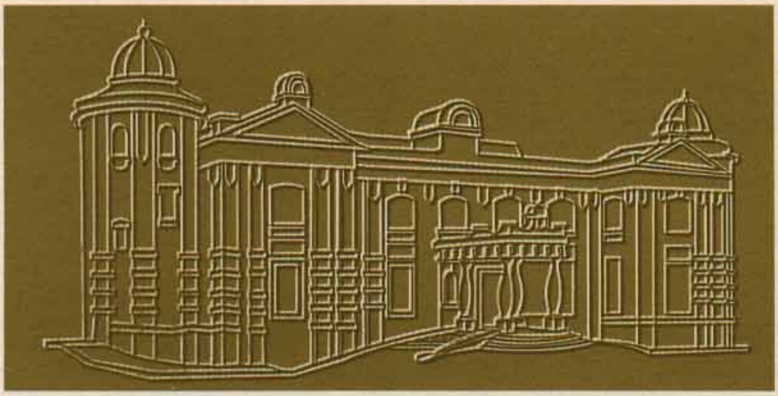
# ANNUAL REPORT
## 1997 48th



THE BANK OF KOREA

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# THE BANK OF KOREA

*March 1998*

In accordance with the provision of Article 43 of the Bank of Korea Act, and with the sanction of the Monetary Board, we herewith publish the 48th Annual Report of the Bank, analyzing economic and financial conditions in Korea during calendar year 1997 and outlining the condition of the Bank, its operations, its monetary and credit policies and the foreign exchange policies of the government during the same period.

CHOL HWAN CHON

Governor
The Bank of Korea

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# Ⅰ. General Economic Trends

In the course of 1997, foreign currency liquidity conditions worsened steadily. Toward the end of the year, the nation experienced a currency crisis in which it had no option but to turn to the IMF for stand-by funds.

From the beginning of the year, the financial and foreign exchange markets had been unsettled by a string of large corporate insolvencies. Early in the fourth quarter, Korea's sovereign rating was downgraded due to procrastination in dealing with the insolvent Kia group, the accumulation of bad loans by financial institutions, the knock-on effects of the Southeast Asian currency crisis, and so forth. As foreign investors repatriated their capital, the foreign exchange reserves shrank rapidly, bringing the nation to the brink of declaring a moratorium on its repayment of external debt.

Structural faults in the Korean economy lay at the root of these problems, including the fragility of firms' capital structures arising from expansion-oriented management strategies and inadequate loan screening on the part of financial institutions which failed to prevent excessive corporate borrowings. In this respect, structural reform of the economy emerged as a top policy priority.

During the year under review, the economic downturn continued from the previous year. GDP growth dropped back, and the pace of price rises accelerated, particularly under the impact of the gathering currency crisis. However, the current account deficit narrowed greatly in response to the contraction of domestic demand.

The growth rate of GDP, in real terms, declined to 5.5 per cent from the 7.1 per cent of the previous year.

Viewing growth rate trends by quarter, for the first three quarters of the year, GDP growth was sustained at around the 6 per cent level, helped by a large increase

[Table 1] **Key Economic Indicators in Korea[1]**

| | unit | 1993 | 1994 | 1995 | 1996 | 1997[10] | 1st half | 2nd half |
|---|---|---|---|---|---|---|---|---|
| Gross domestic product | rate of increase(%) | 5.8 | 8.6 | 8.9 | 7.1 | 5.5 | 6.2 | 4.9 |
| Agriculture, forestry & fishing | 〃 | -2.9 | 1.6 | 3.7 | 4.0 | 2.5 | 2.9 | 2.4 |
| Manufacturing | 〃 | 5.0 | 10.5 | 10.8 | 7.4 | 6.2 | 6.5 | 6.0 |
| Construction | 〃 | 8.4 | 4.7 | 8.6 | 6.6 | 2.8 | 1.0 | 4.2 |
| Services | 〃 | 7.6 | 10.8 | 10.1 | 7.9 | 6.5 | 7.9 | 5.1 |
| Gross national product | 〃 | 5.8 | 8.4 | 8.7 | 6.9 | 4.9 | 5.7 | 4.3 |
| Total consumption | 〃 | 5.3 | 7.0 | 7.2 | 6.9 | 3.5 | 4.7 | 2.4 |
| Fixed investment | 〃 | 5.2 | 11.8 | 11.7 | 7.1 | -3.5 | 0.3 | -6.8 |
| Construction | 〃 | 8.9 | 4.5 | 8.7 | 6.1 | 2.7 | 1.3 | 3.8 |
| Equipment | 〃 | -0.1 | 23.6 | 15.8 | 8.3 | -11.3 | -1.0 | -20.4 |
| Total exports(real) | 〃 | 11.3 | 16.5 | 24.0 | 13.0 | 23.6 | 20.4 | 26.5 |
| Total imports(real) | 〃 | 6.7 | 21.7 | 22.0 | 14.8 | 3.8 | 7.7 | 0.2 |
| Gross saving ratio[2] | % | 35.2 | 35.4 | 36.2 | 34.8 | 34.6 | - | - |
| Gross domestic investment ratio[2] | 〃 | 35.2 | 36.2 | 37.4 | 38.8 | 35.3 | - | - |
| Unemployment rate[3] | % | 2.8 | 2.4 | 2.0 | 2.0 | 2.6 | 2.6 | 2.6 |
| Consumer prices | rate of increase(%) | 5.8 | 5.6 | 4.7 | 4.9 | 6.6 | 2.4 | 4.0 |
| Producer prices | 〃 | 2.0 | 3.9 | 3.4 | 3.5 | 10.9 | 2.0 | 8.7 |
| Current account | billion U.S.$ | 1.0 | -3.9 | -8.5 | -23.0 | -8.6 | -9.9 | 1.3 |
| Goods & Services | 〃 | 0.2 | -4.7 | -7.4 | -21.1 | -6.8 | -8.5 | 1.7 |
| Goods | 〃 | 2.3 | -2.9 | -4.4 | -15.0 | -3.9 | -6.4 | 2.6 |
| Exports[4] | 〃 | 82.2 | 96.0 | 125.1 | 129.7 | 136.2 | 65.3 | 70.9 |
| | rate of increase(%) | (7.3) | (16.8) | (30.3) | (3.7) | (5.0) | (0.9) | (9.0) |
| Imports[4] | billion U.S.$ | 83.8 | 102.3 | 135.1 | 150.3 | 144.6 | 74.4 | 70.2 |
| | rate of increase(%) | (2.5) | (22.1) | (32.0) | (11.3) | (-3.8) | (2.3) | (-9.5) |
| Services | billion U.S.$ | -2.1 | -1.8 | -3.0 | -6.2 | -2.9 | -2.1 | -0.8 |
| Income | 〃 | -0.4 | -0.5 | -1.3 | -1.8 | -2.7 | -1.4 | -1.3 |
| Current transfers | 〃 | 1.2 | 1.3 | 0.2 | -0.0 | 0.9 | -0.0 | 0.9 |
| Exchange rate of won against U.S. dollar | end of period[5](₩) | 808.1 | 788.7 | 774.7 | 844.2 | 1,415.2 | 888.1 | 1,415.2 |
| | | (-2.4) | (2.5) | (1.8) | (-8.2) | (-40.3) | (-4.9) | (-37.2) |
| | period-average[6](₩) | 802.7 | 803.6 | 771.0 | 804.8 | 951.1 | 878.6 | 1,021.2 |
| | | (-2.7) | (-0.1) | (4.2) | (-4.2) | (-15.4) | (-10.7) | (-19.3) |
| $M_2$[7] | rate of increase(%) | 18.6 | 15.6 | 15.5 | 16.2 | 19.2 | 19.4 | 19.1 |
| | | (17.3) | (17.6) | (13.7) | (17.8) | (21.1) | (18.1) | (21.1) |
| MCT[7,8] | 〃 | 22.9 | 23.5 | 21.6 | 21.7 | 15.3 | 16.8 | 14.0 |
| | | (23.2) | (23.6) | (22.0) | (18.6) | (14.7) | (14.8) | (14.7) |
| $M_3$[7] | 〃 | 21.6 | 22.0 | 19.9 | 19.0 | 16.3 | 16.6 | 16.0 |
| | | (20.4) | (23.8) | (18.8) | (17.1) | (15.9) | (15.5) | (15.9) |
| Yield on corporate bonds[9] | period-average(%) | 12.6 | 12.9 | 13.8 | 11.9 | 13.4 | 12.2 | 14.5 |

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) Current price basis.
3) Figures of 1st and 2nd halves are seasonally-adjusted.
4) On a customs-clearance basis.
5) Figures in parentheses indicate appreciation(depreciation-) rates compared with the end of the previous period.
6) Figures in parentheses indicate appreciation(depreciation-) rates compared with the same period of the previous year.
7) Figures in parentheses indicate the average rates of increase in the last month of the period.
8) $M_2$+CDs+Money-in-trust.
9) Yields are for three-year corporate bonds guaranteed by a bank.
10) Figures for national accounts and balance of payments are preliminary.

in the volume of exports which offset the effects of depressed domestic demand. However, during the fourth quarter it dropped back to 3.9 per cent as domestic demand contracted more sharply in line with the outbreak of the currency crisis.

The unemployment rate rose to 2.6 per cent from the 2.0 percent of the previous year, reflecting lackluster production and downsizing by enterprises; most notably, in December it climbed above the 3 per cent level.

Prices maintained a generally stable pattern of movements throughout the year to November, but from early December they rose steeply as import prices soared following the massive depreciation of the won.

As a result, on a December-to-December basis, consumer price inflation rose from the 4.9 per cent of the previous year to 6.6 per cent, and producer price inflation from 3.5 per cent to 10.9 per cent.

Meanwhile, the current account deficit for the year under review narrowed from the 23.0 billion U.S. dollars of the previous year to 8.6 billion U.S. dollars. The ratio of the current account deficit to GDP consequently eased to 1.9 per cent as against the 4.7 per cent of the prior year.

Looking at current account movements by quarter, the first quarter's figures showed a large deficit due to the sluggish pace of exports during that period. From the second quarter onwards, however, the deficit narrowed owing to the dullness of imports. For the fourth quarter, the current account shifted into surplus.

In the year under review, financial and foreign exchange markets continued to show an unstable range of movements. They were thrown into turmoil toward the end of year by the outbreak of the currency crisis: the exchange-rate value of the Korean won plunged and interest rates rose sharply.

Market interest rates turned upward from the beginning of the year in response to a string of large corporate insolvencies. They shifted back to a more stable trend in the second quarter as the wave of corporate failures tailed off. However, a renewed upswing commenced in July, when Kia Motors became subject to the Bankruptcy Deferment Accord, an agreement reached among financial institutions to maintain support to distressed firms whose turnarounds were deemed feasible. This upward trend became extremely pronounced from December with the strengthening of the tight-money stance in line with the agreement reached on the provision of emergency credits between the Korean government and the IMF.

The Korean won continued its underlying decline against the U.S. dollar, apart from a transient strengthening in the second quarter. From October onward, as instability mounted in the Korean foreign exchange market, the exchange value of the Korean won dropped sharply. As a result, by the year-end its value in terms of the U.S. dollar had fallen by 40.3 per cent.

The growth rate of market liquidity declined compared to that of the previous year, affected by the shrinking of money demand due to the economic slowdown and the credit squeeze. The growth rate of MCT($M_2$+CD+money-in-trust), on a December daily-average basis, declined from the 18.6 per cent of the previous year to 14.7 per cent, and that of broad money($M_3$) eased from 17.1 per cent to 15.9 per cent over the same period.

During the first half of the year, macroeconomic policy was conducted with a focus on improving the current account position and stabilizing prices. From the start of the third quarter, though, with the growing instability in the domestic financial and foreign exchange markets, wide-ranging measures were taken to stabilize the financial markets and restore confidence in the Korean economy.

The Bank of Korea supplied special loans to some banks and merchant banking corporations whose financial statuses had become fragile, in an attempt to soothe the financial market instability caused by the string of large corporate insolvencies.

In order to speed up the process of resolving financial institutions' bad loans, a Non-performing Asset Resolution Fund was established under the aegis of the Korea Asset Management Corporation(KAMCO). In addition, the government guaranteed the payment in full of depositors' principal and interest by all financial institutions, for a period of three years up until the end of the year 2000, to avoid the possibility of a run on banks amid the financial-sector turmoil.

In order to help stabilize the interplay of supply and demand in the foreign exchange market, it widened the opening of the stock and bond markets to foreign investors and eased regulations on the induction of commercial loans and trade related credits.

In a further move, the Korean Government guaranteed the payment of foreign debt liabilities by Korean financial institutions to heighten their international creditworthiness, and the Bank of Korea provided short-term foreign currency liquidity to those financial institutions experiencing difficulties in this regard.

From early December, when an understanding was reached with the IMF on the provision of emergency credit, a number of measures addressing economic stabilization and structural reform issues stipulated in the agreement were energetically pursued.

As a first step, the policy authorities further tightened their monetary and fiscal policy stance as part of efforts to stabilize prices and the exchange rate, thereby bringing about a sharp rise in market interest rates.

The government ordered 14 ailing merchant banking corporations whose severe shortage of liquidity was disrupting the financial markets to suspend their business. Meanwhile, it supported an improvement in the capital structure of banks through the Public Money Management Fund's purchase of banks' subordinated notes and the enlargement of the Non-performing Asset Resolution Fund, which buys up the bad loans of financial institutions.

To encourage inflows of foreign capital, it greatly raised the ceilings on foreigners' stock investment, opened all sectors of the bond market, and eased regulations on the inducement of commercial and cash loans and the issuance of foreign securities by Korean corporations.

In a parallel move, the daily fluctuation band of the foreign exchange rate was abolished, to help break the paralysis of the domestic foreign exchange market brought about by the rapid deterioration in foreign currency liquidity and mounting expectations of a further massive depreciation of the Korean won.

On the other hand, a wide-ranging overhaul of legislation relating to the financial sector was undertaken, both to heighten the competitiveness and efficiency of the financial industry and to augment the financial system's stability.

Specifically, the central bank law was revised so as to strengthen the neutrality and independence of the Bank of Korea, and an integrated system of financial supervisory was set up. Also, a substantial body of financial sector related legislation was newly enacted or revised with a view to accelerating the restructuring of the domestic financial industry.

## Advanced Economies Continue Expansion, Asian Developing Countries' Growth Slackens

During the year under review, the world economy continued to grow rapidly at a rate of around 4 per cent, helped by the expansion of the advanced economies and

Latin American economies, despite the slowdown of growth in the Asian countries.

In the advanced economies, GDP growth accelerated to around 3 per cent. Among them, that of the U.S. grew by nearly 4 per cent, thanks to both the sharp increase in consumer spending, brought about by the rise in the number of people employed and an ebullient stock market, and to the expansion of facilities investment and exports.

The European Union(EU) member states registered a higher economic growth

[Table 2] **Key International Economic Indicators**

| | unit | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|
| World real GDP growth[1] | growth rate(%) | 2.7 | 3.9 | 3.6 | 4.0 | 4.1 |
| Industrial countries | 〃 | 1.2 | 3.1 | 2.5 | 2.7 | 3.0 |
| (U.S.) | 〃 | 2.3 | 3.5 | 2.0 | 2.8 | 3.8 |
| (Japan) | 〃 | 0.3 | 0.6 | 1.5 | 3.9 | 0.9 |
| (EU) | 〃 | -0.5 | 2.9 | 2.5 | 1.7 | 2.6 |
| Developing Countries | 〃 | 6.5 | 6.8 | 6.0 | 6.6 | 5.8 |
| (Asian NIEs) | 〃 | 6.3 | 7.6 | 7.3 | 6.4 | 6.1 |
| (China) | 〃 | 13.5 | 12.6 | 10.5 | 9.7 | 8.8 |
| (Thailand) | 〃 | 8.5 | 8.6 | 8.8 | 5.5 | -0.4 |
| (Indonesia) | 〃 | 7.3 | 7.5 | 8.2 | 8.0 | 5.0 |
| (Malaysia) | 〃 | 8.3 | 9.2 | 9.5 | 8.6 | 7.3 |
| (Western hemisphere) | 〃 | 3.9 | 5.1 | 1.2 | 3.5 | 5.0 |
| Countries in transition | 〃 | -6.4 | -7.6 | -1.3 | -0.1 | 1.7 |
| World trade volume[1] | rate of increase(%) | 4.0 | 9.3 | 9.5 | 6.6 | 9.4 |
| Industrial countries' imports | 〃 | 1.7 | 9.7 | 8.9 | 6.4 | 8.6 |
| (U.S.) | 〃 | 8.9 | 12.2 | 8.9 | 9.1 | 14.3 |
| Developing countries imports[2] | 〃 | 8.7 | 7.1 | 11.9 | 9.3 | 12.1 |
| Three-month Euro-dollar interest rate[3] | % per annum | 3.4 | 6.5 | 5.6 | 5.6 | 5.8 |
| U.S. ten-year Treasury bond yield rate[3] | 〃 | 5.8 | 7.8 | 5.6 | 6.4 | 5.8 |
| Yen/U.S. $[4] | yen | 111.2 | 102.2 | 94.1 | 108.8 | 121.0 |
| DM/U.S. $[4] | DM | 1.653 | 1.623 | 1.433 | 1.505 | 1.734 |
| Oil prices[4][5] | U.S. $/bbl | 18.5 | 17.2 | 18.5 | 22.2 | 20.5 |
| Non-fuel primary commodity prices[4][6] | rate of increase(%) | 4.5 | 18.5 | 12.7 | -9.7 | -4.7 |

Notes: 1) The values are IMF estimates.
2) Except countries in transition.
3) As of the end of period.
4) On a period-average basis.
5) WTI spot prices.
6) Reuter commodity price index.
Source: World Economic Outlook, IMF, 1998. 5

rate than in the previous year. It stood at around the $2\frac{1}{2}$ per cent level, as a business recovery got underway during the second half of the year, led mainly by a recovery of facilities investment and the buoyancy of exports supported by the weakness of core EU member states' currencies. Japan, however, failed to improve upon a low 1 per cent growth rate amid the sluggishness of domestic demand that reflected the hike in its consumption tax and the instability in the financial market following the failure of several banks and securities companies.

The group of countries in transition, although their performances varied widely, displayed a positive overall growth rate for the first time since 1990, as their earlier economic structural reforms began to bear fruit.

The GDP growth rate of the developing countries' group declined to around 6 per cent. That of those belonging to the Association of Southeast Asian Nations(ASEAN) dropped especially sharply in the aftermath of the currency crises that broke out in the second and third quarters.

Among ASEAN members, Thailand's current account deficit widened sharply as a result of the rapid shrinking of its exports since 1996, owing to severe price competition with Chinese-made goods; meanwhile, many loans of Thai financial institutions turned sour as corporate bankruptcies increased owing to the depressed property market.

The maintenance of an overvalued exchange rate for the Thai baht against the U.S. dollar, despite the deterioration of the economic situation, caused foreign investors to mount speculative attacks on the baht from early May onwards. The acceleration of capital outflow that this provoked led to the outbreak of a currency crisis in early July.

The currency crisis that started in Thailand spread by contagion to other ASEAN member states including Indonesia, Malaysia, and the Philippines, whose currencies had also been kept overvalued taking their economic situations into account. Accordingly, the international value of their currencies plummeted and stock prices slumped in all these countries. GDP growth in Thailand and Indonesia fell especially sharply in response to the shock of their severe currency crises.

However, the Asian newly industrializing economies(NIEs) other than Korea, namely Taiwan, Singapore and Hongkong, saw some acceleration in their growth rates thanks to increased private consumption and facilities investment. Although China's GDP growth rate slowed somewhat compared to the previous year, as a result of its determined pursuit of economic stabilization policies, its economy still achieved a high growth rate of close to 9 per cent. This was driven by the brisk increase in exports and in facilities investment, the latter supported by the expansion of inward direct investment. In Central and South America, too, GDP growth rates rose thanks to buoyant exports to the U.S.A. and strong facilities investment supported by foreign capital inflows.

During the year under review, the total volume of world trade rose by around 9 per cent as against around 6 per cent in the previous year. This was largely attributable to the sharp increase in imports that arose from the expansion of domestic demand in the two major advanced economies, the U.S.A. and the EU, and which offset the effects of the reduction in import demand by Asian countries, particularly ASEAN members, stemming from the Southeast Asian currency crisis.

Viewing international interest rates, short-term interest rates rose slightly, but long-term interest rates moved generally downward. Until March, short-term U.S. interest rates exhibited a rising trend in response to the raising of target interest rates on Federal funds carried out by the Federal Reserve Board. They then shifted to a steady, stable downward trend, helped by continued price stability. Meanwhile, long-term U.S. interest rates maintained downward stability, reflecting the increased demand for U.S. Treasury bonds stimulated by the Asian currency turmoil.

Looking at international foreign exchange market movements, the U.S. dollar maintained a firm tone on the whole against major currencies including the Japanese yen and the Deutsche mark during the year. This was mainly attributable to differences in macroeconomic fundamentals between the U.S.A. and most other developed countries including Japan, such as the divergence of their GDP growth rates and of their interest rates.

Viewing the price trends of international raw materials during the year, crude oil prices dropped sharply until April. Their fall was prompted by the reduction of demand that resulted from the resumption both of the normal temperature pattern in major oil consuming countries such as the U.S.A., which had experienced unusually severe cold toward the end of the previous year, and of Iraqi crude oil exports. For the rest of the year, they showed downward stability. Non-fuel primary commodity prices were generally lower than in the previous year thanks to the decline of grain prices in line with good harvests, the effects of which offset higher prices for minerals and for coffee and cocoa beans.

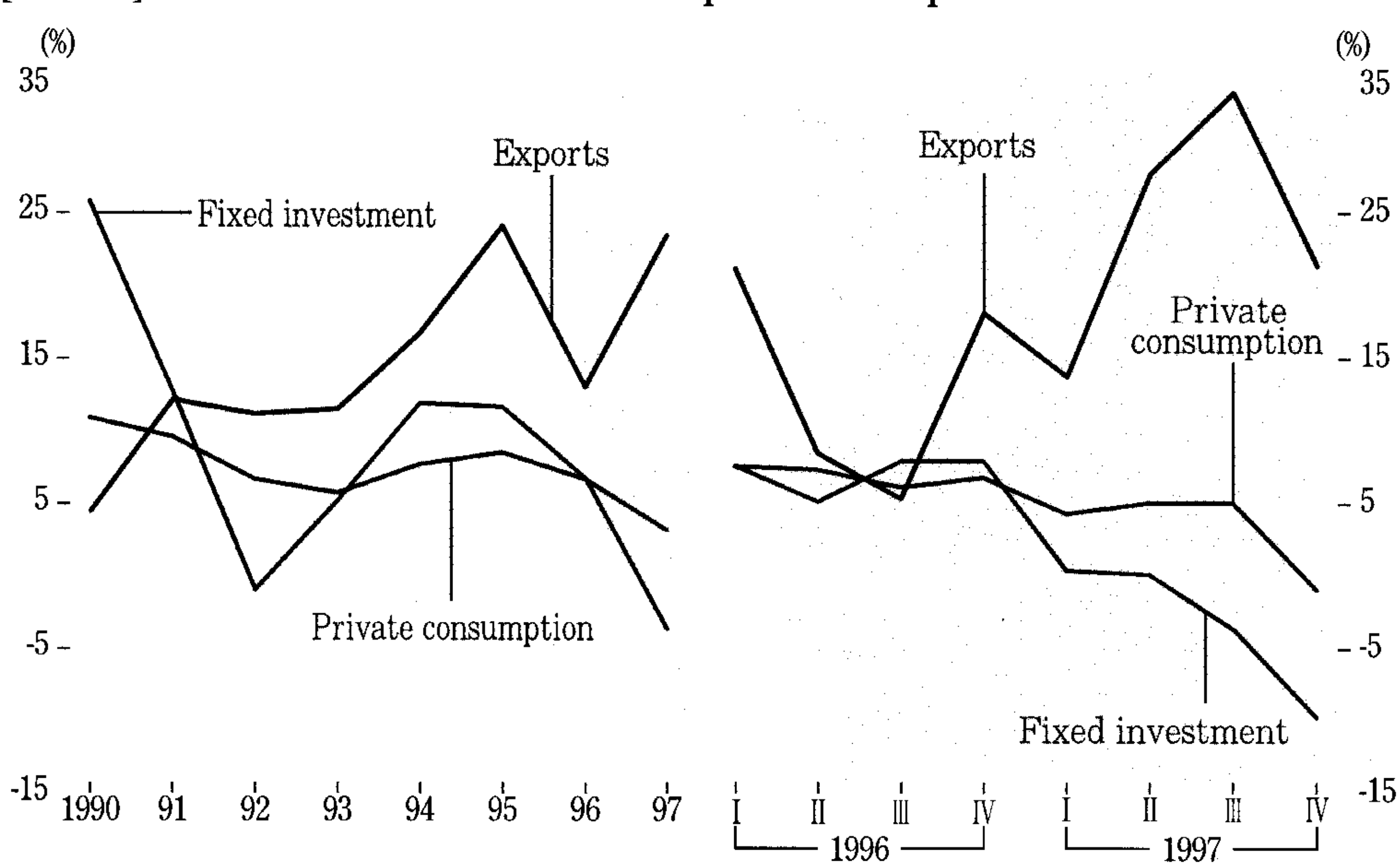
## Domestic Economy Slows Abruptly During Fourth Quarter

In the year under review, Korean GDP growth dropped sharply to 5.5 per cent as against the 7.1 per cent of the previous year.

