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ANNUAL REPORT

THE BANK OF KOREA

June 1999

In accordance with the provision of Article 102 of the Bank of Korea Act, and with the sanction of the Monetary Policy Committee, we herewith publish the Annual Report of the Bank, analyzing economic and financial conditions in Korea during calendar year 1998 and outlining the condition of the Bank, its operations, its monetary policies and the foreign exchange policies of the government and financial system management during the same period.

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Ⅰ. General Economic Trends

In 1998, the Korean economy experienced severe difficulties for a considerable period from the beginning of the year, affected by the impact of the currency crisis that broke out toward the end of 1997. Korea responded with energetic efforts to secure foreign exchange liquidity and pursue structural reforms in both the financial and corporate sectors under an agreement with the IMF. Thanks to these, the real sector of the Korean economy slowly began to show more favorable movements which, with the restoration of foreign exchange and financial market stability, presaged a gradual recovery from the crisis.

Real Sector Economy Movements

In the course of the rapid structural adjustment, the growth rate of GDP for the year as a whole turned negative for the first time since 1980, and unemployment rose sharply. Prices continued to show a moderate downward trend from March onwards, but the rate of increase of prices on a year-on-year basis exceeded the previous year's rate. However, the current account registered a large surplus, which was mainly due to the sharp decline of imports in response to dull domestic demand.

The growth rate of GDP declined to a negative 5.8 per cent as against the positive 5.0 per cent of the previous year, as domestic demand, in the form of both consumption and investment, shrank sharply under the effects of the shock triggered by the currency crisis and the structural reforms taken to overcome it. Viewing growth rate trends by quarter, GDP registered a negative growth rate of 3.6

per cent in the first quarter, and further declined to the negative 7 per cent level during both the second and third quarters. However, its downward trend slowed to show 5.3 per cent decrease in the last quarter, helped by a robust expansion of goods exports and some slight stirring of domestic demand.

Looking at GDP growth by component of expenditure, exports, in real terms, showed a relatively high growth pace. However, consumption expenditure declined sharply in response to the decrease of purchasing power brought about by wage reductions, asset-price deflation, and worries over future economic conditions. Fixed investment also contracted sharply in both facilities and construction, affected by the shrinkage of domestic demand and the structural adjustment of the corporate sector. Especially as inventories were drawn down on an unprecedented scale during the year, inventory adjustment was a major contributor to the reduction in GDP, accounting for as much as 5.6 percentage points of the decline. Imports also declined sharply reflecting the dullness of both consumption and investment. Viewed by industrial sector, most industries registered negative growth rates. The depressed state of construction, manufacturing, and the wholesale and retail trade, restaurants and hotels sector was especially remarkable.

The employment situation worsened sharply, reflecting the drying-up of job opportunities in response to the business depression and the shedding of employees in the course of firms' structural adjustment. Thus, the total number of persons in employment decreased by 1 million 122 thousand persons over the previous year. In consequence, although the number of persons who gave up actively seeking employment increased markedly, particularly among women, the number of the unemployed rose to 1 million 463 thousand persons, much more than the 556 thousand persons in the previous year. The unemployment rate also soared sharply to stand at 6.8 per cent as against the 2.6 per cent of the previous year. Nominal wages in all industries dropped by 2.5 per cent over the previous year, due to the business depression and the deterioration of the labor market. Nominal wages showed a decline for the first time since 1970, when statistics on them were first compiled. Meanwhile, real wages fell by 9.3 per cent, reflecting the strength of consumer price inflation.

Prices showed rather stronger upward trends than those of the preceding year, with consumer prices and producer prices rising by 7.5 per cent and 12.2 per cent, respectively, on an annual average basis. Looking at prices movements by period,

prices soared during the first two months, owing to the massive depreciation of the won following the onset of the currency crisis, but from March they turned to a downwardly stable pattern of movements, due largely to the dullness of domestic demand, the appreciation of the Korean won, and the fall of international raw material prices. These stable trends persisted throughout the remainder of the year. As a result, on a December-to-December basis, consumer price inflation eased from the 6.6 per cent of the previous year to 4.0 per cent, and producer price inflation from 9.6 per cent to 3.6 per cent.

Real estate prices decreased sharply both for housing and land. Their downward trends, which had begun toward the end of the previous year, gathered pace until the second quarter due to the business depression and high level of interest rates. The downward trend slowed from the third quarter onwards, thanks to the measures to revitalize the real estate business and the easing of market interest rates.

The current account shifted from its deficit of 8.2 billion U.S. dollars in the previous year to a substantial surplus of 40.0 billion U.S. dollars, equivalent to more than 12 per cent of current GDP. Contributions to this surplus came from not only the large surplus on the goods account but also from the improvements in the services and current transfers accounts. The goods account registered a surplus of 41.2 billion U.S. dollars. This resulted from a sharp contraction of imports, whose effects were only partially mitigated by a mild decline of exports. Exports, on a customs-clearance basis, turned to a decrease of 2.8 per cent from the increase of 5.0 per cent of the previous year owing to the business depression in the Southeast Asian area, one of Korea's major export markets, and the sharp drop in the unit value of exports. The rate of decrease of imports accelerated sharply to 35.5 per cent from 3.8 per cent in the preceding year, responding firstly to the sharp decline of import volumes affected by the shrinkage of domestic demand, and secondly to the rapid decrease of import prices in dollar terms following the fall of international raw material prices. Meanwhile, the services account shifted into the black to the tune of 0.4 billion U.S. dollars centering on the travel balance, as against a deficit of 3.2 billion U.S. dollars in the previous year. The surplus on the current transfers account also widened from 0.7 billion U.S. dollars in the previous year to 3.3 billion U.S. dollars, mainly swelled by an increase in remittances from ethnic Koreans living overseas. However, the deficit on the income account widened to 4.8 billion U.S. dollars, double that in the previous year, in response to a sharp increase in interest

payments on external debt.

The capital account turned to a net outflow of 4.0 billion U.S. dollars from a net inflow of 1.3 billion U.S. dollars in the previous year, due to the large-scale repayment of both trade credits and financial institutions' borrowings.

Foreign Exchange and Financial Market Movements

Foreign exchange and financial markets continued to move unstably until February, but from March onwards, they showed a progressive recovery of stability owing to lower interest rates and the Korean won's regaining of some of its ground lost against the U.S. dollar.

The foreign exchange market was characterized for much of the year by a preponderance of supply over demand. The main contributors to this abnormal conjuncture included the sustained current account surplus, the inflow of funds from international financial organizations such as the IMF, financial institutions' success in extending the maturities of their short-term debts, the issue of Foreign Exchange Stabilization Fund bonds, and an influx of foreign direct and portfolio investment capital. Thanks to these improvements in foreign exchange market conditions, the value of the Korean won in terms of the U.S. dollar(closing value), which continued in a low range of 1,600～1,700 won until February, showed more stable movements from March onwards. Thus, the Korean won ended the year at 1,204 won against the U.S. dollar, an appreciation of 40.8 per cent over the end of the previous year. Together with this, usable foreign exchange reserves, which had plunged to just 8.9 billion U.S. dollars at the end of 1997, had increased to 48.5 billion U.S. dollars by the end of 1998, and residents' foreign currency deposits had also increased greatly. Thanks to this stability in the foreign exchange market, in December, Korea was able to redeem in full a loan of 2.8 billion U.S. dollars which had constituted the earliest maturing tranche of the IMF bailout funds.

The financial market, too, was unsettled early in the year, but from the second quarter onwards, it staged a gradual recovery, backed by the stability of the foreign exchange market. Major market interest rates had risen to the 30 per cent level after the onset of the currency crisis, affected by the high interest rate policy agreed with the IMF. However, as the Bank of Korea gradually lowered its market intervention

rate, call market rates fell back to the 6 per cent level, and yields on commercial paper(CP) and corporate bonds dropped to the 8 per cent level by the end of the year. Similarly, interest rates on the loans and deposits of financial institutions continued on a downward trend.

The rate of increase in financial institutions' deposit-taking slowed compared to the previous year, while portfolio shifts among financial institutions intensified in response largely to the structural adjustment, changes in deposit insurance, and the rapid decline in market interest rates. Viewing deposit-taking by type of financial institution, that by deposit money banks maintained a steady increase centering on time deposits, while that by investment trust companies rose substantially, boosted mainly by bond-type beneficial certificates which offered comparatively high yields. However, deposit-taking by banks' trust accounts continued its downward trend. This was attributable not only to the lengthening of the maturity of new installment-type money-in-trust products, which had previously proved attractive, and the rise of the commission charge for cancellation prior to maturity, but also to a more general recognition after the exit of five banks that the depositor protection system does not guarantee banks' trust account products.

Financial institutions' credits shrank sharply owing to the high credit risk of enterprises and the burden of meeting the BIS's capital adequacy ratio. However, the provision of direct financing to enterprises through purchases of their corporate bonds and commercial paper by investment trust companies and so on increased by a large margin. In consequence, those large blue-chip enterprises which could easily issue their own corporate bonds or commercial paper had few problems in fund-raising, whereas small and medium enterprises(SMEs), which depend mainly on bank loans for their funds, continued to experience severe difficulties in raising funds. From the fourth quarter, however, there were signs of the credit crunch fading. Bank loans to SMEs turned to an increase and the issue of corporate bonds and commercial paper by enterprises with slightly lower credit ratings gradually increased, thanks to the effects of the imposition of ceilings on financial institutions' holdings of large companies' corporate bonds and commercial paper.

In the bond market, issuance volumes increased sharply for corporate bonds, government and public bonds. Secondary market turnover also expanded greatly, and market interest rates continued to fall, thanks to the greatly augmented appetite for bonds on the part of institutional investors.

The stock market staged a brief rally during the first two months, but otherwise maintained a generally sluggish tone until the end of the third quarter. From October onwards, though, the Korea Composite Stock Price Index(KOSPI) shifted to an upward trend, as domestic and foreign investors bought stocks on lower interest rates and expectations of a coming economic recovery. As a result, KOSPI stood at 562.5 points at the end of the year, 49.5 per cent increase on a year-end basis. In particular, its rate of increase for the three months from October registered the high figure of 81.3 per cent.

Meanwhile, a divergence in the growth rates of the monetary aggregates became evident in the course of the year, due to the enlargement of portfolio shifts among financial institutions. The growth rate of M2(on a December daily-average basis), which had stood at 21.1 per cent in the last month of the previous year, slowed to 13.1 per cent in April, having maintained a downward trend from the beginning of the year. However, it shifted back to an upward trend from May onward with the migration of funds from money-in-trust to banks' time and savings deposits, accelerating sharply to 21.5 per cent in December. On the other hand, the growth rate of MCT^{+}(MCT plus cover bills plus RPs plus financial debentures), which embraces all deposit products of banks, fell sharply to 0.3 per cent in December 1998 as against its 18.5 per cent increase in the last month of the preceding year. This was largely attributable to the shift of a considerable volume of funds from banks' money-in-trust into the bond beneficiary certificates offered by investment trust companies. It also reflected banks' caution in raising funds through high-yield, short maturity products such as negotiable certificates of deposit(CDs) and repurchase agreements(RPs), following the initial easing of their difficulties in fund-raising. Meanwhile, the growth rate of M3, which is the broadest monetary indicator and is used as a barometer of overall liquidity conditions including deposits at non-bank financial institutions, dropped from its 15.9 per cent of the previous year to 12.4 per cent, on a December daily-average basis. This reflected the expansion in the supply of non-bank financial institutions by way of their purchases of corporate bonds and CP, which moderated the effects of the reduction of loans by deposit-money banks.

[Table 1] Key Korean Economic Indicators[1)]

	unit	1994	1995	1996	1997	1998[7)] year	1998[7)] 1st half	1998[7)] 2nd half
Gross domestic product	rate of increase(%)	8.3	8.9	6.8	5.0	-5.8	-5.5	-6.2
(Manufacturing)	〃	10.8	11.3	6.8	6.6	-7.2	-7.6	-6.8
(Construction)	〃	4.6	8.8	6.9	1.4	-9.0	-5.4	-11.8
Private consumption	〃	8.2	9.6	7.1	3.5	-9.6	-10.6	-8.7
Fixed investment	〃	10.7	11.9	7.3	-2.2	-21.1	-22.3	-20.0
Changes in inventories[2)]	%p	1.2	-0.1	0.6	-2.0	-5.6	-7.8	-3.7
Total Exports	rate of increase(%)	16.1	24.6	11.2	21.4	13.3	18.9	8.4
Total Imports	〃	21.6	22.4	14.2	3.2	-22.0	-26.3	-17.6
Unemployment rate[3)]	%	2.4	2.0	2.0	2.6	6.8	5.8	8.2
Consumer prices	rate of increase(%)	5.6	4.7	4.9	6.6	4.0	3.3	0.6
Producer prices	〃	4.0	3.6	3.7	9.6	3.6	5.5	-1.8
Current account	bil. U.S. $	-3.9	-8.5	-23.0	-8.2	40.0	21.7	18.3
Goods	〃	-2.9	-4.4	-15.0	-3.2	41.2	21.0	20.2
Exports[4)]	〃	96.0	125.1	129.7	136.2	132.3	67.1	65.2
		(16.8)	(30.3)	(3.7)	(5.0)	(-2.8)	(2.8)	(-8.0)
Imports[4)]	〃	102.3	135.1	150.3	144.6	93.3	47.2	46.1
		(22.1)	(32.0)	(11.3)	(-3.8)	(-35.5)	(-36.6)	(-34.4)
Services	〃	-1.8	-3.0	-6.2	-3.2	0.4	0.7	-0.3
Income	〃	-0.5	-1.3	-1.8	-2.5	-4.8	-2.0	-2.8
Current transfers	〃	1.2	0.2	-0.0	0.7	3.3	2.0	1.3
Exchange rate of won against U.S. dollar[5)]	end of period(₩)	788.5	775.7	844.9	1,695.0	1,204.0	1,373.0	1,204.0
		(2.4)	(1.7)	(-8.2)	(-50.2)	(40.8)	(23.5)	(14.0)
M2[6)]	rate of increase(%)	17.6	13.7	17.8	21.1	21.5	18.1	21.5
MCT[6)]	〃	23.6	22.0	18.6	14.7	2.6	8.2	2.6
MCT+[6)]	〃	··	··	··	18.5	0.3	10.4	0.3
M3[6)]	〃	23.8	18.8	17.1	15.9	12.4	14.2	12.4
Call market rate	period-average(%)	12.3	12.4	12.4	13.2	15.0	21.3	8.7
Yield on corporate bonds	〃	12.9	13.8	11.9	13.4	15.1	19.1	11.1

Notes : 1) Rates of increase are compared with the same period of the previous year except for those of prices, which are compared with the last month of the previous period.
2) Contributions to GDP growth.
3) Figures of 1st and 2nd halves are seasonally-adjusted.
4) On a customs-clearance basis. Figures in parentheses indicate the average rates of increase compared with the same period of the previous year.
5) Closing value basis. Figures in parentheses indicate appreciation(depreciation-) rates compared with the end of the previous period.
6) The average rates of increase in the last month of the period compared with the last month of the same period of the previous year.
7) Figures for national accounts and balance of payments are preliminary.

Major Economic Policies During the Year

Macroeconomic policy was conducted during the year under review with a twin focus on achieving foreign exchange market stability as early as possible by securing foreign currency liquidity and on an intensive drive for structural adjustment throughout the economy, upon the basis of the agreement with the IMF. Once the foreign exchange market had regained a comparative degree of stability from the second quarter onwards, the stance of both monetary and fiscal policy was eased in order to cope with the severe contraction of the real economy and a deepening credit crunch. Besides this, various measures were devised to consolidate financial support for SMEs and export companies.

The Bank of Korea raised its market intervention rate to 35 per cent after the currency crisis broke out, and maintained it at the high level of 20～30 per cent in the early months of 1998. The high interest rate policy was dictated by the need to acquire foreign exchange liquidity and stabilize the foreign exchange rate in an environment in which foreign capital repatriation had increased sharply, influenced by the loss of confidence in the Korean economy. However, it involved considerable side-effects, such as an excessive contraction of the real economy. Consequently, on the basis of a stable foreign exchange market, the Bank of Korea steadily lowered its market intervention rate to 6 per cent at the end of 1998, in order to avoid an overly deep depression. This induced a reduction in financial institutions' deposit and lending rates as well as market interest rates to lower levels towards the end of the year than before the onset of the currency crisis.

Within the parameters set by the need to maintain the stability of both prices and the foreign exchange market, the emphasis of monetary management was placed on adjusting levels of market liquidity as flexibly as possible in line with the evolution of the financial markets and the real economy. Reserve money was supplied throughout the year within the limits agreed with the IMF, and the growth rate of M3, on a daily-average basis, exhibited a mild downward trend.

The Bank of Korea supported the structural adjustment of financial institutions, and also expanded financial support for SMEs and export companies, which were experiencing difficulties because of the credit crunch generated by the structural adjustment process. In this context, the Bank absorbed Deposit Insurance Fund Bonds to the value of 6.5 trillion won in January that were issued to raise funds for

the payment of deposit insurance claims and the recapitalization of Korea First Bank and Seoul Bank. In September, the Bank extended the maturity of a one-trillion won special loan to Korea First Bank. Seeking to boost financial support to SMEs through the expansion of trade financing and the discounting of commercial bills, the Bank of Korea raised the ceiling on its aggregate credit to banks by 1 trillion won in March to 5.6 trillion won and by another 2 trillion won in September to 7.6 trillion won. In an associated move, the Bank heightened banks' incentive to make loans to SMEs by both lowering its refinancing rate and changing the method of allocating its credits. Furthermore, in order to increase the supply of export and import financing for export-oriented companies, which were experiencing difficulties, the Bank supplied foreign currency funds for their support. It also abolished the ceiling set on foreign trade loans along with the maximum ratios.

The Bank also undertook a number of initiatives to improve the operating environment for monetary policy, by making greater use of open market operations and refining its monetary policy tool-kit. The range of instruments available for use in open market operations was expanded by the addition of Monetary Stabilization Bonds to government and public bonds as underlying securities for RP transactions. Meanwhile, the Bank moved to relieve some of banks' problems, such as the pressure on their funds and profitability, by raising the ratio of their reserve requirements that may be held in the form of vault cash. Their autonomy in loan management was also heightened by the abolition of all prohibitions on credit sectors and of the system that had set ceilings on their taking of collateral.

