



Office Memorandum

To: Mr. Fisher

February 8, 1998

From: Alejandro Santos 

Subject: **Korea--Gold Purchase Scheme**

In early January this year, Bank of Korea (BOK) invited banks and financial institutions to participate in a scheme whereby these institutions would be conducting "gold drives" to collect gold from the population, melt it and convert it into ingots, and finally sell them abroad. The foreign exchange proceeds would be sold to BOK. The won equivalent would be distributed by the institutions among the participant citizens.

In the event, four banks and two (non-bank) financial institutions decided to participate. (i) Korea Housing Bank (two drives, Jan 5-31 and Feb 5-21); (ii) Korea Exchange Bank (Jan 12-Feb 14); (iii) Korea Industrial Bank (Jan 15-Feb 15); (iv) Korea Citizens Bank (Jan 13-Feb 14); (v) National Agriculture Cooperative (Jan 12-Feb 21); and (vi) Community Credit Cooperative (Jan 13-Feb 14).

The banks and financial institutions would accept gold of 99 percent grade or higher in deposit for future won payment (including gold 24K) and any other form of gold of a lower grade as a donation to the Republic (including gold 14K and 18K). Citizens can go to any of the six participating institutions and surrender the gold in exchange for a certificate that indicates the weight and grade of the gold but does not include any value or price for the gold.

As of February 6, the institutions had collected 169.8 tons of gold with an estimated market value of US\$1.7 billion. The bulk of the collections have been made by Korea Housing Bank (117.0 tons or 69 percent of the total). As expected, the majority of the transactions are sales (169.65 tons) and only a very small fraction are donations (0.15 tons). Thus far, 70 tons of gold have already been shipped abroad and the remaining 100 tons are either still deposited or in the process of being converted to ingots. The rate of participation has been impressive, about 2 million people has been involved in selling their gold or almost 20 percent of the families in the country.

BOK has purchased US\$0.60 billion in foreign exchange from this scheme, of which US\$0.22 billion took place in January and the remainder US\$0.38 billion during the first week of February. Further purchases are expected in the rest of the month and in March when the scheme is expected to be terminated.

To avoid problems of multiple sales of gold abroad at different prices and different sales of foreign exchange at different exchange rates, it is expected that each institution will pay to the

- 2 -

participating citizens the average price and exchange rate of all transactions at the end of the scheme. Since it takes about one month to convert the gold into ingots, to ship it abroad, get the payment, and convert it to won, it is expected that the population will get paid at the end of March.

The scheme is based on good faith and in the spirit of cooperation of all parties as there does not seem to be a supervisory body to ensure no wrongdoing is involved. I was told that the banks and financial institutions do not charge fees for their services (other than those related to hiring gold experts to determine the weight and grade of the gold) and that they make sure that the companies in charge of melting the gold charge a fair price and also that the export agency obtains a fair price from abroad. Needless to say that these institutions do profit from holding the won (and /or dollar) proceeds during several weeks as they can buy short-term securities.

While the motivation of the population to engage in this scheme is mostly for nationalistic reasons (I was told), there are certain incentives for the population to participate. It appears that the gold market at the retail level is rather inefficient and large spreads exist between the local selling prices and the equivalent world price. A unit of 3.75 grams of fine gold (called "stone" by the locals) can be sold in the local market for W 58,000 and local traders buy it for as much as W 48,000. It is estimated that those participating in this scheme will receive an average price of W 54,000 per stone, or 12.5 percent more than the price prevailing at the retail level.

BOK has announced that starting last Friday (February 6) they may purchase some of the gold directly from the banks and financial institutions to prevent undue pressures on the international gold market. I advised them not to purchase gold as liquid foreign exchange is needed given the low level of reserves at present.

cc: Mr. Neiss (via fax to Bangkok)
Ms. Tseng (via e-mail)
Mr. Burton (via e-mail)
Mr. Dodsworth
Mr. Ishii (via e-mail)
Mr. Moser (via e-mail)



Office Memorandum

1/14

To Mr Fischer

February 6, 1998

From Hubert Neiss and Wanda Tseng

Subject **Korea Draft Memorandum on Economic Program**

The following provides responses to the comments to the respective paragraphs of your memorandum of February 5, 1998

1 The understandings on interest rates (that was faxed to you earlier) would be a **verbal** understanding with the authorities. They are adamantly opposed to any "side" letter, not because they do not intend to follow through on the understandings, but because they do not want to be accused of having "side" agreements with the Fund that they are not revealing to the public. In the December negotiations, the authorities were heavily criticized for having made "secret" agreements with the Fund. Korea is becoming an open society, and transparency is all in fashion. We should go along with this.

2 The foreign exchange window at the Bank of Korea (BOK) is an emergency feature. Banks needing foreign exchange for whatever purpose should buy it in the market. We believe that closing the window as soon as feasible would be an important signal of normalization. (The early unification of the foreign exchange market is also a point emphasized by the Executive Board). BOK, of course, would maintain its role as lender of last resort.

The current repayment period for foreign exchange support (used for purposes *other* than debt repayments) is presently a maximum of one month, and the agreement now is to shorten it to a maximum of two weeks. While a further shortening would be desirable, it is not practical in the present situation where some weaker banks continue to experience difficulties in arranging new lines of credit. In any case, the high penalty interest is a strong incentive for early repayment. It should be noted that stronger banks have been repaying the BOK since last week.

3 The fiscal section has been modified to take account of your comments (attached). An important breakthrough was achieved this morning with the Tripartite Accord. While we are awaiting a translation of this accord, the government would need to provide higher social expenditure as part of its contribution to the social compact. We have indicated to the authorities that such expenditures should be accommodated through an increase in the budget deficit.

4 We have suggested special (temporary) programs to alleviate the burden of high interest on medium and small enterprises. The authorities are now under intense political

pressure because of increasing bankruptcies and layoffs among SMEs due to high interest rates. Charging market interest rates under the BOK rediscount facility for SMEs would defeat its purpose. The SME lending funded by the BOK rediscount facility is small (the stock outstanding amounts to some W4.6 trillion at end-January, with a planned increase to W5.6 trillion during 1998). The subsidy element in this scheme is estimated at about W0.75 trillion for 1998 (0.1 percent of GDP). The small cost is needed for the authorities to maintain the high interest rates.

5 The authorities have indicated that there may be some scope to accelerate the implementation of prudential measures, but the feasibility of doing that can only be decided after the new Financial Supervisory Board is set up in April. We would therefore intend to review this at the second quarterly review.

On the spot and forward positions, there is at present a rather restrictive combined limit for forward and spot positions (15 percent of equity capital) but there is in addition a separate restriction on spot positions (5 percent), which unnecessarily impedes the development of the forward market. The measure would remove the separate restriction on spot positions.

As to the capital adequacy standards, the current timetable gives banks six to 24 months to reach the 8 percent requirement. The precise schedule for each bank will be set in the context of the recapitalization plans that will be approved by the bank restructuring unit in June. The authorities are very mindful of avoiding a further credit crunch and have indicated their intention to stand ready to also provide some further assistance to banks in meeting their requirements if that proved necessary.

6 The guidelines are intended to clarify the Banking Act that was passed in December, setting transparent conditions under which foreign investment in domestic financial institutions can take place (e.g., the foreign banks must meet BIS capital adequacy ratios, etc.).

7 It was not possible this time to get more on the adjustment tariffs and the tariff quotas. The authorities insist that they have already done a lot in December, and that these tariff issues are mainly for bilateral discussions, and that many of the items relate to agricultural products. This program contains the additional conditions of deadlines for reviewing import certification procedures and bringing them in line with international practice, and for rationalizing the subsidy programs. We think we got as much as possible (also given the availability of time and staffing resources) and will try again next time. Trade policy, in any case, is not a major focus of this program.

8 Please see point 2 above on the Tripartite Accord.

9 We are, of course, not sure that the corporate governance measures will suffice for restructuring the chaebols. However, the program does address the most important issues cited by outside experts, which are essentially to create the laws, institutions, and financial

markets that will impose market discipline on the behavior of the chaebols so that they will be profit-oriented. These include transparency, increasing the commercial orientation of bank lending, liberalizing the corporate financing market (equity and mergers and acquisitions), and accountability to shareholders. We have prepared a study of the chaebol issues, and it will be circulated as part of the background documentation for the Article IV

10 We would like your reaction before we conclude discussions tonight. Agreement here will in any case, as usual, be ad referendum. **We will, therefore, call you at 7 00 a.m. your time since the authorities would like to announce tonight (Seoul time) that agreement with the mission had been reached.**

11 The Memorandum (with changes sidelined) is attached

Attachment

- cc Mr Tanzi
- Mr Aghevli/Goldsbrough
- Mr Leddy
- Mr Larsen
- Mr Alexander
- Mr Adams
- Mr Bennett
- Ms Meesook



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cc Mr Tanzi
Mr Aghevi/Goldsbrough
Mr Leddy
Mr Larsen
Mr Alexander
Mr Adams
Mr Bennett
Ms Meesook



Office Memorandum

To: Mr. Neiss
Ms. Tseng
Mr. Dodsworth

February 6, 1998

From: Jeanne Gobat

Subject: **Corporate Governance Code**

At my meeting with Mr. Yong-Beom Kim from the Securities Policy Division at MOFE, I passed on two excellent reports on corporate governance: one by the Toronto Stock Exchange (TSE) Committee on Corporate Governance in Canada and the other by the California Public Employee Retirement System (CalPERs), the world's fourth largest pension fund. Both the TSE and CalPERs have formulated a Corporate Governance Code and both have identified principles of best practices. The code of best practice is used as guideline, recommendation but is not a requirement. The TSE Committee recommends that listed members disclose differences between their governance systems and the guidelines recommended by the TSE. The disclosure approach allows each listed company on the TSE to develop its own system of governance. Studies have shown that companies that reveal their corporate governance system and their intentions to improve on it have been rewarded by markets.

I have suggested to Mr. Kim that the Korean Stock Exchange, similar to the TSE, establish a committee that would develop a Corporate Governance Best Practice Code for the Korean Stock Exchange (KSE). The committee would consist of institutional investors, experts from academia and other foreign stock exchanges, business representatives, and representatives of the KSE. Mr. Kim passed on privately the two reports and thoughts to the KSE. **He told me today that the KSE is very much interested in the Toronto Stock Exchange approach and has internally established a study group that will try to develop a corporate governance code for listed member companies on the KSE.**

cc: Mission Team



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Department/Division/ Collection	Asia and Pacific Department Records
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Doc title & dates	Meeting with Two Partners from Deloitte & Touche, February 6, 1998
Doc Classification	Strictly Confidential



外換保有高, 金利 및 株價 動向 日日報告

(億달러, %, p, 億원)

Feb. 6, 1998

日 字	外 換 保有高	日中增減	增 減 要 因			金 利			株 式	
			政策資金 ¹⁾	決濟資金 不足支援	其他(純) ²⁾	콜金利 (1일물)	會社債 (3년)	C P (91일)	株價指數	外國人株式 純買受
97.12.31(水)	88.7	4.1	9.4	△4.7	△0.6	31.32	28.98	40.77	376.31	-
98. 1.30(金)	123.4	3.5	-	4.1	△0.6	27.79	18.50	22.16	558.33	1,144
31(土)			休 場			27.21	18.50	22.16	567.38	2,400
2. 2(月)	125.9	2.5	-	1.5	1.0	24.26	19.50	22.16	543.68	2,126
3(火)	128.3	2.4	-	1.8	0.6	23.91	19.32	22.16	550.21	936
4(水)	131.3	3.0	-	1.3	1.7	23.33	18.11	21.61	547.28	1,021
5(木)	133.8	2.5	-	1.9	0.6	23.18	18.22	21.06	528.05	207
6(金)	136.2	2.4	-	2.3	0.1*	23.46	18.42	21.05	540.45	3,025

* 金決濟代金 0.6, 運用收益 0.3, 先物換決濟 △0.5, 外貨支準 △0.5 等

<主要内容>

※ 換率: 2.6日 終價 1,556.00원/달러 (基準換率對比 △50.2)
(2.7日 適用 基準換率 1,574.60원/달러)

— 2.6日 外換保有高는 金融機關 支援資金의 持續的인 回收(2.3億달러) 등으로
前日보다 2.4億달러 增加하여 136.2億달러에 달함

- 金融機關 短期借入金 Roll-over比率은 90.0%
- 公的資金 總流入額(190億달러)對比 53.8億달러 미달

◎ 98年中 今日까지 公的資金 累計: 30億달러(ADB 10, IMF 20)
(97.12月以後 公的資金 累計: 190億달러(IMF 130, IBRD 30, ADB 30))

- 주) 1. IMF, IBRD, ADB, G-7 등 주요국의 지원package 포함
2. 운용자산운용수익, 달러외의 기타외화평가변동분, 선물환결제 등

98. 2. 6

非常經濟對策委員會 企劃團



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MSG NO	DATE February 6, 1998	PAGE 1 OF 2
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TO Mr Hubert Neiss/Ms Wanda Tseng
 c/o Seoul Hilton, Room 1730
 Seoul Korea
 82 2 317-3532

Hubert/Wanda

I attach PDR's comments on the performance criteria

Wanda should be prepared to give an informal briefing to the Board early next week
 EDs will certainly request it

In a lunchtime discussion with EDs on interest rate policy in Asia, Mr. Fischer apparently said that we could see the impact on the exchange rate and reserves "day by day and hour by hour" when the authorities raised interest rates! Of course, EDs are now requesting that we urgently provide them with the evidence I don't think things were that simple, but we will put together a few illustrative charts This issue will undoubtedly come up again in future Board discussions on Korea (They asked Bijan about it at today's informal session on Indonesia)

Cheers,

FROM David Goldsborough
 APD/FO

ROOM NO 4-320	EXTENSION 34735	ACCOUNT CODE 55
AUTHORIZED BY David Goldsborough		SIGNATURE



Office Memorandum

To Mr Goldsbrough

February 6, 1998

From Thomas Leddy *TL*

Subject **Korea -- Performance Criteria**

We have looked at the material sent to us this morning by Ms Coorey, and are satisfied that the performance criteria for NDA and NIR are appropriately defined and calibrated. We note that the base money projection (14 percent through the year) appears quite generous given the nominal GDP path, and wonder about the realism of the inflation target (7 percent through the year) especially given what has happened to the exchange rate. Nonetheless, we recognize the tactical value of an ambitious inflation assumption.

