FOR AGENDA

EBS/83/119

CONFIDENTIAL

June 9, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Korea - Staff Report for the 1983 Article IV Consultation and Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Korea and its request for a stand-by arrangement. Draft decisions appear on page 20. It is proposed to bring this subject to the agenda for discussion on Friday, July 8, 1983.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Aghevli, ext. 72925.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

KOREA

Staff Report for the 1983 Article IV Consultation and Request for Stand-By Arrangement

Prepared by the Asian and Exchange and Trade Relations Departments

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

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

June 8, 1983

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I. Introduction

The 1983 Article IV consultation discussions with Korea were held in Seoul during February 27-March 17, 1983.1/ At the same time, the authorities initiated discussions on a Fund-supported program. A subsequent mission visited Seoul during April 15-30 and negotiated an economic program in support of which Korea has requested access to Fund resources. During the staff visits, meetings were held with the Deputy Prime Minister and Minister of Economic Planning; the Ministers of Finance, Agriculture and Fisheries, Commerce and Industry, and Energy and Resources; the Senior Advisor for Economic Affairs of the President; the Governor of the Bank of Korea; and other senior officials. The two staff missions consisted of Messrs. Aghevli (Head, ASD), Kincaid (ASD), Marquez-Ruarte (ETR), Rommel (ETR), Shah (ASD), Wattleworth (FAD), Yusuf (IBRD), Sharma (Secretary, ETR), and Mrs. Sehmi (Secretary, ASD), and were assisted by Mr. Villanueva, the Fund's Resident Representative in Korea. Mr. A.R.G. Prowse, Executive Director for Korea, and Mr. Hak-Sung Lee, Advisor to Mr. Prowse, attended some of the meetings.

In support of a policy program for 1983 and 1984, which is described in the attached letter from the Minister of Finance (dated June 3, 1983), the Government of Korea has requested a stand-by arrangement in an amount of SDR 575.8 million or equivalent to 225 per cent of Korea's quota, for a period from the date of approval of the stand-by arrangement through March 31, 1985.2/ A waiver of the limitations in Article V, Section 3(b)(iii) of the Articles of Agreement is required.

As of May 31, 1983, Fund holdings of Korean won stood at 545 per cent of Korea's quota of SDR 255.9 million. Korea has had 14 stand-by arrangements with the Fund; the last one expired on February 28, 1982. Full use of the requested stand-by arrangement, together with scheduled repurchases, would raise Korea's use of Fund credit to 518 per cent of quota by the end of the stand-by period (Table 1). Under the Eighth Quota Review, Korea's quota would be increased by 80.9 per cent to SDR 462.8 million. The authorities anticipate that Korea will formally consent to the proposed increase in its quota by September 1983. Information on Korea's relations with the Fund are presented in Annex I.

II. Historical Economic Trends

Korea's record of economic growth and development since the early 1960s has been outstanding. During the period 1963-79, output grew by 10 per cent per annum, real income per capita more than tripled, and the

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1/ The last consultation discussions were concluded by the Executive Board on May 5, 1982. Korea continues to avail itself of the transitional arrangements of Article XIV.

2/ Only SDR 4,499 is from ordinary resources.

Table 1. Korea: Projection of the IMF Position

	Operations in 1983			Operations in 1984	Operations in 1985
	Jan.-June	July-Sept.	Oct.-Dec.		Jan.-March
		(In millions of SDRs)			
Purchases	--	96.0	96.0	287.9	95.9
Stand-by	--	96.0	96.0	287.9	95.9
Ordinary resources	(--)	(--)	(--)	(--)	(--)
Borrowed resources	(--)	(96.0)	(96.0)	(287.9)	(95.9)
Repurchases	3.5	3.9	33.5	261.5	89.5
Stand-by	--	3.9	13.5	181.5	69.5
Ordinary resources	(--)	(--)	(8.0)	(120.3)	(35.0)
Borrowed resources	(--)	(3.9)	(5.5)	(61.2)	(34.5)
Compensatory financing facility	--	--	20.0	80.0	20.0
Oil facility	3.5	--	--	--	--
		(In per cent of quota)			
Purchases	--	37.5	37.5	112.5	37.5
Use of Fund credit (end of period)	444.8	480.8	505.2	515.5	518.0
(Excluding compensatory financing facility)	(340.8)	(376.7)	(409.0)	(450.6)	(460.9)
		(In per cent of proposed quota) 1/			
Use of Fund credit (end of period)	--	--	279.3	285.0	286.4
(Excluding compensatory financing facility)	(--)	(--)	(226.2)	(249.1)	(254.8)

Source: International Monetary Fund.

1/ Under the Eighth Quota Review.

proportion of population below the poverty line declined from 40 per cent of total to 10 per cent. Substantial and efficient investment in the industrial sector resulted in the rapid transformation of a predominantly agricultural economy with heavy dependence on foreign aid into a semi-industrial economy with a dynamic export sector. Manufacturing output grew by 18 per cent a year and doubled its share in GNP to about 25 per cent; the share of agriculture was halved to 23 per cent. Even more striking was the performance of exports, which rose by 30 per cent a year in real terms. The rapid industrial growth, based on an expansion of labor-intensive manufactured goods, contributed to a substantial increase in employment. As a result of these developments, Korea was elevated from one of the world's poorest to the ranks of the middle-income countries.

Korea's accomplishments during the past two decades were made possible by the interaction of several factors, including: a firm commitment to development; a modern agricultural sector which had already undergone a thorough and successful land reform in the 1950s; and a well-educated, industrious, and thrifty population. The most important factor, however, was the early formulation of a development strategy that concentrated on the expansion of labor-intensive manufacturing exports to compensate for the paucity of natural resources.1/ Domestic and external policies were designed to provide the necessary incentives to encourage accumulation of capital in areas in which Korea had a comparative advantage. A liberal credit policy directed to the industrial sector supported the Government's development effort, although it led to relatively high rates of inflation; CPI inflation averaged about 15 per cent during 1963-79. The share of gross investment in GNP rose rapidly in the 1960s and averaged about 28 per cent in the 1970s. Notwithstanding a large increase in domestic savings, the current account deficit averaged about 5 per cent of GNP during the 1970s and foreign debt rose substantially. The vigorous expansion of the export sector ensured that Korea's debt servicing capacity grew in line with its external debt burden--the debt service ratio averaged about 15 per cent during the 1970s.

Toward the end of the 1970s, the Korean economy experienced strains caused by bottlenecks and imbalances accumulated over the long period of inflationary growth. Tight labor market conditions, together with ingrained inflationary expectations, led to increases in real wages far in excess of productivity gains. The combination of relatively high inflation and exchange rate rigidity during 1974-79 resulted in a progressive deterioration of export competitiveness. The consequent pressures on the balance of payments were magnified by increased investment in capital-intensive industries. These underlying difficulties were severely exacerbated in 1980 by political crises, poor harvests, and adverse external developments, culminating in an acute worsening of economic conditions.

1/ See P. Hasan and D.C. Rao, Korea: Policy Issues for Long-Term Development (Johns Hopkins University Press, 1979), as well as a joint study undertaken by the Korea Development Institute and the Harvard Institute for International Development entitled, Studies in the Modernization of the Republic of Korea: 1945-75 (Harvard University Press, 1980).

III. Developments During 1980-82

In response to the economic difficulties in 1980, the authorities implemented a wide-ranging adjustment program, which was supported by two one-year stand-by arrangements from the Fund (March 1980-February 1982). The main elements of the program were a substantial depreciation of the currency, tight financial policies, strict wage guidelines, and adjustments of administered prices, particularly of energy products. These policies were effective in sharply reducing the volume of imports in 1980 (by 14 per cent) and increasing the volume of exports (by 11 per cent). Nevertheless, the current account deficit widened to over 9 per cent of GNP because of large increases in the oil import bill and in interest payments on external debt. At the same time, the inflation rate (CPI) soared to 35 per cent, because of the depreciation of the won, foreign inflation, and higher domestic prices of energy and food products. A marked decline in agricultural production and contractionary financial policies resulted in a 6 per cent fall in real GNP (Table 2 and Chart 1).

During 1981, the authorities pursued their objectives of reducing inflation and the external imbalance, but adopted a more stimulative policy stance to counter the domestic recession. Budgetary expenditures were increased and taxes were cut; as a result, the public sector 1/ deficit increased to 5.0 per cent of GNP from 3.4 per cent in 1980. There was also a marked easing of monetary conditions. Nevertheless, domestic inflation fell to 13 per cent, reflecting a moderation in agricultural prices, a sharp decline in foreign inflation, and a stable effective exchange rate. The significant improvement in external competitiveness achieved in 1980 contributed to a 20 per cent growth in export volume in 1981, but exports weakened considerably late in the year as external conditions worsened and competitiveness deteriorated; the real effective exchange rate appreciated by 5 per cent during 1981 as domestic inflation remained higher than foreign inflation. Despite exceptionally large rice imports (equivalent to 1 per cent of GNP) and a continued increase in interest payments, the current account deficit fell to 7.4 per cent of GNP. Real GNP grew by 6.4 per cent due to the strong export performance, a recovery of agricultural production, and the fiscal stimulus.

With the resumption of growth, the authorities placed greater emphasis in 1982 on achieving external adjustment and price stability. This shift in policy objectives, embodied in the Fifth Five-Year Development Plan (1982-86), represented a significant departure from Korea's

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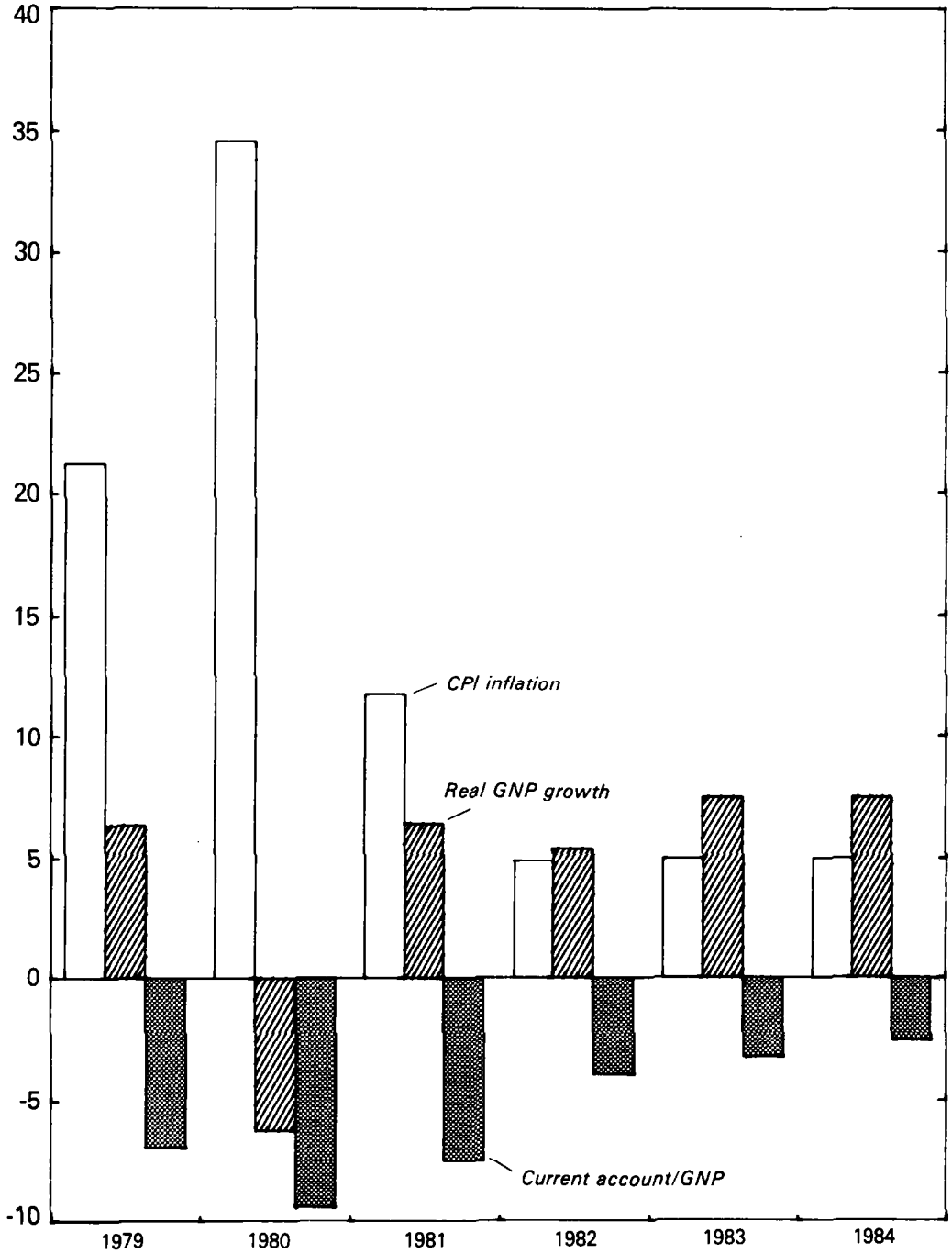
1/ The public sector includes the consolidated operations of the Central Government and the five enterprise funds (National Railroads, Communications, Grain Management Fund, and the offices of Monopoly and of Supply), whose transactions are closely linked with those of the Central Government. Operations of financially autonomous public enterprises are excluded.