During the year, the issue of government bonds expanded greatly to finance a budget deficit. The method of issue was also changed to one at actual market interest rates and fully based on market principles, a substantial improvement on previous methods, such as absorption by the central bank and quasi-competitive issue. The increase in the volume of government bonds issued and the improved method of issue are seen to establish the yield on government bonds as a benchmark for market interest rates and accelerate the broadening and deepening of the bond market. This should create a more efficient operating environment for monetary policy as well as develop the bond market.

However, the raising of the ceiling on aggregate credit to banks and the reduction of the associated interest rate, although inevitable in view of the need to relieve the credit crunch, acted as a constraint on both liquidity management itself and the

signalling function of changes in rediscount rate. In addition, the rigidities in the supply structure of reserve money deepened, as the excess liquidity, which was provided to facilitate the structural reform of the financial sector, had to be siphoned off by the issue of MSBs and RPs. This will represent a major obstacle for future monetary management.

Following the introduction of an inflation target system as provided for under the revised Bank of Korea Act, which entered into force on April 1, the Bank of Korea in September announced an inflation target for 1998 of 9±1 per cent on the basis of the annual rate of increase of the CPI. The central point for the annual average rate of increase was set at 9 per cent in reflection both of the economic outlook and the basis for the operation of macroeconomic policy agreed by the Korean government, the Bank of Korea, and the IMF. A target band with upper and lower bounds of 1 percentage point above and below the central point was then imposed to allow for possible changes in the domestic and international economic environments and variability in the transmission effects of monetary policy. Consumer price inflation for the year as a whole registered 7.5 per cent, which was below the lower bound of the target range. The explanation for the undershoot is that production costs, centering on wages and prices of imported materials, decreased much more sharply than had been anticipated, despite the easing of the monetary policy stance from the second quarter onwards.

Foreign exchange policy was pursued with an emphasis on securing adequate foreign currency liquidity at an early stage and promoting the inflow of foreign capital. The government undertook a number of diverse initiatives in this regard. It successfully facilitated the prolongation to one to three year maturities of financial institutions' short-term foreign debts falling due within the year and amounting to some 21.7 billon U.S. dollars. It also successfully issued Foreign Exchange Stabilization Fund bonds to an overall value of 4.1 billon U.S. dollars in domestic and overseas markets. In addition, the Korean government induced as scheduled 12.6 billion U.S. dollars in successive tranches, forming part of the total package of 35 billion U.S. dollars in support funds arranged with the IMF and other international financial organizations. This brought the amount of borrowings from international financial organizations to 28.7 billion U.S. dollars in all as of the end of the year under review. Meanwhile, to promote foreign portfolio capital inflows, the government undertook the full opening of the stock and money markets during

the year, having already opened the corporate bond market at the end of 1997. Besides this, it moved to provide a greatly improved environment for inward foreign direct investment, allowing hostile foreign takeovers, enlarging the number of business sectors open to foreign investment, abolishing controls on real-estate acquisition by foreigners, and simplifying investment procedures generally. The inducement of trade credits was liberalized, and restrictions were eased both on foreign borrowings by residents and the disposal of the foreign assets holdings of corporations and financial institutions. The objectives of these moves were to support an improvement in financial institutions' foreign currency liquidity conditions and a seamless structural adjustment process.

Meanwhile, the government pressed ahead energetically with the financial reforms which form a vital link in the four-fold structural adjustment process involving the financial and corporate sectors, the government, and the labor market. Most tellingly, financial institutions that were deemed nonviable, owing to their accumulation of non-performing assets, were closed down. For those judged potentially viable, the authorities sought to bring about a rapid turnaround by supporting recapitalization and the resolution of their non-performing assets on the condition that they themselves pursue intensive self-rescue efforts, such as merger, the replacement of their management team, and the downsizing of both their organization and staff.

In order to give more effective support to the legislative aspects of the restructuring of financial institutions and the strengthening of their managerial soundness, a number of acts relating to financing were revised including the Act on the Structural Improvement of the Financial Industry, the Depositor Protection Act, the General Banking Act, and the Merchant Banking Corporation Act. Further progress was made in the improvement of the financial market infrastructure and the creation of deep and orderly markets. Legislative provision was made for mutual funds and new financial techniques such as asset securitization; financial institutions' accounting and disclosure standards were tightened; the bank trust account system and the securities investment trust system were realigned; and ceilings were placed on financial institutions' holdings of large companies' CP and corporate bonds, so as to widen these markets to include smaller companies' paper.

Policy Tasks and Monetary Policy Stance in the Future

In 1999, the Korean economy is expected to bottom out from its severe depression in 1998 and shift to positive growth. Together with this, the underlying favorable trends of a current account surplus and price stability will be sustained. However, little improvement is foreseen in unemployment. In the foreign exchange market, the foreign exchange supply-demand conjuncture is anticipated to be favorable, thanks to the continued current account surplus and the increasing inflow of funds from foreign direct and portfolio investment. In the financial market, the overall corporate demand for funds is unlikely to be large, mainly due to the continuing sluggishness of new facilities investment and the general reduction in debt ratios. However, as the economic recovery gathers pace, the demand for funds will gradually increase.

It is forecast that the state of the Korean economy in 1999 will prove to be somewhat more favorable than in the preceding year. However, the structural weaknesses of Korean economy, which were at the root of the currency crisis, have not yet been completely cured, and there remain a number of unsettling factors with the potential to cause difficulties for the Korean economy both domestically and internationally. Hence, the top priority for economic policy must be to facilitate the Korean economy's emergence from the crisis zone completely, and to shift the economy onto a sustainable growth track. To this end, the structural weaknesses of Korean economy must be fully overcome through the resolute pursuit of economic restructuring. This must be accompanied by appropriate support to restore the vitality of the real economy. At the same time, effective countermeasures must be devised to prevent social unrest arising from the worsening of unemployment in the course of structural adjustment. The stability of the foreign exchange market should meanwhile be steadily consolidated so as to eliminate the possibility of a recurrence of the currency crisis, while a firm basis for price stability on a par with the advanced countries should be constructed.

Taking account of these imperatives, the Bank of Korea, after consultation with the government, set the inflation target for 1999 at 3 ± 1 per cent, in terms of the annual rate of increase of consumer prices. The Bank will conduct monetary policy with a focus on supporting the recovery of the real sector, insofar as this does not conflict with the attainment of the inflation target.

Money will be supplied within a stable range to prevent the emergence of inflationary pressures on the demand side. To this end, the Bank set its target range for the annual growth rate of M3 in 1999 at 13 to 14 per cent, considering the projected GDP growth rate, the outlook for inflation, and the expected rate of decrease of the velocity of money in circulation. Liquidity will be managed flexibly quarter by quarter within the annual target range for 1999.

With respect to interest rate policy, the Bank of Korea will, for the time being, maintain its policy stance of favoring lower call market interest rates in order to support the recovery of the real economy. In case the trend of economic recovery accelerates, with a consequent increase in the demand for funds, liquidity will be managed at an appropriate level by maximizing the role of interest rates in balancing the supply and demand for funds.

In tandem with this, the Bank intends to devise varied measures so as to provide effective support for the funding of SMEs and exporters. Especially in the event of a deepening credit crunch for SMEs in the course of the structural reform of the non-bank financial institutions, the Bank will facilitate financial support to them by adjusting its aggregate credit ceiling flexibly.

Provided all the preconditions are met upon the completion of structural reforms and the consolidation of financial market stability, the Bank will strive to ease the rigidities in the supply structure of reserve money and work to facilitate its utilization of orthodox monetary policy instruments, in order to heighten the effectiveness of monetary policy. From April 1999, when the Foreign Currency Transactions Act enters into effect, closer linkages are expected between monetary growth, interest rates and the exchange rate, as well as an increase in their volatility, in response to heightened capital in- and out-flows. The Bank will therefore do its utmost to achieve the effective and harmonious coordination of these three variables; namely monetary growth, interest rate and exchange rate. Plans are also being finalized for the effective operation of inflation targeting through, for example, the development of inflationary pressure indicators and the construction of an inflation forecasting system.

Ⅱ. Monetary Policy of the Bank of Korea

1. Inflation Target

In accordance with the provisions of Article 6 of the revised Bank of Korea Act that came into effect on April 1, 1998, the Bank of Korea, in consultation with the government in September, set the inflation target for 1998 at 9±1 per cent, based on the yearly average rate of increase in the CPI. The midpoint of the target range, 9 per cent, was set on the basis of macroeconomic forecasts and the policy stance adopted by agreement among the IMF, the government and the Bank of Korea. Inflation would be tolerated within a range between 1 per cent above and 1 per cent below this figure to allow for economic uncertainties, for example, the variations in international and domestic economic conditions and the transmission effects of monetary policy.

But CPI maintained a downward trend from March onwards, and, as a result, it rose only at an annual rate of 7.5 per cent in 1998. Thus, the actual rate of increase of CPI stayed below the lower bound of its target range, even though the Bank of Korea loosened its tight monetary policy stance, inducing a steady decline in interest rates from the second quarter of 1998, to keep the real economy from contracting excessively. The undershoot was largely brought about by the decline in major cost factors, such as the exchange rate and wages, which proved more substantial than had been expected when the target was set. It also reflected the government' s restraint in raising charges for public services.

2. Interest Rates

The Bank of Korea worked actively to bring about a lowering of market interest rates from the second quarter of 1998 in order to prevent too deep a contraction of the real economy. But it cautiously adjusted the scale and pace of the reduction of interest rates, taking into consideration developments in the real economy and the foreign exchange market, since the external environment was still very unsettled with international financial markets in turmoil.

Upon the outbreak of the currency crisis, the Bank had dramatically raised its market intervention rate in consultation with IMF to 35 per cent in order to engineer a rapid stabilization of the exchange rate. Thus, major market interest rates had increased to 30～40 per cent at the end of 1997 and they remained at around the 20 per cent level until the March of the year under review. This high interest rate policy was the only viable option in order to secure foreign currency liquidity and to stabilize the exchange rate, in the face of the surge in capital outflows due to the loss of international confidence.

But there were a number of malign side-effects accompanying the high interest rate policy. It accelerated the slowdown in real economic activities through its contraction of consumption and, investment, and it greatly increased the incidence of corporate failure and the accumulation of bad loans by financial institutions.

In response, the Bank steadily lowered its market intervention rate from the second quarter, by when foreign exchange market conditions had improved considerably, thanks to the sustained current account surplus, the arrival of support funds from the international financial institutions, and renewed inflows of foreign investment capital.

Call rates consequently dropped to 8.5 per cent by the end of August in 1998, by when yields on commercial paper(CP) had eased to 10.9 per cent and those on corporate bonds(three-year) to 11.7 per cent.

In a further related move, the interest rate on the Bank' s aggregate credit ceiling loans was cut substantially from 5 per cent to 3 per cent, and the ceiling on them was raised by 2 trillion won. Commercial banks were thus induced to expand the size of the differential on their preferred discount rate for eligible bills under the

aggregate credit ceiling.

Notably, on September 30, the Bank carried out a large reduction in its market intervention rate, bringing it down from 8.1 per cent to 7 per cent level. This was done in order to support the recovery of the real economy and to ease the credit crunch, taking advantage of the lowering of interest rates in developed countries such the U.S.A.

As the Bank steadily brought down its market intervention rate, the call market rate eased to 6.5 per cent by the end of December. Also, yields on three-year corporate bonds and Treasury bonds dropped to 8.0 per cent and 7.0 per cent, respectively, well below their pre-crisis level. In line with this, commercial banks' average lending rates, which had remained at around the 16 per cent level until June, also continued to drop, falling to 11.3 per cent in December. This fall in interest rates was attributable to the marked decrease in banks' overall cost of funds, with the steady fall of market interest rates and the maturing of deposits which had flowed into them attracted by the high interest rates paid upon the outbreak of the crisis.

But commercial banks' average lending rates, which were still high compared to market interest rates, are anticipated to ease gradually. This is because deposits taken at high interest rates are steadily maturing while high corporate credit risk has declined, as is indicated by the considerable decrease in the ratio of dishonored bills.

3. Money

After the outbreak of the foreign currency crisis, financial institutions adopted a very cautious approach to corporate lending. This reflected firm's heavy debt ratios and the fall of their credit ratings amid the economic depression, as well as the need to meet the BIS capital adequacy ratio. A peculiar banks' situation consequently arose in the financial markets in which liquidity floated within the financial sector itself or flowed back to the central bank.

Furthermore, in the aspect of the structure of the money supply, there was an increase in the supply of funds through direct financing such as investment trust companies' purchases of corporate bonds or CPs. In contrast, the supply of funds through bank loans contracted. Accordingly, large corporations, which were

relatively better placed to issue corporate bonds or CPs, enjoyed easy fund raising conditions, while SMEs, which rely heavily on commercial banks for fund-raising, suffered a persistent credit crunch.

Under these circumstances, the Bank basically maintained its monetary policy stance decided upon with the IMF: it supplied money flexibly but on a scale that did not detract from the stability of prices and the foreign exchange market.

Following this policy direction, the Bank gradually lowered the growth rate of M3 from 15.9 per cent (daily-average basis) in December 1997 to 12.4 per cent in December 1998, while engineering the downward stability of market interest rates. It also coped with the temporary signs of financial instability in the course of corporate and financial sector structural adjustment through flexibility in money supply.

Through its maintenance of this monetary stance, the Bank was able to observe the quarterly ceilings on the supply of reserve money established in consultation with the IMF. Also, NIR and NDA satisfied their performance criteria. Notably, in the meeting for the fourth quarter with the IMF in October 1998, the Bank was able to heighten its autonomy in the conduct of monetary policy, agreement having been reached on the abolition of the ceiling previously set as an indicative limit on the

[Table 2] Management of Monetary Policy under the IMF Program
(the end of period)

Unit: billion won

	1997		1998							
			Ⅰ		Ⅱ		Ⅲ		Ⅳ	
	ceiling	perform-ance	ceiling	perform-ance	ceiling	perform-ance	ceiling	perform-ance	ceiling	perform-ance
Reserve	23,270.0	22,519.3	23,580.0	22,035.1	23,540.0	20,798.9	25,430.0	22,026.0	-	20,703.0
Money[1)]	(-9.5)	(-12.5)	(15.2)	(7.7)	(13.5)	(0.3)	(14.2)	(-1.1)	(-)	(-8.1)
NIR(lower) [billion dollars]	-3	-3	3.8	8.2	13.9	19.1	15.0	24.5	23.7	31.2
NDA (upper)	26,571.0	25,819.3	17,875.0	10,145.0	4,080.0	-5,941.1	248.0	-11,062.5	-777.0	-19,857.0
M3[2)]	15.4	13.9	13.5	14.3	14.1	13.2	14.0	13.9	13.5	12.5

Notes: 1) Figures in parentheses represent percentage changes compared with the same period of the previous year.
2) Percentage changes compared with the same period of the previous year.

supply of reserve money.

Over the year, the outstanding balance of reserve money generally showed a downward trend compared to the previous year. This was attributable to the Bank's appropriate management of reserve money through open market operations in order to hold the M3 growth rate within its desired range, the money multiplier having increased considerably in response to the decrease of private-sector demand for money in circulation owing to the sustained high interest rates and economic recession after the outbreak of the crisis.

Meanwhile, the Bank supplied reserve money of around 20 trillion won between September 1997 and December 1998. This was done in order to stabilize the financial market and to support the structural adjustment of the financial sector. It took the form of special loans to Korea First Bank and merchant banking corporations, the absorption of bonds issued by the Non-performing Assets Resolution Fund and the Deposit Insurance Fund, and the increase of the ceiling on

[Table 3] Support for Financial Market Stabilization and Structural Reforms on Financial Sector

Unit : billion won

	1997	1998				Total
	Sep.~Dec.	Ⅰ	Ⅱ	Ⅲ	Ⅳ	
Korea First Bank	1,000.0[1]	—	—	—	—	1,000.0
16 merchant banking corporations	1,000.0[2]	-61.3	-157.8	-114.2	-666.7	0.0
Non-performing Asset Resolution Fund	2,000.0[3]	—	—	—	—	2,000.0
Deposit Insurance Fund	—	6,500.0	—	—	-230.0	6,270.0
Support for Financial Market Stabilization	6,003.9[4]	1,395.9	-1,586.2	471.4	-38.0	62,470.0
Increase of aggregate credit ceiling	1,000.0[4]	1,000.0	—	2,000.0	—	4,000.0
Total	**11,003.9**	**8,834.6**	**-1,744.0**	**2,357.2**	**-934.7**	**19,517.0**

Notes: 1) September 2) October 3) November 4) December

its aggregate credit.

The Bank siphoned off most of the reserve money supplied by the sale of government and public bonds under repurchase agreements(RPs) and the issue of

MSBs in a move to defuse the inflationary pressure. Consequently, the total outstanding balance of issuance of MSBs and sales of government and public bonds under repurchase agreements reached 49.2 trillion won, which was 2.4 times that of reserve money at the end of 1998. This situation is expected to impose a major burden on monetary management in the future.

[Table 4] Outstanding Balance of Reserve Money and Size of Market Liquidity Manipulation
(the end of period)

Unit : billion won

	1997		1998			
	Nov.	Dec.	Ⅰ	Ⅱ	Ⅲ	Ⅳ
Reserve Money(A)	22,085.9	22,519.3	22,035.1	20,798.9	22,026.0	20,703.0
Size of market liquidity manipulation(B)	18,611.8	28,525.8	40,425.8	44,312.4	45,460.8	49,173.1
(Sales of gov. & pub. bonds under RPs)	-1,500.0	5,054.9	7,995.4	1,959.3	4,741.7	3,499.8
(Issuance of MSBs)	20,111.8	23,470.9	32,430.4	42,353.1	40,719.1	45,673.3
B/A(times)	0.8	1.3	1.8	2.1	2.1	2.4

4. Financial Support

(1) Improvement of the Aggregate Credit Ceiling System

During the year, the Bank of Korea implemented various measures to solve the credit crunch whose effects were concentrated on small and medium enterprises (SMEs) in the restructuring process of the corporate and financial sectors.

