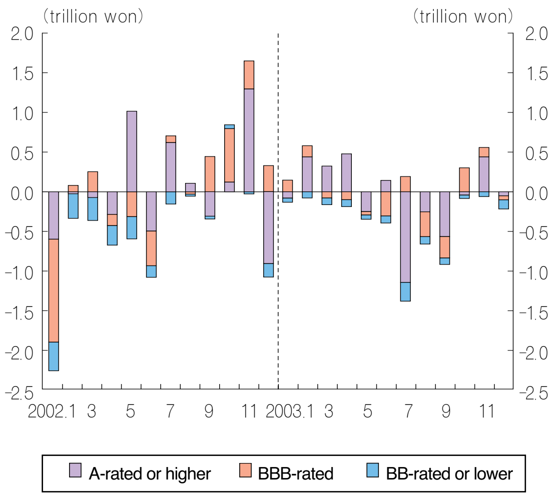
Note: 1) Based on changes.
Sources: The Financial Supervisory Service, Representative associations.

market interest rates as anticipations of business recovery grew more widespread. Accordingly, total net redemption of corporate bonds for the year as a whole narrowed to 4.0 trillion won, less than half of the previous year's 8.1 trillion won.

Broken down by the type of bond, the scale of net redemption of corporate bonds issued through public subscription widened slightly from the 1.5 trillion won of the preceding year to 1.8 trillion won. Despite the large-scale redemption of maturing bonds, those packaged into primary-CBOs saw incessant new issues, bringing down the scale of their net redemption from 6.2 trillion won the year before to just 2.0 trillion won.

<Figure Ⅱ-43>

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



Notes: 1) Based on changes.
On the basis of corporate bonds issued by public subscription.

Looked at by credit grade on the basis of corporate bonds issued by public subscription, there was an intensification of the tendency toward credit differentiation despite a general reduction in the scale of issuance. The proportion of corporate bonds issued with an A rating (total amount basis) rose from 57.5% to 68.7%, whereas that of those with a rating of BBB or below declined from 42.5% to 31.3%. Strikingly, that of those with a speculative grade rating of BB or lower shrank still further from 4.9% to 1.9%; moreover, the scale of their net redemption during the year marked 0.9 trillion won, standing higher than that of both A-rated and BBB-rated corporate bonds, 0.6 trillion won and 0.3 trillion won respectively.

(Issue of CP)

The issuance of CP in the year 2003 showed a very subdued pattern ascribable both to the low level of corporate demand for funds and financial institutions' shrunken purchasing power. As a net consequence, there was a shift from net issuance of 10.9 trillion won the previous year to a large-scale net redemption of 22.6 trillion won for the year under review.

CP issuance started off the year maintaining its brisk trend of the previous year, helped by the increased placement of deposits with MMFs. From mid March onwards, however, it began to show a steep contraction. This came as the environment for the issuance of paper worsened sharply in a movement centering on credit card companies’ CP, as financial institutions grew increasingly risk averse in response to worries over possible defaults on credit card companies’ paper and the corporate accounting scandal at SK Global. Apart from this, investment trust companies and banks’ trust accounts were greatly restricted in their capacity to purchase CP owing to the reduction in deposit-taking by MMFs and specific money trusts.

From July to October, a renewed increase in the flow of deposits into MMFs in line with the short-termism of market funds meant that the issue of CP turned buoyant, centering on non-financial businesses, and the net redemption trend moderated somewhat. From the beginning of November, though, the scale of net redemption widened again, centering on financial institutions’ CP, amid renewed withdrawals from MMFs owing to fears about the management status of credit card companies.

(Issue of Stocks)

Corporate Financing through the stock market showed a subdued pattern.

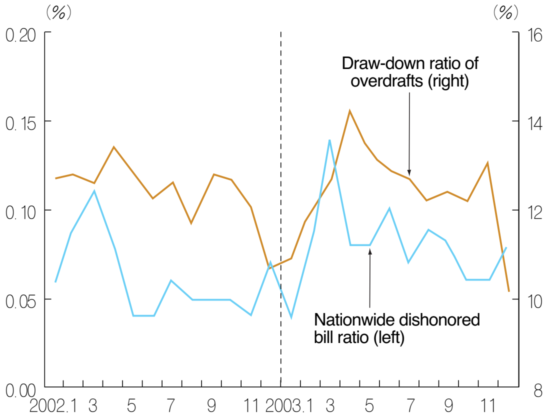
Funding through rights offerings and initial public offerings (excluding debt-for-equity swaps by creditor financial institutions for the purpose of corporate structural adjustment) narrowed from the previous year's 4.0 trillion won to 2.8 trillion won owing to businesses' diminished demand for long-term investment funds despite the hike of KOSPI. Viewing by period, though, the scale of funding showed an increasing trend in line with the rise of the KOSPI as the year-end drew near.

Broken down by the type of market, the scale of funding through the Korean Stock Exchange market shrank sharply from the previous year's 2.7 trillion won to 1.1 trillion won while that through the KOSDAQ market maintained the previous year's level of 1.7 trillion won.

(C) Corporate Status of Fund

<Figure Ⅱ-44>

Nationwide Dishonored Bill Ratio[1] and Draw-down Ratio of Overdrafts



Note: 1) After adjustment for electronic settlement amount.

Major indicators of corporate status of fund conditions exhibited a generally favorable pattern during the year 2003.

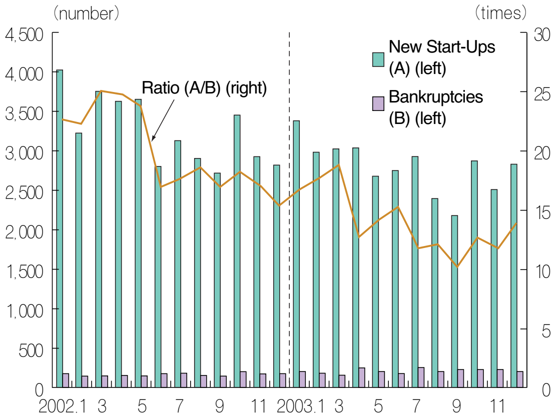
The dishonored bill ratio (after adjustment for electronic settlement amount) showed stable movements, generally remaining at the low level of below 0.1%. However, it registered a modest rise to 0.08% for the year as a whole, higher than the 0.06% of the previous year, because of the large-scale defaults of bill associated with the SK Global accounting scandal in March.

The drawdown ratio of overdrafts, an indicator of the urgency of businesses' demand for funds, rose briefly to the high level of 13.2% during April because of seasonal factors including collections of value-added tax. With this exception, it showed stable movements, remaining at around the 12% level.

The proportion of new corporate start-ups to corporate

<Figure Ⅱ-45>

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



Note: 1) Seoul, Busan, Daegu, Incheon, Gwangju, Daejeon, Suweon, Ulsan.

failures in eight major cities including Seoul fell markedly from 19.8 the previous year to 13.8. This was attributable to the increase in the number of bankruptcies, owing to the contraction of domestic consumption activities, along with the decline in the number of new corporate start-ups. From the beginning of the fourth quarter, nevertheless, amid more widespread anticipations of a business recovery, the number of new start-ups increased somewhat, causing the proportion to show a mild upward trend.

5. Foreign Exchange Markets

(Foreign Exchange Supply and Demand)

A clear preponderance of foreign exchange supply over demand prevailed during the course of the year 2003, with the current account and the capital account both showing much wider surpluses than the year before, owing in the former case to the buoyancy of exports and in the latter to increased inflows of foreign capital for investment in stocks.

Reflecting this interplay of foreign exchange supply and demand, the scale of the net creditor position rose from 24.7 billion dollars as of the end of the preceding year to stand at 66.8 billion dollars at the year-end. Gross claims on the rest of the world increased 40.5 billion dollars over the preceding year-end to reach 226.6 billion dollars. External debt mounted 15.8 billion dollars over the end of December 2002 to stand at 159.8 billion dollars at year-end.

The rise in the rest-of-the-world's claims on Korea, which occurred despite the repayment of borrowings by the government sector, was ascribable to the expanded issuance of overseas bonds by banks and public companies and to the increase in the prepayment for exports on a deferred payment basis owing to brisk shipbuilding exports. Together these acted to increase long-term debt, causing the ratio of short-term debt to total foreign indebtedness to ease slightly from its 34.8% at the previous year-end to 34.6% as of the end of 2003.

Foreign exchange reserves rose from 121.4 billion dollars as of the end of the year 2002 to stand at 155.4 billion dollars as of the end of the year under review.

<Table Ⅱ-24>

Foreign Credits and Liabilities[1)]

(billion US$)

	2001	2002(A)	2003(B)	Change (B-A)
Credits	165.5	186.1	226.6	40.5
Liabilities	130.8	144.0	159.8	15.8
Long-term	88.9 (68.0)	93.9 (65.2)	104.5 (65.4)	10.6
Short-term	41.9 (32.0)	50.1 (34.8)	55.3 (34.6)	5.2
Net foreign credit	34.7	42.1	66.8	24.7

Notes: 1) Year-end basis.
Figures in parentheses refer to shares in total (%).

<Table Ⅱ-25>

Foreign Exchange Reserves[1)]

(billion US$)

	2001	2002	2003 Ⅰ	2003 Ⅱ	2003 Ⅲ	2003 Ⅳ
FX Reserves	102.8	121.4	123.8	131.7	141.5	155.4

Note: 1) Year-end basis.

Their build-up was attributable to the preponderance of foreign currency supply over demand, profits on the operation of foreign-currency-denominated assets, and the increased value in US dollar terms of euro and yen-denominated assets owing to the strength of these two currencies.

(Foreign Exchange Rates)

During the year 2003, the annualized average exchange rate of the Korean won against the US dollar eased by 58.8 won from the previous year's level of 1,250.7 won per dollar to stand at 1,191.9 won per dollar, representing a 4.9% appreciation of the Korean won. The exchange rate, nevertheless, followed a fluctuating path in line with changes in conditions at home and abroad.

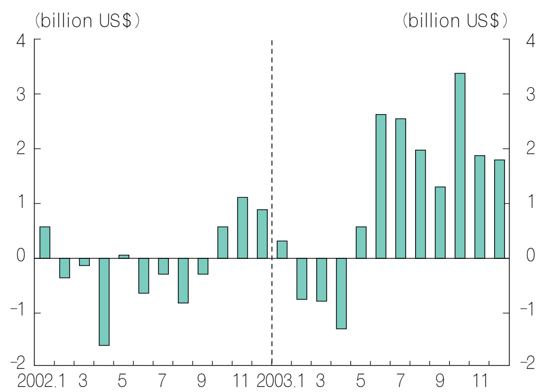
During January, the US dollar showed a weakening trend in international foreign exchange markets, influenced by the looming threat of a US war against Iraq, and the Korean won-dollar rate remained on the downward trajectory evident since mid-October 2002. From the beginning of February until the first week or so of April, it shifted to an upward trend in response to the North Korean nuclear issue, the SK Global accounting irregularities and other peninsular issues. The exchange rate's downward trend (Korean won appreciation) carried on until mid-October amid the lowering of geopolitical threats, and the increased scale of inflows of foreign portfolio capital. Most notably, the won-dollar exchange rate dropped to 1,151.2 won per US dollar on September 22, just after the G-7 meeting of finance ministers and central bankers (September 20). From mid-October onwards, the exchange rate rose to stand at the 1,200 Korean won per dollar level, owing to the liquidity problems of credit card companies and so forth. Subsequently,

<Figure Ⅱ-46>

Trends of Won/US$

<Figure Ⅱ-47>

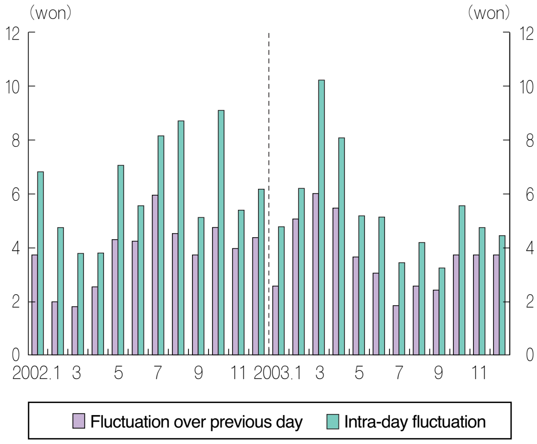
Trends of Net Inflows of Foreign Portfolio Capital



Source: The Financial Supervisory Service.

<Figure Ⅱ-48>

Trends of Won/US$ Fluctuations



<Table Ⅱ-26>

Trends of Changes in Korea's Sovereign Credit Ratings

	S&P	Moody's	Fitch IBCA
1997	A+(Oct.24) A-(Nov.25) BBB-(Dec.10) B+(Dec.22)	A3(Nov.27) Baa1(Dec.10) Ba1(Dec.21)	A+(Nov.18) A(Dec.3) BBB-(Dec.11) B-(Dec.23)
1998	BB+(Feb.17)	-	BB+(Feb.2)
1999	BBB-(Jan.25) BBB(Nov.11)	Baa3(Feb.12) Baa2(Dec.16)	BBB-(Jan.19) BBB(Jun.24)
2000	-	-	BBB+(Mar 30)
2001	BBB+(Nov.13)	Baa2(Nov.30)	-
2002	A-(Jul.24, outlook : S)[1]	A3(Mar.28) upward adjust-ment of outlook (S→P,Nov.15)[1]	A(Jun.27, outlook : S)[1]
2003	-	downward adjust-ment of outlook (P→N, Feb.11)[1]	-

Note: 1) P(Positive), S(Stable), N(Negative)
Figures in parentheses refer to the announcement dates.

