

EBS/84/99

CONFIDENTIAL

May 3, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Korea - Staff Report for the 1984 Article IV Consultation  
and Review Under the Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Korea and the review under its stand-by arrangement. Draft decisions appear on pages 20-22.

This subject, together with Korea's request for a purchase under the compensatory financing facility (EBS/84/100, 5/3/84), will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Aghevli (ext. (5)7177).

Att: (1)

INTERNATIONAL MONETARY FUND

KOREA

Staff Report for the 1984 Article IV Consultation  
and Review Under the Stand-by Arrangement

Prepared by the Asian, and Exchange and  
Trade Relations Departments

(In consultation with the Fiscal Affairs, Legal,  
Research and Treasurer's Departments)

Approved by P. R. Narvekar and Donald K. Palmer

May 2, 1984

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## I. Introduction

The 1984 Article IV consultation discussions with Korea were held in Seoul during February 13-March 12, 1984; the staff also assessed Korea's performance under the stand-by arrangement and discussed the policies and measures to be carried out during the remaining period of the arrangement. 1/ Meetings were held with the Deputy Prime Minister, the Minister of Finance, the Minister of Energy and Resources, the President's Chief Secretary, the President's Senior Secretary for Economic Affairs, the Governor of the Bank of Korea, and other senior officials. Mr. A.R.G. Prowse, Executive Director for Korea, attended some of the meetings. 2/

Korea has observed all performance criteria under the present stand-by arrangement (Table 1); it has made three purchases, totaling SDR 256 million (55 percent of quota), and will be able to make four additional purchases, totaling SDR 320 million (69 percent of quota), contingent upon Board approval of the performance criteria for 1984 and the observance of these criteria for June 30, September 30, and December 31, 1984. The policy program for 1984 is described in the attached letter from the Minister of Finance (dated April 23, 1984). The Korean authorities have also requested a purchase under the compensatory financing facility in the amount of SDR 280 million (60 percent of quota); the request is dealt with in a separate document circulated at the same time as this paper.

As of March 31, 1984, Korea's use of Fund credit under tranche policies stood at 234 percent of Korea's quota of SDR 462.8 million; in addition, 49 percent of quota was outstanding under the compensatory financing facility. Full use of the present stand-by arrangement, net of scheduled repurchases, would raise Korea's use of Fund credit under tranche policies to 255 percent of quota by the end of the stand-by period (Annex I). Information on Korea's relations with the Fund are provided in Annex II.

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1/ The Executive Board concluded the 1983 Article IV consultation with Korea and approved the present stand-by arrangement on July 8, 1983 (EBS/83/119). Korea continues to avail itself of the transitional arrangements of Article XIV.

2/ The staff team consisted of Messrs. Aghevli (Head, ASD), Kincaid (ASD), Marquez-Ruarte (ETR), Wattleworth (FAD), Yanagita (ASD), and Mrs. Odell (Secretary, INST); Mr. Villanueva, the Fund's Resident Representative in Korea, assisted the staff team.

Table 1. Korea: Performance Under Stand-by Arrangement, 1983

	Sept. 30		Dec. 31	
	Ceiling	Actual	Ceiling	Actual
(In billions of won)				
Net domestic assets of the banking system	27,586	27,123 <u>1/</u>	28,785	27,680 <u>1/</u>
Net credit to the public sector from the banking system	2,500	1,766	2,708	2,013
(In millions of U.S. dollars)				
Increase in outstanding external debt, excluding IMF credit	...	2,039 <u>1/</u>	4,200	3,019 <u>1/</u>
Outstanding short-term debt <u>2/</u>	...	14,527 <u>1/</u>	14,215	14,078 <u>1/</u>

Source: Ministry of Finance.

1/ Constant exchange rate basis.

2/ Defined as external debt with initial maturity of less than one year.

## II. Background to the Discussions

### 1. Developments during 1980-82 1/

After two decades of rapid growth, the Korean economy encountered serious difficulties in the early 1980s. The adverse effects of structural imbalances and excess demand pressures that were becoming evident by the late 1970s were exacerbated in 1980 by a political crisis and a number of exogenous shocks (including a very poor harvest and the second oil price increase), culminating in an acute deterioration in economic conditions. Output declined for the first time in Korea's recent history, inflation soared, and the gap in the external current account widened to a record level. In response to these developments, the Government implemented a wide-ranging adjustment program which was

1/ A more detailed assessment of developments during this period are provided in EBS/83/119, SM/83/141, SM/82/54, and SM/82/70.

supported by two one-year stand-by arrangements with the Fund (March 1980-February 1982). By 1982, substantial adjustment had taken place: the economy recorded a rate of growth of about 6 percent, an inflation rate of about 5 percent, and a reduced current account deficit of below 4 percent of GNP (Table 2 and Chart 1).

Notwithstanding the improvement in the external position, Korea's foreign borrowing during 1980-82 was substantial; the outstanding external debt almost doubled to \$37 billion, with short-term loans accounting for 42 percent of total borrowing (Chart 2). Korea's debt-service payments remained manageable--the debt service ratio rose moderately to 23 percent in 1982--but the high level of short-term debt became a source of increasing concern, particularly against the background of the emerging international debt crisis.

## 2. Review of the 1983 program

Economic performance in 1983 far surpassed the program targets: output growth nearly doubled to over 9 percent, inflation fell to a historically low level of 2 percent, and the current account deficit was almost halved to about 2 percent of GNP. The rapid rate of growth in 1983, which was reminiscent of the growth experienced during the 1960s and 1970s, was propelled by a rebound in manufacturing and the continued construction boom. Increases in private consumption, exports, and domestic investment accounted, in almost equal proportions, for the rise in aggregate demand. However, comparison of developments in the first and the second half of the year reveals a striking shift in the pattern of growth: the stimulus provided by domestic demand, which was the main expansionary force in 1982 and early 1983, gradually diminished as a result of tight financial policies and was replaced by foreign demand (Table 3). Appropriate demand management, together with stable prices of traded goods, plentiful food supplies, and moderate wage increases, was responsible for the lowering of domestic inflation. Nominal wages rose by 12 percent compared with productivity gains of about 8 percent.

The improvement in the current account position was associated mainly with higher domestic savings--the ratio of national savings to GNP rose from 23.3 percent in 1982 to 25.4 percent, while the ratio of domestic investment to GNP rose slightly to 27.6 percent. <sup>1/</sup> The savings effort by the private sector, however, remained weak by historical standards. During the recession of 1980, the savings rate of the private sector fell precipitously (from 21 percent of GNP to 16 percent) as the public apparently regarded the decline in its income as a transitory phenomenon and did not adjust its standard of living. During the subsequent economic recovery, the savings rate increased only marginally and by 1983 still remained well below the level of the late 1970s.

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<sup>1/</sup> National accounts data indicate a sharp decline in inventories for the second consecutive year in 1983. The inventory data, however, are not very reliable; for a description of the problems involved see the report on Recent Economic Developments.

Table 2. Korea: Selected Economic and Financial Indicators, 1980-84

	1980	1981	1982	1983		1984	
				Orig. prog.	Prel. Act.	Orig. prog.	Rev. prog.
(Annual percent changes, unless otherwise specified)							
National income and prices							
GNP at constant prices <u>1/</u>	-5.2	6.2	5.6	7.5	9.3	7.5	8.0
GNP deflator <u>1/</u>	25.6	15.9	7.1	5.5	2.9	5.0	3.0
Consumer prices (Dec.-Dec. basis)	34.6	12.6	4.8	4.5	2.0	...	2-3
Wages	22.7	20.1	14.7	...	12.2	...	7.0
Unit labor costs	10.8	1.6	6.8	...	4.0	...	--
External sector <u>2/</u>							
Exports, f.o.b.	17.1	20.2	1.0	9.7	10.7	16.6	14.7
Imports, f.o.b.	13.1	12.6	-3.4	8.3	5.5	12.2	11.1
Non-oil imports, f.o.b.	0.2	10.2	-3.1	14.4	9.1	15.4	16.0
Export volume	11.2	17.2	5.4	7.6	15.5	11.0	11.4
Import volume	13.6	7.4	4.8	7.2	12.1	7.5	7.9
Terms of trade	-17.0	-2.2	3.9	1.0	2.0	0.6	--
Nominal effective exchange rate <u>3/</u>	89.9	88.6	87.6	...	82.2	...	...
Real effective exchange rate <u>3/</u>	98.1	100.7	100.8	...	93.6	...	...
Ratio of consumer prices to export unit values <u>4/</u>	103.1	108.3	110.8	...	106.3	...	...
Public sector							
Revenue <u>5/</u>	26.2	27.0	8.9	9.6	15.1	...	5.7
Total expenditures	36.2	34.3	8.3	8.1	2.0	...	7.5
Money and credit							
Net domestic assets <u>6/</u>	34.2	40.9	39.0	22.8	22.4	...	16.8
Public sector <u>6/7/</u>	4.0	8.1	2.7	2.7	-0.7	...	--
Private sector <u>6/</u>	46.1	33.7	32.5	22.1	22.4	...	16.8
Money and quasi-money	26.9	25.0	27.0	15.0	15.2	...	13.0
Velocity	-5.4	-3.4	-11.6	-4.5	-5.9	...	-2.5
Interest rate (end of period, one-year savings deposit)	19.5	16.0	8.0	8.0	8.0	...	9.0
(In percent of GNP) <u>1/</u>							
Public sector							
Expenditure	22.7	24.8	23.7	23.5	21.5	...	20.8
Revenue <u>5/</u>	19.5	20.2	19.4	19.7	19.9	...	18.9
Deficit <u>5/</u>	-3.2	-4.6	-4.3	-3.8	-1.6	-3.5	-1.9
Domestic bank financing	1.0	2.0	0.6	0.8	-0.4	...	--
Other domestic financing	1.3	1.4	2.4	2.0	1.3	...	1.1
Foreign financing	0.9	1.2	1.3	1.0	0.7	...	0.8
Gross domestic investment	31.3	29.1	27.0	28.0	27.6	...	27.9
Gross national savings	22.6	22.2	23.3	24.9	25.4	...	26.7
External current account <u>5/</u>	-8.7	-6.9	-3.7	-3.1	-2.2	-2.5	-1.2
External debt <u>8/</u>	43.4	46.3	50.6	53.6	51.8	54.2	51.3
Inclusive of use of Fund credit	(44.6)	(48.3)	(52.4)	(55.6)	(53.6)	(56.2)	(53.4)
Debt service ratio <u>9/10/</u>	19.7	21.5	23.1	...	21.6	...	20.8
Interest payments <u>9/10/</u>	11.6	13.1	13.3	...	11.1	...	10.3
(In billions of U.S. dollars, unless otherwise specified)							
Current account of the BOP	-5.3	-4.6	-2.6	-2.3	-1.6	-2.0	-1.0
Overall balance of payments	-1.7	-2.7	-2.5	-1.7	-1.3	-1.0	-1.1
Gross official reserves (months of imports of goods and services)	(2.9)	(2.7)	(2.9)	(...)	(2.8)	(...)	(2.6)

Sources: Ministry of Finance; and Fund staff estimates.

1/ The national income accounts have been revised; as a result, all ratios to GNP have been lowered slightly.

2/ Based on U.S. dollar values.

3/ December position; decline represents depreciation (1980=100).

4/ Fourth quarter position; decline represents improvement in competitiveness (1980=100).

5/ Grants are a negligible amount.

6/ As a percentage of previous year's stock of money and quasi-money.