On the fiscal target, we have been informed that monitoring difficulties make it impractical to set this as a performance criterion at this stage. However, we believe that measurement problems should have been overcome by the time of the next review, and that it would then be appropriate to convert the June indicative target into a performance criterion. We also note the absence of the customary performance criterion on external debt. Again, Korea's special situation makes us understanding of this omission, but we would hope that, once the situation stabilizes, we can also include the usual structure of performance criteria on external debt.

cc Mr Neiss (o/r)

Statement to the Press
by Deputy Minister Chung, Ministry of Finance and Economy
Seoul, February 6, 1998

The teams of the Korean Government and the IMF have successfully concluded their discussions on the first quarterly review of the Stand-By Arrangement. The policy understandings reached are set down in an updated letter of intent with the economic program for 1998. After approval by IMF management, the program documents will be submitted to the IMF's Executive Board for discussion, scheduled to take place on February 17. Upon Board approval, a further disbursement of IMF funds of about \$2 billion will be made.

The new letter of intent, which will be published by the Government immediately after the Fund's Board approval, builds upon, and extends, the previous policy agreements. The following are the main elements of the review:

(1) An update of the macroeconomic forecasts for 1998. We now expect GNP to fall in the first half of the year, but recover in the second half, so that for the year as a whole growth is about flat. Inflation is expected to accelerate in the first half, followed by a decline thereafter, resulting in an annual average of slightly below 10%. We now expect a much higher current account deficit, which could be more than \$8 billion.

(2) Because of lower GDP growth, budget revenue will rise less and the overall budget balance will no longer show a small surplus. At the same time, there will be higher expenditures to boost unemployment benefits and to provide other forms of social assistance. As a result of these developments, the budget will show a small deficit of less than 1% of GDP.

(3) With signs of a beginning stabilization of the foreign exchange market, interest rates have been eased cautiously. To prevent a renewed destabilization of the market, further interest reductions will only be made when confidence has been fully established and the exchange rate of the won has durably stabilized. In the meantime, special programs will mitigate the effects

of high interest rates on small and medium-size enterprises

(4) Measures to strengthen the financial system will continue to be the main focus of the program. Efforts to recapitalize banks, improve standards of banking operations, and strengthen banking supervision will be accelerated.

(5) Corporate restructuring will be facilitated through mergers and acquisitions and takeovers, and a series of measures will be implemented to improve the transparency of operations, and increase the accountability to shareholders.

(6) Measures to improve labor market flexibility and improve the social safety net will be taken in line with the Tripartite Accord.

(7) Further progress will be made in the liberalization of the capital account and trade.

We expect that the full implementation of this program will further restore confidence and lay the groundwork for a durable strengthening of the Korean economy to benefit all the Korean people.

Feb. 6, 1998

RDW Breakfast 2/6/98

credit squeeze

big corp. no big problem

small med-size bus

(a) guarantee fund

(b) subsidiary

Emergency committee should continue

look into banking operations

SMB procedure

→ suggestions for improvement

political interference

Bank independence

within / from govt

avoid pol. govt interference

decision of monetary board

govt ownership

→ priv. ownership

→ shareholders limited (chaebol)

→ govt utilized vacuum

Growth risk evaluation
Role of special committee
continue under whom?

Presid. office

MOFE can no longer coordinate
downsized too much

power centralized for crisis management

→ Main role internal revenue

→ coord econ. ministries

Preside

Corporate reform

cosmetic in the past

must be institutionalized

must revise existing laws

+ 2 laws.

force reduced by legal framework.

Laws presented to special session

this time they will be serious

institutionalized policy with last

collusion between business + politics

As to be cut off

Financial institutions will have
influence.

compit with for for inst.

Modern for inst operators needed.

Banks must exercise their new
power over corporations, in the past
it was otherwise.

Stock of foreigners - should operate
one or 2 banks

SHB ABB guarantee fund
just i → members to reduce
leverage, but it takes time
Should not be a focus

INTERNATIONAL MONETARY FUND

Strictly Confidential

February 5, 1998

To: Mission Team

Subject: **Balance of Payments/External Debt Projections**

Please find attached a set of updated monthly and quarterly BOP, external debt, and international reserves tables.

DECLASSIFIED

By

[Handwritten signature]

Date

11/27/99

Gary Moser *GM*
(Room 2028)

Table 1 Korea Balance of Payments and Financing Requirements 1996-98
(In millions of U S dollars)

	1996	1997	1998	1998	1998	1998	1998
		Est.	Q1	Q2	Q3	Q4	Proj
			Proj	Proj	Proj	Proj	
Current account balance	23 716	8 850	3 994	1 834	232	1 893	7 953
Trade balance	15 306	2 808	4 694	3 984	3 632	5 685	17 995
Exports	128 303	137 567	32 446	36 036	35 671	38 809	142 962
(growth rate)	4 1	7 2	6 0	1 3	2 8	5 8	3 9
Imports	143 609	140 375	27 752	32 052	32,039	33 124	124 967
(growth rate)	12 2	2 3	22 9	11 6	7 2	1 3	11 0
Services and transfers (net)	8 410	-6 041	700	2,150	3 400	3 792	10 042
Of which Interest obligations	5 719	6 110	2,528	2 265	3 384	2 431	10 608
Capital account balance	23 741	22,394	3 638	1 230	1 286	786	2 796
Direct investment	1 981	2,932	200	200	0	100	500
Portfolio investment	11 207	10 679	1 800	1 300	900	1 000	5 000
Net official borrowing		4 500	875	125	125	125	500
Net private medium and long term capital		7 000	307	20 584	-472	-410	19 394
New domestic fin inst borrowing 1/			1 741	23 357	2 675	2,326	30 098
Domestic financial inst amortization 1/			2,048	2 773	3 147	2,736	10 704
Other net inflows (corporations) 2/			0	0	0	0	0
Trade credits net	4 310	591	1 122	1 756	900	700	1 278
Net private short term capital		9 700	5,222	21 000	0	0	26 222
New borrowing 1/			15 715	11 037	11 037	11 037	48 826
Amortization 1/			20 937	32,037	11 037	11 037	75 048
Other net inflows (corporations) 2/			0	0	0	0	0
Deposit money banks 3/	5 721	23 963	0	0	0	0	0
Other	3 490	582	130	-433	83	-479	959
Errors and omissions	994	-6 806	268	0	0	0	268
Overall balance	25	31 244	355	604	1 518	2 679	5 157
Financing	25	31 244	8 886	10 000	5 500	-6 361	30 747
Change in reserves (increase) 4/	25	20 344	10 907	10 000	5 500	3 593	30 000
IMF purchases/repurchases	0	10 900	2 021	0	0	2 768	747
Financing gap	0	0	8 531	9 396	3 982	3 682	25 590
Possible additional IMF funding	0	0	2 031	1 896	982	982	5 890
Possible additional World Bank/ADB funding	0	0	2 000	0	0	2 700	4 700
Possible bilateral /market financing	0	0	4 500	7 500	3 000	0	15 000
Support from official bilateral creditors	0	0	2 500	5 500	0	0	8 000
Market borrowing by government	0	0	2 000	2 000	3 000	0	7 000
Remaining financing gap	0	0	0	0	0	0	0
Memorandum items							
Current account balance (as a percent of GDP)	-4 9	2 0					2 5
Usable gross reserves	29 437	9 093	20 000	30 000	35 500	39 093	39 093
Usable reserve cover (months of imports of goods and nonfactor services)	2 0	0 6	1 5	2 2	2 6	2 9	2 9
Stock of external debt 5/ of which short term 5/	160 700	154 360	161 425	170 725	174 625	175 417	175 417
Stock of external debt (in percent of GDP) 5/	33 1	34 5	50 7	53 7	54 9	55 1	55 1
Short term debt/usable reserves 5/	3 4	7 5	3 2	1 4	1 2	1 1	1 1

1/ Domestic financial institutions Assumes rollover rate of 85/90/95 percent in Jan-Mar., 1998 Assumes \$21 billion of financial institutions short term debt is converted to medium term loans as of April 1 1998 Assumes rollover rate of 85 percent on medium and long term debt falling due in 1998

2/ Assuming 100 percent rollover for 1998 (the year as a whole)

3/ Adjusted upward to include the impact of foreign currency liquidity support by the BOK to overseas branches of DMBs in 1995-97

4 Adjusted to exclude the impact of foreign currency liquidity support by the BOK to overseas branches of DMBs in 1995-97

5/ Including offshore borrowing of domestic financial institutions and debt contracted by overseas branches of domestic financial institutions

Table 2 Korea International Reserves
(In billions of US dollars)

	Dec-97 est	Mar-98	Jun 98	Sep-98	Dec 98
		Projections			
A Usable reserves (Gross International Reserves less overseas branch deposits)	9 1	20 0	30 0	35 5	39 1
B Gross foreign liabilities	12 1	16 2	18 1	19 0	17 3
C NIR reserves floor	-3 0	3 8	11 9	16 5	21 8

Table 3 Korea Foreign Exchange Cash Flow 1998
(In billions of U S Dollars)

	1998 Q1	1998 Q2	1998 Q3	1998 Q4	1998 Proj
(A) Beginning of period usable reserves	9 1	20 0	30 0	35 5	9 1
(B) Inflows	36 4	46 6	20 6	22 2	125 9
Current account surplus	4 0	1 8	0 2	1 9	8 0
IMF purchases	4 1	1 9	1 0	1 0	7 9
IBRD/AsDB	3 0	0 0	0 0	2 7	5 7
Bilateral financing	2 5	5 5	0 0	0 0	8 0
Market borrowing	2 0	2 0	3 0	0 0	7 0
MLT capital 1/	1 7	23 4	2 7	2 3	30 1
Foreign investment (net)	2 0	1 5	0 9	1 1	5 5
Short-term capital	15 7	11 0	11 0	11 0	48 8
Other	1 4	-0 6	1 8	2 2	4 9
(C) Outflows	25 5	36 6	15 1	18 6	95 9
IMF repurchases/charges	0 0	0 0	0 0	2 8	2 8
MLT public sector capital	0 1	0 1	0 1	0 1	0 5
MLT capital	2 0	2 8	3 1	2 7	10 7
Short-term capital 1/ 2/	20 9	32 0	11 0	11 0	75 0
Net repayment of forwards	2 3	1 2	0 9	1 5	5 9
Other	0 1	0 4	-0 1	0 5	1 0
(D) Inflows less outflows	10 9	10 0	5 5	3 6	30 0
(E) End of period usable reserves	20 0	30 0	35 5	39 1	39 1

1/ Assumes debt restructuring implemented April 1 1997 converting \$21 billion of short term debt to medium term

2/ Assume rollover rate for financial institutions short term debt of 85 percent in January 90 percent in February 95 percent in March and 100 percent subsequently

Table 1 Korea Balance of Payments and Financing Requirements 1996-98
(In millions of US dollars)