<Table Ⅱ-27>

Spreads[1] on Foreign Exchange Stabilization Fund Bonds

(bp)

	2002	2003			
	Dec.	Mar.	Jun.	Sep.	Dec.
FESF (2008)	123	161	82	60	45
(2013)[2]	..	..	110	78	45

Notes: 1) Spread over US T-notes. Period-end basis.
2) Issued on May 29, 2003.

sustained inflows of foreign portfolio capital and a large-scale increase in exports caused the exchange rate to dip again, so that the Korean won finished the year at 1,192.6 won per US dollar.

During 2003, the day-to-day range of the won-dollar exchange rate narrowed from the previous year's 3.8 won to 3.4 won and the intraday trading range from 6.2 won to 5.4 won. Seen by quarter, volatility showed a pattern of expanding movements in the first and fourth quarters, owing to the heightened market uncertainty generated in the former case by the war against Iraq and in the latter by the liquidity problems of credit card companies.

(Foreign Borrowings Environment)

Korea's sovereign credit rating retained its investment status unchanged from the previous year. Moody's, nevertheless, adjusted its outlook for the sovereign credit rating from positive to negative on February 11 in consideration of the heightened geopolitical risks associated with the North Korean nuclear issue.

During the course of 2003, the premium on Foreign Exchange Stabilization Fund bonds (FESF, 2008 maturity basis) over US Treasuries widened to 215 basis points on March 12 in response to Moody's downward adjustment of the outlook for the sovereign credit rating and the SK Global accounting scandal. But with the reduction in geopolitical tensions including the greater likelihood of a peaceful resolution of the North Korean nuclear issue, and the buildup of foreign exchange reserves, the premium narrowed to close the year at 45 basis points, a 78 basis point reduction compared to the previous year-end. In the last month of the year, the premium over LIBOR paid by domestic banks on their short-term borrowings

<Table Ⅱ-28>

Spreads on Short-term Borrowings of Domestic Banks

(bp)

	2002	2003			
	Dec.	Mar.	Jun.	Sep.	Dec.
Spread[1]	25	26	23	22	18
Libor[2]	1.41	1.29	1.12	1.14	1.17

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

showed a 7 basis point fall from the December of the previous year, standing at 18 basis points.

Ⅲ. Conduct of Monetary Policy

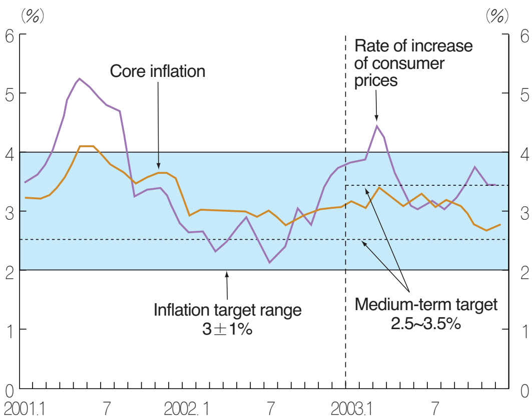
1. Inflation Targeting

The Bank of Korea set the annual inflation target for the year 2003, in consultation with the government, at 3±1%, unchanged from the previous year. At the same time, it adjusted the medium-term inflation target from its existing 2.5% to a range of 2.5~3.5%.

The index employed as the reference for the inflation target was, as in the previous year, the annual average level of core inflation, a measure which strips out from the Consumer Price Index both petroleum-based fuels and farm products other than grains, which are liable to wide temporary fluctuations depending upon international oil prices and weather conditions.

<Figure Ⅲ-1>

Changes in Inflation Target[1] and Rate of Increase of Prices[2]



Notes: 1) Based on annual average rate of increase.
2) Compared with the same period of the previous year.
Sources: The Bank of Korea, Korea National Statistical Office.

The annual inflation target was established, after taking into overall consideration the outlook for price rises and the level at which they are capable of supporting stable growth. Even though the demand side pressures on core inflation remained limited, it was expected to be running slightly above 3% owing to the increases in wages and housing prices. Accordingly, after setting the midpoint of the target range at 3%, a 1 percent point fluctuation band above and below this midpoint was fitted in view of the possibility of financial market instability and the geopolitical risks including the US-led war against Iraq and the North Korean nuclear issue.

The adjustment of the medium-term target to a range of 2.5~3.5% was carried out because the trend of price increases in Korea was estimated to lie slightly above

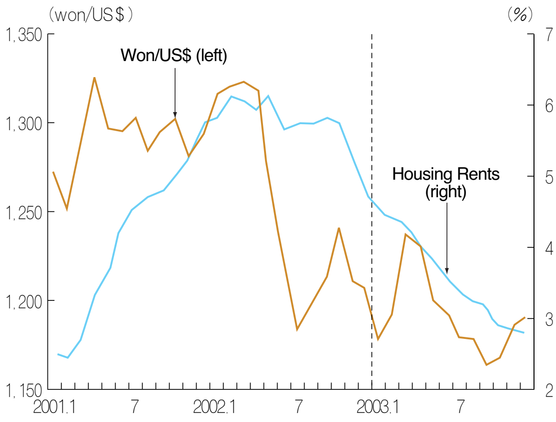
2.5%. A further consideration was the necessity of securing sufficient room for maneuver, so as to allow the flexible operation of monetary and credit policies in response to the uncertainties of the domestic and international economic environments.

During the year 2003, core inflation registered 3.1% on an annual average stabilizing around the 3% midpoint of the inflation target range, similar to the level of the previous year (3.0%).

The sustained stable trend of core inflation was ascribable to a combination of several factors: even though charges for public utilities shifted back to an upward trend and the rate of increase in wages was running at a relatively high level, demand side pressures remained very moderate because of the delay in the recovery of domestic demand; the Korean won also appreciated on average over the course of the year against the US dollar.

<Figure Ⅲ-2>

Trends in Rates of Increase of Housing Rents[1] and Exchange Rate



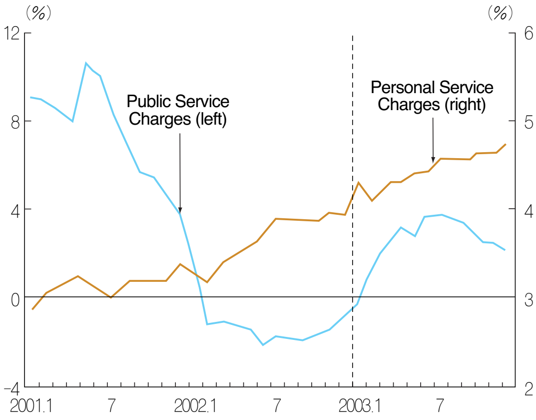
Note: 1) Compared with the same period of the previous year.
Sources: The Bank of Korea, Korea National Statistical Office.

Looking at the factors of price changes, on the demand side the upward pressures on prices weakened greatly, with the growth rate of the economy remaining at 3.1%, well below its potential growth pace. The exchange rate of the Korean won against the US dollar also fell by 58.8 won (Korean won appreciation of 4.9%) on an annualized average compared to the previous year, which is estimated to have had the effect of lowering the rate of core inflation by 0.8 percent point (Input-Output Table basis). Housing rents also exhibited a stable trend by virtue of the increase in apartments. Their contribution to core inflation showed a contraction from the previous year's 0.9 percent point to 0.5 percent point.

On the other hand, the all-industry nominal wage rose 9.4% during the year with unit labor costs increasing

<Figure Ⅲ-3>

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



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

6.4% while charges for personal services accelerated from the previous year's rise of 3.7% to reach 4.5%, increasing their contribution to core inflation from 1.1 percent point to 1.4 percent point. In addition, charges for public services and utilities, which had fallen in the previous year owing to the lowering of mobile phone call tariffs, rose 2.1% as a result of hikes in bus and train fares and an increase in public health insurance contributions. The combined effect of these rises was to push up core inflation by 30 basis points.

A further factor fueling price rises was the sharply rising trend of prices of grains, such as soybeans and wheat, and nonferrous metals, such as tin and nickel in line with the recovery of the world economy and the expansion of Chinese demand. Reuters Index of Commodity Prices, which reflects comprehensive changes in the prices of international raw materials apart from crude oil, rose 17.6% on an annual average compared to its level the year before.

Meanwhile, the steep rise in oil prices set off by the US-led war against Iraq is considered to have acted to increase upward pressures on core inflation, at least in part, by its influence on inflationary expectations. By way of reference, the scale of the increase in the Consumer Price Index as a result of the actual rise in international oil prices is put at 0.5 percent point (Input-Output Table basis).

2. Call Rate Target

<Table Ⅲ-1>

Stance of Interest Rate Policy

	Interest rate policy direction
Jan.~Apr. 2003	Maintain current level of overnight call rate (4.25%)
May	Decrease by 25bp (4.0%)
Jun.	Maintain current level
Jul.	Decrease by 25bp (3.75%)
Aug.~Dec.	Maintain current level

During the course of the year under review, the Bank of Korea conducted interest rate policy with an emphasis on supporting economic recovery while giving its full attention to price stability. From early in the year, the GDP growth rate dropped sharply owing to uncertainty surrounding the looming US-led war against Iraq, but the central bank held its call rate target unchanged at 4.25% until April, deeply concerned over the risk of a worsening of the current account position and of upward pressures on prices brought about by the run-up in international oil prices. Subsequently, price movements and the current account position showed some improvement as international oil prices moved to a downward trend upon the early conclusion of conventional warfare in Iraq. On the other hand, there was apprehension concerning an overly deep contraction of economic activity under the negative impact of the spread of the SARS epidemic, the North Korean nuclear issue, decrease of private consumption due to households' heavy debt burden, and the delay in the global economic recovery. And consequently, the policy rate was adjusted downward in May and again in July, bringing the overnight call rate target to its lowest-ever level of 3.75%. From August onwards, private consumption and facilities investment remained in the doldrums whereas exports and construction investment enjoyed continued buoyancy. The call rate target was maintained at the 3.75% level in view of anticipations of a smooth upswing for domestic business activity thanks to the brighter overseas environment, including the rapid recovery of the global economy, most notably the US economy.

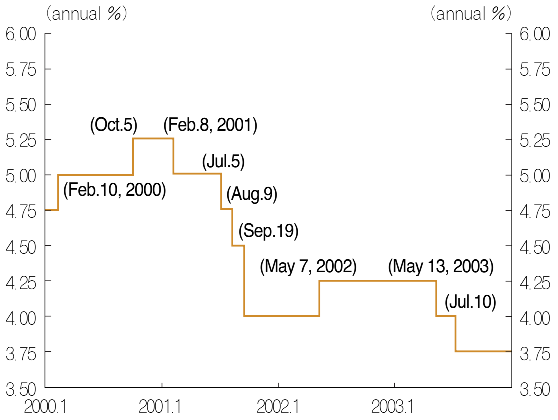
The Monetary Policy Committee decided to maintain the call rate target at 4.25% at both its January and

February meetings. It judged that the upward trend of the Korean economy would, despite booming exports, remained subdued in line with the sharp contraction of consumption. In the financial markets, too, market confidence shrank, with share prices and market interest rates moving downward together, while uncertainty was running high owing to geopolitical factors including the North Korean nuclear issue and the threat of a looming war against Iraq. Meanwhile, prices accelerated their upward trend in response to higher international oil prices and rising prices for agricultural products. The CPI showed a rise of close to 4% compared with the same month of the previous year, spreading a more general mood of unease.

In March and April, the Monetary Policy Committee, concerned about prices and the current account position, kept its call rate target on hold. The real economy at this period continued to present a gloomy picture with consumption and facilities investment both depressed while there was a large accumulation of inventories. Apart from this, financial instability was greatly increased as exemplified by the large-scale withdrawal of funds from the MMFs offered by investment trust companies amid worries over ailing credit card companies and the SK Global accounting scandal. Turning to the external environment, despite the heightened possibility of a prompt conclusion of hostilities following the outbreak (March 20) of the war against Iraq, the post-war political situation and the pace of global economic recovery still remained shrouded in obscurity. Meanwhile the upward trend of prices accelerated, spurred on by the sharp jump in international oil prices and the rise in prices of agricultural products. Despite steadily increasing exports, the current account remained in the red from December 2002 onwards except for February, owing to high international oil prices and a widened service

<Figure Ⅲ-4>

Changes in Overnight Call Rate Target



account deficit.

At its meeting on May 13, the Monetary Policy Committee lowered its policy rate target by 25 basis points from 4.25% to 4%. This measure was taken to avoid an overly deep contraction of economic activity while utilizing the greater scope for maneuver provided by the favorable evolution of the current account position and price movements, thanks to the lowering of international oil prices after the declared conclusion of the war in Iraq.