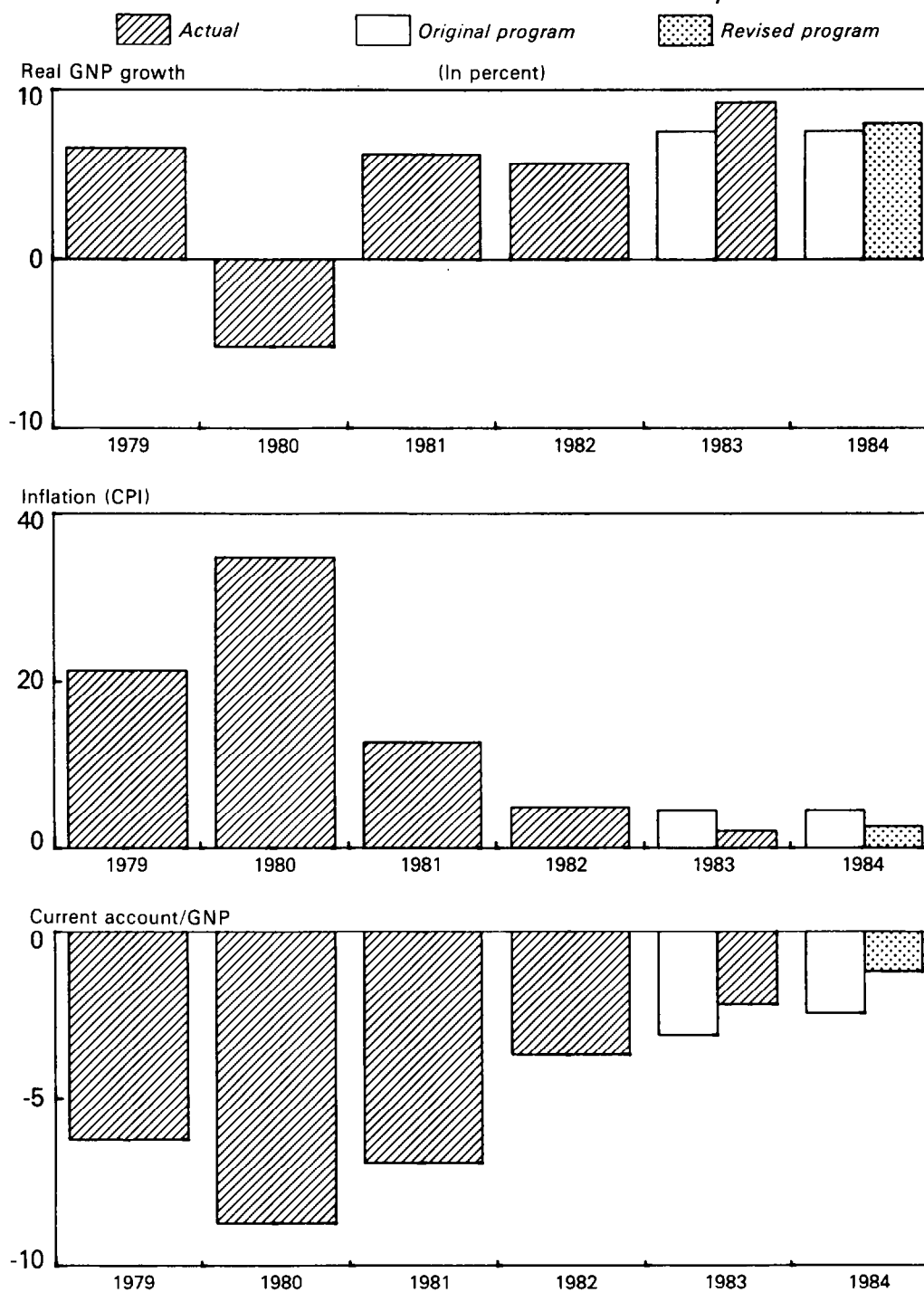
7/ Includes Fertilizer Fund.

8/ Includes public, publicly guaranteed, and private sector bank and nonbank debt of all maturities.

9/ Includes interest payments on short-term debt.

10/ As a percent of exports of goods and services.

# CHART 1 KOREA SELECTED ECONOMIC INDICATORS, 1979-84



Sources: Korean authorities; and Fund staff.

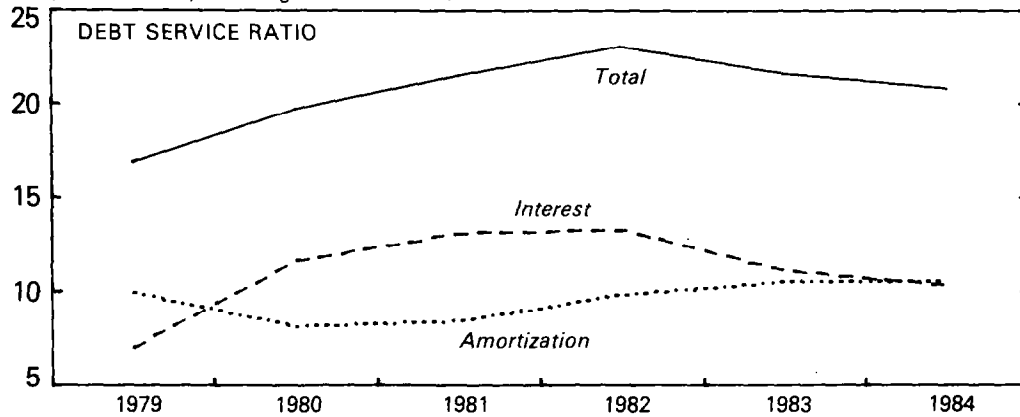


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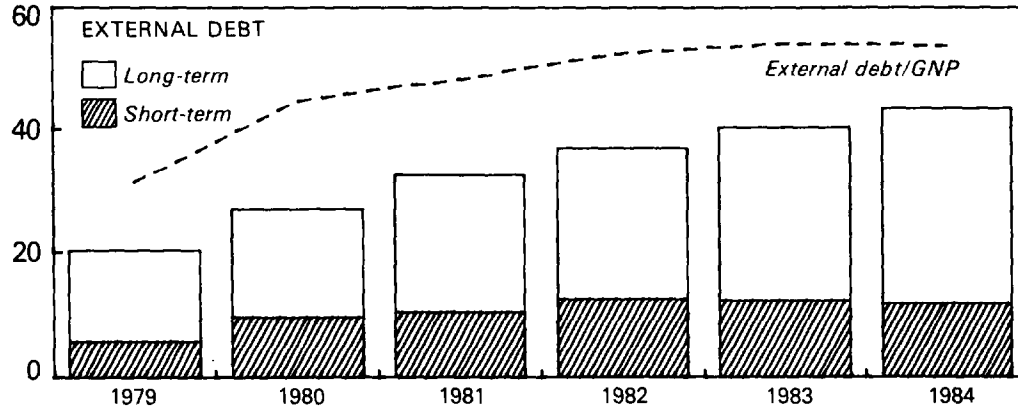
CHART 2  
KOREA  
EXTERNAL DEBT INDICATORS, 1979-84

As percent of exports of goods and services

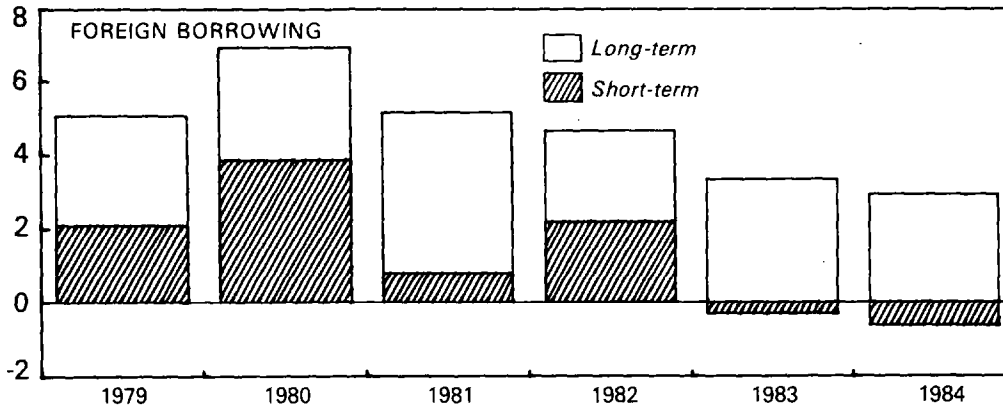


In billions of U.S. dollars

As percent of GNP



In billions of U.S. dollars



Source: Data provided by the Korean authorities.



Table 3. Korea: Selected GNP Indicators, 1979-83

	1979	1980	1981	1982	1983		
					1st half	2nd half	Year
<hr/>							
	<u>(In Percent)</u>						
Growth in aggregate demand	8	-4	6	5	11	9	10
Contribution to growth in aggregate demand							
Domestic demand	<u>111</u>	<u>-145</u>	<u>36</u>	<u>67</u>	<u>85</u>	<u>42</u>	<u>63</u>
Consumption	<u>50</u>	<u>2</u>	<u>28</u>	<u>46</u>	<u>40</u>	<u>30</u>	<u>34</u>
Private	(50)	(-9)	(25)	(43)	(33)	(29)	(31)
Government	(--)	(11)	(3)	(3)	(7)	(1)	(3)
Investment	<u>61</u>	<u>-148</u>	<u>8</u>	<u>21</u>	<u>45</u>	<u>12</u>	<u>29</u>
External demand	<u>-11</u>	<u>45</u>	<u>64</u>	<u>33</u>	<u>15</u>	<u>58</u>	<u>37</u>
	<u>(As a percent of GNP)</u>						
National savings <u>1/</u>	<u>29</u>	<u>23</u>	<u>22</u>	<u>23</u>	<u>...</u>	<u>...</u>	<u>25</u>
Private	<u>21</u>	<u>16</u>	<u>15</u>	<u>16</u>	<u>...</u>	<u>...</u>	<u>17</u>
Government	<u>7</u>	<u>6</u>	<u>6</u>	<u>6</u>	<u>...</u>	<u>...</u>	<u>7</u>
Foreign savings	<u>7</u>	<u>9</u>	<u>7</u>	<u>5</u>	<u>...</u>	<u>...</u>	<u>3</u>
Domestic investment	<u>36</u>	<u>31</u>	<u>29</u>	<u>27</u>	<u>...</u>	<u>...</u>	<u>28</u>

Source: Bank of Korea.

1/ Domestic savings include transfers and therefore may exceed the sum of private and government savings.

Greater government savings accounted for about half of the increase in national savings in 1983. 1/

Fiscal policy was tightened considerably during 1983. The public sector deficit declined from 4.3 percent of GNP in 1982 to 1.6 percent, a level markedly below the program target (Table 4). While cyclical factors contributed to the improvement in the fiscal position, particularly on the revenue side, the major portion of fiscal adjustment was associated with discretionary measures. Higher indirect taxes were supplemented by the newly imposed 5 percent tariff on imported oil, resulting in an increase of 1.3 percentage points in the ratio of

1/ The definition of the public sector used in the national accounts differs from that used for fiscal analysis.

Table 4. Korea: Central Government and Consolidated Public Sector, 1980-83

(In percent of GNP)

	1980	1981	1982	1983		1984
				Prog.	Act. <u>1/</u>	Prog.
Central Government						
Expenditure <u>2/</u>	20.6	22.3	22.5	22.7	20.9	20.5
Revenue	18.3	18.8	19.3	19.5	19.8	18.9
Deficit	-2.3	-3.5	-3.2	-3.2	-1.1	-1.6
Consolidated public sector						
Expenditure <u>2/</u>	22.7	24.8	23.7	23.5	21.5	20.8
Revenue	19.5	20.2	19.4	19.7	19.9	18.9
Deficit	-3.2	-4.6	-4.3	-3.8	-1.6	-1.9

Sources: Ministry of Finance; and Fund staff estimates.

1/ The Civil Servants' Pension Fund and Special Account were removed from the public sector in 1983.

2/ Includes net lending.

revenues to GNP. 1/ The ratio of central government expenditures to GNP declined by 0.7 percent of GNP, mainly because of a cut in capital outlays for economic infrastructure; 1/ current expenditure on health, education, housing, and public services rose broadly in line with GNP. The resulting shift in the composition of expenditure was in accordance with the Fifth Plan's objective of concentrating the development effort during 1982-86 on social infrastructure. The Government's decision to freeze the support prices of rice and barley reduced the deficit of the Grain Management Fund by half (to 0.4 percent of GNP), thereby significantly increasing public sector savings.