	1996	1997	1998	1998	1998	1998	1998	1998	1998	1998	1998	1998	1998	1998	1998	1998	1998	1998	1998
		Est	Jan-98	Feb 98	Mar 98	Q1 Proj	Apr 98	May 98	Jun-98	Q2 Proj	Jul 98	Aug 98	Sep 98	Q3 Proj	Oct 98	Nov 98	Dec 98	Q4 Proj	1998 Proj
Current account balance	23 716	8 850	1 565	1 165	1 265	3 994	788	638	408	1 834	955	755	1 478	232	1,337	1 005	449	1 893	7 953
Trade balance	15 306	2 808	1 565	1 565	1 565	4 694	1 188	1 388	1 208	3 984	1,555	522	3 632	2,337	2 005	1,343	5 685	17 995	
Exports	128 303	137 567	10 815	10 815	10 815	32 446	12 072	12 072	11 892	36 036	12 128	12 128	11 415	35 671	12 936	12,936	12 936	38 809	142,962
(growth rate)	4.1	7.2				6.0				1.3				2.8				5.8	3.9
Imports	143 609	140 375	9 251	9 251	9 251	27 752	10 684	10 684	10 684	32 052	10 573	10 573	10 893	32 039	10 600	10 931	11 594	33 124	124,967
(growth rate)	12.2	2.3				22.9				11.6				7.2				1.3	11.0
Services and transfers (net)	8 410	6 041	0	400	300	700	600	750	800	2 150	-600	800	2 000	3 400	1 000	1 000	1 792	3 792	10 042
Of which Interest obligations	5 719	6 110	809	947	772	2,528	664	934	667	2 265	698	996	1 690	3,384	698	1 020	713	2 431	10 608
Capital account balance	23 741	22 394	178	1 196	2 264	3 638	112	1 134	208	1 230	445	163	678	1 286	163	195	428	786	2 796
Direct investment	1 981	2 932	200	0	0	200	200	0	0	200	0	0	0	0	100	0	0	100	500
Portfolio investment	11 207	10 679	800	600	400	1 800	600	300	400	1 300	300	300	300	900	300	300	400	1 000	5 000
Net official borrowing		4 500	1 000	0	125	875	0	0	125	125	0	0	125	125	0	0	125	125	500
Net private medium and long term capital		7 000	78	26	203	307	20 909	123	202	20 584	176	165	131	472	103	86	221	410	19,394
New domestic financial borrowing 1/			444	145	1 152	1 741	21 517	694	1 146	23 357	999	936	740	2 675	584	488	1,254	2,326	30 098
Domestic financial inst amortization 1/			522	171	1,355	2 048	608	817	1,348	2 773	1 175	1 101	871	3 147	687	574	1 475	2 736	10 704
Other net inflows (corporations) 2/			0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Trade credits net	4 310	591	0	122	1 000	1 122	600	856	300	1 756	400	100	400	900	300	0	400	700	1,278
Net private short term capital		9 700	2,368	1 858	996	5 222	21 000	0	0	21 000	0	0	0	0	0	0	0	0	26 222
New borrowing 1/			13 419	16 719	18 934	15 715	3 679	3 679	3 679	11 037	3 679	3 679	3 679	11 037	3 679	3 679	3 679	3 679	48 826
Amortization 1/			15 787	18 577	19 930	20 937	24 679	3 679	3 679	32 037	3 679	3 679	3 679	11 037	3 679	3 679	3 679	11 037	75 048
Other net inflows (corporations) 2/			0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Deposit money banks 3/	5 721	23 963	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Other	3 490	582	0	210	340	130	3	455	19	433	79	72	234	83	434	19	26	479	-959
Errors and omissions	994	6 806	268	0	0	268	0	0	0	0	0	0	0	0	0	0	0	0	268
Overall balance	25	31 244	1 386	31	1 000	355	900	495	200	604	1 400	918	800	1 518	1,500	1,200	21	2 679	5 157
Financing	25	31 244	1 386	4 000	3 500	8 886	-6 400	3 400	200	10 000	4 400	1 900	800	5 500	1,500	1 200	3 661	6 361	30 747
Change in reserves (increase) 4/	25	20 344	3 407	4 000	3 500	10 907	-6 400	3 400	200	10 000	-4 400	1 900	800	5,500	1,500	1 200	893	3 593	30 000
IMF purchases/repurchases	0	10 900	2 021	0	0	2 021	0	0	0	0	0	0	0	0	0	0	2 768	2 768	747
Financing gap	0	0	0	4 031	4 500	8 531	5 500	3 895	0	9 396	3 000	982	0	3 982	0	0	3 681	3 682	25,590
Possible additional IMF funding	0	0	0	2 031	0	2 031	0	1 896	0	1 896	0	982	0	982	0	0	982	982	5 890
Possible additional World Bank/AIDB funding	0	0	0	2 000	0	2 000	0	0	0	0	0	0	0	0	0	0	2 700	2 700	4 700
Possible bilateral /market financing	0	0	0	0	4 500	4 500	5 500	2 000	0	7,500	3 000	0	0	3 000	0	0	0	0	15 000
Support from official bilateral creditors	0	0	0	0	2 500	2 500	5 500	0	0	5 500	0	0	0	0	0	0	0	0	8 000
Market borrowing by government	0	0	0	0	2 000	2 000	0	2 000	0	2 000	3 000	0	0	3 000	0	0	0	0	7 000
Remaining financing gap	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Memorandum Items																			
Current account balance (as a percent of GDP)	4.9	2.0																	2.5
Usable gross reserves	29 437	9 093	12 500	16 500	20 000	20 000	26 400	29 800	30 000	30 000	34 400	36,300	35 500	35 500	37 000	38 200	39 093	39 093	39 093
Usable reserve cover (months of imports of goods and nonfactor services)	2.0	0.6				1.5				2.2				2.6				2.9	2.9
Stock of external debt 5/	160 700	154 360				161 425				170 725				174 625				175 417	175 417
of which short term 5/	100 000	68 400				64 065				43 113				43 113				43 113	43 113
Stock of external debt (in percent of GDP) 5/	33.1	34.5				50.7				53.7				54.9				55.1	55.1
Short term debt/usable reserves 5/	3.4	7.5				3.2				1.4				1.2				1.1	1.1

1/ Domestic financial institutions. Assumes rollover rate of 85/90/95 percent in Jan-Mar 1998. Assumes \$21 billion of financial institutions short term debt is converted to medium term loans as of April 1 1998. Assumes rollover rate of 85 percent on medium and long term debt falling due in 1998.

2/ Assuming 100 percent rollover for 1998 (the year as a whole).

3/ Adjusted upward to include the impact of foreign currency liquidity support by the BOK to overseas branches of DMBs in 1995-97.

4/ Adjusted to exclude the impact of foreign currency liquidity support by the BOK to overseas branches of DMBs in 1995-97.

5/ Including off-balance borrowing of domestic financial institutions and debt contracted by overseas branches of domestic financial institutions.

Table 3 Korea. Foreign Exchange Cash Flow 1998
(In billions of US Dollars)

	1998 Jan 98	1998 Feb 98	1998 Mar 98	1998 Q1	1998 Apr 98	1998 May 98	1998 Jun 98	1998 Q2	1998 Jul 98	1998 Aug 98	1998 Sep-98	1998 Q3	1998 Oct 98	1998 Nov 98	1998 Dec 98	1998 Q4	1998 Proj
(A) Beginning of period usable reserves	9 1	12 5	16 5	9 1	20 0	26 4	29 8	20 0	30 0	34 4	36 3	30 0	35 5	37 0	38 2	35 5	9 1
(B) Inflows	20 8	23 1	25 9	36 4	32 8	8 4	5 4	46 6	9 6	6 9	4 1	20 6	7 1	6 2	9 0	22 2	125 9
Current account surplus	16	12	13	40	08	06	04	18	10	08	15	02	13	10	04	19	80
IMF purchases	20	20	00	41	00	19	00	19	00	10	00	10	00	00	10	10	79
IBRD/AsDB	10	20	00	30	00	00	00	00	00	00	00	00	00	00	27	27	57
Bilateral financing	00	00	25	25	55	00	00	55	00	00	00	00	00	00	00	00	80
Market borrowing	00	00	20	20	00	20	00	20	30	00	00	30	00	00	00	00	70
MLT capital 1/	04	01	12	17	215	07	11	234	10	09	07	27	06	05	13	23	301
Foreign investment (net)	10	06	04	20	08	03	04	15	03	03	03	09	04	03	04	11	55
Short term capital	134	167	189	157	37	37	37	110	37	37	37	110	37	37	37	110	488
Other	14	05	-04	14	05	-09	-02	-06	07	02	09	18	11	07	04	22	49
(C) Outflows	174	191	224	255	264	50	52	366	52	50	49	151	56	50	81	186	959
IMF repurchases/charges	00	00	00	00	00	00	00	00	00	00	00	00	00	00	28	28	28
MLT public sector capital	00	00	01	01	00	00	01	01	00	00	01	01	00	00	01	01	05
MLT capital	05	02	14	20	06	08	13	28	12	11	09	31	07	06	15	27	107
Short term capital 1/ 2/	158	186	199	209	247	37	37	320	37	37	37	110	37	37	37	110	750
Net repayment of forwards	11	06	06	23	11	00	01	12	03	01	05	09	08	07	00	15	59
Other	00	02	03	01	00	05	00	04	01	01	02	01	04	00	00	05	10
(D) Inflows less outflows	34	40	35	109	64	34	02	100	44	19	08	55	15	12	09	36	300
(E) End of period usable reserves	12.5	16.5	20.0	20.0	26.4	29.8	30.0	30.0	34.4	36.3	35.5	35.5	37.0	38.2	39.1	39.1	39.1

1/ Assumes debt restructuring implemented April 1 1997 converting \$21 billion of short term debt to medium term

2/ Assume rollover rate for financial institutions short term debt of 85 percent in January 90 percent in February 95 percent in March, and 100 percent subsequently

Table 4 Korea Stock of External Debt
(In billions of US dollars)

	Debt Stock													
	End 1996	Lnd 1997	1998											
			Jan 98	Feb-98	Mar 98	Apr 98	May 98	Jun 98	Jul 98	Aug 98	Sep-98	Oct 98	Nov 98	Dec 98
Short term debt	100 0	68 4	64 1	64 1	64 1	43 1	43 1	43 1	43 1	43 1	43 1	43 1	43 1	43 1
Financial institutions	78 0	43 8	39 4	39 4	39 4	18 5	18 5	18 5	18 5	18 5	18 5	18 5	18 5	18 5
Domestic financial institutions 1/	65 2	28 9	24 6	24 6	24 6	3 6	3 6	3 6	3 6	3 6	3 6	3 6	3 6	3 6
Resident domestic financial institutions	26 2	11 7	9 9	9 9	9 9	1 5	1 5	1 5	1 5	1 5	1 5	1 5	1 5	1 5
Off shore banking of domestic financial institutions	12 7	8 7	7 4	7 4	7 4	1 1	1 1	1 1	1 1	1 1	1 1	1 1	1 1	1 1
Foreign branches of domestic financial institutions	26 4	8 5	7 2	7 2	7 2	1 0	1 0	1 0	1 0	1 0	1 0	1 0	1 0	1 0
Branches of foreign banks	12 8	14 9	14 9	14 9	14 9	14 9	14 9	14 9	14 9	14 9	14 9	14 9	14 9	14 9
Domestic corporations	22 0	24 7	24 7	24 7	24 7	24 7	24 7	24 7	24 7	24 7	24 7	24 7	24 7	24 7
Long term debt	60 7	86 0	89 0	93 0	97 4	123 8	127 7	127 6	130 6	131 6	131 5	131 5	132 5	132 3
Financial institutions	44 7	50 4	50 4	50 4	50 4	71 4	71 4	71 4	71 4	71 4	71 4	71 4	71 4	71 4
Domestic financial institutions 1/	41 5	46 4	46 4	46 4	46 4	67 4	67 4	67 4	67 4	67 4	67 4	67 4	67 4	67 4
Resident domestic financial institutions	27 7	29 9	29 9	29 9	29 9	38 4	38 4	38 4	38 4	38 4	38 4	38 4	38 4	38 4
Off shore banking of domestic financial institutions	8 5	9 2	9 2	9 2	9 2	15 5	15 5	15 5	15 5	15 5	15 5	15 5	15 5	15 5
Foreign branches of domestic financial institutions	5 3	7 3	7 3	7 3	7 3	13 5	13 5	13 5	13 5	13 5	13 5	13 5	13 5	13 5
Branches of foreign banks	3 2	4 0	4 0	4 0	4 0	4 0	4 0	4 0	4 0	4 0	4 0	4 0	4 0	4 0
Domestic corporations	13 6	17 6	17 6	17 6	17 6	17 6	17 6	17 6	17 6	17 6	17 6	17 6	17 6	17 6
Public Sector	2 4	18 0	21 0	25 0	29 4	34 9	38 8	38 7	41 7	42 7	42 6	42 6	43 6	43 4
IMI	0 0	10 9	13 0	15 0	15 0	15 0	16 9	16 9	16 9	17 9	17 9	17 9	18 9	16 2
World Bank	0 0	2 9	2 9	4 9	4 9	4 9	4 9	4 9	4 9	4 9	4 9	4 9	4 9	6 9
Asian Development Bank	0 0	2 0	3 0	3 0	3 0	3 0	3 0	3 0	3 0	3 0	3 0	3 0	3 0	3 7
Market financing/other donors	0 0	0 0	0 0	0 0	4 5	10 0	12 0	12 0	15 0	15 0	15 0	15 0	15 0	15 0
Other	2 4	2 0	2 0	2 0	1 9	1 9	1 9	1 8	1 8	1 8	1 7	1 7	1 7	1 6
Total External Liabilities	160 7	154 4	153 0	157 0	161 4	166 9	170 8	170 7	173 7	174 7	174 6	174 6	175 6	175 4

Source: Bank of Korea and Fund staff estimates and projections

1/ Assumes short term debt restructuring as of April 1 1998 with \$21 billion conversion of short term financial institution debt into MLT debt

Table 5 Korea External Interest Obligations 1998
(In billions of US dollars)