CHART 1

KOREA

SELECTED ECONOMIC INDICATORS, 1979-84

(In per cent)



Sources: Korean authorities; and Fund staff projections.

Table 2. Korea: Selected Economic and Financial Indicators, 1979-83

	1979	1980	1981	1982	1983 Program
	(Annual per cent changes, unless otherwise specified)				
National income and prices					
GNP at constant prices	6.4	-6.2	6.4	5.4	7.5
GNP deflator	19.3	25.4	16.2	8.0	5.5
Consumer prices (Dec.-Dec. basis)	21.2	34.6	12.6	4.8	4.5
External sector (in U.S. dollars)					
Exports, f.o.b.	15.7	17.1	20.2	1.4	9.7
Imports, f.o.b.	31.8	13.1	12.6	-3.9	8.3
Non-oil imports, f.o.b.	28.1	0.2	10.2	-3.9	14.4
Export volume	-0.9	11.2	17.3	5.8	7.6
Import volume	11.8	-13.6	7.4	4.3	7.2
Terms of trade	-1.2	-17.0	-2.2	3.9	1.0
Nominal effective exchange rate 1/	124.1	100.0	90.2	89.8	86.1 2/
Real effective exchange rate 1/	103.4	100.0	103.1	104.2	99.6 2/
Public sector					
Revenue 3/	31.6	26.2	27.0	9.0	14.2
Total expenditures	24.2	36.2	34.3	8.3	11.6
Money and credit					
Net domestic assets 4/	30.7	35.2	38.4	40.2	22.8
Government 4/	-1.6	4.0	8.1	2.7	2.7
Private sector 4/	40.7	46.1	33.7	32.5	22.1
Money and quasi-money	24.6	26.9	25.0	27.0	15.0
Velocity	--	-6.2	-3.1	-11.0	-4.5
Interest rate (end of period, one-year savings deposit)	18.6	19.5	16.0	8.0	8.0
	(In per cent of GNP)				
Public sector					
Expenditure	21.4	24.6	26.8	25.5	25.0
Revenue 3/	19.9	21.2	21.8	20.9	21.0
Deficit 3/	-1.5	-3.4	-5.0	-4.6	-4.0
Domestic bank financing	-0.4	1.1	2.1	0.7	0.8
Other domestic financing	1.0	1.4	1.6	2.5	2.2
Foreign financing	0.9	0.9	1.3	1.4	1.0
Gross domestic investment	35.4	31.5	28.4	26.5	28.0
Gross domestic savings	28.5	22.1	21.0	22.6	24.8
External current account 3/	-6.9	-9.4	-7.4	-3.9	-3.2
External debt 5/	33.9	47.3	50.1	54.5	56.7
Inclusive of use of Fund credit	34.1	48.4	52.1	56.5	58.7
Debt service ratio 6/	15.2	18.4	20.7	20.9	19.5
Interest payments 6/	6.9	11.6	13.4	13.5	11.5
	(In millions of U.S. dollars, unless otherwise specified)				
Current account of the BOP	-4.2	-5.3	-4.6	-2.5	-2.3
Overall balance of payments	-1.0	-1.9	-2.3	-2.7	-1.7
Gross official reserves (months of imports of goods and services)	(2.8)	(2.8)	(2.6)	(2.7)	(2.7)
(As percentage of short-term debt)	(89.6)	(64.0)	(60.5)	(50.7)	(54.2)

Sources: Ministry of Finance; and staff estimates.

1/ Index based on annual averages (1980 = 100); decline represents depreciation.

2/ First quarter of 1983.

3/ Grants are a negiblible amount.

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

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

6/ As a per cent of exports of goods and services.

historical development strategy, which had aimed at maximizing growth by accepting relatively high inflation and substantial recourse to foreign financing. Favorable price developments abroad reinforced the Government's adjustment policies and resulted in outcomes for inflation and the current account that were far better than originally envisaged. Inflation was lowered to below 5 per cent, and the current account deficit was reduced to 3.9 per cent of GNP, while output grew by 5.4 per cent.

A main element of the Government's adjustment strategy in 1982 was a reduction of the public sector deficit. The attainment of this goal was made difficult by a poor revenue performance resulting from the sharp decline in inflation, the slowdown in economic activity, and sluggish imports. Nevertheless, the Government was successful in trimming the deficit to 4.6 per cent of GNP (W 2.2 trillion) through strict expenditure control (the expenditure/GNP ratio fell by 1.3 percentage points), as well as improvements in the financial performance of the Grain Management Fund, the Supply Fund (procurement office), and the Fiscal Monopoly (tobacco and ginseng products).

Early in 1982, the Korean authorities changed the instruments by which they conduct monetary policy. The Bank of Korea eliminated credit ceilings on individual banks and adopted a system of reserve money management. The task of monetary management was complicated in mid-year by a financial scandal in the curb loan market, which forced two large corporations into default. A curtailment of lending in the curb market (which provides a significant portion of the industrial and commercial finance in Korea) created serious liquidity problems for many firms. The Government took immediate action to prevent a generalized financial crisis by allowing a rapid expansion of bank credit to offset the contraction of nonbank lending. During the June-September period, bank credit and broad money expanded at an annual rate of about 47 per cent. With the passing of the crisis, the authorities brought monetary expansion under control; broad money increased at an annual rate of 12 per cent during the period October 1982-April 1983.

In mid-1982, the Government reduced interest rates, which had become high in real terms because of the decline in inflation. Deposit rates were halved to 8 per cent, and lending rates, which ranged from 12 to 17.5 per cent, were unified at 10 per cent. The adjustment of interest rates was aimed at reducing interest costs of firms and spurring investment, while still maintaining a positive level of real interest rates. Domestic rates fell below foreign rates, but the differential narrowed as foreign rates declined in the latter part of the year.

Output growth, although below expectations, was satisfactory, in view of the weakness in export markets and the restraint in public spending. Fiscal incentives for new housing provided a major impetus for the expansion of the economy. A sharp pickup in residential construction contributed to a 12 per cent increase in gross fixed investment, which had declined in the previous two years. Agricultural output expanded at its

trend rate of growth of about 4 per cent. Production in the manufacturing sector remained sluggish because of weak export demand and a substantial drawdown of inventories. The marked improvement in price performance was associated with the sizable decline in foreign prices (import prices fell by 8 per cent and export prices by 4 per cent) as well as the anti-inflationary policies of the Government.

The current account deficit in 1982 was almost halved to US$2.5 billion (3.9 per cent of GNP), reflecting mainly an improvement in the terms of trade and higher earnings from overseas construction (Appendix Table I). Import volume increased by only 4 per cent due to reductions in oil and rice imports, although capital goods imports increased sharply. Export volume grew by 6 per cent despite weak external demand and the rise in protectionist pressures abroad. A bouyant performance of the ship-building industry, however, masked the weak growth of other exports. Despite the strengthening of the current account, the overall balance of payments deficit increased to US$2.7 billion, as net capital inflows declined and errors and omissions recorded an outflow of US$1.4 billion.1/ By end-1982, gross international reserves stood at US$7.2 billion (about 2.7 months of imports of goods and services).

The growth in external debt, which had averaged about 28 per cent per annum during 1979-81, was slowed to 15 per cent in 1982 (Appendix Table II). Outstanding debt (including public, publicly guaranteed, and private sector bank and nonbank debt of all maturities) rose by close to US$5 billion to US$37.3 billion (56 per cent of GNP). The authorities believe that this amount of debt, although high, is well within manageable levels; service payments (including interest payments on short-term debt) in 1982 remained at about 21 per cent of exports of goods and services. The authorities shared the staff's concern that the recent rapid expansion of short-term debt had increased Korea's vulnerability to potential disruptions in international capital markets. Short-term debt increased by an annual average rate of 25 per cent during 1979-82, raising its share in total debt from 29 per cent at end-1978 to 38 per cent at end-1982;2/ the ratio of external reserves to short-term debt fell from 110 per cent in 1978 to 50 per cent in 1982. The substantial increase in short-term debt, which outpaced the growth of imports, reflected the availability and relatively favorable terms of short-term credits (Chart 2).

The slow growth of exports (excluding ship-building) during 1982 was associated with the erosion of external competitiveness as well as with unfavorable market conditions. Following the exchange rate adjustment

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1/ The unusually large errors and omissions could reflect an underestimation of the current account deficit as well as possible outflows of short-term capital in response to both interest rate differentials and currency speculation.

2/ Short-term debt in Korea includes short-term liabilities of commercial banks. A portion of these liabilities are associated with borrowings by branches of foreign banks in Seoul from their parent banks. It should be noted, however, that part of these borrowings are in turn on-lent on a medium- and long-term basis.

in 1980, the won has been linked to a basket of major currencies. During the first ten months of 1982, the won depreciated by about 6 per cent against the U.S. dollar (the intervention currency); but because of the appreciation of the dollar, the effective exchange rate appreciated by 4 per cent in nominal terms and by 3 per cent in real terms. To restore competitiveness, the Government allowed the won to depreciate in December 1982, along with the dollar, against other foreign currencies; during the November 1982-March 1983 period, the won depreciated by 6.5 per cent in real effective terms.

The authorities stated that a major obstacle facing Korean exporters has been protectionism, particularly in the industrial countries; during 1982, industrial countries had increased administrative and other barriers to Korean exports. Data available for the first nine months of the year indicate that 41 per cent of merchandise exports to OECD members (representing 26 per cent of total merchandise exports) were subject to various import restrictions--textiles, steel and electronic products were particularly affected by these restrictions. In addition, anti-dumping investigations initiated in a number of industrial countries had created uncertainties which slowed the expansion of Korean exports. Exports to developing countries were affected by the growing reliance of these countries on counterpurchase arrangements and trade restrictions. The authorities indicated that the restrictive trade practices abroad had constrained their efforts to liberalize imports. Nevertheless, they had proceeded to liberalize imports to improve the efficiency of Korean industries. Effective July 1, 1982, import items on the automatically approved list were increased from 74.7 per cent of total import items to 76.6 per cent.