Monetary expansion, which had hovered around 27 percent throughout the previous three years, was reduced to 15 percent in 1983 (Table 5). The implementation of monetary policy was hindered by two financial incidents which forced the Bank of Korea (BOK) to step in as lender of last resort and rescue the affected banks. But the authorities

1/ A comparison of the fiscal outcome for 1983 and 1982 must take into account the removal of the Civil Servants' Pension Fund and Special Account in 1983, which lowered both revenues and expenditures by close to 1 percent of GNP without altering the deficit.

Table 5. Korea: Monetary Survey, 1980-84

(In trillions of won; end of period)

	1980	1981	1982	1983		1984
				Program	Actual	Program
Net foreign assets	-0.6	-2.2	-4.4	-5.9	-5.0	-5.5
Swaps with nonbank financial institutions	--	-0.3	-0.1	...	-0.9 <u>1/</u>	-1.3
Net domestic assets	<u>-13.1</u>	<u>18.2</u>	<u>24.4</u>	<u>28.8</u>	<u>28.8</u> <u>1/</u>	<u>32.7</u>
Credit to the private sector	16.1	20.3	25.4	29.8	29.8	33.7
Net credit to the public sector	0.7	1.7	2.2	2.7	2.0	2.0
Net other items	-3.7	-3.8	-3.2	-3.7	-3.0	-3.0
Broad money (Percentage change)	<u>12.5</u> (26.9)	<u>15.7</u> (25.0)	<u>19.9</u> (27.0)	<u>22.9</u> (15.0)	<u>22.9</u> (15.2)	<u>25.9</u> (13.0)

Sources: Ministry of Finance; and Fund staff estimates.

1/ Program ceiling for 1983 included the BOK swaps with nondeposit money banks; net domestic assets were therefore well below the ceiling.

successfully sterilized the monetary impact of these rescue operations by tightening rediscount policy and issuing additional stabilization bonds. The increase of net domestic assets (a performance criterion) declined from 34 percent to 18 percent. As the public sector recorded a surplus with the banking system--the related subceiling had envisaged a moderate increase in credit to the public sector--there was adequate room for extending credit to the private sector. Pressures on bank credit were also eased by measures designed to encourage firms to liquidate their speculative holdings of real estate and to increase their direct financing from the nonbank private sector. Bank lending rates were significantly higher than the rate of inflation (by about 8 percent) but remained below the rates prevailing in the nonbank financial sector.

Korea's external trade environment has been influenced by protectionism abroad and trade liberalization at home. 1983 saw an intensification of restrictive measures against Korean exports; the number of

items under restriction rose from 152 to 165. <sup>1/</sup> However, the ratio of restricted items to total merchandise exports remained about 22 percent as exporters diversified their product mix and markets. Notwithstanding the adverse external trade climate, the authorities continued to liberalize imports. During 1983, they added 300 additional items to the automaticallay approved list, raising the import liberalization ratio from 75 percent to 80 percent.

The liberalization of imports was facilitated by a flexible exchange rate policy, which reinforced the revival of external demand and led to a strengthening of the external position. During 1983, the effective exchange rate depreciated by 6 percent in nominal terms and 7 percent in real terms (based on relative consumer prices)--Chart 3. <sup>2/</sup> The effective depreciation of the won improved slightly the profitability of the traded sector relative to that of the nontraded sector--the ratio of domestic consumer prices to export prices declined by 4 percent.

The current account deficit declined from \$2.6 billion in 1982 to \$1.6 billion in 1983, well below the program target of \$2.3 billion (Table 6). The volume of merchandise exports rose by 15 percent in 1983, led by a rapid growth in the exports of ships, electronic products, and footwear. Exports to the North American market were particularly buoyant because of both the strength of the recovery in the United States and Canada, and the improvement of Korea's competitiveness vis-a-vis those countries. Import growth was also very high (13 percent in volume terms), reflecting the rapid expansion of exports, investment, and economic activity in general. Foreign prices declined and contributed, in net terms, to an improvement in the trade balance. Service receipts from overseas construction fell sharply, owing to a retrenchment of investment by Middle Eastern countries. However, this loss was offset by some increase in other receipts and a large reduction in services payments (particularly interest payments). The net outflow on errors and omissions declined by \$0.3 billion to \$1.0 billion (3 percent of exports of goods and services), <sup>3/</sup> but continued to account for a significant portion of Korea's borrowing needs. These developments,

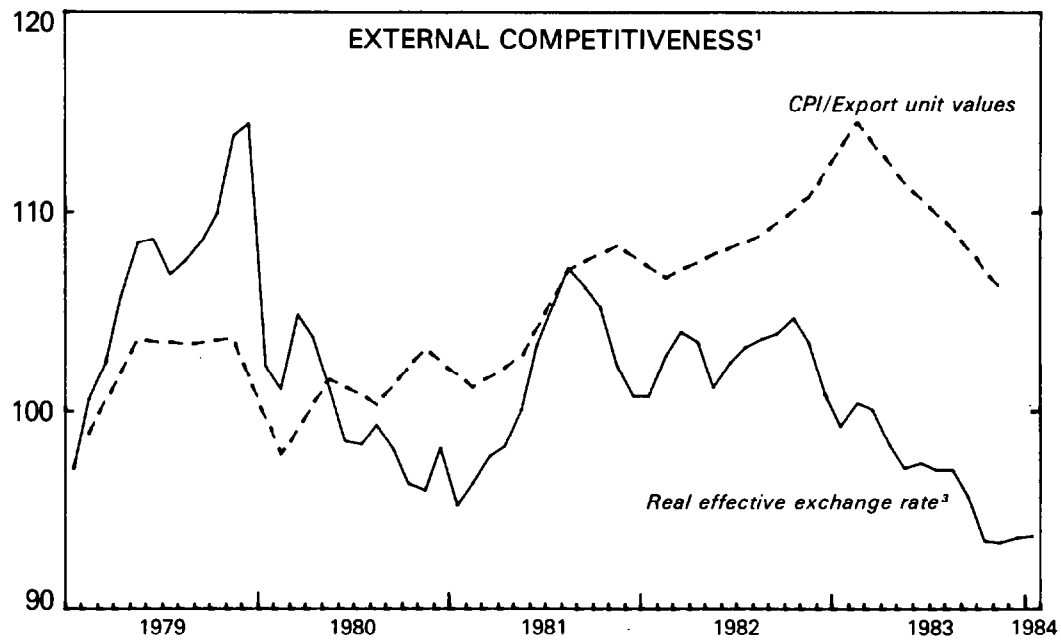
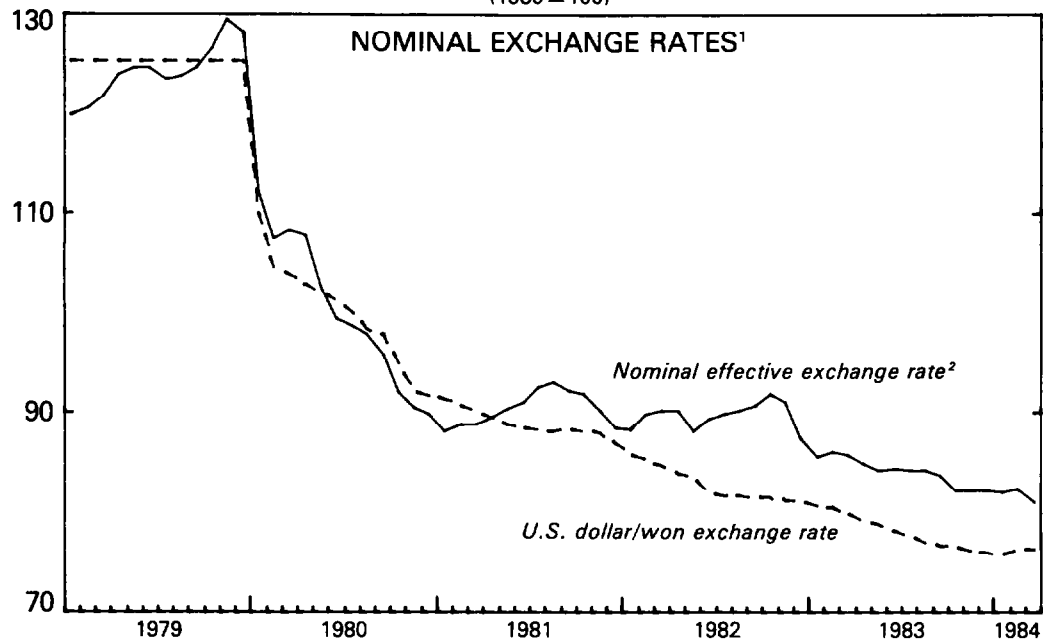
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<sup>1/</sup> According to the four-digit classification of the Customs Cooperation Council Nomenclature. Restricted items under the five major commodity groups (textiles, steel products, footwear, fishery products, and electronic products and parts) accounted for 42 percent of these exports in 1983, up from 36 percent in 1981-82.

<sup>2/</sup> These effective exchange rate indices are based on a basket of 10 major currencies. The indices used for notification purposes, which are based on a basket of 35 currencies, indicate an effective depreciation of about 1 percent in nominal terms and 5 percent in real terms.

<sup>3/</sup> The large (albeit declining) level of errors and omissions has prompted the authorities to establish a task force to study the matter.

CHART 3  
KOREA  
EXCHANGE RATE DEVELOPMENTS, 1979-84  
(1980 = 100)



Source: IMF, *International Financial Statistics*.

<sup>1</sup>Decline represents a depreciation.

<sup>2</sup>Trade weighted.

<sup>3</sup>Nominal effective exchange rate adjusted for relative movements in consumer prices.





Table 6. Korea: External Indicators, 1980-84

(In billions of U.S. dollars)

	1980	1981	1982	1983	1984
Exports	22.6	27.3	28.4	30.2	34.7
Imports	28.3	32.4	31.5	32.4	36.3
Current account	-5.3	-4.6	-2.6	-1.6	-1.0
(As percent of GNP)	(8.7)	(-6.9)	(-3.7)	(-2.2)	(-1.2)
Overall balance	-1.7	-2.7	-2.5	-1.3	-1.1
External debt	27.3	32.5	37.1	40.2	43.1
(As percent of GNP)	(44.6)	(48.3)	(52.4)	(53.6)	(53.4)
(Share of short-term debt)	(34.3)	(31.5)	(33.5)	(30.1)	(26.7)
(Debt service ratio)	(19.7)	(21.5)	(23.1)	(21.6)	(20.8)
External reserves	6.8	7.2	7.7	7.5	8.0
(Months of imports of goods and services)	(2.9)	(2.7)	(2.9)	(2.8)	(2.6)
(Percent of short-term debt)	(73.2)	(70.4)	(61.7)	(61.8)	(69.5)

Source: Appendix Tables 7 and 8.

combined with somewhat larger capital inflows, resulted in a lower overall deficit of \$1.3 billion. <sup>1/</sup>

Outstanding external debt rose to \$40.2 billion at the end of 1983; the rate of increase of debt decelerated to 8 percent, compared with 14 percent in 1982 and an average of 26 percent during 1979-81. Debt service payments, including interest on short-term debt, declined to 21.6 percent of exports of goods and services. During 1983, the authorities reduced the level of short-term debt to \$14.1 billion (below the program ceiling of \$14.2 billion). This reduction was partly at the expense of international reserves, as Korea's access to the international capital market was hindered by the global debt crisis. The reluctance of commercial banks to increase their exposure limits to Korea was also related to the fallout from the financial crisis in the region as well as the uncertainties arising from the Rangoon incident.

<sup>1/</sup> In the staff's definition of the overall balance of payments, foreign exchange swaps of the BOK with nondeposit money banks are placed below the line, while in the official definition these swaps are placed above the line.