	Jan 98	Feb-98	Mar 98	Apr 98	May 98	Jun 98	Jul 98	Aug 98	Sep-98	Oct 98	Nov 98	Dec 98	Total Year
Short term debt													
Financial institutions													
Domestic financial institutions 1/													
Resident domestic financial institutions	0 08	0 08	0 07	0 01	0 01	0 01	0 01	0 01	0 01	0 01	0 01	0 01	0 3
Off shore banking of domestic financial institutions	0 06	0 06	0 06	0 01	0 01	0 01	0 01	0 01	0 01	0 01	0 01	0 01	0 2
Foreign branches of domestic financial institutions	0 06	0 06	0 06	0 01	0 01	0 01	0 01	0 01	0 01	0 01	0 01	0 01	0 2
Branches of foreign banks	0 09	0 09	0 09	0 09	0 09	0 09	0 09	0 09	0 09	0 09	0 09	0 09	1 1
Domestic corporations	0 20	0 20	0 18	0 18	0 18	0 18	0 18	0 18	0 18	0 18	0 18	0 18	2 2
Long term debt													
Financial institutions													
Domestic financial institutions 1/													
Resident domestic financial institutions	0 24	0 24	0 20	0 12	0 12	0 12	0 12	0 12	1 11	0 12	0 12	0 12	2 7
Off shore banking of domestic financial institutions	0 07	0 07	0 07	0 10	0 10	0 10	0 10	0 10	0 10	0 10	0 10	0 10	1 2
Foreign branches of domestic financial institutions	0 06	0 06	0 06	0 09	0 09	0 09	0 09	0 09	0 09	0 09	0 09	0 09	1 0
Branches of foreign banks	0 03	0 03	0 03	0 03	0 03	0 03	0 03	0 03	0 03	0 03	0 03	0 03	0 3
Domestic corporations	0 13	0 13	0 13	0 13	0 13	0 13	0 13	0 13	0 13	0 13	0 13	0 13	1 5
Public Sector													
IMF	0 00	0 12	0 00	0 00	0 26	0 00	0 00	0 30	0 00	0 00	0 32	0 00	1 0
World Bank	0 02	0 04	0 03	0 03	0 03	0 03	0 03	0 03	0 03	0 03	0 03	0 04	0 4
Asian Development Bank	0 02	0 02	0 02	0 02	0 02	0 02	0 02	0 02	0 02	0 02	0 02	0 02	0 2
Market financing/other donors	0 00	0 00	0 03	0 07	0 08	0 08	0 10	0 10	0 10	0 10	0 10	0 10	0 9
Other	0 01	0 01	0 01	0 01	0 01	0 01	0 01	0 01	0 01	0 01	0 01	0 01	0 1
Total	1 06	1 20	1 02	0 87	1 14	0 89	0 91	1 21	1 90	0 91	1 23	0 92	13 263
Total (excluding nonresidents)	0 809	0 947	0 772	0 664	0 934	0 677	0 698	0 996	1 690	0 698	1 020	0 713	10 618
Source Bank of Korea and I und staff estimates and projections													

1/ Assumes short term debt restructuring as of April 1 1998 with \$21 billion conversion of short term financial institution debt into MLT debt

Table __ Korea Stock of Short-Term External Liabilities, December 1996-January 1998

(In billions of U S dollars)

	1996	1997			1998	
	End-Dec	End-Jun	End-Sep	End-Nov Est	End-Dec Est	End-Jan Proj
1 Financial institutions	78 0	77 7	78 3	63 1	43 8	40 1
A Domestic financial institutions 1/	65 2	63 5	62 0	45 9	28 9	24 7
Resident domestic financial institutions 2/	26 2	28 5	23 6	18 7	11 7	9 4
Offshore banking of domestic financial institutions 3/	12 7	13 0	13 1	11 3	8 7	8 1
Overseas branches and subsidiaries of domestic financial institution	26 3	22 0	25 3	16 0	8 5	7 2
B Branches of foreign banks 5/	12 8	14 2	16 3	17 2	14 9	15 4
2 Domestic corporations 6/ 7/	22 0	25 1	25 8	25 8	24 7	24 7
Total short-term external liabilities	100 0	102 8	104 1	88 9	68 4	64 8

Sources Bank of Korea, Ministry of Finance and Economy and Fund staff estimates

1/ Includes commercial banks specialized banks merchant banks and development institutions

2/ Includes commercial paper call money refinance and term loans

3/ Domestic financial institutions short-term offshore borrowings excluding interoffice account borrowings

4/ Domestic financial institutions' overseas branches and subsidiaries short term borrowings (including call money and term loans) excluding interoffice account borrowings from other Korean overseas branches and deposits According to international standards nonresident institutions would normally not be included in external debt statistics which are based on residency The data in the table exclude the nonresident deposits in the overseas branches and subsidiaries of domestic financial institutions These deposits are measured through a sample survey the last of which was at end September 1997 when they were unofficially estimated at US\$11 8 billion

5/ Includes nonresidents deposits call money refinance term-loan and interoffice account borrowings

6/ Includes trade credit loans for oil imports and advance receipts of export

7/ In line with international standards these data exclude nonresident subsidiaries of Korean corporations Based on a biannual survey of Korean corporations the obligations of these subsidiaries at end-June 1997 were unofficially estimated at US\$23 7 billion (excluding borrowing from domestic financial institutions overseas branches and subsidiaries)

Feb 5, '98

HN

Seoul, Korea
February --, 1998

Mr Michel Camdessus
Managing Director
International Monetary Fund
Washington, D C 20431

Dear Mr Camdessus

The government's steadfast implementation of its strengthened economic program supported by the Fund has begun to yield encouraging results the official international financial community is accelerating financial support, agreement was reached with international creditor banks on the voluntary extension of maturities of Korea's short-term debt, and the external current account is improving rapidly These positive developments have set the stage for Korea to decisively overcome its external financing crisis The government will build on this solid beginning, and continue to further advance its far-reaching structural reform program

The attached Memorandum on the Economic Program sets out the policies the government intends to pursue as well as a revised macroeconomic framework for 1998 Macroeconomic policies will aim to maintain stability in the foreign exchange market, sustain the restoration of confidence, and support economic recovery The government will also push ahead to achieve further progress with structural reforms in the areas of financial sector restructuring, capital account liberalization, and trade liberalization In addition, the attached Memorandum details

the government's policies to reform labor marks, restructure the corporate sector, and improve corporate governance

In the transitional phase of adjustment, those segments of society most adversely affected will be protected. Toward that objective, fiscal expenditure on the social safety net, including unemployment insurance, will be increased within a framework of continued fiscal discipline. Moreover, the government is strongly committed to maintain an open dialogue with labor and business to achieve social consensus on sharing the burden of adjustment. The government will make every effort to achieve a new social compact that has broad popular support as that would be essential to the successful implementation of reforms, regain investor confidence, and return the economy to a path of sustained growth that will benefit all the Korean people.

Yours sincerely,

/s/

Kyung-shik Lee
Governor
Bank of Korea

/s/

Chang-Yuel Lim
Deputy Prime Minister and
Minister of Finance and Economy

Attachment



Office Memorandum

To: Mr. Goldsbrough

February 5, 1998

From: Thomas Leddy 

Subject: **Korea--MEP Matrix**

The matrix mainly covers structural reform, and does not, for example, include quantitative performance criteria for 1998. We assume that we will get a chance to review the performance criteria, supported by a quantitative macroeconomic framework, once they have been prepared.

Specific comments

1. On monetary policy, in the second bullet, replace "will be cautiously allowed to ease" with "have been cautiously allowed to ease, ..." This is in light of likely date of signature and to avoid conflict with "further" in the next bullet.
2. On exchange rate policy, in the first bullet, add "to smoothing operations and to replenish the foreign exchange window." We believe there should be firmer discipline on intervention, while leaving open the door for them to purchase dollars to replenish reserves if the drain through the foreign exchange window to banks should accelerate.
3. On the second bullet, we are not convinced that the BOK support window should be closed as soon as the debt deal has been finalized and when usable reserves have reached a more comfortable level. The need for the support window reflects a combination of difficulties associated with banks' liabilities and the illiquidity of their assets. Also, the offshore branches and subsidiaries, which are open when the on-shore market is closed, will continue to need a lender of last resort. The level of the BoK's official reserves is not relevant. We therefore recommend that the window be kept open for access on an exceptional basis, with a clear understanding that resources obtained through the window would be repaid within, say, two days, and that frequent recourse to the window would trigger intensified supervision.
4. On reserve management, the last item seems to lack teeth. Would it be appropriate now to put an expected time frame for repayment to the BOK (say, six months or one year?)
5. On financial sector restructuring (middle of page 5), the presentation is confusing: shouldn't the bullets after the first one go with "Banks to submit recapitalization plans" below. If we read this correctly, February 28 is only the date on which the authorities put out the list of banks that need to submit recapitalization plans. Specifics of plans are relevant for April 30, when banks must respond.

- 2 -

6. On corporate borrowing, the matrix could usefully clarify what the remaining restrictions are to be reviewed and announced by December 31, 1998. We understand that they only relate to borrowing of 0-1 year maturities.
7. On foreign borrowing, we would suggest adding an item setting out the authorities' plans for improved debt management and debt information collection.
8. On trade, we are disappointed that the MEP includes significantly less and weaker commitments on trade reform than what the brief had set out. For example, it does not include anything on the elimination of tariff exemptions, and the adjustment tariff system will be reduced rather than eliminated. We would prefer that these be reinstated but understand that the revised commitments may have been approved by management. If that is the case, we should return to these points at a later stage. On subsidies, the MEP should at least refer to the objective of sharply curtailing and eventually eliminating these subsidies. Also, the date of the review should preferably be brought forward.
9. The matrix is vague about the timing of the reforms related to labor market and corporate governance. We assume it is because these are areas where the World Bank is taking the lead. At some point, perhaps in the staff report, the timetable that the authorities agree with the Bank in these areas should be presented.

cc: The Managing Director
The Deputy Managing Director
Mr. Boorman
FAD
LEG
MAE
RES
Mr. Cross

To: Mr. Fischer

February 5, 1998

From: Mr. Neiss

Korca— further update.

(1) Main issue of interest here are the tripartite negotiations which are going on day and night, as Kim Dae Jung has set a deadline. We met the presidents of the major unions and had involved discussions, with some marginal impact, I hope. They are basically willing to settle, but are afraid to lose influence on the rank and file. If the outcome is positive, it would be a welcome boost to confidence in the market.

(2) The Bank staff still argue for lower unemployment payments, lower duration, and lower coverage (they are fiscally responsible people). Our view is that improved compensation is desirable per se, but may also be essential to reach a tripartite agreement. I may have a chance to talk to Mr. Wolfensohn about this.

(3) On interest rates, they have accepted to be patient, and the call rate should remain firm in the near future. (The exchange market, in any case, was weak, probably because of anxiety over the outcome of the tripartite discussions). At the same time, we have shown that we are not rigid and not oblivious to the side effects. I have explained in a TV interview today that interest rate movements will be related to what happens in the exchange market, in a symmetrical way. I will repeat this in a Reuters' interview tomorrow morning.

(4) We had a long meeting on the LOI tonight, with the less important issue of trade policy taking most of the time. Wanda will send the preliminary text for comments, and we want to finalize with them tomorrow afternoon. I hope you can spare some time.

(5) I have agreed to meet with some Seoul University faculty and students, something the MD wanted to do but in the end could not because there was not enough time.



Office Memorandum

Feb. 5, 1998

cc: HNU
FOSS
DJ4.

Confidential

To: The Managing Director
From: Kadhim Al-Eyd (K.A.)
Subject: Mr. Wolfensohn's Visit to Indonesia

I was invited to attend a meeting today between Mr. Wolfensohn and Indonesian officials on bank reforms. The meeting was attended by officials from the Ministry of Finance, Bank Indonesia, and World Bank and IFC staff. During the discussions, Mr. Wolfensohn indicated serious concern about the impact of high interest rates on the real sector. He made the following points:

- IMF's prescription of high interest rates have failed to stabilize the currency.
- High interest rates have adversely affected the real sector.
- This strategy needs to be revised and he will discuss it with the Managing Director upon his return to Washington.
- He assured me that he has so far refrained from airing his views in public.
- He requested that I convey his views "diplomatically".

I promised to do so. I concurred that a prolonged high interest rate regime will not be sustainable and explained that we have been working very hard to stabilize the currency in order to pave the way for lower interest rates.



INTERNATIONAL MONETARY FUND
WASHINGTON D C 20431

February 5, 1998

CABLE ADDRESS
INTERFUND

Mr Chang-Yuel Lim
Deputy Prime Minister and
Minister of Finance
Korea

Dear Minister

Last week's favorable developments in the foreign exchange market have been reversed in the first three days of this week, with the exchange rate depreciating about 6 percent. At the same time, there was a significant drop in the call rate by 2.5 percentage points.

	<u>Exchange rate</u>		<u>Call rate</u>
	won/\$	percent change	percent
Friday, 1/30	1,525		26.5
Monday, 2/2	1,555	-2	25.1
Tuesday, 2/3	1,585	-2	24.9
Wednesday, 2/4	1,608	-2	24.1

We had earlier agreed that in the near future, interest rate policy should be linked to exchange market developments, and that a cautious easing of the call rate would be warranted, as the exchange market firms. Symmetrically, as the exchange market weakens, the call rate should be tightened.

At this crucial stage, we should not risk a renewed loss of market confidence, but make sure that the benefits from the earlier efforts and sacrifices are not lost. As we discussed this morning, I would, therefore, suggest that the drop in the call rate be reversed so as not to give a contradictory signal to the market.

Sincerely yours,

Hubert Neiss

cc Governor Lee

The Wall Street Journal
IMF
Wed. 2/4/98

Korea Gains in Attempt to Ease Rates

IMF Aide Agrees to Seek Fund's Backing for Plan: Bank Pact Signing Seen

By NAMJU CHO
And JOHN BRISSEY

Staff Reporters of THE WALL STREET JOURNAL

SEOUL, South Korea -- Lim Chang Yuel, minister of finance and economy, and Hubert Neiss of the International Monetary Fund agreed to seek IMF board approval to gradually loosen interest rates here.