Viewing GDP growth by quarter, it held steady at around 6 per cent until the third quarter thanks to the large increase in the volume of exports, despite the economic downturn that continued from the previous year. GDP posted only 3.9 per cent growth during the fourth quarter, however, owing to the sharp contraction of domestic demand in terms of both consumption and investment that occurred under the impact of the currency crisis.

Looking at GDP growth by component of expenditure during the year, the growth of final consumption expenditure stood at just 3.5 per cent, well below the 6.9 per cent of the previous year and reflecting both the easing of the pace of income increases and deepening worries over job security amid the economic slowdown. Viewed by quarter, during the first three quarters final consumption expenditure maintained an upward trend of 4~5 per cent. However, during the

**[Chart 1] Rates of Increase of Components of Expenditure[1)]**




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

fourth quarter it shifted to a decreasing trend mainly due to the contraction of households' spending, especially on durables.

Fixed investment, which had registered a rate of increase of 7.1 per cent in the previous year, decreased by 3.5 per cent on a year-on-year basis. Facilities investment shrank by 11.3 per cent, and its downward trend accelerated sharply during the second half of the year, amid the deepening instability of the domestic financial markets. Its decline was mainly attributable to the deterioration of corporate profitability brought about by the protracted economic downturn, fund-raising difficulties caused by the credit crunch, and increased uncertainties concerning future economic conditions. Construction investment slowed its pace of growth owing to the sluggishness of building construction, which more than offset the relative briskness of civil engineering centering on infrastructure projects.

As a result of lackluster fixed investment, the gross domestic investment ratio on a current price basis fell back from the 38.8 per cent of the preceding year to 35.3 per cent. However, the gross saving ratio on a current price basis declined slightly from 34.8 per cent in the previous year to 34.6 per cent. In consequence, the degree to which domestic investment was covered by domestic saving rose further to 97.8 per cent from the 89.8 per cent of the previous year.

Total exports of goods and services, in real terms, rose sharply from the 13.0 per cent growth rate of the previous year to 23.6 per cent on the back of both the expansion of the global economy and the depreciation of the Korean won. Meanwhile, total imports, in real terms, slowed from the 14.8 per cent of the previous year to 3.8 per cent. This was a result of the contraction of import demand brought about by the slowdown in domestic demand in the form of both consumption and investment.

## Industrial Production Generally Depressed

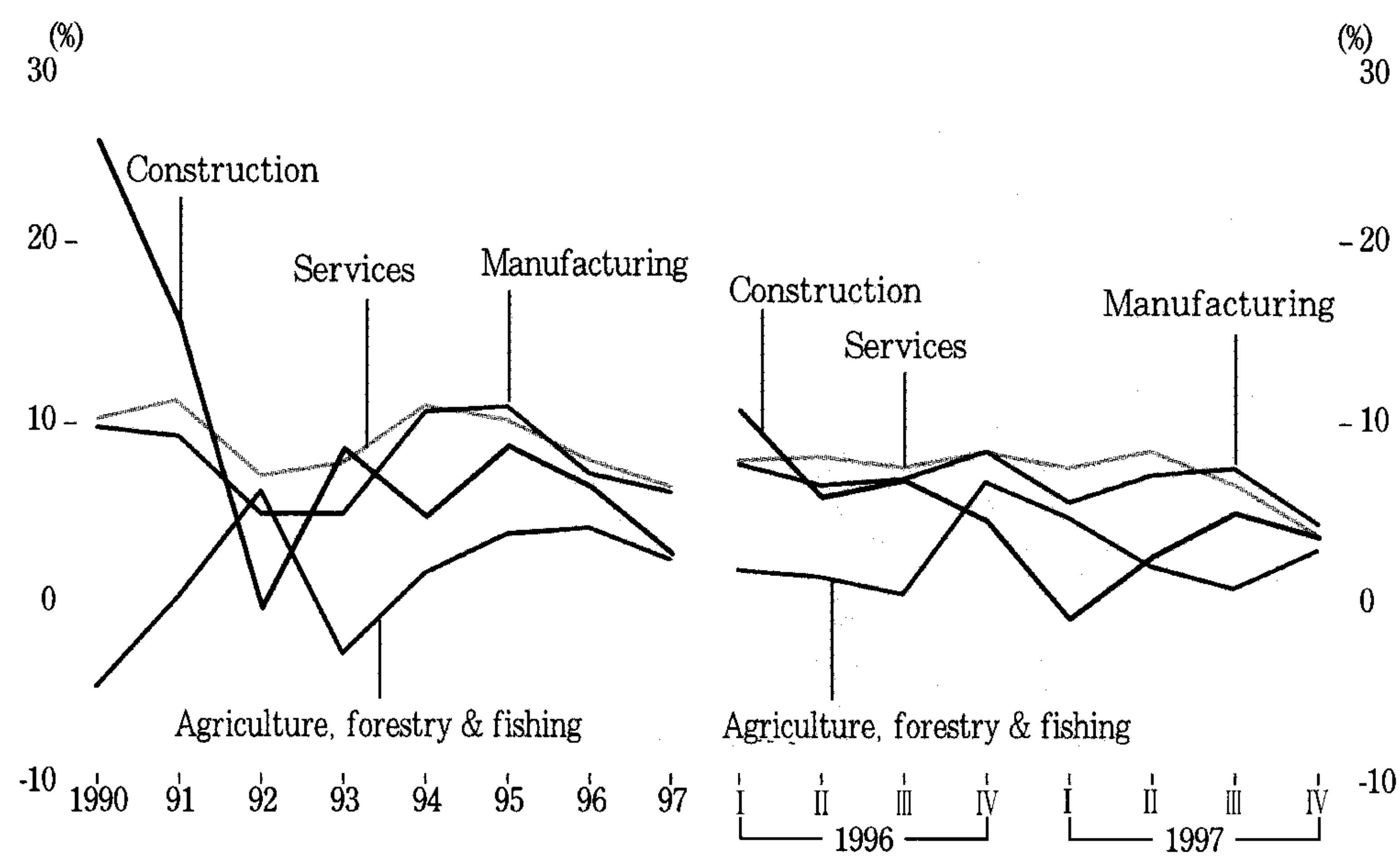
Looking at the pattern of growth by sector of economic activity, it is clear that the slowdown affected most industries.

The growth rate of manufacturing fell from the 7.4 per cent of the previous year to 6.2 per cent. The production of the light industrial sector continued its negative growth trend, which had become evident in the preceding year, with most subsectors including textiles, apparel, and footwear maintaining a downward trend. The production of the heavy industrial and chemical sector slowed its upward pace from that of the previous year. Its deceleration, which occurred despite an export driven boost in electrics and electronics and petrochemicals, was largely attributable to reduced production in the industrial machinery and transportation equipment sectors caused by the sluggishness of facilities investment.

The pace of growth in the construction industry dropped sharply from the 6.6 per cent of the previous year to 2.8 per cent. Government construction showed brisk activity centering on infrastructure projects, whereas private construction slumped, reflecting the slackness of residential construction business, the contraction of facilities investment, and an increase in the number of construction companies going insolvent.

The growth rate of the service sector eased to 6.5 per cent from its pace of 7.9 per cent of the previous year. The wholesale and retail trade displayed a lower growth rate than that of the previous year as a result of the slow pace of transactions involving domestic industrial and imported goods alike amid sluggish domestic

**[Chart 2]** **Growth Rates by Industry**[1)]




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

demand. Financial businesses witnessed slower growth, due to the increase of non-performing loans arising from the string of large corporate bankruptcies, and the growth rate of the business services sector also declined largely owing to lackluster advertising business. However, the communications sector maintained its strong growth pace thanks to the continuing massive expansion in mobile communications and information communications services.

Agriculture, forestry and fishing production stayed at a growth rate of 2.5 per cent owing to the lackluster production of vegetables and animal husbandry, the effects of which dulled the favorable increases in the rice harvest and fish catches.

## Employment Situation Worsens

During the year, the economically active population increased by 2.0 per cent, similar to its rise in the previous year. However, the total number of persons employed grew by only 1.4 per cent, less than in the previous year, reflecting the drying-up of job opportunities and the downsizing efforts of enterprises in response to the economic slowdown. In consequence, the unemployment rate rose to 2.6 per cent from the 2.0 per cent in the previous year. Most notably, in December it climbed above the 3 per cent level. Meanwhile, during the year as a whole, the total number of the unemployed increased by 556,000 persons, rather more than the 425,000 persons in the previous year. Also, as regards aspects of the employment structure, employment security deteriorated, as the share of daily and temporary workers rose at the expense of permanent and fulltime workers.

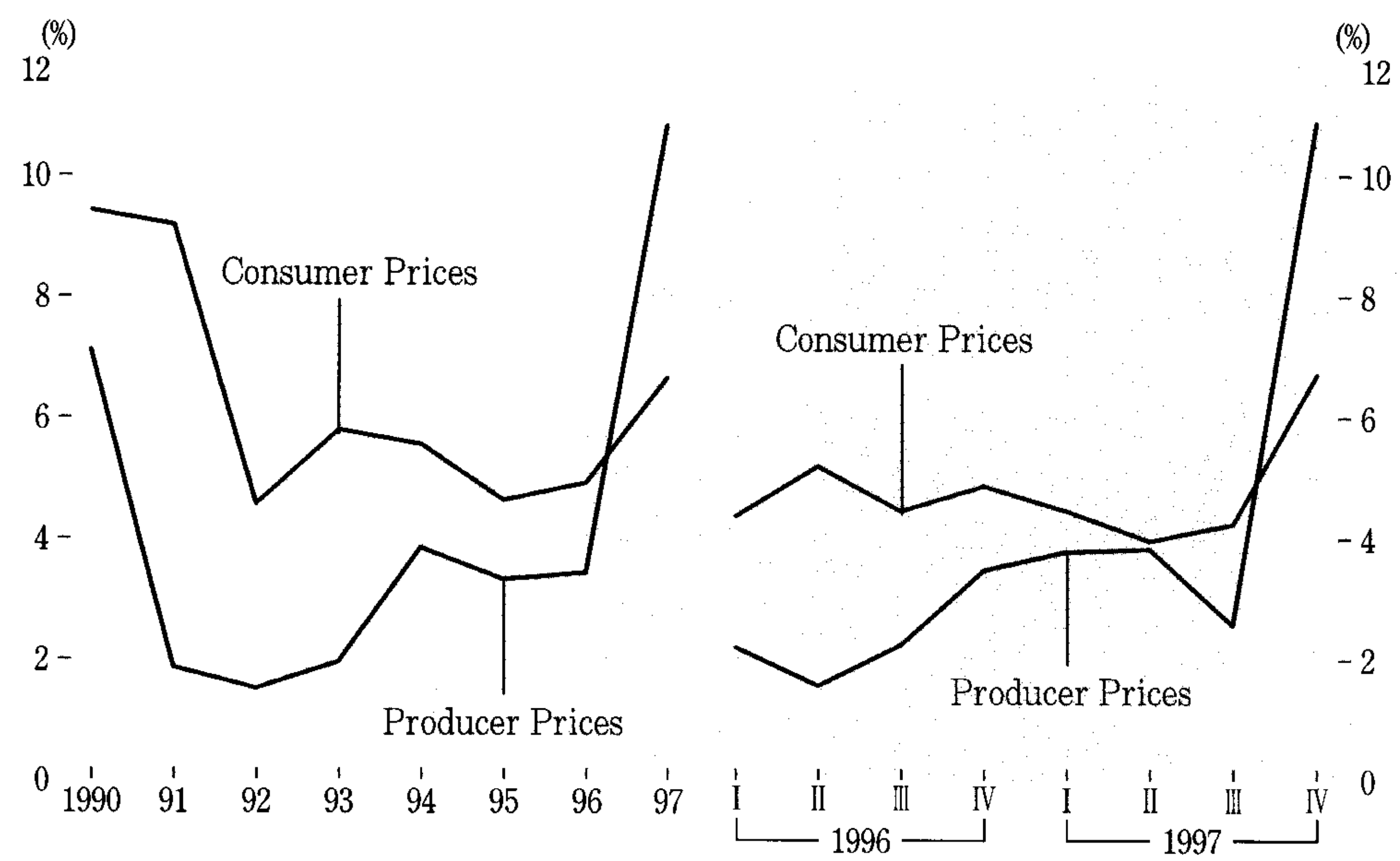
Viewing the pattern of employment by industry, manufacturing employment decreased by a broader margin than in the previous year, affected by the contraction of production and increasing insolvencies in the labor-intensive light industrial sector. Construction employment also slackened greatly in response to the slowdown in the construction business. In contrast, employment in the services sector maintained its brisk pace of increase, which matched that of the previous year.

The rate of increase in nominal wages in all industries dropped sharply from 11.9 per cent in the previous year to 7.0 per cent, reflecting the deepening worries over job security, the fewer hours worked, and the deterioration in firms' financial status. Most notably, in the case of the manufacturing sector, the rate of increase in nominal wages fell to less than half the previous year's. Moreover, in December the absolute level of wages in manufacturing was far below that of the same month in the previous year.

## December Sees Steep Upward Price Trends

The pace of price increases accelerated greatly from the preceding year, with consumer prices and producer prices rising by 6.6 per cent and 10.9 per cent, respectively, over the last month of the previous year. Viewing the movements of prices by period, prices continued to move within a stable range until November. Consumer prices rose by 3.9 per cent and producer prices by 2.5 per cent, respectively, for the year to November over their level in the last month of 1996. In December, however, they shifted to a steep upward trajectory due to the rapid depreciation of the Korean won. Consumer prices in December rose by 2.5 per cent

[Chart 3] **Price Increase Rates[1)]**




Note: 1) Percentage change compared with the same period of the previous year.

over the previous month while producer prices climbed 8.2 per cent.

By commodity, the prices of agricultural and marine products temporarily showed unstable movements earlier in the year centering on fruit and grain, but they gradually stabilized from the second quarter as demand-supply imbalances cleared. The prices of manufactured goods continued to move within a stable range until November owing to lackluster demand amid dull business conditions together with the stability of international prices of raw materials such as those for crude petroleum. The higher cost of imported raw materials due to the massive depreciation of the Korean won, though, quickly fed through to the prices of manufactured goods, which rose steeply from early December. Charges for services maintained stable movements from the second quarter onwards, thanks to the stability of charges for personal services and housing rents, which largely offset the inflationary pressures caused by the upward adjustment of charges for public utilities.

Among real estate prices, land prices maintained a stable range of movements during the year, thanks both to the large area of land put on the market by several large corporations facing insolvency and to the choking of demand by the persistent economic slowdown. Housing prices showed a somewhat steeper upward trend earlier in the year, centering on apartments in the Greater Seoul area, particularly in the satellite cities, but from the second quarter onwards, they shifted back to their stable pace affected by subdued demand.

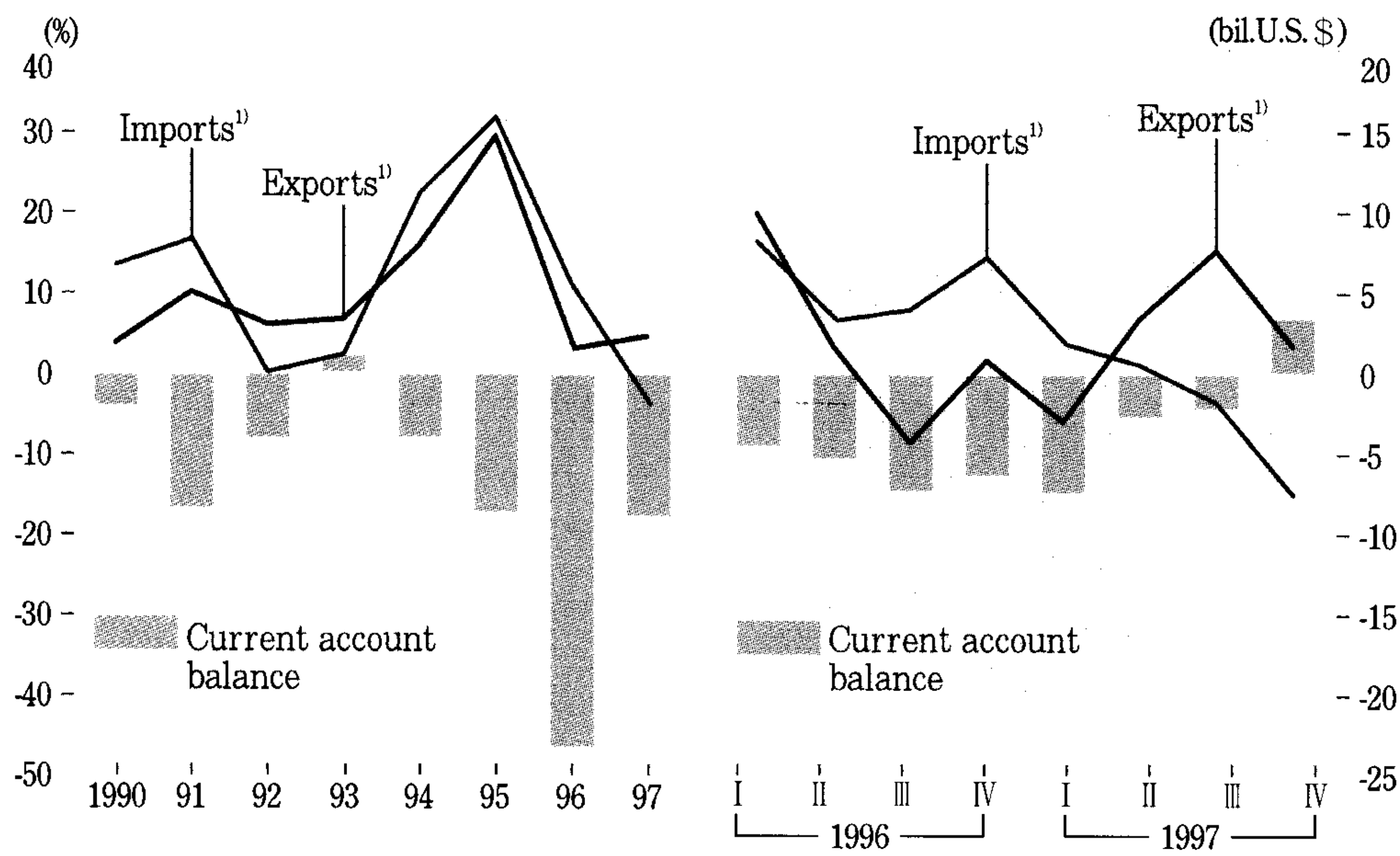
## Current Account Deficit Narrows

Exports, on a customs-clearance basis, registered a growth rate of 5.0 per cent, a little higher than in the previous year, as the volume of exports rose rapidly, offsetting the effects of the drop in the unit value of exports due to the fall in the international prices of major export items. Viewed by commodity group, exports of heavy industrial and chemical products showed an upward trend, higher than in the previous year, thanks to the favorable performance of exports of both petrochemical, and iron and steel products. However, the growth of exports of light industrial products decelerated from the preceding year's performance, held back by lower exports of footwear, and of tires and tubes. Seen by region, exports to developed countries picked up again, thanks to the briskness of EU-bound exports which served to offset the protracted decrease in those to Japan. In contrast, exports to developing countries, notably the Southeast Asian and Latin American countries, slowed their growth rate, compared with the previous year.

Imports, on a customs-clearance basis, decreased by 3.8 per cent in response firstly to the sluggishness of import demand, which reflected the dullness of domestic business activities and the depreciation of the Korean won, and secondly to lower international raw material prices such as those for crude oil and grain. By commodity group, imports of capital goods and consumer goods both decreased in response to the contraction of domestic demand, while imports of raw materials maintained only a slow growth rate. Seen by region, imports from developed countries decreased sharply, led downward by those from the U.S.A., Japan and the EU. Meanwhile, those from the developing countries showed only modest growth at a lower level than in the previous year, held back by the downturn in those from the Southeast Asian and the Central and South American countries.

During the year, the current account deficit narrowed greatly from the 23.0

[Chart 4] **Balance of Payments**




Note: 1) Percentage change compared with the same period of the previous year, on a customs-clearance basis.

billion U.S. dollars of the previous year to 8.6 billion U.S. dollars. Most significantly, the fourth quarter figures showed a shift into surplus on the current account, the first quarterly surplus for four years. Contributions to this improved performance came not just from the large surplus on the goods account arising from the sharp decrease in imports induced by the slowdown of domestic demand. They came also from a shift into surplus on the services and transfers balance as a result both of declines in overseas travel and in payments for other services, and the rapid improvement in the current transfers account, thanks to increased personal remittances from expatriate Koreans.

The deficit on goods narrowed to 3.9 billion U.S. dollars from the 15.0 billion U.S. dollars of the previous year due to the steady increase in exports together with the sustained deceleration of import growth. Viewing the trade account by type of economy, as measured by the difference between exports and imports on a customs-clearance basis, the trade balance with developing countries maintained a surplus similar to that of the previous year, and the deficit on trade with the developed countries narrowed to about 12.0 billion U.S. dollars.

The deficit on services lessened from 6.2 billion U.S. dollars in the previous year to 2.9 billion U.S. dollars. This was attributable both to sharply increased incomings for transportation services, reflecting the increase in the volume of freight transportation, and to a rapid decline in overseas travel in response to the abrupt depreciation of the Korean won from early November.

The deficit on the income account widened to 2.7 billion U.S. dollars from 1.8 billion U.S. dollars in the preceding year, as interest payments increased in response to the heightened external debt and the increased cost of borrowing funds abroad owing to the country's loss of international credibility.

The current transfers account shifted into surplus to the tune of 0.86 billion U.S. dollars from the small deficit of the previous year. The transition occurred in December when inward remittances from expatriate Koreans increased greatly while personal remittances overseas declined.

Meanwhile, the capital account surplus decreased to post a net inflow of 5.4 billion U.S. dollars, a figure substantially less than that of 23.3 billion U.S. dollars in the previous year, despite the inflow of bailout funds for Korea from international financial organizations such as the IMF. Its contraction was attributable to the decline in both the issue of foreign currency securities and the induction of trade credits, along with a large-scale repayment of financial institutions' short-term borrowings. These developments came in addition to the large net outflow of foreign portfolio capital from the stock market from August onwards as doubts spread about the credit standing of the Korean economy.

## Currency Crisis Breaks Out

From early in the year, the relation between receipts and payments of foreign exchange showed unstable movements. The large current account deficit and the slowdown of foreign capital inflows combined to bring about a decrease in the country's foreign exchange reserves and in the exchange value of the Korean won. However, from April the Korean won strengthened temporarily against the U.S. dollar, thanks to the announcement of an early capital market opening schedule by the government and the narrowing deficit in the goods balance.

From the beginning of the third quarter, however, foreign investors' misgivings about the health of the Korean economy deepened, owing to the delay in handling Kia's financial difficulties, financial institutions' accumulation of bad loans, and the negative impact of the Southeast Asian currency crisis. Accordingly, there was a large net outflow of foreign portfolio capital, new external borrowing became almost impossible, and Korean financial institutions faced substantial difficulty in rolling over their existing short-term debts in the international financial markets. In consequence, Korea found itself in crisis, lacking sufficient foreign currency liquidity to meet its maturing liabilities following a sharp decline in its foreign exchange reserves from early November.