Looking at the contemporary state of the real economy, inventories built up as consumption remained depressed and facilities investment marked a low ebb. The growth rate of industrial production fell sharply and the business activity of the service sector was also deeply in the doldrums. Looking outward, although the war against Iraq had been promptly concluded, there was still a high level of uncertainty resulting from the spread of SARS and the North Korean nuclear issue. In view of the negative influence of these external factors, the state of the economy from the second quarter onwards was anticipated to show a more subdued pattern than had been originally forecast.[1] It was considered that this would bring difficulties in absorbing the increase in the economically active population (estimated at some 200 thousand people). Meanwhile, after showing a steep upward trend for some time, prices slackened their rising pace thanks to the stabilization of the prices of petroleum and agricultural products. The current account was also expected to shift into surplus because exports showed sustained buoyancy while the rate of increase of

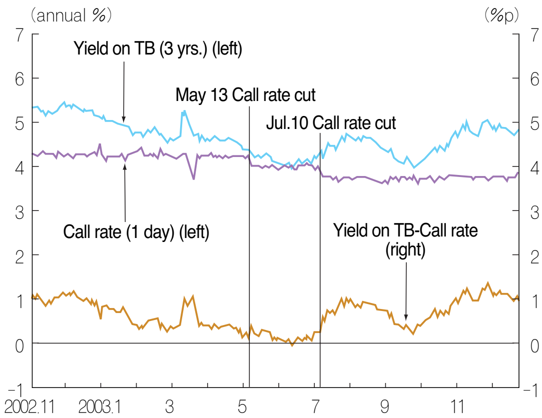
1) At that juncture, it was estimated that the growth rate of the Korean economy would be reduced by 0.3 percentage point for the year as a whole owing to the reduction of earnings from inbound tourism and of exports to regions most affected by the spread of SARS across China and much of Southeast Asia.

imports was slackening in response to the sluggishness of domestic business activity and the fall in international oil prices.

The call rate target was retained at the 4% level for June. Although the real economy remained sluggish, the spread of SARS had been checked and the US economy was expected to recover from early in the latter half of the year in view of the improved external environment. It was consequently judged desirable to wait and observe the evolution of the economy a while longer.

<Figure Ⅲ-5>

Trends of Overnight Call Rate and Yields on Treasury Bonds



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

Despite the healthy expansionary pace of exports, the downward trend of the real economy became steadily more evident with domestic demand remaining lackluster. It was difficult to anticipate any great improvement in GDP growth during the second half of the year. Consequently, the Monetary Policy Committee reduced its overnight call rate target on July 10 by a further 25 basis points from 4% to 3.75%. At the same time, it lowered the interest rate on Liquidity Adjustment Loans from 3.75% to 3.5%. The almost complete absence of demand side pressures on inflation, because of the business downturn, along with the relative strength of the Korean won against the US dollar led to the judgment that there would be no substantial difficulties in attaining the inflation target for the year. In particular, the CPI maintained a month-on-month decline from April onwards owing to the stability of the prices of both oil and agricultural products. In addition, housing prices, having shown a sustained upward trend since February, saw a slackening of their upward trend in response to the government's rigorous stabilization package. The scale of the current account surplus had also widened since its shifting into the black during May thanks to the large goods account surplus.

<Table Ⅲ-2>

Trends of Policy Rate Changes in Major Countries

(annual %)

	US	UK	ECB	Canada	Australia
Dec. 2001	1.75	4.00	3.25	2.25	4.25
Dec. 2002	1.25	4.00	2.75	2.75	4.75
Feb. 2003		3.75			
Mar.			2.50	3.00	
Apr.				3.25	
Jun.	1.00		2.00		
Jul.		3.50		3.00	
Sep.				2.75	
Nov.		3.75			5.00
Dec.					5.25

Sources: Central banks of individual countries and the ECB.

Over this period, other countries also generally lowered their policy rates. In June, the US Federal Reserve lowered its Federal funds rate to 1% and the European Central Bank brought down its policy rate to 2%. The Bank of England and the Bank of Canada both reduced theirs in July, bringing them to 3.5% and 3% respectively. Among Asian countries, Indonesia, Malaysia, Taiwan, Thailand, and the Philippines all reduced their policy rate in the three-month period from May to July.

Even after the additional downward reduction of the call rate target in July, domestic demand remained in the doldrums, but the real economy showed signs of a patchy improvement thanks to the sustained strong growth of exports. Prices remained on a stable course owing, among several factors, to the government's reduction of special consumption tax. In the light of these developments, the Monetary Policy Committee maintained its policy rate target at 3.75% in August, deeming it advisable to await the effects of the two reductions in the call rate already undertaken in May and July and of the government's compilation and disbursement of its supplementary budgets.

This policy stance was maintained in September and October. Industrial activity remained subdued because of the shrinking of domestic demand, but exports and construction investment continued buoyant. A gradual improvement of domestic business activity was also anticipated down the road owing to the clearly marked recovery trend of the major advanced economies including the United States. There was a short-lived spurt in prices that was driven by a sharp increase in those for agricultural products following typhoon damage and a reduction in shipments owing to frequent heavy rainfalls. There was a renewed acceleration in housing prices in response to increased seasonal demand at a time of year favored for house-moving and the emergence of speculative demand in certain areas.

The real economy subsequently showed stirrings of recovery albeit on a modest scale with, for example, a turn for the better in industrial activity helped by the buoyancy of exports and construction investment, despite the continuing sluggishness of private sector consumption and facilities investment. Prices regained their stability with many agricultural product prices declining. Housing prices shifted to a downward trend influenced in part by the government's announcement on October 29 of 「Comprehensive Package of Housing Market Stabilization Measures」. The Monetary Policy Committee, giving overall consideration to these and suchlike points, decided to leave its call rate target on hold at 3.75% in November and December.

<Reference Ⅲ-1>

Effects of the Reduction of the Call Rate Target in May and July 2003

The two-step reduction of interest rates undertaken on May 13 and July 10, 2003 is judged to have had a marked effect on the financial markets in the long- and short-term market interest rates and financial institutions' deposit and lending rates also declined.

After the reduction of the call rate undertaken in May, both long- and short-term market interest rates moved downward. Strikingly, the decline in long-term market rates was greater, reflecting market participants' anticipations of further reductions in the policy rate. Accordingly, the yield curve showed a pattern of flattening out. Following the reduction in July, short-term market rates declined whereas long-term market rates rose slightly, opening up the gap between short-term and long-term rates and causing the yield curve to steepen again. This can be interpreted as showing a weakening of anticipations on the part of market participants of additional policy rate reductions, but it was also fed by anticipations of future economic recovery.

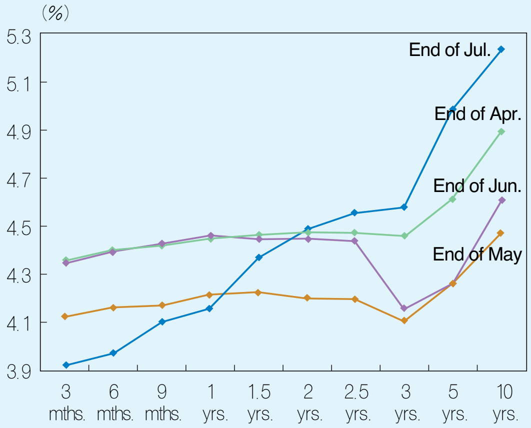
Volatility of Treasury Bond (3 yrs.) Yields after Call Rate Reductions[1]

(%p)

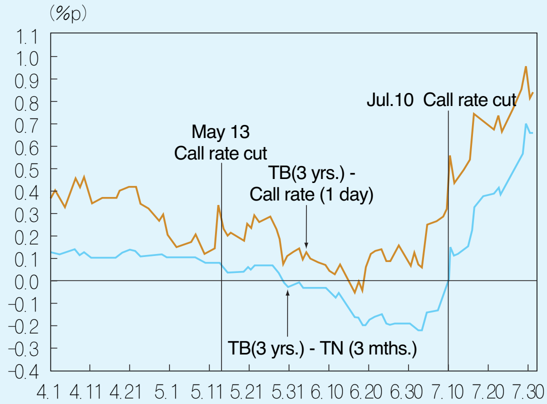
	20 days before	10 days before	5 days before	Actual day	After 5 days	After 10 days	After 20 days
May 13 (4.25→4.0)	-0.29	-0.19	-0.07	-0.05	-0.20	-0.11	-0.35
Jul. 10 (4.0→3.75)	0.28	0.22	0.23	0.01	0.18	0.15	0.31

Note: 1) Volatility (business day basis) of interest rates during periods of 20 days, 10 days, and 5 days before each announcement, on the day of each announcement and during periods of 5 days, 10 days, 20 days after each announcement.

Trends of Treasury Bond Yield Curve



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



Banks reacted to the reduction in call rate by adjusting their deposit and lending rates downward. Following the cut in the call rate target in May, the reduction in the loan rates was led by those on household loans, a large proportion of which are linked to market interest rates while the scale of the reduction in deposit rates was narrower than that in loan rates because of banks' fear of a migration of deposits. After the July reduction of the call rate, however, the scale of the decline in both deposit and lending rates was relatively minor, being influenced by the upward trend of long-term market rates.

Share prices rebounded from about the outbreak of the US-led war against Iraq owing to the reduction of geopolitical risks. They continued their upward trend to the end of the year thanks to the reductions of call rate target, that brought in their train a decrease of firms' borrowing costs and heightened expectations of a recovery of the domestic business activity. They were also influenced by the bullish US stock market.

Trends of Banks' Deposit and Lending Rates[1]

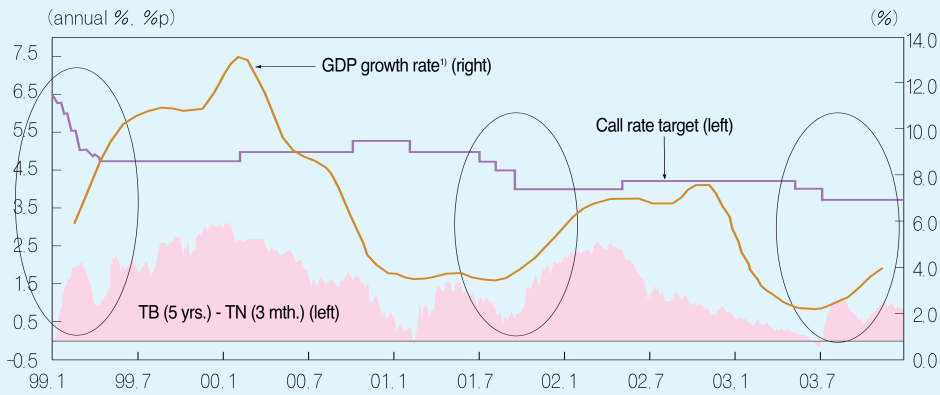
(annual %, %p)

	Apr. 2003(A)	May(B)	Jun.(C)	Jul.(D)	B-A	D-C
Interest rates on deposits[2]	4.30	4.19	4.12	4.07	△0.11	△0.05
Time deposits	4.29	4.21	4.16	4.08	△0.08	△0.08
Interest rates on loans[3]	6.41	6.28	6.24	6.20	△0.13	△0.04
Companies	6.31	6.18	6.18	6.14	△0.13	△0.04
(Large companies)	6.04	5.93	6.12	6.10	△0.11	△0.02
(SMEs)	6.38	6.24	6.20	6.15	△0.14	△0.05
Household	6.84	6.64	6.47	6.41	△0.20	△0.06

Notes: 1) Newly extended deposit and lending basis.
2) Excluds demand deposits, instant access deposits and financial debentures.
3) Excluds overdraft loans and minus account loans.

Meanwhile, the reductions of the call rate target are evaluated as having contributed to domestic business activity's avoidance of an overly deep contraction and entry onto a recovery phase in the fourth quarter through the uplift of economic agents' spirits. Notably, the widening of the differential between long-term and short-term interest rates brought about by the rise in long-term market rates after the downward adjustment of the call rate target on July 10 is judged to have reflected greater confidence of an approaching business recovery on the part of economic agents in line with the Bank of Korea's reductions of its policy rate and the government's expansion of fiscal spending. In fact, the reductions of the call rate target in the first half of 1999 and the latter half of 2001 also brought about a widening of the differential between long-term and short-term rates that was followed by a recovery of business activity.

Call Rate Target, Long- & Short-Term Interest Rate Spread and GDP Growth Rate Trends

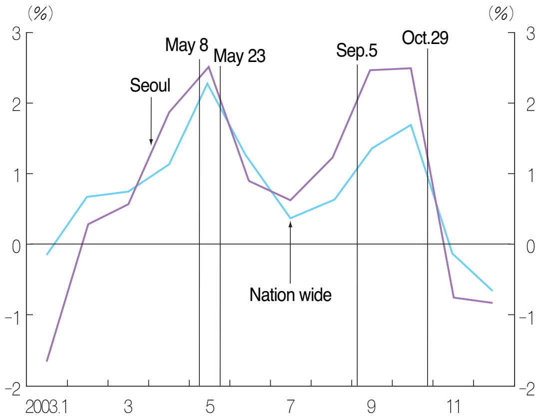


Note : 1) Compared with the same period of the previous year.