Meanwhile, William Rhodes, Citibank's vice chairman and a key negotiator in debt-restructuring talks with South Korea, said he expects to finalize and sign the agreement before the end of the first week in April. An agreement in principle was reached last week.

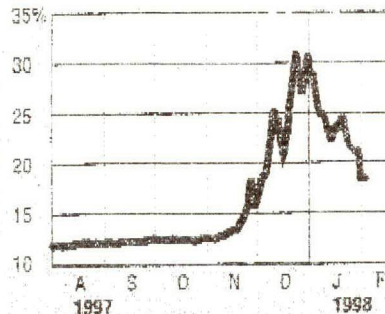
As part of its \$57 billion bailout of the South Korean economy, the IMF had insisted on high interest rates to boost the value of the currency, the won.

South Korea's overnight call rates, which reached nearly 30% on Dec. 24 at the height of the currency crisis, have eased since then, closing at about 24% Tuesday. The won has strengthened from its December levels of nearly 2,000 won against the dollar, and closed at 1,585 won to the dollar Tuesday.

The government has been seeking to further lower interest rates, which are nearly twice as high as they were in September, out of fear that a credit squeeze could lead to wholesale corporate bankruptcies and mass unemployment. Economic impact aside, reports of vandalism and suicides related to unemployment fears and resentment have been on the

Easing Rates

Interest rate on South Korea's three-year corporate bonds with government guarantee



Source: Dalziel & Partners

rise, sparking additional social concerns.

The IMF apparently has agreed to softer terms. "Once the IMF board is notified and approves on Feb. 17, we will make efforts to gradually stabilize interest rates to lower levels," Mr. Lim told reporters after meeting with Mr. Neiss, head of the IMF's Asia Department.

"The government and the IMF had agreed to ease high interest rates once foreign-exchange markets improved," said Hur Kyung Wook, a director in charge of IMF matters at the finance ministry, and "with faithful implementation of IMF measures and the New York debt deal [to restructure Korea's debt] in place, we felt that environment had been set up."

The IMF's Mr. Neiss praised the government's reform efforts and agreed that "the stage is now being set for an easing of interest rates," according to a statement. But he warned that "a premature full-scale interest-rate reduction to precrisis levels would risk a return to exchange-rate instability, which would also hurt banks and en-

terprises and delay recovery.

"Everything should be done to mitigate the effect of high interest rates on enterprises, in particular exporters and on small and medium-size enterprises, so as not to interrupt production and trade," he added.

Citibank's Mr. Rhodes, who has been buttonholing bankers at the World Economic Forum in Davos, Switzerland, to sell the debt-restructuring plan, challenged assertions that the South Koreans got the better of the banks in the talks.

"We came out with a very fair and realistic deal for both parties," he said.

Korea's major bank creditors, which have been getting four percentage points above the benchmark London inter bank offering rate on short-term loans to Korea, agreed to refinance the now-government-guaranteed loans at between 2.25 and 2.75 percentage points above LIBOR, or between 7.785% and 8.375% at current rates. Yields on Korean Development Bank bonds maturing in 2001 are now at around 9.25%.

Bankers who negotiated the pact, and now have to persuade other banks to accept the terms, were annoyed at comments last week by IMF Managing Director Michel Camdessus that the banks were taking a "hit" because they accepted a rate "significantly lower" than the market rate. IMF No. 2 Stanley Fischer said subsequently that the rate "seemed like a fair price, given the ongoing turnaround in Korea."

Earlier this week, rating agency Fitch IBCA upgraded South Korea's long-term foreign currency rating to BB plus from B minus, one notch below investment grade. It cited "the swift and successful outcome to the short-term debt negotiations, which the agency believes will substantially lift South Korea's short-term external liquidity constraint and allow the country's long-term external credit fundamentals to reassert themselves."

STATEMENT BY MR HUBERT NEISS
DIRECTOR, ASIA AND PACIFIC DEPARTMENT
International Monetary Fund

Seoul, February 3, 1998 -- The question of when interest rates should come down from their current high levels is one that rightly concerns the Korean public. Since my own views have been quoted in the media only partially, I think it might be useful for me to summarize them as clearly as I can for everybody to judge. However, I recognize that in the current circumstances there is no simple answer to this question, and different people may have different views. Here are my views.

- Korea has suffered a serious foreign exchange crisis, and high interest rates are inevitable to restore market confidence, discourage speculation, and stabilize the exchange rate. Everybody agrees this is the first priority, but it is an illusion to think that this could be achieved with low interest rates. It would also be an illusion to think that there are no side-effects of high interest rates. So we are faced with a temporary dilemma.
- High interest rates do have a cost, as they hurt banks and enterprises, but this cost has to be accepted until the foreign exchange market is durably stabilized. Let's keep in mind that we have high interest rates not because of the IMF, but because of a foreign exchange crisis that must be overcome as quickly as possible so that the economy can start recovering.
- There are good news in this respect: the government is steadfastly implementing a strengthened economic program, the official international community is accelerating financial support, and a favorable agreement with creditor banks to roll-over Korea's short-term debt has been concluded. As Korea's foreign exchange crisis has started to ease and the won has strengthened from its overdepreciated level, the stage is now being set for an easing of interest rates.

- However, we must be cautious and be sure that exchange rate stability is durably in place. The foreign exchange market is still moving towards normalization. It has yet to supply foreign exchange for debt service by banks which is presently allocated by BOK, and it has yet to fully benefit from the repatriation of capital and export earnings. Some patience may be needed. This is not yet the time for a full-scale interest rate reduction to pre-crisis levels.
- Premature cuts in interest rates would only risk a return to exchange rate instability, which would also hurt banks and enterprises. Thus, in deciding the right timing of interest rate reductions, a balance has to be struck very carefully between the damage to enterprises of continued high interest rates and the damage of renewed exchange rate instability.
- Also, everything should be done to mitigate the effect of high interest rates on enterprises, in particular on exporters and on small and medium-size enterprises, so as not to interrupt production and trade. Several measures have already been taken, and we should make sure that they work effectively without delay. Other measures, including interest rate subsidies (transparently provided for in the budget) to enterprises most hurt by high interest rates, should be open for discussion.

Nobody likes high interest rates, but in a time of crisis we unfortunately cannot do without them. The IMF team will, in the coming days, discuss with the government how best to strike a balance in interest rate policy that minimizes the risks of either choking the economy or relapsing into renewed exchange rate instability. Confidence building measures are vital to complement such a policy, in particular accelerated structural reforms. The sooner confidence of the Korean people and of the international community strengthens, the sooner our dilemma will be resolved.

**STATEMENT BY MR HUBERT NEISS
DIRECTOR, ASIA AND PACIFIC DEPARTMENT
International Monetary Fund**

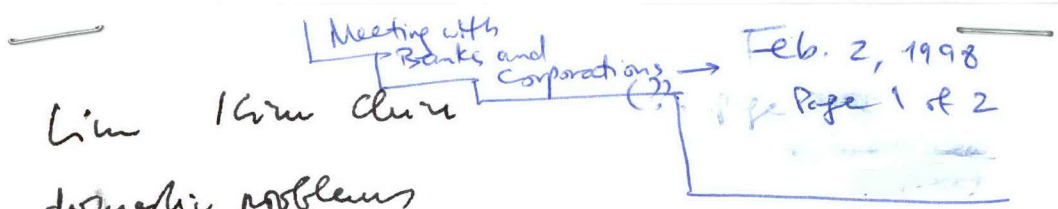
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Feb. 2, 1998



Lim Kim Chue

domestic problems

- 1) VE issue
- 2) infl
- 3) X ind (measurement)
- 4) SM bus
- 5) cost } restructuring
- 6) banks }

interest rate policy

diffic for corp.
 actual cost higher. bonds not guaranteed
 SM bus can't disc prom. notes 40% auto market
 company losses → cred. rating
 bonds + syndic loan APB guarantee
 market floor criteria
 big corp will adjust, slim down
 neg. with bot I bot sell. oil refineries
 Hyundai dropped newspaper business
 banks restructure, forget clients

→ IMF has advised

overcoming crisis with minimum cost
 compound with cost & time
 with support of people
 current acct perf. if not meet expect. of world
 cost more

Meeting with Banks and Corporations Feb. 2, 1958

Page 2 of 2

High expect of tripart meeting

Mass 20 June 30

Dec 50+

\$1.46B gold sale

tax dis. I work mise

1st qu. traffic control in market

gov't, large banks, enterprise -----
as the market is ready.

wind down at \$20 Bly

VEIUS.

balanced fiscal deficit less 1%

start, then re-evaluate if needed

allow bond issues to help VE protection fund
false names to sectors

1974

closure of for. branches not announced

lists discussed with indiv. banks.

Meeting with Banks and Corporations

Feb. 2 (Monday)

o 10 00 a m

(1) Korea Federation of Small Business

- A car is waiting in Hilton at 9 00 a.m.(T 011-720-3600)

o 11 00 a m

(1) LG Corp

o 2 00 p m

(1) Chohung Bank (Tel 739-0537)

- A car is waiting at 13 45, Hilton Hotel

(2) Hana Bank (Tel 757-6694)

- A car is waiting at 13 45, Hilton Hotel

o 5 00 p m

(1) Ssangyong Corp (Tel 270-5489)

- A car is waiting at 16 30, Hilton Hotel

Revised, February 1, 1998

Macroeconomic Projections

Growth GDP growth and domestic demand are expected to fall sharply in 1998 (Table 1 attached) At the time of the January 8 review, we projected growth of 1-2 percent, but the brief was less sanguine (-½ percent) We are now projecting growth of 1 percent, the same as the authorities, on the grounds that markets might not understand the Fund marking down growth when the economic news since the last Board meeting has been generally good Our projection is almost 1 percentage point higher than the consensus (table below) Each element of domestic demand is expected to show negative growth Table 1b compares our current macroeconomic projections with those presented to the Board on January 8

Consensus forecast for growth in 1998
(in percent)

Forecast made in	November 1997	December 1997	January 1998
Average	5.4	1.8	-0.1
High		4.0	3.0
Low		-2.0	-3.0

There is, of course, considerable uncertainty about the projection actual growth will obviously depend on how quickly confidence returns and interest rates can be brought down One of the private sector forecasters we spoke to had a scenario where interest rates remain at 27 percent all year, resulting in growth of -3 percent

Growth projections for 1998 are made difficult by the paucity of data available so far to indicate what has happened to activity since the crisis struck The latest observation on industrial output shows growth of 2½ percent in December (year-on-year), compared to 9 percent in October, and 7½ percent for 1997 as a whole The authorities are estimating that Q4 1997 GDP growth was 5.4 percent, only a percentage point below the level in the preceding two quarters

A good indicator of declining activity is recent import data, which suggest a dramatic slowing in domestic demand However, imports have also been affected by the reluctance of banks to discount import bills, which hopefully will be temporary Year-on-year growth in retail sales fell by 4 percent in December, compared to growth of 5 percent in October, suggesting very weak consumption

It is also difficult to predict the extent to which growth will decline in the first part of 1998 KDI, for example, assume that quarterly growth will display the following pattern

KDI growth projections for 1998
(in percent)

	Q1	Q2	Q3	Q4	Year
Year-on-year	-2.6	0.1	2.4	2.6	0.8
Annualized Q-on-Q s a	-30.9	24.9	17.7	9.2	

The KDI projections assume that output (seasonally adjusted) will fall at an annualized rate of 30 percent in the first quarter and then recover from the second quarter, with annualized growth converging toward the growth of potential output in the second half of the year. Our projection (Table 2), which is closer to the authorities' view (Table 2b), shows a somewhat shallower downturn.

Growth projections for 1998
(in percent)

	Q1	Q2	Q3	Q4	Year
Year-on-year	0.0	0.8	1.5	1.7	1.0
Annualized Q-on-Q s a	-23.3	15.6	10.5	9.2	

Unemployment

In light of our discussions with the authorities, our earlier estimate that unemployment would rise to 4 percent appears too optimistic (the consensus forecast is 6 percent). Unemployment rose to 3.1 percent in December--the average for 1997 was 2.6 percent--and we have adopted the consensus forecast.

External sector

As discussed in Gary Moser's BOP note, we are projecting export volumes to grow at 16 percent in 1998, compared to the assumption of 10 percent when the program was first put together. This assumed export elasticity of 0.5 may seem rather small, on the other hand, forecasters have been marking export demand down as a result of the Asian crisis and the depreciation may represent a much-needed opportunity for Korean exporters to restore profit margins. It should also be noted that KDI are less sanguine about export growth than we are.

Import volumes are currently projected to fall by 6½ percent--this primarily reflects the collapse of facility investment (down by almost 30 percent). With consumption projected to decline, and domestic frugality campaigns renewed, imports of consumer goods will also fall sharply, although they represent only about a tenth of imports.

These assumptions imply an enormous contribution to growth from the net foreign balance (9 percent of GDP)--a little above that estimated for 1997--although not sufficiently large to completely offset the decline in domestic demand

Our projections show the current account balance switching to a surplus of \$8 billion in 1998. This would be considerably larger, were it not for an assumed 6 percent decline in the terms of trade. The latter is primarily carryover from the decline experienced in 1997 (for example, the export unit value index which averaged 87 percent in 1997, fell from 76 to 67 between January and November 1997) ¹. Our projections allow for a substantial deterioration in the investment income balance in light of the recent increase in interest rates faced by Koreans borrowing overseas.