What brought about this large mismatch between demand and supply in the foreign exchange market was mainly the heavier foreign debt taken on to finance the current account deficit, and the difficulty in coping with a flood of repayment demands because of the heavy reliance on short-term external borrowings. Besides these factors, the building of expectations of a massive depreciation of the Korean won due to the persistent wide current account deficit also played a large part in the further worsening of the foreign exchange situation.

The country's foreign exchange reserves, which had stood steady at around 30 billion U.S. dollars until October, declined sharply to 24.4 billion U.S. dollars at the end of November and to 20.4 billion U.S. dollars at the end of December. The reason they dwindled so rapidly was because the Bank of Korea was forced, as the lender of last resort, to provide support for the settlement of foreign claims on domestic financial institutions when demands for the redemption rather than the customary roll over of their maturing short-term foreign liabilities mounted from early November.

Most seriously, usable official foreign exchange reserves, which are official foreign exchange reserves less the BOK's deposits at overseas branches of domestic banks, decreased to just 7.3 billion dollars as of the end of November as against 22.3 billion dollars as of the end of October.

Consequently, the government had to turn to the IMF to request a stand-by credit on November 21. An agreement was reached with the IMF on December 4 for the provision of an amount of some 21 billion U.S. dollars.

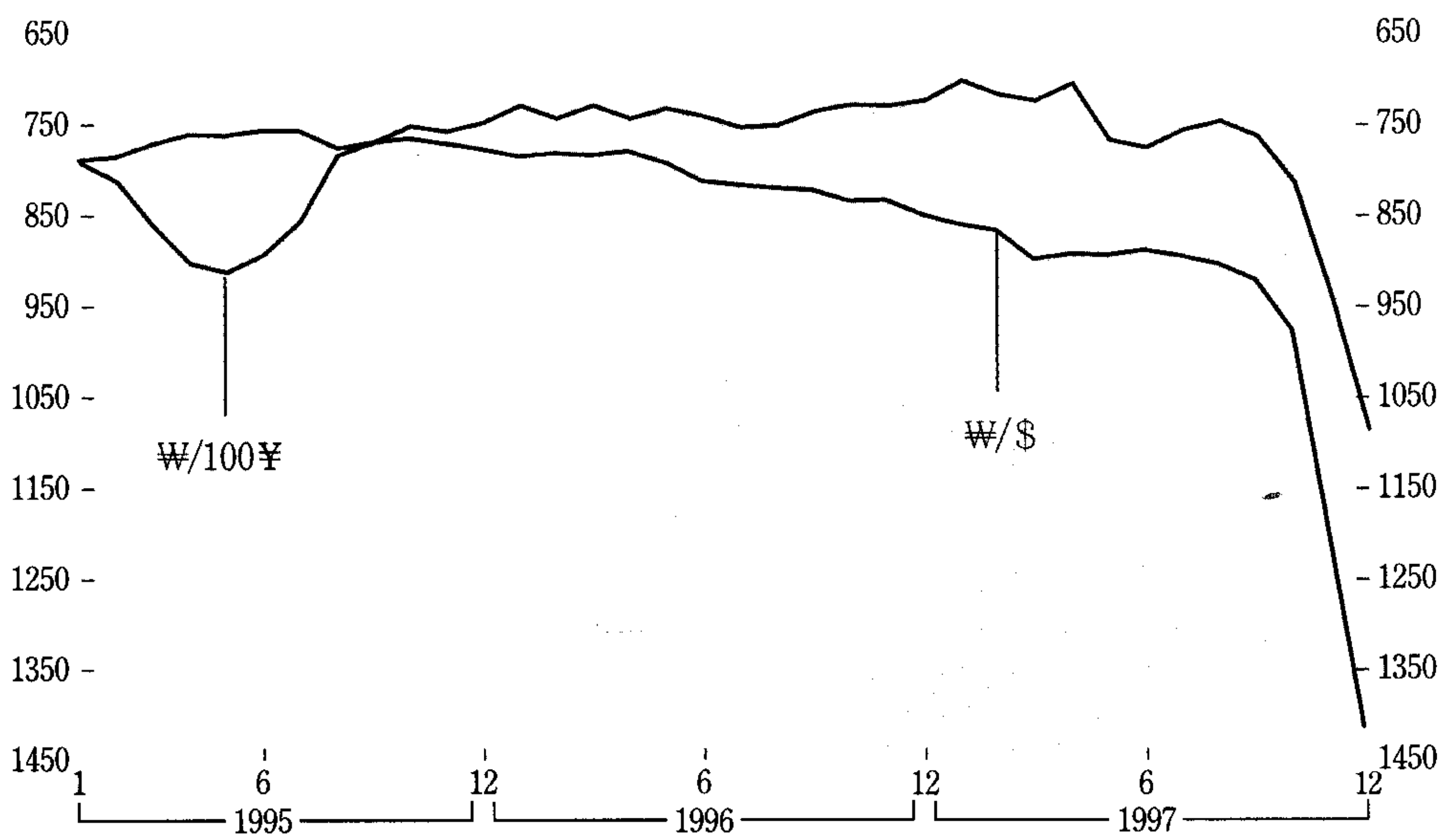
In addition, major international financial institutions such as the IBRD and the ADB and also a number of developed countries including the United States and Japan indicated their readiness to provide an additional 36 billion U.S. dollars, upon the conclusion of the agreement with the IMF. This meant that Korea was to receive in stages a total amount of 57 billion U.S. dollars by way of the emergency rescue package.

## Value of Korean Won Falls Sharply

The value of the Korean won in terms of the U.S. dollar continued the previous year's weakening trend until the first quarter of the year, but began to strengthen slightly from April onwards before falling again from July. Especially from October onward, the Korean won's depreciation became steeper and it dropped to 1,965 won per dollar on December 24. However, the won rebounded to 1,415 won against the U.S. dollar a week later on December 31, bolstered by the IMF's announcement on December 24 that it would bring forward its provision of the agreed financial assistance to Korea. As a net consequence of these wide swings, the Korean won ended the year showing a depreciation of 40.3 per cent against U.S. dollar over its exchange-value twelve months earlier.

Meanwhile, the value of the Korean won in terms of the currencies of other

[Chart 5] **Exchange Rates of the Korean Won[1]**
(inverted scale)




Note: 1) End of month basis.

major developed countries, such as the Deutsche mark and the Japanese yen, declined sharply in the fourth quarter. The won ended the year showing an depreciation of more than 30 per cent against both of these currencies.

## Measures Taken to Stabilize Domestic Foreign Exchange Market

From the beginning of the year, when signs of a demand-supply mismatch in the exchange market began to appear, the government took measures to promote an inflow of foreign capital, such as raising the overall ceiling on foreigners' stock investment. During the fourth quarter of the year, as the foreign exchange situation worsened acutely, it struggled to soothe the unrest in the foreign exchange market by widening capital market liberalization and shifting to a freely floating exchange rate system. Notably, in December, in line with its agreement with the IMF, the government greatly liberalized capital transactions through the complete opening to foreign investment of all listed bonds, and the raising of the ceilings on foreign investment in a company's stocks to 55 per cent for overall foreign holdings and 50 per cent for individual foreign holdings. Also, it allowed Korean corporations for a limited time period to raise overseas commercial and cash loans with maturities of at least 3 years and to issue foreign securities.

In early November, the foreign exchange market was paralyzed by the spread of expectations of an early and massive depreciation of the Korean won. The government responded by widening the daily fluctuation band from $\pm 2.25$ per cent to $\pm 10$ per cent of the previous business day's market average rate. Soon after, the exchange regime was effectively converted to a free floating exchange rate system with the complete elimination of the band on December 16.

## BOK Stabilizes Money Supply

From the beginning of the year, the emphasis of monetary and credit policies was placed on maintaining stability in the supply of liquidity in order to narrow the current account deficit and moderate the inflationary pressures. In parallel with this, efforts were also directed toward ensuring financial market stability so as to accommodate the enlarged portfolio shifts among financial business sectors and financial products arising from the reorganization of the financial system.

The target ranges for the growth rate of the money supply were set at 14～19 per cent for $M_2$, on a December daily-average basis, and 15～20 per cent for MCT, which adds negotiable certificates of deposit(CDs) and money-in-trust to $M_2$. The BOK's adoption of this type of double monetary target system was guided by the strong possibility that $M_2$, long employed as the main intermediate target, would continued to show unstable movements, affected by the preceding year's realignment of the trust account system.

Viewing monetary and financial movements in the year under review, the growth rate of $M_2$, a relatively narrow monetary indicator, increased sharply, while that of MCT declined steadily during the year; and that of $M_3$, the broadest monetary indicator, also continued its downward trend during the year.

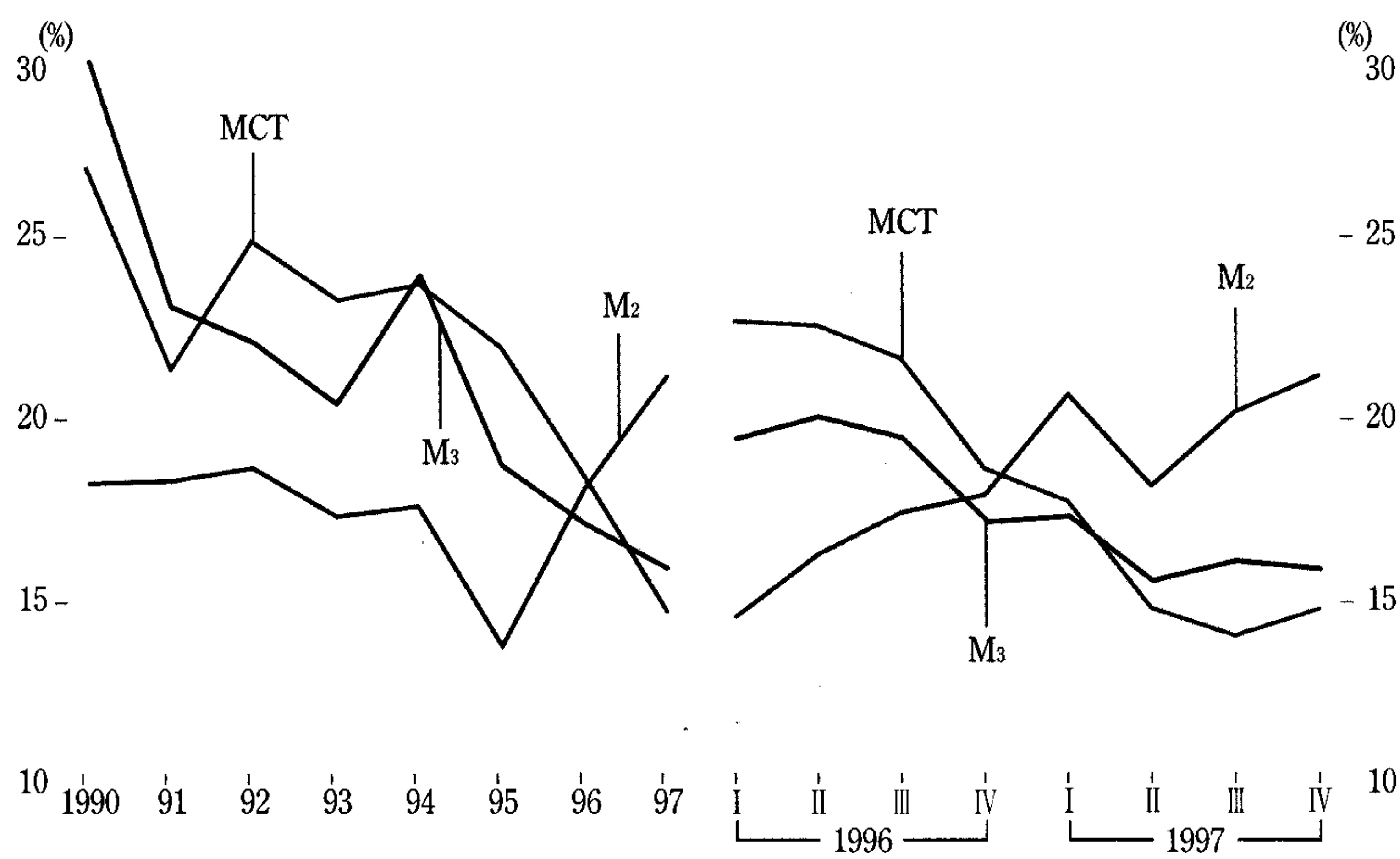
The growth rate of $M_2$ rose from the 17.8 per cent of the previous year to 21.1 per cent, on a December daily-average basis, due to the large shift of funds from non-bank financial institutions into commercial banks as a result of the introduction of money market deposit accounts(MMDAs).

However, the growth rate of MCT eased to 14.7 per cent from the 18.6 per cent of the previous year, on a December daily-average basis. This was mainly due to the contraction of firms' demands for funds amid the protracted economic downturn, and to portfolio shifts into cover bills and sales of bond repurchase agreements(RPs), and rather than CDs, upon which reserve requirements were newly imposed.

The growth rate of $M_3$, upon which the effects of shifts of funds following the realignment of the system related to deposit products were broadly neutral, declined, on a December daily-average basis, from the 17.1 per cent of the previous year to 15.9 per cent. Its deceleration reflected the slowdown of firms' demands for funds and the tightening of liquidity supply.

From early December onwards, the monetary authorities, acting in line with their agreement reached with the IMF, strengthened their existing tight monetary policy stance, lowering the growth rate of money and inducing sharp rises in market interest rates. Their objective in doing so was to stabilize the exchange rate and

[Chart 6] **Growth of Principal Monetary Indicators**[1)]




Note: 1) Percentage change over the last month of the previous base period, on an average-balance basis.

price movements.

During the same month, the monetary management system was also changed, with $M_3$, which is more neutral to changes in the financial structure, being adopted as the monitoring variable in place of the previous dual system involving $M_2$ and MCT. Once the appropriate growth of $M_3$ has been determined, the corresponding growth rate of the indicative limit on reserve money is derived. The Bank of Korea fixes the floor of net international reserves(NIR) and the ceiling of net domestic assets(NDA) as performance criteria, and concentrates its efforts on achieving them.

Partly as a result of these efforts, growth rates of reserve money and $M_3$ as of the end of December were below the indicative limits set under the IMF program, and the balances of NIR and NDA also satisfied the performance criteria.

Market interest rates meanwhile rose to about twice their level before the recourse to the IMF, as the Bank of Korea's market intervention interest rate was operated at a very much higher level in the process of monetary tightening.

The Bank of Korea also lowered reserve requirement ratios on commercial banks' deposit liabilities, bringing them down from 5.5 per cent to 3.3 per cent on average. This represented a further step, following the preceding year's reduction, toward increasing commercial banks' discretion in operating their funds. In order to pave the way for the setting up of an indirect monetary management system and improve the effectiveness of its open market operations, the Bank of Korea expanded the scope of its counterparts for RP transactions, previously restricted to commercial banks, to include merchant banking corporations, securities companies, and investment trust companies.

## Money Market Conditions Worsen Sharply

In the year under review, as the economic downturn became protracted, corporate insolvencies increased drastically, and the percentage of bills dishonored rose markedly. The number of corporate insolvencies increased rapidly to 17,168 from the 11,589 of the previous year. Among them were included many large corporations belonging to large interlinked business groups such as Hanbo and Kia.

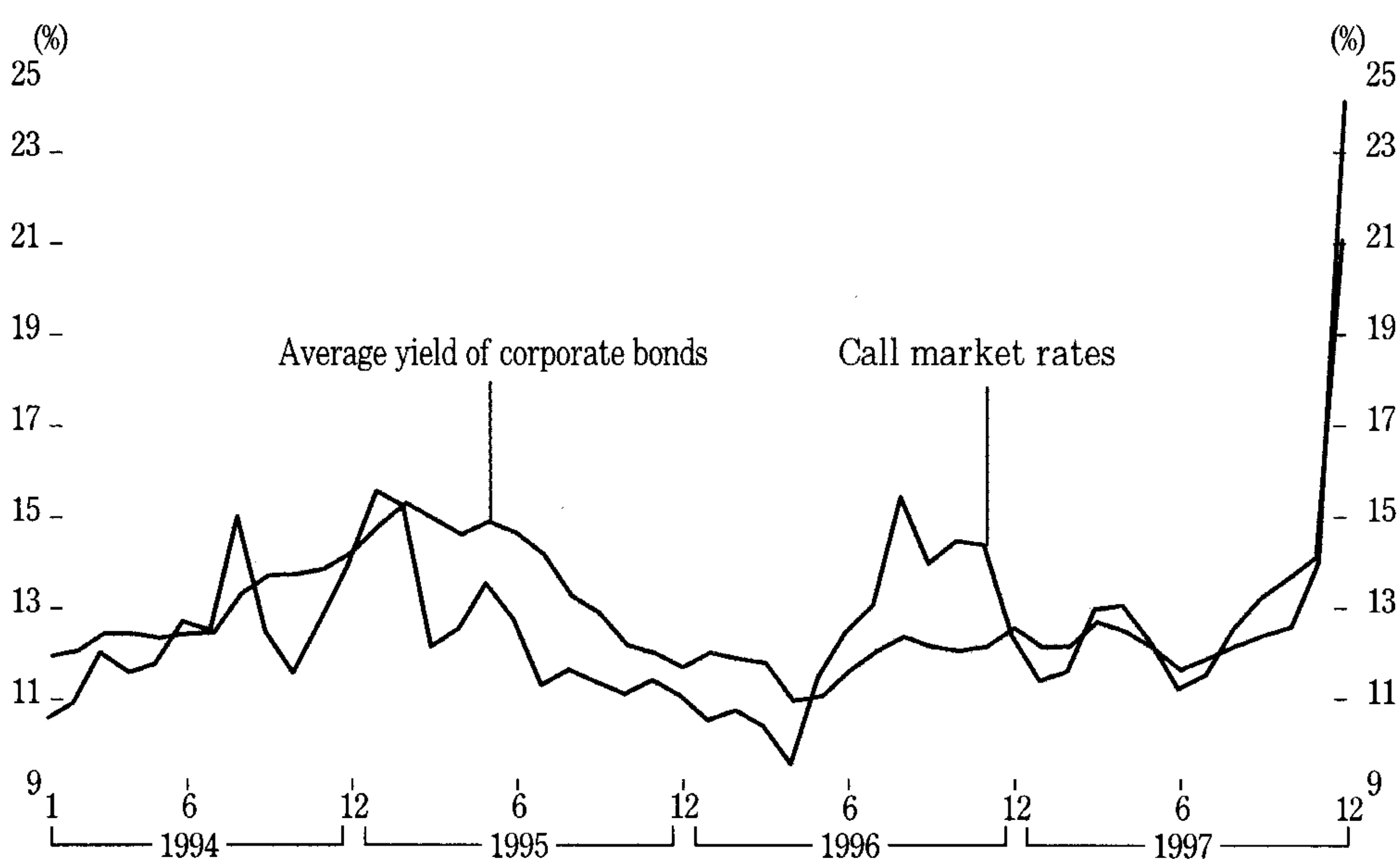
Accordingly, the nationwide percentage of cheques & bills dishonored in clearing houses nationwide increased considerably to 0.40 per cent from the 0.14 per cent in the previous year. Particularly, in December, when the financial and currency crises were at their height, the percentage rose steeply to 1.49 per cent.

The size of financial institutions' non-performing assets increased steeply with the effects of the widespread corporate bankruptcies. The figure for non-performing credits, which is the sum of substandard credits, doubtful credits and estimated loss credits, in all banks including specialized banks, doubled from 15.2 trillion won in the preceding year to 32.3 trillion won, on an end-of-year basis. In the case of merchant banking corporations, the size of bad loans approximately tripled from 1.3 trillion won at the end of the previous year to 3.9 trillion won at the end of October 1997.

Market interest rates showed stable movements on the whole during the first half of the year, despite the increase in corporate bankruptcies, but they shifted to a pronounced upward trend from the second half of the year.

The yield on corporate bonds(three-year) rose narrowly at the beginning of the year, reflecting financial market apprehensions caused by the insolvencies of several large corporations, notably Hanbo Iron & Steel Co. Thereafter, it turned to a

[Chart 7] **Major Interest Rates**[1)]




Note: 1) On a period average basis.

downward trend owing to the government's announcement of an accelerated opening plan for the capital market. Early in June, it dropped to 11.4 per cent.

However, in July it shifted back to an upward trend again, climbing to 13~14 per cent in mid-November, as market fears deepened and financial institutions experienced difficulty in borrowing abroad amid the repercussions from the insolvency arrangements for Kia Motors.

From late November, when the Korean government applied for IMF emergency financing, the benchmark yield continued its sharp upward trend, driven by the preemptive demand for funds in anticipation of a fast-approaching monetary tightening, and apprehensions of a further wave of corporate failures. Following the strengthening of the austere monetary policy stance upon the conclusion of the arrangement with the IMF, it fluctuated around the high level of 30 per cent toward the end of December.

Call market rates, which had been fluctuating within a range of 12~14 per cent since the beginning of the year, showed a steep upward trend from early December, rising to 26 per cent by the end of the year. Yields on commercial paper(CP), which was perceived as carrying a generally higher insolvency risk, soared to 41 per cent.

## Financial Institutions' Credit Shrinks, Deposit-taking Slows

Viewing trends in the extension of credit by financial institutions, the rate of increase declined amid a continuing wave of corporate failures, as commercial banks and merchant banking corporations refused to roll over loans due for redemption, and curtailed the supply of new credit to any corporation showing symptoms of financial distress. These tendencies became still more clearly pronounced from early December.

Deposit money banks' credits showed only a 13.1 per cent increase, lower than the 16.2 per cent increase in the preceding year. A squeeze on lending to firms became evident especially from the second quarter, and in December deposit money banks sharply reduced their lending in order to meet the 8 per cent capital adequacy ratio set by the Balse Committee.

The total volume of credits extended by non-bank financial institutions grew at a much lower rate than during the previous year, due mainly to the sharp fall in lending activity on the part of merchant banking corporations. Credits extended by merchant banking corporations declined sharply, reflecting their management problems and institutional investors' strong reluctance to purchase bills issued by them; the figure being also affected by the suspensions of operation ordered toward the year-end at some merchant banking corporations.

However, for non-banks as a whole, the contraction of merchant banking corporations' credits was substantially offset by the active discounts of commercial paper by securities companies, a business opened to them from August. Credit extension from the trust accounts of banks remained decidedly subdued until the third quarter and its growth for the year as a whole declined considerably, even though the new installment-type money-in-trust products launched in December attracted a large volume of funds. Trust account funds operated in the form of discounts of commercial paper, however, rose considerably. The scale of new credit extension by development institutions was also relatively small in scale and the growth rate of credit extension by life insurance companies' credits lost its momentum.

In a parallel movement, deposit-taking by financial institutions slowed, compared to the previous year. Funds shifted rapidly from financial institutions with low credit ratings to those with higher ratings, and there were also portfolio shifts into high-yielding deposit products.

Deposit-taking by deposit money banks slowed compared with the previous year. Nevertheless it still recorded a rate of increase of 17 per cent, higher than that of all other types of financial business except for investment trust companies, as a result of the brisk influx of funds into the newly-launched MMDAs and into time deposits with interest rates linked to market rates and maturities of less than one year.

There was a relative decline in the growth of deposits at non-bank financial institutions in comparison with the previous year, due to the massive outflow from merchant banking corporations and the slowdown of the increase in deposit-taking by banks' trust accounts. Deposit-taking by merchant banking corporations was especially subdued: their sales of commercial paper declined considerably overall, despite a sharp increase in sales of their own paper, whose issuance largely replaced call market borrowings from other financial institutions as a source of funds.

There was a slowdown in the flow of funds into banks' trust accounts, as funds managed in the form of general non-specific money-in-trust products, new offers of which were suspended, saw a much greater contraction and that into household money-in-trust and company money-in-trust products, whose competitiveness had weakened, slowed abruptly. These losses were offset only to a minor degree by a strong inflow of funds into the new installment-type money-in-trust products launched in December. However, deposits taken by investment trust companies showed much faster growth than in the previous year, thanks to their enhanced competitiveness following the introduction of short-term money market fund(SMMF) products, and the liberalization of repurchase fees on money market funds(MMFs).