Most notably, the Bank induced banks to expand their lending to SMEs by flexibly operating its aggregate credit ceiling system. The ceiling on its aggregate credit was lifted by 1 trillion won in March and by a further 2 trillion won in September bringing it up to 7.6 trillion won. On September 1, the Bank lowered the interest rate of loans under its aggregate credit ceiling system from 5 per cent to 3 per cent.

The method of allocating credit quotas to individual banks was also improved as a means of encouraging an expansion of their lending to SMEs.

Firstly, in February, the method of quota calculation was changed from the total lending performance of banks' commercial bill discounts, foreign trade financing and so on to the net lending performance record.

Secondly, the percentage deducted from its credit quota for an individual bank failing to achieve the mandatory lending ratio to SMEs was widened from 50 per cent of the shortfall to 60 per cent in July, and further to 100 per cent in November, that is, the full amount of the shortfall. The resulting extra aggregate credit was then allocated to banks whose performance exceeded the mandatory lending ratio to SMEs.

Thirdly, from December, after evaluating the performance of individual banks in their support of SMEs, the Bank reallocated the individual credit quotas deducted from banks with a record of poor performance to those with a record of good performance.

In addition, on May 1, the Bank abolished the restriction on the maturity of commercial bills eligible for loans under its aggregate credit ceiling system, previously limited to no more than 90 days. This was done to moderate the funding problems of SMEs as a result of the extension of the maturity of commercial bills.

(2) Activation of Foreign Trade Financing and Bills

The Bank of Korea launched various initiatives in order to strengthen support for export firms.

On May 1, credit ceilings on such support calculated by financing method or use of the funds were abolished. Also the Bank abolished the regulations whereby SMEs and independent large firms had been respectively allowed to borrow only up to 90 and 60 per cent of the required funds calculated on the basis of the average exchange rate. On October 1, the limit on the period of export loans, formerly for a maximum of 90 days, was abolished.

With regard to the range of companies eligible for foreign trade financing, on August 20, the Bank extended the scope of eligibility for overall-purpose funds, which form an exception to the general segmentation of export loans according to use, from those companies whose export performance during the previous twelve months did not exceed 10 million dollars to those whose export performance did not exceed 20 million dollars. On October 1, it also widened eligibility for financing for construction & services, formerly limited to SMEs, to include independent large

firms as well.

Moreover, on October 1, the Bank included financing for service exports and for purchase of finished products within the scope of foreign trade financing. On December 14, companies exporting idled facilities and second-hand goods were made eligible for foreign trade financing.

(3) Enlargement of Support for Foreign Currency Financing

On May 1, the Bank introduced a system of lending on the security of export bills of exchange whereby it provides domestic banks purchasing export bills of exchange issued by SMEs with foreign currency funds of up to 300 million dollars. The refinancing rate on the above scheme was gradually lowered from LIBOR+4.35 percentage points in May to LIBOR+2.67 percentage points by December, and the number of banks eligible for such support was increased from 10 to include most domestic banks in August.

[Table 5] Refinancing Rate on Funds for the Purchase of Export Bills of Exchange

May 1998	July	Sep.	Nov.	Dec.
LIBOR+4.35%p	LIBOR+3.35%p	LIBOR+2.59%p	LIBOR+2.67%p	LIBOR+2.67%p

In order to increase exports through securing a stable supply of raw materials, on August 10, the Bank introduced with the agreement of the IMF a system whereby it provides domestic banks other than Peace Bank of Korea and Chungbuk Bank with funds for SMEs' import of raw materials of up to 2 billion dollars, provided usable foreign reserves exceed the stipulated minimum level.

On August 1, the Bank eased the limits on foreign currency loans with a view to enhancing the international competitiveness of domestic companies. This brought companies' entire foreign economic activity such as the import of goods, payments for services, etc. within the scope of objects eligible for foreign currency loans. And the scope of such loans for the redemption of external debt was widened from those for redemption prior to maturity to those for maturing debt.

In a similar move, the Bank extended the maximum ratio of foreign currency loans, previously limited to 70～100 per cent of the required amount depending on the intended use and the scale of the company, to the full amount required. It also abolished the previous ceiling of 15 million U.S. dollars per company for funds for the purchase of domestically-produced machinery.

5. Financial Markets

During the year, the Bank of Korea actively aided the rigorous restructuring of the financial industry and was flexible in its management of liquidity in order to avoid any destabilization of the financial markets in the course of restructuring.

In January, the Bank purchased 6.5 trillion won of Deposit Insurance Fund Bonds issued by the Korea Deposit Insurance Corporation for the refund of personal and corporate deposits placed with merchant banking corporations whose business had been suspended and for the recapitalization of the two distressed banks, Korea First Bank and Seoul Bank.

In September, seeking to facilitate the sale of Korea First Bank to a foreign investor, the Bank rolled over a special loan(1 trillion won), which had been facilitated in September 1997 to support the management rehabilitation of Korea First Bank, and thus to ease financial market instability. But in contrast to the original facility, the interest rate on the loan was set at the market interest rate with a view to avoiding moral hazard.

[Table 6] Purchase of Bonds for Financial Restructuring by the Bank of Korea

Unit : billion won

	Deposit Insurance Fund Bonds			Non-performing Asset Resolution Fund Bonds	**Total**
		Refund of deposits at suspended merchant banking corporations	Government' s recapitalization of Korea First Bank and Seoul Bank		
Amount	6,500	5,000	1,500	2,000	**8,500**
Date of Purchase	-	Jan. 3, Jan. 21, Jan. 23, 1998	Jan. 30, 1998	Nov. 28, 1997	-
Interest Rate	15%			5%	-

Moreover, the Bank managed liquidity flexibly to prevent the financial market from seizing up as the result of a liquidity shortage in the course of financial restructuring. Particularly concerned over possible effects from the closure of the five ailing banks, the Bank raised its aggregate credit ceiling by an additional 500 billion won, which was allocated by its branches in the main operating areas of the closed banks.

The Bank's flexible liquidity management was also influenced by a desire to maintain the stability of interest rates and facilitate the smooth absorption of the large volume of government and public bonds issued at market interest rates to support financial restructuring and finance the fiscal deficit.

6. Monetary Policy Instruments

From early in the year under review, the Bank of Korea placed great emphasis on improving the operational environment of monetary policy, by, for example, including the more active utilization of open market operations and the refining of its monetary policy instruments.

The frequency and scale of open market operations increased markedly from the previous year, reflecting the Bank's active use of open market operations on a daily basis in its attempt to achieve the flexible adjustment of market liquidity.

According to the provisions of the Bank of Korea Act in effect prior to April 1, the Bank had been required to cancel MSBs immediately upon its repurchase of these

[Table 7] RP Transaction[1] Trends

Unit : billion won

	1996	1997	1998		
			Year	1st half	2nd half
Purchases	38,902 (31)	72,786 (80)	9,065 (18)	4,735 (10)	4,330 (8)
Sales	32,350 (37)	30,784 (42)	471,253 (261)	243,769 (139)	227,484 (122)
Total	**71,252 (68)**	**103,570 (122)**	**480,318 (279)**	**248,504 (149)**	**231,814 (130)**

Note: 1) Figures in parentheses represent the number of RP transactions.

which it had already issued. However, where the Bank purchases MSBs under the terms of a repurchase agreement, this obligation was abolished under the revised Bank of Korea Act which came into force from April 1. This paved the way for the Bank to consolidate further the basis for its open market operations by adding MSBs on May 21 to the underlying instruments eligible for utilization in repurchase transactions.

On April 13, the Bank widened the scope of securities eligible for rediscount or collateral among those that financial institutions had acquired in the course of extending loans for general industrial activity. Commercial paper discounted by financial institutions and credit securities accepted in connection with loans to the non-manufacturing sector were accordingly considered eligible.

On May 23, the Bank raised bank's vault cash ratio - the proportion of their required reserves that they may hold in the form of bank-notes of the Bank of Korea - from 25 per cent to 35 per cent. This measure sought to alleviate the deadweight of financial institutions' large holdings of vault cash above the minimum required, following the Bank's substantially reduction of the reserve requirement ratio in three steps from April 1996.

[Table 8] Trends of the Average Reserve Requirement Ratio

Unit : %

before 2nd half month Apr. 1996	2nd half month Apr. 1996	1st half month Nov. 1996	2nd half month Feb. 1997
9.4	7.4	5.5	3.1

On January 26, in a move in keeping with the trend of financial opening and liberalization, the Bank completely abolished all direct restrictions on lending to prohibited sectors and the limit on the taking of collateral, thereby heightening banks' autonomy in their lending operations.

During the year under review, the government issued a considerable volume of bonds in order to finance the fiscal deficit. The method of issue was also changed from absorption by the central bank or quasi-competitive sale at nominally market rates to fully competitive sale at the effectively prevailing market interest rates. This

initiative is expected to help not only broaden and deepen the Treasury bond markets, but also to prepare the foundation for the efficient conduct of monetary policy, using the Treasury bonds rate as the benchmark rate.

Ⅲ. Foreign Exchange Policy of the Government and Financial System Management

1. Foreign Exchange Policy

(1) Securing Foreign Liquidity

Under the judgment that securing adequate foreign liquidity was the most urgent task for a fast recovery from the currency crisis, the government sought to extend the maturities of financial institutions' short-term external debts, to issue the Foreign Exchange Stabilization Fund Bonds(FESFBs), and to induce financial support from international financial institutions such as the IMF and the Export-Import Banks of the U.S. and Japan.

A. Maturity of Financial Institutions' Short-Term External Debts Extended

In order to facilitate the conversion of financial institutions' short-term external debts to medium- and long-term debts, the government obtained the approval of the National Assembly in December 1997 and January 1998 for its provision of repayment guarantees on external debts to a total of 27 billion U.S. dollars. This enabled an agreement to be reached on basic principles with foreign creditor banks on January 28 in New York regarding the prolongation of the maturities of domestic financial institutions' short-term external debts.

The main details of the agreement were as follows. Short-term external debts falling due within one year would be converted into one- through three-year medium- and long-term debts backed by government repayment guarantees.

Interest rates on one-year, two-year, and three-year debt maturities were set at Libor + 225bps, Libor + 250bps, and Libor + 275bps per annum, respectively. Notably, in case the borrowing conditions of financial institutions improved, the agreement allowed repayment of two- and three-year debts at six monthly intervals before maturity(call option).

On the basis of the agreement, on April 8, through negotiations with creditors, 21.7 billion U.S. dollars of short-term debts were converted into new external debts carrying one- through three-year maturities. By maturity, medium- and long-term maturities of at least two years made up over 80 per cent of all debts rescheduled: one-year maturities came to 3.8 billion U.S. dollars; two-year maturities to 9.8 billion U.S. dollars; and three-year maturities to 8.2 billion U.S. dollars.

Thanks to these arrangements, the ratio of short-term external debts to total external debts was reduced from 40 per cent as of the end of March to 20 per cent as of the end of April.

B. Foreign Currency Denominated Foreign Exchange Stabilization Fund Bonds Issued

The government received the approval of the National Assembly for its issue of FESFBs to a value of below 10 billion U.S. dollars on December 22, 1997, following which it sold U.S. dollar and Japanese-yen denominated FESFBs in the domestic market to residents and non-residents including Korean residents abroad. They are one-year maturity bearer bonds with an interest rate of 8per cent per annum for the U.S. dollar denominated bond and of 2.5 per cent for the Japanese-yen denominated bond. As of April 3, U.S. dollar denominated bonds had been sold to the value of 108 U.S. million dollars and Japanese-yen denominated bonds to the value of 2,651 million yen.

On April 8, the government floated U.S. dollar denominated FESFBs to the value of 4 billion U.S. dollars, including a 1 billion U.S. dollar issue of five-year maturity bonds and a 3 billion U.S. dollar issue of ten-year maturity bonds. These were issued in the international financial market in the form of a global bond. The interest rates on the five-year maturity and ten-year maturity bonds were set respectively at the five-year US T-bond yield rate + 345bps and the ten-year US T-bond yield rate + 355bps per annum.

C. Financial Support from International Financial Institutions Induced

Under agreements reached with international financial institutions to overcome the currency crisis at the end of the previous year, financial support was made available as scheduled. During the year, the government drew down a total of 7.9 billion U.S. dollars from the Supplemental Reserve Facility(SRF) of the IMF in four tranches; and 3 billion U.S. dollars from the IBRD' s Structural Adjustment Loan and 1.7 billion U.S. dollars from the ADB' s Financial Sector Program Loan, each in two tranches. In consequence, 28.7 billion U.S. dollars of the total support package of 35 billion U.S. dollars in all had been drawn down(IMF: 19 billion U.S. dollars; IBRD: 6 billion U.S. dollars; ADB: 3.7 billion U.S. dollars) by the end of the year. Meanwhile, during the year, thanks to the improvement of FX market conditions, the government repaid to the IMF 2.8 billion U.S. dollars at maturity.

Meanwhile, the government reached an agreement with the Japanese government to induce 130 billion yen from the Export-Import Bank of Japan on May 23. These funds, which were borrowed by the Export-Import Bank of Korea, are being used to finance trade credits for the import of raw materials and manufacturing equipment. They carry a two-year maturity and an interest rate of 2.2 per cent per annum. In addition, at a Korea-Japan summit meeting on October 8, both governments agreed on a loan of 3 billion U.S. dollars to Korea from the Export-Import Bank of Japan, carrying an eight-year maturity and an interest rate at the Commercial Interest Reference Rate(CIRR) as announced by the OECD. Of this facility, 2.7 billion U.S. dollars was not restricted in use to the import of Japanese products, so 1.3 billion U.S. dollars was assigned to small and medium enterprises(SMEs), 1 billion U.S. dollars to the energy industry, and 0.4 billion U.S. dollars to Korea-Japan joint venture businesses.

On June 11, the government agreed with the Export-Import Bank of the U.S. to borrow trade credits of 2 billion U.S. dollars. These funds were stipulated to be assigned to domestic firms wishing to finance their import of capital goods from U.S. companies within a one-year time period. These trade credits carry maturities ranging between two and five years and the interest rate on them will be set at the CIRR.

[Table 9] Financial Assistance from International Financial Institutions
(As of the end of 1998)

Unit: U.S.$ billion

	Agreed	Drawn down		Repaid	Out-standing	Interest rate and conditions of repayment
IMF	210.0[1]		19.0[2]	2.8	16.2	
	Credit Tranches	Dec. 5, 97.~Dec. 8	5.6	-	5.6	· IMF credit fee(about 3.9% per annum) · Eight installments over two years after a three-year grace period
	Supple-mental Reserve Facility (SRF)	Dec. 19, 97~Dec. 22 Dec. 30, 97~Dec. 31 Jan. 8, 98~Jan. 12 Feb. 20, 98~Feb. 27 May 29, 98~June 3 Aug. 28, 98~Sep. 2 Dec. 17, 98	3.5 2.0 2.0 2.0 1.9 1.0 1.0	1.8[3] 1.0[3] - - - - -	1.7 1.0 2.0 2.0 1.9 1.0 1.0	· IMF credit fee + 300~350bps · Two installments after one year and one and a half years of the date drawn down
IBRD	100.0		6.0	-	6.0	
		Dec. 23, 97	3.0	-	3.0	· Libor + 100bps · Ten installments over five years after a five-year grace period
		Mar. 27, 98 Oct. 23, 98	2.0 1.0	- -	2.0 1.0	· Libor + 75bps · 20 installments over ten years after a five-year grace period
ADB	40.0		3.7	-	3.7	
		Dec. 24, 97 Jan. 5, 98 Dec. 31, 98	2.0 1.0 0.7	- - -	2.0 1.0 0.7	· Libor + 40bps · Repayment in full after a seven-year grace period
Total	**350.0**		**28.7**	**2.8**	**25.9**	

Notes 1) 15.5 SDRs. 2) 14.1 SDRs.
3) Total amount was repaid in five tranches from December 18 to 30, 1997.

(2) Liberalization of Financial Market Further Widened

In order to promote inflows of foreign capital, the government had opened the domestic bond market at the end of the previous year and proceeded to complete the opening of the domestic stock and money markets during the year. In addition, it further widened the sectors open to inward foreign direct investment(FDI) and allowed the acquisition of domestic real estate by foreigners. It also improved the FDI support systems by simplifying investment procedures and expanding the scope of tax incentives.

A. Inward Portfolio Investment Liberalized

On February 16, the government widened the scope of short-term financial products available to foreigners for domestic portfolio investment to include commercial papers, commercial bills, and trade bills. Later, short-term financial products issued by financial institutions such as certificates of deposit(CDs), cover bills, bills issued by merchant banking corporations, and RPs, originally scheduled to be made available by the end of the year, were opened for purchase by foreigners from May 25. In addition, ceilings on the purchase of domestic stocks by foreigners were abolished on May 25, earlier than under the original plan. In the case of public corporations, such as Pohang Iron & Steel Corp.(POSCO) and Korea Electric Power Corp.(KEPCO), however, the ceilings were retained but at a higher level: the aggregate ceiling was lifted from 25 per cent to 30 per cent and the individual ceiling from 1per cent to 3 per cent.

Meanwhile, from July 1, all kinds of securities stipulated in the Securities and Exchange Act were made available for foreign investment with the addition of unlisted stocks and bonds, beneficial certificates issued by investment trust companies, and certificates of capital participation to eligible objects for portfolio investment. In addition, in order to simplify inward investment procedures, the government eliminated the prime FX bank system for domestic portfolio investment and the registration certificate for investment, while retaining the system of registration certificates for investment in domestic stocks. And foreign investors were allowed to borrow and lend out Korean-won denominated securities both between residents and non-residents and between non-residents through the Korea Securities Depository.

B. Scope of Inward Direct Investment Widened Further

Through the year, the government steadily expanded the number of business sectors open to inward direct investment. On April 1, it entirely opened seven businesses including the renting of residential and non-residential buildings and securities trading, etc., and in case of forwards and futures trading, foreigners were allowed to purchase less than 50 per cent of existing company's stocks provided they were not the largest shareholder.

On May 6, the government added nine businesses including merchandise exchanging business, investment companies, gas station operation, and so forth, to those entirely liberalized. Later, on July 1, the credit rating business was fully opened and, in case of cigarette manufacture, foreigners were allowed to hold up to a limit of 25 per cent of firm's total shares(individual ceiling: 7 per cent). The petroleum refining process was entirely opened on August 1.

