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%.

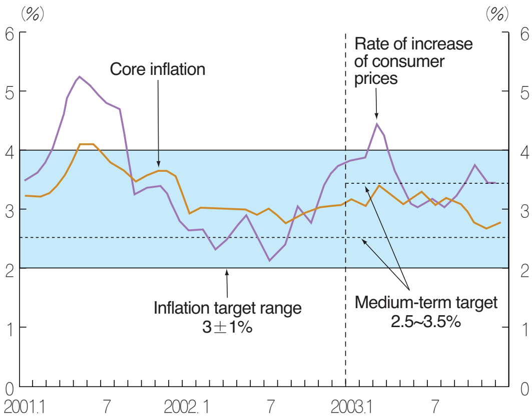
The index employed as the reference for the inflation target was, as in the previous year, the annual average level of core inflation, a measure which strips out from the Consumer Price Index both petroleum-based fuels and farm products other than grains, which are liable to wide temporary fluctuations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

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

<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.

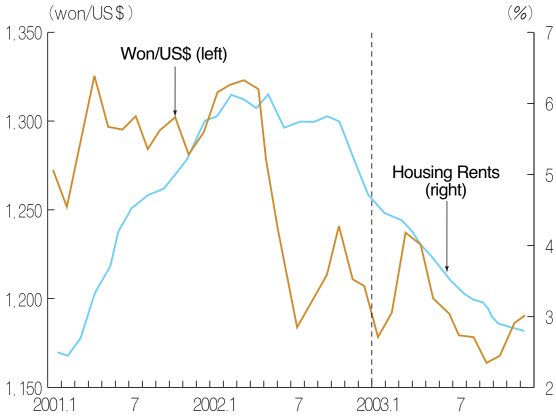
2.5%. A further consideration was the necessity of securing sufficient room for maneuver, so as to allow the flexible operation of monetary and credit policies in response to the uncertainties of the domestic and international economic environments.

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



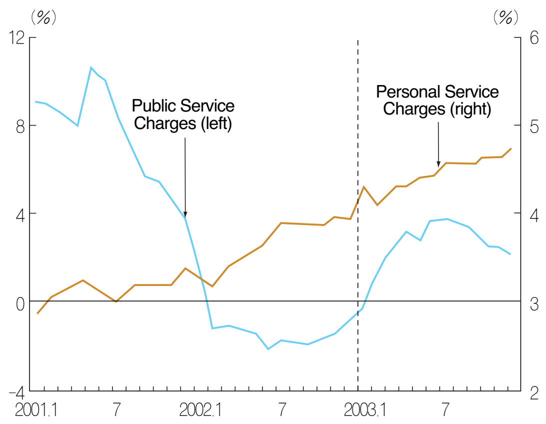
Note: 1) Compared with the same period of the previous year.
Sources: The Bank of Korea, Korea National Statistical Office.

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.

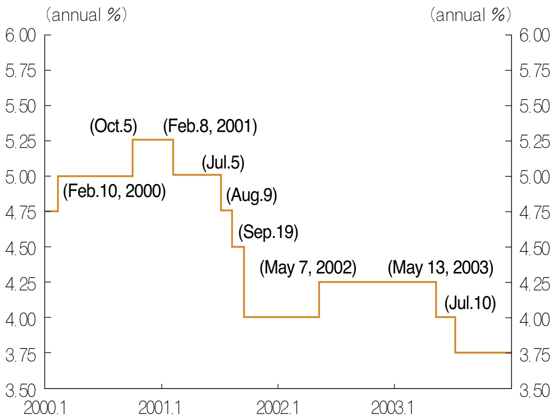
The Monetary Policy Committee decided to maintain the call rate target at 4.25% at both its January and

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

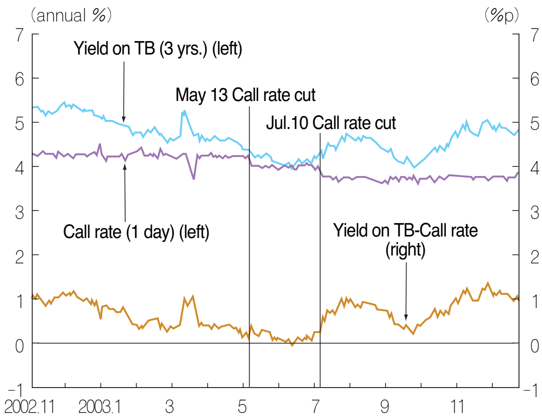
1) At that juncture, it was estimated that the growth rate of the Korean economy would be reduced by 0.3 percentage point for the year as a whole owing to the reduction of earnings from inbound tourism and of exports to regions most affected by the spread of SARS across China and much of Southeast Asia.