## Stock Market Depression Deepens

The stock market remained in the doldrums throughout most of the year, affected by the economic downturn and the instability of the financial and domestic foreign exchange market. The Korea Composite Stock Price Index(KOSPI) fluctuated without enthusiasm within a narrow range from the beginning of the year, affected by labor protest action against proposed labor law revisions and a wave of large corporate bankruptcies. During the second quarter, stock prices rebounded briefly, swayed by the raising of the ceiling on foreign portfolio investment. However, they shifted back to a downward trend from July, when the bankruptcy deferment accord was applied to Kia, a large interlinked business group. They fell more sharply after October, in response to tumbling stock prices in Southeast Asia and a massive retreat by foreign institutional investors in the face of the gathering currency crisis. As a result, KOSPI stood at 376 points at the end of 1997, a 42 per cent decline on a year-end basis. Meanwhile, average daily stock turnover expanded to 560 billion won, a 14 per cent increase compared to that of the previous year, led by an increase in transaction frequency following heightened market instability.

The raising of capital in the stock market decreased substantially from the 5.0 trillion won of the previous year to 3.2 trillion won as fund-raising through public and rights offerings slackened due to the sharp drop in stock prices. In the bond market, moreover, the net issuance of corporate bonds amounted to 13.8 trillion won, much less than in the preceding year, due mainly to the reluctance of credit guarantee institutions to guarantee corporate-bond issues following the increased number of corporate insolvencies, and investors' lack of appetite for them.

## Monetary Authorities Strengthen Efforts to Stabilize Financial Markets

The Korean government and the Bank of Korea undertook a number of measures from the beginning of the year in response to the deepening financial market instability aroused by the succession of insolvencies of large corporations.

Amid the deterioration of liquidity conditions for some types of non-banking financial institutions, particularly merchant banking corporations, during the first half of the year, the Korean government cancelled its plan to enforce a system permitting call brokerage on a limited scale, which had initially been scheduled to come into effect from May 1, and it also abolished the system regulating the volume of corporate bonds that might be issued.

In the face of the substantial deterioration in the financial status caused by the series of corporate insolvencies, the Bank of Korea supplied, from early in the third quarter onwards, one trillion won in the form of special loans to Korea First Bank, and another one trillion won to 16 merchant banking corporations. For its part, the government decided to set up a Non-performing Asset Resolution Fund, initially capitalized at 3.5 trillion won, under the aegis of the Korea Asset Management Corporation.

In early November, when panic mounted in the financial and foreign markets, the government took measures to increase this Fund to 10 trillion won so as to clear off the bad loans from financial institutions' books as fast as possible. It was also decided that the assets and liabilities of banks and merchant banking corporations should be examined at their market value with a view to encouraging structural adjustment on the part of financial institutions themselves.

In addition, to dispel depositors' misgivings, the government resolved that the payment of all deposits with financial institutions including banks, merchant banking corporations, mutual savings and finance companies and so on, should be guaranteed through the Deposit Insurance Fund up until the year 2000.

Wide-ranging measures for the structural reform of the financial sector were brought into effect in December, even as the government and the Bank of Korea were pressing ahead with the comprehensive economic reforms that formed part of the conditionality element of the IMF's stand-by credit package. Notably, the government ordered fourteen merchant banking corporations, two securities companies(Coryo, Dongsuh) and one investment trust company(Shinsegi), which were all suffering management problems, to suspend their business operations.

Furthermore, the Bank of Korea decided to extend special liquidity amounting to 11.3 trillion won to those financial institutions, including banks, securities firms, investment trust companies and merchant banking corporations, that were faced with temporary cash-flow problems as a result of the freezing of the call-market liabilities of the fourteen suspended merchant banking corporations and a run on their deposits. Meanwhile, the government had the Public Money Management Fund accept subordinated notes issued by banks in exchange for government and public bonds held by it in order to help banks raise their capital adequacy ratios.

In further moves, the Bank of Korea raised the ceiling on its aggregate credit by one trillion won to help bolster financial support to small and medium enterprises, and also put in place a scheme to give renewed impetus to trade financing, which was experiencing a severe contraction, whereby exporters could get loans from financial institutions on presentation of export bills of exchange.

## Reorganization of Financial System Proceeds

During the year under review, a wide-ranging reform of the financial system was pursued with the objective of strengthening the competitiveness and heightening the efficiency of financial institutions. Toward the end of the year, this realignment of the financial system on the basis of comprehensive financial reforms was accelerated in accordance with the conditionality element of the IMF program.

The Bank of Korea Act was revised so as to give greater independence to the Bank of Korea in its framing and implementation of monetary and credit policies. An Act Concerning the Establishment of Financial Supervisory Organizations was passed to bring about the integration of financial supervisory functions which had formerly been conducted by separate supervisory agencies for each type of financial institution. As a result of the realignment of the central banking and financial supervisory system, the Office of Bank Supervision, long part of the Bank of Korea, has been separated from the Bank of Korea and placed under the control of a newly-created Financial Supervisory Commission.

As a further step in the structural readjustment of the financial industry, the Depositor Protection Act was revised to integrate various deposit insurance schemes under the umbrella of the Korea Deposit Insurance Corporation(KDIC), and to enlarge the latter's functions in dealing with the resolution of troubled financial institutions.

In order to give greater support to the resolution of financial institutions' non-performing assets and ailing corporations' self-rescue efforts, a piece of legislation entitled the Act Concerning the Efficient Disposal of Financial Institutions' Non-performing Assets and the Establishment of the Korea Asset Management Corporation, was passed by the National Assembly. This laid the legal foundation for the establishment of the Korea Asset Management Corporation and the Non-performing Asset Resolution Fund. Amendments were also made to the Financial Industry Restructuring Act with the objectives of strengthening the prudential supervision of financial institutions and of preparing the legal basis for orders by the supervisory agency to ailing financial institutions to reduce their capital and for the government' s participation in their capital.

In keeping with the general opening and liberalization of the financial sector, the General Banking Act, the Korea Development Bank Act and the Industrial Bank of Korea Act were revised in order to enhance banks' managerial autonomy and the efficiency of their management. Legislation abolishing the Korea Housing Bank Act was also passed, as a result of which the Korea Housing Bank was converted into a commercial bank under the provisions of the General Banking Act, changing its name to the Korea Housing and Commercial Bank.

In addition, legislation relating to non-banking financial institutions including securities, insurance and trust institutions was revised, to bring it into line with the setting-up of a unified financial supervisory agency and the integration of the various deposit insurance schemes.

## Expansion of Government Spending Slackens

In the year under review, the government conducted public finance with an emphasis on strengthening support for the improvement of national competitiveness and of the quality of life for the general public. These objectives were pursued subject to the dual constraints of maintaining a tight fiscal stance for price stabilization and the improvement of the current account position.

Fiscal expenditure increased by 10.5 per cent, on an overall account(net) basis, much less than in the previous year. Nevertheless, the ratio of fiscal expenditure to gross national product(GNP) at current prices rose from 21.7 per cent in the previous year to 22.2 per cent in 1997, as the rate of increase of GNP expenditures outpaced that of GNP.

By account, the general account expanded by 9.4 per cent, lower than its 13.6 per cent growth of the previous year. Its deceleration was helped by the restraint of rigid expenditures, such as those on defense and personnel, whose effects were only partially offset by the expansion of the fiscal spending on public works and on social welfare. Special accounts, meanwhile, were also held to a 6.9 per cent increase, much lower than 14.2 per cent in the previous year, due to the slowdown in the expansion of all major special accounts other than the National Railroad Enterprise Special Account and the Communications Service Enterprises Special Account.

The growth rate of total tax revenues slowed from the 13.9 per cent of the previous year to 9.4 per cent, due to the sharp slowdown in collections of direct taxes such as income tax, and corporation tax in response to the economic stagnation.

The ratio of tax revenues, including local tax, to nominal GNP registered 21.2 per cent, similar to that of the previous year.

In order to help raise the overall level of the nation's competitiveness, the government strengthened fiscal support for some sectors, such as infrastructure, science and technology, SMEs and export enterprises. In addition, it expanded spending on areas such as social welfare programs, environmental improvement and the safety of public facilities, all of which contribute to improving the quality of life for the general public.

Meanwhile, revisions were made to the tax system in order to help bring about an improvement in corporations' capital structures, encourage savings and promote structural adjustment. The major revisions were the exemption from liability to the special value added tax on sales of real estate undertaken by firms for the repayment of their debts to financial institutions, the withdrawal of recognition of interest expenses on excessive borrowings, and the launch of tax-exempt preferential savings products for workers.

# Ⅱ. Monetary and Foreign Exchange Policy

During the year, the Bank of Korea supplied money flexibly, seeking to soothe the market's instability. At the same time, it sought to refine its monetary policy instruments in order to prepare the environment for indirect monetary management. The Bank also took various measures to expand financial support to small and medium enterprises (SMEs), which were experiencing numerous difficulties as a result of a credit crunch.

In the area of foreign exchange policy, the government pursued extensive foreign exchange and capital account liberalization, fulfilling its undertakings given on joining the OECD in September 1995. Concerned over the growing mismatch between demand and supply in the domestic foreign exchange market, it also carried out earlier than originally planned a number of steps, such as a wider capital market opening and the improvement of the system for current transactions.

Especially during the fourth quarter, with the mounting instability of the foreign exchange market, additional measures designed to restore stability were carried out within the framework of the agreement concluded with the International Monetary Fund. These included a much wider capital market opening and a shift to a free-floating exchange rate system.

## 1. Monetary Policy

### (1) Setting and Operating the Monetary Target Ranges

In view of the disruptive impact of the previous year's realignment of the trust account system on its chosen monetary aggregate, the Bank of Korea adopted a system of dual monetary intermediate targets; namely, the growth rate of $M_2$ and that of MCT($M_2$+CDs+Money-in-Trust). The target range for the growth of $M_2$ was set within a range of 14~19 per cent and that for MCT at 15~20 per cent on a December daily-average basis.

The emphasis of monetary and credit policies during the year was placed on flexibility in the supply of money with a view to regaining stability in the financial markets, which were unsettled by the managerial difficulties of some financial institutions and the credit crunch arising from the increased number of large corporate insolvencies. Especially during the last two months of the year, when financial institutions and firms alike experienced an acute shortage of liquidity owing to the financial and currency crises, the Bank of Korea purchased bonds issued by the Non-performing Asset Resolution Fund, extended special loans to some troubled financial institutions, and raised the aggregate credit ceiling. However, it subsequently acted to minimize the inflationary pressures on aggregate demand by absorbing the excess liquidity through open market operations.

Under the terms of Korea's agreement with the IMF, the Bank changed its method of monetary policy operation in December from a focus on the dual intermediate targets to the management of reserve money itself determined in consideration of $M_3$ which serves as an informative indicator. Reserve money is classified into Net International Reserves (NIR), which are the BOK's net external assets, and Net Domestic Assets (NDA). Reserve money is managed by setting a floor for NIR and a ceiling for NDA.

The Bank of Korea in concert with the IMF set the indicative limits of $M_3$ and

**[Table 3] Management of Monetary Policy under the IMF Program**

(As of the end of December 1997)

Unit: billion won

| | IMF Program(A) | Performance(B) | B-A |
|---|---|---|---|
| Reserve Money | 23,270.0 | 22,519.3 | -750.7 |
| | (-9.5) | (-12.5) | |
| NIR | -3,300.0 | -3,300.0 | 0 |
| <billion dollars> | <-3> | <-3> | <0> |
| NDA | 26,570.0 | 25,819.3 | -750.7 |

Note: Figures in parentheses represent per centage changes compared with the same period of the previous year.

reserve money as of the end of December at 15.4 and -9.5 per cent respectively, and established the floor for NIR at -3 billion dollars and the ceiling for NDA at 26,570 billion won as the performance criteria. In response to the conduct of monetary policy, the growth rate of reserve money stood at -12.5 per cent at the end of the year and that of $M_3$ at 13.9 per cent. Meanwhile, NIR and NDA met their performance criteria by registering -3 billion dollars and 25,819 billion won, respectively.

### (2) Rediscount Policy

#### A. Improvement of Marginal Lending Facility

On February 24, the Bank improved its marginal lending facility(B2 funds), which is a system of loans to banks which are suffering from temporary shortages of reserve requirements or settlement funds. Because the determination and scale of B2 lending had been at the discretion of the Bank, call rates had risen steeply and call market transactions had shrunk dramatically whenever there was a shortage of reserves. Thus, it was decided to allow banks to borrow B2 funds at their discretion in order to heighten the predictability of their fund management and inhibit excessive volatility in short term interest rates. Ceilings for each bank's B2 borrowings were set at 50 per cent of the daily average reserve requirement for one day and at 100 per cent of the average reserve requirement for each half-month reserve period. However, in the case of requests for borrowings of B2 funds over and above these, the Bank decides whether or not to lend and the scale of the accommodation on a case-by-case basis.

#### B. Managing the Aggregate Credit Ceiling Flexibly

On February 24, the Bank lowered the ceiling on its aggregate credit by 2.8 trillion won, reducing the amount available from 6.4 trillion won to 3.6 trillion won in order to absorb the excess liquidity induced by that month's reduction in reserve requirements. But, on December 12, the ceiling was lifted by 1 trillion won to facilitate support for SMEs suffering from the credit squeeze.

Also, the Bank changed its method of allocating credit quotas to individual banks as a means of inducing their support for SMEs and high technology industries. On

February 24, the method of quota calculation was changed from an item-by-item basis, for example, commercial bill discounts and foreign trade financing, to the sum of such items. And in calculating eligible commercial bill discounts, the weighting of local branch lending and the bar on those to non-manufacturers were abolished. On April 1, banks' loan to information and telecommunication industries were included in calculating that portion of the aggregate ceiling allocated by provincial branches. On May 1, in order to induce banks to expand their credit-based lending, the Bank raised the weighting of such lending from 5 to 15 per cent in calculating their quotas under the aggregate credit ceiling.

### C. Measures for Stabilizing the Financial Market

On September 8, the Bank provided a special loan of one trillion won with a one-year maturity to Korea First Bank (KFB), which was acutely short of liquidity owing to its accumulation of bad loans. The interest rate on this special loan was set at 8 per cent, the average cost of funds for commercial banks. In an attached memorandum, KFB agreed to carry out faithfully the self-rescue scheme it had submitted to the Bank.

On October 16, the Bank also extended special loans to the sixteen merchant

[Table 4] **Support for Financial Market Stabilization**

| Date | Institution | Amount | Contents |
|---|---|---|---|
| 9.8 | Korea First Bank | 1 trillion won | Maturity: 1 year<br>Interest rate: 8.0% |
| 10.16 | 16 merchant banking corporations | 1 trillion won | Maturity: 1 year<br>Interest rate: 8.0% |
| 11.28 | Non-performing Asset Resolution Fund | 2 trillion won | Maturity: 5.5, 6, 6.5, 7 years<br>Interest rate: 5.0% |
| 12.12 | Banks, Merchant banking corporations, Securities companies, Investment trust companies | Ceiling: 11.3 trillion won<br>Performance: 6 trillion won | Bank: Maturity: Less or equal to 3 months; Interest rate: Average call rate minus 1 per centage point<br>Merchant banking corps, Securities companies: Maturity : Up to 3 months; Interest rate: Average call rate<br>Investment trust companies: Outright purchase of government and public bonds |

banking corporations whose loans to firms falling under the "Bankruptcy-Prevention Accord" exceeded 50 per cent of their equity capital. The terms of the loans were identical to that provided to KFB. And it imposed a condition that failure to carry out self-rescue schemes sincerely might result in the loans being called in before maturity or having their interest rate raised.

On November 28, through purchasing in full a two-trillion won bond issue by the Non-performing Asset Resolution Fund, the Bank gave its support to banks in clearing bad loans, thus backing financial market stabilization and financial industry restructuring. The discount rate on the bonds was 5 per cent. The Bank made payment to the Fund in the form of Monetary Stabilization Bonds (MSBs), whose redemption was permitted in the case of necessity.

In December, fourteen merchant banking corporations were ordered to suspend their business and two securities companies were declared insolvent. Fund transactions among financial institutions in the call market shrank drastically and financial markets went into turmoil. The Bank thus stepped in to support banks, merchant banking corporations, securities companies and investment trust companies on December 12, setting a ceiling of 11.3 trillion won on this support facility. To give the banks access to funds equivalent to those locked in as call loans to suspended merchant banking corporations, the Bank provided loans of 7.3 trillion won to them under this facility through a new loan scheme scheduled to operate temporarily until the end of 1998. The investment trust companies were furnished with liquidity by the Bank's outright purchase of their government and public bonds. Its support for the merchant banking corporations and securities companies was channelled through the Korea Securities Finance Corporation and the Korea Non-Bank Deposit Insurance Corporation. As a result of these various measures, a total of 6 trillion won had been supplied in the form of these special loans as of the end of December.

### D. Financial Support for SMEs and Export Firms Strengthened

The Bank extended emergency funds to SMEs in order to prevent chain bankruptcies among them in response to their acute shortage of funds owing to the large corporate insolvencies and the very tight financial conditions. On February 14, the Bank channelled 182.6 billion won to banks by redeeming MSBs to the same value as their loans to SMEs hit by the failure of Hanbo Iron and Steel. On

October 1, it furnished support to subcontractors and other firms associated with Kia group which had fallen into managerial difficulties and been brought under the Bankruptcy Prevention Accord. The support took the form of an increase in banks' individual quotas under the aggregate credit ceiling system equivalent to half of their loans extended to the affected firms, subject to an overall limit of 350 billion won.

In relation to the foreign trade financing system, on February 15, the Bank linked the basis for calculation of the unit loanable amount to the average exchange rate. So SMEs and independent large firms were allowed to borrow up to 90 and 60 per cent, respectively, of the required funds. And raw materials purchase funds and raw material import funds were unified as raw material funds. On April 23, the Bank expanded the range of instruments eligible for foreign trade financing from letters of credit and advance bills of export to other instruments including export factoring contract documents.

Moreover, as banks were reluctant to discount export bills owing to the extremely tight foreign exchange market after the standby loan accord with IMF, the Bank from December 4 supplied liquidity to banks by redeeming MSBs to an amount equivalent to their lending performance against export bills.

## (3) Open Market Operations Policy

### A. Efficiency of Open Market Operations System Enhanced

During the year, the Bank of Korea took several measures to enhance the efficiency of its open market operations.

Firstly, it moved to a completely competitive bidding system for all its offers of RP transaction and the issuance of MSBs without exception. However, in spite of this measure, the competitive bidding ratio for the Bank's MSBs issuance (the proportion of the total offered through competitive bidding) decreased from 89 per cent in 1996 to 60 per cent in 1997. This was due, on the one hand, to a big increase in unsuccessful bids owing to the large gap between market interest rates and Bank's market intervention rate from November onwards, and on the other hand, to foreign banks' branches operation of their funds in the form of MSBs.

Secondly, on July 23, the Bank changed its method of conducting open market

[Table 5] **Competitive Bidding Ratios for the Bank's RPs and Issuance of MSBs**

Unit: per cent

| | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|
| RP Transactions | 49.6 | 75.7 | 99.1 | 100.0 |
| Issuance of MSBs | 31.5 | 33.0 | 89.1[1)] | 59.5 |

Note: 1) Excludes the issuance of MSBs in connection with the reduction of banks' reserve requirements on April 23, 1996.

operations from receiving written bids to screen-based offers and bids through BOK-wire. As the complete procedure from announcement of bidding to the reporting of the result went on-line, the Bank's counterparts could reduce their bidding-costs and the Bank was able to heighten the efficiency of its open market operations through the prompter fine-tuning of conditions.

In a further move, the Bank extended its counterparts for repo transactions, which had been limited to banks, to include merchant banking corporations (September 1), securities companies (October 2), and investment trust companies (December 19). Thereby, it opened up a channel for the direct supply of liquidity to merchant banking corporations and securities companies through its use of reverse repo transactions, which should be helpful in relieving temporary funds shortages on the part of these non-bank financial institutions.

### B. Active Employment of Transactions Involving Government and Public Bonds under Repurchase Agreements

The Bank of Korea made active use of repurchase agreements involving government and public bonds during the year in order to maintain money supply at an appropriate level. During the year, the overall value of the Bank's RP operations amounted to some 104 trillion won in a total of 122 transactions, figures respectively 1.8 and 1.5 times those for the preceding year. Apart from the second quarter when the market showed relatively stable range of movements, purchases of government and public bonds under resale agreements, or reverse RPs, exceeded sales. Particularly in the second half of the year, the Bank greatly enlarged the scale of its offers of reverse repos to the market as banks were experiencing acute liquidity shortages owing to the failure to resolve the problems of the Kia group and the foreign exchange crisis.

[Table 6] **Transactions under Repurchase Agreements Involving Government and Public Bonds**

Unit: billion won

| | 1995 | 1996 | 1997 | | | | |
|---|---|---|---|---|---|---|---|
| | | | Year | I | II | III | IV |
| Purchases | 12,424 | 38,902 | 72,786 | 8,650 | 5,375 | 26,088 | 32,673 |
| | (15) | (31) | (80) | (10) | (9) | (31) | (30) |
| Sales | 38,838 | 32,350 | 30,784 | 3,646 | 13,338 | 4,700 | 9,100 |
| | (61) | (37) | (42) | (7) | (18) | (6) | (11) |
| **Total** | **51,262** | **71,252** | **103,570** | **12,296** | **18,713** | **30,788** | **41,773** |
| | **(76)** | **(68)** | **(122)** | **(17)** | **(27)** | **(37)** | **(41)** |

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

## C. Outstanding Balance of Monetary Stabilization Bonds Reduced

As the Bank provided liquidity by way of the redemption of MSBs to alleviate the very tight conditions in financial markets throughout much of the year, net redemption of MSBs totalled 1,559 billion won during the year. Thus, their outstanding balance eased from 25 trillion won to 23.5 trillion won at the end of the year and the ratio of the outstanding balance of MSBs to $M_2$, correspondingly, dropped from 14 per cent to 12 per cent.

The net redemption of MSBs increased in the first quarter as the Bank eased its monetary management to soothe the market unrest. However, net issuance took place in the second quarter when the Bank needed both to sterilize inflows and to

[Table 7] **Issuance and Redemption of Monetary Stabilization Bonds**

Unit: billion won

| | 1995 | 1996 | 1997 | | | | |
|---|---|---|---|---|---|---|---|
| | | | Year | I | II | III | IV |
| Net issuance | 485 | -795 | -1,559 | -3,361 | 4,691 | -17 | -2,873 |
| Issuance | 39,458 | 30,725 | 31,224 | 5,548 | 12,040 | 1,886 | 11,750 |
| Competitive tender | 12,243 | 23,705 | 18,577 | 3,977 | 7,740 | 1,274 | 5,587 |
| Direct sale | 27,215 | 7,019 | 12,647 | 1,571 | 4,300 | 612 | 6,163 |
| Redemption | 38,972 | 31,520 | 32,783 | 8,908 | 7,349 | 1,902 | 14,623 |
| Outstanding balance | 25,825 | 25,030 | 23,471 | 21,670 | 26,361 | 26,344 | 23,471 |

absorb the excess liquidity released during the first quarter.

But in the third quarter, MSBs shifted back to a slight net redemption position, because the Bank provided liquidity in accordance with an enlarged short-term capital account deficit and the deepening financial market turmoil. Moreover, in the fourth quarter, the scale of the net redemption was greatly enlarged as the Bank strove to ease the shortage of liquidity arising from its large-scale intervention in the foreign exchange market in support of the Korean won.

### (4) Reserve Requirement Policy

The Bank reduced the average reserve requirement ratio by 2.1 per centage points on February 23 with a view to improving commercial banks' autonomy in their asset management, and providing a level playing field between banks and non-banks. Previously the level of reserve requirements had been differentiated by type of deposit, but this system failed to reflect their varying degrees of liquidity or "moneyness". The Bank thus realigned the reserve requirement system by grouping deposits into either demand deposits or time deposits(including special purpose

[Table 8] **Reduction of Banks' Reserve Requirement Ratios**

Unit: per cent

| Type of deposit | | Previous | Feb. 23 onwards |
|---|---|---|---|
| Special purpose deposits | Workman's property formation savings deposits, Workman's long-term savings deposits, Workman's savings deposits for housing, Household long-term savings deposits, Long-term savings deposits for housing | 2.0 | 1.0 |
| Time deposits | Mutual installments deposits and Housing installments deposits | | 2.0 |
| | Time & savings deposits with a maturity of less than two years4 | 4.0 | |
| | Time & savings deposits with a maturity of at least two years | 7.0 | |
| Demand deposits, etc. | Demand deposits and other time and savings deposits | 7.0 | 5.0 |
| | Average(excluding CDs) | 5.5 | 3.3 |
| Time & savings deposits | CD | - | 2.0 |
| | Average(including CDs) | 4.6 | 3.1 |

deposits), and imposing reserve requirement on the basis of the degree of liquidity.