In Korea meanwhile, despite the sluggishness of domestic economic activity, housing prices were rising by a large margin and the argument was put forward that the Bank of Korea shouldn't lower its policy rate, or rather, should raise it to respond to this. The Bank, however, judged that countering this surge in housing prices by the use of interest rate policy would face certain limitations. Although low interest rates contributed in part to the rise in housing prices, there were other factors at work. It was engendered by a combination of factors including the imbalances between housing supply and demand in certain districts that reflected disparities in schooling and quality-of-life plus the speculative demand for apartments slated for reconstruction and in areas touted as sites for the

<Figure Ⅲ-6>

Trends of Housing Prices[1] along with Government's Announcement of Measure to Stabilize Housing Prices



Note: 1) Compared with the previous month.
Source: Kookmin Bank.

relocation of Korea's administrative capital. What is more, because the influence of an adjustment of the policy rate affects every sector of the economy alike, raising interest rates even though business activity was already in a downturn phase would lead to a deepening of the recession and run the risk of increasing unemployment. The Monetary Policy Committee accordingly deemed it desirable to tackle the surge in housing prices through governmental microeconomic and administrative stabilization policies rather than through an upward adjustment of interest rate.[2]

At the same time, it was also argued that interest rates were already at a sufficiently low level, and that a reduction of the call rate target would not exercise any great influence on consumption and investment in view of the persistently high degree of uncertainty at home and abroad. It was, nevertheless, anticipated that economic agents' mood of unease would be considerably alleviated by recognition of the policy authorities' unmistakable intention to boost the economy in line with the Bank of Korea's reduction of its policy rate and the government's compilation and disbursement of its supplementary budgets. At the same time, companies' and households' financial costs would be reduced by the lowering of both market interest rates and financial institutions' lending rates. With the more plentiful supply of liquidity, the phenomenon of financial differentiation could be expected to ease, bringing about a relative improvement in fund-raising conditions for enterprises with low credit standing.

2) The following statements of comments were contained in the announcements of the Monetary Policy Committee concerning the direction of monetary policy released on May 13 and July 10; "While it is expected the determined measures announced by government to stabilize the real estate market will be effective in calming down housing prices, a close eye should be kept on movements of real estate markets and more resolute actions should be taken if necessary" and "Meanwhile, for sustainable growth and stability of the economy, a more positive role should be played by fiscal policy, and furthermore, a cautious eye should continue to be kept on the stability of real estate market."

<Reference Ⅲ-2>

Discussion of the Desirability of a Monetary Policy Response to the Rise in Housing Prices

Even though the business cycle entered onto a downward phase worldwide from the end of the year 2000, housing prices maintained a generally upward trend. During the three years from 2000 to 2002, US housing prices rose at an annual average of 7.6% and UK housing prices registered sharp increases of 8.5% in the year 2001 and 17.4% during the year 2002. In Ireland and Australia, housing prices also saw large-scale rises. In the Asian region, housing prices increased greatly in Korea and in Indonesia.

Housing prices are formed over the long term by the interplay of housing demand, influenced by population, disposable income and interest rates, and of housing supply, affected by the price of land, construction costs and so forth. But in the short term, because the supply of housing is limited, housing prices react very sensitively to the demand-side factors such as interest rates and anticipated yields on alternative assets. When the central bank cuts interest rates, housing prices rise as the demand for it is boosted because the financial expenses involved in purchasing housing are reduced and by the decline in yields on bonds, deposits and other interest-bearing assets decline.

When housing prices rise, homeowners' wealth increases to a similar extent and this has the psychological effect of bringing about an expansion of households' consumption spending. What is more, household consumption, in fact, increases as homeowners take out additional loans from financial institutions (e.g. mortgage refinancing, remortgage) within the scale of the increase of the market value of their houses, and use the proceeds for consumption spending.

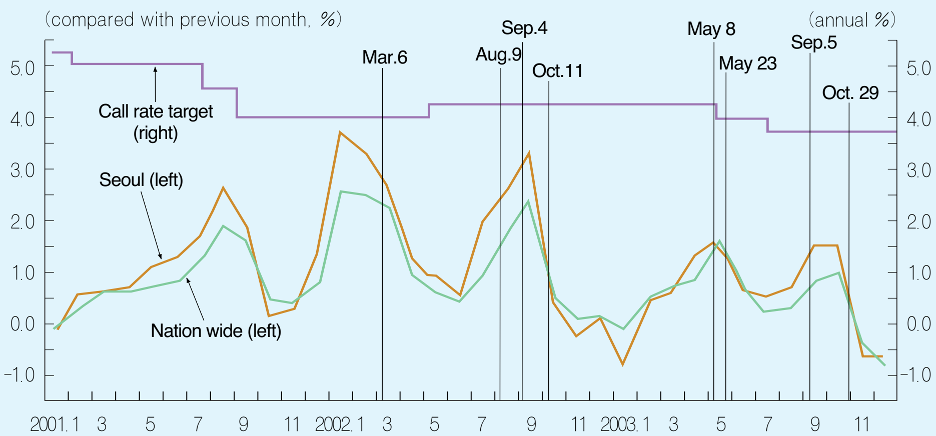
On the other hand, the economy may suffer serious damage in the long term if housing prices rise excessively through the over-expansion of credit to households or speculative demand. This is because, if housing prices fall back sharply owing to an expansion of housing supply and an abrupt change in financial conditions, financial institutions' bad bonds and household bankruptcies increase and, therefore, the likelihood of a financial crisis breaking out rises.

Against this background, an ongoing debate has arisen worldwide concerning the monetary policy response to changes in housing prices. For some time, most central bankers have taken a very cautious position regarding the use of monetary policy to counter rises in the price of assets such as housing. This is because it is very hard to tell whether a rise in asset prices results from the formation of a bubble or from an improvement in fundamental economic conditions. Moreover, they are not confident that the central bank is equipped with appropriate policy tools to tackle a rise in asset prices. Alan Greenspan, Chairman of the US Federal Reserve Board, declared that it was not in practice possible to counter an asset price bubble through monetary policy as the only policy option available to deflate it would be to raise interest rates by a large margin, which would generate a deep business recession. It has been argued persuasively that in the downward phase of the business cycle it is desirable to employ micro level measures, rather than monetary policy to counter the rise in housing prices. However, when there is concern that the change of asset prices may jeopardize the stability of prices and financial market, it seems desirable for the central bank to undertake an indirect and selective response.

With the rapid rise in housing prices in Korea since 2001, some have advocated the necessity of countering it through the use of monetary policy. Particularly when housing prices having exhibited a stable trend for some time from October 2002 shifted to a renewed upward trend after February 2003, the argument gained ground among the public that the policy rate should be increased. The Bank of Korea, though, judged it inappropriate to tackle the rise in housing prices by the use of macro economic tools, such as monetary policy, given the lackluster state of business activity owing to the abrupt shrinking of domestic demand. In order to stabilize housing prices the call rate target would have to be raised to a large extent, in which event the business downturn would become even more severe. At this juncture, in view of the state of the economy, it was desirable, the Bank argued, to make use of expansionary monetary and fiscal policies in a positive manner to deal with the economic downturn, while the government should take appropriate micro economic steps to tackle the sharp rise in housing prices by, for example, easing the imbalance between housing supply and demand and neutralizing speculative demand. Accordingly, the Bank lowered its call rate target on two occasions by a total of 50 basis points in 2003 while advocating the government's pursuit of resolute measures to stabilize the run-up in housing prices in tandem with the fiscal pump-priming of the economy.

The government's use of micro and administrative policy is seen to have been effective to a certain extent. After the government's announcement of measures to stabilize housing prices, their upward trend moderated and shifted to a downward trend for quite a while. Housing prices exhibited a stable trend from early in the fourth quarter of 2002 after the government acted on several occasions (August 9, September 4, and October 11, 2002). During the year 2003, the movements of housing prices also showed a slowdown followed by a transition to a downward trend after a series of government measures (May 8, May 23, September 5, and October 29, 2003) to cool down the housing market.

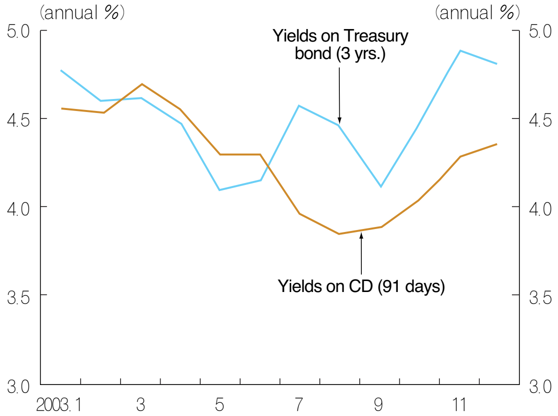
Trends of Rate of Increase in Apartment Prices



3. Financial Market Stability

<Figure Ⅲ-7>

Trends of Market Interest Rates[1)]



Note: 1) Month-end basis
Source: Korea Securities Computer Corp.

The Bank of Korea strove to ensure financial market stability by the flexible adjustment of liquidity when there was concern over spreading financial market unrest, for example, the greatly heightened volatility of market interest rates generated by changes in conditions at home and abroad.

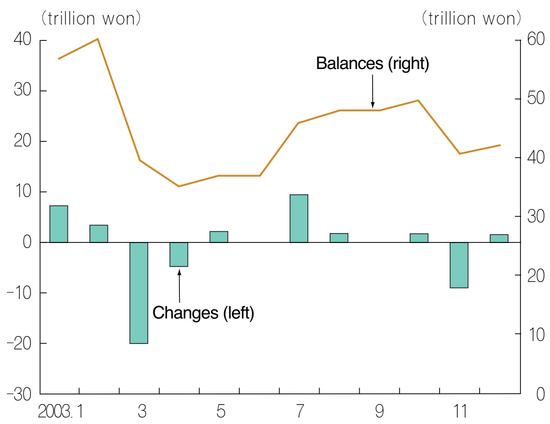
In January 2003, the preference for safe assets such as Treasury bonds rose steeply amid mounting domestic and external uncertainties including the threat of the US-led war against Iraq and the North Korean nuclear issue. Financial markets briefly showed a pattern of agitated movements characterized by imbalances between demand and supply in the bond market, a steep drop in benchmark bond yields, and the substantial narrowing of the spread between long-term and short-term interest rates. In order to deal with this financial market unrest, the Bank of Korea expanded the supply of bonds to stabilize the market interest rates, by resuming its over-the-counter sales of MSBs[3)] (1.9 trillion won), which had been suspended for nine months since April 2002. From early February, market liquidity continued to concentrate in the bond market and, accordingly, the volume of issuance of MSBs was again expanded.[4)]

From early March, the volatility of interest rates, share prices and the exchange rate rose greatly in line with

3) This is a tool for the adjustment of the monetary stock through the absorption of liquidity with the interest rate on successful bids being notified in advance by the Bank of Korea according to market liquidity conditions. As such, it is separate from the Bank's regular auctions of MSBs held in every Tuesday.
4) During January 2003, the net issuance of MSBs amounted to 2.3 trillion won. This was followed by net issuance of 2.8 trillion won in February. (For the whole of 2003, net issuance of MSBs amounted to 21.2 trillion won, with monthly net issuance averaging 1.6 trillion won for the ten-month period from March to December.)

<Figure Ⅲ-8>

Trends of MMF at Investment Trust Companies



Source: Investment Trust Association.

the large-scale withdrawal of funds from the MMFs offered by investment trust companies amid worries over ailing credit card companies and the accounting scandal at SK Global. The Bank of Korea made a considerable contribution to counteracting this. It unveiled a 「Financial Market Stability Package」 on March 13 and nipped financial market unrest in the bud by prompt liquidity support through open market operations. Through the purchase of bonds under repo conditions on March 13, it supplied short-term liquidity to the tune of 2 trillion won[5]. This was followed on March 17 by the outright purchase of government and public bonds valued at 2 trillion won and the carrying out of a mid-term redemption of MSBs.[6] Furthermore, when the war against Iraq broke out on March 20, the Bank of Korea, seeking to nip in the bud the spread of unease among market participants, announced 「Measures for the Stability of Financial and Foreign Exchange Markets in the Face of the Outbreak of War between the United States and Iraq」[7], including prompt steps to expand liquidity supply. Contingency plans were drawn up centering on working level teams in all major departments of the Bank and these were brought into operation until the end of the hot war in Iraq.

During June, a problem arose from large-scale deposit withdrawals from Chohung Bank, just before and after a strike by its employees. The Bank of Korea, in its role as lender of last resort, supplied the missing funds in order to ensure the stability of the financial system. On June 19, it provided short term liquidity support of

5) The results of the auction with successful bids were valued at 1.2 trillion won among total bids of 1.3 trillion won.
6) The results of the auction with successful bids were valued at 1.5 trillion won among total bids of 1.7 trillion won
7) Major points of the plan included expansion of the supply of liquidity through RP purchases, etc. when needed, positive inducement of financial institutions' support of SMEs, and actions to bring about foreign exchange market stability.

2 trillion won to Chohung Bank by means of counterpart repo purchases, following this up on June 23 with the extension of a Liquidity Adjustment Loan of 3 trillion won. In an associated move, the Bank of Korea raised the ceiling on its Liquidity Adjustment Loans from 3 trillion won to 5 trillion won from the beginning of the third quarter in order to expand its capacity to deal with situations arising where financial institutions experienced liquidity shortages due to contingencies such as abrupt deposit withdrawals.