IV. Adjustment Program for 1983-84 1/

1. Objectives and prospects

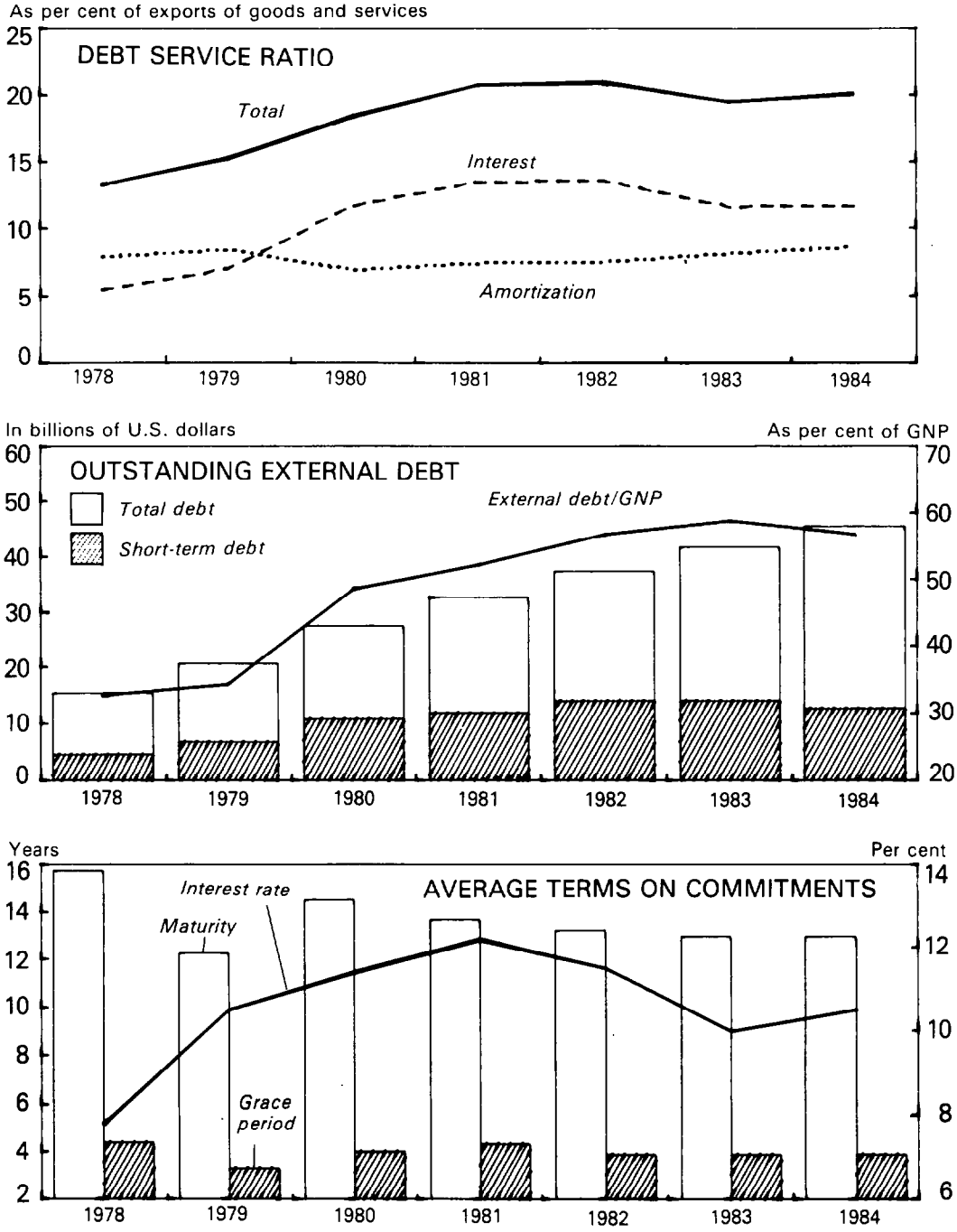
The substantial progress made last year in reducing both inflation and the current account imbalance has already surpassed the targets set initially for 1986 in the Fifth Five-Year Plan. The authorities intend to consolidate the gains of 1982 and make further progress in achieving their macroeconomic objectives. Accordingly, targets of the program include: containment of inflation (CPI) to below 5 per cent; reduction in the current account deficit to 3.2 per cent of GNP in 1983 and to 2.5 per cent in 1984; and output growth of 7.5 per cent in both years. Control of inflation is given top priority; the authorities are intent upon eradicating inflationary expectations to establish the foundation for a sustained and balanced growth of the economy.

1/ The financial program is summarized in Annex III.

CHART 2

KOREA

EXTERNAL DEBT INDICATORS, 1978-84



Sources: Korean authorities; and Fund staff projections.

The current account objectives reflect the authorities' desire to limit their dependence on external borrowing. The external environment is expected to improve in 1983. There are early signs that the recovery in industrial countries, particularly the United States, is under way. However, the decline in foreign prices, which last year made a major contribution to reducing the current account deficit, is not expected to be repeated in 1983.1/ In line with the projected growth in external demand and the recent improvement in competitiveness, export volume is projected to increase by 7-8 per cent (largely on the strength of nonship exports). A decline in the oil import bill is anticipated to exceed by US$0.5 billion a reduction in construction and export receipts from oil-exporting countries. Higher prices of raw materials and the revival of the manufacturing sector would increase non-oil imports by about 14 per cent (Table 3). The overall balance of payments deficit is projected to be US$1.7 billion. The balance of payments targets for 1983 appear realistic and are in line with developments so far in the year.2/

Based on the strong growth of real GNP and the price performance so far in 1983, the authorities are confident that their domestic objective will be met.3/ Higher investment and export growth are expected to lead the upswing in economic activity. Residential construction is expected to remain buoyant and nonresidential investment to increase further with improved demand and profits.

2. Policies

a. Fiscal policy

The authorities will continue their efforts to reduce the public sector deficit. The Central Government's expenditures and revenues are expected to increase in line with the rise in GNP. Overall expenditures are budgeted to decline as a ratio of GNP to 25.0 per cent (25.5 per cent in 1982), reflecting an improved financial position of the enterprise funds (Table 4). The composition of expenditures will continue to shift toward priority areas of the Fifth Five-Year Plan (i.e., education, health, social security and welfare, and housing). Substantial savings are expected to be realized by better management of the enterprise funds and by appropriate pricing policies. In particular, the authorities

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1/ Import prices are expected to rise by 1 per cent in 1983 compared with a decline of 8 per cent in 1982. External terms of trade are expected to improve by 1 per cent in 1983, compared with 4 per cent in 1982.

2/ According to preliminary data, the current account deficit in the first four months of 1983 was US$0.7 billion and the overall deficit was US$0.5 billion.

3/ Real GNP grew by 9.3 per cent in the first quarter of 1983 and consumer prices rose by 4.3 per cent during the 12-month period ending April 1983.

have indicated that purchase and release prices of rice will be adjusted to reduce the deficit of the Grain Management Fund. Revenues are projected to remain at about 21 per cent of GNP. Increases associated with the underlying elasticity of the tax system and with the lagged effects of the tax reform package introduced in January 1982 are anticipated to exceed the negative impact on revenues of the stimulative tax package introduced in January 1983. The recent decision to impose a tariff of 5 per cent on imported oil will provide additional revenues.

Table 3. Korea: External Indicators, 1979-84

(In billions of U.S. dollars)

	1979	1980	1981	1982	Program 1983	Program 1984
Exports	14.7	17.2	20.7	21.0	23.0	26.8
Imports	-19.1	-21.6	-24.3	-23.4	-25.3	-28.4
Current account balance	-4.2	-5.3	-4.6	-2.5	-2.3	-2.0
(As a per cent of GNP)	(-6.9)	(-9.4)	(-7.4)	(-3.9)	(-3.2)	(-2.5)
Overall balance	-1.0	-1.9	-2.3	-2.7	-1.7	-1.0
External debt outstanding disbursed	20.5	27.4	32.5	37.3	41.7	45.4
(Total external debt as a per cent of GNP)	(34.1)	(48.4)	(52.1)	(56.6)	(58.7)	(56.6)
(Short-term debt as a per cent of total external debt)	(32.2)	(39.1)	(36.3)	(38.1)	(34.1)	(28.2)
(Debt service ratio)	(15.2)	(18.4)	(20.7)	(20.9)	(19.5)	(20.0)
External reserves	5.9	6.8	7.1	7.2	7.7	8.2
(In months of imports of goods and services)	(2.8)	(2.8)	(2.6)	(2.7)	(2.7)	(2.6)
(As a per cent of short-term debt)	(89.6)	(64.0)	(60.5)	(50.7)	(54.2)	(64.1)

Sources: Appendix Tables I and II.

Adherence to the budgetary ceiling for expenditures, together with the attainment of the revenue target (which appears likely on the basis of staff estimates), would ensure that the public sector deficit would not exceed the level of the 1982 deficit of W 2.2 trillion (4.0 per cent of projected GNP for 1983). The authorities indicated that should a revenue shortfall materialize, they would lower expenditures to contain the

public sector deficit to the program target. Bank financing of the combined deficit of the public sector and the Fertilizer Fund 1/ will be limited to W 550 billion (a performance criterion under the program), equivalent to 1.0 per cent of GNP.

Table 4. Korea: Central Government and Consolidated Public Sector, 1979-83

	1979	1980	1981	1982	1983 Program
		(In trillions of won)			
Central Government					
Expenditure 1/	6.0	7.6	10.2	11.6	13.2
Revenue	5.5	6.8	8.6	10.0	11.3
Deficit	-0.5	-0.8	-1.6	-1.6	-1.9
Consolidated public sector					
Expenditure 1/	6.2	8.5	11.4	12.3	13.7
Revenue	5.8	7.3	9.3	10.1	11.5
Deficit	-0.4	-1.2	-2.1	-2.2	-2.2
Domestic bank financing	-0.1	0.4	0.9	0.3	0.5
Other domestic financing 2/	0.3	0.5	0.7	1.2	1.1
Foreign financing	0.2	0.3	0.5	0.7	0.6
		(In per cent of GNP)			
Central Government					
Expenditure 1/	20.6	22.4	24.0	24.1	24.1
Revenue	18.7	19.9	20.3	20.7	20.7
Deficit	-1.9	-2.5	-3.7	-3.4	-3.4
Consolidated public sector					
Expenditure 1/	21.4	24.6	26.8	25.5	25.0
Revenue	19.9	21.2	21.8	20.9	21.0
Deficit	-1.5	-3.4	-5.0	-4.6	-4.0

Sources: Ministry of Finance; and Fund staff estimates.

1/ Includes net lending.
2/ Includes nonbank financing and discrepancies between the cash and accrual budget.

1/ Bank financing of the Fertilizer Fund (a government-directed agency in the private sector) is projected to be W 100 billion.

As the preparation of the 1984 budget is only in its early stages, the authorities are not in a position to make specific commitments at this time. They have stated, however, that fiscal policy in 1984 will be consistent with the objectives of the program. Further adjustments will be made to scale down the relative size of the Government, and the ratio of the public sector deficit to GNP will be reduced at a pace similar to that envisaged for 1983.

b. Monetary policy

The authorities are determined to restrain credit expansion in order to avoid a rekindling of inflation and to support their balance of payments objective. Tight credit policy since September 1982 has been instrumental in holding down inflation. During the first quarter of 1983, net domestic assets have increased at an annual rate of about 14 per cent, but they are expected to grow more rapidly in the latter part of the year because of seasonal factors. Under the program ceiling (a performance criterion), net domestic assets of the banking system will not exceed W 28.8 trillion by the end of 1983--a 19 per cent increase during the year (Table 5). The Government's commitment to limit the public sector's credit requirement (to 12 per cent of the increase in net domestic assets) will allow adequate room for the expansion of credit to the private sector. Credit policy is consistent with the projected decline in net foreign assets and a 15 per cent growth of broad money. Monetary expansion is in line with the estimated demand for money based on projected GNP growth, lowered inflationary expectations, a narrowing of interest rate differential between the bank and nonbank financial sectors, and some reflow of funds into the nonbank financial sector. Considerable uncertainty exists concerning the extent of the narrowing of interest rate differentials and of the reflow of funds. The authorities are closely monitoring the situation and will avoid an excessive creation of liquidity. Recent measures to slow reserve money expansion and to tighten the rediscount policy should ensure that the ceiling for credit expansion is not exceeded.