The Bank also imposed reserve requirement on negotiable certificates of deposit(CDs), setting the ratio at 2 per cent. However, inter-bank CDs remain exempt from reserve requirements.

In a matching move, the Bank absorbed the approximately 2,800 billion won in surplus liquidity released through its lowering of reserve requirements by the reduction of its aggregate credit ceiling.

## (5) Loan System of Banking Institutions

### A. Regulations on Credit Extension Steadily Eased

The Bank continued to ease regulations on the credit extension of commercial banks with a view to establishing banks' loan management on the bases of market principles and the strengthening of firms' competitiveness.

With effect from February 10, to increase infrastructure investment, the Bank allowed banks to lend funds for purchase of land needed for road construction by local governments and for primary facilities (roads, railways, ports, airports, multipurpose dams, water supply, sewage disposal, telecommunications, etc.) among the private-capital-initiative facilities selected by the government. And the bank eased remaining prohibitions on credit extension except for business which threaten to provoke a recurrence of real estate speculation.

The Bank on July 4 lowered the mandatory ratio for lending to small and medium enterprises by local banks and Industrial Bank of Korea. The ratio applied to local banks was reduced from 70 per cent to 60 per cent, in view of local banks' comparative disadvantage in attracting funds from households because of the limitation on their fund management imposed by the higher ratios than those on with nationwide commercial banks(45 per cent). And the Enforcement Decree of Industrial Bank of Korea Act was amended, so bringing down its mandatory ratio for lending to small and medium enterprises from 90 per cent to 80 per cent with effect from November 29.

On August 1, the Bank abolished regulations imposed on the main banks of the ten largest conglomerates in connection with the latter's acquisition of real estate. It was considered that the effectiveness of such restrictions had declined since an institutional frameworks had already been put in place and the interlinked business groups were themselves pressing ahead with sale of own real estate in the course of industrial restructuring.

### B. Management System of Banking Institutions' Credit Realigned

With effect from August 1, credit ceilings on a single interlinked business group ("chaebol") were introduced, the main objectives being to enhance the effectiveness of banks' credit concentration management and to avoid joint failures on the part of the chaebol and banks.

The legal foundation for this system, which prohibits an individual bank's credit extension to a chaebol from exceeding a certain ratio of its equity capital, had already been laid under the 1982 revision of the General Banking Act. But, since the size of banks' equity capital had been too small, and information about individual firms within each chaebol and banks' credit statistics had not been computerized, introduction of the system had been deferred. However, these obstacles having resolved themselves in the course of time, it was decided to put the system in operation.

Loans(including loans from banks' trust accounts) and acceptances & guarantees in won fall within the scope of the system, and the ceiling on such credit to a single chaebol is set at 45 per cent of a bank's equity capital. An interim period of 3 years(till July 31, 2000)was allowed so that banks could call in credit in excess of the ceiling as of the enforcement date, August 1, 1997. A bank unable to handle the problem within this time frame must obtain the consent of the Superintendent of Banks or his successor , the Financial Services Commissioner.

Meanwhile, the Bank decided to retain the existing system of credit ceilings on chaebols as a whole up until July 31, 2000 when the interim period set for withdrawal of credit in excess of the ceiling as of the enforcement date expires. This decision was motivated by worries that if it were to be abolished, smaller chaebols or SMEs in relatively poor credit standing would find themselves in a more difficult position as a handful of the leading chaebols might borrow up to the limit of the ceiling from several banks at the same time.

### C. Single Borrowers Credit Ceilings Introduced on Banks' Trust Accounts

With effect from August 1, the government introduced a ceiling on single borrowers from banks' trust accounts, restricting loans to single individuals or corporations to five per cent of the outstanding balance of a bank's total trust account loans as of the previous year-end. The system was introduced to prevent the possibility of loans from banks' trust accounts being used to circumvent the ceilings on bank account credit to single borrowers. Banks were required to withdraw that portion of their credit from their total account in excess of the new single-lender ceiling within three years. But, when approval is obtained from the Minister of Finance and Economy, a bank may exceptionally be allowed to continue extending credit from its trust account in excess of the new ceiling.

#### D. Types of Financial Institutions Handling with Commercial Paper(CP) Temporarily Broadened

Alert to the likelihood of a further contraction in firms' short-term fund raising due to the suspension of nine merchant banks' operations on December 2, the government allowed seven local banks to handle the discount of accommodation-bills between December 16,1997 and March 31,1998. And on December 10 it allowed banks' trust accounts to purchase CP up until the end of 1998. Meanwhile, securities companies received permission to engage in the underwriting, dealing and brokerage of CP without any limit on the amount as of August 1.

### (6) Banking Institution Deposits

#### A. Fund-Raising Regulations Eased

The Bank continued to ease regulations concerning banks' fund-raising both to enlarge their autonomy and to promote competition in the financial market.

On February 10, it abolished restrictions on the maximum maturities(10 years) of bank deposits in a move corresponding to the abolition of regulations on those(10 years) of bank loans under the revised General Banking Act(January 13). Its regulations on the minimum maturities(one year) of deposits with fixed maturity on which floating rates could be applied were also eliminated. But the Bank kept in place the regulations on the maximum maturities of special-purpose-deposits such as long-term savings for households, which were stipulated under relevant legislations, notably the Regulation of Tax Reduction and Exemption Act.

On February 17, the Bank eliminated ceilings on banks' issuance of CDs, the need for which had disappeared with the imposition of reserve requirement on CDs(February 23). It also removed those on banks' issuance of cover bills to enlarge their fund-raising-capacity for the discount of firms' commercial bills. And the ban on banks' acceptance of their own CDs as collateral, which had been imposed to prevent their abuses as a form of compensating balance, were abolished, as the deregulation of lending rules had obviated the need for regulation.

As of July 7, saving-type products were consolidated with the integration of savings deposits and preferential savings deposits, which allow 'free deposit and withdrawal' at any time, and all restrictions abolished except those concerning depositor eligibility(individual persons only) on interest rate, ceilings on the amount of deposit, the method of calculating the interest rate, etc. For company savings deposits, although the Bank freed up interest rates, it decided not to permit the payment of interest on deposits of less than seven days in order to maintain the effectiveness of regulations concerning interest rates on passbook deposits and checking deposits. As a result, banks were able to launch market-interest-bearing money market deposit accounts(MMDA), products which combine the features of 'free deposit and withdrawal' and the 'checkability' of demand deposits, with the high yields of time & savings deposits.

Regulations were lifted on the interest rate payable after the maturity of deposits

[Table 9] **Interest Rate Deregulation of 'Free Paying-in and Withdrawal' Time & Savings Deposits**

| | Before July 6th | After July 7th | Comments |
|---|---|---|---|
| Savings deposits | 3.0% a year | liberalized | integrated |
| Preferential savings deposits | 3 months or more: liberalized<br>less than 3 months: 3.0% a year | liberalized | |
| Company savings deposits | 3 months or more: liberalized<br>less than 3 months: 2.0% a year<br>less than 7 days: non-accrued | 7 days or more: liberalized<br>less than 7 days: non-accrued | |

with fixed maturity whose effectiveness had disappeared with the liberalization of those interest rates(November 1995) and the abolition of restrictions on maximum maturities(February 1997). Individual banks were allowed to set interest rate for the mid-term cancellation at their discretion for deposits with fixed maturity held for at least one month, the minimum contract period for them.

In addition, the Bank removed restrictions on the minimum issuance of CDs, cover bills and high-value RPs, and deregulated interest rates on low-value financial products. And it also scrapped most requirements on the issue of short-term marketable financial products such as those on the maturities of commercial bills, trade bills, RPs, etc. However, the thirty-day minimum maturity on CDs, cover bills and RPs remained in place.

[Table 10] **Enlarged Deregulation of Money Market Financial Instruments**

<table>
<tr><th rowspan="2"></th><th rowspan="2">Dealing institutions</th><th colspan="2">Maturity</th><th colspan="2">Minimum Denomination (million won)</th></tr>
<tr><th>before July 6th</th><th>after July 7th</th><th>before July 6th</th><th>after July 7th</th></tr>
<tr><td>CD</td><td>banks</td><td>30~270 days</td><td>30 days or more</td><td>10</td><td rowspan="6">liberalized</td></tr>
<tr><td>Cover Bills</td><td>banks<br>merchant banks<br>community credit cooperatives</td><td>30~180 days<br>1~180 days<br>30~180 days</td><td>30 days or more<br>less than 1 year<br>liberalized</td><td>5</td></tr>
<tr><td>large-value RPs</td><td>banks<br>securities companies</td><td>30 days~1 year<br>30 days~1 year</td><td>30 days or more<br>liberalized</td><td>10</td></tr>
<tr><td>large-value commercial bills</td><td>banks</td><td>30 days or more</td><td>liberalized</td><td>10</td></tr>
<tr><td>large-value trade bills</td><td>banks<br>merchant banks</td><td>30~270 days</td><td>liberalized<br>less than 1 year</td><td>10</td></tr>
<tr><td>sale of government & public bonds</td><td>banks,<br>securities companies</td><td>one day or more</td><td>one day or more</td><td>5</td></tr>
<tr><td>small-value commercial bills and trade bills</td><td>banks</td><td colspan="4">within 7.0% a year → liberalized</td></tr>
<tr><td rowspan="2">low-value RPs</td><td>banks</td><td colspan="4">91 days~1 year: within 8.0% a year → 30 days or more: liberalized</td></tr>
<tr><td>securities companies</td><td colspan="4">less than 7 days: non-accrued<br>7 days~1 year : within 8.0% a year<br>liberalized</td></tr>
</table>

## B. Commercial Banks' Issuance of Financial Debentures Allowed

In keeping with the trend toward financial liberalization, commercial banks were allowed to issue financial debentures from July 7 with a view to encouraging the development of long-term financial business.

Banks were allowed to determine the type of financial debenture, the method of issuance and the use of the funds raised, at their discretion, but the minimum maturity was set at three years to minimize side effects arising from the direct competition with banks' deposit products and the existing financial debentures offered by specialized banks and development institutions. Repurchase by the bank prior to maturity was also prohibited.

Meanwhile, the issuance ceiling on financial debentures was set at 50 per cent of a bank's equity capital, with a proviso added that it be set at 25 per cent thereof for one year from the date of enforcement. But the Bank abolished this proviso on December 22 so that banks could improve their BIS capital adequacy ratios through the issue of subordinated notes.

In addition, Korea Development Bank and Korea Long Term Credit Bank, which had long issued financial debentures as a source of funds, were allowed to issue CDs and cover bills to keep a level playing field with commercial banks.

## C. Issuance Ceiling of Development Money in Trust Expanded and New Type Installment Trusts Launched.

Seeking to stabilize financial market and increase institutional investor's purchase of stocks, the government on November 26 raised, by two trillion won, the ceiling on development money in trust which had been frozen for since January. Banks were instructed to use more than 30 per cent of amounts newly raised through development money in trust for the purchase of stocks.

On December 15, the government shortened the minimum maturities of banks' trust account products(one year and six months) to one year. It reduced the penalties for mid-term cancellation to a fixed rate of one per cent of the amount cancelled where the period held in trust was less than six months, and allowed banks to set penalties for mid-term cancellation at their discretion within a maximum of 0.5 per cent where that period held in trust was at least six months. This paved the way for the launch of new type installment trusts whose maturity was 6 months. These moves represented back-up measures following the suspension of the operations of some merchant banks, and were taken in the light of the need to strengthen banks' fund-raising capacity so as to facilitate their trust accounts discount and purchase of CP, an activity previously carried out by merchant banks.

#### D. Reserve Requirements on Workman-Preferential Savings Set Low

On August 30, the government introduced interest-income-tax exempt workman-preferential savings with maturities from three to five years to support worker's accumulation of financial assets. On September 18, the Bank set the reserve requirement ratio on these products at one per cent, in view of their characteristics as long-term saving products with a low possibility of mid-term cancellation.

### (7) Major Changes in Financial Industry Legislation

#### A. Revision of the Bank of Korea Act

The Bank of Korea Act was revised in order to enhance the independence and autonomy of the Bank of Korea and to divest it of its bank supervisory function. It was provided that the revised Act should enter into effect as of April 1, 1998.

The revised Act defines the Bank of Korea's objective as being solely 'to maintain price stability', abandoning the former dual objectives of 'the maintenance of the stability of the value of money, and the strengthening of the soundness of the banking and credit system.'

Under the new Act, the Minister of Finance and Economy is excluded from the chairmanship and membership of the Monetary Board while the Governor of the Bank of Korea serves concurrently as the Chairman of the Monetary Board. The membership of the Monetary Board is reduced from nine to seven, of which a smaller proportion is recommended by the government. In addition, all members are to serve on a full-time basis and no member shall be discharged from office against his will.

In regard to monetary and credit policy, the Act prescribes that the Bank of Korea set a price stability target every year in consultation with the government, and formulate and publicly announce an operation plan including this target for its monetary and credit policy. The Bank of Korea is to engage in the operation and management of the payment systems, insofar as this is related to monetary and credit policy. The revised Act also stipulates that the Bank of Korea exercise an advisory function concerning the government's policies on the exchange rate, foreign currency loans and deposits of banks, and the setting of foreign exchange overbought and oversold position limits on them.

In parallel with the restructuring of the financial supervisory functions, the former provisions related to the Office of Bank Supervision are abolished. However, the Act does give the Bank of Korea certain indirect and limited supervisory powers. Under these, the Bank of Korea has the right to request all banks, and all non-banks entering into agreements on checking accounts with it, to submit such materials as it may request. The Bank of Korea may require the Financial Supervisory Board to conduct on-site examination or joint examination with it on specific banking institutions when the Monetary Board deems it necessary for the implementation of its monetary and credit policy. It also may require the Financial Supervisory Board to submit the findings of such examinations, and on the basis of these findings to order corrective actions by the banks concerned.

The revision leaves the Minister of Finance and Economy with the right to request the Monetary Board to reconsider a resolution it has adopted, while adding a provision which restricts potential abuse of this right. Under the provision concerned, he may ask for reconsideration only when the resolution is in conflict with the government's economic policies and in such cases he should at once announce this publicly.

Under the new Act, the Bank of Korea is required, at least once a year, to prepare a report on the implementation of its monetary and credit policy, and submit this to the National Assembly. The revised Act stipulates that the central bank's budget for expenses other than those related to monetary and credit policy must receive the prior approval of the Minister of Finance and Economy.

### B. Passage of the Act Concerning Establishment of Financial Supervisory Organizations

An Act was passed to consolidate and integrate within a single financial supervisory institution the financial supervisory function, which had previously been divided among separate agencies according to the type of financial institution. Entitled the Act Concerning the Establishment of Financial Supervisory

Organizations, it was to come into effect as of April 1, 1998.

The Act provides that the Financial Supervisory Commission be instituted as the supreme policy-making body for financial supervision under the jurisdiction of the Prime Minister. It should deliberate and resolve on major aspects of financial supervision: the establishment and revision of regulations relevant to the supervision of financial institutions; authorizations and permissions relevant to the operations of financial institutions; important matters relevant to the examination and sanction of financial institutions; and important matters relevant to the administration, supervision, and oversight of securities and futures markets. It is also required to instruct and supervise the duties, operations, and administration of the Financial Supervisory Board.

The Financial Supervisory Commission is to be made up of nine members: three ex-officio members and six members appointed by the President. The Chairman of the Financial Supervisory Commission is to be appointed by the President after the deliberation of the State Council.

The Securities and Futures Commission is to be established under the Financial Supervisory Commission. It will be in charge of the investigation of unfair transactions in the securities and futures markets, and the pre-deliberation of matters concerning the standards of corporate accounting and the auditing of accounts, etc.

The Financial Supervisory Board is to be established by the merger of the existing financial supervisory bodies on a date in 1999 as prescribed by the related Presidential Decree. It will take the form of a special juridical person with no capital and will undertake the examination and supervision of financial institutions under the direction of the Financial Supervisory Commission and the Securities and Futures Commission. Until the establishment of the Financial Supervisory Board, its functions are to be performed by the four existing supervisory bodies - the Banking Supervisory Authority, the Securities Supervisory Board, the Insurance Supervisory Board, and the Credit Management Fund.

### C. Revision of the Depositor Protection Act

The Depositor Protection Act was revised in order to enhance the depositor protection function and promote the stability of the financial industry. Its provisions consolidated the various existing deposit insurance institutions into the Deposit Insurance Corporation and strengthened the latter's functions in the resolution of distressed financial institutions.

The four previous deposit insurance bodies - the Deposit Insurance Corporation, the Securities Supervisory Board, the Insurance Supervisory Board and the Credit Management Fund - were consolidated into one, i.e. the Deposit Insurance Corporation. Along with this integration, the scope of financial institutions covered by the Act was extended to include not only banks but also securities companies, insurance companies, merchant banking corporations, mutual savings and finance companies, and credit unions. The scope of the deposits covered by the Act was similarly expanded to include those of the newly-embraced financial institutions. The five separate deposit insurance funds established for each type of financial institution were also integrated into the Deposit Insurance Fund.

The functions of the Corporation relating to funding support for mergers and acquisitions involving distressed financial institutions and the resolution of such institutions were extensively strengthened. The scope for the Corporation's provision of funding support was widened, allowing it to help fund the smooth takeover or merger of a troubled financial institution and support a "possible-distressed financial institution", that is one the likelihood of whose insolvency is considered by the Operating Committee of the Corporation as high owing to its weak capital structure. Such support might take the form of capital participation, contribution, or the purchase of its outstanding securities.

And a "deposits purchase system" and "bridging financial institution system" were introduced. Under the deposits purchase system the Corporation buys deposits or claims from depositors and creditors, allowing them to obtain their funds quickly when an incident entailing insurance claims occurs but before the distressed financial institution concerned goes into liquidation. Under the bridging financial institution system a newly established bridging financial institution takes over the business or contracts of a distressed financial institution so that the distressed financial institution may exit the market easily.

### D. Legislation Concerning Efficient Disposal of Financial Institutions' Non-performing Assets and Establishment of the Korea Asset Management Corporation

Legislation was enacted providing for the efficient disposal of financial institutions' non-performing assets and establishment of the Korea Asset

Management Corporation, whose purpose is to clear non-performing loans off the books of financial institutions swiftly and support the self-rescue efforts of potentially distressed enterprises having borrowings from them. Provision was also made for the setting-up and operation of the Non-performing Asset Resolution Fund under the Korea Asset Management Corporation.

The main functions of the Corporation are the assumption or resolution of non-performing assets entrusted to it by financial institutions, and investigating the property of debtors(and their close associates). Should the Corporation be asked by a financial institution to support the self-rescue scheme of a potentially distressed enterprise, it can sell or dispose of those assets included in the self-rescue scheme which it has purchased or had entrusted to it in order to assist in the turnaround. It may also undertake a diagnostic management study of the enterprise in question and advise on the rehabilitation of its management.

Meanwhile, the Non-performing Asset Resolution Fund was set up within the Corporation so as to resolve the non-performing assets of financial institutions effectively. The Fund's resources consist of contributions from financial institutions and the government, funds raised by the issuance of its bonds, borrowings from the Bank of Korea and other institutions, operating surplus, etc. The Fund is drawn on for the purchase of non-performing assets of financial institutions and those assets included in the self-rescue plans of potentially distressed enterprises, and for the repayment of principal and interest on its bonds and on its other borrowings.

### E. Revision of the Act on the Structural Improvement of the Financial Industry

The Act on the Structural Improvement of the Financial Industry was revised with a view to strengthening management improvement measures and orders, and the pursuit of efficient financial industry restructuring. It set standards for government investment in a distressed financial institution and for capital reduction orders by the financial supervisory authorities.

Firstly, the scope of management improvement measures issued by the Superintendent of the Financial Supervisory Board for a financial institution which is financially unsound in that, for example, its ratio of equity capital is below the specified standard, was expanded to include actions such as the increase or reduction of capital, the disposal of asset holdings, the downsizing of its organization, the prohibition of acquisitions of high-risk assets, suspension of some parts of its business, submission of a plan for managerial improvement, etc. Previously, it had encompassed simply the issue of a caution, warning, etc.

The scope of management improvement orders issued by the Financial Supervisory Commission for a distressed financial institution was similarly expanded to include actions such as the cancellation of some stocks(including the cancellation of all of the stocks held by some shareholders) or the consolidation of shares; the suspension of officers from the performance of their duties; the appointment of administrators; and the merger or the transfer of all or part of the business, or its takeover by a third party, etc.

Secondly, the Financial Supervisory Commission was empowered to request the government or the Deposit Insurance Corporation to invest in a distressed financial institution which could not continue to carry out its business because it had suffered a run on deposits, etc. If the government or the Deposit Insurance Corporation invests in the capital of a distressed financial institution, the board of directors of the latter may determine matters concerning the issue of new stocks such as their type and conditions, volume, issue price, allotment method and other procedures related to issuance, the provisions of the Commercial Code notwithstanding.

Meanwhile, the board of directors of a distressed financial institution which is ordered to reduce its capital may make a resolution that this be done and stipulate such matters as the methods and procedure of the reduction of capital, and the procedure for the consolidation of shares, etc., notwithstanding the provisions of the Commercial Code. But so as to prevent the rights of creditors or current shareholders from being impaired through such a reduction of capital, conditions were attached that a distressed financial institution which decided to reduce its capital should give public notice concerning the decision of the board of directors, and shareholders, etc. should have the opportunity to present opposing views.

### F. Revision of the General Banking Act

The General Banking Act was revised to improve the corporate governance and management of commercial banks. It strengthened the accountability of management through changes in their shareholding structure and enlarged the sphere of its business discretion through abolition of the approval system of establishment, closure or relocation of a branch, agency, etc. The role of non-executive directors was also heightened.

Although the basic four-percent ceiling on ownership of stocks by a single person remains in place, greater allowance is made for exceptions. Notwithstanding the ceiling, a non-resident may own stocks up to ten percent of the total voting stocks of a bank provided details of the share-holding are reported to the Financial Supervisory Commission. A foreigner intending to acquire or hold stocks of a bank in excess of this 10% level should obtain prior approval from the Commission for holdings at above the 10%, 25% and 33% levels in each case. A Korean individual or juridical person may own the stocks of a bank through the same procedures as for the report by a foreigner at up to the ten percent level, or within the subsequent holding brackets for which approval for a foreigner's shareholding has been obtained. Concerning insider loans, the aggregate amount of loans and guarantees to a single person who holds more than ten percent of its outstanding stocks should not exceed the lesser of an amount determined by the related Presidential Decree within 45% of the equity capital of the bank and an amount proportionate to the share of the bank's equity held by that single person.

Next, in order to heighten the effectiveness of non-executive directors within the board of directors, the ratio of the composition of non-executive directors was changed. Previously half of the non-executive membership of the board was to be made up of representatives of large shareholders, three-tenths of representatives of small shareholders and one-fifth of persons proposed by the board of directors. Under the new Act this make-up of non-executive board membership was changed to seven-tenths for representatives of shareholders and three-tenths those proposed by the board.

And, in order to enlarge the scope for the exercise of banks' managerial judgement, the approval system of the Monetary Board concerning establishment, closure or relocation of a branch, agency, etc. was abolished. The Financial Supervisory Commission may nevertheless determine the standards and the procedures concerning those actions. In case of a change in the bank's capital, the capitalization of reserves may be carried out at a bank's discretion, but the reduction of its capital still requires authorization from the Financial Supervisory Commission.

### G. Other Related Legislation

The Act on Lending-specialized Financial Business was passed allowing companies wishing to operate lending businesses not involved in deposit-taking, such as credit card business, leasing, installment credit business, and venture capital business, to engage in such businesses generally. Various pieces of legislation concerning lending businesses were consolidated into this Act, and, thanks to its passage, entry barriers to establishing a lending-specialized financial company were lowered and restrictions on its subsequent operation eased.