The authorities, in consultation with the staff, have revised Korea's external debt and international reserves statistics. Before this revision, all interoffice liabilities of local branches of foreign banks (which have no stated maturity) were classified as short-term debt. Information that has recently become available indicates that a substantial portion of these liabilities correspond to medium- and long-term loans extended to domestic residents and should, therefore, be excluded from the definition of short-term debt. <sup>1/</sup> This reclassification lowers the level of short-term debt at the end of 1983 from \$14.1 billion to \$12.1 billion. Also, international reserves were revised to include the foreign assets of branches of foreign banks and exclude interoffice assets of domestic banks; revised gross international reserves at the end of 1983 amounted to \$7.5 billion (2.8 months of imports of goods and services), down from \$7.7 billion at the end of 1982.

### III. Policy Discussions and Review Under the Stand-by Arrangement

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#### 1. Objectives and prospects

The authorities' program of economic and financial policies for 1984 is designed to maintain the growth momentum (7-8 percent), contain domestic inflation (to 2-3 percent), and further reduce the current account deficit (to 1 percent of GNP). The control of inflation continues to receive top priority, particularly in view of the anticipated rise in inflationary pressures emanating from external sources. The authorities firmly believe that any wavering on the inflation front would quickly erode the public's hard-won confidence in the Government's commitment to maintain price stability.

With the sustained recovery in the United States and the emerging recovery in the other industrial countries, prospects for exports continue to be bright. Based on the expected growth of external demand and Korea's capacity to increase its market share, the volume of exports is projected to increase by 11 percent. <sup>2/</sup> In line with the projected increase in exports and in domestic demand, import volume is expected to rise by about 8 percent. Assuming a moderate increase in raw material prices and a small improvement in the terms of trade, a current account deficit of about \$1 billion (1.1 percent of GNP) should be a realistic target. Capital inflows of about \$0.8 billion are expected to largely offset net errors and omissions and result in an overall deficit of about \$1.1 billion (see Table 6).

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<sup>1/</sup> For a more detailed description of these loans, see the report on Recent Economic Developments.

<sup>2/</sup> For a more detailed projection of exports see the accompanying paper on the request for a purchase under the Compensatory Financing Facility.

The realization of domestic and external objectives critically depends on the international trade environment. Korean exports are concentrated in a number of products that are subject to strong protectionist pressures in the industrial countries. In particular, exports of textiles, steel, consumer electronics, and footwear have been affected by restrictive measures (such as quota restrictions, orderly marketing arrangements, antidumping actions, and voluntary export restraints). The authorities are also concerned about the adverse effect of the exclusion of Korean exports from the Generalized System of Preferences of the United States. The projected export growth for 1984 is contingent upon the assumption that restrictive measures aimed at Korean exports are not intensified.

The feasibility of the current account target should also be assessed from the perspective of the balance between domestic investment and savings. The ratio of gross domestic investment to GNP is projected to rise slightly to about 28 percent. The targeted reduction in the current account deficit will therefore require an increase of 1.5 percentage points in the ratio of national savings to GNP. This increase in savings is expected to be mobilized by the private sector. With the upturn in economic activity, the recovery of business profits, and higher real interest rates, the required increase in private savings to about 18.5 percent of GNP in 1984 should be attainable; this savings rate would still be well below the 1979 level of 21 percent. Continued high government savings should ensure that the target for domestic savings is met.

## 2. Policies

The even-better-than-expected economic performance of last year has strengthened the authorities' resolve to persevere with their present course of stabilization policies (Chart 4). The 1984 program aims at preserving the substantial improvements made in the fiscal position and the external competitiveness, while further tightening monetary policy to avoid a resurgence of inflation.

### a. Fiscal policy

The authorities are cognizant of the need for a continued high level of government savings to supplement private savings and ensure that the planned level of investment can be financed without jeopardizing the realization of the current account target. The 1984 budget envisages a small decline in the ratios of public sector revenues and expenditures to GNP, resulting in an overall deficit of less than 2 percent of GNP (see Table 4). The projected decline of about 1 percentage point in the ratio of revenues to GNP is based partly on the anticipated lagged effect of the 1983 tax reform package which lowered and rationalized corporate tax rates. Staff projections suggest, however, that actual revenues may again exceed official projections (which are traditionally on the conservative side). Consequently, there should be additional room for budgetary savings.

Public sector expenditures are budgeted to rise somewhat slower than the projected GNP. A slowdown in the growth of the wage bill (from 13 percent to 4 percent) and cuts in a number of projects are expected to more than offset the budgeted increase in the deficit of the Grain Management Fund. A source of concern, however, is the mounting pressure to raise the purchase price of rice, which could result in a substantially higher deficit in the Grain Management Fund. The staff underscored the importance of resisting such pressure in light of the already high domestic price of rice relative to the international price and the low level of domestic inflation. Under the program, the authorities are committed to contain the public sector deficit to a level that is below 2 percent of projected GNP. Such a deficit would be consistent with the projected improvement in the current account, given the anticipated developments in the private sector's investment and savings.

The public sector investment program will continue to concentrate on the development of social infrastructure, including housing, water supply, sewerage systems, and urban transport. Investment in the energy sector will also remain high, reflecting the Government's policy of reducing Korea's dependence on imported petroleum through construction of electricity plants powered by coal, LNG, and nuclear fuel. The World Bank staff concurs broadly with the Government's investment strategy. Recent loans by the Bank have been designed to support the Government's efforts to improve policies and institutional arrangements in transport and in urban services. In late 1983, the Bank approved a second structural adjustment loan (\$300 million) that supports import liberalization, tariff rationalization, investment planning and regulatory reforms in the energy sector, and improvements in the allocative efficiency of the public sector. <sup>1/</sup>

b. Monetary policy

The authorities consider the control of monetary expansion to be the most effective means for maintaining price stability. Following the sharp deceleration of monetary expansion last year, the target for monetary growth has been further reduced to a range of 11-13 percent. An increase in money supply in this range would be consistent with the estimated increase in money demand associated with projected output, prices, and interest rates. The balance of payments position will be protected by limiting the increase in net domestic assets (a performance criterion) to below 14 percent. This ceiling should provide ample room for meeting the credit needs of the private sector, as the public sector will refrain from using any bank credit in 1984 (a performance criterion).

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<sup>1/</sup> Information on Korea's financial relations with the World Bank are provided in Annex III. A Fund staff member participated in a recent Bank mission which discussed the medium-term prospects and the revisions in the Fifth Five-Year Plan.

CHART 4  
KOREA  
POLICY DEVELOPMENTS, 1979-84



Sources: Korean authorities; and Fund staff.



The task of reserve money management has been greatly eased by the recent decision to cease supplying credit from the BOK to the Grain Management Fund and the Fertilizer Account. A remaining problem is the rapid expansion of rediscounts for preferred sectors. Less reliance on the rediscount mechanism for directing credit would free this instrument for regulating reserve money, thus strengthening the effectiveness of monetary management. In view of these considerations, the staff suggested that the amount of directed credits by the Bank of Korea be reduced and that, if necessary, subsidized credits be channeled through specialized development agencies.

An important step in the area of financial sector reform was the decision to introduce (in January 1984) a narrow band for bank lending rates (10-10.5 percent), so as to permit banks to charge different rates according to borrowers' creditworthiness. Also, a new term structure for deposit rates was established (ranging up to 9 percent for one-year deposits) to encourage a shift of financial savings into longer-term deposits. The staff fully supported these actions, but noted that the gap between interest rates in bank and nonbank financial sectors remained large. The authorities attributed the high level of interest rates in the nonbank sector partly to inflationary expectations; after 20 years of relatively high inflation, the public was understandably slow in adjusting its expectations downward. They were of the view that with continued price stability, inflationary expectations would dissipate and result in a gradual decline in the nonbank interest rates during 1984. The authorities indicated that they were also assessing the impact of the recent adjustment of bank rates, with a view to further widening the range for lending rates. The staff encouraged the authorities to take advantage of the favorable economic climate to move more rapidly in the direction of liberalizing interest rates.

Institutional changes are an important element of financial reform. The recent increase in banks' spreads and fees and the broadening of the range of permissible services should improve their profitability. To permit an increase in banks' capital, which is generally considered to be low, the supervisory authorities are placing more emphasis on the enforcement of prudent banking practices. The development of the financial sector will also be enhanced by recent measures that make it easier for firms to issue commercial paper, bonds, and stocks. The Government intends to maintain its momentum in further liberalizing the financial system. In April 1984, the authorities announced that restrictions on local branches of foreign banks will be eased later in the year. Also, the authorities plan to gradually shift the burden of making preferential policy loans from the commercial banks to the budget, thereby increasing the autonomy of banks in their lending operations. A World Bank mission recently visited Korea to discuss a second industrial finance loan similar to the one extended last year for \$225 million.



c. Exchange and trade policy

Following a depreciation of the won against a basket of major currencies in 1983, the nominal effective exchange rate has remained stable during the first quarter of 1984. The authorities indicated that they intended to maintain this stability in the period ahead. Such a policy, together with projected developments in domestic and foreign prices, would preserve external competitiveness at its present level, which the authorities view as appropriate. The staff concurred with the authorities' assessment and their policy stance, which would support the balance of payments objective and facilitate the authorities' trade liberalization efforts.

Korea continues to rapidly liberalize its exchange and trade system. Early in 1984 the Government made public its intention to follow a five-year plan of import liberalization. Under this plan, about 1,200 items would be freed from import restrictions during 1984-88, raising the import liberalization ratio to 95 percent by the end of the period. The Government also announced the list of 352 items being liberalized during 1984, and the list of 543 items currently scheduled for liberalization in 1985 and 1986. The advance announcement of the liberalized items is designed to provide domestic manufacturers with adequate time to adapt to greater competition from imports. To further smooth the adjustment process, tariffs on certain liberalized items have been raised temporarily; the authorities have announced that these tariffs will be reduced over a period of 3-5 years.

Late in 1983 the Government amended the Tariff Act, with effect from January 1, 1984. The amendment puts in place a comprehensive tariff reform, which aims at eliminating excess protection, reducing the dispersion of tariff rates, and lowering tariffs on raw materials. Under the tariff reform program, tariff rates will be reduced on over 700 of 2,300 dutiable items in 1984 and on nearly 1,000 items by 1988; the average tariff rate would fall from close to 23 percent in 1983 to less than 21 percent in 1984 and to 17 percent in 1988. Tariff rates will be concentrated in a range of 5-50 percent during 1984, and a range of 5-30 percent by the end of 1988--prior to the reform, they were as high as 150 percent. Duty rates on most imports of raw materials have already been reduced from 10-30 percent to 5-10 percent. The authorities have also announced that they will reduce nontariff barriers by ensuring that enforcement of regulations is focused on their original purpose (i.e., protection of public health, safety, and national security).

Korea does not maintain any restrictions on payments and transfers for current international transactions that require Fund approval under Article VIII, Section 2(a), but a number of exchange restrictions are maintained in accordance with Article XIV. 1/

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1/ For a description of Korea's exchange and trade system, see the report on Recent Economic Developments.

d. External debt policy

The authorities are committed to reducing further their reliance on external borrowing. External indebtedness is projected to rise by 7 percent in 1984, bringing the level of outstanding debt to \$43.4 billion. Although the level of Korea's outstanding debt is high by international comparisons, its debt-servicing obligations are consistent with its capacity to earn foreign exchange; the debt service ratio (including interest payments on short-term debt) is expected to decline slightly to about 21 percent.

The improvement of the maturity structure of the debt continues to be an important element of the authorities' external borrowing strategy. Notwithstanding last year's reduction in short-term debt, the level of such debt remains high. Although a large portion of short-term debt is trade-related, the sharp decline in the ratio of international reserves to short-term debt since 1979 raises concerns about Korea's vulnerability to shifts in market sentiment. To correct the situation, the authorities intend to simultaneously reduce the level of short-term debt and increase international reserves during 1984. Progress in this area will naturally depend on market conditions. While on economic grounds Korea should be an eminently attractive borrower, under the present unsettled conditions in financial markets it may prove difficult to increase gross external borrowing significantly above last year's level of \$7 billion.<sup>1/</sup> The authorities have undertaken to reduce the level of short-term debt in 1984 by \$0.6 billion to \$11.5 billion (a performance criterion). They are also committed to increase international reserves by \$0.5 billion. These undertakings would raise the ratio of reserves to short-term debt from 62 percent to 70 percent.