Interest rate policy will be formulated to preserve a positive level of real interest rates (relative to CPI inflation) so as to ensure continued mobilization of financial savings. In addition, due attention will be given to the movements in foreign interest rates and their implications for capital flows.

c. Wage policy

The Government's wage policy is designed to dampen inflationary pressures and to improve Korea's international competitiveness. The increase in government wages in 1983 has been set at 6 per cent--government wages rose by 10 per cent in 1982. By effectively freezing the real wages of civil servants, the Government is seeking to moderate wage demands in the private sector. The guidelines established for the private sector call for a wage increase of 10 per cent; such an increase would limit the rise in real wages to below that of productivity and reinforce the Government's anti-inflationary efforts. Many of the large firms have already announced their intention of limiting wage increases to below this target.

Table 5. Korea: Monetary Survey, 1979-83

(In trillions of won; end of period)

	1979	1980	1981	1982	1983 Program
Net foreign assets	0.2	-0.6	-2.3	-4.3	-5.9
Net domestic assets	9.6	13.1	17.9	24.2	28.8
Net credit to the public sector 1/	0.3	0.7	1.7	2.2	2.7
Credit to the private sector	11.5	16.0	20.3	25.4	29.8
Net other items	-2.2	-3.7	-4.1	-3.3	-3.7
Broad money	9.9	12.5	15.7	19.9	22.9
(Percentage change)	(24.6)	(26.9)	(25.0)	(27.0)	(15.0)

Sources: Ministry of Finance; and Fund staff estimates.

1/ Includes the Fertilizer Fund.

d. Exchange rate policy

External competitiveness has improved significantly with the recent effective depreciation of the won. The authorities believe that this improvement has been sufficient to restore profitability in the export sector. However, they affirmed their intention to use exchange rate policy in support of their balance of payments objectives. The exchange rate will be managed to prevent a deterioration in competitiveness due to relative price movements or realignments of major currencies; in this context, the authorities cited the depreciation of the won against the dollar (by about 3 per cent) during the first four months of 1983 (Chart 3).

e. External debt policy

The growth in external indebtedness in 1983 is projected to slow to below 12 per cent. The increase in stock of outstanding external debt in 1983, including all maturities but excluding the use of Fund resources (of SDR 156 million net), will be limited to US$4.2 billion (a performance criterion). This ceiling on external debt will allow an accumulation of international reserves of about US$0.5 billion to US$7.7 billion (equivalent to 2.7 months of projected imports of goods and services in

1983). The stock of external debt will rise to US$41.7 billion by the end of 1983. The net financing requirement is projected to decline to US$3.7 billion in 1984. Korea's outstanding external debt will continue to remain high (Korea is currently the fourth largest debtor among developing countries), but its debt servicing obligations will remain consistent with its capacity to earn foreign exchange during the program period; debt service payments (including interest payments on short-term debt) in 1983 and 1984 will remain about 20 per cent of exports of goods and services. The external financing requirements in 1983 and 1984 should not pose a problem, although borrowing terms may harden because of the general worsening of market conditions.

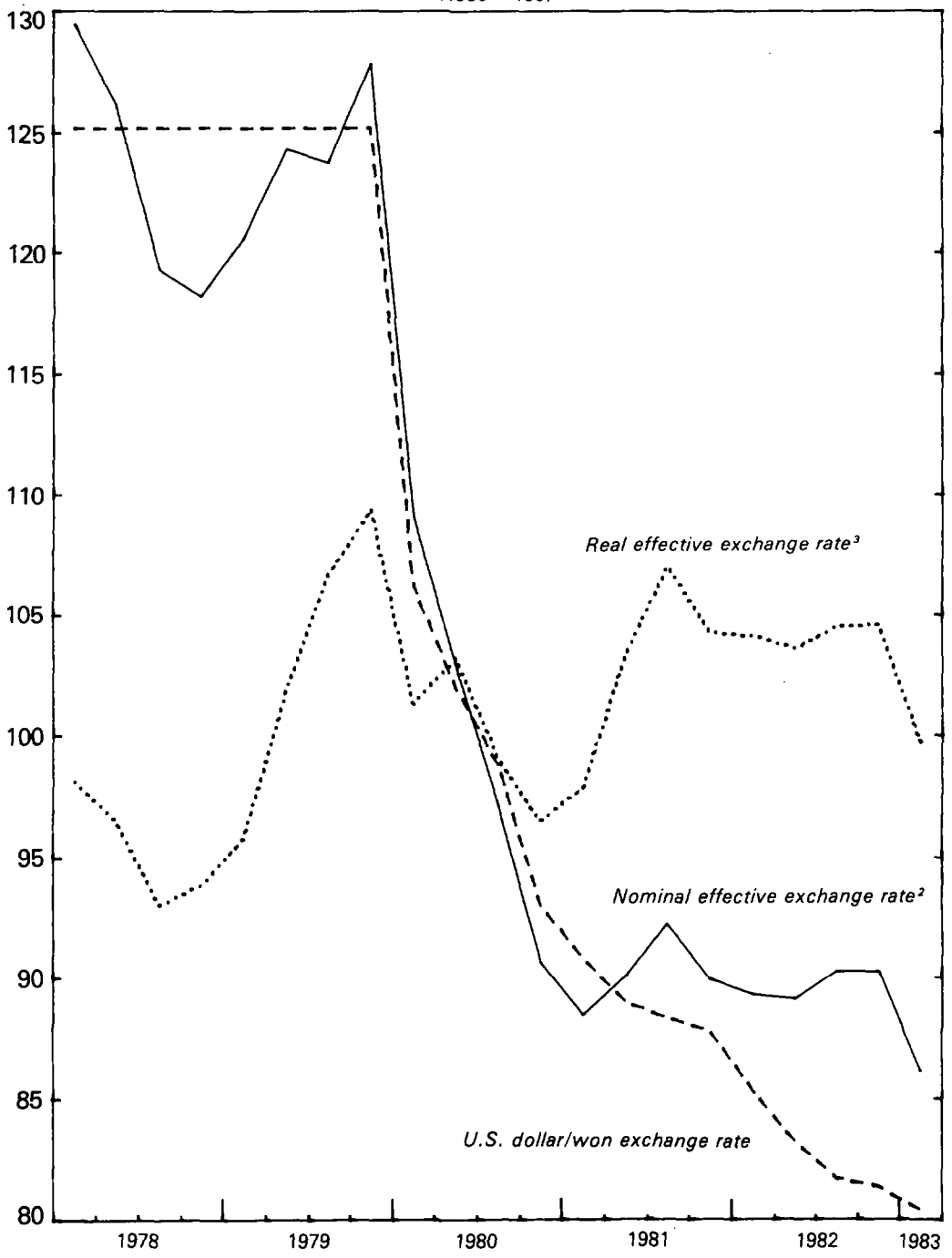
To safeguard against financial difficulties that might occur in case of disruptions in international capital markets, the authorities have decided to reduce the level of short-term debt over the program period. The pace of implementation of this policy naturally depends on market conditions. The authorities indicated that Korea's access to medium- and long-term borrowings in 1983 may prove to be limited under current unsettled market conditions, even at higher spreads. The program provides that the level of short-term debt at the end of 1983 not exceed the level at the end of 1982, US$14.2 billion (a performance criterion). The authorities are committed to reduce short-term debt during 1984; the ceiling for 1984 will be set at the time of the mid-term review in early 1984.

To assess the viability of Korea's external position, the staff has developed two alternative medium-term scenarios of the balance of payments for the period 1985-87 (Table 6). Scenario A is broadly in line with the official balance of payments projections,1/ while scenario B is based on more conservative assumptions relating to export growth and external terms of trade. In both scenarios, the ratios of investment and savings to GNP would rise closer to the average of these ratios prior to 1980. Under scenario A, the current account deficit would be eliminated by 1986 and turn to a small surplus in 1987; external debt would decline to 47 per cent of GNP by 1987, and debt service payments would fall to 16.7 per cent of exports of goods and services. Under scenario B, the current account deficit would decline by 1987 to 2.3 per cent of GNP, the external debt to 52 per cent of GNP, and the debt service ratio to 18.1 per cent. An important prerequisite for these outcomes is continued access of Korean exports to foreign markets.

The authorities indicated that the larger current account deficits under scenario B were not acceptable; if actual external factors turned out to be closer to the more conservative assumptions, additional measures would be taken to achieve their objective of eliminating the current account imbalance by 1987. The staff expressed the view that in light of uncertainties in the international capital markets, the authorities' policy to reduce its recourse to external financing was appropriate.

1/ Official projections are provided in the Economic Management Plan for 1983, prepared by the Economic Planning Board.

CHART 3
KOREA
EXCHANGE RATE DEVELOPMENTS[1], Q1 1978-Q1 1983
(1980 = 100)



Sources: IMF, *International Financial Statistics;* and Fund staff calculations.
[1]An increase in the index represents an appreciation.
[2]Trade weighted.
[3]Nominal effective exchange rate adjusted for relative movements in wholesale price index.

Nevertheless, Korea's high marginal productivity of capital and its present stage of development justified continued reliance on foreign savings, albeit less than in the past.

Table 6. Korea: Medium-Term Scenarios, 1982-87

	1982	1983	1984	1985		1986		1987	
				A	B	A	B	A	B
	(In billions of U.S. dollars)								
Exports 1/	28.5	31.0	35.6	41.0	40.2	47.0	45.4	53.9	51.3
Imports 1/	31.5	33.8	38.1	43.0	42.9	48.1	48.2	53.9	54.3
Current account 2/	-2.5	-2.3	-2.0	-1.5	-2.2	-0.6	-2.3	0.5	-2.5
External debt	37.3	41.7	45.4	48.6	49.3	51.4	53.1	53.4	56.4
	(As per cent of GNP)								
Investment	26.5	28.0	28.0	28.5	28.0	28.5	28.0	28.5	28.0
Savings	22.6	24.8	25.5	26.9	25.5	27.9	25.7	28.9	25.7
Current acccount	-3.9	-3.2	-2.5	-1.6	-2.5	-0.6	-2.3	0.4	-2.3
External debt	56.6	58.7	56.6	53.7	56.5	50.8	54.0	47.2	52.1
Debt service ratio 3/	20.9	19.5	20.0	19.2	19.4	18.4	19.2	16.7	18.1

Source: Appendix Tables I, II, and III.
1/ Includes services.
2/ Includes net transfers.
3/ As a ratio of exports of goods and services.

f. Structural policies

During the program period, the authorities will continue to pursue policies aimed at increasing the productivity and efficiency of the economy. These policies encompass the scope and composition of public sector investment, industrial restructuring, tax and financial sector reform, and trade liberalization. In assessing these policies, the staff has benefited from the views of the World Bank staff, who have had extensive discussions with the authorities on the details of their structural policies; preparation of an industrial finance loan and a second structural adjustment loan to support these policies have reached an advanced stage.1/

1/ Information on Korea's financial relations with the World Bank are provided in Annex II.

(i) Public sector investment program

The investment program is designed to support an increasingly urban and industrial economy. The World Bank staff considers the investment program to be well-conceived; the Bank is actively supporting elements of the program through project loans. An important objective of the investment plan is the reduction of dependency on imported petroleum through expansion of domestic coal production and construction of electricity plants powered by coal, LNG, and nuclear fuel. The opening of the third nuclear power station in April 1983 will raise the contribution of nuclear power to total generating capacity from 12 per cent to 15 per cent. The Government intends to press on with its program of building nuclear power stations and to reach its target of supplying nearly 40 per cent of electricity from this power source.

