

CONFIDENTIAL

To: Members of the Executive Board

From: The Secretary

Subject: Korea - First Review and Request for Modification of
Performance Criteria Under the Stand-By Arrangement

Page 3, Table 2, column 2, line 2: for "35,324" read "35,824"

Page 7, Table 4, column 5, line 1: for "31.7" read "33.1"

Page 9, Table 5, column 3, line 3: delete "4/"

 line 8: add "4/\" after "5.2"

 bottom of page: add as footnote 4/ "At constant
exchange rates, the increase was
equivalent to 6.9 percent."

Att: (3)

Table 2. Korea: Stand-by Arrangement--Quantitative Performance Criteria
for the Period through December 31, 1985

	1984	1985		
	Dec. 31	Sept. 30 Orig. Ceiling	Sept. 30 Actual	Dec. 31 Orig. Ceiling
<hr/>				
	(In billions of won)			
Net credit to the public sector from the banking system	1,973	2,023	1,311	2,268
Net domestic assets of the banking system	32,706	35,824	37,760	36,806
<hr/>				
	(In millions of U.S. dollars)			
Outstanding external debt of all maturities, excluding IMF credit	40,989	43,889	43,125	43,889
Outstanding short-term debt <u>1/</u>	11,425	...	10,340	11,125

Sources: Korean Ministry of Finance; and Fund staff estimates.

1/ Defined as external debt with initial maturity of one year or less.

financing facility. Assuming full use of the present stand-by arrangement, together with scheduled repurchases, Korea's use of Fund credit would be reduced to 287 percent of quota by the end of the stand-by period. Information on Korea's relations with the Fund is provided in Annex I. ^{1/} Korea continues to avail itself of the transitional arrangements of Article XIV.

II. Performance Under the 1985 Program

1. The economic program for 1985

The 1985 economic program aimed primarily at further strengthening the external position through continued demand restraint and exchange rate flexibility. The external current account deficit was targeted to decline by \$0.5 billion, to \$0.9 billion (1.1 percent of GNP) in 1985, thus permitting a significant slowdown in the rate of growth of overall external debt (Table 3). On the basis of assumptions about the external environment and projections of export receipts, the program envisaged that output growth would be maintained at about 7 percent and inflation (CPI) contained to 2-3 percent in 1985. The economic program called for continued restraint in fiscal and credit policy. The consolidated public sector deficit was to be kept to a modest 1.8 percent of GNP in 1985, while the rate of growth of NDA was projected to decline moderately, to below 13 percent. The program also called for continued flexibility in exchange rate management and further progress in liberalizing both the financial and the trade systems.

2. Recent developments

The external environment was less favorable to Korea than foreseen when the economic program was developed. In retrospect, the program underestimated the adverse impact of protectionist pressures, competition from other producers, the slowdown in economic activity in the U.S., and the severity of cutbacks in construction activity in the Middle East. All told, the aggregate shortfall in 1985 current account receipts is likely to be as large as \$3.5 billion (equivalent to more than 4 percent of GNP). Nevertheless, the Korean economy recorded a highly satisfactory performance in terms of the external current account and inflation, but growth fell well below the target (Chart 1).

The growth of exports of goods and nonfactor services (at constant prices) dropped from 8 percent in 1984 to less than 3 percent in the

^{1/} A description of World Bank activities in Korea, with particular emphasis on structural adjustment and financial sector loans, is contained in Annex II.

Table 4. Korea: Balance of Payments, 1983-86

(In billions of U.S. dollars)