These changes reduced the number of businesses subject to restrictions on inward FDI to 31, of which 13 remained closed and 18 partially opened. The liberalization ratio consequently rose to 98.9 per cent.

C. Acquisition of Domestic Real Estate by Foreigners Entirely Allowed

In order both to boost the domestic real estate market and to encourage corporate M&A, the government liberalized the acquisition of domestic real estate by foreigners.

Most importantly, on June 26, the procedure for land acquisition by foreigners was changed from prior permission to simple ex-post declaration by revising the enforcement decree of Foreigners' Landholdings Act. In other words, foreigners can buy land regardless of their residential status, and the usage and size of the land upon condition of their subsequent declaration to the head of the relevant city, *gun* and *gu*. However, for purchases by foreigners in areas reserved for military facilities, cultural heritage sites, or land set aside for ecological purposes or on islands designated by the Minister of Construction and Transportation, approval is needed before conclusion of the contract.

On July 1, the procedure whereby foreigners purchasing real estate other than land had been required to obtain the prior permission of the Minister of Finance and Economy(MOFE) was abolished.

D. Support System for Foreign Direct Investment Improved

On September 2, the government repealed the Act on Investment by Foreigners and Foreign Capital Inducement, replacing it with the Foreign Direct Investment Promotion Act which came into effect from November 17. The main details of this new Act, which marked a shift from regulation and control towards promotion and support, were as follows: the system of reporting was changed from the submission

of a report and its acceptance to a simple declaration; the systems of reporting the arrival of foreign capital and appointing a reporting agent were abolished. The number of documents to be filed for inward FDI was also significantly reduced from 69 to 29. And supporting services for industries and companies in FDI zones were included among FDI businesses eligible for tax incentives. In addition, the tax holiday for national taxes such as corporation tax, income tax, and dividend income tax was extended to uniform seven years from the previous three years for companies in the export free zone and five years for companies involved in advanced technologies.

Meanwhile, hostile foreign takeovers of domestic enterprises were also allowed upon the abolition on May 25 of the requirement that foreigners intending to acquire over one third of a domestic firm's equity should obtain the prior consent of its board of directors.

(3) Foreign Liquidity of Firms and Financial Institutions Supported

In order to improve the foreign exchange liquidity conditions of firms and financial institutions, the government liberalized the inducement of trade credits, and eased restrictions on residents' foreign borrowings and on the overseas sale of foreign assets owned by firms and financial institutions.

A. Inducement of Firms' Trade Credits Liberalized

On February 3, the government extended the period of deferred payments for imports to 360 days regardless of their usage and source. Following on from this, on April 6, in the case of commodities imported on the basis of trade credits provided by foreign financial institutions, where the scale of the imports is set by intergovernmental agreement, a period of deferred payments of up to three years was allowed regardless of the level of tariff.

In a further move, from July 1, the inducement of trade credits was fully liberalized in order to support exporters' activities. Specifically, all restrictions as to the eligibility of goods and the credit period for imports under deferred payments or installment payments were eliminated. Ceilings on receipts of advances on exports and deposits against contracted exports, which had been limited to no more than

100 per cent of the overall export amount in the preceding year were abolished as was the period for performance of the exports corresponding to the export advances, previously up to 180 days.

B. Restrictions on Foreign Borrowings by Residents Eased

On February 6, as a temporary measure until the end of the year under review, the government allowed foreign borrowings by venture businesses in order to foster their development. Venture businesses were permitted to borrow on a short-term basis for less than three years foreign funds of up to 2 million U.S. dollars per year and also to borrow foreign capital of up to 1 million U.S. dollars with a repayment or settlement period of over three years.

In addition, on June 13, the issuance of overseas securities was liberalized by abolishing the restrictions on both the qualifications of issuers and the usage of the capital raised.

On July 1, in order to resolve the financial difficulties of excellent companies caused by the credit crunch and promote their overseas fund raising, the minimum maturity of firms' medium- and long-term foreign borrowings and securities issued overseas was shortened from the previous minimum of three years to one year or more. The government also allowed importers to open import L/C accounts with non-resident financial institutions in order to support small and medium export firms, which were having difficulties in procuring raw materials because of domestic banks' reluctance to open L/Cs.

Meanwhile, from July 1, the restrictions on medium- and long-term foreign borrowings with over one-year maturity by FX banks were eased to improve their external debt structure, which is overweight at the short-term end. Specifically, the regulation prescribing a prior declaration to the MOFE for foreign borrowings of over 10 million U.S. dollars, was revised to require the ex-ante report only for foreign borrowings of 50 million U.S. dollars or more.

In addition, with effect from July 1, the government eased the restrictions on foreign fund-raising in relation to the offshore banking of FX banks.

[Table 10] Easing of Restrictions on FX Banks' Offshore Fund-Raising
(As of July 1, 1998)

	Former	Revised
Fund Raising Methods	○ Borrowings from non-residents or other offshore banking accounts ○ Deposit-taking from non-residents or other offshore banking accounts ○ Issue of foreign currency securities in foreign countries	Unchanged ○ Sales of foreign-currency bonds to non-residents
Reporting Requirements	○ Ex-ante report to the MOFE in case of consortium-type borrowings above 20 million U.S. dollars with a maturity of one year or more ○ Ex-post report to the MOFE in case of non-consortium-type borrowings of at least 20 million U.S. dollars with a maturity of one year or more	○ Ex-ante report to the MOFE in case of borrowings over 50 million U.S. dollars with over one-year maturity

C. Restrictions on Foreign Assets Sales by Firms and Financial Institutions Eased

Seeking to facilitate structural adjustment, the government, on July 1, eased the restrictions on overseas sales of foreign assets owned by firms and financial institutions. Most notably, where FX banks sell foreign assets exceeding 10 million U.S. dollars such as export bills and foreign currency credits to non-residents, the reporting procedure was changed from ex-ante declaration to the MOFE to ex-post report, and the reporting limit was also lifted to 50 million U.S. dollars or above. In addition, for the issue of asset-backed securities(ABSs), the procedure was eased from a report to the MOFE and its acceptance to the simple filing of a report.

Meanwhile, the government liberalized the trading and transfer of foreign currency denominated bonds between residents, which had previously only been allowed for certain transactions including L/C transfers. Sales by residents to non-residents of promissory notes issued by residents and foreign-currency bonds with a

face value of not exceeding 10 million U.S. dollars which had been acquired in the course of normal business were also allowed.

(4) Regulations on FX Market Eased but Prudential Supervision Strengthened

In order to improve the workings of the domestic FX market, the government revised the FX position management system for FX banks and partially expanded the scope of FX forward transactions by non-residents. In addition, a competitive system was launched for FX brokerage. On the other hand, prudential supervision was strengthened over the FX business of domestic commercial banks.

A. FX Position Management System Revised

On July 1, in order to enable FX banks to manage their FX positions in a more flexible manner, the limits on the spot and the overall position were consolidated into an overall position limit. Therefore, the limits on the spot short position and the spot long position, which had been set at 5 per cent of the equity capital as of the end of the previous month, were abolished. Similarly, the ceiling on the overall short position was lifted from 10 per cent of the equity capital as of the end of the previous month to 15 per cent thereof. The limit on the overall long position was retained unchanged at 15 per cent of the equity capital as of the end of the previous month.

In addition, the scope of assets and liabilities subject to FX position management was widened with effect from August 1 to embrace merchant banking corporations' leased assets and liabilities.

B. FX Forward Transactions by Non-Residents Expanded

Non-residents' FX forward transactions, previously allowed only in the case of capital transactions supported by real demand, were permitted also for current transactions underlain by real demand.

In addition, in the case of designated securities companies, the maximum length limit was abolished on FX forward transactions related to domestic securities with foreign investors, which had hitherto been restricted to the transaction period from

the date of contract to the date of settlement(three business days for stocks and five business days for beneficiary certificates). However, for the better management of exchange-rate risk, such transactions were restricted to the equivalent of no more than 5 per cent of a company's equity capital as of the end of the preceding fiscal year.

C. Competitive System on FX Brokerage Introduced

On November 23, as one of a series of steps to strengthen the infrastructure of the domestic FX market, the government permitted Korea Fund Brokerage Ltd. to carry on FX brokerage, which had before then been undertaken solely by Korea Financial Telecommunications and Clearings Institute(KFTC). The Governor of the Bank of Korea was given the authority to determine the details of the supervisory arrangement for FX brokerage business such as the reports to be filed, the scope and frequency of examinations, ex-post management and sanctions.

D. Controls on the Purchase of Foreign Currencies by Residents Eased

On July 22, the restrictions on the purchase of foreign currencies by residents, which had been imposed on October 31, 1997 to constrain precautionary or speculative demand for foreign currencies, were abolished. In consequence, residents were allowed to hold foreign currency equivalent to up to 20,000 U.S. dollars per person for a year and their purchase of foreign currency for the purpose of deposit in a resident account was liberalized. In addition, the restriction was abolished on the period of the purchase, which had been set at no more than five days from the date of the intended payment or departure. However, restrictions were retained on the purchase of foreign currencies for the purpose of overseas deposit.

E. Prudential Supervision on FX Transactions Strengthened

On July 1, to bring about the more efficient management of the risks that accompany FX businesses, the prudential supervision of the FX business was strengthened.

As a major step in this direction, leased assets were included among all loans in

calculating the mandatory holding ratio of loanable resources to the medium- and long-term foreign currency loans of FX banks. The maturity of items included in the denominator was also set at one year or more as opposed to the previous three years or more.

In addition, the government widened the scope of the items included in the foreign currency liquidity ratio. This is the ratio of foreign currency assets to those foreign currency liabilities falling due within 90 days, and it is currently set at a minimum of 70 per cent. The assets and liabilities of FX banks' overseas subsidiaries and offshore accounts were added to those of domestic head offices, branches and overseas branches for computation of the ratio. The government also introduced a maturity mismatch ratio control system for short-term foreign currency assets and liabilities, which was put into effect from January 1, 1999 and requires the gap ratio between assets and liabilities by period compared with total foreign assets to be maintained at above zero for those maturing within seven days and at below −10 per cent for those with a remaining maturity of less than one month.

(5) Liberalization Schedule for FX Transactions Arranged

On June 22, the government announced a liberalization schedule for FX transactions whose details covered the entire revision of the FX transaction system.

A. The First Stage of FX Liberalization

On September 2, the Foreign Exchange Transaction Act was passed to replace the existing Foreign Exchange Management Act. Its provisions are to come into effect from April 1, 1999, and its passage represents a major step in FX liberalization.

The main points of the new Foreign Exchange Transaction Act are as follows. The procedure for the establishment of FX business by a financial institution or money exchanger is changed from the obtaining of permission to the filing of a registration. And in order to promote FX transaction activities by firms, the approval system for some FX settlements methods including offsetting and payment by a third party has been rescinded.

In addition, most transactions related to the foreign activities of firms and financial institutions have been liberalized with a shift of the principle of regulation

from a positive system to a negative system for capital transactions. The following types of transaction are clearly listed as prohibited: firms' overseas deposits and overseas credits; short-term(under one-year maturity) won-denominated deposits by non-residents; overseas borrowings, deposits, and credits by an individual; domestic and foreign securities investments other than through domestic securities companies; and direct derivatives contracts with overseas financial institutions. All types of transaction not specifically prohibited are in principle permissible. Moreover, it will be permissible to conduct foreign currency and derivatives transactions not underlain by real demand following the elimination of the real demand principle for domestic FX transactions.

Meanwhile, in order to minimize the malign side effects arising from the liberalization of FX transactions, the government put in place the legislative foundation for the introduction of a system of variable deposit requirements(VDRs).

B. The Second Stage of FX Liberalization

The government declared its intention of liberalizing all kinds of FX transactions by the end of year 2000, other than those which threaten international peace or public order, such as international crime, money laundering, gambling, and so forth. Consequently, FX transactions not included in the first stage of liberalization are to be liberalized in the second stage.

2. Financial System Management

(1) Financial Restructuring

During the year, the government pressed ahead energetically with financial restructuring. This stemmed from a recognition that, in the wake of the currency crisis, the first priority was to stabilize the financial market and to restore external confidence. For this reason, financial institutions no longer viable owing to their accumulation of non-performing loans(NPLs) were closed down and those still viable turned around quickly through recapitalization and the purchase of their NPLs by the government on the condition of their own intensive self-rescue efforts

including mergers, replacement of the management, and the downsizing of staff and networks, etc.. This financial restructuring was pursued on the basis of the Act Concerning the Structural Improvement of the Financial Industry, the Depositor Protection Act, the Legislation Concerning Efficient Disposal of Financial Institutions' Non-performing Assets and Establishment of the Korea Asset Management Corporation.

A. Resolution of Non-viable Financial Institutions

In consultation with the IMF, the government deemed it advisable to restructure the distressed commercial banks and merchant banking corporations as a first step. In the case of non-bank financial institutions such as securities, insurance and leasing companies, the sequencing decided was that those companies facing insolvency in the process of bank restructuring should be restructured and the remaining institutions would be encouraged to raise additional capital from calls on major shareholders, and to seek a management turnaround through their own efforts.

Thus, in the banking sector, Korea First Bank and Seoul Bank, the two banks in deepest trouble, were recapitalized by the government and the Korea Deposit Insurance Corporation(KDIC) in January 1998. Next, the Financial Supervisory Commission(FSC) had accounting firms inspect assets and liabilities of the twelve banks which had failed to meet BIS's 8 per cent capital adequacy ratios as at the end of 1997 and required them to present management rehabilitation plans. Upon its examination of these plans, the FSC decided to order the exit of five banks(Daedong, Dongnam, Dongwha, Kyungki and Chungchung) deemed to have little possibility of rehabilitation. The resolution of these banks was achieved through a purchase and assumption(P&A) formula, whereby each acquiring bank(Kookmin, Housing & Commercial, Shinhan, KorAm and Hana) would purchase the sound assets and assume the liabilities of those acquired banks. The five acquiring banks were chosen on the criterion of the holding of a BIS capital adequacy ratio of more than 8 per cent at the end of 1997.

Meanwhile, among the remaining seven banks which had their management rehabilitation plans conditionally approved, five banks have completed or are in the process of mergers. That is, Commercial Bank of Korea and Hanil Bank merged

into Hanvit Bank, and Chungbuk Bank and Kangwon Bank are pursuing merger with Chohung Bank according to the FSC's directive. The two of this group of seven banks that have not been involved in merger or takeover activity are Korea Exchange Bank, to whose capital Commerzbank of Germany contributed 350 billion won, and Peace Bank, which chose to withdraw from international business.

Among banks whose BIS ratios exceeded 8 per cent at the end of 1997, Hana Bank merged with Boram Bank and Kookmin Bank with Korea Long-term Credit Bank.

As for merchant banking corporations, after evaluating the management rehabilitation plans of a total of thirty merchant banking corporations, the government revoked sixteen insolvent merchant banks' licenses and required their assets and liabilities to be transferred to a bridge merchant banking corporation.

Among other financial institutions, two securities companies had their licenses revoked and the licenses of three others are in the process of revocation, and one securities company is in the course of liquidation.

Four life insurance companies deemed non-viable after evaluation of their management rehabilitation plans were ordered to close and had their assets and liabilities transferred to sound life insurance companies. Meanwhile, two guarantee insurance companies were ordered to merge and achieve a management turnaround through self-rescue efforts.

Among leasing companies, most of which are subsidiaries of banks, restructuring has been linked to the restructuring of the banks involved. Five leasing companies are in the process of liquidation and the assets and liabilities of five companies are being transferred to a bridge leasing company.

Meanwhile, two investment trust companies and four investment trust management companies had their licenses revoked and one is in the process of liquidation.

In addition, twenty-two mutual savings and finance companies and sixty-nine credit unions exited the market.

[Table 11] Resolution of Non-viable Financial Institutions
(As of the end of 1998)

	No. of institutions of the end of 1997 (A)	Type of resolution			No. of institutions newly established (C)	No. of institutions operating (A-B+C)
		Exit	Merger	Total (B)		
Banks	33	5	3	8	-	25
Merchant banking corporations	30	16	-	16	-	14
Securities companies	36	6	-	6	1	31
Investment trust companies	8	2	-	2	-	6
Investment trust management companies	23	5	-	5	-	18
Insurance companies	50	4	1	5	-	45
Leasing companies	25	10	-	10	-	15
Mutual savings and finance companies	231	22	2	24	4	211
Credit unions	1,666	69	14	83	9	1,592
Total	**2,102**	**139**	**20**	**159**	**14**	**1,957**

B. Fiscal Support for Viable Financial Institutions

In order to promote the recapitalization of banks and to resolve NPLs, the government injected a total of 40.9 trillion won through the Korea Deposit Insurance Corporation(KDIC) and the Korea Asset Management Corporation between November 1997 and December 1998.

So as to protect depositors and to prevent deterioration of the management status of the acquiring banks in the process of the resolution of insolvent financial institutions, the government provided a total of 14.7 trillion won through the KDIC. Of this amount, 7.8 trillion won was for the repayment of deposits with closed institutions and 6.9 trillion won by way of compensation for the losses sustained by the acquiring banks.

Meanwhile, in order to prevent any further decline in their BIS capital adequacy ratios, the government injected through the KDIC a total of 6.3 trillion won into

the acquiring banks and into banks arranging to merge. As for Korea First Bank and Seoul Bank which were nationalized since January 1998, the government signed MOUs with a U.S. financial consortium led by Newbridge Capital to sell its shares in Korea First Bank; and with a British financial corporation, HSBC Holdings BV, to sell its shares in Seoul Bank.

Moreover, to resolve the large amount of NPLs held by financial institutions, the government set up the Non-performing Asset Management Fund in November 1997 and had it purchase at a discount NPLs with a book-value of 44.8 trillion won for 19.9 trillion won in the period between November 1997 and December 1998.

(2) Revision of Legislation to Facilitate the Restructuring of Financial Institutions

The government sought to facilitate the restructuring of financial institutions through revision of the relevant legislation including the Act Concerning Structural Improvement of the Financial Industry and the Depositor Protection Act.