To reinforce its efforts to conserve energy, the Government has passed through to domestic consumers only 30 per cent of the US$5 per barrel reduction in OPEC oil prices; domestic prices of only two oil products--fuel oil and naphtha--have been lowered significantly (i.e., between 6 and 10 per cent). About 40 per cent of the savings from the decline in OPEC oil prices has been earmarked for a special multipurpose fund to finance projects primarily in the energy area; the remainder of the savings has been absorbed by an import duty.

Housing is the centerpiece of the Government's social development efforts, as basic needs for clothing and food have largely been met. Housing construction will be promoted by a combination of financial incentives to private investors and direct public sector investment. Approximately 20 per cent of fixed capital formation over the next three years is allocated for housing. The urban mass transit is being modernized through the construction of subway systems in Seoul and Pusan (to be completed in the mid-1980s). In agriculture, greater reliance will be placed on investments, rather than on direct price supports, to improve productivity. Agricultural investment will concentrate on farm mechanization, modernization of marketing services, and construction of small manufacturing firms in rural areas to increase off-farm income. The irrigation network will be extended by building seven multipurpose dams.

(ii) Industrial restructuring

The Government will support the development of high-technology industries. The assimilation of new technology will be accelerated by placing more emphasis on research and development and providing technical assistance to industry. Foreign investment laws will be further liberalized to encourage joint ventures and technical licensing agreements. To ensure that small- and medium-sized firms have equal access to new technology, a venture capital system will be operated by the Korean Technology Development Corporation. Revitalization of small- and medium-sized industries is an important element of the Government's efforts to generate employment for the rapidly growing labor force.

(iii) Tax and financial sector reforms

The recent tax reform measures (effective January 1983) modify the exemption and deduction system (by reducing the number of industries eligible for special tax advantages) and simplify and lower individual and corporate tax rates. In the coming years, the Government will continue to simplify the corporate tax structure, to improve the administration of the value added tax, and to eliminate differential taxation of income from different sources. As part of the continuing financial sector reform, the Government has imposed punitive tax rates on income from financial assets held under assumed names.

The Government has also decided to reduce reliance on centralized investment planning and to enhance the role of market signals. Toward this goal, the Government has transferred ownership of the remaining nationwide commercial banks to the private sector and has permitted the development of autonomous banking management. Banks will also be exposed to greater competition by permitting freer entry into bank and nonbank financial markets and by easing regulations on the types of services, deposits, and loan instruments that banks can provide. To further improve the process of financial intermediation, the Government intends to liberalize interest rates gradually.

(iv) Exchange and trade liberalization

The exchange system has been progressively liberalized. Korea does not maintain any restrictions on current international transactions that require Fund approval under Article VIII, but there are a number of restrictions maintained in accordance with Article XIV.1/ Korea has continued to liberalize exchange restrictions as part of its efforts to improve the efficiency of Korean industry. An expansion of the automatic approval list scheduled for July 1, 1983 is expected to increase the import liberalization ratio to 80 per cent. The authorities' medium-term goal is to raise this ratio gradually to 90 per cent--the level presently prevailing in industrialized countries--by 1986. The Government, in conjunction with the business and academic communities, is studying a proposal to restructure import tariffs. Under this proposal, import tariffs, which presently range from zero to 100 per cent, would be gradually adjusted by 1988 to a uniform rate of 20 per cent for finished products and 5-10 per cent for raw materials.

3. Performance criteria 2/

The program contains the following quantitative performance criteria: (1) quarterly ceilings for September 30 and December 31, 1983 on the stock of net credit to the public sector from the banking system (paragraph 2 of the Technical Memorandum attached to the Letter of Intent,

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

2/ Quantitative performance criteria are presented in Annex III.

Attachment II); (2) quarterly ceilings for September 30 and December 31, 1983 on the stock of net domestic assets of the banking system (paragraph 3 of the Technical Memorandum); and (3) a ceiling for December 31, 1983 on the stock of 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 4 of the Technical Memorandum). The program contains the customary injunction against the introduction or intensification of exchange and trade restrictions. A review clause is also included, as a performance criterion, which requires consultation with the Fund prior to April 30, 1984 (i.e., before the fourth purchase can be effected) to reach understandings with the Fund on suitable performance criteria for the remainder of the program period (paragraph 3 of the Letter of Intent). Total purchases will not exceed SDR 192 million (75 per cent of quota) until the review has been concluded.

V. Staff Appraisal

The authorities' stabilization policies have brought about considerable adjustment since 1980, when the economy foundered after a decade and-a-half of remarkable performance. In 1982, the decline in foreign prices reinforced the Government's adjustment policies and resulted in a substantial reduction in domestic inflation and the current account deficit. The public sector's financial position improved through expenditure restraint, while monetary policy struck a delicate balance between dampening inflation and stimulating the economy. Notwithstanding the large decline in domestic inflation, external competitiveness remained unfavorable during most of 1982 and contributed to the sluggishness of exports (excluding ship-building). The decision to allow the won to depreciate along with the dollar in December 1982 resulted in a significant improvement in competitiveness.

The adjustment program for 1983 and 1984, in support of which the authorities have requested a stand-by arrangement, seeks to reduce the external imbalance further, to contain inflation to below 5 per cent, and to raise output growth. During the program period, projected debt service payments will rise in line with the increase in export earnings. To realize these objectives, the Government has stepped up its adjustment effort, which is built on a firm commitment to fiscal discipline and monetary restraint.

Under the program, the public sector deficit in 1983 will be reduced to 4 per cent of GNP through strict expenditure control and improvements in the financial position of the enterprise funds. The staff urges the adoption of the necessary measures to reduce the financing requirement of the enterprise funds, particularly that of the Grain Management Fund. Continued fiscal adjustment is anticipated in 1984. The Government's intention is to reduce the public sector deficit as a ratio to GNP in 1984 at a pace similar to that anticipated for 1983. In line with the inflation and external objectives, the program envisages a substantial

slowdown in the growth of money and credit. The relatively small credit requirement of the public sector will ensure that the credit needs of the private sector will be met. The recent curtailment of credit expansion through the control of reserve money gives every indication that the authorities will be able to achieve their monetary target. Interest rate policy will aim at preserving a positive level of real interest rates and will also take into account movements in foreign interest rates.

Growth in external indebtedness is projected to slow markedly in 1983 and 1984. The level of Korea's outstanding external debt is consistent with its debt servicing capacity. However, the maturity structure of its debt has shortened excessively in the recent past. Notwithstanding the underlying strength of the Korean economy, the sharp accumulation of short-term debt in recent years has increased Korea's vulnerability to potential disruptions in international capital markets. This vulnerability will be substantially reduced by the Government's decision to freeze the level of short-term debt in 1983 and to reduce it in 1984. The authorities' well-conceived adjustment effort should bolster Korea's standing in financial markets and enhance its ability to raise the required medium- and long-term loans. The staff's medium-term projections indicate that Korea's external debt position should further improve after the program period, provided that appropriate policies continue to be pursued.

Korea's ability to service its external debt depends critically on the performance of exports. The present level of competitiveness should be adequate for the realization of external objectives. The staff attaches great importance to the authorities' commitment to support the balance of payments objective and protect export competitiveness by a flexible management of the exchange rate. The attainment of export targets also requires that Korea's access to foreign markets is not impeded by protectionism.

The Government's structural policies, encompassing the composition of public sector investment, industrial restructuring, tax and financial sector reforms, and trade liberalization, should further improve resource allocation during the program period. The authorities' continued efforts to liberalize imports are particularly encouraging.

The staff believes that the program targets and associated policies represent a comprehensive adjustment effort worthy of Fund support. Notwithstanding Korea's ability to borrow in international capital markets, the large balance of payments need of Korea relative to its quota justifies access to Fund resources on the scale proposed. The authorities' record of economic management testifies to their commitment to effectively implement the required policies and attain the objectives of the program.

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

VI. Proposed Decisions

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

Article IV Consultation

1. The Fund takes this decision in concluding the 1983 Article XIV consultation with Korea, in the 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 restrictions 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 .., 1983 to April 30, 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).

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

(In billions of U.S. dollars)

	1979	1980	1981	1982	1983	1984
					Program	
Exports, f.o.b.	14.7	17.2	20.7	21.0	23.0	26.8
Volume (percentage change)	(-0.9)	(11.2)	(17.3)	(5.8)	(7.6)	(11.0)
Unit value (percentage change)	(16.5)	(5.3)	(2.5)	(-4.2)	(2.0)	(5.0)
Imports, f.o.b.	-19.1	-21.6	-24.3	-23.4	-25.3	-28.4
Volume (percentage change)	(11.8)	(-13.6)	(7.4)	(4.3)	(7.2)	(7.5)
Unit value (percentage change)	(17.9)	(26.9)	(4.8)	(-7.8)	(1.0)	(4.4)
Services - receipts	4.8	5.4	6.6	7.5	8.0	8.8
Services - payments	-5.0	-6.7	-8.1	-8.1	-8.5	-9.7
Transfers (net)	0.4	0.4	0.5	0.5	0.5	0.5
Current account balance	-4.2	-5.3	-4.6	-2.5	-2.3	-2.0
(As a per cent of GNP)	(-6.9)	(-9.4)	(-7.4)	(-3.9)	(-3.2)	(-2.5)
Long-term capital (net)	2.7	1.9	2.8	1.3	1.2	1.0
Short-term capital (net)	0.8	1.9	-0.1	-0.1)		
				)	-0.6	--
Errors and omissions	-0.3	-0.4	-0.4	-1.4)		
Overall balance	-1.0	-1.9	-2.3	-2.7	-1.7	-1.0
Monetary movements	1.0	1.9	2.3	2.7	1.7	1.0
Assets	-0.9	-1.0	-0.4	-0.6	-0.5	-0.5
Liabilities	1.9	2.9	2.7	3.3	2.2	1.5
Use of Fund resources (net)	(-0.1)	(0.6)	(0.6)	(0.1)	(0.2)	(0.1)
Other bank liabilities	(2.0)	(2.3)	(2.1)	(3.2)	(2.0)	(1.4)
Memorandum items:						
Gross international reserves	5.9	6.8	7.1	7.2	7.7	8.2
(Months of imports of goods and services equivalent)	(2.8)	(2.8)	(2.6)	(2.7)	(2.7)	(2.6)
(As a per cent of short-term debt)	(89.6)	(64.0)	(60.5)	(50.7)	(54.2)	(64.1)

Sources: Ministry of Finance; and Fund staff estimates.

Table II. Korea: External Debt, 1979-84

(In billions of U.S. dollars)

	1979	1980	1981	1982	1983	1984
					Program	
External debt outstanding 1/ (end of period)						
Medium- and long-term debt	13.8	16.1	19.4	21.8	26.0	31.0
Short-term debt	6.6	10.6	11.8	14.2	14.2	12.8
(Trade-related)	(3.8)	(6.6)	(7.7)	(8.8)	(...)	(...)
(Swap arrangements)	(0.4)	(0.9)	(1.0)	(1.5)	(...)	(...)
(Other)	(2.4)	(3.1)	(3.1)	(3.9)	(...)	(...)
Use of Fund resources	0.1	0.7	1.3	1.3	1.5	1.6
Total	20.5	27.4	32.5	37.3	41.7	45.4
(Excluding IMF)	(20.4)	(26.7)	(31.2)	(36.0)	(40.2)	(43.8)
Debt service						
Principal repayment	1.6	1.5	2.0	2.1	2.5	3.0
Interest payments	1.4	2.6	3.7	3.8	3.6	4.1
On short-term debt	(0.4)	(1.2)	(1.9)	(1.5)	(1.5)	(1.4)
On medium- and long-term debt	(1.0)	(1.4)	(1.8)	(2.3)	(2.1)	(2.7)
Total	3.0	4.1	5.7	5.9	6.1	7.1
(As a per cent of exports of goods and services)	(15.2)	(18.4)	(20.7)	(20.9)	(19.5)	(20.0)
Memorandum items:						
Gross foreign financing requirements	6.7	8.4	7.1	6.9	6.9	6.7
Percentage increase in external debt outstanding	32.8	33.5	18.7	14.9	11.8	8.9
External debt outstanding as per cent of GNP	34.1	48.4	52.1	56.5	58.7	56.6
Share of short-term debt in total debt	32.2	39.1	36.2	38.1	34.1	28.2

Sources: Ministry of Finance; and Fund staff estimates.