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.

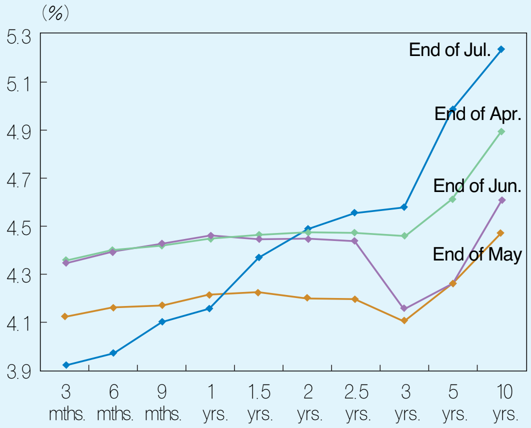
Volatility of Treasury Bond (3 yrs.) Yields after Call Rate Reductions[1]

(%p)

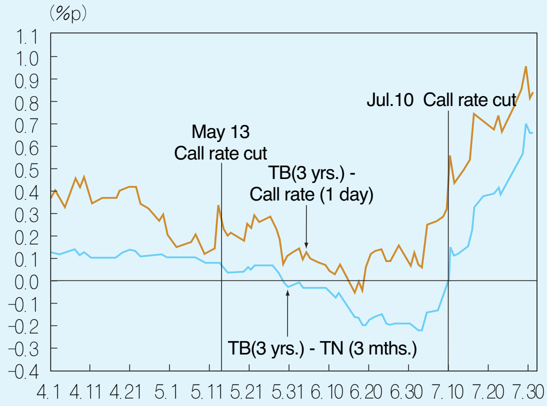
	20 days before	10 days before	5 days before	Actual day	After 5 days	After 10 days	After 20 days
May 13 (4.25→4.0)	-0.29	-0.19	-0.07	-0.05	-0.20	-0.11	-0.35
Jul. 10 (4.0→3.75)	0.28	0.22	0.23	0.01	0.18	0.15	0.31

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]

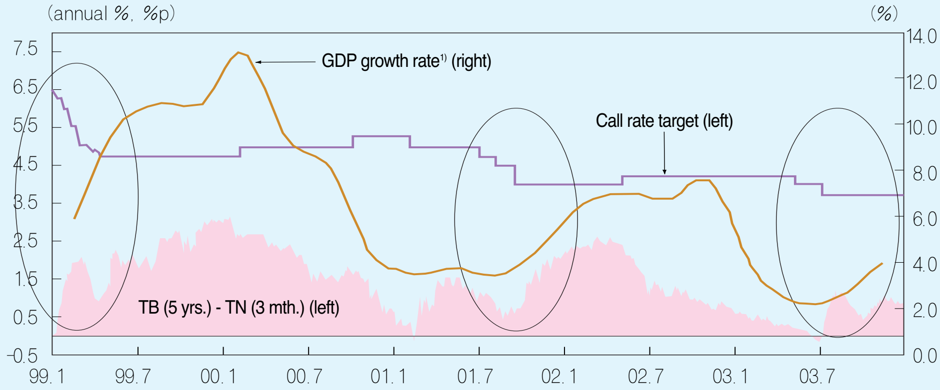
(annual %, %p)

	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

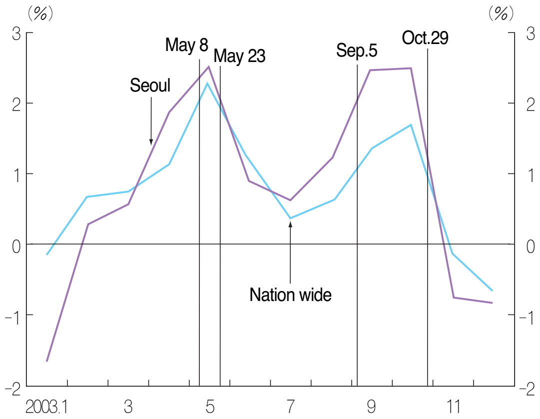


Note : 1) Compared with the same period of the previous year.