There are early indications that the market is responding favorably to Korea's attempts to increase its medium- and long-term borrowing. The staff encouraged the authorities to increase their level of reserves by more than the program target, should market conditions permit. To allow for this, the ceiling for the increase in outstanding external debt, including all maturities but excluding the use of Fund resources (of SDR 0.6 billion), has been set at \$3.5 billion, which is somewhat higher than the projected net borrowing requirements.

To safeguard the country's standing in international capital markets, the authorities intend to keep requirements for gross foreign borrowing from rising above present levels. In line with this policy, the authorities plan to nearly close the current account gap by 1985 and move to a moderate surplus in the following years. (Gross borrowings of about \$6-7 billion a year would be needed to finance accumulation of international reserves, repayment of debt, and exports on credit.) The

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<sup>1/</sup> In setting their exposure limits for Korea, commercial banks also include loans to foreign subsidiaries of Korean firms and to foreign branches of Korean banks; these loans are excluded from Korea's external debt because they do not constitute a liability of Korean residents.

staff projections for the period 1985-89--which are presented as Scenario A in Appendix Table 9--are based on this policy stance, and are broadly in line with the official projections. <sup>1/</sup> In this scenario merchandise export growth would remain strong during 1986-87, but would slow somewhat during 1988-89 as both market growth and Korea's export response moderate. The output growth is projected to remain at about 7.5 percent over 1985-89, with investment and savings rising to over 30 percent of GNP by 1989. The current account balance would swing into surplus in 1986, and the surplus would rise to a level of about 1 percent of GNP during 1987-89. The growth of external debt would slow to 3 percent a year during 1985-89--the ratio of external debt to GNP would fall from 54 percent in 1984 to 35 percent in 1989--and the debt service ratio would decline gradually to 16 percent in 1989.

While the above projections are consistent with Korea's traditionally high rates of investment and savings, their realization will depend heavily on export growth. The projected volume growth of exports is certainly reasonable in the light of Korea's historical performance. However, export prospects are clouded by the present protectionist atmosphere. To analyze the sensitivity of the medium-term projections, the staff has prepared two additional scenarios (B and C in Appendix Table 10), both of which assume an annual export growth of 2-3 percentage points lower than that under scenario A. The two new scenarios present polar cases in terms of policy responses to the changed external environment. Under scenario B, domestic absorption and imports are reduced by tightening financial policies. As a result, the external debt profile remains similar to that under Scenario A, but output growth falls by 2 percentage points to 5.5 percent a year. In contrast, under scenario C the output growth is maintained at 7.5 percent by sustaining investment and generating growth from domestic sources. In this case, the current account deficit rises significantly in relation to GNP, and the resulting foreign borrowing raises external debt by one-third over the level in Scenario A by 1989. The debt service ratio under this scenario remains close to 20 percent during the projection period.

### 3. Performance criteria <sup>2/</sup>

The program contains the following quantitative performance criteria: (1) quarterly ceilings for June 30, September 30, and December 31, 1984 on the stock of net credit to the public sector from the banking system (paragraph 1 of the Technical Memorandum attached to the Letter of Intent, Attachment I); (2) quarterly ceilings for June 30, September 30, and December 31, 1984 on the stock of net domestic assets of the banking system (paragraph 2 of the Technical Memorandum); and (3) a ceiling for December 31, 1984 on the increase in the stock of

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<sup>1/</sup> These projections are based on assumptions somewhat more conservative than those in the World Economic Outlook exercise, particularly as regards the growth of export markets and of international interest rates. Official projections extend only through 1988.

<sup>2/</sup> Quantitative performance criteria are presented in Annex IV.

outstanding disbursed external debt, including all maturities but excluding IMF resources, as well as a subceiling on the stock of outstanding disbursed external debt with initial maturity of less than one year (paragraph 3 of the Technical Memorandum). The program contains the customary injunction against the introduction or intensification of exchange and trade restrictions (paragraph 4 of the Technical Memorandum).

#### IV. Staff Appraisal

Korea's performance under the stand-by arrangement has been outstanding. Program targets for 1983 were far surpassed as growth rose to almost double digits, inflation was virtually eliminated, and the current account deficit was almost halved to about 2 percent of GNP. A recovery in the United States and declining foreign prices contributed to this favorable outcome. But the authorities deserve much of the credit for implementing what could best be described as a classic adjustment program: strict financial discipline which sharply reduced the public sector deficit and the rate of monetary expansion, and a flexible exchange rate policy which improved external competitiveness.

The 1984 program is designed to maintain the economy on its present course of noninflationary growth and to effect further external adjustment. Macroeconomic targets for 1984--growth of 7-8 percent, inflation of 2-3 percent, and a current account deficit of 1 percent of GNP--represent challenging objectives. The authorities' perseverance in implementing appropriate policies should ensure their attainment.

The staff supports the authorities' fiscal policy which is aimed at containing the public sector deficit to below 2 percent of GNP. As the staff believes that official revenue projections may be surpassed, there should be room for attaining an even lower deficit by adhering to the budgetary ceiling for expenditures. In this context, the staff urges the authorities to resist pressures to raise the purchase price of rice and to limit the deficit of the Grain Management Fund to the budgeted level. The Government's commitment to refrain from resorting to bank credit should allow adequate expansion of credit to the private sector. The target of 11-13 percent for monetary growth is consistent with the projected increase in prices and income. It should be noted, however, that the task of monetary management has been complicated by the rapid expansion of rediscounts for preferred sectors and the consequent excess liquidity which has to be absorbed through other instruments. Consideration may therefore be given to reducing the amount of directed credits by the BOK and, if necessary, channeling such credits through specialized development agencies.

With the Korean economy becoming increasingly industrialized and complex, it is essential that the banking system performs its financial intermediation function effectively. The recent introduction of a

narrow band for bank lending rates and the broadening of banking activities were important measures. The relaxation of restrictions on local branches of foreign banks later in the year will also enhance the development of the banking sector. The staff welcomes the authorities' intention of further liberalizing the financial system during 1984 and urges a widening of the band for lending rates as soon as circumstances permit.

The authorities' flexible exchange rate policy in 1983 was instrumental in strengthening the external position. The effective exchange rate has remained stable during the first quarter of 1984, and the authorities intend to maintain this stability in the period ahead. The staff endorses this policy, which, together with projected developments in domestic and foreign prices, should preserve external competitiveness. Continued flexibility in the conduct of exchange rate policy should ensure that the authorities' extensive trade liberalization program can be implemented without jeopardizing the balance of payments objective.

An important element in Korea's external borrowing strategy has been the improvement of the maturity structure of its debt. The staff notes the authorities' success in reducing the stock of short-term debt during 1983 despite the limited availability of medium- and long-term loans. Nevertheless, the level of short-term debt remains high relative to international reserves, leaving Korea vulnerable to shifts in market sentiment. The staff therefore strongly endorses the authorities' commitment to further reduce short-term debt and to accumulate international reserves.

Korea's overall level of outstanding debt is consistent with its debt servicing capacity. However, the repercussions of the international debt crisis have limited Korea's access to foreign capital markets. There are early signs that as commercial banks are becoming more aware of Korea's excellent record of economic management and performance, they are more willing to provide the requisite financing. The authorities' strong adjustment policies for 1984 and continued support provided by the Fund should further enhance Korea's standing in international capital markets.

As regards the authorities' medium-term strategy, a fundamental question arises concerning the desirability of moving to a current account surplus. In view of Korea's development needs and its relatively high marginal productivity of capital, a case could be made for continued reliance on foreign savings. On the other hand, the fragile conditions in the international capital markets and the high level of Korea's external debt argue for reducing foreign borrowing. The staff believes that, on balance, the conservative approach adopted by the authorities is appropriate under the present circumstances, but this approach should be reassessed if circumstances improve.

By adopting an export-led growth strategy, Korea has been successful in utilizing its comparative advantage and circumventing the constraint imposed by the size of its domestic market. The rapid growth of Korean exports and imports over the last two decades has generated sizable benefits to both Korea and its trading partners. The Korean success story, however, should not obscure the fact that Korea is still a developing country with a relatively low level of income--its per capita income in 1983 was about \$1,900, compared to \$6,200 in Singapore, \$9,700 in Japan, and \$14,100 in the United States. The authorities are making an admirable effort to elevate Korea to the ranks of industrial nations. But the specter of protectionism casts a shadow over Korea's prospects for meeting its growth potential and its debt servicing obligations. It would be unfortunate if the attainment of Korea's development objectives were to be obstructed by the imposition of trade barriers in its export markets. For their part, the Korean authorities are making commendable progress in liberalizing imports.

It is recommended that the next Article IV consultation with Korea be held on the standard 12-month cycle.

## V. Proposed Decisions

The following draft decisions are proposed for adoption by the Executive Board:

### 1984 Consultation

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Korea, and in the light of the 1984 Article IV consultation with Korea conducted under Decision No. 5391-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The existing restrictions on payments and transfers for current international transactions are maintained by Korea in accordance with Article XIV. The Fund welcomes the progressive liberalization by Korea of restrictions on payments for current international transactions and encourages the authorities in their determination to remove remaining restrictions as Korea's external position improves.

### Stand-By Arrangement

1. Korea has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement for Korea (EBS/83/119, Supplement 2) and paragraph 3 of the letter dated June 3, 1983 from the Minister of Finance of Korea, in order to review the progress made by Korea in implementing its program, reach understandings with the Fund regarding policies, measures, and establish suitable performance clauses for the remaining period of the stand-by arrangement.

2. The letter dated April 23, 1984 from the Minister of Finance of Korea, together with the annexed Technical Memorandum, shall be attached to the stand-by arrangement for Korea; and the letter dated June 3, 1983 with annexed memoranda, shall be read as supplemented by the letter dated April 23, 1984 with annexed Technical Memorandum.

3. Korea will not make purchases under the stand-by arrangement for Korea that would increase the Fund's holdings of Korea's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 percent of quota:

a. during any period in which the data for the preceding calendar quarter indicate that:

(1) the ceiling on net credit to the public sector from the banking system described in paragraph 1 of the Technical Memorandum annexed to the letter of April 23, 1984, has been exceeded;

(2) the ceiling on net domestic assets of the banking system described in paragraph 2 of the Technical Memorandum annexed to the letter of April 23, 1984, has been exceeded; or

(3) the ceiling on overall outstanding disbursed external debt described in paragraph 3 of the Technical Memorandum annexed to the letter of April 23, 1984, has been exceeded; or



b. if Korea fails to observe the limit on outstanding disbursed external debt with initial maturity of less than one year described in paragraph 3 of the Technical Memorandum annexed to the letter of April 23, 1984.

4. The Fund decides, pursuant to paragraph 4(c) of the stand-by arrangement for Korea, that the respective review of policies, including the specification of performance clauses for the remaining period of the stand-by arrangement, is completed.