1/ Includes public, publically guaranteed, and private sector bank and nonbank debt.

Table III. Korea: Medium-Term Scenarios, 1985-87

(In billions of U.S. dollars)

	1985		1986		1987	
	A	B	A	B	A	B
Debt service payments						
Interest	4.4	4.4	4.7	4.8	5.0	5.3
Amortization	3.4	3.4	3.9	3.9	4.0	4.0
Total	7.8	7.8	8.6	8.7	9.0	9.3
Debt service ratio (as a per cent of exports of goods and services)	19.2	19.4	18.4	19.2	16.7	18.1
Balance of payments (overall)	-0.6	-1.0	--	-0.8	0.8	-0.5
Current account	-1.5	-2.2	-0.6	-2.3	0.5	-2.5
(As a per cent of GNP)	(-1.6)	(-2.5)	(-0.6)	(-2.3)	(0.4)	(-2.3)
Exports of goods and services	41.0	40.2	47.0	45.4	53.9	51.3
Imports of goods and services	-43.0	-42.9	-48.1	-48.2	-53.9	-54.3
Of which: interest payments	(4.4)	(4.4)	(4.7)	(4.8)	(5.0)	(5.3)
Capital account (net)	0.9	1.2	0.6	1.5	0.3	2.0
Gross external reserves (in months of imports)	2.3	2.3	2.3	2.3	2.2	2.2
External debt outstanding	48.6	49.3	51.4	53.1	53.4	56.4
Of which: IMF (net)	(1.3)	(1.3)	(1.1)	(1.1)	(0.8)	(0.8)
(As a per cent of GNP)	53.7	56.5	50.8	54.0	47.2	52.1
Other macroeconomic variables (change in per cent)						
Real growth rate of GNP	7.5	7.0	7.5	7.0	7.5	7.0
Export unit value (in U.S.dollars)	5.0	4.0	4.0	3.0	4.0	3.0
Import unit value (in U.S. dollars)	5.0	5.0	4.0	4.0	4.0	4.0
Export volume	11.0	10.0	11.0	10.0	11.0	10.0
Import volume	8.0	9.0	8.0	9.0	8.0	9.0
Domestic price inflation	4.0	4.0	3.0	3.0	3.0	3.0
International rate of interest (LIBOR)	10.0	10.0	10.0	10.0	10.0	10.0

Sources: Ministry of Finance; and Fund staff estimates.

Summary of Fund Relations with Korea 1/

Date of membership:	August 26, 1955.
Exchange rate:	Determined daily on the basis of a currency basket; middle rate of US$1 = W 769.80 on May 25, 1983.
Quota:	SDR 255.9 million.
Proposed quota:	SDR 462.8 million.
Status:	Article XIV.

Use of Fund resources outstanding:	In millions of SDRs	Per cent of quota
Compensatory financing facility	266.2	104.0
Stand-by arrangement 2/	872.0	340.8
Of which: SFF	(616.1)	(240.8)
Total	1,138.2	444.8

SDR position:	Korea held SDR 9.78 million, or 13.41 per cent, of net cumulative allocation of SDR 72.9 million.
Gold distribution (four):	68,465.92 fine ounces.
Direct distribution of profits from gold sales:	US$12.72 million.
Technical assistance:	The Fund maintains a resident representative in Seoul. The position is currently held by Mr. D. Villanueva.
Last Article IV consultation:	Staff discussions were held in Seoul during January 31-February 13, 1982. The Staff Report (SM/82/54) was discussed by the Executive Board on May 5, 1982.

1/ As of May 31, 1983.
2/ Korea was granted two successive one-year stand-by arrangements in March 1980 and February 1981, respectively.

Activities of IBRD, IDA, and IFC in Korea

IBRD and IDA lending: 1/

	IBRD	IDA	Total	Per cent	Undisbursed
		(In millions of U.S. dollars)			
Agriculture and social development	598.0	32.5	630.5	15.0	145.7
Education	168.5	34.8	203.3	4.8	51.0
Development finance corporations	1,027.5	--	1,027.5	24.4	119.5
Industry	229.0	--	229.0	5.4	123.8
Population	30.0	--	30.0	0.7	28.5
Power	115.0	--	115.0	2.7	39.0
Program lending/SAL	425.0	--	425.0	10.1	--
Tourism	25.0	--	25.0	0.6	--
Transportation	1,000.5	43.5	1,044.0	24.8	158.1
Urbanization	270.0	--	270.0	6.4	218.9
Water supply and sewerage	215.0	--	215.0	5.1	128.1
Total	4,103.5	110.8	4,214.3	100.0	1,012.9
Repayments	434.3	4.4	438.7		
Debt outstanding including undisbursed):	3,669.2	106.4	3,775.6		
Commitments for FY 1983	977.0	--	977.0		

Structural adjustment loan: A loan in the amount of US$250 million, approved in December 1981, was fully disbursed at the end of 1982.

IFC activity: As of February 28, 1983, total loan and equity commitments amounted to US$135.3 million, of which US$0.7 million is undisbursed.

1/ As of March 31, 1983.

Korea: Summary of the Financial Program, 1983-84

I. Targets

1. The inflation rate is expected to remain below 5 per cent in both 1983 and 1984. The increase in consumer prices over the 12-month period ending in April 1983 was 4.3 per cent.

2. The current account deficit is projected to decline from $2.5 billion (3.9 per cent of GNP) in 1982 to $2.3 billion (3.2 per cent of GNP) in 1983 and to $2.0 billion (2.5 per cent of GNP) in 1984. The overall balance of payments deficit is programmed to decline from $2.7 billion in 1982 to $1.7 billion in 1983 and to $1.0 billion in 1984.

3. Real GNP is projected to rise by 7.5 per cent in both 1983 and 1984. A recovery in investment and an improvement in export performance are expected to provide the main impetus to growth. During the first quarter of 1983, real GNP grew by 9.3 per cent (over the first quarter of 1982).

II. Assumptions

1. The rate of inflation in Korea's trading partners (CPI) is expected to be 5 per cent a year in 1983 and 1984. Export unit values are projected to rise by 2.0 per cent in 1983 and 5.0 per cent in 1984. Korea's market growth (measured as the weighted increase in import volume of Korea's major trading partners) is anticipated to be 3 per cent in 1983 and 6 per cent in 1984. Prices for non-oil imports are projected to rise by 4.5 per cent in 1983 and 5.5 per cent in 1984. Non-oil import volume is forecast to increase by 9.5 per cent in 1983 and 9.4 per cent in 1984. The price of petroleum is projected to decline by 10 per cent in 1983 and remain stable in 1984. The volume of petroleum imports is expected to rise by 3 per cent in 1983 and 2 per cent in 1984.

2. The average interest rate on Korea's external debt is projected to decline from 11 per cent in 1982 to 9 per cent in 1983 in line with the decline expected in LIBOR and some increase in spreads. An average interest rate of 10 per cent is assumed for 1984.

3. Velocity, the ratio of nominal GNP to average broad money, is projected to decline by 4.5 per cent in 1983 compared with 11.0 per cent in 1982. Inflationary expectations are expected to decline to the actual rate of inflation in 1983. A narrowing of interest rates between the bank and nonbank financial sectors is projected in 1983 along with a flow of funds out of the banking system and into the nonbank financial sector.

4. Short-term capital outflows (including errors and omissions) are expected to decline from $1.5 billion in 1982 to $0.6 billion in 1983 and to near zero in 1984. Gross international reserves are programmed to increase by $0.5 billion in both 1983 and 1984.

III. Principal Elements of the Program 1/

1. Public sector policies

a. The authorities will utilize measures to control expenditures in order to achieve an improvement in the financial position of the public sector in 1983. Public sector expenditures are estimated to decline to 25.0 per cent of GNP in 1983 from 25.5 per cent in 1982. Strict adherence to budgetary ceilings on expenditures in the Central Government will be enforced. Budgetary savings are expected from improved management of the public enterprises and by appropriate pricing policies. The purchase and release price of rice will be adjusted to reduce the deficit of the Grain Management Fund. Revenues of the public sector are projected to remain virtually unchanged at 21.0 per cent of GNP; a new tariff of 5.0 per cent on imported oil will provide additional revenue in 1983. As a result of these policies, the public sector deficit is to be limited to W 2,215 billion in 1983, or equivalent to 4.0 per cent of GNP.

b. For 1984, the authorities are committed to reducing, at a pace similar to that envisaged for 1983, the ratio of the public sector deficit to GNP. Preparation of the budget for 1984 is still at its early stages; consequently, the authorities are unable to specify the measures underlying this commitment.

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 is 22.8 per cent of the previous year's stock of broad money.

b. Quarterly limits on net credit to the public sector from the banking system have been established as a performance criterion. Under the program, about one quarter of the public sector's deficit would be financed through the banking system.

c. Deposit interest rates are to be maintained at positive real levels (relative to CPI). Due regard will also be given to movements in foreign interest rates and their implications for Korea's balance of payments.

3. External sector

a. Exchange rate policy will be managed flexibly to ensure the attainment of the balance of payments objectives of the program and to protect the profitability of the export sector.

1/ Quantitative performance criteria through December 31, 1983 are provided in the attached table.

b. The increase in external debt of all maturities, but excluding IMF credit, will be limited to $4.2 billion in 1983 (performance criterion). The level of short-term debt at end-1983 will not exceed the level of such debt at end-1982 (performance criterion). Limits for 1984 will be set at the time of the mid-term review.

c. The authorities will continue to liberalize restrictions on current international payments by placing additional categories of imports on the automatically approved list. The import liberalization ratio (i.e., number of automatically approved items as a ratio of all imported items) will be raised from 76.6 per cent in 1982 to about 80.4 per cent in 1983. Further progress will be made in 1984 toward achieving the authorities' medium-term goal of a liberalization ratio of 90.0 per cent.

Korea: Stand-by Arrangement--Quantitative Performance Criteria for the Period Through December 1983

	Actual		Projection	Ceilings and Limits for 1983	
	Dec. 31, 1982	March 31, 1983	June 30, 1983	Sept. 30	Dec. 31
	(In billions of won)				
Net credit to the public sector from the banking system	2,158	2,065	2,291	2,500	2,708
Net domestic assets of the banking system	24,244	25,168	26,280	27,586	28,785
	(In millions of U.S. dollars)				
Outstanding external debt of all maturities, excluding IMF credit 1/	36,053	...	...	...	40,253
Outstanding short-term debt 2/	14,215	...	...	...	14,215

Sources: Ministry of Finance; and staff estimates.

1/ Increase is limited to US$4.2 billion.
2/ Defined as external debt with initial maturity of less than one year.

Korea--Stand-By Arrangement

Attached hereto is a letter, with annexed memoranda, dated June 3, 1983, from the Minister of Finance of Korea requesting a stand-by arrangement and setting forth:

(a) the objectives and policies that the authorities of Korea intend to pursue for the period of this stand-by arrangement;

(b) the policies and measures that the authorities of Korea intend to pursue for the first ten months of this stand-by arrangement; and

(c) understandings of Korea with the Fund regarding a review that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Korea will pursue for the remaining period of this stand-by arrangement.