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.

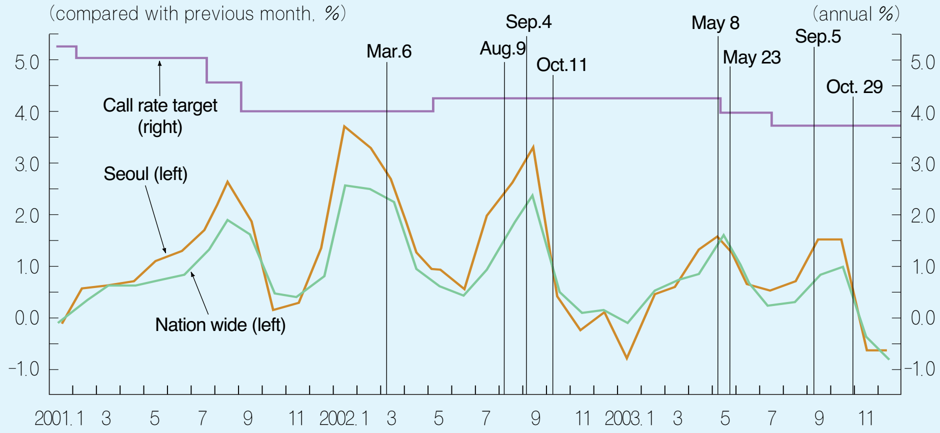
On the other hand, the economy may suffer serious damage in the long term if housing prices rise excessively through the over-expansion of credit to households or speculative demand. This is because, if housing prices fall back sharply owing to an expansion of housing supply and an abrupt change in financial 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.

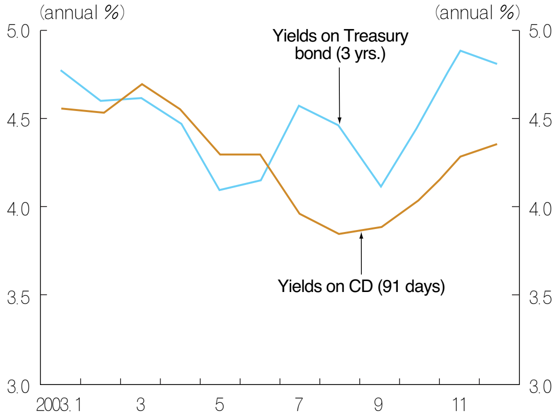
Trends of Rate of Increase in Apartment Prices



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.

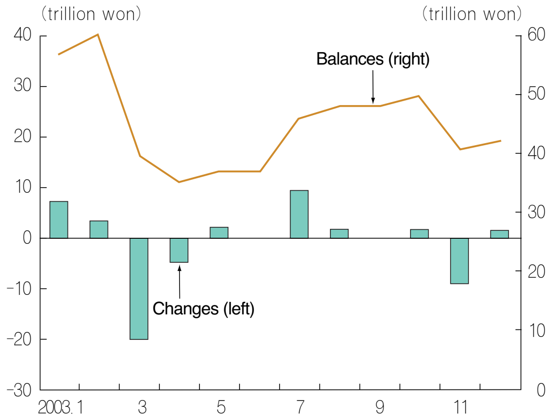
In January 2003, the preference for safe assets such as Treasury bonds rose steeply amid mounting domestic and external uncertainties including the threat of the US-led war against Iraq and the North Korean nuclear issue. Financial markets briefly showed a pattern of agitated movements characterized 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	2002	2003	
	Dec.	Dec.	Jun.	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

<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

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 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

	Lending Rates	Deposit Rates	Bond Issue Rates
Third Stage (Jul.1994~ Dec. 1995)	–	<Jul. 1994> - Reduction of the minimum maturities of short-term marketable products(CDs, RPs and CP)	–
	<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	<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)	
	<Jul. 1995> - Loans financed through the aggregate credit ceiling system of the Bank of Korea (Consequently, all lending rates were freed up)	<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	
	–	<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	
Fourth Stage (Jul. 1997)	–	- 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	- Allowing banks to issue financial debentures

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’.