A. The Amendment of the Act Concerning Structural Improvement of the Financial Industry

The revised Act Concerning Structural Improvement of Financial Industry came into effect from September 14, 1998. It enlarged the range both of insolvent financial institutions eligible for financial support by the government or the KDIC, and of those subject to Prompt Corrective Action to avoid insolvency including the financial supervisory authority's advice, demands or orders for management improvement. Also it strengthened the range of the financial supervisory authority's actions under the Prompt Corrective Action framework and simplified procedures for M&A between financial institutions.

The main features of the revised Act are as follows. First, it brings within its compass those insolvent financial institutions which the financial supervisory authority or the management committee of the KDIC strongly expect to experience difficulties in remaining under normal management because of the possibility of their liabilities exceeding their assets as a result of a major financial incident or the occurrence of large non-performing assets. The original definition of insolvent

financial institutions was restricted to those institutions whose liabilities already exceeded their assets or which had suspended payment of their deposit liabilities.

Second, it enlarged the range of those financial institutions within the Prompt Corrective Action framework and strengthened the mandatory supervisory actions. The range of those institutions was widened to include not just those whose financial status in terms such as their capital adequacy ratio is below the standard set by the FSC but those whose financial status is deemed by the FSC to be likely to fall below its standards because of a major financial scandal or the occurrence of non-performing assets.

And the Prompt Corrective Action framework was strengthened through the addition of further mandatory supervisory actions including cancellation of financial institution's entire share capital, the complete cessation of its business operations, the mandatory disposal on a purchase and assumption(P&A) basis of contracts regarding financial transactions such as deposits or loans, and other measures which are deemed necessary to enhance the financial soundness of the financial institution itself. The mandatory actions previously available were limited to the issue of a caution or warning, increase or reduction of capital, down-scaling of its organization, partial cancellation or consolidation of its shares, total or partial transfer of business, and disposal through merger or acquisition. Besides this, in order to facilitate the steps mandated under the Prompt Corrective Action framework, the FSC can designate another financial institution and recommend that it undertake a merger, transfer of business or purchase and assumption of the insolvent institution.

Third, the revised Act shortened the notice period for an extraordinary general meeting of shareholders and the presentation of creditor's objections in connection with mergers or takeovers involving financial institutions and it also simplified the procedures for merger of a financial institution or the reduction of its capital upon the order of the FSC.

And the government revised the regulations concerning Prompt Corrective Action to improve its effectiveness, by setting out stage-by-stage requirements triggering management improvement advice, demands or orders. Under the revised regulations, measures appropriate to the stage are triggered when the financial status of an institution fails to meet certain requirements.

If a bank's BIS capital adequacy ratio falls to between 6 per cent and 8 per cent, its

asset soundness is found to be problematic, or a severe capital deficit is revealed, the Governor of the Financial Supervisory Service(FSS) should advise the institution to take such measures as increasing or reducing its capital, restricting its distribution of profits or setting aside special loan loss provisions.

And if a bank's BIS capital adequacy ratio is below 6 per cent, or its financial status is shown to be very fragile by the management status evaluation, or if it fails to carry out a management rehabilitation plan even though advised by the FSC to improve its financial status, the Governor of the FSS upon the FSC's resolution should require the bank to dispose of subsidiaries, or cease some parts of its business. If a bank is judged to be insolvent by the FSC, the FSC should order it to take actions such as the cancellation or consolidation of its shares, the partial or complete transfer of its business, or merger with another bank.

B. The Amendment of the Depositor Protection Act

The government also revised the Depositor Protection Act, which came into effect from September 16, 1998, to adjust the scope of insured deposits and increase deposit premium rates.

The revised act brings the scope of guaranteed deposits into line with the deposit products of financial institutions subject to the KDIC. It therefore adds CMA deposits with merchant banking corporations, and cover bills sold by mutual savings and finance companies to the scope of insured deposits. However, it excludes bills resold with recourse by merchant banking corporations, since these are not in the nature of deposit liabilities.

In order to expand the Deposit Insurance Fund, the Act increased the subscription premium rate(previously 0.05~0.15 per cent) to 0.5 per cent. And the Act provides that, in order to protect depositors who maintain deposit accounts with more than one institution, a merged institution, merging institution or institution newly established by merger or business conversion according to the Financial Industry Restructuring Act shall be regarded, for this purpose, as a separate institution for one year after a merger or business conversion.

(3) Enhancement of the Standard of Management Soundness Required of Financial Institutions

The government amended other financial legislation including the General Banking Act and the Merchant Banking Corporation Act to heighten the management soundness of individual financial institutions.

A. Bank

The revised General Banking Act(effective April 1, 1998) changed the concept of a bank's equity capital, which is used as the base for calculating a bank's single borrower credit ceilings, from the sum of paid-in capital, reserves and retained surplus to the sum of basic capital plus supplementary capital as defined by the BIS standard. In addition it extended the scope of the credit ceiling system from credit(loan and payment guarantees) to credit extension(loan, guarantees, underwriting of securities and other direct and indirect trading of a bank involving credit risk).

It also reduced the single borrower credit ceiling from 45 per cent(loan 15 per cent, guarantees 30 per cent) to 20 per cent(credit extension basis) of a bank's equity capital, and changed the system of ceilings on credit to a single interlinked business group to a system of ceilings on credit extension to a single borrowing group(a single individual or single juridical person and those persons or entities who share credit risk with that person), and also lowered this ceiling from 45 per cent to 25 per cent of equity capital.

In addition, the ceiling on credit to large shareholders(a single shareholder with more than 10 per cent of the voting shares of a nation-wide bank or 15 per cent thereof in the case of a regional bank) was changed. Previously it had been set at the lower of the rate set by the Enforcement Decree of the General Banking Act within 45 per cent of equity capital(i.e. 25 per cent of equity capital) and the large shareholder's participation in the bank's capital. This was redefined, on a credit extension basis, as the lower of the rate specified by the Enforcement Decree within 25 per cent of the equity capital and the large shareholder's participation in the bank's capital. And the revised Act changed the definition of large credits whose sum is restricted to no more than five times the equity capital from credits

exceeding 15 per cent of the equity capital to credit extension exceeding 10 per cent of equity capital.

The government also revised the Regulations Concerning the Supervision of Banking Institutions to tighten the classification standard for asset soundness and the assessment standard for the BIS capital adequacy ratio. The revised regulations changed the definition of a precautionary loan from credit between 3 months and 6 months in arrears to credit between 1 month and 3 months in arrears. Substandard loans were redefined from those with credit arrears of more than 6 months to those with credit arrears of more than 3 months(effective July 1, 1998). The loan loss provisions which could be partially set aside until the end of 1997 should be set aside in full with effect from the provisional closing of accounts as of the end of June, 1998. The ratio of loan loss reserves to be held against precautionary credits was increased from 1 per cent to 2 per cent(effective July 1, 1998) and loan loss provisions for guarantees should also be set aside according to asset classification standards from the 1999 fiscal year.

Regarding the calculation of the BIS capital adequacy ratio, accumulated loan loss reserves for substandard loans were excluded from the definition of supplementary capital(effective January 1, 1999). The credit conversion factor for calculating risk-weighted trust assets whose principal or profit was guaranteed by contract was raised from 50 per cent to 100 per cent(effective 2000) and the risk weight applied to trust assets, which was formerly 20 per cent, should be applied according to creditworthiness of the asset providers(effective January 1, 1999).

B. Non-Banking Institutions

The government revised the Merchant Banking Corporation Act(effective April 1, 1998), the Securities Investment Trust Business Act(effective May 25, 1998 and subsequently amended with effect from February 1, 1999), the Securities and Exchange Act(effective April 1, 1999), the Specialized Credit Financial Business Act(effective February 1, 1999) and related regulations to improve the systemic framework for the sound management of non-banking institutions.

In order to bring it into line with the General Banking Act, the revised Merchant Banking Corporation Act adopted the BIS standard of equity capital, i.e. the sum of basic capital and supplementary capital, and widened the scope of the credit ceiling

system from credit to credit extension(loans, discounts, guarantees, underwriting of securities and other direct and indirect trading activities of a merchant banking corporation involving credit risk).

Moreover, the single-borrower credit ceiling was reduced from 50 per cent(loans 25 per cent, guarantees 25 per cent) of equity capital to 20 per cent(credit extension basis) and the system of ceilings on credit to a single interlinked business group was changed to a system of ceilings on credit extension to a single borrowing group(the same definition as that in the General Banking Act) and the level at which it was set was lowered from 100 per cent to 25 per cent of equity capital.

The system of ceilings on credit to large shareholders(a single shareholder with more than 10 per cent of total shares and person(s) having some special connection with him/her) was changed to one of ceilings on credit extension to related persons(shareholders, officers, subsidiaries and persons who share credit risk with them) and the ceiling limit was reduced from 50 per cent of equity capital to 25 per cent. Meanwhile, the revised Act introduced a system of ceilings on total large credit extensions. Under the system, a large credit extension is defined as a credit extension to a single borrowing group exceeding 10 per cent of the equity capital of a merchant banking corporation. Total large credit extensions are restricted to no more than five times the equity capital of any merchant banking corporation.

Furthermore, an asset soundness classification scheme(effective April 1, 1998) was introduced requiring loan assets to be classified as normal, precautionary(arrears of 3 to 6 months), substandard(arrears of more than 6 months), doubtful, and estimated loss credits. Loan loss provisions are to be set aside at a rate of 0.5 per cent for normal, 1 per cent for precautionary, 20 per cent for substandard, 75 per cent for doubtful, and 100 per cent for estimated loss credits.

Investment trust companies were required to change their method of redemption. They must sell securities held in trust and make redemption to the customer at the market price of these securities on the day of his/her request for cancellation in whole or in part of the beneficiary certificate contract. This represents a change from redemption at the book-value of the corresponding securities to redemption at the market-value of those securities at the time of the request. The purpose of this change was to improve the redemption system, which had contributed to the weakening of these companies' status.

In order to facilitate the restructuring of investment trust companies through the

subscription of additional capital by large shareholders, the government abolished ceilings on the ownership of shares of a investment trust company by a single person, and allowed a single person to hold simultaneously more than 10 per cent of the shares of individual investment trust companies, thus, making it possible for a single person to control several investment trust companies.

Securities companies were required to keep customers' deposits distinct from their basic account, and to account for them separately in order to improve customer protection. Meanwhile, the ceiling on the ratio of subordinated borrowings that might be used for the calculation of net operating capital was reduced from 300 per cent of net assets to 150 per cent(effective July 15, 1998).

The revised Specialized Credit Financial Business Act provided that financial institutions or large-scale distributors like department stores wishing to operate a credit card business should have equity capital of at least two billion won, in addition to the previous requirement of a paid-in capital of at least two billion won.

(4) Broadening and Deepening the Financial Market

During the year, the Korean financial market was broadened and deepened through the introduction of new financial techniques such as asset securitization and products such as mutual funds, the upgrading of accounting and disclosure standards imposed on financial institutions, and the improvement of the structure of banks' trust accounts and securities investment trusts.

A. Introduction of Asset Securitization System

Financial institutions' fund-raising capacity was expanded through the passage of two new acts: the Act on Asset Securitization(effective September 16, 1998) which provides for the introduction of companies specializing in securitization, and the Mortgage-backed Securitization Companies Act(effective April 29, 1999) which provides for the introduction of companies specifically handling the securitization of mortgages.

Companies specializing in securitization act as vehicles for the securitization process, acquiring assets from the original asset holders, packaging them, and issuing asset-backed securities for sale to investors. They pay investors principal and

interest, or a performance-related dividend arising from the management and disposal of the assets.

A company specializing in securitization may be set up only in the form of a limited liability company under the Commercial Code, having capital of at least 10 million won. Such a company may not hire staff or establish business offices but should act solely as a paper company, entrusting the administration of the assets underlying its issue of asset-backed securities to the original asset holder or a third party. The securitization process and all operations related to it may also be handled by a trust company(including a bank's trust account).

The company specializing in securitization or the trust company should register each individual asset securitization scheme with the FSC. Provided the transfer of assets to it from the original asset holders is registered with the FSC, all requirements for an asset transfer as stipulated in the Civil Code under the asset securitization scheme are considered to have been fulfilled from the day of registration, ruling out claims against a third party other than the original debtor. Only one securitization scheme may be operated by one company specializing in securitization, although this is not the case for trust companies.

The introduction of a system for companies dealing specifically with mortgage securitization was based on the need for continuity in this field as opposed to other types of securitization where the purpose-formed paper company is dissolved after only one securitization scheme.

The method of mortgage securitization takes place as follows. Companies specializing in mortgage securitization acquire mortgages from the original asset holders, package the mortgages to provide backing for the issue of mortgage-backed securities, and sell these to investors. They repay investors their principal along with interest, or distribute profits arising from the management and disposal of the mortgages. A company intending to specialize in mortgage securitization should have a minimum capital of 25 billion won and it may be established with the approval of the Minister of Finance and Economy on the recommendation of the FSC.

B. Introduction of Mutual Fund System

The government introduced legislation, the Securities Investment Company

Act(effective September 16, 1998), designed to provide for the development of a mutual funds industry in order to encourage the growth of institutional investors, promote corporate sector reform, and strengthen support for small and medium enterprises.

Securities investment companies are established under its provisions as paper companies. They collect funds by selling shares to investors to whom they pay a performance-related dividend arising from the investment of the subscribed funds in securities. In this point, securities investment companies differ from investment trust companies, first formed in 1970, which sell beneficiary certificates to investors. Of the two categories of securities investment companies, only closed-end securities investment companies, which are not allowed to repurchase their shares, may now be established. It will become possible to establish open-end securities investment companies, which are allowed to repurchase their shares, from a date to be designated by the Presidential Decree within five years after the Act's entry into force. A securities investment company may be set up after registration with the FSC, provided that it has a minimum capital of 800 million won.

Certain restrictions are imposed to heighten the soundness of securities investment companies. Investment in the same issue of a security must be less than 10 per cent of its total assets, and its investment in the stocks of any one enterprise must be less than 10 per cent of that enterprise's total stocks. Also, a securities investment company is not allowed to take loans or provide debt guarantees. However, those securities investment companies which invest more than 50 per cent of their total assets in securities issued by small and medium enterprises which do not belong to large business groups as defined in the Monopoly Regulation and Fair Transaction Act are not subject to the restrictions mentioned above, such as single-issue investment ceilings or limits on the maximum holding of any one company's equity.

C. Arrangements of Accounting and Public Disclosure Systems

Standards for accounting and public disclosure were heightened during the year to enable shareholders, creditors, and others to gauge financial institutions' management performance with greater accuracy from their financial statements.

Most notably, banks and merchant banking corporations were obliged to set

aside full provisions against loan losses and against valuation losses on securities holdings. In addition, the previous accounting treatment of financial institutions' holdings of stocks and foreign currency bonds(lower of historical cost or market) and of domestic currency bonds(historical cost) were changed to a uniform standard of current market valuation for all marketable securities.

Moreover, financial institutions including banks, securities companies and insurance companies were required to draw up their financial statements according to corporate accounting standards from the fiscal year of 1999, to facilitate comparison of management performance not just among financial institutions but across all financial and non-financial companies.

In addition, the range of financial institutions subject to public disclosure was enlarged to include all kinds of financial institutions and the scope of the details to be disclosed was also expanded from fiscal 1998.

In order to upgrade the standards of public disclosure to those of advanced countries, the list of items subject to periodic public disclosure was extended to include the foreign currency liquidity ratio, credit ratings from credit rating agencies, and actual transactions with subsidiaries. Also, the frequency of periodic public disclosure was increased from once a year(after the annual closing of accounts) to twice a year(after both annual and semi-annual closing), and the minimum period for public disclosure was lengthened from one year to three years.

The Financial Supervisory Service's release of statistics concerning non-performing loans was also enlarged to include substandard credits, doubtful credits and estimated loss credits. The frequency for its release of statistics was also increased from once a year to twice a year.

The standards for public disclosure for securities companies and insurance companies were tightened, bringing them on a par with those for banks. In addition, the scope of financial institutions requested to make public disclosure which had previously included only banks, securities companies and insurance companies was expanded to include foreign bank branches, merchant banking corporations, mutual savings and finance companies, credit unions, and specialized credit financial companies. The specific items to be disclosed periodically and the method of disclosure were also brought into uniformity.

D. Modification of Banks' Trust Account and Securities Investment Trust Systems

The government lengthened the minimum maturities of banks' trust account products. It also prohibited their further sale of products guaranteeing payment of principal plus profit. This move was undertaken to correct the abuse whereby bank's trust account products, earnings on which should be performance-based, had come to be operated in a similar fashion to the fixed-interest products. In addition, a market price valuation system was introduced in accounting for debt securities held by a bank's trust account or investment trust companies.

First, the minimum maturity of the newly-introduced reserve trusts was increased from one year to eighteen months, and no further subscriptions were allowed for development trusts. Also, market-value accounting treatment was required for all debt securities brought into the portfolios of funds set up by banks' trust accounts and investment trust companies on or after November 15, 1998. Market-value accounting treatment must be used after July 1, 2000 for all debt securities contained in the portfolios of these financial institutions' previously-existing funds. Moreover, from January 1, 1999, they may not acquire bonds that do not carry a credit rating by an approved credit rating agency(apart from government bonds and Monetary Stabilization Bonds).

In addition, the system of shadow voting for the shares held by banks' trust accounts and investment trust companies was abolished, helping to invigorate corporate governance by promoting the active exercise of their voting rights by these institutional investors.

E. Imposition of Single-Issuer Ceilings on Financial Institutions' Holdings of CP and Bonds

Ceilings were imposed on financial institutions' holdings of CP and bonds issued by any single enterprise or any single interlinked business group in order to correct the concentration, particularly since late 1997, of their holdings in CP and bonds issued by a few large enterprises; and thus to facilitate fund-raising by other enterprises.

In the case of CP, the ceiling on holding of CP issued by any single enterprise was

set for a bank's trust account or a investment trust company at 1 per cent of total trust assets, and that on its holdings of CP issued by any single interlinked business group at 5 per cent of total trust assets. The ceilings on banks(including their trust accounts), insurance companies and investment trust companies' holdings of corporate bonds issued by any single interlinked business group were set, respectively, at 10 per cent, 10 per cent and 15 per cent of their total corporate bond holdings as at the end of the previous month.