As the Korea Development Bank and the Industrial Bank were excluded from the institutions controlled within the framework of the Act on the Management of Government-invested Institutions, the Korea Development Bank Act and the Industrial Bank of Korea Act were amended to enhance the managerial independence of those banks through the reform of articles concerning their executives, budgeting, final accounts, etc., and the easing of restrictions on their operations. In the meantime, the Korea Housing Bank Act was abolished, thereby allowing the conversion of the related bank, the weight of whose specialization had greatly declined amid changes in the financial environment, etc., to a general bank governed under the General Banking Act.

The Securities and Exchange Act, the Insurance Business Act, the Act Concerning Merchant Banking Corporations, the Mutual Saving and Financing Act, and the Trust Business Act were all revised in line with the integration of financial supervisory authorities and the consolidation of deposit insurance institutions. Amendments were also made to enhance the transparency and soundness of financial institution management.

In order to mitigate the continuing anxieties and inconvenience brought about by the enforcement of the "real name financial transaction system" while strengthening guarantees of the confidentiality of financial transactions, the Presidential Financial and Economic Emergency Decree Concerning Real Name Financial Transactions and Guarantee of the Confidentiality of Financial Transactions was abolished upon the enactment of the Real Name Financial Transactions and Guarantee of the Confidentiality of Financial Transactions Act.

# 2. Foreign Exchange Policy

## (1) Greater Liberalization of Capital Account Transactions

### A. Korean Stock Market Greatly Opened

During the year under review, the government greatly widened the opening of the Korean equity market, easing restrictions on both direct and indirect investment in domestic stocks by foreigners and liberalizing stock index futures and options markets.

In order to promote inflows of foreign capital, the aggregate ceiling within which foreign investors could purchase domestic stocks listed on the Korea Stock Exchange(KSE) was raised on May 1 from 20 per cent to 23 per cent of the outstanding stocks issued by a listed firm, and from 15 per cent to 18 per cent of those issued by a public corporation. The ceiling on holdings by an individual foreign investor was also raised from 5 per cent to 6 per cent of a firm's outstanding stocks. On November 3, the aggregate ceiling was further raised to 26 per cent for a firm, and to 20 per cent for a public corporation. The individual ceiling was at the same time increased to 7 per cent. On December 11, the aggregate and individual ceilings on the purchase of stocks in a listed company were both raised to 50 per cent in line with the agreement with the IMF, the ceilings for a public corporation remaining at the same level as before. The aggregate ceiling was further raised to 55 per cent on December 30.

As for indirect investment in the domestic equity market, on January 3, foreigners were allowed to invest in equity-type beneficial certificates subject to a maximum limit of 20 per cent of each new issue. On February 26, equity-type country funds were allowed to acquire stocks in the primary or issue market, and on May 2, a capital increase of US 140 million dollars by the Korea Fund was authorized.

The government substantially raised the ceiling on foreign investment in the stock index futures market from 30 per cent of the average daily open interest for the last three months to 100 per cent with effect from July 7. In addition, it set the ceiling on foreign investment in stock index options at the same level as that in stock index futures. On September 1, foreigner-only funds whose capital was gathered through the sale of beneficial certificates were allowed to invest in KOSDAQ-listed stocks without limit, and also in stock index futures and options.

The government announced that taxes on capital gains from stocks, which were imposed on nationals of countries, such as Japan, that did not have bilateral taxation agreements with Korea, would be scrapped, beginning October 25. On November 15, foreigners were allowed to invest in companies listed on the KOSDAQ market, subject to aggregate and individual foreign investment ceilings of 15 per cent and 5 per cent, respectively.

### B. External Liberalization of Domestic Bond Market Widened

On January 3, the government raised the ceilings on foreign investment in non-guaranteed convertible bonds(CBs) issued by small and medium enterprises(SMEs). The aggregate ceiling was increased from 30 per cent to 50 per cent of each issue and the individual ceiling from 5 per cent to 10 per cent. From June 2, foreigners were allowed to invest in the non-guaranteed CBs of large listed companies and in the non-guaranteed bonds of SMEs with a maturity of more than three years. Aggregate and individual limits for non-guaranteed CBs of large listed companies were set, respectively, at 30 per cent and 6 per cent of the volume of any issue listed. The aggregate limit for foreign investment in SMEs' non-guaranteed long-term bonds was set at 50 per cent of the volume of the issue listed, but no individual limit was set.

On December 12, right after the currency crisis, foreigners were given carte blanche to invest in the non-guaranteed CBs of large enterprises, and in the guaranteed bonds and non-guaranteed bonds of large enterprises, both with maturities of at least three years. The aggregate and individual investment ceilings for large enterprises' non-guaranteed CBs were set at 50 per cent and 10 per cent respectively, and for their guaranteed bonds and non-guaranteed bonds at 30 per cent and 10 per cent, respectively. Meanwhile, foreign investment ceilings on non-guaranteed long-term bonds and SMEs' non-guaranteed CBs were abolished.

Furthermore, the government removed the individual foreign investment ceiling on corporate bonds on December 23. Also national and municipal bonds, specific-law bonds including financial debentures, and corporate bonds with maturities of less than three years were opened up to foreign investment. The aggregate foreign investment ceiling on such bonds was set at 30 per cent of those of each issuer and the individual ceiling at 10% thereof.

On December 30, all restrictions on foreigners' investment in corporate bonds were removed, completely liberalizing the domestic bond market. This had originally been scheduled only for such time as stable macroeconomic conditions were maintained or the differential between Korean and international interest rates fell below two percentage points.

Regarding the issuance of bonds in the domestic market by nonresidents, the government on March 17 permitted international financial institutions, including the International Bank for Reconstruction and Development(IBRD) and the European Bank for Reconstruction and Development(EBRD), to issue won-denominated bonds and list them on the KSE. In accordance with this measure, the

[Table 11] **Bond Market Opening during 1997**

| | Jan. 3 | June 2 | Dec. 12 | Dec. 23[1] | Dec. 30[2] |
|---|---|---|---|---|---|
| National & Municipal bonds | | | | aggregate: 30% individual: abolished | Complete removal of all ceilings on foreigners' investment in Korean bond market |
| Non-guaranteed long-term bonds of SMEs | | aggregate: 50% | both ceilings abolished | | |
| Non-guaranteed short-term bonds of SMEs | | | | both ceilings abolished | |
| Non-guaranteed CBs of SMEs | aggregate (ceiling): 50% individual (ceiling): abolished | | both ceilings abolished | | |
| Non-guaranteed long-term bonds of large companies, Guaranteed long-term bonds, and Guaranteed CBs | | | aggregate : 30% individual: 10% | aggregate: 30% individual: abolished | |
| Short-term bonds, Specific-law bonds | | | | aggregate: 30% individual: abolished | |
| Non-guaranteed CBs of large companies | | aggregate: 30% individual: 6% | aggregate: 30% individual: 10% | aggregate: 50% individual: abolished | |

Notes: 1) Basis for calculation of foreign investment ceiling was changed from 'each-issue' to 'each-issuer'.
2) To be implemented on January 1, 1998.

IBRD listed bonds to the value of approximately US 100 million dollars on April 23 and the EBRD floated a similar amount on May 2.

### C. Restrictions on Inward Foreign Direct Investment Further Lifted

The revision of the previous Foreign Capital Inducement Act came into force on February 1, being renamed the Foreign Investment and Foreign Capital Inducement Act. Under the revision, foreign enterprises were allowed to receive loans from affiliated companies within a limit of the amount of foreign investment committed. The loan had to be used for the import of capital goods and have a maturity of more than five years. Also friendly mergers and acquisitions engineered by a foreign company were permitted if approved by the board of directors of the targeted enterprise. An exception, however, was made for enterprises having assets of at least two trillion Korean won in view of the potential impact on the national economy. In these cases the permission of the Minister of Finance and Economy had to be obtained.

With effect from July 14, the government dismantled most restrictions on the use of long-term cash loans with maturities of more than five years by foreigner-owned manufacturing firms, allowing them to borrow working capital abroad subject to a ceiling of the lower of 50 per cent of the total investment committed or US 10 million dollars.

The system for receiving authorization to set up an office in Korea for a foreign securities-related institution, such as a securities firm, an investment trust company, or an investment consulting firm was changed as of January 1 from approval by the Minister of Finance and Economy to a declaration whose acceptance was conditional upon its examination. On November 1, foreigners and foreign-invested companies were allowed to operate currency exchange business. For opening a registered currency exchange business or altering its type of operation, simple notification to the Governor of the BOK was required, instead of a declaration whose acceptance had been conditional upon its examination. The government on December 31 designated ten branches of foreign securities firms in Korea as institutions for the conduct of foreign exchange(FX) transactions, enabling them to engage in currency exchange business and short-term FX forward transactions related to securities investment.

### D. Restrictions on Foreign Borrowings by Residents Eased

Starting from January 1, both large enterprises and foreign-invested companies were allowed to receive commercial loans for the import of capital goods. For infrastructure projects conducted in line with the Private Capital Inducement Act whose net construction cost was over 500 billion Korean won, the government allowed foreign borrowings of up to 20 per cent of the annual net cost per project in order to finance the domestic part of the infrastructure project. This was subject to a ceiling of US$ 50 million, but for those projects with a net construction cost of over 1 trillion Korean won, the ceiling on such foreign borrowings was set at US$ 100 million.

The government also permitted firms the ratio of whose domestic-made machinery use for plant investment was at least 50 per cent, and also fifteen local governments, to raise funds overseas through commercial loans or the issue of foreign currency securities.

The annual limit on long-term foreign borrowings by domestic banks was abolished on March 15, and that on domestic firms' issue of stock-related securities on April 1. The previous ceiling on individual firms' issue of equity-related securities of 50 per cent of total stocks issued was eliminated on April 14 along with the requirement of at least a BBB rating from an international credit rating agency for the issue of debt securities overseas.

On November 1, the government liberalized residents' use of foreign borrowings raised via local financing for all purposes other than overseas portfolio investment, overseas real estate purchases, and funds for the establishment and operation of overseas branches. Similarly, the ex-post management of local financing was lightened so that a declaration to the Governor of the BOK was needed only when the debt outstanding was over US 30 million dollars and the increment during the year exceeded 30 per cent of the balance outstanding at the end of previous year. The government liberalized both the use of funds raised through the issue of depository receipts by foreign exchange banks, and the borrowing terms for commercial loans, which had previously been set at no more than Libor + 2 per cent for SMEs or Libor + 1 per cent for other companies.

Following the currency crisis, foreign borrowings in the form of commercial loans of cash with at least a three-year maturity or the issue of foreign currency denominated bonds by private firms were allowed for an interim period from December 16, 1997 until the end of 1998.

In addition, the government improved the system for the raising of foreign currency funds by firms, and this was scheduled to be put into practice from January 1, 1998. Under the new arrangement, the various uses of firms' fund-raising were integrated and the limit on commercial loans intended for the import of capital goods abolished. The government also permitted firms operating in a technological frontier industry to receive commercial loans for the purchase of domestic-made capital goods even if the ratio of domestic-made machinery of the relevant enterprise was less than 50 per cent. Furthermore, the ratio of the required funds that might be borrowed when large enterprises purchase capital goods using commercial loans was raised to the same level as that when the purchase was financed through the issue of foreign currency securities; namely, up to 80 per cent of the cost incurred.

### E. Overseas Direct and Portfolio Investment Liberalized

The government eased or abolished many restrictions on overseas direct investment to allow enterprises to carry through their own investment strategies, in pursuit of profit at their own initiative and risk.

On August 1, the system of a declaration to the BOK and its acceptance for overseas direct investments exceeding US 10 million dollars was replaced by a simple declaration to a commercial bank. Regarding routine overseas direct investment, the examination by the Overseas Direct Investment Examination Committee, and the requirement that a certain ratio of equity capital be met were abolished.

In order to allow interested parties such as small stockholders to obtain a better grasp of intended overseas investments, the list of items subject to public disclosure by the firm involved was expanded to include the total projected scale of the operation and the method of raising the required funds, in addition to the amount and ratio of invested capital, and the name of the local subsidiary. Also the responsibility for the compilation of statistics related to overseas direct investment, which had been handled by the BOK, was transferred to the National Federation of Banks.

Regarding overseas portfolio investment, having liberalized institutional investors' investment in unlisted foreign stocks on March 20, 1995, the government allowed private investors to invest in such stocks as of March 11. The aggregate ceiling on Korean residents' investment in each such issue was limited to 10 per cent of the total outstanding of any foreign-currency denominated unlisted issue, and the individual ceiling was set at less than 10 per cent of the value of that individual's outstanding investment in foreign-currency denominated securities.

## (2) Improvement of the System for Current Transactions

### A. Period of Deferred Payments for Imports Liberalized

Seeking to provide disincentives to the flow of imports, the government reclassified China from the rest-of-the-world category to the neighboring country category in relation to the period of import on a deferred-payment basis. When import was for domestic use on a deferred-payment basis against a Letter of Guarantee(L/G), the settlement period was shortened from 20 days to 10 days, this latter regulation being, however, subsequently abolished on February 10.

In order to ease exporters' difficulties in raising foreign capital when they import raw materials for export use from neighboring countries, the period for deferred payment was lengthened from 150 days to 180 days in the case of SMEs on April 14, and from 120 days to 150 days in the case of large enterprises on August 29. For imports intended for domestic use by SMEs, the settlement periods for deferred payments were, as of October 31, all lengthened to 180 days, the same as for imports for export use.

On December 12, after the currency crisis had erupted, the settlement periods for deferred payments imports were standardized at 180 days, regardless of use, source, and size of the importing firm. However, where the credit is supplied by the US Commodity Credit Corporation, the maximum period of settlement was extended to 36 months.

In a related move, which came into effect as of November 28, it was provided that for imports of crude oil against shipper's credit or ex-post payment, that portion of the eligible deferred payments period exceeding the duration of the credit offered might be financed by borrowings of short-term foreign funds or the issue of commercial paper.

### B. Receipt Limit on Export Advances and Deposits Abolished

As a measure to improve the current account balance, the government, on February 10, raised the ceiling on large enterprises' receipt of advances on exports from 20 per cent of the previous year's exports to 25 per cent, and increased the ceiling on deposits against contracted exports during the manufacturing period from 30 per cent of the total contract amount to 40 per cent thereof. On August 29, the former ceiling was abolished and the latter ceiling was raised from 50 per cent to 60 per cent.

From November 1, exporters were allowed to receive advances against exports from other companies' local subsidiaries or overseas branches. Effective from December 12, the period for the performance of the exports corresponding to the export advances was lengthened from 120 days to 180 days, and limits on deposits against exports made at the time of entering into a contract were liberalized to help ease exporters' financial woes.

The government relaxed restraints on some types of invisible payments on November 1. First of all, the remittance of interest accrued from non-residents' won-denominated accounts to another country would require only a declaration to the head of FX bank rather than the previous approval by the Governor of the BOK. When Korean residents abroad wished to take their financial assets out of Korea, they might do so up to a limit of US 1 million dollars per year through an emigration account, with no limit on the number of withdrawals, after declaring their intention to their prime foreign exchange bank.

### C. Ex-post Management of Payments for Invisibles Reformed

On February 10, as part of the drive to improve the current account position, donations to educational, cultural, or religious institutions in excess of US 5 thousand dollars per transfer were made subject to the same ex-post supervision as general transfers. Also pre-examination and ex-post supervision regarding expenses of students studying aborad were strengthened, and overseas educational expenses for minors were no longer to constitute expenses necessary in connection with overseas stay. On May 1, the right to examine persons making FX transactions and those related or connected with them was transferred to the Head of National Tax Administration to facilitate the suppression of unauthorized transfers of foreign exchange and capital flight involving the evasion of tariffs.

Moreover, from November 1, when advance payments for imports or the provision of services exceeded US 100 thousand dollars per transaction, or trade brokerage fees exceeded both 10 per cent of the total value of the trade and US 100 thousand dollars, the National Tax Administration had to be notified.

## (3) Revigoration of the Foreign Exchange Market

### A. Free-floating Exchange Rate System Introduced

In accordance with the government's agreement with the IMF, the daily exchange rate fluctuation band was eliminated as of December 16, Korea thereby effectively switching to a free-floating exchange rate system. This decision was dictated by the need to restore the price function of the exchange rate, after the won had collapsed against the dollar repeatedly hitting its daily lower limit shortly after market opening and paralyzing the domestic FX market. This pattern had continued even after a massive widening of the band from ±2.5 per cent to ±10 per cent on November 20. It was agreed, however, that the basic rate, which is the weighted average of the previous business day's transactions in the interbank FX market, would continue to be used when commercial banks set their own FX selling-buying rates or when the BOK conducted FX transactions.

### B. Foreign Exchange Position Management System Improved

To dampen the excess demand for foreign exchange and promote capital inflows, the government carried out a number of measures on October 31. The limit on a bank's spot over-bought position was set at the higher of 5 per cent of its equity capital or US 8 million dollars, and the amount of spot FX sold, where it resulted from swaps involving selling spot and buying forwards, was excluded from the calculation of the spot FX position. Furthermore, the limit on the spot over-sold position was increased on November 1 from the higher of 3 per cent of equity capital or US 5 million dollars to the higher of 5 per cent of equity capital or US 8 million dollars.

Starting from October 31, in order to constrain the excess FX demand, the government imposed temporary restrictions on purchases of foreign currency for

Korean won until the market recovered its stability. Accordingly the purchase of foreign exchange for holding purposes, which was previously allowed up to US 20 thousand dollars annually per person, and its purchase to make FX deposits, were both prohibited, and even in the case of real demand transactions, the purchase of foreign exchange was allowed only within the five days before the actual payment.

Previously, foreign exchange banks had had to file FX transaction records with the National Tax Administration when receiving or purchasing foreign currency from a single person to the value of more than US 20 thousand dollars per year. But with effect from December 12, this requirement was suspended in order to promote the inflow of foreign exchange held by residents into the domestic market.

### C. FX Business of Domestic Financial Institutions Expanded

Approval from the Minister of Finance and Economy had previously been required for a securities firm to set up an overseas branch, but as of April 1, only a simple declaration was necessary. From September 11, leasing companies were allowed to engage in the extension of loans to local subsidiaries of financial institutions and to take on medium and long-term borrowings of foreign capital for this purpose.

The government as of November 1 allowed sales of foreign currency denominated assets abroad through the off-shore marketing of banks' loan receivables and the issue of asset-backed securities. As of that same date, a new system was introduced for the granting of authorization for participation in the capital of overseas financial institutions whereby preliminary authorization would first be given, after which full institutional authorization had to be obtained.

On December 31, the government allowed domestic securities firms to engage in currency exchange business and short-term FX forward transactions related to investment in bonds, stock index futures, and stock index options. Also seven investment trust companies were allowed to conduct a similar range of FX business to that allowed for securities firms except for the borrowing of foreign capital for the purchase of foreign securities. Restrictions on the Export-Import Bank of Korea's operations were eased to allow it to engage in foreign exchange business on the same basis as commercial banks.

## (4) Negotiation of the Stand-by Credit Arrangement with the IMF

### A. The Request to the IMF for Financial Support and the Reaching of a Settlement to the Negotiations

From the beginning of 1997, as a mismatch between foreign exchange supply and demand emerged, the government undertook a series of policy initiatives to stabilize the foreign exchange market and to restore the foreign credibility of the Korean economy.

On March 31, it announced plans for the acceleration of the capital market opening. These involved removing restrictions on foreigners' investment in the domestic equity and bond markets, and encouraging overseas financing by Korean financial institutions and corporations. On August 25, the government unveiled measures designed to stabilize the domestic financial markets and shore up the credit standing of domestic financial institutions in the international financial markets. The package included a government guarantee of repayment of all overseas debt liabilities by Korean financial institutions, and the provision by the Bank of Korea of short-term foreign currency liquidity to financial institutions.

On October 29 and 31, the government again acted to stabilize the securities market and the foreign exchange market. This time the package included the wider opening of the corporate bond market, encouragement for the inducement of cash loans, the placing of temporary restraints on purchases of foreign currency to place on deposit, and the adjustment of the limits on banks' spot over-bought position.

A further financial market stabilization package followed on November 19. Its initiatives included arrangement for the early resolution of bad loans through the Korea Asset Management Corporation's Non-performing Asset Management Fund, promotion of the structural adjustment of the financial industry, and the widening of the Korean won's daily fluctuation band from $\pm$2.25 per cent to $\pm$10 per cent.

These policy responses, however, failed to calm the markets' fears. Korea's foreign currency liquidity status had deteriorated sharply in late October following the sharp fall in the Hang Seng index on October 23, and the downgrading of Korea soverign rating by international credit rating agencies. Facing almost insurmountable difficulties in external financing, the government turned to the IMF for financial assistance on November 21. It engaged in full and frank negotiations with the IMF's working-level delegation on the amount and conditions of the financial assistance including policy programs from November 25. An agreement was reached, on December 4, on a Letter of Intent containing the economic and financial programs the government should implement in conjunction with the financial assistance from the IMF.

In spite of the conclusion of this agreement, foreign currency liquidity continued to worsen and instability mounted in the domestic foreign exchange market. Therefore, on December 24, the government and the IMF agreed on a Second Letter of Intent, whereby Korea undertook to speed up its economic reforms, including the full opening of the bond market, the setting of a timetable for the opening of the domestic money market, and the abolition of the Interest Limitation Act. In recognition of this, it was agreed that disbursement of the support previously committed to Korea by the IMF and major advanced countries would be brought forward and accelerated.

### B. Details of the IMF's Stand-by Arrangement

The total scale of the emergency credit package put together by multilateral financial institutions, including the IMF, the IBRD, and the ADB, and a number of industrialized countries, which was announced on December 4, amounted to US 57 billion dollars. This was increased to US 58.35 billion dollars when additional supplementary financial commitments were made by other participant countries on December 24.

The IMF granted a stand-by credit of 15.5 billion SDRs(approximately US 21 billion dollars), the conditions being repayment in installments over two years after a three-year grace period and an interest rate of about 4.7 per cent per annum.

Later, the government and the IMF agreed that the disbursement equivalent to 10 billion SDRs to be completed between December 18, 1997 and December 17, 1998 should be handled under the Supplemental Reserve Facility(SRF). This enabled the accelerated provision of financial support subject to the condition that repayment of each tranche be made within one to one and a half years of the date it was drawn down. The interest rate during the first year was set at 300 basis points above the rate carried by the IMF loans(4.7 per cent per annum), and it is to be increased by 50 basis points at the end of that year and subsequently every six months until it reaches 500 basis points. Under these arrangements, the government drew 4.1 billion SDRs(US 5.56 billion dollars) on December 5 and 8, 2.6 billion SDRs(US 3.53 billion dollars) between December 19 and 22, and 1.5 billion SDRs(US 2.02 billion dollars) on December 30 and 31.

In addition to the financial assistance from the IMF, the government took up financial assistance equivalent to US 10 billion dollars from the IBRD. On this facility the period of repayment was set at five years following a five-year grace period, the interest rate was set at Libor+1.0 per cent per annum, and it was to be used in support of specific structural reform programs. The government drew down US 3 billion dollars on December 23 in the first tranche according to the agreement with the IBRD. Similarly, Korea was granted US 4 billion dollars by the ADB in support of policy and institutional reforms, the conditions being repayment in full after a seven-year grace period and an interest rate of Libor+0.4 per cent per annum. Under this arrangement, the government initially drew down US 2 billion dollars on December 24.

A number of countries, including members of the G7, also participated in the emergency credit package put together by the IMF. They made supplemental financial commitments totalling US 22 billion dollars(Japan US 10 billion dollars ; the United States US 5 billion dollars ; Germany, the United Kingdom, France, and Italy US 1.25 billion dollars each ; and Australia and Canada US 1 billion dollars each). This second line of defense would, it was arranged, be made available through bilateral negotiations in the event of unanticipated adverse external circumstances creating a need for additional resources to supplement Korea's reserves and the resources provided by the IMF and other multilateral institutions. On December 24, four more countries agreed to participate in the second line of defense. Belgium, the Netherlands, Sweden, and Switzerland, each volunteered to make a total of US 1.25 billion dollars available, and New Zealand made a supplemental financial commitment of US 0.1 billion dollars. This brought the total amount committed to the second line of defense to a total of US 23.35 billion dollars. Upon the IMF's formal declaration that it would accelerate the provision of financial support to Korea, the countries participating in the second line of defense also agreed to make available earlier than scheduled almost one third(US 8 billion dollars) of the total committed, as well as accelerating the provision of other agreed financial commitments.