From November the markets were gripped by a climate of unrest following the renewed liquidity crises of several credit card companies. The Bank of Korea did not put in place any special measures in response, anticipating that the financial markets would absorb the impact by themselves in view of the overall abundance of market liquidity thanks to the accommodating monetary policy stance that had been maintained for quite some time.

4. Credit Policy

<Table Ⅲ-3>

Aggregate Credit Ceiling Allocation[1)]

(trillion won)

Sorting		Sum
Quota allocated to financial institutions	Quota for support for the substitution of bills	2.7
	General quota	2.7
	Sub total	5.4
Quota allocated to the Bank of Korea's regional branches		4.1
Retained reserve		0.1
Total		9.6

Note: 1) As of the year-end 2003.

Credit policy during the year 2003 was conducted by the Bank of Korea with an orientation toward the continual strengthening of financial institutions' incentives for the provision of funding support to small and medium exporting businesses and regionally based small and medium enterprises (SMEs).

In order to bring about a further expansion of financial institutions' lending to small and medium exporters, which were in difficulties with the delayed world economic recovery, the entire retained quota of 385 billion won under the Aggregate Credit Ceiling of 9.6 trillion won was allocated to the General Ceiling, the sub-category of the Aggregate Credit Ceiling Facility which includes trade finance, so as to give them preferential support such as trade finance. In a further move, financial institutions were encouraged to handle trade finance for non-L/C exports positively in order to expand trade financing opportunities for small exporters and those just starting to export. In October, the General Ceiling was raised from 1.7 trillion won to 2.7 trillion won.

Additionally, the Bank of Korea strengthened financial support for regionally based SMEs. From August onwards the amount allocated under the Aggregate Credit Ceiling to the Bank of Korea's regional branches for the support of regionally-based SMEs was raised from 3.6 trillion won to 4 trillion won. Notably in September, emergency funding support was provided for regional SMEs that had suffered damage from Typhoon Maemi. A retained reserve of 85 billion won within the Aggregate Credit Ceiling was additionally allocated to the Bank of Korea's regional branches in areas affected by typhoon damage. Meanwhile, the increase in the quota allocated to the Bank's regional branches in August was distributed so as to provide priority support to SMEs that had suffered damage from the typhoon. In addition, exporters who had received trade finance support for the production of export goods but because of flood damage had had no option but to consign their production to another business were recognized as exceptions, allowing them again to receive trade finance support. In addition, steps were taken so that financial institutions extended the term of trade finance loans to exporters facing difficulties in redemption as a result of delays in shipment brought about by flood damage to transport facilities.

Efforts continued to ensure that the practice of the cash settlement of commercial transactions between businesses took deep root. With a view to reducing settlement by means of commercial bills, the recognition ratio for banks' performance in discounting them, which is used when calculating their individual quotas under the Aggregate Credit Ceiling, was lowered in May from 50% to 30% and from October, it was further reduced to 20%. And thanks to suchlike endeavors, the ratio of cash settlement based on bill substitution-related loans (Corporate Procurement Loans and Electronically-Processed Secured Receivables Loans) to commercial bill discount performance rose from 104% as of the end of 2002 to 142% at year-end 2003. Nevertheless, the scale of the support for bill-substitution related loans under the Aggregate Credit Ceiling has been ratcheted down step by step from the original 4.3 trillion won to 2.7 trillion won[8] under the judgment that it was necessary to give priority to strengthening financial support to small and medium exporters and to regionally-based SMEs.

<Table Ⅲ-4>

Trends of Bill Substitution-Related Loans and Commercial Bill Discounts[1]

(trillion won, %)

	2001 Dec.	2002 Dec.	2003 Jun.	2003 Dec.
Corporate procurement loans (A)	8.2	11.1	13.5	12.4
Electronically-processed secured receivables loans (B)	1.3	3.4	4.4	6.3
A+B	9.5	14.5	17.9	18.7
Commercial bill discounts[2] (C)	15.2	14.0	12.8	13.2
(A+B)/C	62.8	103.6	139.5	141.8

Notes: 1) Based on month-end balance.
Based on won-denominated loans from bank accounts (excludes the Korea Development Bank and the Export-Import Bank of Korea).
2) SMEs basis.

8) During the year 2003 the allocation of the Aggregate Credit Ceiling for support to bill substitution related loans was reduced step by step from 4.3 trillion won to 3.8 trillion won in August, to 2.8 trillion won in October, and to 2.7 trillion won in November.

5. Monetary Policy Instruments

The Bank of Korea augmented its drive to improve the instruments of monetary policy, and to heighten the transparency and credibility of its policy establishment and implementation. In this connection, interest rates on demand deposits were deregulated.

(Improvement of Monetary Policy Instruments)

With its deregulation of interest rates on banks' demand deposits, the Bank of Korea completed the interest rate deregulation based upon the 「Four-Stage Interest Rate Liberalization Plan」 announced in 1991.

The Monetary Policy Committee on December 24, 2003 revised the 「Regulation Concerning Deposit and Loan Rates of Financial Institutions」. In line with this, controls were abolished, with effect from February 2, 2004 on the interest rates on demand accounts, including passbook accounts, household checking accounts, and temporary deposits, and on company savings deposits of less than seven days. The prohibition on the payment of interest on ordinary checking accounts was, however, maintained in force. This reflected the relatively high operating costs on such accounts as compared to other deposits because of the check and bill payment operations performed on behalf of clients. It was also taken into consideration the low degree of their utilization as banks' operational capital because of their relative instability.

In line with interest-rate liberalization, almost all remaining regulations concerning banks' deposits were abolished. In the case of household checking accounts, all regulations were abolished except for the restriction on eligibility. In the case of savings deposits and

<Table Ⅲ-5>

Details of Liberalization of Banks' Deposit Rates and Other Conditions

Sorting	Item	Before liberalization	After liberalization
Interest rates	Passbook accounts	1.0% p.a.	Liberalized
	Ordinary checking accounts	Interest rate-free	Maintained
	Household checking accounts	1.0% p.a.(3 month average balance exceeding 1 million won: 3% p.a.)	Liberalized
	Temporary accounts	Interest rate-free(2% p.a. when necessary to impose interest rate)	Liberalized
	Company savings deposits of less than seven days	Interest rate-free	Liberalized
Other conditions	Minimum maturity of term deposits	– Fixed deposits: more than 1 month – Fixed term installment deposits: more than 6 months	Maintained
	Eligibility	– Household checking accounts: individual	Maintained
		– Savings deposits: individual – Corporate preferential deposits: corporations and private companies	Liberalized
	Interest paid on mid-term withdrawals	Less than 3% p.a. for mid-term withdrawal after one month with limited maturity	Liberalized
	Related to household current accounts	– Prohibit opening double accounts – Personal check issuance limit: 1 million per sheet (5 million for independent enterprises) – Obligation to measure delinquent clients – Interest accounting method, procedure payment guarantee for personal check etc.	Liberalized
	Method of withdrawal	Withdraw corporate preferential deposits by the method of FIFO	Liberalized
CDs and cover bills	Minimum maturity	More than 30 days	Maintained
	Mid-term withdrawals and repurchase	Impossible	Maintained

company savings deposits, restrictions on eligibility were abolished. In addition, the interest rate payable on mid-term withdrawals before one-month on time deposits and other deposits with limited maturity was freed up.

This measure is evaluated as serving to heighten policy effectiveness by augmenting the transmission channels of interest rate policy. What is more, it is anticipated that it will serve to bring about a climate of fair competition among financial institutions, promote the development of new products and, over and above this, serve to increase convenience for the general public in using financial services.

The Bank of Korea has been making use of its monetary policy tools including open market operations and loans in a more market-friendly way.

From January onwards, the timing of the announcement of auctions of MSBs was changed from the actual day itself to the business day preceding the auction day. The purpose of this change was to allow financial institutions to operate their funds in a more stable manner by increasing their forecasting ability as to the status of funds supply and demand conditions from day to day. To facilitate the more efficient conduct of open market operations, reaccessment was done on the counterpart institutions.[9]

From March onwards, financial institutions were able to access information on the Bank of Korea's web site allowing them to check straightaway upon enterprises' eligibility for support under the Aggregate Credit Ceiling. From September, exporters were able to settle

9) As a result, the number of counterpart institutions for purchases and sales of securities was reduced from 41 to 37 and that of institutional participants in auctions of MSBs from 47 to 45.

domestic L/Cs through electronic document interchange (EDI) as well as through the existing method of submission of documents, making their use of trade finance simpler.

The criteria for allocation of the Aggregate Credit Ceiling and the method of adjusting assessment of financial institutions' performance in the operation of their funds were both simplified. From October onwards, the items taken into consideration in the allocation of the General Ceiling in financial institutions' individual quotas under the Aggregate Credit Ceiling, which had previously comprised total loans to eligible objects of support, newly extended amounts and net amount of increase, were integrated to form a single item of total lending of funds eligible for support. For adjustment of the allocated quota, the previous two stages of the process of evaluating financial institutions' fund operation performance were combined into a single step and the number of assessment items was reduced. Specifically, the previous two-stage appraisal process covered five items, household lending performance, credit based loans to SMEs, total credit to SMEs, management status and operation of interest rates was changed to a one-stage process embracing 3 items, such as interest rate pricing behavior, management status and ratio of credit-based lending to SMEs against total credit to SMEs.

(Efforts to Heighten the Credibility of Monetary Policy)

The Bank of Korea devotesd great efforts to improve the transparency and credibility of its formulation and implementation of monetary policy with a view to facilitating its clear transmission to the financial markets and the real economy.
The Bank of Korea stopped announcing an M3

monitoring range from 2003, as the interest rate oriented system of monetary policy operation had settled down to a certain extent. The Bank of Korea, however, continues to pay close attention to the movements of M3 and other monetary indicators as information variables in the course of conducting monetary policy.

At a press conference held each month just after the monthly policy-setting meeting of the Monetary Policy Committee, the details and background to the policy decisions taken are explained. The feedback relationship between the central bank and the financial markets has come to be strengthened by its efforts to grasp in minute detail of the markets' anticipations and reactions following this explanation. To assist in heightening the transparency of the decision-making process, the minutes of the deliberations of the Monetary Policy Committee concerning its decisions on the direction of monetary policy are published two months later in the Bank's 「Monthly Bulletin」.

Along with this, monthly meetings are held of the 「Economic Trends Discussion Meeting」, bringing together directors of major economic research institutes and eminent academics and of the 「Financial Consultation Meeting」, whose membership consists of the presidents of financial institutions. Members of Monetary Policy Committee also commonly check the situation in regard to business activity and prices by direct visits to firms and markets. By thus listening to the opinions of outside experts and gathering on-the-spot information across a broad spectrum, the Bank gains a base for reference in the formation of its policies.

Intense endeavors were directed toward securing a heightened public understanding concerning monetary policies and their greater credibility in the eyes of the general public. The three months of June, July and August saw the holding for the first time of 「Monetary Policy Contest」 in which students from around the country made presentations on decisions on the direction of monetary policy under an inflation targeting policy regime. A total of 71 teams took part in the contest drawn from 51 universities. In addition, a wide range of initiatives including public opinion surveys was undertaken in order to broaden the channels for mutual understanding and feedback between the Bank and the general public.

<Table Ⅲ-6>

Performance of Joint Examinations

		Banks examined
2000		Hanvit, Korea exchange, Daegu
2001	Domestic banks	Hanvit, Chohung, Seoul, Korea exchange, Peace, Pusan, Kwangju, Kyungnam, Jeonbuk, Cheju
	Foreign bank branches	Citi, Deutsche, HSBC
2002	Domestic banks	Korea First, KorAm, Shinhan, Chohung, Kookmin, Woori, Daegu, Industrial Bank of Korea, National Federation of Fisheries Cooperative, National Agricultural Cooperative Federation
	Foreign bank branches	Tokyo Mitsubishi, BOA, Standard Chartered
2003	Domestic banks	Pusan, Korea Exchange, Korea First, Shinhan, Hana, Kwangju, Kyungnam, Jeonbuk, KDB
	Foreign bank branches	Citi, BNP Paribas, JP Morgan Chase

(Capturing Financial Institutions' Management Status)

The Bank of Korea secured the information needed for the efficient formulation and implementation of monetary policy by undertaking joint examinations of financial institutions together with the Financial Supervisory Service (FSS) and the intensive analysis of their management status. The Bank of Korea also further strengthened its role in regard to financial stability by, for example, the publication of 「Financial Stability Report」.

The management soundness and risk management of financial institutions were subjected to rigorous analysis employing the Financial Institution Management Evaluation Model. Further to this, through the quarterly 「Financial Institution Lending Behavior Survey」, lending policy, the demand for loans, and credit risk trends are analyzed for use in the formation of monetary policy.

In the course of the year under review, joint examination were held with the FSS on a total of eleven banks. This was done in order to gather on-the-spot information needed for the drawing up of monetary policies, such as tendencies in banks' credit operations and their strategies in securities investment, while at the same time checking the transmission effects of the central bank's policies. The transmission effects of monetary policy were augmented by bringing to light errors in the handling of operations or violations of regulations and taking measures for their rectification. This involved checking compliance with regulations and the guidelines concerning monetary policies including Aggregate Credit Ceiling loans, deposit payment reserves and payments and settlements.