In addition, the government allowed securities companies and merchant banking corporations to underwrite issues of short-term corporate bonds having a maturity of less than twelve months.

IV. Operation and Organization

1. Banking

(1) Loans and Deposits

During the year, loans and discounts extended by the Bank of Korea to financial institutions continued to increase, bringing them up to 14,303.5 billion won as of the end of the year. The increase of 1,116.7 billion won was, however, smaller than the 6,078.4 billion won of the preceding year.

By type of loans and discounts, those classified as aggregate ceiling credits increased by 2,095.2 billion won during the year. This reflected the lifting of the aggregate credit ceiling by 1,000.0 billion won in March, and its subsequent raising in September by another 2,000.0 billion won. These actions were taken to encourage commercial banks to expand lending to small and medium enterprises and producers of export goods, who had experienced severe borrowing constraints after the outbreak of the currency crisis.

Loans for the stabilization of the financial markets, which were extended to financial institutions that had had management problems since the preceeding December due to the withdrawal of deposits and the call market crunch, increased by 308.1 billion won during the year. But the outstanding total of the special loans which had been extended to Korea First Bank and to sixteen merchant banking corporations during September and October 1997, decreased to 1,000.0 billion won as of the end of the year, led downward by the redemption at maturity of a total of 1,000.0 billion won by merchant banking corporations during October.

Meanwhile, general loans decreased by 254.3 billion won, largely reflecting their continuing collection, because new lending has been suspended since March 1994 for purposes such as loans for firms' technology development, equipment loans for pollution prevention, and equipment loans for firms' producing export goods. Loans for agriculture, fishery and livestock were collected in full as they were to be abolished by the end of the year under review. Those for the procurement of fertilizer maintained the same outstanding balance as at the previous year-end while other loans, including especially those against the collateral of export bills of exchange, expanded by 83.3 billion won.

[Table 12] Loans and Discounts[1] of the Bank of Korea

Unit: billion won

	Outstanding		Change during	
	1997	1998	1997	1998
Aggregate ceiling credits	4,266.4	6,361.6	-1,406.3	2,095.2
Loans for the stabilization of the financial markets	5,938.9	6,247.0	5,938.9	308.1
Special loans	2,000.0	1,000.0	2,000.0	-1,000.0
General loans	496.0	241.7	-382.5	-254.3
Loans for agriculture, fishery and livestock	115.5	-	-71.7	-115.5
Loans for the procurement of fertilizer	370.0	370.0	-	-
Other Loans[2]	-	83.3	-	83.3
Total	**13,186.8**	**14,303.5**	**6,078.4**	**1,116.7**

Notes: 1) Excludes loans to government 2) Loans secured against export bills of exchange.

In January, the Bank of Korea purchased Deposit Insurance Fund Bonds to the value of 6,500.0 billion won, so as to enable the Deposit Insurance Corporation to refund the deposits of fourteen merchant banking corporations that had been closed down and to recapitalize Korea First Bank and Seoul Bank in the course of financial institution restructuring. Net Deposit Insurance Fund Bonds purchased, however, totaled 6,270.0 billion won as of year-end as a result of the redemption of bonds to the value of 230.0 billion won during December.

Total deposits with the Bank continued to expand more rapidly, bringing them up by 15,657.7 billion won over the course of the year, as compared to the

preceding year's increase of 11,147.1 billion won. Total deposits stood at 37,867.8 billion won as of the end of the year. Their increase was largely attributable to an expansion of non-residents' deposits by 8,819.4 billion won in accordance with the receipt of emergency funds from the IMF, and an increase in the deposits of the Foreign Exchange Stabilization Fund by 6,355.1 billion won following its successful issue of Foreign Exchange Stabilization Fund Bonds.

[Table 13] Deposits with the Bank of Korea

Unit: billion won

	Outstanding		Change during	
	1997	1998	1997	1998
Won Deposits	18,759.9	27,615.9	10,806.5	8,856.0
Reserve deposits by deposit money banks	4,530.6	4,379.3	-3,284.5	-151.3
Private deposits[1]	288.8	476.7	202.3	187.9
Deposits by non-residents[2]	13,940.5	22,759.9	13,888.7	8,819.4
Foreign currency deposits	3,450.2	10,251.9	340.6	6,801.7
Reserve deposits by deposit money banks	538.5	985.1	490.4	446.6
Deposits by Foreign Exchange Stabilization Fund	2,911.7	9,266.8	-149.8	6,355.1
Total	**22,210.1**	**37,867.8**	**11,147.1**	**15,657.7**

Notes: 1) Includes reserve deposits by the Korea Development Bank.
2) Include won deposits by foreign institutions including the IMF.

(2) Issuance of Banknotes and Coin

During the year, a total of 25,965.7 billion won in banknotes and coin was issued and 27,817.7 billion won withdrawn, resulting in a net withdrawal of 1,852.0 billion won. This brought the year-end outstanding balance of banknotes and coin in circulation to 15,934.1 billion won.

The decline largely responded to the decrease of private money demand due to the economic contraction. Broken down by denomination, the share of the 10,000 won denomination in total banknotes in circulation decreased compared with that at the previous year-end.

[Table 14] Banknotes and Coin Issued by Denomination

Unit: billion won, %

	1997	1998			Change
	Outstanding(A)	Issued	Withdrawn	Outstanding(B)	(B-A)
Banknotes	16,839.9 (94.7)	25,925.1	27,709.7	15,055.3 (94.5)	-1,784.6
10,000 won	15,626.5 (87.9)	24,719.5	26,483.4	13,862.6 (87.0)	-1,763.9
5,000 won	482.2 (2.7)	503.2	510.0	475.4 (3.0)	-6.8
1,000 won or less	731.2 (4.1)	702.4	716.3	717.3 (4.5)	-13.9
Coin	946.2 (5.3)	40.6	108.0	878.8 (5.5)	-67.4
Total	**17,786.1 (100.0)**	**25,965.7**	**27,817.7**	**15,934.1 (100.0)**	**-1,852.0**

Note: Figures in parentheses are percentage shares in total banknotes and coin in circulation.

Meanwhile, on August 14, the Bank of Korea issued one hundred thousand memorial coins of the 10,000 won denomination to commemorate the 50th anniversary of the Republic of Korea. During February and March, the Bank bought 3,042kg of gold from financial institutions which had been collected in the 'Gold Collection Campaign' to help overcome the currency crisis.

(3) Treasury Transactions

Treasury funds received during the year came to 567.3 trillion won and those disbursed reached 566.8 trillion won, resulting in net receipts of 505.2 billion won. This increased the year-end figure of government deposits from the 5,409.7 billion

[Table 15] Loans to Government

Unit: billion won

	1997	1998		1998
	Outstanding	Issued	Withdrawn	Outstanding
The Special Account for Grain Management	0.0	510.0	80.0	430.0
The Special Account for Procurement	0.0	100.0	100.0	0.0
The Bounty Fund on Workmen's Property Formation Deposits	419.0	259.5	259.5	419.0
Total	**419.0**	**869.5**	**439.5**	**849.0**

won of the previous year to 5,914.9 billion won.

As for loans to government, during the year, the Bank of Korea loaned 869.5 billion won to the Special Account for Grain Management and the Special Account for Procurement, and withdrew 439.5 billion won from the government. The net total of loans to government thus increased by 430.0 billion won to 849.0 billion won as of the end of the year.

Also the Bank of Korea set the overall ceilings on its loans to government in 1999 at 6,732.4 billion won. This represented an increase of 3,139.0 billion won compared to that set for the year under review and consisted of a ceiling of 6,697.4 billion won on Temporary Loans and one of 35.0 billion won on Long-term Loans

[Table 16] Ceilings of Loans to Government

Unit: billion won

	1997	1998(A)	1999(B)	Change(B-A)
Ceiling on Temporary Loans	2,113.4	3,293.4	6,697.4	3,404.0
Ceiling on Long-term Loans	19.5	300.0	35.0	-265.0
Total	**2,132.9**	**3,593.4**	**6,732.4**	**3,139.0**

to the Bounty Fund on Workmen's Property Formation Deposits.

The Treasury agencies of the Bank and its Treasury collection agencies decreased by 953 during the year, lowering their combined total to 8,146 as at the end of the year. This was attributable to the exit of five banks including Donghwa Bank and the sharp reduction of branch networks as one part of banks' structural adjustment. By type of agency, Treasury agencies increased by 30 and Treasury collection offices by 1, while the total number of Treasury collection agencies decreased by 984.

(4) Securities Operations

During the year, Monetary Stabilization Bonds(MSBs) to the value of 364,304.2 billion won were issued while MSBs to the value of 342,101.9 billion won were redeemed. As a result, MSBs outstanding totaled 45,673.3 billion won as of year-end, an increase of 22,202.4 billion won over the previous year-end. This large expansion reflected the need to absorb the excess liquidity generated by the Bank's

extension of loans for the stabilization of the financial markets and its absorption of Deposit Insurance Fund Bonds to support financial institution restructuring.

By method of issuance, the Bank of Korea issued MSBs to the value of 3,920.2 billion won by private placement in order to siphon off directly from the related institutions the excess liquidity which was generated by its purchase of Non-performing Loans Resolution Fund Bonds in November 1997 and of Deposit Insurance Fund Bonds. And the Bank also issued MSBs to a value of 360,384.0 billion won by public offerings, of which those issued by competitive bidding amounted to 345,216.5 billion won and those issued by non-competitive sale to

[Table 17] Issuance and Redemption of Monetary Stabilization Bonds(MSBs)

Unit: billion won

	1997	1998			Change
	Outstanding(A)	Issued	Withdrawn	Outstanding(B)	(B-A)
Public offerings	23,131.7	360,384.0	337,842.5	45,673.2	22,541.5
Non-competitive sale	9,643.1	15,167.5	13,683.6	11,127.0	1,483.9
Competitive bidding	13,488.6	345,216.5	324,158.9	34,546.2	21,057.6
Private placements	339.2	3,920.2	4,259.4	-	-339.2
Total	**23,470.9**	**364,304.2**	**342,101.9**	**45,673.3**	**22,202.4**

15,167.5 billion won.

The value of government bills and bonds issued via the Bank during the year amounted to 12,468.2 billion won, while 319.1 billion won worth was redeemed. This brought the year-end's outstanding balance to 22,697.5 billion won, an increase of 12,149.1 billion won over the figure at the preceding year-end. Among government bills and bonds issued, Treasury Bonds(former Government Bond Management Fund Bonds), which were issued to raise public finance to be used for measures to deal with unemployment and floods, made up a major portion. The year-end's outstanding balance of Foreign Exchange Stabilization Fund Bonds and Public Land Compensation Bonds decreased by 300.0 billion won and 13.9 billion won respectively.

[Table 18] **Issuance and Redemption of Government Bills and Bonds via the Bank of Korea**

Unit: billion won

	1997	1998			Change
	Outstanding(A)	Issued	Withdrawn	Outstanding(B)	(B-A)
Treasury Bonds	6,320.2	12,463.0	-	18,783.2	12,463.0
Foreign Exchange Stabilization Fund Bonds	4,200.0	5.0[1]	305.0	3,900.0	-300.0
Public Land Compensation Bonds	28.2	0.2	14.1	14.3	-13.9
Total	**10,548.4**	**12,468.2**	**319.1**	**22,697.5**	**12,149.1**

Note: 1) Excludes foreign currency denominated Foreign Exchange Stabilization Fund Bonds to the value of 5,752.9 billion won.

(5) Government Funds Management

During the year, the Government Bond Management Fund raised 12,463.0 billion won by way of the issuance of bonds. Its placements took the form of deposits; specifically with the General Account(9,698.9 billion won), the National Housing Fund(1,599.8 billion won), the Special Account for Structural Improvement of Agriculture and Fisheries(599.8 billion won), and other such special accounts. The year-end balance of the Fund as of the end of the year stood at 19,637.3 billion won, an increase of 12,815.2 billion won over the previous year-end.

The Foreign Exchange Stabilization Fund raised 10,175.9 billion won, consisting of 5,757.9 billion won from the flotation of debentures, 765.6 billion won by way of the receipt of interest, and 3,127.3 billion won from its withdrawal of foreign currency deposits with other financial institutions. Among the uses of the Fund, 8,074.1 billion won was operated in the form of foreign currency deposits, 1,207.8 billion won as foreign currency call loans, 218.8 billion won as deposits and domestic currency short-term loans, and 675.2 billion won for the redemption of principal and interest on its bonds. It recorded a net loss of 1,058.2 billion won for the year, largely incurred through the negative margin that opened up between the cost of its funds through the issue of debentures and the interest earned on their operation and also through valuation losses(820.2 billion won) on its foreign

currency assets as a result of the large appreciation of the Korean won during the year under review. The year-end balance of the Fund as of the end of the year stood at 10,717.3 billion won, an increase of 4,754.3 billion won over the previous year-end.

The National Investment Fund, new lending by which was suspended from 1992, raised 90.1 billion won mainly through the redemption at maturity of loans of 85.4 billion won. Concerning its operations, the bulk of the funds raised was devoted to the repayment of deposits, which accounted for 88.3 billion won. Its year-end balance decreased from the 155.3 billion won of the previous year to 86.4 billion won.

The Bounty Fund on Workmen's Property Formation Deposits raised 309.9 billion won during the year, of which 259.5 billion won represented borrowings from the Bank, 28.5 billion won took the form of a contribution from the Bank, and 5.2 billion won consisted of contributions from depositors themselves. As for the Fund's uses, 279.6 billion won was paid in redemption of borrowings from the Bank and 21.3 billion won as legal subsidies to depositors. In consequence, the Fund suffered a net loss of 20.2 billion won for the period.

The Bounty Fund on Farmers' and Fishermen's Property Formation Deposits raised 131.4 billion won, consisting principally of contributions of 52.1 billion won from the government and of 51.9 billion won from the Bank. In the utilization of the Fund, 99.6 billion won was paid in the form of legal subsidies to depositors, and 21.2 billion won was used in the purchase of Monetary Stabilization Bonds. The Bounty Fund recorded a net profit of 2.4 billion won for the year.

(6) Supervision of Banking Institutions

The banking supervision activities of the Bank of Korea are restricted following the revision of the Bank of Korea Act, to requests for the filing of reports by financial institutions or to the Financial Supervisory Service for the examination or joint examination of a financial institution. Consequently, during the year under review, the Bank concentrated its supervisory activities on securing the effectiveness of monetary policy and forming a firm foundation for its effectiveness as the lender of last resort.

As a major step in meeting these objectives, following consultations with the

Financial Supervisory Service, the Bank of Korea defined the scope of materials and information which may be pooled with it. This was done to alleviate the reporting burden on financial institutions and to heighten the efficiency of the Bank and the Service' s conduct of their business. And in order to carry out effectively these duties confined to the Bank of Korea, it pursued the development of the analytical techniques needed to grasp and analyze bank' s business conditions. Drawing on these intensification of its efforts to ascertain accurately the status of financial institutions business the bank analyzed the accounts of commercial banks for the first half of 1998 and forecasted their business operating results for the fiscal year.

2. Foreign Exchange and International Finance Business

(1) FX Management Business

On May 1, the Bank of Korea acted to ease small and medium enterprises' difficulties in arranging trade-finance. It made available to FX banks foreign currency loans of up to 0.3 billion U.S. dollars against the collateral of export bills that they had purchased from such enterprises. Bills eligible as collateral for foreign currency loans were restricted to those usance and document acceptance export bills with a face value of at least 20 thousand U.S. dollars issued by small and medium enterprises. So as to reflect market interest rates, interest rates on these loans were set in consideration of leading international interest rates and banks' exchange commissions. On August 1, the range of banks eligible for these foreign currency loans was expanded to include all domestic FX banks except Korea Development Bank, Export-Import Bank of Korea, Peace Bank of Korea, and the Chungbuk Bank.

On August 1, the Bank of Korea greatly eased restrictions on the provision of foreign currency loans, seeking to bring them into line with the liberalization of enterprises' medium- and long-term foreign borrowings and short-term trade credits following the entry into force on July 1 of the Foreign Exchange Management Regulation. The scope of eligibility for foreign currency loans, which had previously been restricted to funds for the import of production facilities and equipment, was expanded to include all other foreign-currency funds to meet

external settlements related to corporate production activities such as the import of products and payments for services. The loanable ratio, which had previously ranged from 70 per cent to 100 per cent of the required amount, could, it was announced, now be set at the discretion of the FX bank for up to the amount required regardless of the purpose of the loan and the size of the enterprise. But, in order to strengthen the prudential regulation of FX banks, the mandatory ratio of their medium- and long-term foreign currency resources to their medium- and long-term foreign currency loans would be raised from 50 per cent to 100 per cent, with effect from July 1, 1999.

And, on August 10, the Bank of Korea earmarked 2 billion U.S. dollars as fund for the import of raw materials to make it possible for export-enterprises to acquire raw materials stably. Of this, 50 per cent, or 1 billion U.S. dollars, was allocated to small and medium enterprises to ease their difficulties in purchasing raw materials.

Meanwhile, on August 1, in connection with the liberalization of FX and capital account transactions to be undertaken in April 1999, the Bank of Korea launched the development of a FX network jointly with the government. It set up a Forex Network Development Group to manage FX information effectively and strengthen the ex-post facto control over transactions. In addition, to improve the availability and credibility of the external debt statistics as a key indicator for FX policy, the Bank laid down appropriate guidelines for compiling external debt statistics and improved their precision through inclusion of statistics derived from a survey of private sector external debt.

(2) International Finance Business

The official FX reserves as of year-end 1998 amounted to 52.04 billion U.S. dollars, representing an increase of 31.64 billion U.S. dollars over the previous year-end. The reasons for this expansion of the reserves were as follows: with the maintenance of a current account surplus throughout the year, inflowed funds for foreign portfolio investment and proceeds from the sale of assets in the course of restructuring made it possible for financial institutions to repay the emergency funding provided by the Bank of Korea during the currency crisis; in addition funds received from international financial institutions such as the IMF helped to increase the reserves.