### C. The Economic Program

The economic program negotiated with the IMF as the conditionality element of the stand-by arrangements included a macroeconomic stabilization and structural reform program, which covered macroeconomic policy, financial sector restructuring, trade and capital account liberalization, the reform of corporate governance and corporate management, labor market reform, etc.

At first, the macroeconomic objectives of the program included : narrowing the external current account deficit to below 1 per cent of GDP in 1998 and 1999, containing inflation at or below 5 per cent, and limiting real GDP growth to about 3 per cent in 1998, followed by a recovery toward the potential growth rate in 1999.

Monetary policy was to be tightened immediately to restore and sustain calm in the markets and contain the inflationary impact of the recent won depreciation. A flexible exchange rate policy was to be maintained, with intervention limited to smoothing operations. In line with these policies, the fiscal stance was to remain tight throughout 1998 to achieve equilibrium or a small surplus through measures affecting both revenue and expenditure.

The centerpiece of the economic program was a comprehensive restructuring and strengthening of the financial system to make it sound, transparent, and efficient. Concerning financial sector restructuring, the strategy was to comprise three broad elements : a clear and firm exit policy, strong market and supervisory discipline, and increased competition. The exit policy would seek to ensure the rapid resolution of troubled financial institutions in a manner that minimized systemic distress and avoided moral hazard. The government's policy would involve the restructuring and recapitalization of all banks that failed to meet the Basle Committee capital standards, and in order to improve transparency in the financial sector, large financial institutions were to be required to upgrade their accounting and disclosure standards toward best international practice. To strengthen financial sector supervision, the government would urgently request passage of financial sector reform bills including the revised Bank of Korea Act, which would provide for the central bank's independence with price stability as its overriding mandate ; a bill to set up an agency that would integrate the supervisory functions distributed among various agencies ; and a bill requiring that corporate financial statements be prepared on a consolidated basis and be certified by external auditors. To promote competition and efficiency in the financial sector, the government would allow foreigners to establish banking and securities subsidiaries by mid-1998.

Regarding trade liberalization, a time table would be set in line with the commitments to the WTO to eliminate trade-related subsidies, restrictive import licensing, and the import diversification program. Steps would also be taken to streamline and improve the transparency of import certification procedures.

The government would substantially accelerate the ongoing capital account liberalization program. The ceiling on aggregate foreign ownership was to be increased from 26 per cent to 50 per cent by end-1997, and to 55 per cent during 1998. By the end of February 1998, steps were to be taken to liberalize other capital account transactions, including those restricting foreigners' access to domestic money market instruments and the corporate bond markets, and there would be a further reduction of restrictions on foreign direct investment by the simplification of approval procedures. A timetable would be set by the end of February 1998 to eliminate restrictions on foreign borrowings by corporations.

Concerning corporate governance and corporate structure, the government was to take measures to improve the transparency of corporate balance sheets, to change the system of cross-payment guarantees among interlinked business groups to reduce the risks involved, and to reduce the restrictions on the take-over of corporations by foreigners.

The government undertook to strengthen the employment insurance scheme to facilitate the re-deployment of labor, and to remove labor market rigidities so as to make the rationalization of employment easier for structural adjustment or a merger and acquisition.

Moreover, the government would review the Bank of Korea's international reserves management with the intention of bringing it more closely into line with standard international practice and regularly publish data on FX reserves, including their composition and net forward position, initially with a two-week delay. The government also undertook to release twice a year data on financial institutions, including their non-performing loans, capital adequacy, ownership structure, and affiliations.

# Ⅲ. Operation and Organization

## 1. Banking

### (1) Loans and Deposits

Loans and discounts extended by the Bank to financial institutions shifted to an increase, during the year, bringing them up by 6,078.4 billion won as compared to the previous year's decrease of 4,540.8 billion won. This growth was mainly attributable to special loans and loans for stabilization of financial markets extended to financial institutions whose liquidity status had been worsened due to large corporate insolvencies and the foreign currency crisis.

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

Unit : billion won

| | Outstanding | | Change during | |
|---|---|---|---|---|
| | 1996 | 1997 | 1996 | 1997 |
| Aggregate ceiling credits | 5,672.7 | 4,266.4 | -3,395.1 | -1,406.3 |
| General loans | 878.5 | 496.0 | -464.5 | -382.5 |
| Loans for agriculture, fishery and livestock | 187.2 | 115.5 | -481.2 | -71.7 |
| Loans for the procurement of fertilizer | 370.0 | 370.0 | -200.0 | - |
| Special loans | - | 2,000.0 | - | 2,000.0 |
| Loans for the stabilization of the financial markets | - | 5,938.9 | - | 5,938.9 |
| **Total** | **7,108.4** | **13,186.8** | **-4,540.8** | **6,078.4** |

Note: 1) Excludes loans to government.

By type of loan, those classified as aggregate ceiling credits decreased by 1,406.3 billion won during the year. This reflected the lowering of the aggregate credit ceiling by 2,800.0 billion won, so as to absorb the excess liquidity generated by the reduction of reserve requirements in February, and the subsequent lifting of the ceiling by 1,000.0 billion won in support of funds for small and medium-sized enterprises in December. The total of aggregate ceiling credits outstanding thus dropped to 4,266.4 billion won as of the end of the year. General loans decreased by 382.5 billion won, largely reflecting the continuing collection of general loans while new lending was suspended from March 1997 for purposes such as loans for firms' technology development, equipment loans for pollution prevention, equipment loans for firms' producing exports goods or basic materials and parts for import-substitution.

During the year, the Bank introduced two new loan schemes. Special loans were extended during September and October to the value of one trillion won to Korea First Bank and another one trillion won in all to sixteen merchant banking corporations which were having difficulties in management due to their large overhang of non-performing loans. Loans for the stabilization of the financial markets of 5,938.9 billion won were granted in December to banks and securities companies etc. suffering severe liquidity problems because of a run on their deposits and the paralysis of the call market.

Meanwhile, loans for agriculture, fishery and livestock decreased by 71.7 billion won, led downward by reduced funding support for agriculture. Those for the procurement of fertilizer maintained the same outstanding balance as at the previous year-end.

Total deposits with the Bank shifted to an increase, bringing them up by 11,147.1 billion won over the course of the year, as compared to the preceding year's decrease of 3,897.8 billion won. By currency denomination, won deposits increased 10,806.5 billion won during the year. This was largely attributable to the augmentation of nonresidents' deposits of 13,888.7 billion won in accordance with the IMF's provision of emergency funds support: reserve deposits by deposit money banks in contrast decreased by 3,284.5 billion won following the reduction in reserve requirements. Foreign currency deposits rose by 340.6 billion won mainly because of an increase in foreign currency reserve deposits equivalent to 490.4 billion won as enterprises stepped up their deposits of foreign currency with banks, thereby offsetting the effects of a decline of 149.8 billion won in the Foreign Exchange

[Table 13] **Deposits with the Bank of Korea**

Unit : billion won

| | Outstanding | | Change during | |
|---|---|---|---|---|
| | 1996 | 1997 | 1996 | 1997 |
| Won Deposits | 7,953.4 | 18,759.9 | -4,162.4 | 10,806.5 |
| Reserve deposits by deposit money banks[1] | 7,815.1 | 4,530.6 | -4,112.7 | -3,284.5 |
| Private deposits[2] | 86.5 | 288.8 | -53.9 | 202.3 |
| Deposits by nonresidents | 51.8 | 13,940.5 | 4.2 | 13,888.7 |
| Foreign currency deposits | 3,109.6 | 3,450.2 | 264.6 | 340.6 |
| **Total** | **11,063.0** | **22,210.1** | **-3,897.8** | **11,147.1** |

Notes: 1) Include reserve deposits by Korea Development Bank and Korea Long Term Credit Bank.
2) Include won deposits by foreign institutions including the IMF.

Stabilization Fund caused by the expanded provision of foreign currency call loans to domestic foreign exchange banks.

### (2) Issuance of Banknotes and Coin

During the year, a total of 29,185.9 billion won in banknotes and coin was issued and 29,307.2 billion won withdrawn, resulting in a net withdrawal of 121.3 billion won. This brought the year-end outstanding balance of banknotes and coin in circulation to 17,786.1 billion won, down by 0.7 per cent compared with that at the

[Table 14] **Banknotes and Coin Issued by Denomination**

Unit: billion won, %

| | 1996 | 1997 | | | Change |
|---|---|---|---|---|---|
| | Outstanding(A) | Issued | Withdrawn | Outstanding(B) | (B-A) |
| Banknotes | 17,029.3 (95.1) | 29,106.5 | 29,295.9 | 16,839.9 (94.7) | -189.4 |
| 10,000 won | 15,799.2 (88.2) | 27,756.2 | 27,928.9 | 15,626.5 (87.9) | -172.7 |
| 5,000 won | 482.0 (2.7) | 567.5 | 567.3 | 482.2 (2.7) | 0.2 |
| 1,000 won or less | 748.1 (4.2) | 782.9 | 799.8 | 731.3 (4.1) | -16.9 |
| Coin | 878.0 (4.9) | 79.4 | 11.3 | 946.1 (5.3) | 68.2 |
| **Total** | **17,907.3(100.0)** | **29,185.9** | **29,307.2** | **17,786.1(100.0)** | **-121.3** |

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

end of the preceding year.

Of the outstanding balance of banknotes and coin in circulation, 94.7 per cent was accounted for by banknotes, slightly less than the year before, and 5.3 per cent by coin. Meanwhile, the share of the 10,000 won denomination in total banknotes in circulation decreased somewhat compared with that of the previous year-end.

### (3) Treasury Transactions

Treasury funds received during the year grossed 482.4 trillion won and those disbursed reached 483.7 trillion won, resulting in a net disbursement of 1,274.2 billion won. This brought the year-end figure of government deposits from the 6,683.9 billion won of the previous year to 5,409.7 billion won.

As for loans to the government, new advances of 19.5 billion won were made to the Bounty Fund on Workmen's Property Formation Deposits. This brought the year-end outstanding balance from the 399.5 billion won of the previous year to 419.0 billion won at the year-end.

The Treasury agencies of the Bank and its Treasury collection agencies increased by 52 and 410, respectively, bringing their totals to 622 and 6,918 as at the end of the year.

### (4) Securities Operations

During the year, Monetary Stabilization Bonds(MSBs) to the value of 31,223.9 billion won were issued while MSBs to a value of 32,783.0 billion won were redeemed. As a result, MSBs outstanding totaled 23,470.9 billion won as of year-end, a decrease of 1,559.1 billion won compared to the previous year-end's level of 25,030.0 billion won. This was mainly attributable to the expansion of money supply effected through redemption of MSBs in order to deal with the market's lack of liquidity.

By method of issuance, the outstanding balance of those issued by public offerings stood at 23,131.7 billion won, a decrease of 1,898.3 billion won during the year. Among them, those issued by non-competitive sale increased by 4,544.8 billion won whereas those issued by competitive bidding declined by 6,443.2 billion won.

[Table 15] **Issuance and Redemption of Monetary Stabilization Bonds**

Unit : billion won

| | 1996 | 1997 | | | Change |
|---|---|---|---|---|---|
| | Outstanding(A) | Issued | Redeemed | Outstanding(B) | (B-A) |
| Public offerings | 25,030.0 | 30,022.6 | 31,920.9 | 23,131.7 | -1,898.3 |
| Non-competitive sale | 5,098.3 | 11,445.3 | 6,900.5 | 9,643.1 | 4,544.8 |
| Competitive bidding | 19,931.8 | 18,577.3 | 25,020.5 | 13,488.6 | -6,443.2 |
| Private placements | - | 1,201.3 | 862.1 | 339.2 | 339.2 |
| **Total** | **25,030.0** | **31,223.9** | **32,783.0** | **23,470.9** | **-1,559.1** |

In November, the Bank underwrote Non-performing Loans Resolution Fund Bonds to the value of two trillion won issued by the Non-performing Loans Resolution Fund of the Korea Asset Management Corporation. It also sold MSBs to the value of 1,201.3 billion won to the Non-performing Loans Resolution Fund through private placement, the first use of this method since 1993. Five successive redemptions of MSBs by the Fund to a total value of 862.1 billion brought the outstanding balance of those issued by private placement down to 339.2 billion won as at the year-end.

The value of government bills and bonds issued via the Bank during the year amounted to 3,372.8 billion won, while 1,945.7 billion won worth was redeemed. This brought the year-end's outstanding balance to 10,554.7 billion won, an increase of 1,427.1 billion won over the figure at the preceding year-end. The year-end's outstanding balance of Foreign Exchange Stabilization Fund Bonds was unchanged from the 4,200.0 billion won of a year earlier, reflecting the issue of bonds to the value of 1,294.6 billion won and matching redemptions. The value of Public Land Compensation Bonds issued during the year amounted to 1.2 billion won, while 25.6 billion won's worth was redeemed. This brought the year-end's outstanding balance to 34.5 billion won, a decline of 24.4 billion won over the figure at the previous year-end. Meanwhile, Government Bond Management Fund Bonds were issued to the value of 2,077 billion won in the course of the year following the first redemption, to the value of 625.5 billion won worth since their introduction in 1994, resulting in a year-end's outstanding balance of 6,320.2 billion won, an increase of 1,451.5 billion won over the figure at the preceding year-end.

[Table 16] **Issuance and Redemption of Government Bills and Bonds via the Bank of Korea**

Unit : billion won

| | 1996 | 1997 | | | Change |
|---|---|---|---|---|---|
| | Outstanding(A) | Issued | Redeemed | Outstanding(B) | (B-A) |
| Foreign Exchange Stabilization Fund Bonds | 4,200.0 | 1,294.6 | 1,294.6 | 4,200.0 | - |
| Public Land Compensation Bonds | 58.9 | 1.2 | 25.6 | 34.5 | -24.4 |
| Government Bond Management Fund Bonds | 4,868.7 | 2,077.0 | 625.5 | 6,320.2 | 1,451.5 |
| **Total** | **9,127.6** | **3,372.8** | **1,945.7** | **10,554.7** | **1,427.1** |

## (5) Government Funds Management

During the year, the National Investment Fund raised 359.4 billion won, mainly through the collection of loans of 108.0 billion won and the receipt of deposits of 213.8 billion won. Concerning its operation, the bulk of the funds raised was devoted to the repayment of deposits, which accounted for 340.8 billion won. The Fund recorded a net profit of 12.2 billion won for the period. Its year-end's balance decreased from the 270.1 billion won of the previous year to 155.3 billion won chiefly owing to the suspension of new loans and the collection of existing loans.

The Bounty Fund on Workmen's Property Formation Deposits raised 87.1 billion won during the year, of which 12.9 billion won consisted of contributions from depositors themselves, 46.4 billion won took the form of a contribution from the Bank, and 19.5 billion won represented borrowings from the Bank. As for the Fund's uses, 50.8 billion won was paid as legal subsidies to depositors and 19.6 billion won in redemption of borrowings from the Bank. In consequence, the Fund suffered a net loss of 19.7 billion won for the period.

The Bounty Fund on Farmers' and Fishermen's Property Formation Deposits raised 325.1 billion won, consisting principally of contributions of 31.2 billion won from the government, 25.0 billion won from the Bank, 5.7 billion won from the National Agricultural Cooperative Federation and the National Federation of Fisheries Cooperatives and its Member Cooperatives, and 204.5 billion won from its withdrawal of deposits with the National Investment Fund. In the utilization of the

Fund, 57.1 billion won was paid in the form of legal subsidies to depositors, and 187.3 billion won placed on deposit with the National Investment Fund. The Bounty Fund recorded a net profit of 0.7 billion won for the year.

The Foreign Exchange Stabilization Fund raised 6,262.3 billion won, consisting of 650.0 billion won from the flotation of debentures, 360.0 billion won by way of the receipt of interest, and 4,314.6 billion won from its withdrawal of foreign currency deposits with other institutions. Among the uses of the Fund, 273.0 billion won was operated as domestic currency call loans, 2,122.8 billion won as foreign currency call loans, 601.4 billion won as domestic currency deposits, and 2,333.4 billion won as foreign currency deposits; while 650.0 billion won and 281.5 billion won, respectively, were devoted to the redemption of principal and interest on its bonds. It recorded a net profit of 1,624.4 billion won for the year, largely due to valuation gains(1,830.8 billion won) on its foreign currency assets. The year-end balance of the Fund as of the end of the year stood at 5,963.0 billion won, an increase of 1,880.9 billion won over the previous year-end.

The Government Bond Management Fund raised 6,901.9 billion won, of which 2,077.0 billion won was obtained from the issuance of bonds, and 2,382.0 billion won by way of withdrawal of deposits and collection of loans. Its placements took the form of deposits totalling 2,076.7 billion won; specifically with the National Housing Fund(949.9 billion won), the Special Account for Structural Improvement of Agriculture and Fisheries(499.9 billion won), the Special Account for Railroad Business(100.0 billion won), and other institutions(526.9 billion won). A total of 1,298.7 billion won was devoted to payments of principal and interest on its bonds and so forth. The Government Bond Management Fund recorded a net profit of 3.1 billion won for the year, with its year-end balance standing at 6,822.1 billion won, an increase of 1,423.5 billion won over the previous year-end.

### (6) Payments System Related Business

In its conduct of affair related to payments systems during the year, the Bank focussed on strengthening the functions of the nation's real-time gross settlement system, the "Bank of Korea Financial Wire Network" (BOK-Wire); extending the interbank financial network; and securing the stability of the payments system generally.

The number of BOK-Wire participants increased from 152 as of the end of preceding year to 158 at the end of the year under review. The coverage of BOK-Wire was expanded to include the settlement of interbank netting positions in the Local Banks' Shared Network System, and of the domestic currency call loans of the Foreign Exchange Stabilization Fund.

The designated net settlement time for cheque clearing among financial institutions through BOK-Wire was changed from 15:00 to 14:30(Monday to Friday). This enabled financial institutions to draw up their intraday settlement plans more conveniently.

The BOK-Wire queuing mechanism was changed from a "FIFO(First-in first-out)" to a "Bypass FIFO" system. This made an exception to the FIFO principle by leaving "first-in" large value payment orders that exceeded the balance in the front of the queue unsettled while enabling the automatic execution of subsequent payment orders in the queue whenever the account balance was sufficient to cover them.

During the year, BOK-Wire handled on a daily average 5,053 transactions valued at 32,191.0 billion won. These figures represented increases of 17.9 percent and 31.4 percent, respectively, over the previous year.

In a further expansion of the financial network, the Bank lengthened the operating hours of bank-affiliated credit cards' cash advance service through the CD/ATM network, from 09:30~17:00(Monday to Friday, Saturday: 09:30~13:30) to 08:00~22:00(year-round). Non-preset value cashier's cheques issued by a bank other than the transmitting bank were made eligible for funds transfer through the Interbank Funds Transfer(IFT) System, which enabled customers to transfer all types of cashier's cheques through IFT system.

The Bank reinforced its drive to ensure the stability of the payments system. It introduced a settlement risk management system to manage settlement risks effectively in the interbank net settlement systems by issuing a regulation concerning net settlements among financial institutions. In order to guarantee the finality of interbank settlement, it set a ceiling on the net debts of each participant in the interbank net settlements system, collected securities as collateral from each participant, and had participants settle shortages arising in settlement through a joint pool.

In view of the rapidity of the growth of electronic payments systems, the Bank established a common standard for electronic money and "Integrated Circuit Passbooks". And it drew up a detailed plan for the introduction of a Financial

Integrated Circuit Card Network for the use of electronic money, credit cards, debit cards and cash cards alike. In addition, security countermeasures were drawn up, including the issue of guidelines for dealing with the year 2000 problem in programs utilized in the payments and settlements system.

## 2. Foreign Exchange and International Finance Business

### (1) Foreign Exchange Management Business

On March 1, the Bank of Korea partly eased the restrictions on the provision of foreign currency loans in a move to support infrastructure projects. The scope of eligibility for foreign currency loans to finance the redemption of the principal and interest on foreign debts, which had previously been restricted to subway construction and electricity development projects, was expanded to include the high-speed train project. And the use of foreign currency loans was permitted to enable the early redemption of foreign borrowings on onerous terms, thereby improving the structure of foreign debt. Also, the previous maximum maturity of ten years on foreign currency loans was abolished as the revision of the General Banking Act similarly removed the restriction on the length of domestic-currency denominated loans.

Meanwhile, the Bank of Korea raised the ceilings on its swap facilities provided to foreign banks' branches in order to help expand foreign currency financing during the currency crisis. On November 27, the Bank increased the aggregate ceiling limits on the swap facilities of individual branches to the higher of the actual ceiling limits on November 26 or the outstanding swap balance held on December 8. Also, on November 27, it raised the guaranteed profit margin on swap transactions at the end of the term from 0.3% to 1.0% per annum and lowered the mandatory loan ratio of funds supported by swap facilities to domestic companies from 100% to 30%. On December 27, the Bank again raised the aggregate ceiling limits on these swap facilities, increasing them to the higher of the ceiling limits on December 9 or the new outstanding balance held on January 16, 1998, at the same time raising the guaranteed profit margin on swap transactions at the end of the term to a maximum of 3.0% per annum and abolishing the mandatory lending ratio.

In parallel with these moves, the Bank of Korea liberalized interest rates on foreign currency deposits to help quell the currency crisis and strengthen the foreign currency funding base of the foreign exchange banks. On December 23, it abolished the restriction on the maximum interest rates on all foreign currency deposits apart from residents' short-term deposits with maturities of less than 3 months. From December 31, when the Bank also abolished the interest rate ceiling on these residents' short-term deposits, foreign exchange banks were allowed to determine all foreign-currency deposit rates at their own discretion.

### (2) International Finance Business

The official foreign exchange reserves as of year-end 1997 amounted to US$ 20.4 billion, representing a decrease of US$ 12.8 billion over the previous year-end.

By type, deposits and securities, which made up the greatest proportion of these, amounted to US$ 19.7 billion as of year-end 1997, a decrease of US$ 12.7 billion over the previous year-end. Also, the reserve position in the International Monetary Fund(IMF) amounted to US$ 599 million(equivalent to SDR 444 million), representing a decrease of US$ 81 million over the previous year-end.

Meanwhile, usable foreign exchange reserves, i.e. foreign exchange reserves less BOK's deposits with overseas branches and subsidiaries of Korean banks, amounted to US$ 8.9 billion as of year-end 1997, registering a decrease of US$ 20.5 billion compared with their level at the previous year-end.

During 1997 the Bank of Korea made payments equivalent to US$ 90.83 million

**[Table 17] Change in Foreign Exchange Reserves**

Unit: mil. US$

| | Year-end 1996 | Year-end 1997 | Change |
|---|---|---|---|
| Foreign Exchange Reserves(A) | 33,236.7 | 20,405.5 | -12,831.2 |
| Gold | 35.9 | 36.9 | 1.0 |
| SDR | 118.2 | 58.9 | -59.3 |
| Reserve Position in IMF | 680.7 | 599.3 | -81.4 |
| Foreign Exchange | 32,401.9 | 19,710.4 | -12,691.5 |
| (Deposits with Korean banks, B) | (3,824.0) | (11,531.9)[1] | (7,707.9) |
| Usable Foreign Exchange Reserves(A-B) | 29,412.7 | 8,873.6 | -20,539.1 |

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

to international financial institutions in Korean won and convertible currencies. Details of these subscriptions and contributions are set out below.

The Bank credited US$ 36.58 million to the Bank for International Settlements(BIS) as its subscription following entry to that organization. It credited US$ 1.39 million to the International Financial Corporation(IFC) as its fifth annual installment of the IFC's fourth general increase in capital stock. Moreover, it subscribed US$ 12.25 million, in cash and securities in equal proportions, to the European Bank for Reconstruction and Development, representing its special subscription. It made payment of 3.5 billion Korean won(US$ 3.58 million) to the Asian Development Bank as its third annual installment of the fourth general increase in capital stock. Of this, 15 percent was in the form of Korean currency and 85 percent in the form of Korean-won denominated subscription securities. In addition, the Bank made payments of 7.1 billion Korean won(US$ 9.28 million) to the African Development Bank as the first and second installments of the seventh replenishment, and of 19.3 billion Korean won(US$ 25.17 million), in the form of Korean-won denominated subscription securities, to the International Development Association by way of special funding and the first installment of the eleventh replenishment.

Meanwhile, the Bank disbursed SDR 0.42 million(US$ 0.58 million) as the third and fourth installments of the additional amount of SDR 8.30 million committed to the Expanded Structural Adjustment Facility of the IMF. The Bank also made payment of US$ 2 million to the Consultant Trust Fund of the International Bank for Reconstruction and Development.