The following table shows the consensus forecast for the current account balance. There is a considerable range in the forecasts being made. We will be better informed in early February when the estimate for January becomes available, although preliminary indications suggest another significant surplus (on top of the December surplus of \$3.6 billion).

Consensus forecast for current account balance in 1998
(in billions of US dollars)

Forecast made in	November 1997	December 1997	January 1998
Average		-4.6	1.1
High			17.1
Low			-9.0

Saving-Investment balance

Investment comes down by 5 percentage points of GDP in our projections. The counterpart is primarily reduced use of foreign saving (with the resource transfer changing direction).

¹ The decline in export unit values can be seen as to some extent self-inflicted, its counterpart is the rapid growth of export volumes over the last few years. In particular, increased supply of semiconductors by new producers such as Korea led to a collapse of world prices in 1996, by Q3 1997, Korean electrical goods export volumes were 238 percent higher than in 1995, whereas unit values had fallen by 70 percent over the same period. This can be interpreted as a move down a unitary elastic demand curve, although presumably with sharply lower profits.

Inflation

Our current projection for average inflation is 9.5 percent (Tables 3 and 4), a little above the consensus

Consensus forecast for inflation in 1998
(in percent)

Forecast made in	November 1997	December 1997	January 1998
Average	4.6	5.1	8.9
High		7.0	12.0
Low		3.8	4.5

The assumed quarterly pattern is as follows

Quarterly Inflation Projections for 1998
(in percent)

	Q1	Q2	Q3	Q4	Year
End of period, year-on-year	10.6	10.6	9.5	7.4	9.5
Annualized Q-on-Q, s a	19.0	2.1	3.3	6.1	
Exchange rate (W/\$)	1,500	1,450	1,350	1300	1440

We have a flash estimate for January inflation of 8½ percent and our projections show the inflation rate rising still further in the coming months, with the pass through complete by June. The inflation rate edges down in the second half of the year as the won appreciates, falling to 7½ percent by year end (compared to the pre-crisis level of about 4 percent)

For the year as a whole, the won per dollar rate depreciates by 50 percent, and average inflation increases by 5 percentage points, implying a pass through coefficient of about 0.01. This is a little lower than some of the estimates we have heard (0.12-0.15), on the other hand, there will be a large resource gap in 1998 and there are already signs of moderation in wage demands.

Table 1 Korea Real GDP by Expenditure, 1994-98

	1996		1994	1995	1996	Estimate	Projection	Authorities
	Trillions of won	Percent of GDP				1997	1998	1998
GDP by expenditure	(current prices)		(Percent change over the previous at 1990 prices)					
Final consumption	252.7	64.8	7.0	7.2	6.9	3.0	-2.3	1.8
Private consumption	211.2	54.2	7.6	8.3	6.9	2.6	-2.1	1.5
Public consumption	41.5	10.6	4.2	1.0	7.1	5.3	3.7	3.7
Fixed investment	143.4	36.8	12.0	11.7	7.1	5.5	21.1	17.6
Construction	93.0	23.9	4.6	9.8	6.3	-0.5	16.0	9.3
Equipment	50.4	12.9	23.5	16.2	8.2	-13.0	-28.5	-29.7
Final domestic demand	396.1	101.6	8.8	8.8	7.0	-0.2	9.0	7.3
Stockbuilding 1/	5.6	1.4	1.4	-0.5	0.9	2.7	0.5	0.5
Foreign balance 1/	15.7	-4.0	1.7	0.5	0.3	8.8	9.0	7.2
Exports (goods and non factor services)	126.2	32.4	16.5	24.0	14.1	22.0	14.2	12.0
Imports (goods and non-factor services)	141.9	36.4	21.7	22.0	14.8	2.0	-4.1	-2.5
Gross domestic product	390.0	100.0	8.6	8.9	7.1	5.9	1.0	1.0
Memorandum items								
Savings and investment (as percent of GDP)								
Gross national savings			34.6	35.1	33.3	33.4	32.7	32.0
Gross domestic investment			35.8	37.0	38.2	35.4	30.1	
Current account balance			1.2	-2.0	-4.9	-2.0	2.5	2.3
Employment (in millions)			19.8	20.4	20.8	21.0	20.7	

Source: Bank of Korea Monthly Statistical Bulletin and staff estimates and projections

1/ Contribution to GDP growth

Table 1a Korea Projections 1997-98

	1996	1997		1998	
		8-Jan	31-Jan	8-Jan	31-Jan
Consumption	69	45	30	03	-23
Fixed investment	71	-40	-55	-162	-211
Final domestic demand	70	13	-02	-63	-90
Stockbuilding 1/	09	-27	-27	10	05
Net exports 1/	-03	72	88	59	90
GDP	71	59	59	15	10
<u>Memorandum items</u>					
Current account balance					
Billions of dollars	-237	-90	-90	36	79
Percent of GDP	-49	-20	-20	08	25
Export volume	189	250	248	100	160
Import volume	126	50	27	-50	-65
Terms of trade	-117	-89	-98	-36	-59
Inflation average	50	45	45	85	95
Inflation e o p	49	66	66	66	74
GDP deflator	34	21	18	56	

1/ Contribution to growth

Table 2 Korea Quarterly Real and External Sector Developments

	1996	1997					1998 1/				
	Annual	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Annual
(Year on year growth in percent, unless otherwise indicated)											
GDP	7.1	5.5	6.4	6.3	5.4	5.9 1/	0.0	0.9	1.5	1.7	1.0
(Annualized quarter on quarter growth) 2/		5.3	11.9	7.5	8.3		23.3	16.0	10.0	9.2	
Industrial production 3/	8.3	8.3	12.0	10.1	2.4						
Unemployment 2/ 3/	2.0	2.9	2.5	2.4	3.1						6.0
(Year on year growth in percent unless otherwise stated)											
Exports (billions of U.S. dollars)	128.3	30.6	35.6	34.6	36.8	137.5	32.5	36.0	35.7	38.8	143.0
Export volumes	19.8	17.3	24.1	35.8	23.5	24.2	25.0	17.0	15.0	6.8	16.0
Imports (billions of U.S. dollars)	143.6	36.0	36.3	34.6	33.5	140.3	27.8	32.0	32.0	33.1	125.0
Import volumes	12.7	5.5	6.2	0.1	1.8	3.1	17.5	6.0	5.0	1.2	6.5
Current account balance (billions of U.S. dollars)	23.7	7.4	2.8	2.3	3.6	8.9	4.0	1.8	0.2	1.9	8.0

Sources: Data provided by the Korean authorities and staff estimates

1/ Staff projections

2/ Seasonally adjusted

3/ End-of period

Table 2a. Korea – 1998 Quarterly GDP Projections

1 Feb-98	IMF -Jan. 8				KDI			MOFE			IMF-Feb. 1		
	NSA	Y-on Y	SA	Annual Q-on-Q	Y-on Y	SA	Annual Q-on-Q	Y-on Y	SA	Annual Q-on-Q	Y on Y	SA	Annual Q-on-Q
1998 1		0 8	70953	20 8	2 6	68560	30 9	0 5	70742	21 7	0 0	70390	23 3
1998 2		1 0	73128	12 8	0 1	72477	24 9	0 4	72694	11 5	0 8	72984	15 6
1998 3		2 0	75191	11 8	2 4	75486	17 7	1 2	74601	10 9	1 5	74823	10 5
1998 4		2 0	76714	8 3	2 6	77165	9 2	1 7	76488	10 5	1 7	76488	9 2
1996			68955			68955			68955			68955	
1997			72930	5 8		72930	5 8		72930	5 8		72930	5 8
1998			73997	1 5		73422	0 7		73631	1 0		73671	1 0

Table 3 Korea Quarterly Prices and Exchange Rates

	1996	1997 1/					1998 2/				
	Annual	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Annual
Prices (1990=100)	141.8	146.4	147.4	149.5	153.3	148.1	161.9	163.1	163.6	164.7	162.4
(Year-on year growth in percent)	4.9	4.5	4.0	4.2	6.6	4.5	10.6	10.6	9.5	7.4	9.7
(Annualized quarter-on quarter) 3/		2.8	1.8	7.8	14.4		19.0	2.1	3.3	6.1	
Won per U.S. dollar 4/	804.5	896.2	889.4	909.5	1484.1	951.3	1500.0	1450.0	1350.0	1300.0	1439.5
(Year-on year growth in percent)	4.3	14.7	11.5	10.7	76.9	18.0	67.4	63.0	48.4	12.4	51.3
(Annualized quarter-on-quarter) 3/		30.2	3.0	9.4	609.0						
Nominal Effective Exchange Rate (1990=100) 5/	82.2	78.4	77.6	77.9	50.1	75.5	50.0	50.6	55.0	56.5	53.0
(Year-on year growth in percent)	0.1	-6.4	-6.6	3.3	37.3	8.1	36.2	34.8	29.4	12.7	29.7
(Annualized quarter-on-quarter) 3/		7.7	-4.0	1.6	82.9		1.0	4.9	39.8	11.3	
Real Effective Exchange Rate (1990=100) 5/	98.7	95.7	95.0	96.2	63.8 2/	92.4 2/	65.4	66.4	72.0	76.3	68.9
(Year-on year growth in percent)	3.6	3.7	-4.7	1.3	34.4	-6.0	31.7	30.0	25.2	19.6	25.4
(Annualized quarter-on-quarter) 3/		6.2	3.2	5.2	80.6		10.4	6.6	37.5	26.4	

Sources Data provided by the Korean authorities and staff estimates

1/ All quarterly figures are for the last month in the quarter

2/ Projected

3/ Seasonally adjusted

4/ Increase is depreciation

5/ Increase is appreciation

1
Table 4 Korea Monthly CPI and Exchange Rates

	Prices 1/			Won per U S dollar			Nominal Effective Exchange Rate			Real Effective Exchange Rate		
	Level	Yr on Yr	Monthly	Level	Yr-on Yr	Monthly	Level	Yr-on Yr	Monthly	Level	Yr on yr	Monthly
	(1990=1)	Growth	Growth		Growth	Growth	(1990=1)	Growth	Growth	(1990=1)	Growth	Growth
1997M1	145 0	4 7	0 8	849 9	8 0	1 3	80 5	3 1	0 6	98 0	0 6	0 8
1997M2	145 8	4 9	0 6	866 8	11 1	2 0	80 8	3 7	0 4	98 7	0 9	0 7
1997M3	146 4	4 5	0 4	896 2	14 7	3 4	78 4	-6 4	3 0	95 7	3 7	3 0
1997M4	147 0	4 3	0 5	893 6	14 5	0 3	79 3	6 1	1 1	96 6	3 9	0 9
1997M5	147 2	3 8	0 1	892 0	14 3	-0 2	78 0	7 7	1 5	95 1	-6 0	1 5
1997M6	147 4	4 0	0 2	889 5	11 5	-0 3	77 6	-6 6	0 6	95 0	4 7	-0 2
1997M7	147 7	3 7	0 2	890 5	9 6	0 1	78 2	3 8	0 8	95 8	2 2	0 8
1997M8	148 8	4 0	0 7	895 9	9 7	0 6	79 1	-1 6	1 1	97 3	0 3	1 6
1997M9	149 5	4 2	0 5	909 5	10 7	1 5	77 9	3 3	1 5	96 2	1 2	1 2
1997M10	149 5	4 2	0 0	921 8	11 4	1 4	76 6	5 0	1 6	94 9	2 8	1 3
1997M11	149 6	4 3	0 1	1025 6	23 8	11 3	69 8	13 0	9 0	85 8	11 9	9 6
1997M12	153 3	6 5	2 5	1484 1	76 9	44 7	50 1	37 3	28 2	63 8	34 4	25 6
1998M1	157 0	8 3	2 4	1694 0	99 3	14 1	44 4	-44 8	11 5	60 2	38 5	5 6
1998M2	158 3	8 5	0 8	1550 0	78 8	8 5	48 7	39 7	9 9	66 0	33 1	9 6
1998M3	161 8	10 6	2 2	1500 0	67 4	3 2	50 0	36 2	2 6	69 3	27 7	4 9
1998M4	164 5	11 9	1 6	1515 0	69 5	1 0	50 0	36 9	0 0	70 5	27 0	1 8
1998M5	164 3	11 7	-0 1	1475 0	65 3	2 6	50 3	35 6	0 6	70 5	25 9	0 0
1998M6	163 1	10 6	-0 7	1450 0	63 0	1 7	50 6	34 8	0 6	70 1	26 2	-0 5
1998M7	162 7	10 2	0 2	1425 0	60 0	1 7	51 8	33 8	2 4	71 2	25 6	1 6
1998M8	163 6	9 9	0 5	1375 0	53 5	3 5	54 3	31 4	4 8	74 5	23 4	4 6
1998M9	163 6	9 5	0 0	1350 0	48 4	1 8	55 0	29 4	1 3	75 1	21 9	0 8
1998M10	162 8	8 9	-0 5	1325 0	43 7	1 9	55 7	27 4	1 2	75 5	20 4	0 6
1998M11	162 1	8 4	0 4	1315 0	28 2	0 8	55 9	19 8	0 5	74 3	13 4	1 6
1998M12	164 7	7 4	1 6	1300 0	12 4	1 1	56 5	12 7	1 0	75 4	18 2	1 5