Table 7. Korea: Balance of Payments, 1979-84

(In billions of U.S. dollars)

	1979	1980	1981	1982	1983		1984	
					Orig. Prog.	Prel. Act.	Orig. Prog.	Rev. Prog.
Exports, f.o.b.	14.7	17.2	20.7	20.9	23.0	23.1	26.8	26.5
Volume (percentage change)	(-0.9)	(11.2)	(17.2)	(5.4)	(7.6)	(15.5)	(11.0)	(11.4)
Unit value (percentage change)	(16.5)	(5.3)	(2.5)	(-4.2)	(2.0)	(-4.2)	(5.0)	(3.0)
Imports, f.o.b.	-19.1	-21.6	-24.3	-23.5	-25.3	-24.7	-28.4	-27.5
Volume (percentage change)	(11.8)	(13.6)	(7.4)	(4.8)	(7.2)	(12.1)	(7.5)	(7.9)
Unit value (percentage change)	(17.9)	(26.9)	(4.8)	(-7.8)	(1.0)	(-6.0)	(4.4)	(3.0)
Services - receipts	4.8	5.4	6.6	7.5	8.0	7.1	8.8	8.2
Services - payments	-5.0	-6.7	-8.1	-8.0	-8.5	-7.7	-9.7	-8.8
Transfers (net)	0.4	0.4	0.5	0.5	0.5	0.6	0.5	0.6
Current account balance	-4.2	-5.3	-4.6	-2.6	-2.3	-1.6	-2.0	-1.0
(As a percent of GNP)	(-6.4)	(-8.7)	(-6.9)	(-3.7)	(-3.1)	(-2.2)	(-2.5)	(-1.2)
Medium- and long-term capital (net)	2.5	2.1	2.4	1.4	1.2	0.4	1.0	0.8
Short-term capital (net)	0.8	1.9	-0.1	-- )	-0.6	0.9 )	--	-0.9
Errors and omissions	-0.3	-0.4	-0.4	-1.3 )		-1.0 )		
Overall balance	-1.2	-1.7	-2.7	-2.5	-1.7	-1.3	-1.0	-1.1
Monetary movements <sup>1/</sup>	1.0	1.7	2.7	2.5	1.7	1.3	1.0	1.1
Assets (increase -)	-0.9	-1.0	-0.4	-0.6	-0.5	-0.1	-0.5	-0.5
Liabilities	1.9	2.7	3.1	3.1	2.2	1.4	1.5	1.6
Use of Fund resources (net)	(-0.1)	(0.6)	(0.6)	(0.1)	(0.2)	(0.2)	(--)	(0.3)
Other bank liabilities	(2.2)	(2.1)	(2.5)	(3.0)	(2.0)	(1.2)	(1.5)	(1.3)
Memorandum items:								
Gross international reserves	5.9	6.8	7.2	7.7	...	7.5	...	8.0
(In months of imports of goods and services)	(2.9)	(2.9)	(2.7)	(2.9)	(...)	(2.8)	(...)	(2.6)

Sources: Data provided by the Korean authorities; and Fund staff estimates.

<sup>1/</sup> Differs from change in net foreign assets of the banking system by the amount of swaps of nondeposit money banks with the Bank of Korea.

Table 8. Korea: External Debt, 1979-84 1/

	1979	1980	1981	1982	1983 Est.	1984 Proj.
(In millions of U.S. dollars)						
External debt (end of period)						
Long-term	14,393	17,185	21,192	23,722	26,190	29,725
Of which: use of Fund credit	(138)	(683)	(1,246)	(1,259)	(1,353)	(1,672)
Medium-term	561	754	1,061	971	1,910	1,910
Short-term	5,456	9,376	10,227	12,427	12,115	11,500
Of which: trade-related <u>2/</u>	(3,839)	(6,573)	(7,717)	(8,824)	(9,438)	(...)
Total	20,410	27,315	32,480	37,120	40,215	43,135
Debt service						
Principal repayment on medium- and long-term debt	1,917	1,840	2,296	2,775	3,164	3,640 <u>3/</u>
Interest payments (includ- ing short-term debt)	<u>1,354</u>	<u>2,609</u>	<u>3,572</u>	<u>3,764</u>	<u>3,356</u>	<u>3,585</u>
Total debt service	3,271	4,449	5,868	6,539	6,520	7,225
(As percent of exports of goods and services)	(16.9)	(19.7)	(21.5)	(23.1)	(21.6)	(20.8)
Gross financing requirements	...	8,841	7,566	7,516	6,739	6,760
(In percent)						
Growth rate of external debt	37.2	33.8	18.9	14.3	8.3	7.3
External debt (as percent of GNP)	31.6	44.6	48.3	52.4	53.6	53.4
Share of short-term in total debt	26.7	34.3	31.5	33.5	30.1	26.7
Gross international reserves/ short-term debt	108.5	73.2	70.4	61.7	61.8	69.5
Trade-related/imports	20.1	30.5	31.8	37.6	38.1	...

Sources: Ministry of Finance; and staff estimates.

1/ Incorporates merchant banks and reclassification of interoffice accounts of branches and foreign banks.

2/ Trade credits, oil bill, and refinance.

3/ Excluding rollover of medium-term swaps (US\$508 million) in 1984.

Table 9. Korea: Medium-Term Scenario A, 1985-89

(In billions of U.S. dollars)

	1985	1986	1987	1988	1989 <sup>1/</sup>
Debt service					
Interest payments	3.9	4.0	4.2	4.3	4.4
Amortization payments	4.2	4.7	5.3	5.6	6.0
Total	8.1	8.7	9.5	9.9	10.4
(Of which: debt service to IMF)	(0.5)	(0.4)	(0.4)	(0.3)	(0.3)
Debt service ratio (as percent of exports of goods and services)	20.1	18.9	18.1	17.0	16.0
Balance of payments (overall)	-0.2	0.3	0.7	0.5	0.8
Current account	-0.3	0.4	1.0	1.2	1.5
(As percent of GNP)	(-0.3)	(0.4)	(0.9)	(0.9)	(1.0)
Exports of goods and services	40.2	46.2	52.1	58.2	64.8
Imports of goods and services	41.1	46.4	51.7	57.6	63.9
Capital account (net)	0.1	-0.1	-0.3	-0.7	-0.7
Gross external reserves	8.4	9.1	9.8	10.6	11.4
(In months of imports)	(2.4)	(2.4)	(2.3)	(2.2)	(2.1)
External debt outstanding	45.7	47.4	48.3	49.3	50.0
(As percent of GNP)	(50.1)	(46.0)	(41.9)	(38.3)	(34.7)
Other macroeconomic variables					
Change in percent					
Real GNP growth rate	7.5	7.5	7.5	7.5	7.5
Export unit value					
(in U.S. dollars)	5.0	5.0	4.0	4.0	4.0
Import unit value					
(in U.S. dollars)	5.0	5.0	4.0	4.0	4.0
Export volume	11.0	10.0	9.0	7.5	7.5
Import volume	7.5	7.8	7.5	7.5	7.5
International rate of interest (LIBOR)	10.0	10.0	10.0	10.0	10.0
Percent of GNP					
Gross domestic investment	28.6	29.3	30.0	30.6	30.6
National savings	28.3	29.7	30.9	31.5	31.6

Sources: Economic Planning Board; and Fund staff estimates.

<sup>1/</sup> Fund staff projections.

Table 10. Korea: Alternative Medium-Term Scenarios, 1985-89

(In billions of U.S. dollars)

	1985		1987		1989	
	Scenario B	Scenario C	Scenario B	Scenario C	Scenario B	Scenario C
Debt service payments	8.1	8.1	9.5	9.8	10.4	11.8
Interest	3.9	3.9	4.2	4.5	4.4	5.6
Amortization	4.2	4.2	5.3	5.3	6.0	6.2
Debt service ratio (as percent of exports of goods and services)	20.6	20.6	19.4	20.0	17.5	19.9
Current account	-0.3	-1.1	1.0	-2.3	1.5	-5.2
(As percent of GNP)	(-0.3)	(-1.2)	(0.9)	(-0.9)	(2.0)	(-3.6)
Exports of goods and services	39.4	39.4	49.1	49.1	59.3	59.3
Imports of goods and services	40.3	41.1	48.7	52.1	58.4	65.1
Gross external reserves	8.4	8.4	9.8	9.8	11.4	11.4
(In months of imports)	(2.5)	(2.4)	(2.4)	(2.3)	(2.3)	(2.1)
External debt outstanding	45.7	46.5	48.3	54.4	50.0	67.7
(As percent of GNP)	(51.0)	(51.0)	(44.4)	(47.2)	(38.2)	(47.0)
Other macroeconomic variables						
Change in percent						
Real GNP growth rate	5.5	7.5	5.5	7.5	5.5	7.5
Export unit value						
(in U.S. dollars)	5.0	5.0	4.0	4.0	4.0	4.0
Import unit value						
(in U.S. dollars)	5.0	5.0	4.0	4.0	4.0	4.0
Export volume	8.0	8.0	6.5	6.5	5.5	5.5
Import volume	5.3	7.5	5.2	7.5	5.5	7.5
International rate of interest (LIBOR)	10.0	10.0	10.0	10.0	10.0	10.0
Percent of GNP						
Gross domestic investment	28.6	28.6	30.0	30.0	30.6	30.6
National savings	28.3	27.4	30.9	28.0	31.7	27.0
Ratio of GNP in alternative scenario to GNP in scenario A (percent)	98.1	100.0	94.5	100.0	91.0	100.0

Source: Fund staff projections.

Korea: Fund Position During Remaining Period of Arrangement

	Outstanding on April 30, 1984	1984			1985
		May-June	July-Sept.	Oct.-Dec.	Jan.-Mar.
(In millions of SDRs)					
Transactions under					
tranche policies (net) <u>1/</u>		22.6	12.3	36.5	26.4
Purchases		64.0	63.8	96.0	95.9
Ordinary resources		(--)	(--)	(--)	(--)
Enlarged access					
resources		(64.0)	(63.8)	(96.0)	(95.9)
Repurchases		-41.4	-51.5	-59.5	-69.5
Ordinary resources		(-30.5)	(-35.0)	(-35.0)	(-35.0)
Enlarged access					
resources		(-10.9)	(-16.5)	(-24.5)	(-34.5)
Transactions under					
special facilities (net) <u>2/</u>		279.7	-20.0	-20.0	-20.0
Purchases		279.7	--	--	--
Repurchases		--	-20.0	-20.0	-20.0
Total Fund credit					
outstanding (end of period)	1,287.8	1,590.1	1,582.4	1,598.9	1,605.3
Under tranche policies <u>1/</u>	1,081.6	1,104.2	1,116.5	1,153.0	1,179.4
Special facilities <u>2/</u>	206.2	485.9	465.9	445.9	425.9
(In percent of quota)					
Total Fund credit outstanding					
(end of period)	278.3	343.6	341.9	345.5	346.8
Under tranche policies <u>1/</u>	233.7	238.6	241.2	249.1	254.8
Special facilities <u>2/</u>	44.6	105.0	100.7	96.3	92.0

Source: International Monetary Fund.

1/ Ordinary and enlarged access resources.

2/ Compensatory Financing Facility.

Korea - Fund Relations  
(As of end March, 1984)

(Amounts in millions of SDRs,  
unless otherwise indicated)

I. Membership Status

- (a) Date of membership: August 26, 1955  
(b) Status: Article XIV

(A) Financial Relations

II. General Department

(a) Quota:	SDR 462.8 million		
(b) Total Fund holdings of Korean won:	<u>Amount</u>	<u>Percent of quota</u>	
	1,770.6	382.6	
(c) Fund credit:	1,307.6	282.6	
Of which: Credit tranches	228.1	49.3	
CFF	226.2	48.9	
SFF	597.5	129.1	
EAR	256.0	55.3	
(d) Reserve tranche position:	--	--	
(e) Current operational budget:	--	--	
(f) Lending to the Fund:	<u>Limits</u>	<u>Out-</u>	<u>standing Uncalled</u>
GAB	--	--	--
SFF	--	--	--
EAR	--	--	--
Total	--	--	--

III. Current Stand-by and Special Facilities

- (a) Current stand-by or extended arrangement  
    (i) Duration: July 8, 1983 to March 31, 1985  
    (ii) Amount: SDR 575.775 million  
    (iii) Utilization: SDR 256 million  
    (iv) Undrawn balance: SDR 319.775 million
- (b) Previous stand-by arrangements during the last 10 years  
    (1) (i) Duration: May 17, 1974 to December 31, 1974  
        (ii) Amount: SDR 20 million  
        (iii) Utilization: SDR 20 million  
        (iv) Undrawn balance: --

(2)	(i)	Duration:	October 22, 1975 to June 30, 1976
	(ii)	Amount	SDR 20 million
	(iii)	Utilization	--
	(iv)	Undrawn balance:	SDR 20 million
(3)	(i)	Duration:	May 6, 1977 to December 31, 1977
	(ii)	Amount:	SDR 20 million
	(iii)	Utilization:	--
	(iv)	Undrawn balance:	SDR 20 million
(4)	(i)	Duration:	March 3, 1980; canceled February 13, 1981
	(ii)	Amount:	SDR 640 million
	(iii)	Utilization:	SDR 320 million
	(iv)	Undrawn balance:	SDR 320 million
(5)	(i)	Duration:	February 13, 1981 to February 12, 1982
	(ii)	Amount:	SDR 576 million
	(iii)	Utilization:	SDR 576 million
	(iv)	Undrawn balance:	--
(c)	Special facilities Compensatory financing:		SDR 106.2 million related to cereal import excess, approved by the Executive Board on January 22, 1982 and purchased on January 27, 1982.

