

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.

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

<Table IV -1>

Outlook for US Growth Rate¹⁾

		(%)					
		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.

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 Prices¹⁾

(period average, US\$/barrel)

	2004				year
	I	II	III	IV	
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 quotas¹⁾, 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 Upturn¹⁾

	(%)					
	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 of 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 system²⁾ 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.

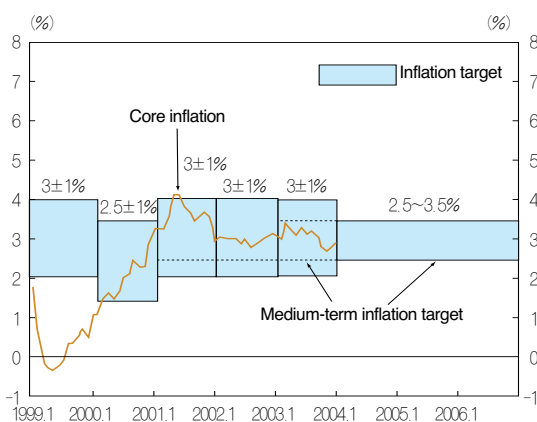
A. Achieving the Medium-Term Inflation Target

(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 Inflation¹⁾



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 ($3 \pm 1\%$).

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

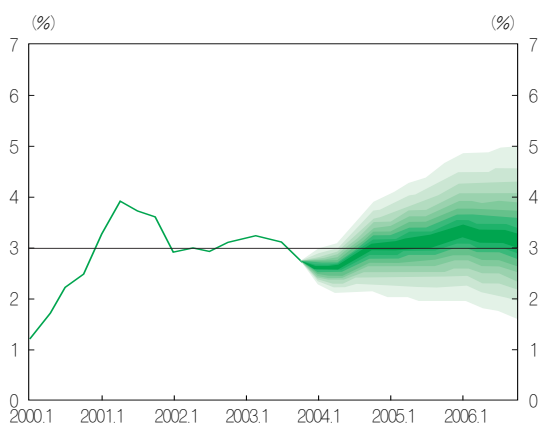
4) The weight of the items excluded from the CPI is 11.7%, of which agricultural products represent 4% and petroleum fractions 7.7%.

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 Inflation¹⁾ Projection



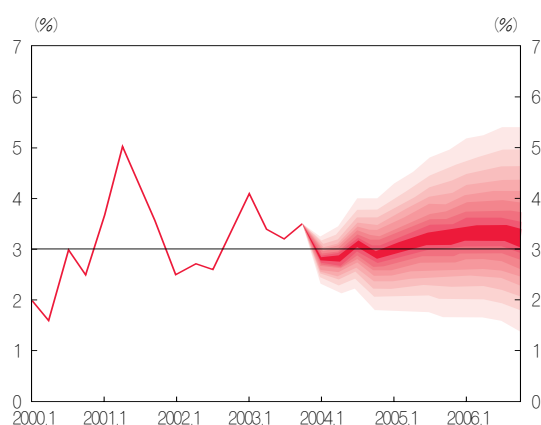
Note: 1) Compared with the same period of the previous year

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 Inflation¹⁾ 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 on 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.