By type, deposits and securities represented the largest components of the reserves, amounting to 51.96 billion U.S. dollars as of year-end 1998, an increase of 32.25 billion U.S. dollars over the previous year-end. But, the reserve position in the IMF, which is the sum of convertible currency payments of the IMF quota and Korean won payments used as reserve facility to the IMF, had been totally drawn down to enhance the liquidity of the reserves.

Meanwhile, usable FX reserves, i.e. FX reserves less the BOK's deposits with overseas branches and subsidiaries of Korean banks, amounted to 48.51 billion U.S. dollars as of year-end 1998, registering an increase of 39.64 billion U.S. dollars over their level at the previous year-end.

[Table 19] Changes in Foreign Exchange Reserves

Unit: U.S.$ million

	Year-end 1997	Year-end 1998	Change
Foreign Exchange Reserves(A)	20,405.5	52,040.8	31,635.3
Gold	36.9	66.3	29.4
S D R	58.9	11.4	-47.5
Reserve Position in IMF	599.3	0	-599.3
Foreign Exchange	19,710.4	51,963.1	32,252.7
(Deposits with Korean banks, B)	(11,531.9)[1]	(3,527.6)[1]	(-8,004.3)
Usable Foreign Exchange Reserves(A-B)	8,873.6	48,513.3	39,639.7

Note: 1) Including US$ 200 million in swaps with a foreign central bank.

During 1998 the Bank of Korea made payments in Korean won and convertible currencies equivalent to 44.02 million U.S. dollars to international financial institutions, and made withdrawals and repayments in accordance with the Stand-by Arrangement with the IMF.

The Bank contributed 0.37 billion Japanese yen(2.87 million U.S. dollars) to the European Bank for Reconstruction and Development(EBRD) as its first installment of the first general increase in capital stock. Of this, 40 percent was in the form of Japanese currency and 60 percent in Japanese-yen denominated subscription securities. Also, the Bank made payment of 3.56 billion Korean won(2.67 million

U.S. dollars) in the form of Korean-won denominated subscription securities to the African Development Fund(AfDF) as its third installment of the seventh replenishment, thereby fulfilling its contribution agreement with the AfDF. And the Bank contributed 8.81 billion Korean won(7.07 million U.S. dollars), in the form of Korean-won denominated subscription securities, to the International Development Association(IDA) as the second and final installment of its contribution to the eleventh replenishment. In addition, 4.71 billion Korean won(3.58 million U.S. dollars) was paid to the Asian Development Bank(ADB) as the fourth installment to its fourth general increase in capital stock. Of this, 15 per cent was in the form of Korean currency and 85 per cent in the form of Korean-won denominated subscription securities.

The Bank of Korea disbursed 0.51 million SDRs(0.69 million U.S. dollars) as the fifth and sixth installments of the additional amount of 8.30 million SDRs committed to the Enhanced Structural Adjustment Facility(ESAF) of the IMF. It also disbursed 21.24 billion Korean won(27.14 million U.S. dollars) as its first and second installments of the sixth replenishment to the Asia Development Fund(ADF) of the ADB, in the form of Korean-won denominated subscription securities.

Meanwhile, under the Stand-by Arrangement of 15.5 billion SDRs(21.0 billion U.S. dollars) concluded on December 3, 1997 with the IMF, in the course of the year, Korea drew down from the Supplemental Reserve Facility(SRF) an additional 5.85 billion SDRs(7.9 billion U.S. dollars) and repaid on schedule 2.05 billion SDRs(2.8 billion U.S. dollars) falling due.

Accordingly, the net withdrawal position with the above-mentioned credit facility amounted to 12.0 billion SDRs(16.2 billion U.S. dollars) as of year-end 1998.

3. Payments System Related Business

In order to improve the stability and efficiency of payments system, during the year, the Bank of Korea focused on guiding financial institutions to solve the "Year 2000 Problem(Y2K)", reducing the settlement risk which arose from the Bank of Korea Financial Wire Network(BOK-Wire) and the interbank financial network, and introducing reforms to improve customer convenience.

Its priority being to ensure that Y2K preparations are fully complete before the end of 1999, the Bank of Korea guided all individual financial institutions to conduct external point-to-point tests through the financial information networks on the basis of the "Guidelines to Financial Institutions' Year 2000 Problem", set out in October 1997. General tests, in which all participants of financial information networks participate at the same time, are also scheduled to be held in 1999. In addition, the Bank encouraged financial institutions to take into account major borrowers' Y2K preparedness in their creditworthiness tests by suggesting a manual for the recognition of borrowers' Y2K compliance and methods for evaluation. Financial institutions have also been consistently encouraged to hire outside auditors or consultants to verify their Y2K compliance status.

Moreover, the Bank guided the Korea Financial Telecommunications & Clearings Institute(KFTC) and financial institutions to prepare their own Y2K contingency plan and it conducted thorough spot checks on the readiness status of individual financial institutions. The Bank devoted a specific section of its internet homepage to Y2K to facilitate information-sharing with regard to the millenium problem.

The Bank of Korea sought to secure the safety and enhance the efficiency of BOK-Wire. In order to reduce settlement risks for securities transactions, it has developed a DVP(Delivery versus Payment)-based securities settlement system inter-connecting BOK-Wire and the computer center of the Korea Securities Depository through which securities transfers and fund settlement take place simultaneously. DVP settlement for corporate bonds is expected to begin operating as the first stage of implementation from the latter half of 1999. And following the changes in the bidding system for government bond from receiving written bids to screen-based offers, the Bank extended the functions of BOK-Wire to handle the complete procedure of bidding for government bonds from announcement of bidding to the reporting of the result. The Bank improved the shortcomings of BOK-Wire by clarifying the selling method of the collateralized securities, which had not been regulated before.

The number of BOK-Wire participants decreased from 158 as of the end of preceding year to 142 at the end of 1998 owing to the exit of several banks and merchant banking corporations in the process of financial sector restructuring. During the year, BOK-Wire handled on a daily average 48 trillion won, a leap of 49.0 per cent over the previous year, although transactions in volume terms were

down by 5.4 per cent. This rapid rise in throughput value was largely attributable to the expansion of interbank call transactions led by frequent portfolio adjustments among financial institutions.

[Table 20] Settlements Handled by BOK-Wire[1)]

Unit :number, billion won, %

	1997(A)	1998(B)	Change(B-A)	% change
<Volume>				
Domestic Currency Funds Transfers	4,289 (84.9)	4,100 (85.8)	-189	-4.4
Gross settlement	3,099 (61.3)	3,051 (63.8)	-48	-1.5
Net settlement	1,190 (23.6)	1,049 (21.9)	-141	-11.8
Treasury Funds	644 (12.8)	576 (12.0)	-68	-10.6
BOK Loans and Discounts	103 (2.0)	73 (1.5)	-30	-29.1
Government and Public Bonds	17 (0.3)	32 (0.7)	15	88.2
Total	**5,053 (100.0)**	**4,781 (100.0)**	**-272**	**-5.4**
Foreign Currency Funds Transfers	16 (-)	19 (-)	3	18.8
<Value>				
Domestic Currency Funds Transfers	30,921 (96.1)	44,135 (92.0)	13,214	42.7
Gross settlement	22,145 (68.8)	34,479 (71.9)	12,334	55.7
Net settlement	8,776 (27.3)	9,656 (20.1)	880	10.0
Treasury Funds	599 (1.9)	652 (1.4)	53	8.8
BOK Loans and Discounts	471 (1.4)	814 (1.7)	343	72.8
Government and Public Bonds	200 (0.6)	2,353 (4.9)	2,153	1,076.5
Total	**32,191 (100.0)**	**47,954 (100.0)**	**15,763**	**49.0**
Foreign Currency Funds Transfers (million US$)	305 (-)	309 (-)	4	1.3

Note : 1) Daily average. Figures in parentheses are percentage shares in total.

Moreover, the Bank of Korea drew up plans for the introduction of check truncation system in the course of 1999 in order to heighten the efficiency of interbank settlement systems. Check truncation refers to the use of electronic information systems, rather than the physical delivery of paper-based documents, for the processing of payment documents such as checks and giros received by banks, thereby allowing interbank clearing through the exchange of electronically transferred information. Also, it changed the Bank Giro System in provincial areas from paper-based giro transfer to electronic giro transfer, and brought the whole

country within the scope of the giro system by introducing on-line transfers to financial institutions situated on islands.

In a similar move, new services were introduced to the Interbank Shared Network during the year. ARS services were expanded from 17 areas to 21 areas, giro payments became possible by way of PCs, and the use of funds transfer services through CD/ATMs was extended to public holidays. In addition, the Bank has worked to prepare for the introduction of electronic money, i.e. IC cards, by acquiring government approval of the security for the pan-bank electronic money scheme. In 1999, a sample IC card will be produced and its public acceptability and safety will be tested through a pilot project to be implemented in a limited area.

4. Financial Status

(1) Assets

Total assets of the Bank, as of the end of the year under review, amounted to 127.9 trillion won, representing a rise of 15.4 trillion won over the previous year-end. This was mainly due to the large increase in its securities holdings.

Securities holdings during 1998 rose by 47.6 trillion won. This increase was led by foreign currency denominated securities(41.9 trillion won) following the substantial build-up of foreign exchange reserves and by public bonds(5.7 trillion won), especially Deposit Insurance Fund Bonds.

Due from banks, however, decreased by 34.2 trillion won. This is explained by the decrease of due from banks in dollars(18.8 billion U.S. dollars) after the repayment of emergency funds(23.3 billion U.S. dollars) provided to financial institutions during the currency crisis and the appreciation of the Korean won during the year under review.

Loans against bills increased by 1.1 trillion won. In detail, the Bank's aggregate credit ceiling loans to support SMEs and export enterprises increased by 2.1 trillion won following the lifting of the ceiling on them, but 1 trillion won provided as special loans to merchant banks in October 1997 was repaid in full.

(2) Liabilities and Capital

Total liabilities of the Bank, as of the end of 1998, amounted to 122.5 trillion won, representing a rise of 13.1 trillion won over the previous year-end. This was mainly caused by the large-scale issuance of Monetary Stabilization Bonds(22.2

[Table 21] Financial Status

Unit : billion won

	1997	1998	Change
Assets	112,420.2	127,865.4	15,445.2
Current assets	109,861.8	125,226.6	15,364.7
Cash	31.2	134.0	102.8
Gold and silver bullion	45.5	74.6	29.1
Holdings of SDRs	109.3	13.8	-95.5
Securities	14,026.5	61,616.3	47,589.8
Due from banks	78,154.8	43,989.3	-34,165.5
Bills discounted	9.7	0	-9.7
Loans against bills	13,177.1	14,303.5	1,126.4
Loans to government	419.0	849.0	430
Loans to international financial institutions	172.1	111.3	-60.8
Other current assets	3,716.6	3,418.8	-297.8
Fixed assets	2,558.3	2,638.8	80.5
Liabilities and Capital	112,420.2	127,865.4	15,445.2
Liabilities	109,347.2	122,484.5	13,137.2
Current liabilities	108,585.6	121,865.5	13,279.9
Currency issued	17,786.1	15,934.1	-1,852.0
Monetary Stabilization Bonds issued	23,470.9	45,673.3	22,202.4
Monetary Stabilization Account	5,409.7	5,914.9	505.2
Deposits	22,210.1	37,867.8	15,657.7
Allocation of SDRs	182.8	123.4	-59.4
Securities sold under repurchase agreements	6,148.0	3,500.0	-2,648.0
Other current liabilities	33,378.0	12,850.3	-20,527.7
(Exchange revaluations adjustment)	(32,360.5)	(11,883.6)	(-20,476.9)
Long-term liabilities	761.6	619.0	-142.6
Allowances	315.4	165.6	-149.8
Liabilities to international financial institutions	446.2	453.4	7.2
Capital	3,072.9	5,380.9	2,308.0
Legal reserve	274.5	457.0	182.5
Voluntary reserve	973.2	1,543.0	569.8
Undivided profit surplus	1,825.2	3,380.9	1,555.7
(Net profit for the period)	(1,825.2)	(1,661.9)	(-163.3)

trillion won) and the increase in deposits(15.7 trillion won) as a result of borrowings from the IMF.

The balance of the exchange revaluation adjustment account decreased by 20.5 trillion won due to the effects of the Korean won's appreciation over the year. Securities sold under repurchase agreements fell by 2.6 trillion won since Monetary Stabilization Bonds rather than RPs were used as the main tool of liquidity management during the year. In addition, currency issued decreased 1.9 trillion won reflecting the drop in money demand following the economic depression.

The Bank's capital increased to stand at 5,380.9 billion won at the end of the year. This rise resulted from the allocation of net profit for the previous period to legal reserves(1.1 trillion won) and voluntary reserves(569.8 billion won). An amount of 3,380.9 billion won was registered as the undivided profit surplus for the fiscal year under review, being the sum of a net profit for the period of 1,661.9 and a special profit surplus of 1,719 billion won caused by a change in accounting rules.

The Bank paid a sum of 1,305.7 billion won into the general revenue account of the government. This consisted of the Bank's undivided profit surplus for the period less the allocation to the legal reserve(338.1 billion won) and the allocation to the voluntary reserves(1.7 trillion won). Voluntary reserves are drawn on for contributions to various funds(75.2 billion won) and earmarked as provisions for future foreign exchange transactions losses and possible increase in monetary management expenses.

(3) Income and expenses

For the year under review, the net profit of the Bank decreased to 1.7 trillion won, slightly below the 1.8 trillion won of the previous year. The decrease was chiefly brought about by the increase in interest payment expenses. Large interest payment were made on Monetary Stabilization Bonds, securities sold under repurchase agreements and the emergency borrowings from the IMF, though interest received on deposits, securities and loans against bills also increased.

Total operating income increased by 5.3 trillion won to 11.4 trillion won during the year. By item, interest on deposits rose by 3.1 trillion won owing to the expansion of their balance (average balance 43 billion U.S. dollars → 50.4 billion U.S. dollars), the depreciation of the Korean won's average exchange value for the

year(951.1 → 1,398.9 won against the U.S. dollar) and the imposition of a penalty interest rate on foreign currency due from domestic banks(maximum LIBOR+15%). Besides these items, interest received on securities increased by 1.9 trillion won due to the expanded balance of public bonds and foreign securities holdings. And interest on loans against bills increased by 1.0 trillion won owing to the supply of funds for financial market stabilization(6.4 trillion won) which were provided in the aftermath of the currency crisis. The expansion of aggregate credit ceiling loans also

[Table 22] Income Statement

Unit : billion won

	1997	1998	Change
Operating income	6,093.6	11,408.9	5,315.3
Interest and discounts received	4,382.5	10,368.2	5,985.8
Interest on securities	1,080.6	2,992.3	1,911.7
Interest on deposits	2,694.0	5,817.7	3,123.7
Discounts on domestic bills	0.4	0.4	0
Interest on loans against bills	319.7	1,345.4	1,025.7
Interest on loans to government	19.6	20.2	0.6
Miscellaneous interest received	89.0	168.5	79.5
Other interest and discount received	179.2	23.7	155.5
Commissions received	3.5	3.5	0
Profit on sales of securities	306.0	82.7	-223.3
Profit on foreign exchange transactions	1,401.6	954.4	-447.2
Operating expenses	3,577.2	8,686.6	5,109.5
Interest and discount paid	3,033.8	8,224.0	5,190.3
Interest on deposits	145.4	483.0	337.6
Interest on Monetary Stabilization Bonds	2,725.4	4,841.2	2,115.8
Interest on Securities sold under repurchase agreements	81.2	1,475.2	1394.0
Miscellaneous interest paid	81.7	1,409.8	1,328.0
Commissions paid	87.3	83.8	-3.5
Banknotes and coin production expenses	115.5	71.6	-43.9
Provision for reserves	65.2	96.6	31.5
Administrative and operating expenses	190.6	162.6	-28.0
Bank supervision and examination expenses	38.3	12.1	-26.2
Net operating income	2,516.5	2,722.3	205.8
Net non-operating profit[1)]	24.1	47.5	23.4
Net non-operating expenses[2)]	0.8	368.2	367.4
Net profit before taxes	2,539.8	2,401.6	-138.2
Taxes	714.6	739.7	25.1
Net profit for the period	1,825.2	1,661.9	-163.3

Notes : 1) Includes extraordinary gains
2) Includes extraordinary losses

contributed to the increase of interest received on loans against bills.

Total operating expenses amounted to 8.7 trillion won, a rise of 5.1 trillion won over the previous year. By item, interest on Monetary Stabilization Bonds(MSBs) increased by 2.1 trillion won following the Bank' s increased issuance of MSBs. And interest payments on securities sold under repurchase agreements rose by 1.4 trillion won due to the expansion of their average balance(0.9 trillion won → 8.5 trillion won). In addition, miscellaneous interest paid was increased by 1.3 trillion won because of the interest payments on the emergency funds from the IMF. Banknotes and coin production expenses, however, decreased 43.9 billion won owing to small scale of their production. Administrative and operating expenses decreased by 28.0 billion won due to staff reductions while bank supervision and examination expenses dropped by 26.2 billion won following the separation from the Bank of the Office of Bank Supervision.

5. Organizational Changes

On April 1, 1998, the revised Bank of Korea Act came into effect, necessitating thoroughgoing changes in its organization and operations.

Most significantly, the Office of Bank Supervision of the Bank of Korea was separated from the Bank and merged, along with other financial supervisory bodies, into the Financial Supervisory Service(FSS). The Monetary Board, the policy-making body of the Bank, was renamed to the Monetary Policy Committee and its composition was changed completely. The Governor of the Bank now serves concurrently as the Chairman of the Monetary Policy Committee, whereas the Minister of Finance and Economy previously presided over meetings of the Monetary Board. The membership of the policy-making body was reduced from nine to seven and all members of the Committee serve on a full-time basis. In April, they were designated upon the revision of the body. As the status and functions of the Monetary Policy Committee were heightened by the revision of the Bank of Korea Act, it was arranged that the Committee should hold special deliberation sessions. In addition, monetary policy operating procedures were also changed substantially with monthly and quarterly directions for monetary policy being set at regular meetings of the Committee.

In September, in conformity with the provisions of the revised Bank of Korea Act, the Bank set an inflation target for 1998 and drew up and put in place an operational plan for monetary and credit policies including this inflation target. In October, it submitted a report on the implementation of its monetary and credit policies to the National Assembly for the first time. In addition, as the revised Bank of Korea Act requires that the budget for operating expenses other than those related to monetary and credit policies be ex-ante approved by the Minister of Finance and Economy, the Bank duly filed its budget proposal on operating expenses for fiscal year 1999 in October.