To support these objectives and policies, the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For the period from , 1983 to March 31, 1985, Korea will have the right to make purchases from the Fund in an amount equivalent to SDR 575.775 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. (a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 96.00 million until October 31, 1983; the equivalent of SDR 192.00 million until January 31, 1984; the equivalent of SDR 256.00 million until April 30, 1984; the equivalent of SDR 320.00 million until July 31, 1984; the equivalent of SDR 383.85 million until October 31, 1984; and the equivalent of SDR 479.85 million until January 31, 1985.

(b) None of these limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Korea's currency in the credit tranches beyond 25 per cent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 per cent of quota.

3. Purchases under this stand-by arrangement shall be made from ordinary resources until purchases under the arrangement reach the equivalent of SDR 4,499; and thereafter from borrowed resources only, provided that any modification by the Fund of the proportions of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. Korea will not make purchases under this arrangement that would increase the Fund's holdings of Korea's currency in the credit tranches beyond 25 per cent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 per cent of quota:

(a) during any period until April 30, 1984, in which the data for the preceding calendar quarter indicate that

(i) the ceiling on net credit to the public sector from the banking system described in paragraph 2 of the Technical Memorandum annexed to the attached letter has been exceeded; or

(ii) the ceiling on net domestic assets of the banking system described in paragraph 3 of the Technical Memorandum annexed to the attached letter has been exceeded; or

(b) if Korea fails to observe the limits on outstanding disbursed external debt described in paragraph 4 of the Technical Memorandum annexed to the attached letter; or

(c) during the period April 30, 1984 to March 31, 1985 until understandings have been reached with the Fund on appropriate policies, and suitable performance criteria, have been established in consultation with the Fund, as contemplated by paragraph 3 of the attached letter, or after such performance criteria have been established, while they are not being observed; or

(d) during the entire period of this stand-by arrangement, if Korea

(i) imposes or intensifies restrictions on payments and transfers for current international transactions, or

(ii) introduces multiple currency practices, or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Korea is prevented from purchasing under this stand-by arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Korea and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Korea's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in

order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Korea. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Korea and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Korea, the Fund agrees to provide them at the time of the purchase.

7. The value date of a purchase under this stand-by arrangement involving borrowed resources will be normally either the 15th day or the last day of the month, or the next business day if the selected day is not a business day. Korea will consult the Fund on the timing of purchases involving borrowed resources.

8. Korea shall pay a charge for this arrangement in accordance with the decisions of the Fund.

9. (a) Korea shall repurchase the outstanding amount of its currency that results from a purchase under this stand-by arrangement, in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Korea's balance of payments and reserve position improves.

(b) Any reductions in Korea's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

(c) The value date of a repurchase in respect of a purchase financed with borrowed resources under this stand-by arrangement will be normally either the 6th day or the 22nd day of the month, or the next business day if the selected day is not a business day, provided that repurchase will be completed not later than seven years from the date of purchase.

10. During the period of the stand-by arrangement, Korea shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Korea or of representatives of Korea to the Fund. Korea shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Korea in achieving the objectives and policies set forth in the attached letter and annexed memoranda.

11. In accordance with paragraph 4 of the attached letter, dated June 3, 1983, Korea will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Korea has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Korea's balance of payments policies.

ATTACHMENT II

Seoul, Korea

June 3, 1983

Dear Mr. de Larosiere:

1. Annexed are (1) a Memorandum of the Government of the Republic of Korea on Certain Aspects of its Economic and Financial Policies for the period July 1, 1983 through December 31, 1984; and (2) a Technical Memorandum setting out certain operational guidelines for the conduct of economic policies from July 1, 1983 to December 31, 1983. The memoranda describe the measures that Korea already has taken and will take to consolidate the gains thus far achieved in adjusting its external accounts and lowering inflation.

2. In support of a program ending March 31, 1985, Korea requests herewith a stand-by arrangement with the International Monetary Fund in an amount of SDR 575.775 million, including access to the Fund's borrowed resources. Korea's request for access to Fund resources on this scale is justified by Korea's exceptional circumstances and particularly the large balance of payments need relative to quota.

3. The annexed Technical Memorandum presents operational guidelines and policy understandings for the period to December 31, 1983. Korea will conduct with the Fund prior to April 30, 1984 a review of progress under the program and in the context of that review reach understandings on appropriate policies and suitable performance criteria for the remaining period of the stand-by arrangement. The Government wishes to assure you at this time that these policies and performance criteria will be fully consistent with the objectives of the program.

4. The Government of the Republic of Korea believes that the policies set out in its annexed Memorandum on Certain Aspects of its Economic and Financial Policies, and further elaborated in the annexed Technical Memorandum, are adequate to achieve the objectives of this program, but it will take any further measures that may become appropriate for this purpose. 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 described in its annexed Memorandum on Certain Aspects of its Economic and Financial Policies and any policy adaptations judged to be appropriate for the achievement of its objectives.

Sincerely yours,

/s/

Mr. Kyong-Shik Kang
Minister of Finance

Attachments:
Memorandum of the Government of the Republic of Korea on Certain Aspects of its Economic and Financial Policies
Technical Memorandum

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

ATTACHMENT II

Seoul, Korea
June 3, 1983

Memorandum of the Government of the Republic of Korea on
Certain Aspects of its Economic and Financial Policies

I. Developments and Objectives

1. The Korean economy has undergone considerable adjustment since 1980, when economic conditions deteriorated sharply as a result of strains from a long period of inflationary growth, a domestic political crisis, poor harvests, and adverse external shocks. Over the past three years, the Government has successfully implemented a wide-ranging adjustment program which was supported by two one-year stand-by arrangements from the Fund (March 1980-February 1982). The stabilization program was designed to lower inflation and strengthen the external position by tight financial policies, a substantial depreciation of the currency, strict wage guidelines, and adjustment of administered prices, particularly of oil products. The stabilization efforts began to bear fruit in 1981. Output rose by 6 per cent, following a 6 per cent decline in 1980; the inflation rate (CPI) declined to 13 per cent; and the current account deficit was reduced to 7.4 per cent of GNP.

2. The principal objectives of Korea's economic management plan for 1982 were to curb domestic inflation, further improve the external position, and sustain growth. In January 1982, the Government prepared a policy package designed to stimulate economic recovery within the framework of the overall stabilization program. Significant emphasis was also placed on basic structural and institutional reforms aimed at promoting competition through the use of the market mechanism. Additional measures were implemented in mid-year to contend with the continued weakness in exports and with the problems arising from a severe disruption in domestic financial markets in May. Under these difficult circumstances, the outcome for 1982 was particularly gratifying. The inflation rate declined to a historically low level, the current account deficit was almost halved, and the growth momentum was maintained.

3. During 1982, domestic inflation was reduced to below 5 per cent. Declining import and export prices, good harvests, and lower interest costs for enterprises contributed significantly to the success in stabilizing prices. In addition, the Government undertook a nationwide campaign to reverse the inflationary psychology and restrain wage demands by promoting a better public understanding of the economic situation.

4. The current account deficit was reduced from US$4.6 billion (7.4 per cent of GNP) in 1981 to US$2.5 billion (3.9 per cent of GNP) in 1982. The reduction reflected principally an improvement in the terms of trade and an increase in earnings from invisibles. Export volume increased

by 6 per cent; while this increase fell short of historical standards, it compared favorably with the performance of Korea's main competitors. Despite the reduction in the current account deficit, the overall external deficit deteriorated, as net capital inflows declined and errors and omissions indicated a substantial outflow. The growth in external indebtedness was reduced to 15 per cent, compared with 28 per cent annual growth between 1978 and 1981. Korea's debt servicing obligations remained in line with its capacity to earn foreign exchange. Debt service payments on medium- and long-term borrowings in 1982 remained at about 15 per cent of exports of goods and services; including interest payments on short-term debt, debt service payments amounted to 21 per cent of exports.

5. Along with the substantial progress made in the areas of price stabilization and external adjustment, real GNP growth of 5.4 per cent was achieved in 1982. This performance, although below expectations, was high in comparison with that of most other countries. A major impetus to growth was provided by government policies, including a lowering of interest rates, flexible monetary and credit management which allowed an expansion of credit available to small- and medium-sized firms, and fiscal incentives for new housing.

6. In view of the more encouraging external outlook, prospects for consolidating the substantial gains made last year, and for further progress, are favorable. Prices of some raw materials are expected to increase in the early stages of world economic recovery, but their impact on domestic inflation should be offset by the decline in oil prices and the abatement of inflation in the industrial countries. With the anticipated expansion of world trade, the growth in exports and output should rise. Accordingly, the Government has set its macroeconomic objectives to include: an inflation rate of below 5 per cent in 1983 and 1984; a current account deficit of about US$2.3 billion (3.2 per cent of GNP) in 1983 and US$2.0 billion (2.5 per cent of GNP) in 1984; and output growth of 7.5 per cent in both years. The actual outcome will greatly depend on external developments, but we believe that these objectives represent realistic targets for the formulation of financial policies.

II. Financial Policies

Fiscal policy

7. Fiscal policy in 1982 supported the Government's adjustment effort. Budgetary revenues fell short of the target because of a sharp decline in domestic inflation, slower-than-expected recovery in the private sector, and a fall in imports. In response to the revenue shortfall, the Government restrained expenditures to below the budgeted amount; the ratio of public sector expenditure to GNP declined by 1.3 percentage points. The consolidated public sector deficit was reduced to 4.6 per cent (W 2.2 trillion) in 1982 from 5.0 per cent of GNP in 1981. The reduced deficit contributed to the improvement in inflation and in the external position.

8. Fiscal policy in 1983 will continue to play a major role in stabilizing the economy. The 1983 budget provides for a further reduction in the overall public sector deficit through improvements in the financial performance of both the Central Government and the nonfinancial public enterprises. To accelerate the recovery of the manufacturing sector, certain investment projects of the public sector have been brought forward into the first half of the year. Moreover, in order to strengthen private investment and consumption demand, taxes on corporations and individuals have been reduced.

9. Government revenues in 1983 are estimated to rise slightly to 21.0 per cent of GNP. Increases associated with the underlying elasticity of the tax system and with the lagged effects of the tax reform package introduced in January 1982 are anticipated to exceed the negative effect of the stimulative tax package announced in January 1983. Additional revenues will be raised by imposing a tariff on imported oil. To reduce further the overall deficit of the public sector, expenditures are budgeted to decline to 25.0 per cent of GNP. In line with the policy emphasis of the Fifth Plan, the composition of outlays will shift slightly toward social expenditures (education, health, social security and welfare, housing, and community amenities). The financial position of the public sector enterprises will be improved by enhancing their managerial efficiency and by appropriate pricing policies. In particular, the deficit of the Grain Management Fund will be further reduced by adjusting purchase and release prices.

10. The Government will make every effort to achieve the revenue target for 1983. However, a revenue shortfall from the budget estimate could arise should the recovery in domestic activity be delayed. Under such an eventuality, the Government intends to lower expenditures below the budgetary target. In any case, the Government is determined to contain the public sector deficit to below the 1982 level. Under current projections, the ratio of the deficit to GNP would fall to 4.0 per cent; bank financing of this deficit will be limited to the equivalent of 1.0 per cent of GNP.

11. Preparation of the 1984 budget is only in its early stages at this time, but the Government wishes to state that fiscal policy in 1984 will be consistent with the objectives of the program. The Government intends to reduce the public sector deficit as a ratio to GNP at a pace similar to that envisaged for 1983. In keeping with the Government's goal of reducing the relative size of the public sector in the economy, adjustments will be made mainly on the expenditure side.