IV.	<u>SDR Department</u>	<u>Amount</u>	<u>Percent of allocation</u>
	(a) Net cumulative allocation:	72.9	100.0
	(b) Holdings:	4.7	6.5
	(c) Current Designation Plan:	--	--
V.	<u>Administered Accounts</u>		
	(a) Trust Fund Loans:	--	
	(i) Disbursed:	--	
	(ii) Outstanding:	--	
	(b) SFF Subsidy Account		
	(i) Donations to Fund:	--	
	(ii) Loans to Fund:	--	
	(iii) Payments by Fund:	--	
VI.	<u>Overdue Obligations to the Fund</u>		
	(a) General Department	--	
	(b) SDR Department	--	
	(c) Trust Fund	--	



(B) Nonfinancial RelationsVII. Exchange rate arrangement

The exchange rate is determined daily on the basis of a currency basket; middle rate of US\$1 = W 791.80 on March 31, 1983.

VIII. Last Article IV Consultation

Staff discussions were held February 27-March 17, 1983. The staff Report (EBS/83/119) was discussed by the Executive Board on July 8, 1983. This consultation with conducted after a 14-month cycle. The following decisions were adopted:

Article IV Consultation

1. The Fund takes this decision in concluding the 1983 Article IV consultation with Korea, in light of the 1983 Article IV consultation with Korea conducted under Decision No 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).
2. The Fund welcomes Korea's progressive liberalization of restrictions on payments for current international transactions. The existing instructions on payments for current international transactions are maintained by Korea in accordance with Article XIV. The Fund encourages the authorities to remove the remaining exchange restrictions as Korea's external position improves.

Stand-by Arrangement

1. The Government of the Republic of Korea has requested a stand-by arrangement for the period July 8, 1983 to March 31, 1985 for an amount equivalent to SDR 575.775 million.
2. The Fund approves the stand-by arrangement attached to EBS/83/119.
3. The Fund waives the limitation in Article V, Section 3(b)(iii).

IX. Technical Assistance

None

X. Resident Representative

The position has been held by Mr. D. Villanueva since October 1982.

Activities of IBRD, IDA, and IFC in KoreaIBRD and IDA lending: 1/

	<u>IBRD</u>	<u>IDA</u>	<u>Total</u>	<u>Percent</u>	<u>Undisbursed</u>
	<u>(In millions of U.S. dollars)</u>				
Agriculture and social development	598.0	32.8	630.8	12.0	68.7
Education	168.5	35.1	203.6	3.8	16.3
Development finance corporations	1,282.5	--	1,282.5	24.3	297.6
Industry	229.0	--	229.0	4.3	101.8
Population	30.0	--	30.0	0.6	24.8
Power	115.0	--	115.0	2.2	16.1
Program lending/SAL	725.0	--	725.0	13.7	100.0
Tourism	25.0	--	25.0	0.5	--
Transportation	1,352.5	51.7	1,404.2	26.7	465.4
Urbanization	330.0	--	330.0	6.3	219.8
Water supply and sewerage	<u>293.5</u>	<u>--</u>	<u>293.5</u>	<u>5.6</u>	<u>72.4</u>
Total	5,149.0	119.6	5,268.6	100.0	1,382.8
Repayments	611.2	5.8	617.0		
Debt outstanding including undisbursed):	4,537.9	113.8	4,651.6		
Commitments for FY 1984	668.5	--	668.5		

Structural adjustment loan:

A second loan in the amount of US\$300 million, approved in November 1983. A first tranche of US\$200 million was disbursed in December 1983. A mission to review progress is scheduled for June 1984, prior to requesting release of the second tranche.

IFC activity:

As of March 31, 1984, total loan and equity commitments amounted to US\$138.3 million which are fully disbursed.

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1/ As of March 31, 1984.

**Technical assistance:**

The IBRD has provided technical assistance to Korea through its standard lending operations for projects. In addition, the IBRD acted as the executing agent for the UNDP Planning Assistance Project for the preparation of the Fifth Five-Year Plan, and for the UNDP project for task forces set up under the IBRD structural adjustment loans.

**Recent economic and sector missions:**

Two Fund staff members participated in the Economic Mission (November 1981). Report: Korea--Adjusting to a New World Environment," June 1, 1982. Preparation missions for an industrial finance project visited Korea in June, 1982 and in November 1982. Preparation missions for a second structural adjustment loan visited Korea in March 1983 and June/July 1983. A new economic country memorandum is being prepared. Missions visited Korea during November-December 1983 and April 1984. A Fund staff member participated in the earlier mission.

**Aid consultative group:**

A meeting is scheduled under the Chairmanship of the IBRD during July 16-18, 1984 in Seoul.

Korea--Summary of the Financial Program, 1984I. Targets

1. Real GNP is projected to rise by 7-8 percent.
2. The inflation rate (CPI) is expected to remain in the range of 2-3 percent.
3. The current account deficit is projected to decline from \$1.6 billion (2.2 percent of GNP) in 1983 to \$1.0 billion (1.2 percent of GNP) in 1984; the overall balance of payments deficit is projected to decline from \$1.3 billion to \$1.1 billion.

II. Assumptions

1. Export unit values are projected to rise by 3 percent in 1984. Korea's market growth (measured as the weighted increase in non-oil import volume of Korea's major trading partners) is anticipated to be 5 percent. The real effective exchange rate of the won is assumed to remain stable from the fourth quarter of 1983 to the fourth quarter of 1984. The 1984 export projections take into account the adverse effect of present trade restrictions on Korean exports, but assume that there will be no significant intensification of these restrictions.
2. Prices for non-oil imports are assumed to rise by 4 percent in 1984. Non-oil import volume is forecast to increase by 11.5 percent, in line with growth in export volume, domestic investment, and manufacturing production. Oil imports, which rose during 1983 and the first quarter of 1984 because of stockpiling operations, are assumed to decline later in the year. For 1984 as a whole, oil imports are projected to remain unchanged as the effect of a decline in prices of close to 3 percent is expected to be offset by an equivalent increase in volume.
3. The interest rate on Korea's floating-rate external debt is assumed to be close to 11 percent per annum, in line with a LIBOR assumption of 10 percent and the recent trend in spreads.
4. Velocity, the ratio of nominal GNP to average broad money, is projected to decline by 2.5 percent, in line with a moderation of inflationary expectations and a narrowing of the gap between interest rates in the bank and nonbank financial sectors.

III. Principal Elements of the Program 1/1. Public sector policies

Revenues of the public sector are projected to rise by 5.7 percent; this growth is smaller than GNP growth because of the impact of corporate tax reductions mandated in January 1983. The Government will continue to exercise control of spending; public sector spending is projected to rise by 7.5 percent. As stated in the Letter of Intent, the Government will limit the public sector deficit to W 1,230 billion, equivalent to 1.9 percent of projected GNP.

2. Money and credit

a. Net domestic assets of the banking system are subject to quarterly ceilings as a performance criterion. The permissible increase in net domestic assets during 1984 is equivalent to 17 percent of the stock of broad money at the end of 1983.

b. Quarterly limits on net credit to the public sector from the banking system have been established as performance criteria. Under the program, the stock of net credit to the public sector will not increase during 1984.

3. External sector

a. Exchange rate policy will be managed flexibly to ensure the attainment of the balance of payments objective of the program.

b. Under the program, external debt of all maturities, but excluding IMF credit, will not increase by more than \$3,500 million during 1984.

c. A subceiling has been established on short-term debt, limiting the stock of such debt to \$11,500 million at the end of 1984 (a reduction of \$600 million from the end of 1983).

d. The authorities intend to increase gross international reserves by \$500 million during 1984.

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1/ Quantitative performance criteria through December 31, 1984 are provided in the attached table.

Korea: Stand-by Arrangement--Quantitative Performance Criteria  
for the Period Through December 1984

	Actual		Ceilings and Limits for 1984		
	Dec. 31, 1983	March 31, 1984	June 30	Sept. 30	Dec. 31
(In billions of won)					
Net credit to the public sector from the banking system	2,013	...	2,013	1,823	2,013
Net domestic assets of the banking system	28,810	...	30,513	31,653	32,667
(In millions of U.S. dollars)					
Outstanding external debt of all maturities, excluding IMF credit <u>1/</u>	38,861	...	...	...	42,361
Outstanding short-term debt <u>2/</u>	12,115	...	...	...	11,500

Sources: Ministry of Finance; and staff estimates.

1/ Increase is limited to US\$3,500 million.

2/ Defined as external debt with initial maturity of less than one year.

Ministry of Finance  
Seoul, Korea

April 23, 1984

Dear Mr. de Larosiere:

1. The stand-by arrangement approved by the Fund on July 8, 1983, supports a comprehensive economic program aimed at continued external adjustment, a reduction in inflation, and sustained economic growth. This letter describes the considerable progress made so far in achieving those objectives, and outlines the policies the Government intends to follow during 1984. The attached Technical Memorandum sets out certain operational guidelines for the remainder of the stand-by arrangement.

Developments in 1983

2. The 1983 Economic Management Plan was a continuation of the Government's stabilization program that was initiated in 1980 in the midst of a severe political and economic crisis. In 1980, real GNP fell by 5 percent, inflation soared to 35 percent, and the external current account deficit rose to nearly 9 percent of GNP. By 1982, the Government's efforts, supported by two stand-by arrangements, had brought about a notable improvement: real growth had increased to nearly 6 percent; inflation had declined to 5 percent; and the current account deficit had declined to less than 4 percent of GNP.

3. As stated in paragraph 6 of our economic memorandum of June 3, 1983, the Government's macroeconomic objectives for 1983 included output growth of about 7.5 percent, consumer price increases below 5 percent, and a current account deficit of 3.2 percent of GNP. Korea's economic performance turned out much better than these expectations; real GNP expanded by 9.3 percent, consumer prices increased by only 2 percent, and the current account deficit declined to 2.2 percent of GNP.

4. While the recovery in the United States and declining raw material prices contributed to Korea's economic improvement, the Government's strong adjustment policies were primarily responsible for the better than anticipated outcome. The economic program for 1983 was based on fiscal and monetary restraint and a flexible exchange rate policy. Fiscal policy was the mainstay of the Government's stabilization efforts. A reduction in the public sector deficit to 4.0 percent of GNP was foreseen in the economic memorandum of June 3, 1983. In fact, the deficit was reduced to 1.6 percent of GNP. The relative size of the public sector in GNP continued to decline. An important element in this outcome was the Government's decision to freeze the farm purchase prices of both rice and barley at the 1982 level, thereby reducing the deficit of the Grain Management Fund. In addition, revenues rose significantly faster than GNP, reflecting the vigorous and broadly-based economic recovery, as well as some discretionary measures, including the tariff on oil imports.