Moreover, in April, new executive officers, including the Governor, the Deputy Governor and Assistant Governors, and the Auditor were appointed. The Articles of Incorporation of the Bank of Korea, which set out basic matters concerning its operations and organization, were completely revised.

The Bank carried out a department-level reorganization on May 14, in a move designed largely to trim down its organization and to enhance the efficiency of operations, reflecting the changing nature of its functions. Nine departments in the Office of Bank Supervision and ten regional bank supervisory offices were closed upon the separation of the Office. In addition, the Bank reduced or closed two departments, one research institute, twelve offices, and fifteen divisions in the Headquarters, together with eighteen divisions in domestic branches and one overseas representative office. As of the end of the year, the Bank' s organization comprised eleven departments and two offices at the Headquarters. It also had sixteen domestic branches and seven overseas representative offices.

As the Bank reduced its manpower needs greatly with slimming down of its organization, the number of employees was reduced from 2,894(excluding the Office of Bank Supervision) as of the end of 1997 to 2,157 as of the end of 1998, a decrease of 25.5 per cent.

Research Department, Statistics Department, and the Institute for Monetary & Economic Research were amalgamated to form a newly-established Research Department. Archives & Secretariat Department and Public Information Department were merged into Planning & Coordination Department, and Treasury Department into Payment Systems Department. Meanwhile, the previous Monetary Policy Department was split into Monetary Policy Department and Financial Market Department in order to strengthen the formulation and implementation of

monetary policy. Additionally, a new department, Banking Department, was established to survey financial institutions' management status and to conduct the joint examination of banking institutions provided for in the revised Bank of Korea Act.

In the branch network, nine Cash & Check Processing Divisions, specifically those in Pusan, Taegu, Kwangju, Chonju, Taejon, Inch'on, Suwon, Ch'angwon and Kangnam Branches, were merged into those branches' Business Divisions, while four divisional-level organizations in Mokp'o, P'ohang, Kangnung and Ulsan Branches were dissolved. Moreover, four domestic representative offices, those in Andong, Hongsung, Ch'onan, and Uijongbu, were downgraded to the status of detached offices.

It was determined that the representative offices in Paris, Brussels, and Singapore should be closed. As the first stage, Paris Representative Office was closed on December 31.

Meanwhile, an Organization Reform Team, reporting directly to the Governor, was established in September in order to study measures for improving the flexibility and degree of expertise of the organization through specialization among staff members, simplification of decision-making, and appropriateness in job placements.

Members of the Monetary Policy Committee

December 31, 1998

Chol-Hwan Chon	(Governor of the Bank of Korea)
Sang-Kyung Kwak	(Recommended by the President of Korea Chamber of Commerce and Industry)
Si-Dam Kim	(Recommended by the Governor of the Bank of Korea)
Yong-Sup Kim	(Recommended by the Minister of Finance and Economy)
Hangmo Muhn	(Recommended by the Chairman of the Financial Supervisory Commission)
Jong-Yong Yoon	(Recommended by the Chairman of Korea Securities Dealers Association)
Seung-Woo Chang	(Recommended by the Chairman of Korea Federation of Banks)

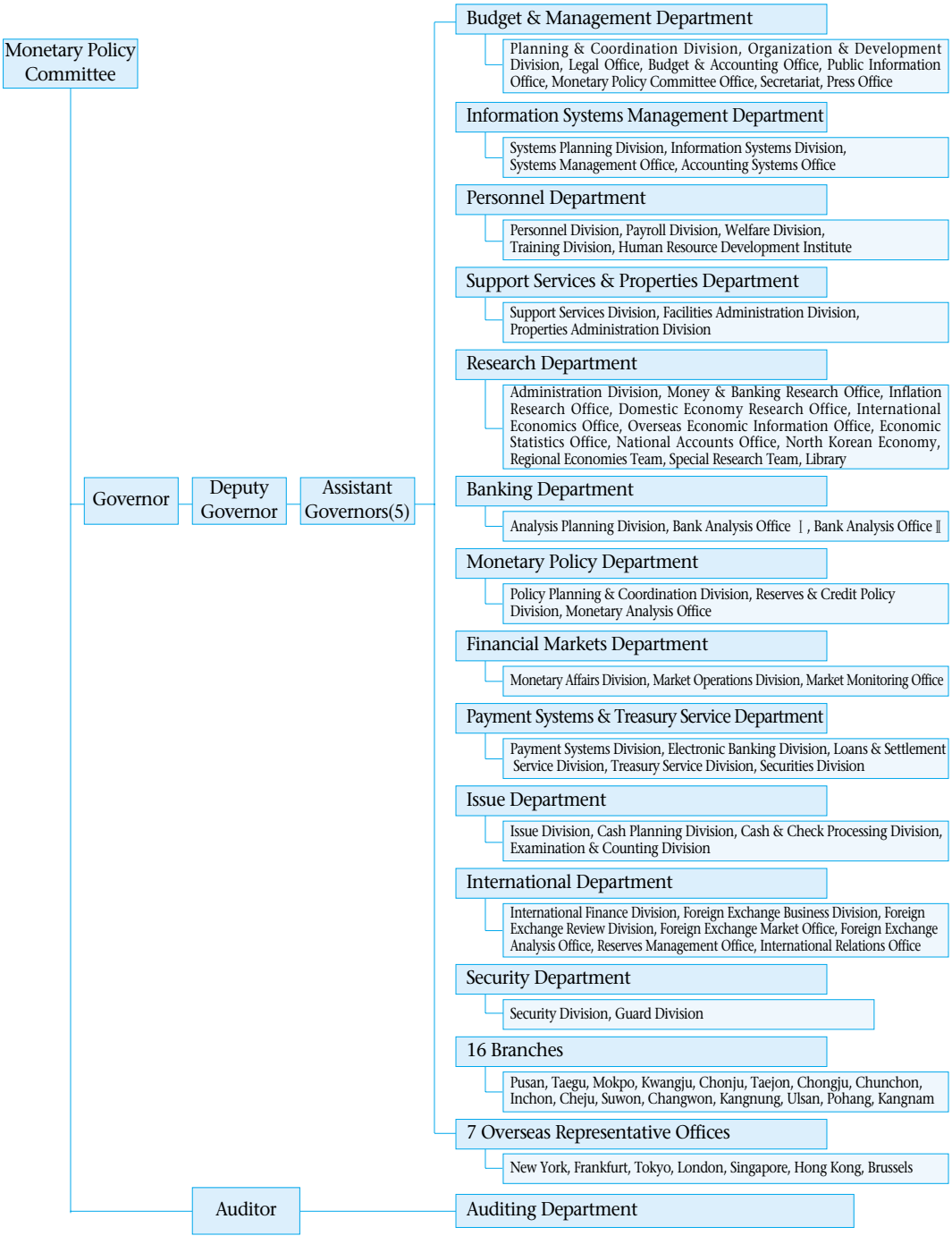
Executives of the Bank of Korea

December 31, 1998

Title	Name
Governor	**Chol-Hwan Chon**
Deputy Governor	**Hoon Shim**
Assistant Governor	**Park, Jae-Joon**
Assistant Governor	**Lee, Kang-Nam**
Assistant Governor	**Park, Cheul**
Assistant Governor	**Yoon, Kwi-Sup**
Auditor	**Yung-Joo Kang**

The Organization of the Bank of Korea

December 31, 1998



Main Economic Indicators

Main Economic Indicators

	Unit	1994	1995	1996	1997	1998	1998. 1
Money[1]							
Reserve money							
<Period-Averages>	billion won	21,456	24,323	24,832	21,116	19,593	22,135
	%	(16.2)	(13.4)	(2.1)	(-15.0)	(-7.2)	(-4.5)
<End of period>	billion won	25,204	29,305	25,722	22,519	20,703	23,756
	%	(9.2)	(16.3)	(-12.2)	(-12.5)	(-8.1)	(4.4)
M2							
<Period-Averages>	billion won	118,603	136,951	159,191	189,820	225,829	205,195
	%	(15.6)	(15.5)	(16.2)	(19.2)	(19.0)	(16.1)
<End of period>	billion won	133,179	153,945	178,312	203,532	258,538	204,426
	%	(18.7)	(15.6)	(15.8)	(14.1)	(27.0)	(15.4)
MCT							
<Period-Averages>	billion won	208,475	253,449	308,356	355,571	382,413	379,769
	%	(23.5)	(21.6)	(21.7)	(15.3)	(7.5)	(12.6)
<End of period>	billion won	234,573	288,484	338,662	377,499	394,390	377,909
	%	(24.4)	(23.0)	(17.4)	(11.5)	(4.5)	(11.7)
M3							
<Period-Averages>	billion won	397,148	476,282	566,793	659,019	750,994	709,555
	%	(22.0)	(19.9)	(19.0)	(16.3)	(14.0)	(15.1)
<End of period>	billion won	442,663	527,017	614,962	700,285	787,627	715,851
	%	(24.7)	(19.1)	(16.7)	(13.9)	(12.5)	(15.5)
Interest rates							
Call market rate(overnight)	per cent per annum	12.3	12.4	12.4	13.2	15.0	25.3
Yields on corporate bonds (3-year)	〃	12.9	13.8	11.9	13.4	15.1	23.4
Time deposits [2] (1~less than 2 years)	〃	8.5-10.0	7.5-10.0	9.8	12.6	13.3	15.9
General loans [3] (less than 1 years)	〃	8.5-12.5	9.0-12.5	11.1	15.3	15.2	17.5
Ratio of dishonored checks [4]	%	0.16	0.17	0.14	0.40	0.38	0.53

Notes: 1) Figures in parentheses are rates of increase compared with the same period of the previous year.
2) Interest rates on time deposits of nation-wide commercial banks, and averages weighted by amount from July 1996.
3) Interest rates on loans for companies, and rates on loans with banking funds from July 1996.
4) Dishonored value basis, ratios that reflected electronic-based payments.

2	3	4	5	6	7	8	9	10	11	12
20,555 (-13.4)	19,515 (-4.7)	18,911 (-5.6)	18,702 (-8.4)	18,427 (-7.5)	18,457 (-7.3)	18,538 (-7.8)	19,174 (-13.2)	20,716 (-0.9)	19,777 (-5.7)	20,209 (-6.6)
19,890 (-7.8)	22,035 (7.7)	18,649 (-9.3)	17,962 (-9.4)	20,799 (0.3)	19,792 (-1.9)	18,179 (-10.3)	22,026 (-1.1)	20,260 (-2.8)	19,766 (-10.5)	20,703 (-8.1)
206,037 (13.8)	206,704 (13.7)	207,061 (13.1)	211,320 (14.8)	218,224 (18.1)	225,556 (20.0)	231,256 (20.8)	240,177 (21.0)`	248,778 (26.4)	253,074 (26.1)	256,567 (21.5)
209,266 (14.6)	204,162 (12.1)	207,584 (12.9)	217,214 (18.3)	218,342 (16.3)	228,838 (20.9)	236,139 (20.7)	246,498 (24.8)	250,268 (25.2)	254,777 (24.6)	258,538 (27.0)
377,450 (10.4)	375,575 (9.5)	375,232 (9.1)	376,575 (8.4)	379,691 (8.2)	382,956 (7.5)	384,138 (6.7)	386,507 (5.4)	388,365 (6.1)	390,739 (5.2)	391,962 (2.6)
378,287 (10.1)	372,989 (8.6)	375,126 (8.6)	380,833 (9.3)	379,326 (6.8)	383,203 (7.0)	386,420 (5.8)	389,493 (6.5)	389,071 (5.2)	391,252 (4.1)	394,390 (4.5)
718,668 (15.1)	722,667 (14.5)	729,688 (14.4)	735,269 (14.1)	742,631 (14.2)	754,954 (14.0)	765,121 (14.0)	772,190 (13.3)	778,627 (13.5)	787,254 (13.1)	793,581 (12.4)
722,722 (14.9)	725,497 (14.3)	739,106 (15.4)	744,417 (14.8)	743,938 (13.2)	763,115 (14.4)	771,299 (13.8)	771,571 (13.5)	783,243 (13.1)	789,649 (12.6)	787,627 (12.5)
23.4	22.5	21.3	18.6	16.3	12.7	9.5	8.5	7.3	7.3	7.0
19.8	18.9	18.1	17.9	16.6	13.7	12.4	12.5	10.0	9.6	8.3
16.4	17.1	17.2	16.5	15.1	12.3	10.8	10.3	9.7	9.2	9.1
17.1	17.2	17.1	17.1	16.6	15.4	14.9	14.2	12.9	11.8	11.1
0.62	0.47	0.42	0.45	0.42	0.50	0.41	0.31	0.20	0.20	0.12

	Unit	1994	1995	1996	1997	1998	1998. 1
GDP growth rate[5]	%	8.3	8.9	6.8	5.0	-5.8	-
Price indexes[7]							
Consumer price	〃	6.2	4.5	4.9	4.5	7.5	8.3
	〃	(5.6)	(4.7)	(4.9)	(6.6)	(4.0)	(2.4)
Producer price	〃	2.7	4.7	3.2	3.9	12.2	13.0
	〃	(4.0)	(3.6)	(3.7)	(9.6)	(3.6)	(4.3)
Unemployment							
Unemployment rate	〃	2.4	2.0	2.0	2.6	6.8	4.5
Number of persons unemployed	thousand persons	489	419	425	556	1,463	934
Wages in the manufacturing	thousand won	1,022	1,124	1,261	1,326	1,284	1,358
Industrial activity indexes[8]							
Production	%	11.1	12.0	8.6	5.2	-7.5	-9.6
Shipment	〃	12.0	12.7	8.8	6.8	-7.2	-5.2
Inventory	〃	4.4	8.8	18.8	8.8	-8.6	1.7
Average capacity utilization ratio	〃	81.3	81.0	80.8	79.0	68.1	69.8
Balance of payments							
Current account	billion U.S.$	-3.9	-8.5	-23.0	-8.2	40.0	3.1
Capital account	billion U.S.$	10.3	16.8	23.3	1.3	-4.0	-0.5
Foreign trade [9]							
Exports	billion U.S.$	96.0	125.1	129.7	136.2	132.3	9.0
	%	(16.8)	(30.3)	(3.7)	(5.0)	(-2.8)	(-0.4)
Imports	billion U.S.$	102.3	135.1	150.3	144.6	93.3	7.5
	%	(22.1)	(32.0)	(11.3)	(-3.8)	(-35.5)	(-40.2)
Foreign exchange							
Foreign exchange holdings[10]	billion U.S.$	25.7	32.7	33.2	20.4	52.0	23.5
Exchange rate of won	won	788.7	774.7	844.2	1,415.2	1,207.8	1,572.9
against U.S. dollar[11]	%	(2.5)	(1.8)	(-8.2)	(-40.3)	(17.2)	(-10.0)

5) Compared with the same period of the previous year.
6) Quarterly data.
7) Rate of increase compared with the same period of the previous year, figures in parentheses indicate rates of increase compared with the last month of the previous year.
8) Rate of increase compared with the same period of the previous year.

2	3	4	5	6	7	8	9	10	11	12
-	-3.6[6]	-	-	-7.2[6]	-	-	-7.1[6]	-	-	-7.1[6]
9.5	9.0	8.8	8.2	7.5	7.3	6.9	6.9	7.2	6.8	4.0
(1.7)	(-0.2)	(0.3)	(-0.5)	(-0.4)	(0.0)	(0.3)	(0.4)	(0.3)	(-0.3)	(-0.2)
15.3	15.1	14.9	13.5	13.3	12.8	11.8	11.4	11.7	11.0	3.6
(2.5)	(-0.2)	(0.1)	(-1.1)	(-0.1)	(-0.5)	(-0.7)	(0.0)	(0.1)	(-0.2)	(-0.6)
5.9	6.5	6.7	6.9	7.0	7.6	7.4	7.3	7.1	7.3	7.9
1,235	1,378	1,434	1,492	1,529	1,651	1,578	1,572	1,536	1,557	1,665
1,220	1,180	1,226	1,136	1,372	1,233	1,236	1,320	1,315	1,136	1,698
0.3	-9.5	-11.7	-11.3	-14.4	-14.3	-13.0	-1.8	-9.2	0.5	5.1
-0.2	-8.1	-10.4	-12.1	-13.6	-13.2	-14.6	-1.7	-9.1	-0.3	3.2
0.0	-4.7	-7.1	-8.3	-8.1	-8.8	-7.0	-11.0	-14.8	-16.8	-17.3
69.6	67.1	67.5	67.3	66.3	64.6	65.1	70.5	69.1	69.6	71.1
4.1	3.6	3.6	4.1	3.3	3.8	2.1	3.7	2.6	3.0	3.1
-0.3	-0.2	2.5	-0.4	-0.5	-0.5	-0.1	-2.3	-0.6	-0.9	-0.2
11.2	12.0	12.1	11.3	11.5	10.0	9.7	10.8	10.6	11.7	12.4
(19.9)	(6.0)	(5.8)	(-3.7)	(-7.1)	(15.1)	(-12.1)	(-5.2)	(-14.7)	(-1.4)	(-0.1)
7.9	8.3	8.2	7.6	7.8	7.1	7.1	7.3	7.7	8.3	8.7
(-31.3)	(-36.5)	(-35.9)	(-38.2)	(-37.0)	(-43.9)	(-38.1)	(-37.2)	(-39.3)	(-28.9)	(-15.3)
26.7	29.7	35.5	38.8	40.9	43.0	45.1	47.0	48.8	50.0	52.0
1,640.1	1,378.8	1,338.2	1,410.8	1,385.2	1,236.0	1,331.8	1,373.6	1,313.8	1,243.7	1,207.8
(-13.7)	(2.6)	(5.8)	(0.3)	(2.2)	(14.5)	(6.3)	(3.0)	(7.7)	(13.8)	(17.2)

9) On a custom-clearance basis, figures in parentheses are rates of increase compared with the same period of the previous year.
10) End of period.
11) End of period, figures in parentheses indicate appreciation(depreciation-) rates compared with the end of the previous year.

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