Sources Data provided by the Korean authorities and staff estimates

1/ Passthrough = 0.12*(percentage change in the Won per U S dollar rate) evenly distributed over 4 months

The Monetary Program and Monetary Policy in 1998

The 1998 Monetary Program

The monetary program for 1998 is based on a projection of average inflation of about 9 ½ percent (7 ½ percent end-of-period basis) and real GDP growth of 1 percent **Money demand is expected to decline from trend growth in the first two quarters and to pick up during the second half of the year** As confidence returns following completion of the external debt restructuring deal, the demand for won assets—both money and bonds—would increase resulting in an appreciation of the nominal exchange rate and a decline in nominal interest rates The program assumes that the nominal exchange rate would decline to about W1500 per U S dollar at the end of the first quarter, W1450 per U S dollar at the end of the second quarter and to W1300 per U S dollar by the end of the year ¹ For 1998 as a whole, both broad money and reserve money are projected to grow faster than nominal activity reflecting a modest increase in money demand, albeit considerably below trend growth

In terms of the **balance sheet of the Bank of Korea**, the program projects a substantial increase in net international reserves of US\$8.5 billion in the first quarter and almost US\$23 billion by end-year This reserve build-up exceeds the increase in reserve money, so that net domestic assets would decline during the year Most of this decline in NDA corresponds to an increase in liabilities to government from depositing the World Bank/ADB loans and donor/market financing in the BOK The rest reflects sterilization of foreign exchange intervention ²

Risks to the Monetary Program

There are both downside and upside risks to the monetary program **If the real demand for won assets—including money—turns out to be lower than projected**, the programmed increase in the monetary aggregates would be consistent with a more depreciated nominal exchange rate, higher nominal interest rates, and higher inflation relative to the program The programmed purchases of foreign exchange by the Bank of Korea would prevent the nominal exchange rate from appreciating as projected while the corresponding increase in reserve money would result in a higher-than-projected inflation rate (Thus, in an operational sense, the program does not target either the nominal exchange rate or inflation) In order to adhere to the program inflation rate, the BOK would have to tighten credit and

¹ The nominal exchange rate projection is an assumption rather than a target

² With sterilized intervention, the BOK purchases foreign exchange in the market and sells bonds The increased supply of bonds drives up interest rates which means nominal interest rates would be higher than with unsterilized intervention This is consistent with the conservative inflation projection in the program

overperform on NDA (i.e., come in lower than the performance criterion) and reserve money

If real money demand turns out to be higher than projected, the programmed increase in the monetary aggregates would result in a more appreciated exchange rate, lower nominal interest rates, and lower inflation relative to program. The BOK could take advantage of these favorable conditions and purchase higher-than-programmed amounts of foreign exchange from the market and overperform on NIR. With unsterilized intervention, reserve money growth would exceed the indicative limit on reserve money, and the nominal exchange rate and inflation would move back up to their programmed paths.

Interest Rate and Exchange Rate Policy

However, quarterly performance criteria on NIR and NDA are blunt instruments with which to achieve the program's inflation and interest rates objectives, given the uncertain conditions in money markets and the lengthy time interval within the quarter. In practice, the day-to-day conduct of monetary policy will have to be guided by developments in interest rates and exchange rates which can be used as short-term indicators of money demand conditions. Thus, **the monetary program would need to be supplemented by understandings on interest rate and exchange rate policy**. In particular, there is a risk in the near term, that the authorities may prematurely lower interest rates as the won strengthens against the U.S. dollar following the expected completion of the debt restructuring agreements with foreign banks. However, there is also a clear need to reduce interest rates as soon as permitted by external financing conditions. (Officials at both the MOFE and BOK have indicated that their concerns about the apparent liquidity squeeze stem mainly from problems companies face because of high interest rates, rather than from the quantity rationing of credit *per se*.)

It is impossible to come up with any rigorous rule or guideline with regard to understandings on interest rate and exchange rate policy. As a **first suggestion**, we could say that if the won stayed below W1550 per U.S. dollar for a week, the call money rate could be brought down to about 25 percent. If the rate declined below W1500 per U.S. dollar after that, the call money rate could be lowered **gradually** another couple of percentage points. If after four weeks, the won stays below W1450 per U.S. dollar, the call money rate could be brought down to a range of about 18-20 percent. In order to avoid an overly-precipitous decline in interest rates, the call rate should not fall below 18 percent in the next two months (a maximum decline of about 10 percentage points, which is significant), even if the won appreciated sharply to below W1450 per U.S. dollar. Exchange markets are volatile and a premature easing of interest rates could risk reversing the hard won strengthening of the currency. At the same time, if the won shows signs of weakening, going above W1550 per U.S. dollar, the call rate would have to be increased as needed to prevent further depreciation.

Sharmini Coorey



Office Memorandum

Forwarded
A.S.

To: Mr. Boorman
Mr. Calamitsis
Mr. Deppler
Mr. Guitián
Mr. Neiss
Mr. Tanzi

January 30, 1998

From: /s/ A. D. Ouattara

Subject: **Meeting of the Committee on the Budget**

During the Executive Board meeting on January 14, 1998 to discuss the Managing Director's Statement on the Budgetary Outlook in the Medium Term, a number of Executive Directors noted concern about the extremely heavy work program of the Fund during the next three years and particularly during the next several months. With this in mind, some Executive Directors suggested that it would be helpful to obtain the views of some department directors on the current and prospective work pressures on the staff. Management suggested that the most appropriate forum for these discussions would be in the Committee on the Budget and this was supported by the Board.

After discussion with the members of the Committee, a meeting of the Committee has been scheduled for 10:00 a.m. on Thursday, February 19 in the Board Committee Room (12-120). It was agreed that the Directors of six departments (PDR, AFR, EU1, MAE, APD and FAD) would provide an oral presentation of some 10 minutes duration addressing the following six questions:

- Discuss the work pressures that are currently faced by the Director and senior staff of the department, including the level of excess travel and unpaid overtime reported in the Budget Reporting System (BRS). The accuracy of the level of unpaid overtime as reported in the BRS will be an issue.
- Are there any significant risks to the Fund of operating at your existing resource level?
- Are there any important activities not being undertaken by the department at present for want of resources?
- What ideas can you bring forward to improve the efficiency of the operations of the department, and what changes or assistance do you need to implement them?

- 2 -

- If you needed to reduce the level of work pressure (or if you had to reduce your resources), what activities would you reduce/eliminate?
- What internal redeployment has been undertaken, or will need to be undertaken, in your department to meet the current work pressures?

As background information for the meeting, I have asked the Office of Budget and Planning to prepare a short paper providing information on available data on work pressure indicators. As to the meeting's format, I would plan to ask each Director to make an oral presentation at the beginning of the meeting and then open the floor to questions from Committee members initially and then non-Committee members. The meeting will conclude with a short briefing by OBP on the FY 1999 staffing requests by departments, bureaus and offices.

cc: The Managing Director
Mr. Fischer (o/r)
Mr. Sugisaki (o/r)
Heads of Departments, Bureaus and Offices
Mr. Evans
Ms. Christensen
Mr. Clément
Mr. Cross

From Sri-ram Aiyer
To MLH3S PO05 (HNEISS)
Date 1/29/98 1 18pm
Subject Korea-Structural Reform Issues

Mr Neiss,

You may recall that we had met in your office on January 7. I would like to share with you some concerns that I have on some of the structural issues that we are all looking into. The first relates to accounting. While we would like to have all Korean listed companies adopt US Generally Accepted Accounting Principles (GAAP) among the differences between currently followed Korean GAAP and US three are more salient-asset classification and provisioning, loss recognition and income accrual. On asset classification, for example, a loan is considered non performing when it is delinquent for 6 months or more, whereas in the US the period is 3 months. Unless this is changed the much talked about (in Korea) BIS capital adequacy ratio of 8% is not really 8% but less since additional provisions would have to be taken. This in turn could affect the ability of institutions to attract foreign investment, since the financial statements are not comparable.

We have arranged for an accounting specialist to be in Seoul next week along with the partner in one of the big accounting firms in New York who has analysed the differences between the two systems in order to identify the key areas that we could propose be revised quickly. I hope that we can all press this point. Ideally I would like to see this revision done before we send our SAL to our Board.

Secondly, on KAMC purchases of assets from banks, as of now it seems that the banks' shareholders are not asked for any quid pro quo. If this is correct, it is troubling to say the least especially now that the Government has bailed out the banks for their short term loans. Can the shareholders not be asked to put in new capital in proportion to the assets removed? I would have liked to have seen each bank subject to an intense inspection as we had arranged in Mexico. We did that with the help of several supervisors from the US who assisted the Mexican supervisors. Without such an examination, given the systemic distress, how can the banks' statements about their financial condition be taken at face value? I say this as I hear that the Korean authorities are not willing to ask for rehabilitation plans from healthy banks-why not have the supervisors conduct an examination to verify this first? We know well that in times of difficulty the banks always understate their portfolio problems.

Then there is the problem of how KAMC will manage the disposition of its acquired assets. To maximise quick disposal and optimal recovery, this will need private firms with experience to manage the process.

I will be at the Shilla Hotel from the evening of Monday February 2 and hope that we can hear how you and your colleagues see these issues. Thank you.

M. E. Sharpe News

Announcing a major work.....

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Hyundai and Chung Ju Yung

Authored by: Donald Kirk

Veteran correspondent Donald Kirk has written a trail-blazing book in this, the first major study of the inner workings of a Korean chaebol or conglomerate. Kirk, over the course of six years, probed deep into the inner fabric of the Hyundai group in pursuit of the story of the Korean economic "miracle" since the end of World War II and the end of Japanese rule over the Korean peninsula. On the basis of scores of interviews with members of the Hyundai family, from founders Chung Ju Yung to vice presidents, managers, clerks and assembly-line workers, Kirk traces the rise of Chung, his family, and Hyundai from a sidestreet garage to international giant in more than 40 areas of industry and finance. The story ranges from wartime construction, to the factories and labor strife of "Hyundai City," Ulsan, to the scene of controversial new Hyundai enterprises in electronics and motor vehicles in California, to Chung's attempt to win a political position commensurate with his economic power in the 1992 presidential elections.

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So, waiters Press
New York
(1998)

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Stories of a War

New Edition

Authored by: Donald Kirk

Foreign Affairs called the first edition of Tell It to the Dead "a searing, skeptical look at the Vietnam war as seen by the GI in the jungles" and this edition enlarges on that theme with reports on current attitudes, views from Saigon, Hanoi and Phnom Penh, and various locales in the countryside.

"[A] factor that makes Kirk's accounts authentic is that he reports something that was lost in later reporting on Vietnam—the fact that the Army sent into Vietnam in 1965 and 1966 and 1967 was probably the finest Army the U.S. had ever put into the field." — Kansas City Star

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INTERNATIONAL MONETARY FUND **KOREA**

Dr/DC

12/1/99

TO Min Klauz

FROM

16 laws to be passed (banks etc)
to improve governance

HW ruling party loses popularity?

K mass media report budget
difficult to make clean records
loss in central systems

OK no more fund disbursements

K count guarantees

HW only if systemic risk

INTERNATIONAL MONETARY FUND

FSC 14/1/95

TO

~~Daesoo~~

some progress

4 affiliates - only Daesoo Corp prob
ask for gov's guarantee

equal treatment

complete - no accent in informal

did not participate in write-out prog

→ don't want to increase exposure

mark cred & chase

unfair transactions between affiliates

for banks want to consolidate them

equal treatment guaranteed

75% restructured D. Com

40% other

if not participate - cash buy out

(in cash scheme is 25%)

guarantee by dom. banks

for banks don't want loss-cut,

keep loans 100% guaranteed

JS want cash

exp banks want legal action -

collateral of D's sub. affiliates

INTERNATIONAL MONETARY FUND

viability not assured by restructuring
business restructurings needed

Financial markets vulnerable

FROM no secondary bond market

" market approach also difficult
gov't guideline based on book value

ITC aren't

confidence game with market participants

ITC 250 trn deposit market,

ren guaranteed 180 trn resolved

(5 banks 30 trn 17 financial 6's 60 trn)

40 trn left ITC, they had to sell bonds

trn. BSE since there is no second. market

↑ bond ↓ → rumor ITCs

later half 2000

market to market val → gradually,

others. market collapses.

IT resolution key to bond market

is rate fixed. risk

develop matrix for valuation

more ITCs make money

10% sharing 1/3 investor 2/3 sec. corp.