5. Fiscal restraint allowed the public sector to reduce its indebtedness to the banking system, instead of increasing it by 1 percent of GNP, as had been envisaged under the program. This development contributed to our success in controlling the expansion of the monetary and credit aggregates. The growth of net domestic assets was kept to 15.5 percent, well below the program ceiling. The growth of broad money was in line with the program's target of about 15 percent, and it represented a significant moderation from the rates of monetary expansion of over 25 percent recorded in each of the previous three years. Real interest rates were maintained at levels that promoted the mobilization of domestic savings and facilitated monetary stability. The official lending rate in 1983 was kept at 10 percent per annum, which was substantially higher than the inflation rate.

6. The Government has managed the exchange rate flexibly to support the balance of payments objective; external competitiveness improved significantly during 1983, as a depreciation of the currency was aided by a marked decrease in domestic inflation relative to inflation overseas.

7. A rapid increase in domestic demand had been the main force behind the economic upswing in late 1982 and the first half of 1983. The tightening of financial policies in 1983 succeeded in curbing the growth of domestic demand and averting inflationary pressures. At the same time, flexible exchange rate management and the economic recovery in the United States resulted in a sharp rise in exports in the latter half of the year and gave a fresh impetus to growth.

8. As a result of brisk export growth and the containment of import demand, the external current account improved by US\$1 billion in 1983. This was a welcome development, since Korea's access to international financial markets during 1983 was constrained by a number of factors, including: the general scarcity of loanable funds; a disproportionate absorption of funds by countries undergoing debt rescheduling; and financial problems in the region. In the face of these constraints, it was particularly difficult to lengthen the maturity structure of external debt and increase gross international reserves. Nevertheless, the Government was successful in reducing the level of the country's short-term external debt; gross international reserves fell marginally, but remained adequate in relation to imports.

#### Policies for 1984

9. The Government's Economic Management Plan for 1984 aims at consolidating the recent gains through continued fiscal and monetary restraint and exchange rate flexibility. The management plan envisages that real GNP growth will moderate to 7 to 8 percent, the increase in consumer prices will be limited to 2 to 3 percent, and the current account deficit will continue to narrow to US\$1 billion, or about 1 percent of projected GNP.



10. Restraint in fiscal policy will continue to be one of the main elements of the Government's adjustment strategy. The 1984 budget has frozen most items of government spending at the level of the 1983 budget. The freeze, which covers most public sector wages, will have direct beneficial effects on the public finances, while also helping to moderate wage demands in the private sector. Our policy is to continue to restrain government spending and to contain the public sector deficit to below W 1,230 billion, or less than 2 percent of projected GNP.

11. The main objectives of monetary policy for 1984 are to limit the growth of the monetary and credit aggregates and to further liberalize the financial system. During 1984, the increase in net domestic assets of the banking system will be kept to no more than 14 percent. To ensure adequate expansion of credit to the private sector the public sector will not resort to bank financing. In line with this credit policy, and the expected movement in the net foreign assets of the banking system, broad money is anticipated to grow by no more than 13 percent, which is consistent with projected developments in output, prices, and interest rates.

12. The Government has accelerated its efforts to liberalize the financial sector. An important start was made this January when lending rates were raised slightly and, for the first time, a narrow range was introduced within which banks could set their own rates. Also, to encourage the private sector to hold a greater share of its financial savings in longer-term assets, rates for deposits of one year or longer were raised and those for shorter-term deposits were lowered. Bank rates remain substantially higher than the inflation rate, but they are still below the rates in other domestic financial markets. We expect the interest rates in the nonbank financial sector to decline as inflationary expectations subside and as the Government's efforts to dampen real estate speculation take hold. The Government has also undertaken a number of important institutional reforms. Following the complete denationalization of the banking sector, commercial banks have been permitted to expand their financial activities by engaging in factoring, trust, and other services. At the same time, the Government has strengthened its enforcement of prudent banking practices. To further develop the nonbank financial sector, measures have been implemented to encourage direct borrowing by firms. The Government is firmly committed to pursue its liberalization policy during the remainder of the stand-by arrangement by intensifying its efforts aimed at institutional reform. The Government will also continue with its efforts to narrow the gap between interest rates in the bank and nonbank financial sectors by maintaining domestic price stability and by broadening the range for bank interest rates.

13. Flexibility in exchange rate policy since late 1982 has served Korea well. It has restored external competitiveness and materially improved Korea's export and growth prospects. We believe that the

present level of competitiveness is appropriate and should be maintained. The Government will continue to manage the exchange rate flexibly to support the balance of payments objective.

14. One of our main external objectives has been to lessen Korea's vulnerability to shifts in sentiment in international capital markets. The Government intends to further reduce Korea's short-term external debt and to increase its gross international reserves during 1984. To this end, the Government has formulated a borrowing program which aims at securing adequate long-term loans.

15. The Government has intensified its efforts to liberalize trade. Import restrictions on over 300 items were lifted in 1983, raising Korea's import liberalization ratio to 80 percent. The Government has announced a list of 350 items to be freed from import restrictions during 1984; this will raise the import liberalization ratio to 85 percent. According to the Government's five-year liberalization plan, the liberalization ratio would rise by 1988 to the level prevailing in the industrial countries; over 800 items are being considered for inclusion in the free import list during 1985-88. Moreover, the Government has undertaken a substantial import tariff reform to rationalize the tariff structure. The average tariff rate will fall from 23 percent to 21 percent in 1984, and to 17 percent in 1988 when the reform will be fully implemented.

16. The Government of the Republic of Korea believes that the policies and measures described in this letter are adequate to achieve the objectives of the program, but will take any additional measures that may become appropriate for this purpose. During the remaining period of the arrangement, the Government will periodically consult with the Fund, in accordance with the Fund's policies on such consultations, about the progress being made in the implementation of the program and any policy adaptations judged to be appropriate for the achievement of its objectives.

Sincerely yours,

/s/

Mahn Je Kim  
Minister of Finance

Mr. Jacques de Larosiere  
The Managing Director  
International Monetary Fund  
700-19th Street, N.W.  
Washington, D.C. 20431  
U.S.A.

Seoul, Korea  
April 23, 1984

Technical Memorandum

This memorandum describes performance criteria for 1984, in accordance with the economic program described in the letter of April 23, 1984.

1. The stock of net credit to the public sector from the banking system will not exceed W 2,013 billion on June 30, 1984; W 1,823 billion on September 30, 1984; and W 2,013 billion on December 31, 1984. The public sector is defined to include the Central Government, as defined in the IMF's Government Finance Statistics; the Grain Management Fund; the Supply Fund; the Enterprise Special Accounts of Grain Management, Supply, Monopoly, National Railroad and Communications; and the Fertilizer Fund. The stock of net credit to the public sector from the banking system was W 2,013 billion on December 31, 1983 and its components are defined in the attached Table 1.

2. The stock of net domestic assets of the banking system will not exceed W 30,513 billion on June 30, 1984; W 31,653 billion on September 30, 1984; and W 32,667 billion on December 31, 1984. For the purpose of the stand-by arrangement, net domestic assets of the banking system are defined as broad money minus the sum of net foreign assets and foreign exchange swaps of the Bank of Korea with non-DMBs; NDA were W 28,810 billion on December 31, 1983. Broad money is defined as set forth in Table 2 and includes narrow money, time and savings deposits, and residents' foreign currency deposits held by the nonbank private sector. Net foreign assets of the banking system are defined as set forth in Table 2 and include gross foreign assets of the Bank of Korea and deposit money banks (DMBs) minus the sum of gross foreign liabilities of the Bank of Korea and DMBs. All foreign assets and liabilities will be converted into U.S. dollars at the market rates of the respective currencies prevailing on December 31, 1983; gold will be valued at a fixed accounting rate of US\$42.22 per fine troy ounce; and the Bank of Korea's SDR holdings and Korea's IMF position will be valued in SDRs converted into U.S. dollars at the basket valuation of the special drawing right prevailing on December 31, 1983. The U.S. dollar value of all foreign assets and liabilities will be converted into Korean won at a constant exchange rate of W 795.5 per U.S. dollar.

3. During the remainder of 1984, the stock of outstanding disbursed external debt, including all maturities but excluding use of IMF resources, will not exceed the stock of such debt outstanding on December 31, 1983 by more than US\$3,500 million. Furthermore, the stock of outstanding disbursed external debt with initial maturity of less than one year will not exceed US\$11,500 million on December 31, 1984. For purposes of these limits, outstanding disbursed external debt will be defined as all external obligations denominated in foreign currency. External debt in currencies other than the U.S. dollar will be converted into U.S. dollars at the exchange rates prevailing on December 31, 1983. The stock of outstanding disbursed external debt on December 31, 1983 is set forth in Table 3.

4. During the remaining period of the stand-by arrangement, the Government of the Republic of Korea will not impose or intensify restrictions on payments and transfers for current international transactions, or introduce any multiple currency practice or conclude any bilateral agreements which are inconsistent with Article VIII, or impose or intensify import restrictions for balance of payments purposes.

Table 1. Korea: Definition of Net Credit to the  
Public Sector from the Banking System

		December 31, 1983 (In billions of won)
A.	Net credit to the public sector from the banking system (D + E)	2,013
B.	Bank of Korea (net)	1,358
	1. Loans to government	2,073
	2. Government bonds	10
	3. National Investment Fund (NIF) bonds	40
	4. Less government deposits	765
	5. Less NIF deposits	--
	6. Less government lending funds	--
C.	Deposit money banks (net)	85
	1. Government bonds	265
	2. NIF bonds	1,365
	3. National Housing Fund (NHF) bonds	353
	4. Deposits with NIF	412
	5. Treasury checks uncleared	--
	6. Less government deposits	144
	7. Less NIF deposits	3
	8. Less NHF deposits	421
	9. Less government lending funds	1,742
	a. Borrowing from the Government	822
	b. Borrowing from the NIF	846
	c. Borrowing from the NHF	74
D.	Net credit from the banking system to the Government (B + C)	1,443
E.	Claims on government agencies	570
	1. Fertilizer Fund	570
	2. Other	--

Table 2. Korea: Definition of Net Domestic Assets of the  
Banking System

	December 31, 1983 (In billions of won)
A. Net domestic assets (B-C-D)	28,810
1. Domestic credit	31,847
a. Net credit to public sector	2,013
b. Credit to private sector	29,834
2. Other items (net)	-3,037
a. Guarantees	-306
b. Capital account	-4,110
c. Valuation account	-305
d. Fixed assets	1,709
e. Stabilization bonds <u>1/</u>	-156
f. Other	131
B. Broad money	22,938
1. Narrow money	6,783
a. Currency outside deposit money banks	2,874
b. Private sector deposits with Bank of Korea	88
c. Demand deposits of deposit money banks	8,235
d. Less unclear checks and bills	4,414
2. Savings and time deposits plus residents' foreign currency deposits	16,155
C. Net foreign assets	-5,009
1. Foreign assets	6,461
a. Bank of Korea	2,292
b. Deposit money banks	4,169
2. Foreign liabilities	11,470
a. Bank of Korea	1,514
b. Deposit money banks	9,956
D. Foreign exchange swaps of Bank of Korea with nondeposit money banks	-863

1/ Excludes foreign exchange swaps of Bank of Korea with nondeposit money banks.

Table 3. Korea: Definition of Outstanding Disbursed  
External Debt

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	December 31, 1983 (In millions of U.S. dollars)
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A. Debt with original maturity in excess of three years	26,190
1. Public loans	10,398
2. Commercial loans	5,885
3. Bank loans	6,869
4. Bond issue	580
5. Interoffice "A" account	1,044
6. Use of Fund credit	1,354
7. F.R.C.D.	60
B. Debt with original maturity of one to three years	1,910
1. Interoffice "A" account	837
2. Others	1,073
C. Debt with original maturity of less than one year	12,115
1. Trade credits	4,114
2. Borrowing for oil bill	584
3. Refinance	4,740
4. Deposits	163
5. Interoffice "A" account	1,474
6. Others	1,040
D. Total outstanding disbursed external debt	40,215
E. Total outstanding disbursed external debt, excluding use of Fund resources (D-A6)	38,861

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