The year under review also saw the publication for the first time (April and October) of「Financial Stability Report」which comprehensively analyses and assesses the debt servicing capacity of households and businesses and the linkages between financial system stability and the real economy. Additionally, in connection with the implementation from year-end 2006 of the New Basel Capital Accord (Basel Ⅱ), analytical materials were published concerning its impact on domestic banks and the response. Meanwhile, by means of explanatory meetings held with staff involved at domestic banks, thoroughgoing preparation was encouraged ahead of the enforcement of Basel Ⅱ.

From August 2003, the conclusion of the「Memorandum of Understanding Concerning the Sharing of Financial Information」[10] among the three institutions with responsibility for supervision, the Bank of Korea, the Financial Supervisory Service and the Deposit Insurance Corporation, was pursued in order to expand the exchange of financial information through a Financial Information Pooling Committee.

10) This memorandum of understanding was finally concluded on January 20, 2004.

<Reference Ⅲ-3>

Anticipated Impact of the Deregulation of Demand Deposit Interest Rates and the Expected Side Effects

Under the「Four-Stage Interest Rate Liberalization Plan」announced in August 1991, the Bank of Korea put in place the required measures of liberalization for the first three stages between November 1991 and November 1995. The fourth stage of interest rate deregulation foresaw the freeing up of interest rates on some short-term deposits and demand deposits from 1997 onwards, but following the liberalization of interest rates on instant access savings deposits in July 1997, a foreign currency crisis erupted, causing the deferment of the remaining liberalization. In this light, the recent measure deregulating interest rates on demand deposits is significant in that it marks the conclusion of the liberalization of all bank lending and deposit rates under the「Four-Stage Interest Rate Liberalization Plan」. Accordingly, through the abolition of almost all regulations concerning banks' deposit and lending rates and conditions on them apart from current checking accounts, the bank deposit rate liberalization ratio was raised from around 90% at year-end 2003 to what is now effectively the 100% level.

(Expected Effects)

For some considerable period, regulations on the deposit interest rates of non-bank financial institutions had been almost completely abolished whereas controls were still kept in place on banks' demand deposits. This meant that in the market for short-term deposits, non-bank financial institutions occupied a superior position by virtue of the very much higher yields and similar convenience of withdrawals on their products compared to those of banks' demand deposits. In this connection, the liberalization of demand deposit interest rates will have the effect of providing conditions for fair competition between primary and secondary financial institutions. In addition, because automatic sweeping between accounts is now possible, it will galvanize the development of innovative financial products incorporating this feature, which is expected to increase customer convenience. Apart from this, it is anticipated to have the effect of widening the channels of interest rate policy transmission in keeping with the taking root of an interest-rate focused operating system for monetary policy.

(Assessment of the Anticipated Side Effects)

The further promotion of interest rate deregulation was put on hold after the currency crisis toward the end of 1997 because of fears over the possibility of side effects arising that might act to destabilize the financial markets. Among the malign side-effects feared were a rise in interest rates following the deregulation of demand deposits because of competition for deposits among banks, an expansion of portfolio shifts between financial institutions and financial products, and an intensification toward the concentration of funds at the short-term end on the part of market funds.

Nevertheless, the scale of the rise in interest rates in the wake of the recent liberalization of demand deposits is expected to be limited. Because demand deposits serve mainly as a stock of extremely short-term funds for the primary purpose of payment and settlement, their sensitivity to interest rates is not high compared to that of other deposits. What is more, because of the general preference for asset safety, the situation of banks in general with regard to funds remains very favorable thanks to the expansion of deposits with them. Then again, there has been a paradigm shift in banks' management style away from the expansion of external scale by luring deposits toward substantive management through a focus on profitability and risk management.

The likelihood of large-scale portfolio shifts between types of financial institutions and financial products is also judged not to be very great. Banks are maintaining the rather negative attitude toward attracting short-term funds both because of their ample funding situation and control of their Korean won liquidity ratios. Consequently, it is foreseen that the scale of the rise in interest paid on demand deposits will be kept to a minimum as far as possible.

It is also anticipated that there is no great likelihood of increased concentration of funds at the short-term end of the market on the part of market funds. In the case of individuals, where there is a need to operate funds from the short-term point of view, savings deposits, which have a similar character to demand deposits, can be used as in the past. There is some possibility of companies shifting operating funds from short-term deposits into company savings deposits of less than seven days, which offer relatively high yields and convenience of withdrawal, but the scale of this shift is seen to be limited.

Interest Rate Liberalization in the 1990s according to the 4-stage plan

	Lending Rates	Deposit Rates	Bond Issue Rates
First Stage (Nov. 1991)	- Bank overdraft and discounts on commercial bills, apart from loans assisted by Bank of Korea rediscounts - Discounts on commercial paper and trade bills of investment and finance companies, etc. - Overdue loans	- Short-term, large denomination deposit instruments such as CDs, trade bills, CP and RPs - Long-term time deposits and money-in-trust with a maturity of at least three years	- Corporate bonds with a maturity of at least two years
Second Stage (Dec. 1993)	- All loans of banks and non-bank financial institutions, apart from those provided through the government or Bank of Korea rediscounts	- Banks and non-bank long-term deposits with a maturity of over two years	- Corporate bonds with a maturity of less than two years and all financial debentures - Monetary Stabilization Bonds and all government and public bonds

<table>
<tr><th></th><th>Lending Rates</th><th>Deposit Rates</th><th>Bond Issue Rates</th></tr>
<tr><td rowspan="4">Third Stage
(Jul.1994~
Dec. 1995)</td><td>–</td><td><Jul. 1994>
- Reduction of the minimum maturities of short-term marketable products(CDs, RPs and CP)</td><td rowspan="4">–</td></tr>
<tr><td><Dec. 1994>
- Allowing banks to set freely interest rates on loans financed through the aggregate credit ceiling system of the Bank of Korea within their prime rates</td><td><Dec. 1994>
- Bank and non-bank time deposits with a maturity of one year or more but less than two years (two years or more but less than three years in case of installment deposits)</td></tr>
<tr><td><Jul. 1995>
- Loans financed through the aggregate credit ceiling system of the Bank of Korea
(Consequently, all lending rates were freed up)</td><td><Jul. 1995>
- Bank and non-bank time deposits with a maturity of six months or more (one year or more in case of installment deposits)
- More deregulation of short-term marketable products</td></tr>
<tr><td>–</td><td><Nov. 1995>
- Bank and non-bank time deposits with a maturity of less than six months (less than one year in case of installment deposits)
- Preferential savings deposits and company savings deposits which are maintained for three months or more
- Further deregulation of short-term marketable products</td></tr>
<tr><td>Fourth Stage
(Jul. 1997)</td><td>–</td><td>- Abolition of the remaining restrictions on deposits
(Consequently, all deposit rates were freed up, except for demand deposits)
- Abolition of the remaining restrictions on short-term marketable products, except for minimum maturities of CDs and RPs sold by banks</td><td>- Allowing banks to issue financial debentures</td></tr>
</table>

6. Payment and Settlement System

For the safe and efficient operation of the nation's payments and settlements, the Bank of Korea pursued the improvement of the related systems. At the same time it acted to put in place a framework for the oversight of payment and settlement systems ahead of the entry into effect of the revised Bank of Korea Act.

(Heightening the Safety and Efficiency of Payment and Settlement Systems)

In order to reduce the net settlement risk that may arise in the call market from the use of promissory notes and to heighten the safety of call funds settlement, from July onwards the Bank of Korea widened the scope of financial institutions eligible to make use of the Call Transactions System[11] of the Bank of Korea's financial settlement network (BOK-Wire). Specifically, in the case of the supply of call funds to non-bank financial institutions or domestic branches of foreign banks, hitherto the collection of call funds had involved a procedure whereby a promissory note for redemption use or a receipt for redemption use had been sent to the clearing house, but call funds may now be collected through the Call Transaction System of BOK-Wire in such cases. Accordingly, the settlement risk accompanying call transactions has been reduced to a similar extent. Not only that but the operational burden imposed on financial institutions by the physical movement of large-value bills for clearing has been eased.

<Table Ⅲ-7>

Scale of Settlements[1] Handled by BOK-Wire

(Unit, billion won, %)

	2002	2003	changes(%)
<Volume>			
Domestic currency funds transfer	4,735(86.0)	4,992(77.9)	5.4
(Gross settlement)	3,984(72.4)	4,329(67.5)	8.7
(Net position settlement)	751(13.6)	663(10.4)	-11.7
Treasury funds transfer	730(13.3)	1,379(21.5)	88.9
BOK loans discounts settlement	27(0.5)	26(0.4)	-3.7
Government and public bonds settlement	11(0.2)	15(0.2)	36.4
Total	5,503(100.0)	6,412(100.0)	16.5
Foreign currency funds transfer	9(-)	10(-)	11.1
<Value>			
Domestic currency funds transfer	76,961(95.8)	83,930(95.4)	9.1
(Gross settlement)	62,812(78.2)	70,041(79.6)	11.5
(Net position settlement)	14,149(17.6)	13,889(15.8)	-1.8
Treasury funds transfer	1,808(2.3)	2,290(2.6)	26.7
BOK loans discounts settlement	883(1.1)	915(1.0)	3.6
Government and public bonds settlement	633(0.8)	907(1.0)	43.3
Total	80,285(100.0)	88,042(100.0)	9.7
Foreign currency funds transfer (million dollars)	88(-)	112(-)	27.3

Notes: 1) Daily average basis.
Figures in parentheses refer to shares in total (%).

11) This is a subsystem of BOK-Wire whereby call funds are supplied through the current accounts of financial institutions held with the Bank of Korea and interest and principal are automatically repaid at the designated time on the maturity date.

In a further move undertaken in October to galvanize collateralized call transactions[12] and reduce settlement risk, supply of the call funds and delivery of the securities posted as collateral, or redemption of funds and collection of the securities could be carried out at the same time, as collateralized call transactions intermediated by fund brokers were added to the list of transactions eligible to use the Delivery vs Payment system of BOK-Wire. Consequently, the settlement risk of a loss of principal arising in connection with collateralized call transactions could be eliminated and the details of collateralized call transactions could be grasped in real-time.

In order to reduce the foreign exchange settlement risk arising in foreign exchange trading where, because of time zone differences between countries, payment of the currency sold and receipt of the currency purchased cannot be completed at the same time, construction of a currency Payment versus Payment system is being pursued with the target date for its entry into operation being the end of 2004. In this connection, the Bank of Korea prepared the institutional and technical environment for domestic financial institutions' introduction of continuously linked settlement for simultaneous foreign currency settlement from September onwards in line with the completion of subscription to CLS Bank[13] by Kookmin Bank and Korea Exchange Bank and the provisional designation

12) It was first introduced in July 1992, but for a long time no transactions actually took place because there was no system in place for handling the linkage of the supply and collection of call market funds and the delivery and collection of collateral.

13) CLS Bank (Continuous Linked Settlement Bank) was established as a specialist private bank based in New York with capital contributions from 66 financial institutions in 17 countries in 1999 for the purpose of the payment versus payment system for the settlement of foreign exchange transactions around the world. In September 2002, the US dollar, Japanese yen, UK pound, euro, Swiss franc, Canadian dollar and the Australian dollar were designated as the 7 settlement currencies for the simultaneous settlement of foreign exchange. In September 2003, the Singapore dollar, the Swedish krona, the Danish krone and the Norwegian krona were additionally designated as settlement currencies.

of the Korean won as a settlement currency by the CLS Bank. Work was also pressed ahead with on the tasks involved in linking the CLS Bank system with domestic financial institutions and BOK-Wire.

Apart from this, at the time of a threatened strike by Chohung Bank staff in June, the Bank of Korea put in place emergency measures to ensure the trouble-free operation of BOK-Wire and payment and settlement systems as a whole. In the face of a liquidity shortage by Chohung Bank, screening of the eligibility of securities to be posted as collateral against Liquidity Adjustment Loans and their registration were undertaken in advance so that such loans could be extended promptly.

(Establishment of a Framework for the Oversight of the Payment and Settlement System)

Ahead of the entry into effect of the revised Bank of Korea Act under whose provisions the Bank of Korea was given responsibility for the holistic management and oversight of the country's payment and settlement system, the Monetary Policy Committee passed a resolution on December 24 entitled 「Regulation for the Operation and Management of the Payment and Settlement System」 in order to build an effective oversight framework for the country's payment and settlement system.

As a first step, the scope of oversight business and the payment and settlement systems that were the objects of that oversight were clearly defined and criteria were set up for the evaluation of the efficiency and safety of payment and settlement systems. In addition, it was provided that where the results of the Bank of Korea's assessment of payment and settlements system fell short of a certain specific level, the operating institution or the institution directly supervising it was to be requested to improve its operating standards and, in the event of an emergency situation arising such as electronic systems failure, calamity, strike, or terrorist attack, the Bank of Korea was to be immediately notified. Along with this, in order to heighten the safety of BOK-Wire, the eligibility criterion for institutions to join BOK-Wire was intensified from the previous ‘an institution maintaining a current account with the Bank of Korea’ to ‘an institution being one conducting current account transactions with the Bank of Korea whose management guidance ratio is deemed satisfactory by the appropriate supervisory institution and whose expected average monthly frequency of usage is above a certain fixed scale’.