ITC < old share loans

Daewoo loans

shareholders carry part of loss

INTERNATIONAL MONETARY FUND

Specifics of K's fin. market must be understood, guidelines book value
Nov 98 m-t-m policy introduction

FROM funds

30% already m-t-m

high-yield fund system

Companies without I grade

bond market shrinking

concern of IMF

GDP below potential 1% above national

open economy → imports.

in rate sub. critical for business

KDI / BOK want higher ϵ

→

Se/DC

12/1/99

TO Newklaus

FROM

16 laws to be passed (banking etc)
to improve governance

- the ruling party loses popularity?
- K mass media report badly
difficult to make clean society
loss incentive systems
- Ok no more fund discussions
- K want guarantees
- W only if systemic risk

Perspectives of the Asian Crisis

The Asian crisis has now been with us for more than one year. The governments of the crisis countries have made substantial progress to overcome the initial shock and initiate reforms. However, the recession which followed, is deeper than we had expected, and the second year will remain difficult. We have learned a lot in this crisis and still have a lot to learn. Questioning to present an assessment at this point, it has to be done with great

Origins of the crisis

The first question we ask ourselves is : why has the world in Asia changed so abruptly and so fundamentally. We cannot explain this by one single reason, but rather by a combination of factors:

- the deterioration in the banking system over the preceding years, caused by imprudent lendings on doubtful investment projects.
- the rapid increase in short-term foreign borrowing
- inadequate macro-policies in the wake of a collapsing boom in real estate

When these weaknesses were recognized by the markets and the public, a sudden loss of confidence set in, leading to withdrawals of bank deposits by the people and massive withdrawals of short-term loans by foreigners. The disruption in the markets spread from one country to the other, and capital flight and sharp exchange rate depreciation paralysed economic life.

Policy Response: the options

The second question was: how should governments respond to the crisis. It was clear that this was not only a traditional BOP crisis, but at the same time a crisis of the financial system, and that stabilization measures as well as restructuring measures were needed.

I will now go through the different policy proposals that have been made --- which are

~~sometimes inconsistent. None of these option is request and taken in IMF programs.~~

~~the policy live that was~~

- Exchange rate stabilization

Option 1 ~~is~~ to keep the ER stable whatever happens. This may require high interest rates and FX market intervention, leading to a depletion of FX reserves. Option 2 is the opposite: lower interest rates and let the ER fall wherever it falls. This risks a disruptive overdepreciation of the ER and outbreak of hyperinflation.

The IMF took a position between these extremes: let the ER depreciate to stop the drain on FX reserves, but limit the depreciation through higher interest rates to stabilize the market and prevent an outburst of inflation. While this solution tries to minimize pain, it cannot eliminate it. Once a crisis has broken out, there is no painless cure.

- financial sector reform

Option 1: keep ailing banks alive through liquidity support from the central bank, in order to maintain the confidence in the public. However, this risks a large credit expansion and inflation.

Option 2: withdraw all public support from weak banks and close them. This will, however, risk a panic.

IMF programs contain elements of both proposals: close some banks which are beyond rehabilitation, merge other weak banks and provide new capital, and strengthen the rest of the banks through a program of recapitalization, by setting higher standards of management, and by strengthening banks supervision.

governments have to carefully weigh the choices to be made, and that we have to be patient to these policies work. It is your duty to critically assess these policies in IMF program. But it is also your duty to carefully consider the programs and

Phases of the crisis

To assess where we are now and where we will be going, it may be useful to distinguish between 3 phases in this crisis.

Stabilization phase

Required a tightening of monetary and fiscal policy to stabilize markets, emergency measures to stabilize the banking system, and a renegotiation of the external debt.

The ER has stabilized, FX reserves have been replenished, the BOP is strong, and inflation is under control. This phase has been successfully completed, monetary and fiscal policies have been relaxed to counteract the recession.

Restructuring phase

The current phase. Efforts have to concentrate to create a strong financial system and an efficient corporate sector --- these are important conditions for sustaining high growth in the future. At the same time, fiscal policy is made more expansionary to support domestic demand and to finance social programs which are urgently needed to mitigate the impact of the crisis on the unemployed and on the poor.

Recovery phase

This is our aim. It will be reached if policies are implemented steadfastly, and if the international environment is supportive.

Director Neiss Donates Lecture Fees to Charity Organization

Hubert Neiss, Director of the Asia Pacific Department of the International Monetary Fund, donated his fees for delivering the keynote speech at the Asia Press Forum on the 14th of last month to "help children in need." In line with this request, Mr. Tae-Jung Kwon, of the Joong-Ang Daily, handed Sister Yung-Ja Cha, of the Sung-Mo Ja-Ae Orphanage in Sang-Gae Dong, Seoul, US\$2,000 (about W2,820,000).

Perspective of the Asian Crisis

A. Origins of the Crisis

1. Remaining gaps, in the explanation beyond that
No single cause explanation satisfactory
Combination of several factors
2. Deterioration in the banking system caused by intruder lending on doubtful investment projects, fostered by sympathetic relationship between bank enterprises and government
Rapid increase in short term external borrowing following capital account liberalization
Inadequate macroeconomic management in some cases
3. Imagines of the difficulties lead to panic and loss of confidence
Manifested by banking crisis and the balance of payment crisis

B. Policy Response

1. Keep exchange rate stable
2. Keep interest rates low and let exchange rate drop

- 3 IMF solution between one and two
- 4 Close ailing banks
- 5 Keep banks alive through liquidity support
- 6 IMF solution between one and two
- 7 Maintain open capital account, IMF solution
- 8 Introduce exchange controls
- 9 External debt renegotiation, IMF solution
- 10 Unilateral default

C Stabilization Phase

Monetary policy

Fiscal policy

Debt rescheduling

Financial sector measures

D Restructuring Phase

- 1 Financial sector restructuring
- 2 Corporate debt restructuring

E Starting the Recovery

- 1 Demand support
 - Expansionary fiscal policy
 - Gradual reduction in monetary policy
 - Measures to ease credit crunch
- 2 Ensure durability of recovery through continuing restructural process

F Lessons

- 1 Maintain soundness of the banking system
- 2 Prevent distortion in resource allocations
- 3 Introduce safeguards to short-term capital inflows

- 4 Maintain flexibility in exchange rate management

- 5 Dampen macroeconomic expansion



Office Memorandum

To Mr Fischer

October 2, 1998

From Hubert Neiss *HN*

Subject **Korea--Roadshow Speech**

Attached for your information is the speech I gave in Tokyo

cc Deputy Managing Directors
PDR

Korea Roadshow
Tokyo
September 29, 1998

Statement by Hubert Neiss, IMF Representative

Ladies and Gentlemen

I am happy to be present at this event and to say a few words about Korea. It is less than a year that the crisis broke out in Korea, but the situation in the country is already quite different. Impressive progress has been made in stabilizing the financial and external situation, although the difficulties are not yet over.

I would like to present a quick review of how it all began, where we are now, and where to go from here.

- At the outbreak of the crisis last December, the Government had to make a number of **crucial decisions** on how to react, what to do and what not to do. Let me mention just four:
 - (1) not to **default on** external obligations, instead, debt service payments were fully met, and agreements with creditors were concluded later,
 - (2) not to resort to **exchange controls**, on the contrary, the capital account was rapidly liberalized, opening the way for direct investment and other long-term inflows,

- (3) to **tighten fiscal and monetary policy** in order to stabilize the exchange market,
- (4) to immediately start **rehabilitating the financial sector** which was on the verge of a breakdown
- These measures were supported by the largest lending operation of the IMF--over \$21 billion--and their determined implementation gradually **restored confidence**. By February it had become evident that the **first phase** of the crisis--**the stabilization phase**--had been **successfully overcome**. The external current account had turned around rapidly, the exchange rate had stabilized and appreciated, Korea had regained access to the international capital market, and Korea's reserves--which had fallen close to zero in December--were being replenished (they are now at \$43.5 billion)
 - However, the economy suffered the consequences of the crisis: the **large withdrawals of capital** in the later part of 1997, the **sharp decline in real estate and stock prices**, the **tightening of financial policies**, and the **general loss of confidence** had led to a **severe recession**. Again, the Government took a number of decisions, in three areas:
 - (1) **A shift in macroeconomic policy** to counteract the recession
 - **interest rates** were gradually reduced (they are now below pre-crisis levels in nominal terms and at around pre-crisis levels in real terms)
 - **fiscal policy** was switched toward expansion (a deficit of 5 percent of GDP is now planned for this year and for 1999)

(2) **An acceleration of restructuring** to create a basis for a durable recovery

- **Bank restructuring** proceeded through closures, mergers, and recapitalization, together with strengthened supervision and higher performance standards (loan classification, provisioning, disclosure)
- **corporate restructuring**, was started, comprising debt restructuring to clean up balance sheets so new bank lending can take place, as well as plant restructuring (trimming of affiliates, elimination of duplications to cut excess capacity) to increase efficiency and competitiveness

(3) **A strengthening of the social safety net**, in particular unemployment insurance, health insurance, and job training. This is essential to preserve **social peace** during a period of unemployment above historical levels and great economic hardship to the people

- We are still in the second phase--**the restructuring phase**. While substantial progress has already been made in rehabilitating the financial system, corporate restructuring has still a long way to go. The positive sign is that it has started, and that this **process is irreversible**, as markets exert increasing pressure of the corporations to change, and the government is no longer sheltering them from this pressure.
- Let me conclude with the third phase--**the recovery phase** -- which is not yet there, but which is bound to come if policies continue to be implemented steadfastly. We expect that the economy will hit bottom by the end of this year and will return to positive growth by mid-1999. This timing will depend, of course, also on the evolution of **global economic conditions**, about which there are still some question marks.

- Once recovery is underway, economic policy will again have to be reorientated
 - (1) the **budget deficit** should gradually be eliminated to ensure financial stability over the medium term,
 - (2) **Monetary policy** should be kept sufficiently firm to keep inflation down,
 - (3) **Banking and corporate restructuring** should be completed

This opens the prospect of a **resumption of durable growth** that will put Korea firmly into the group of **industrialized countries**

Ladies and gentlemen

I tried to show in this overview that Korea **responded resolutely to the crisis**, and that the **strategy adopted has been sound**. If it is continued consistently, **further progress** will be made, **leading to a recovery**.

In concluding, let me emphasize one point. In many respects, **Korea's case is unique**. Its situation and economic policies should, therefore, **be judged by the markets on its own merits**. In my own view, such a judgement should--on balance-- be **overwhelmingly positive**.

Dealing with the Asian Crisis - Policy Options and IMF Programs.

The policy responses incorporated in IMF programs have lately come under considerable criticism. To facilitate an assessment, it may be useful to (1) review systematically the options available at the outset of the crisis, and (2) the adaptations of policies after market stabilization had been achieved.

(1) When the crisis broke out, several decisions had to be made within a very short time, and the consequences of each option had to be carefully considered.

① • Exchange rate policies

option 1: Keep the exchange rate stable, whatever happens. The attractiveness of this option is that it provides an "anchor" for policies and maintains market confidence. In practice, there are difficulties. It requires a strong and credible government, the willingness to accept high interest rates, and plenty of reserves to be able to intervene.

option 2: The opposite: maintain ~~an~~ expansionary financial policies, in particular, low interest rates, and let the exchange rate fall wherever it falls. This is supposed to avoid ~~these~~ (or at least mitigate) the recessionary impact of the crisis. The risk is overdepreciation with serious consequences on debtors with foreign exchange obligations, and for inflation.

IMF programs : A position between these extremes was chosen. The exchange rate was initially allowed to depreciate, but the depreciation was limited through a temporary tightening of financial policies, in particular, higher interest rates. The objective was to stop the drain on reserves, keep inflation under control, and restore market confidence.

④ • Structural Reform

option 1 : pursue stabilization only, so as not to overload the capacity of policy makers ~~and society~~ to implement (and of society to endure) a large number of policy changes,
option 2 : attack at the same time the root causes of the crisis which lie in the banking system and the corporate sector.

IMF programs : Option 2 was solidly included. Dealing with the symptoms only, rather than also with the causes would not provide for a durable recovery and not restore confidence. This applies in particular to the financial sector, where simply keeping ailing institutions alive through central bank liquidity injections would only aggravate the problem rather than initiating a program of closures, merger, and recapitalization.

② • foreign exchange management

option 1 : introduce controls to prevent capital flight and speculation. This would allow lower interest rates to support a recovery. The problem with this option is that (1) controls work only partially and create new distortions, and (2) they delay the restoration of market confidence

Trigau/Wanda - I scribbled a few things in the plane after reading Wolf's article. For your comments please, by tonight.

Mr Wolf's article ("Korea's hurdle", FT 9/2/98), attributing a lot of Korea's difficulties to high interest rates, needs some corrections. To avoid muddying the waters in this discussion, it is important to separate the initial period of stabilization from the post-stabilization period. At the outset of the crisis, when there was panic withdrawal of foreign loans, capital flight, a drying up of the country's foreign exchange reserves, and a plummeting of the exchange rate, financial policies were tightened and interest rates raised sharply to end the chaos in the markets. Once the crisis had progressed to that acute stage, there was ^{alternative feasible policy course} ~~no other other means~~ available. (If there was, Mr Wolf certainly did not tell us). Once stabilization was achieved, policies did ~~switch~~ ^{switch}. Mr Wolf's recommendation that "monetary and fiscal policy should be relaxed" pushes an open door since this has been done for several months. The Budget has switched towards expansion and a deficit of 5% of GDP is planned for this year and next. At the same time interest rates have gradually been allowed to fall and are presently below pre-crisis levels and only slightly positive in real terms (Mr Wolf is wrong that inflation is zero; it is 7-8 percent - not surprising since the won has depreciated by some 30 percent from its pre-crisis level). But the hurdle to Korea's recovery is not only the weakness of

domestic demand. The main challenge to the government is to get on with banking and corporate restructuring. Substantial progress with the former is being made and ~~under the~~ the latter has begun. With both, macroeconomic expansion and restructuring going ahead, ~~do we really have~~ the rationale for Mr Wolf's very pessimistic assessment of the chances for Korea's recovery escapes me.