Monetary policy

12. Credit policy in 1982 was aimed at reducing the rate of inflation and the external imbalance, while accommodating an orderly recovery of economic growth and the associated financing requirements of the public

and private sectors. The task of monetary management was made considerably more difficult by the incident in the curb market, which created a confidence crisis and led to a shift of financial resources into the banking system. The Government acted quickly to prevent a generalized financial crisis by allowing a rapid expansion of bank credit which offset the contraction of lending in the curb market. As a result of these developments, broad money grew by 27 per cent, which was more rapid than originally envisaged.

13. The objectives of monetary policy in 1983 are to consolidate the recent success in reducing both inflation and the external imbalance, and to support economic recovery. The Government recognizes that any rekindling of inflation and inflationary expectations would generate pressures on wages, interest rates, and the exchange rate. Therefore, the Government will continue to pursue a cautious approach to monetary management. Monetary growth has slowed markedly since September 1982 to an annualized rate of 12 per cent (October 1982-April 1983).

14. To ensure that the inflation and balance of payments objectives are met, the growth of the net domestic assets of the banking system will be curtailed to 19 per cent in 1983. This increase in net domestic assets, together with the projected decline in net foreign assets of the banking system, is consistent with an estimated 15 per cent growth in the demand for broad money. The Government's commitment to limit the public sector's recourse to credit from the banking system will ensure that the private sector's credit requirements are satisfied.

15. With the rapid fall in inflation in early 1982, interest rates became high in real terms. To reduce interest costs of firms and spur investment, interest rates were reduced by mid-year. Deposit rates were halved to 8 per cent, lending rates were reduced to 10 per cent, and preferential interest rates were eliminated. The reduction in interest rates was kept below the decline in inflation so as to preserve a positive level of real interest rates.

16. To promote the mobilization of financial savings and secure stability in monetary management, the Government will continue to maintain positive real interest rates (relative to CPI inflation). In implementing this policy, the Government will also take into account movements in foreign interest rates and their implications for capital flows. The Government's intention of containing the public sector deficit and the associated financing from domestic sources should alleviate pressures on interest rates in secondary financial markets and thus narrow the gap between administered interest rates and free market yields.

External prospects and policies

17. Present indications are that the external environment will improve during 1983 and 1984. Korea is well placed to take full advantage of the anticipated pickup in world demand and will also benefit from the decline in world oil prices. Balance of payments projections for 1983 point to

a current account deficit of US$2.3 billion (3.2 per cent of GNP) and an overall deficit of US$1.7 billion. Preliminary projections for 1984 suggest a further improvement in the current account deficit to 2.5 per cent of GNP.

18. The won depreciated by 7 per cent against the U.S. dollar during 1982, but because of the sharp appreciation of the U.S. dollar against other major currencies, the nominal and real effective exchange rates remained stable for most of the year. By January 1983, however, the depreciation of the won, along with the dollar, against other major currencies resulted in a real depreciation of the currency and improved the competitiveness of the export sector. The Government intends to manage the exchange rate flexibly to support the balance of payments objective; competitiveness will not be allowed to deteriorate because of relative price movements or realignments of major currencies.

19. Prudent debt management in the past has ensured that Korea's external debt burden is sustainable and consistent with the potential for export growth. Nevertheless, because of developments in international capital markets, the Government intends to slow the growth of external indebtedness. In order to lessen Korea's vulnerability to disruptions in international capital markets, the Government will reduce gradually the level of short-term external debt over the program period; the share of short-term in total debt will decline sharply.

Wage policy

20. Wage policy is an important element in the Government's efforts to control inflation and strengthen export competitiveness. The Government sets the tone for wage bargaining in the private sector both by determining wages and salaries of civil servants and by establishing guidelines for private sector wage settlements. The increase in public sector wages for this year has been limited to 6 per cent. The target for wage settlements in the private sector is 10 per cent; the decline in inflationary expectations over the past year should help in achieving this target. Many of the large private firms have already announced their intention of limiting wage increases to below the Government's guidelines. Real wages should rise only modestly during 1983, probably less than the growth of productivity.

III. *Structural Reforms*

Industrial restructuring

21. To realize the growth potential of the Korean economy, industrial investment must be expanded and the assimilation of new technology accelerated. In this context, certain small- and medium-sized industries appear especially promising and the Government is pursuing a number of schemes to expedite their development. Several industrial research institutes are being established to nurture the process of technological borrowing and adaptation, while the commercial exploitation of new techniques and products will be given added support by channeling more resources through the

Korea Technology Development Corporation. Marketability of products will be improved by increased emphasis on quality control and standardization of products.

Energy policy

22. The Government continues to assign high priority to conservation programs aimed at diversifying the sources of energy supply. Progress made in the last two years has been heartening. Last year, oil consumption declined slightly while the economy continued to expand. The program of energy audits initiated in 1982 has sharpened awareness of energy costs and induced producers to economize on fuel use. To reduce dependency on oil even further, the Government intends to press on with the program of increasing nuclear power-generating capacity. The opening of the third nuclear power station in April 1983 has raised the contribution of nuclear power to total capacity from 12 per cent to 15 per cent. To reinforce its efforts to conserve energy, only 30 per cent of the $5 per barrel reduction in OPEC oil prices has been passed through to domestic consumers; domestic prices of only two oil products, which are used exclusively for industrial and agricultural purposes, have been lowered significantly. About 40 per cent of the decline in OPEC prices has been earmarked for a special multipurpose fund to finance projects primarily in the energy area, and the remainder will be absorbed through an import duty.

Tax reforms

23. The Government introduced a comprehensive tax reform in 1982 to improve the elasticity, efficiency, and equity of the tax system. The number of key industries eligible for special tax exemptions was reduced and greater emphasis placed on indirect investment incentives. Important changes in individual income taxation, and in capital gains, inheritance, and special excise taxes were also implemented. Tax adjustments were made to further promote technology development and manpower training in order to encourage investment by small- and medium-sized firms, and to support the development of natural resources. A special surtax was introduced and the proceeds earmarked for education projects.

24. In 1983, the Government has further modified the tax system so as to make it more neutral with respect to resource allocation and to collect taxes as efficiently and equitably as possible. The new measures include: further reduction in preferential tax exemptions for certain industries; taxation of income from financial assets that previously was nontaxable, with higher tax rates for incomes derived from instruments held under assumed names; and simplification and lowering of corporate and industrial income tax rates. In the coming years, the Government will continue to rationalize corporate taxes and import tariffs, to expand and improve the administration of the VAT, and to eliminate differential taxation of income from different sources.

Financial sector reform

25. Reform of the financial system continues to receive high priority. Banks will be allowed more discretion in their lending activities and greater emphasis will be placed on market signals. Banks will also be exposed to greater competition by permitting freer entry into the industry. The Government has transferred ownership of all five nationwide banks to the private sector and has licensed two additional banks and a large number of short-term finance and mutual savings institutions. Since early 1982, the Bank of Korea has relied on indirect instruments of credit control, discontinuing the practice of setting credit ceilings for individual banks. The flexibility of reserve money management will be enhanced by reducing the volume of directed loans. To further improve the process of financial intermediation, the Government is planning to liberalize interest rates gradually.

Trade liberalization

26. Notwithstanding the rising protectionism abroad, the Government has continued to liberalize imports. A large number of items covering consumer goods, raw materials, and machinery components have already been transferred from the restricted list to the automatic approval list; as a result, the import liberalization ratio, i.e., the proportion of unrestricted categories of imports in the total, rose to 77 per cent in 1982. A further expansion of the automatic approval list on July 1, 1983 is expected to increase the import liberalization ratio to 80 per cent; this ratio will be raised gradually over the next three years to 90 per cent, the level currently prevailing in the industrialized nations.

27. Much attention has been given to the reform of industrial incentives and improvements in the international competitiveness of Korean products by reducing tariff barriers. The Government is studying in cooperation with business, a proposal to restructure import tariffs, which presently range from zero to 100 per cent. According to this proposal, tariff rates would be adjusted gradually to reach by 1988 targets of 20 per cent for finished products and 5-10 per cent for raw materials.

28. During the 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.

ATTACHMENT II

Seoul, Korea

June 3, 1983

Technical Memorandum

1. This Memorandum describes more concretely the key targets and policy understandings of the accompanying Memorandum of the Government of the Republic of Korea on Certain Aspects of its Economic and Financial Policies.

2. The stock of net credit to the public sector from the banking system will not exceed W 2,500 billion on September 30, 1983; and W 2,708 billion on December 31, 1983. 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 2,065 billion on March 31, 1983 and its components are defined in the attached Table 1.

3. The stock of net domestic assets of the banking system will not exceed W 27,586 billion on September 30, 1983; and W 28,785 billion on December 31, 1983. Net domestic assets of the banking system are defined as broad money minus net foreign assets and were W 25,168 billion on March 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 March 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 March 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 765.67 per U.S. dollar.

4. The stock of outstanding disbursed external debt, including all maturities but excluding use of IMF resources, will not exceed on December 31, 1983 the stock of such debt outstanding on December 31, 1982 by more than US$4.2 billion. Furthermore, the stock of outstanding disbursed external debt with initial maturity of less than one year will not exceed US$14,215 million on December 31, 1983. 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, 1982. The stock of outstanding disbursed external debt on December 31, 1982 is set forth in Table 3.

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

		March 31, 1983 (In billions of won)
A.	Net credit to the public sector from the banking system (D + E)	2,065
B.	Bank of Korea (net)	1,324
	1. Loans to Government	1,928
	2. Government bonds	10
	3. NIF bonds	59
	4. Less government deposits	673
	5. Less NIF deposits	--
	6. Government lending funds	--
C.	Deposit money banks (net)	201
	1. Government bonds	316
	2. NIF bonds	1,192
	3. NHF bonds	206
	4. Deposits with NIF	400
	5. Treasury checks uncleared	8
	6. Less government deposits	147
	7. Less NIF deposits	-3
	8. Less NHF deposits	266
	9. Less government lending funds	1,511
	a. Borrowing from the Government	693
	b. Borrowing from the NIF	753
	c. Borrowing from the NHF	65
D.	Net credit from the banking system to the Government (B + C)	1,525
E.	Claims on government agencies	540
	Fertilizer Fund	540
	Other	--

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

		March 31, 1983 (In billions of won)
A.	Net domestic assets (B - C)	25,168
	1. Domestic credit	28,301
	a. Net credit to public sector	2,065
	b. Credit to private sector	26,236
	2. Other items (net)	-3,133
B.	Broad money	20,181
	1. Narrow money	5,626
	a. Currency outside deposit money banks	2,239
	b. Private sector deposits with Bank of Korea	84
	c. Demand deposits of deposit money banks	6,988
	d. Less uncleared checks and bills	3,685
	2. Savings and time deposits plus residents' foreign currency deposits	14,555
C.	Net foreign assets	-4,987
	1. Foreign assets	5,091
	a. Bank of Korea	1,998
	b. Deposit money banks	3,093
	2. Foreign liabilities	10,078
	a. Bank of Korea	1,230
	b. Deposit money banks	8,848

Table 3. Korea: Definition of Outstanding Disbursed External Debt

		December 31, 1982 (In millions of U.S. dollars)
A.	Debt with original maturity in excess of three years	22,609
	A1. Public loans	9,440
	A2. Commercial loans	6,195
	A3. Bank loans	5,352
	A4. Bond issue	363
	A5. IMF credit	1,259
B.	Debt with original maturity of one to three years	488
C.	Debt with original maturity of less than one year	14,215
	C1. Trade credit	3,339
	C2. Borrowing for oil bill	447
	C3. Refinance	5,038
	C4. Deposits	245
	C5. Others	1,238
	C6. Interoffice "A" account of foreign bank branches	3,908
D.	Total outstanding disbursed debt	37,312
E.	Total outstanding disbursed debt, excluding use of Fund resources (D - A5)	36,053