Ⅳ. Monetary Policy for 2004

1. Environment

A. World Economy

In the course of the first half of the year 2003, the recovery of the global economy was delayed by the influence of the high level of geopolitical risk relating, for example, to the war US-led against Iraq and by the spread of the SARS epidemic. But following the early end of the war in Iraq and the containment of SARS, there was a turn for the better in consumption and investment mood while oil prices stabilized and the effects of the pump-priming measures undertaken by most countries began to emerge. From early in the second half of the year, a recovery trend gradually became evident centering on the US economy. The growth of the world economy is likely to accelerate during 2004 owing to the further pickup of the economies of major advanced countries, and notably that of the US, along with the continued rapid growth of the Chinese economy.

<Table Ⅳ-1>

Outlook for US Growth Rate[1]

(%)

		2003[2]		2004				
		Ⅳ	year	Ⅰ	Ⅱ	Ⅲ	Ⅳ	year
		4.0	3.1					
I M F	(Sep. 2003)			-	-	-	-	3.9
Citigroup	(Feb.27, 2004)			5.1	5.0	4.5	4.1	5.0
Lehman Brothers	(Mar. 1, 2004)			4.0	4.0	4.0	4.5	4.4
Deutsche Bank	(Feb.27, 2004)			4.7	5.5	4.7	4.4	5.0
Morgan Stanley	(Feb.26, 2004)			4.7	4.4	-	-	4.8

Notes: 1) Annualized quarter-to-quarter change.
Figures in parentheses refer to prospect dates.
2) Preliminary.

During the year 2004, the US economy is expected to chalk up high growth above its potential growth rate of 3~3.5%. This will result from a combination of an uninterrupted increase in private consumption and the stepping-up of facilities investment fueled by, in line with the maintenance of an expansionary macro economic policy stance, improved corporate profitability and heightened productivity.

The recovery of the Euroland economy is also seen to gather pace thanks to a gradual rise of domestic consumption and the buoyancy of exports. Households will enjoy enlarged purchasing power owing to price stability, the improvement in the employment situation and reductions in income tax, while corporate investment is expected to show a recovering trend thanks to the maintenance of low interest rates and improved corporate profitability. Despite the strength of the euro, exports are likely to be boosted by the increase in overseas demand generated by the global economic recovery, maintaining the evident buoyancy since the latter half of 2003.

The Japanese economy should see the upward trend of exports and facilities investment maintained thanks to the revival of business activity in the US and Asian countries together with the strong growth of the Chinese economy while private consumption, so long subdued, is seen to continue a steady recovery trend. Accordingly, it is likely that the economic recovery trend will expand and GDP growth maintain the similar rate as in the previous year.

The Chinese economy appears to maintain its rapid growth pace in view of the continued briskness of domestic and foreign demand, but its pace of growth may slacken somewhat. Private consumption is seen to maintain its high growth in line with urbanization and the upgrading of consumption patterns. The robust growth of investment will be sustained by inflows of foreign capital and improved corporate profitability as a result of structural adjustment. The government, however, is expected to take stabilization measures if symptoms of overheating of the economy persist.

International oil prices will maintain their high level during the first quarter because of the increased seasonal demand in the winter and OPEC's decision to

<Table Ⅳ-2>

Outlook for International Oil Prices[1]

(period average, US$/barrel)

	2004				
	Ⅰ	Ⅱ	Ⅲ	Ⅳ	year
ESAI (Jan. 2004)	30.8	27.5	27.7	26.9	28.2
CERA (Jan. 2004)	31.8	28.8	27.5	27.5	28.9
JP Morgan (Feb. 25, 2004)	31.0	29.0	28.0	28.0	29.0
EIA(Feb. 10, 2004)	32.4	30.2	29.8	29.2	30.4

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

<Table Ⅳ-3>

Outlook for Yen/US$[1]

(period-end basis, yen/US$)

	2004			
	Ⅰ[2]	Ⅱ	Ⅲ	Ⅳ
	107			
Morgan Stanley (Mar.4, 2004)		106	103	102
BNP Paribas (Mar.5, 2004)		102	95	90
HSBC (Feb.12, 2004)		103	100	98
Merrill Lynch (Mar.3, 2004)		105	102	-
Deutsche Bank (Feb.27, 2004)		105	99	97
JP Morgan (Feb.26, 2004)		100	97	99

Notes: 1) Figures in parentheses refer to date of forecast.
2) The average from Jan.1 to Mar.20.

reduce production quotas[1], but the prevailing forecast is that they will gradually evolve to show downward stability from the second quarter onwards as the use of heating oil declines and Iraqi crude oil production comes on-stream. There is, however, concern that the price of crude oil may continue to run at a high level throughout the first half of the year should there be a delay in getting Iraqi production on-stream again, or should the political instability in several producing countries persist. As for other international raw materials, prices of metals such as iron and copper are likely to show steeply increasing trends owing to the acceleration of global economic recovery, the weakening of US dollar, etc. while grain prices are also expected to show comparatively high upward trends owing to the conjuncture between supply and demand.

The US dollar will, it is foreseen, maintain its weak tone against other major currencies in view of the widened US current account deficit and the likelihood that the Bush administration may tolerate a weak dollar in the run-up to the presidential elections.

B. Domestic Economy

For the year 2004, the Korean economy is forecast to exhibit GDP growth at around the 5% level, helped by the buoyancy of exports in line with the more rapid growth of the global economy and the progressive recovery of facilities investment. Over the first half of the year, GDP growth should rise mainly on the back of the pronounced briskness of exports. Moving into the latter half, we expect facilities investment activity

1) In a general meeting on February 10, 2004, OPEC decided to reduce production quotas per day by one million barrels (24.5 million → 23.5 million) from April 1. Also it urged its member countries to reduce that quantity of production in excess of their quotas estimated at more than 1.5 million barrels in all.

to pick up and private consumption to show a gradual recovery.

Exports will, it is foreseen, sustain their strongly increasing trend, driven by the accelerated growth pace of major advanced economies, and particularly that of the United States, together with China's continuing rapid growth. Investment is predicted to expand, centering on exporting businesses, as capacity utilization rates in manufacturing move higher. The government's efforts to boost investment through tax support and so forth and businesses' holdings of surplus funds should, it is anticipated, act as factors accelerating the recovery of investment in future. Nonetheless, the relocation of production in China and elsewhere overseas in search of low wage costs and the constant possibility of labor disputes are acting to dampen the recovery of investment confidence, so that facilities investment is not seen to reach the double-digit rates of increase registered in the upturn phase of previous business cycles. From the beginning of the latter half of the year, private consumption should be able to break free of the evident declining trend in 2003 as, for example, the influence of the phased introduction of the five-day week makes itself felt. It is only likely, however, to attain a feeble growth trend since the weight of household debt and the problem of the huge numbers of people blacklisted for credit delinquency will act as restraining factors. Consequently, the pace of recovery of the domestic economy is expected to be modest. The pickup in domestic economic activity will be primarily driven by the exports of large companies, especially those in the IT industry and the heavy and chemical industry. In contrast, the recovery of small and medium enterprises and the domestic demand sector is likely to be tardy, so that no substantial effect in terms of an increase in overall employment can be awaited.

<Table Ⅳ-4>

Rate of Increase of GDP and Facilities Investment during Previous Business Upturn[1]

(%)

	5th cycle[2]		6th cycle[3]		7th cycle[4]	
	1st year	2nd year	1st year	2nd year	1st year	2nd year
G D P	9.2	8.8	6.6	8.4	5.2	10.4
Facilities investment	17.4	15.8	9.3	24.7	15.1	47.4

Notes: 1) The rate of increase in the first and second year entering business upturn
2) From the last quarter of 1989 to the first quarter of 1992
3) From the second quarter fo 1993 to the first quarter of 1996
3) From the last quarter of 1998 to the third quarter of 2000

Core inflation is expected to maintain generally stable trend in that upward pressures on the demand side are unlikely to be heavy owing to the mildness of the business recovery together with the likelihood of the continuing weakness of the US dollar. However, should high oil prices and the upward trends of other international raw material prices prove sustained, the likelihood of price instability cannot be excluded. Moving into the latter half of the year, moreover, demand side pressures are expected to increase gradually in line with the recovery of the domestic economy.

In terms of the current account, imports of capital goods will increase to feed the expansion of facilities investment and the service account deficit is likely to widen. However, thanks to continued brisk exports helped by the accelerated recovery trend of the global economy, a comparatively large scale current account surplus is anticipated to be maintained.

The financial markets are foreseen to remain generally stable with the conjuncture of funds supply and demand generally presenting a smooth picture, as market liquidity is ample while the demand for corporate funds is not large. Financial institutions are likely to remain prudent in their attitude toward lending, but neither businesses nor households are foreseen to have a large demand for borrowings. The pace of increase of household loans will decelerate from the previous year, both because of the 「Comprehensive Package of Housing Market Stabilization Measures」 (October 29, 2003) and financial institutions' more rigorous credit screening as a result of the increase in delinquency ratios on household loans. For its part, the corporate sector is unlikely to see any large expansion of its borrowings despite the anticipated recovery of facilities investment.

The reason is that many companies are holding large quantities of surplus funds and are continuing their efforts to reduce debt ratios. The volume of bond supply is predicted to be slightly larger than in the preceding year with an expanded issuance of Treasury and corporate bonds offsetting a reduction in that of card companies' paper and of ABS underlain by it.

Investment trust companies are seen to have a reduced appetite for bonds in view of the impact of the realignment of the MMF system[2)] and expectations of rising interest rates in the course of economic recovery. On the other hand, major purchasers of long-term bonds, including pension funds and insurance companies, are expected to constantly expand the scale of their bond operations. Accordingly, the interplay of supply and demand for bonds is expected to be generally friction-free.

There are, however, a number of uncertainties that may exert a negative influence on this forecast. Firstly, looking at overseas conditions, there is the possibility that the high oil prices will persist for longer than expected because of the delay in resuming normal oil production in Iraq and the difficulties in establishing a new Iraqi government. The growth of the world economy may be weakened as a result of an increase in geopolitical risk such as the spread of international terrorism, the sustained large-scale deficit on the US current and fiscal accounts, and delay in the improvement of employment conditions. If additional pressure from the US for appreciation is brought to

2) During the first half of 2004, the credit rating for bonds eligible for purchase by MMFs is to be adjusted upward from BBB to AA and higher and a new ceiling will be set on holdings of securities by a single issuer (10% of the fund's assets). Besides this, during the latter half of 2004, the method of repurchase will be changed from the existing 'repurchase today' on the basis of the previous business day's aggregate closing valuation to 'repurchase the following business day' on the basis of today's aggregate closing valuation.

bear upon Asian currencies and the exchange rate of Chinese yuan is readjusted, the foreign exchange markets could be thrown into turmoil. On the domestic front, if contrary to expectations the North Korean nuclear issue deteriorates, there is the possibility that Korea's sovereign credit rating may be downgraded and that foreign investment capital will flow out of the country. Financial instability may also emerge as a result of a further increase in the number of people blacklisted for credit delinquency, a further rise in the ratio of household and SME credit delinquencies, or delay in improving the management of credit card companies or in the restructuring of investment trust companies. Nor can the possibility be excluded that industrial activity will contract in line with an increase in strife between labour and management over major outstanding issues including the pursuit of the road map for reform of labor relations, the five-day workweek system, and questions relating to the employment conditions of temporary and casual workers.

2. Monetary Policy Direction

Taking into account the economic environment at home and abroad, monetary policy will be conducted over the year 2004 in such a way as to bring about the stability of prices within the range of the medium-term inflation target by preemptive action to counter inflationary pressures while underpinning the recovery of business activity and the improvement of the employment situation. Intensive efforts will be devoted, in parallel with this, to ensuring that an efficient operating system for the medium-term inflation target takes firm hold and that improvement of the monetary policy toolkit commensurate with the changes in the financial and economic environment can be achieved. A system for the oversight of institutions concerned with payments and settlements will also be constructed at an early date.

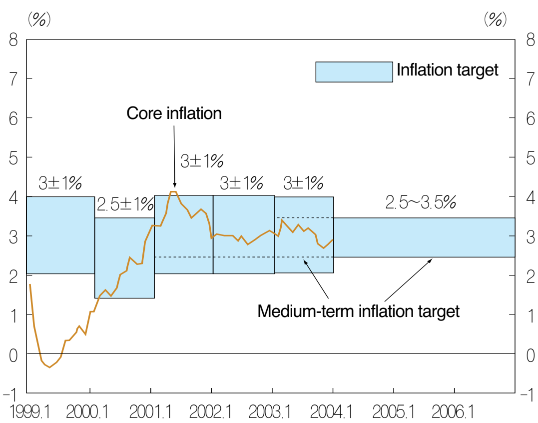
A. Achieving the Medium-Term Inflation Target

(Setting a Medium-Term Inflation Target)

Following the choice of a system of inflation targeting, the Bank of Korea in accordance with the Bank of Korea Act revised December 1997 and entered into effect April 1998, each year established and publicly announced an inflation target for the year ahead. From the year 2000, in view of the time lags involved in the transmission of monetary policy, it additionally set and publicly announced a medium-term inflation target that it would endeavor to achieve from the following year in tandem with the annual target stipulated under the

<Figure Ⅳ-1>

Trends of Medium-Term Inflation Target and Core Inflation[1]



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

Act.[3] However, the provisions of the Bank of Korea Act revised September 2003 that came into effect from the beginning of 2004 require the method of establishing the inflation target to be changed from the previous annual targeting system to medium-term targeting system. Accordingly, the Bank of Korea, after consultation with the government, set medium-term inflation target of 2.5~3.5% in terms of the average level of core inflation during the period 2004~2006. In doing so, it took into overall consideration domestic and international economic conditions, the strength of the will for price stability, and the maintenance of consistency in the policy objective.