## 3. Supervision of Banking Institutions

### (1) Guidance for Sound Banking Management

During the year, the Office concentrated its banking management guidance on ensuring that banks adopt a system of managerial accountability and improve the effectiveness and soundness of their management.

As a first step, it required the board of directors to exercise a surveillance function over bank management. Specifically, seeking to allow new system of board of directors to take firm root at an early stage, the Office reviewed the required qualification of non-executive directors, and made it mandatory for the president of a bank to report on its management status to the board of directors more than once every quarter. Along with this, it improved the system of public disclosure. In detail, it directed that banks include market price and appraised profit or loss by product among the disclosure items for financial derivatives, enlarge the scope of public disclosure concerning bad loans, and announce the status of non-performing loans along with that for bad loans every half year. The Office required Korea First Bank and Seoul Bank, whose managerial soundness had deteriorated sharply as a large number of their loans turned sour, to implement management improvement measures including an increase in equity capital; restrictions on dividend payout and advance into new business sectors; and the rationalization of their domestic and overseas networks and subsidiaries.

Concerned to enhance the efficiency of bank management, the Office also checked the status of banks' internal and managerial controls over their branches as a matter of priority in its examinations. It urged them to draw up adequate countermeasures such as rationalizing branches that recorded chronic deficits or weak profitability, made it obligatory to reflect subsidiaries' management performance in the bank management rating (CAMEL), and to report the examination results to the general meeting of shareholders.

Futhermore, in order to seek the consolidation of equity capital, the Office facilitated banks' expansion of their equity capital through debt-type financing instruments such as subordinated notes and cumulative preference-stocks. It also strongly urged them to set aside securities valuation reserves to provide against losses on stock revaluation at an early stage, thereby helping bring prudential supervisory standards up to internationally accepted levels.

Meanwhile, the Office, with the intention of preventing the occurrence of large bad loans, endeavored to bring about improvements in banks' credit screening and the systemic management of their credit risk. Among the major initiatives in this respect the Office had banks set up credit committees chaired by an executive director or the deputy president and with the authority to examine and decide upon large credits. And it urged banks to draw up special credit agreements with companies whose financial structure was fragile mandating improvements in their financial structure and advance consultation with the bank on matters significantly affecting debt redemption ability.

The Office, with a view to lessening the risks to banks' soundness due to the fragility of certain interlinked business groups whose total credit from the banking systems is excessive, abolished with effect from Jul. 31, 2000 the system of credit ceilings (basket management) on the ten largest interlinked business groups and instead introduced a system of credit ceilings on single interlinked business groups.

### (2) Deregulation of Banking Network

During the year, the Monetary Board eased its regulations concerning branching.

First of all, in order to enhance banks' discretion in the operation of their branch networks, the Office allowed banks to file a post-facto report rather than obtain advance consent from the Monetary Board when they wished to establish, close down, or transfer business offices, provided their business-use fixed asset ratio was less than 60% and that they had achieved at least the second grade in the most recent assessment of management effectiveness. In a parallel more, the Office eliminated the criterion of asset size (among the 500 largest banks in the world) which had been one of the eligibility criteria for foreign banks wishing to establish an initial business presence in Korea.

Domestic commercial banks opened a net total of 430 business offices during the year. These comprised 339 offices of nationwide commercial banks and 91 offices of local banks. By type, the number of branches increased by 344 and that of sub-offices increased by 86. As of the end of 1997, the total number of domestic offices of commercial banks stood at 5,987.

There was an expansion of domestic commercial banks' overseas presence during the year with the establishment of nine branches, one subsidiary, and five representative offices. This brought their total overseas network to 90 overseas branches, 46 subsidiaries, and 54 representative offices, making 190 delivery points in all as of the end of the year.

In the case of foreign bank branches in Korea, five branches including those of NationsBank, CoreStates Bank, and Industrial & Commercial Bank of China, were established, while four branches including those of Credit Lyonnais and BankBoston were closed. Thus the number of foreign bank branches stood at 68 as of the end of 1997, a net increase of one compared with the end of the preceding year.

Meanwhile, looking at representative offices, three were established, namely those of Bayerische Landesbank Girozentrale and Deutsche Genossenchaftsbank were established, while that of the Hokkaido Takushoku Bank was closed and three

**[Table 18]** **Domestic Network of Commercial Banks**

| | Year-end 1996 | Increase in 1997 | | | Year-end 1997 | | |
|---|---|---|---|---|---|---|---|
| | | Total | Head Offices & Branches | Other Offices | Total | Head Offices & Branches | Other Offices |
| Nationwide Commercial Banks | | | | | | | |
| Cho Hung | 444 | 41 | 48 | -7 | 485 | 342 | 143 |
| Commercial | 442 | 71 | 25 | 46 | 513 | 271 | 242 |
| Korea First | 403 | 10 | 16 | -6 | 413 | 270 | 143 |
| Hanil | 439 | 39 | 16 | 23 | 478 | 280 | 198 |
| Seoul | 355 | 2 | 27 | -25 | 357 | 306 | 51 |
| Korea Exchange | 382 | 18 | 10 | 8 | 400 | 352 | 48 |
| Kookmin | 499 | 12 | 8 | 4 | 511 | 478 | 33 |
| Housing & Commercial | 452 | 47 | 22 | 25 | 499 | 445 | 54 |
| Shinhan | 198 | 25 | 13 | 12 | 223 | 193 | 30 |
| KorAm | 109 | 13 | 10 | 3 | 122 | 110 | 12 |
| Dongwha | 125 | 13 | 12 | 1 | 138 | 135 | 3 |
| Dongnam | 105 | 14 | 14 | 0 | 119 | 112 | 7 |
| Daedong | 103 | 4 | 24 | -20 | 107 | 105 | 2 |
| Hana | 99 | 11 | 10 | 1 | 110 | 107 | 3 |
| Boram | 90 | 9 | 7 | 2 | 99 | 94 | 5 |
| Peace | 98 | 10 | 8 | 2 | 108 | 105 | 3 |
| **Subtotal** | **4,343** | **339** | **270** | **69** | **4,682** | **3,705** | **977** |
| Local Banks | | | | | | | |
| Daegu | 201 | 6 | 5 | 1 | 207 | 133 | 74 |
| Pusan | 173 | 22 | 42 | -20 | 195 | 165 | 30 |
| Chungchong | 113 | 7 | 2 | 5 | 120 | 102 | 18 |
| Kwangju | 145 | 2 | -10 | 12 | 147 | 114 | 33 |
| Cheju | 45 | 1 | 1 | 0 | 46 | 37 | 9 |
| Kyungki | 171 | 23 | 8 | 15 | 194 | 136 | 58 |
| Jeonbuk | 81 | 4 | 8 | -4 | 85 | 65 | 20 |
| Kangwon | 64 | 6 | 5 | 1 | 70 | 60 | 10 |
| Kyongnam | 158 | 10 | 7 | 3 | 168 | 150 | 18 |
| Chungbuk | 63 | 10 | 6 | 4 | 73 | 56 | 17 |
| **Subtotal** | **1,214** | **91** | **74** | **17** | **1,305** | **1,018** | **287** |
| **Total(Domestic Banks)** | **5,557** | **430** | **344** | **86** | **5,987** | **4,723** | **1,264** |
| Foreign Banks | 91 | 0 | 1 | -1 | 91 | 68 | 23 |

representative offices including that of NationsBank were upgraded to branch status. This brought the number of foreign bank representative offices to 23, a net decrease of one compared with the end of the previous year.

[Table 19] **Overseas Network of Commercial Banks**

| | Year-end 1996 | | | Increase in 1997 | | | Year-end 1997 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Branches | Subsidiaries | Representative Offices | Branches | Subsidiaries | Representative Offices | Branches | Subsidiaries | Representative Offices |
| Nationwide Commercial Banks | | | | | | | | | |
| Cho Hung | 9 | 6 | 3 | 1 | - | - | 10 | 6 | 3 |
| Commercial | 8 | 5 | 1 | 1 | - | - | 9 | 5 | 1 |
| Korea First | 7 | 6 | 4 | - | - | - | 7 | 6 | 4 |
| Hanil | 11 | 6 | 1 | 2 | 1 | -1 | 13 | 7 | - |
| Seoul | 8 | 2 | 2 | - | - | - | 8 | 2 | 2 |
| Korea Exchange | 25 | 11 | 4 | 1 | - | 1 | 26 | 11 | 5 |
| Kookmin | 1 | 3 | 7 | 1 | - | - | 2 | 3 | 7 |
| Housing & Commercial | 1 | - | 6 | 2 | - | -1 | 3 | - | 5 |
| Shinhan | 6 | 2 | 3 | 1 | - | - | 7 | 2 | 3 |
| KorAm | 3 | - | 2 | - | - | 1 | 3 | - | 3 |
| Dongwha | 1 | - | 3 | - | - | - | 1 | - | 3 |
| Dongnam | - | 2 | - | - | - | - | - | 2 | - |
| Daedong | - | - | 1 | - | - | - | - | - | 1 |
| Hana | - | 1 | 2 | - | - | 1 | - | 1 | 3 |
| Boram | 1 | 1 | - | - | - | 1 | 1 | 1 | 1 |
| Peace | - | - | - | - | - | - | - | - | - |
| **Subtotal** | **81** | **45** | **39** | **9** | **1** | **2** | **90** | **46** | **41** |
| Local Banks | | | | | | | | | |
| Daegu | - | - | 3 | - | - | - | - | - | 3 |
| Pusan | - | - | 3 | - | - | 1 | - | - | 4 |
| Chungchong | - | - | - | - | - | - | - | - | - |
| Kwangju | - | - | 1 | - | - | - | - | - | 1 |
| Cheju | - | - | - | - | - | - | - | - | - |
| Kyungki | - | - | 1 | - | - | - | - | - | 1 |
| Jeonbuk | - | - | - | - | - | - | - | - | - |
| Kangwon | - | - | - | - | - | 1 | - | - | 1 |
| Kyongnam | - | - | 2 | - | - | 1 | - | - | 3 |
| Chungbuk | - | - | - | - | - | - | - | - | - |
| **Subtotal** | - | - | **10** | - | - | **3** | - | - | **13** |
| **Total** | **81** | **45** | **49** | **9** | **1** | **5** | **90** | **46** | **54** |

## (3) Increases in Banks' Capital

During the year, one of the nationwide commercial banks and three of the local banks increased their paid-in capital by a total of 323.3 billion won, of which 38.1

[Table 20] **Paid-in Capital of Commercial Banks**

Unit : billion won

| | Year-end 1996 | Increase in 1997 | Year-end 1997 |
|---|---|---|---|
| Nationwide Commercial Banks | | | |
| Cho Hung | 930.4 | – | 930.4 |
| Commercial | 850.0 | – | 850.0 |
| Korea First | 820.0 | – | 820.0 |
| Hanil | 830.0 | – | 830.0 |
| Seoul | 820.0 | – | 820.0 |
| Korea Exchange | 825.0 | – | 825.0 |
| Kookmin | 464.4 | 58.8 | 523.2 |
| Housing & Commercial | 235.0 | 86.2 | 321.2 |
| Shinhan | 616.0 | – | 616.0 |
| KorAm | 215.0 | – | 215.0 |
| Dongwha | 400.0 | – | 400.0 |
| Dongnam | 200.0 | – | 200.0 |
| Daedong | 200.0 | – | 200.0 |
| Hana | 161.7 | 71.8 | 233.5 |
| Boram | 175.6 | – | 175.6 |
| Peace | 273.0 | – | 273.0 |
| **Subtotal** | **8,016.1** | **216.8** | **8,232.9** |
| Local Banks | | | |
| Daegu | 210.0 | 106.5 | 316.5 |
| Pusan | 171.0 | – | 171.0 |
| Chungchong | 118.5 | – | 118.5 |
| Kwangju | 180.0 | – | 180.0 |
| Cheju | 50.0 | – | 50.0 |
| Kyungki | 200.2 | – | 200.2 |
| Jeonbuk | 115.3 | – | 115.3 |
| Kangwon | 106.2 | – | 106.2 |
| Kyongnam | 147.0 | – | 147.0 |
| Chungbuk | 113.5 | – | 113.5 |
| **Subtotal** | **1,411.7** | **106.5** | **1,518.2** |
| **Total(Domestic Banks)** | **9,427.8** | **323.3** | **9,751.1** |
| Branches of Foreign Banks | | | |
| Class A Funds | 2,118.4 | 1,704.7 | 3,823.1 |
| Class B Funds | 1,392.1 | 218.8 | 1,610.9 |
| **Total** | **726.3** | **1,485.9** | **2,212.2** |

billion won was raised through the issue of depositary receipts (DRs) in international markets. The total additional equity issued brought the paid-in capital of all commercial banks to 9.75 trillion won as of the end of the year. This, though, represented an increase of only 3.4% over the previous year.

Following on the substantial rise from the previous year (365.5 billion won), 12 foreign bank branches including Seoul Branch of Credit Suisse First Boston Bank enlarged their Capital A funds, bolstering them by a total of 218.8 billion won. In addition, during the year, the Capital B funds of foreign bank branches, which had decreased by 83.8 billion won the year before, shifted to show a sharp increase (1.49 trillion won), mainly due to the enlargement of their swap facilities with the central bank (on Dec. 8). As a result, the outstanding balance of all foreign bank branches' in-country capital stood at 3.82 trillion won, which represented an increase of 1.70 trillion won during the year.

## 4. Financial Status

### (1) Assets

Total assets of the Bank, as of the end of the year under review, amounted to 112.4 trillion won, representing a rise of 42.7 trillion won over the previous year-end. This was mainly caused by large increases in due from banks and loans against bills, which served to more than offset the reduction of securities and cash holdings.

Due from banks grew by 40,924.1 billion won, chiefly owing to the translation effects from the weakened Korean won and the inflow of emergency funds from the IMF. In spite of the reduction(1,406.3 billion won) of the Bank's aggregate credit ceiling, loans against bills increased by 6,082.4 billion won. The main reasons for the increase were the extension of special loans(totalling 2 trillion won) to Korea First Bank and several merchant banking corporations, which were suffering difficulties in management owing to the rapid accumulation of nonperforming loans in September and October, and the supply of funds for financial market stabilization to commercial banks and securities companies, whose liquidity conditions were worsened markedly owing to withdrawals of deposits and the paralysis of the call market in December.

Meanwhile, despite increased holdings of government bonds, the Bank's holdings of securities decreased 5,368.0 billion won, mainly because of the run-down of holdings of foreign securities in order to stabilize the foreign exchange market. And there was also a reduction of 187.2 billion won in cash holdings.

[Table 21] **Financial Status**

Unit: billion won

| | 1996 | 1997 | Change |
|---|---|---|---|
| **Assets** | **69,742.8** | **112,420.2** | **42,677.4** |
| Current assets | 67,629.1 | 109,861.8 | 42,232.7 |
| Cash | 218.4 | 31.2 | -187.2 |
| Gold and silver bullion | 26.9 | 45.5 | 18.6 |
| Holdings of SDRs | 99.1 | 109.3 | 10.2 |
| Securities | 19,394.5 | 14,026.5 | -5,368.0 |
| Due from banks | 37,230.7 | 78,154.8 | 40,924.1 |
| Bills discounted | 13.7 | 9.7 | -4.0 |
| Loans against bills | 7,094.7 | 13,177.1 | 6,082.4 |
| Loans to government | 399.5 | 419.0 | 19.5 |
| Loans to international financial institutions | 73.6 | 172.1 | 98.5 |
| Other current assets | 3,078.0 | 3,716.6 | 638.6 |
| Fixed assets | 2,113.7 | 2,558.3 | 444.6 |
| **Liabilities and Capital** | **69,742.8** | **112,420.2** | **42,677.4** |
| Liabilities | 68,208.0 | 109,347.2 | 41,139.2 |
| Current liabilities | 67,511.2 | 108,585.6 | 41,074.4 |
| Currency issued | 17,907.3 | 17,786.1 | -121.2 |
| Monetary Stabilization Bonds issued | 25,030.0 | 23,470.9 | -1,559.1 |
| Monetary Stabilization Account | 0 | 0 | 0 |
| Government deposits | 6,683.9 | 5,409.7 | -1,274.2 |
| Deposits | 11,063.0 | 22,210.1 | 11,147.1 |
| Allocations of SDRs | 87.7 | 182.8 | 95.1 |
| Securities sold under repurchase agreements | 2,057.0 | 6,148.0 | 4,091.0 |
| Other current liabilities | 4,682.3 | 33,378.0 | 28,695.7 |
| Long-term liabilities | 696.8 | 761.6 | 64.8 |
| Borrowings | 0 | 0 | 0 |
| Allowances | 278.3 | 315.4 | 37.1 |
| Liabilities to international financial institutions | 418.5 | 446.2 | 27.7 |
| Capital | 1,534.8 | 3,072.9 | 1,538.1 |
| Legal reserve | 242.6 | 274.5 | 31.9 |
| Voluntary reserve | 973.2 | 973.2 | 0 |
| Net profit for the period | 319.0 | 1,825.2 | 1,506.2 |

### (2) Liabilities and Capital

Total liabilities of the Bank of Korea as at year-end stood at 109.3 trillion won, an increase of 41.1 trillion won during the year. By type of liability, other current liabilities expanded by 28,695.7 billion won, mostly supplied by an increase of 27,989.1 billion won in the exchange revaluation adjustment account.

The deposit liabilities of the Bank increased by 11,147.1 billion won following the rise in temporary deposits resulting from the inflow of emergency funds from the IMF. Securities sold under repurchase agreements increased by 4,091.0 billion won, owing to the Bank's utilization of open market operations involving the sale of securities under repurchase agreements to siphon off a possible excess of liquidity caused by the supply of special loans and loans of financial market stabilization funds around the end of the year. And liabilities to international financial institutions increased by 27.7 billion won following decisions made concerning subscriptions and contributions to international financial institutions such as the AfDA and the IDA.

Meanwhile, Monetary Stabilization Bonds(MSBs) issued declined by 1,559.1 billion won owing to the increased redemption of MSBs to cope with the credit crunch. Influenced by declining tax revenues, government deposits decreased by 1,274.2 billion won.

The Bank's capital increased to stand at 3,072.9 billion won as at the end of the year. This increase was due to the allocation of the entire net profit for the previous period of 31.9 billion won to legal reserves, and the achievement of a net profit for the period of 1,825.2 billion won.

### (3) Income and Expenses

For the year under review, the net profit of the Bank increased by 1,506.2 billion won, a sharp rise from the 319.0 billion won of the previous year to 1,825.2 billion won. This large expansion in net profits was chiefly attributable to the increased profit on foreign exchange transactions, interest on deposits and profit on sales of securities, while operating expenses were held at a similar figure to those of the previous year.

Total operating income increased by 2,098.0 billion won to 6,093.6 billion won during the year. By item, profit on foreign exchange transactions rose by 1,265.6 billion won, reflecting the decline in the exchange value of the won and enlarged disposals of foreign exchange to prevent any failure in external payments. Interest on deposits increased by 696.6 billion won because the boost to won-denominated deposits that was delivered by the effects of the won's sharp depreciation against

[Table 22] **Income Statement**

Unit: billion won

| | 1996 | 1997 | Change |
|---|---|---|---|
| **Operating income** | **3,995.6** | **6,093.6** | **2,098.0** |
| Interest and discounts received | 3,816.0 | 4,382.5 | 566.5 |
| Interest on securities | 1,127.5 | 1,080.6 | -46.9 |
| Interest on deposits | 1,997.4 | 2,694.0 | 696.6 |
| Discounts on domestic bills | 1.1 | 0.4 | -0.7 |
| Interest on loans against bills | 511.0 | 319.7 | -191.3 |
| Interest on loans to government | 19.3 | 19.6 | 0.3 |
| Miscellaneous interest received | 156.7 | 89.0 | -67.7 |
| Other interest and discounts received | 3.0 | 179.2 | 176.2 |
| Commissions received | 3.0 | 3.5 | 0.5 |
| Profit on sales of securities | 40.5 | 306.0 | 265.5 |
| Profit on foreign exchange transactions | 136.0 | 1,401.6 | 1,265.6 |
| **Operating expenses** | **3,570.1** | **3,577.2** | **7.1** |
| Interest and discounts paid | 3,125.2 | 3,033.8 | -91.4 |
| Interest on deposits | 169.0 | 145.4 | -23.6 |
| Interest on Monetary Stabilization Bonds | 2,854.6 | 2,725.4 | -129.2 |
| Interest on Securities sold under repurchase agreements | 80.7 | 81.2 | 0.5 |
| Miscellaneous interest paid | 20.9 | 81.7 | 60.8 |
| Commissions paid | 3.6 | 87.3 | 83.7 |
| Banknotes and coin production expenses | 129.6 | 115.5 | -14.1 |
| Provision for reserves | 88.8 | 65.2 | -23.6 |
| Administrative and operating expenses | 185.9 | 190.6 | 4.7 |
| Bank supervision and examination expenses | 36.9 | 38.3 | 1.4 |
| **Net operating income** | **425.5** | **2,516.5** | **2,091.0** |
| **Net non-operating profit[1)]** | **20.7** | **24.1** | **3.4** |
| **Net non-operating expenses[2)]** | **1.0** | **0.8** | **-0.2** |
| **Net profit before taxes** | **445.2** | **2,539.8** | **2,094.6** |
| **Taxes** | **126.2** | **714.6** | **588.4** |
| **Net profit for the period** | **319.0** | **1,825.2** | **1,506.2** |

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

leading currencies more than offset the decline in the scale of deposits. Profit on sales of securities also increased, rising by 265.5 billion won owing to the large-scale disposal of foreign securities.

In contrast, interest on loans against bills decreased by 191.3 billion won compared to the previous year as a result of the reduced extension of aggregate ceiling credits. Interest on securities decreased by 46.9 billion won compared to the previous year owing to the reduction in the scale of foreign securities holdings, which more than offset the increase in holdings of Korean government bonds.

Meanwhile, total operating expenses amounted to 3,577.2 billion won, a slight rise of 7.1 billion won over the previous year. By item, interest on Monetary Stabilization Bonds declined by 129.2 billion won due to the Bank's reduced issuance of MSBs. And banknotes and coin production expenses also declined, falling by 14.1 billion won, owing to the lower volume of production. Interest on deposits fell by 23.6 billion won owing to the contraction of reserve deposits following the reduction in reserve requirements. In contrast, commissions paid and miscellaneous interest paid increased by 83.7 billion won and 60.8 billion won, respectively, due to the payment of IMF fees(81.2 billion won) and interest(55.6 billion won) in connection with the receipt of credits.

Meanwhile, the Bank paid a sum of 992.5 billion won into the general revenue account of the government. This represented its after tax net profit for the period, excluding 182.5 billion won for the allocation to the legal reserve and 650.2 billion won for the allocation to the voluntary reserve for contributions to various funds.

## 5. Organizational Changes

The Bank carried out a divisional-level reorganization on 17 March, the objective being to heighten the efficiency of operations and to rationalize management within the framework of the existing departmental structure. This resulted in the closure of one office and two divisions, and the establishment of three new divisions within the Bank's Head Office, and in the closure of three divisions and six domestic representative offices within the domestic branch network.

As of the end of 1997, the Bank's organization comprised thirteen departments, one office and one research institute at the Head Office itself; nine departments in the Office of Bank Supervision; and the Auditing Department. The Bank also had sixteen domestic branches and eight overseas representative offices.

In the organizational changes carried out within the Head Office, National Accounts Office of Statistics Department was split into two divisions, namely National Income Division and Inter Industry Economics Division. The rationale for this was that differences in methods and cycles of compilation between the national accounts and input-output tables largely nullified the gains from working within the same organizational framework. Reflecting the progressive shift toward indirect monetary management, Monetary Affairs Desk was split from Market Operations Office to create a separate division, Monetary Affairs Division.

In the case of the branch network, the Bank dissolved three Planning & Research Divisions, those in Mokp'o, P'ohang and Kangnung Branches, with a view to heightening the efficiency of operational performance and personnel management through the integration of provincial research functions among neighboring branches. Six domestic representative offices, those in Haenam, Yosu, Kunsan, Chech'on, Wonju and Taebaek, were downgraded to detached offices. Meanwhile four detached offices, in S'ongbuk, Sasang, Chech'on and Puch'on, were dissolved on 1 September.