In connection with the choice of the medium-term inflation target, a period of three years was taken to refer to "medium-term" in consideration of the time lag of monetary policy transmission, the leading example of foreign countries, and the general perception as to "medium-term". If the period for the application of the inflation target were taken as two years, it would give the impression that the target is frequently changed. Moreover, if inflation moved above the upper band of its target range during the first year of the binary cycle, this might impose the burden of having to bring down the rate of price increases in too brutal a manner in the following year. On the other hand, if the period of application of the target were four years or more then there would be a general tendency to recognize this as being long-term.

The target range was set at 2.5~3.5%, since the appropriate level of inflation consistent with underlying economic conditions and supportive of economic

3) Despite the Bank of Korea's setting and publicly announcing an medium-term target, the criterion as to whether the price stability target had been successfully achieved was the annual inflation target as stipulated under the Bank of Korea Act before revision, and the general public tended to have little interest in the medium-term target.

stability is estimated as being in the region of 3% and inflation over the coming two or three years is forecast to be somewhere close to 3%. There was, furthermore, a clear intention to secure the credibility and consistency of monetary policy underlying the setting of the medium-term target range at the same level as the inflation target for the year 2004 and onwards that had been publicly announced in 2003. Additionally, to stabilize prices, the upper bound of the medium-term target range for 2004~2006 (2.5~3.5%) was set 0.5 percentage point lower than that of the annual target range for the year 2003 (3±1%).

The target indicator of inflation employed will continue to be core inflation. This is because core inflation, while including most of the items that make up the CPI,[4] is more appropriate as the target monetary policy index because it does not suffer the latter's exposure to severe short-term volatility. In addition, it is only four years since core inflation was adopted as the target indicator. Consequently, if a further change were to be made after such a short lapse of time, it could prove disturbing for the general public. Also it has to be clearly borne in mind that, in contrast to what happens in major advanced countries, non-monetary factors such as the oil price still exert a considerable influence on changes in the CPI in Korea.

In order to secure scope for flexibility in monetary policy, the standard for assessment as to whether the inflation target had been attained was established as the average rate of increase in the target indicator during the period. The rationale for this was that if non-monetary factors such as a supply shock caused prices to breach the bounds of their target range temporarily, provoking an immediate monetary policy

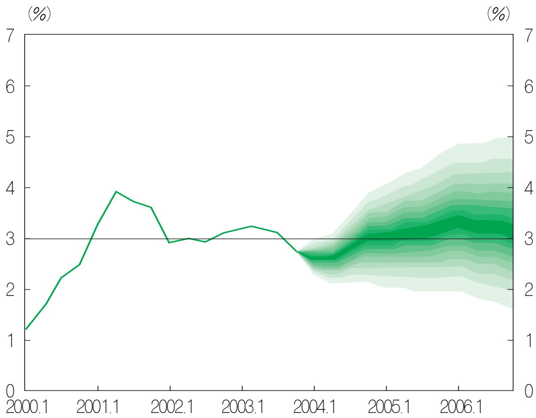
4) The weight of the items excluded from the CPI is 11.7%, of which agricultural products represent 4% and petroleum fractions 7.7%.

response, this could instead lead to increased volatility in the financial markets and the real economy.

(Status and Prospects of Inflation)

<Figure Ⅳ-2>

Core Inflation[1] Projection



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

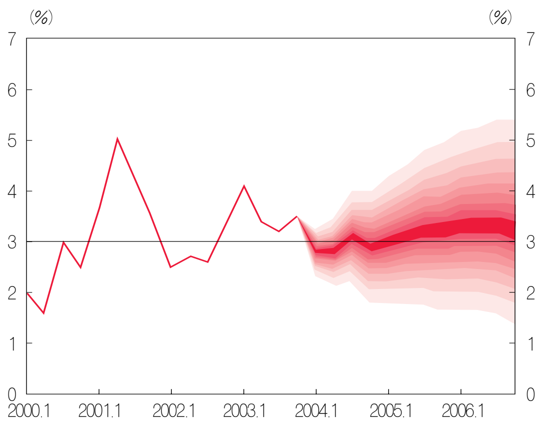
Over the course of 2004, core inflation is expected to be a little lower than the previous year's 3.1%. The rise in the CPI, which accelerated sharply in 2003 at the level of 3.6%, is expected to slacken its pace on an annual average basis, unless a situation arises in which high oil prices defy expectations by persisting for a long period or international raw material prices surge greatly. This forecast of price stability is predicated upon anticipations that, over the year as a whole, demand pressures will not be all that great thanks to the moderate pace of the recovery, that the exchange rate will act as a stabilizing factor, and that the steeply upward trend shown by housing prices since 2001 will flatten out.

This forecast for the course of inflation from 2004 onwards coincides with what emerges from a study of the fan charts in <Figure IV-2> and <Figure IV-3>, showing not just the expected level of inflation but also the associated degrees of uncertainty at the same time. The degree of probability that core inflation will stay within the bounds of the medium term target range during the year 2004 is shown to be about 80%. From early in the second half of 2004, however, the upward risk of prices is shown to gradually become greater as the rate of increase of private consumption and facilities investment both accelerate, adding to the factors making for greater uncertainty as the forecasting horizon widens.

If we examine the environment for rising price from the year 2005 onwards, we can expect demand-pull pressures on prices to gradually materialize as the

<Figure Ⅳ-3>

CPI Inflation[1] Projection



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

domestic and global economies maintain their recovery trends. On the cost side, international oil prices should show stable movements, as Iraq increases oil production. But international prices of raw materials will likely accelerate their upward trend due to the recovery of the global economy. Domestically, there is the possibility of the upward trend of wages gathering pace. Moreover, if charges for certain public services and utilities, such as transport fares and tariffs for water and sewage services that have so far only slowly been adjusted to realistic levels, are raised by a large margin and taxes on cigarette continue to be increased, the rise in prices will be larger than forecast.

(Policy Direction in Relation to the Medium-Term Inflation Target)

The fan chart for core inflation shows that, as of the early part of 2004, it may be anticipated that the inflation target for the years 2004~2006 will be generally achieved, although uncertainty over the prospect for prices will heighten and the upward pressures on them mount over the course of time from the latter half of 2004 onwards. Monetary policy will, it is planned, be accordingly conducted in a flexible manner with the aim of a progressive convergence of prices upon the midpoint of the target range should the rate of inflation stray temporarily outside its bounds owing to non-monetary factors such as supply shocks. Vigilance, however, should not be relaxed, as a number of latent factors exist with the potential to destabilize prices. Looking at the year 2004 alone, these include continued high oil prices owing to a possibly persistent delay in getting Iraqi oil production back on-stream or frictions over the establishment of a new government in Iraq, an upswing in the prices of international raw materials, a worsening of the North Korean nuclear issue with consequent exchange rate instability, and so forth. Taking into consideration the influences that these and other uncertainties may exercise on prices, the Bank of Korea is committed to dedicating its utmost efforts to ensure that inflation during 2004 and in the years ahead remains stable within the bounds of its medium-term target range.

Additionally, it plans to analyze price trends every year and to check them in the intervening period. And the Bank of Korea will also explain the medium-term price forecast, the possibility of achieving the medium-term inflation target, and the primary factors for the any major divergence of actual inflation performance from that forecast. Besides this, it will explain the reasons, should inflation breach its target bounds, together with details of the policy response.

B. Flexible Operation of Monetary Policy

The intention is to conduct monetary policy during the year of 2004 with a particular emphasis on holding prices stable within the bounds of the medium-term inflation target while keeping a vigilant eye on the possible emergence of imbalances in terms of growth, prices and the current account. Therefore, there will be a preemptive response should demand-side pressure pick up in the course of the accelerated recovery of domestic demand while underpinning the recovery of business activity and the improvement of the employment situation.

In addition, with the entry into effect of medium-term inflation targeting from this year onwards the Bank will conduct monetary policy more flexibly in the period ahead in view of a number of latent factors surrounding the Korean economy. Specifically, should there be an expectation that there is a danger of the medium-term inflation forecast breaching the bounds of its target range, account will be taken of the cause of its deviation, the time lag in the transmission of policy, and financial and economic conditions in deciding whether there should be a policy rate response and the strength of such response. Moreover, the policy response undertaken will seek to minimize side-effects on the real economy and the financial markets by aiming inflation at the midpoint of the inflation target range from a medium-term perspective.

Efforts will be stepped up to heighten the effectiveness of monetary policy by its operation in a harmonious policy-mix with fiscal and foreign exchange policy. What is more, since financial supervisory policy exerts a direct influence on financial institutions' operation of their assets, and to this extent also influences the effectiveness of monetary policy and the channels of its transmission, coordination with the financial supervisory authority will be augmented so as to avoid conflicts of interest between monetary and supervisory policies.

It is intended that money supply should be implemented flexibly, taking account of financial market's conditions, while seeking to bring about the stable formation of call market interest rates at the target level decided by the Monetary Policy Committee.

Apart from this, the Bank of Korea also plans to step up its drive to promote the credibility of monetary policy and a greater understanding of it on the part of the general public. To the existing channels of communication that include the 「Economic Trends Discussion Meeting」 and the 「Financial Consultation Meeting」, there will be added the 「Survey Concerning

Public Consciousness as to Monetary Policy」. By augmenting public relations and spreading economic know-how among citizens, the Bank is seeking to broaden and diversify channels for feedback and mutual communication with the general public.

C. Improvement of Monetary Policy Instruments

The Bank of Korea intends to pursue the step-by-step improvement of its loan system toward the upgrading of its liquidity adjustment function and heightened effectiveness in the support of small and medium enterprises (SMEs). Loans under the Aggregate Credit Ceiling will be adjusted with an emphasis on the support for objectives such as galvanizing regional economies, supporting for small and medium exporting businesses, and ensuring that the practice of cash settlement in commercial transactions takes firm hold. Careful consideration will be given to plans to convert the system of Liquidity Adjustment Loans from a means of temporary funding support for banks experiencing liquidity shortages, as at present, to a tool for the routine adjustment of the level of liquidity of banks as a whole.

The Bank of Korea intends to heighten the liquidity adjustment and interest rate signalling functions by the flexible operation of the Bank's interest rates an loans in line with financial and economic conditions. Interest rates on loans under the Aggregate Credit Ceiling will be adjusted in consideration of fund-raising conditions for SMEs, changes in market interest rates and banks' deposit and lending rates. Interest rates on the Liquidity Adjustment Loans will, it is intended, be adjusted together with the call rate target when there is a need to send a strong signal to the financial markets of a shift in the policy stance in line with changes in financial and economic conditions.

In addition, it will be considered to work on plans to realign the reserve requirement system to incorporate changes in the structure of financial transactions including the full liberalization of interest rates, the wide diversification of deposit products, and the widespread use of electronic financial transactions.

D. Strengthening of Efforts for Financial Stability

The Bank of Korea intends to intensify its drive to secure financial stability. It will keep a constant check on factors with a potential to create market instability including developments in the restructuring of investment trust companies, the management status of credit card companies, and the increase in the credit risk of households and SMEs. Should there be indications that they are about to materialize, it will react in a timely manner by its use, for example, of open market operations. Actively implementing its function of inspection in regard to financial institutions, it will strive to pick up promptly factors working to destabilize the financial system while, at the same time, gathering on-the-spot information for the formation of monetary policy and ascertaining the effectiveness of policy transmission in the markets.

E. Improvement in the payment and settlement system

Under the revised Bank of Korea Act, the Bank of Korea is explicitly endowed with the functions of the holistic management and oversight of the payment and settlement system. Accordingly, it is now pressing resolutely ahead with upgrading its safety and efficiency.

Payment media and methods of settlement will be improved with a view to reducing risk factors that may generate settlement risk. The Bank intends to move strongly to increase its monitoring activities regarding credit card-based settlement and mobile phone-based settlement, two trends that have been witnessing sustained expansion. In order to reduce settlement risk, a plan has been mooted to have large-value inter-bank transactions through low-value settlement systems absorbed into BOK-Wire. Another plan is under consideration to convert all transactions involving the production of physical documents such as checks and bills to an electronic method of settlement. In addition, a system is being prepared to enable simultaneous settlement between the Korean won and foreign currencies from the end of 2004. In parallel with this, the completion of construction is scheduled for a continuously linked settlement (CLS) system for the simultaneous settlement of foreign exchange that will be available for the joint use of all domestic financial institutions.

Apart from this, through the construction for a system for the seamless exchange of information and co-operation in regard to materials between the Bank of Korea and other institutions operating payment and settlement systems, and those participating in them, it is intended to strengthen monitoring operations and upgrade the surveillance system to bring it up to par with those of advanced countries. Work is also well underway on specific plans for evaluating the safety and efficiency of payment and settlements systems.