	1983	1984	1985		1986	
			Orig. Prog.	Rev. Proj.	Orig. Proj.	Rev. Proj.
Exports, f.o.b.	23.2	26.3	29.5	26.7	33.1	29.6
Volume (percentage change)	(15.5)	(9.8)	(9.0)	(4.1)	(8.0)	(7.1)
Unit value (percentage change)	(-4.2)	(3.2)	(3.0)	(-2.6)	(4.0)	(3.5)
Imports, f.o.b.	-25.0	-27.4	-30.0	-26.9	-33.4	-29.1
Volume (percentage change)	(12.1)	(8.2)	(7.0)	(2.3)	(7.0)	(5.5)
Unit value (percentage change)	(-6.0)	(1.3)	(2.5)	(-3.9)	(4.0)	(2.2)
Net services	-0.4	-0.9	-0.9	-1.1	-0.7	-1.4
Receipts	(7.2)	(7.3)	(7.7)	(7.0)	(8.6)	(7.4)
Payments	(-7.6)	(-8.2)	(-8.6)	(-8.1)	(-9.3)	(8.8)
Transfers (net)	0.6	0.5	0.5	0.5	0.6	0.6
Current account balance	-1.6	-1.4	-0.9	-0.8	-0.4	-0.2
(As a percent of GNP)	(-2.2)	(-1.7)	(-1.1)	(-1.0)	(-0.5)	(-0.2)
Medium- and long-term capital (net)	0.4	1.6	0.8	-0.9	0.8	-0.2
Of which: External borrowing (net)	0.9	1.4	0.9	0.8	...	1.0
Short-term capital (net)	0.9	-0.8)	-0.6	-0.5	-0.6	--
Errors and omissions	-1.0	-0.8)		-0.5		-0.6
Overall balance	-1.3	-1.4	-0.7	-2.7	-0.2	-1.0
Monetary movements ^{1/}	1.3	1.4	0.7	2.7	0.2	1.0
Assets (increase -)	-0.1	-0.8	-0.2	--	-0.4	-0.3
Liabilities	1.4	2.2	0.9	2.7	0.6	1.3
Use of Fund resources (net)	(0.2)	(0.3)	(-0.2)	(-0.2)	(-0.1)	(--)
Other bank liabilities	(1.2)	(1.9)	(1.1)	(2.9)	(0.7)	(1.3)
Memorandum items:						
Gross international reserves	7.5	8.2	8.4	8.2	8.6	8.5
(In months of merchandise imports)	(3.6)	(3.6)	(3.4)	(3.7)	(3.1)	(3.5)

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

^{1/} Including swaps of nondeposit money banks with the Bank of Korea.

contract by almost 2 percent, compared with the originally projected increase of about 10 percent. In contrast to the improvement in the trade balance, the services account deficit is projected to widen to an estimated \$1.1 billion in 1985, from \$0.9 billion in 1984, due mainly to a continued decline in receipts from overseas construction.

The medium- and long-term capital account is expected to swing from a surplus of \$1.6 billion in 1984 to a deficit of \$0.9 billion in 1985. An important factor underlying this turnaround is the repayment by some resident Korean firms (or guarantor banks) of up to \$0.9 billion in foreign debt obligations of their overseas subsidiaries, mainly construction companies operating in the Middle East. Since these repayments were largely financed through foreign borrowing by the domestic banking system, the nonmonetary capital account (and the overall balance of payments) will record an equivalent deterioration. ^{1/} With a further sizable reduction in short-term nonmonetary debt and continued large negative errors and omissions, the overall balance of payments deficit is projected to widen from \$1.4 billion in 1984 to about \$2.7 billion in 1985.

Outstanding external debt, excluding amounts owed to the Fund, is projected to rise to \$44.3 billion at the end of 1985 (Table 5), exceeding the original program ceiling by about \$0.4 billion (0.9 percent), owing in large part to the unprogrammed repayments of debts of foreign subsidiaries, described above. ^{2/} The external obligations of Korean firms residing abroad were approximately \$6 billion in August 1985, virtually the same as at end-1984. Within this total, debts of the overseas construction firms were \$3.5 billion, or \$0.1 billion less than at the end of 1984. The latter debt, and probably the total as well, are expected to have declined in the remainder of the year.

Debt service payments, including interest on short-term debt, rose from 21 1/2 percent of exports of goods and services in 1984 to an estimated 23 percent in 1985. The excess over the ratio projected in the program reflects entirely the effect of the shortfall in current account receipts. Aided by a reduction in import financing requirements, the maturity structure of Korea's external debt improved in line with expectations. Short-term debt, including reserve-related liabilities, is projected to decline by about \$0.4-0.5 billion, to below the program ceiling of \$11.1 billion. The share of short-term debt in total

^{1/} Foreign borrowing by commercial banks is treated as compensatory borrowing in the balance of payments presentation for Korea.

^{2/} External debt statistics in this report include debt of all maturities and cover both public and publicly guaranteed debt and private debt. In accordance with international practices, these statistics exclude foreign borrowings of branches of Korean banks and subsidiaries residing abroad.

Table 5. Korea: External Debt Excluding
Fund Credit, 1982-86 1/

	1982	1983	1984	1985		1986
				Prog. <u>2/</u>	Rev. Proj.	Proj.
(In millions of U.S. dollars)						
Medium- and long-term	23,432	26,836	29,564	32,764	33,130 <u>3/</u>	35,630 <u>3/</u>
Short-term	12,446	12,115	11,425	11,125	11,125	10,825
Total external debt (end period)	35,878	38,951	40,989	43,889	44,255	46,455
Debt service payments						
Principal, on medium- and long-term debt	2,736	3,121	3,564	3,762	3,841	4,336
Interest, including on short-term debt	<u>3,488</u>	<u>3,052</u>	<u>3,611</u>	<u>3,926</u>	<u>3,896</u>	<u>4,072</u>
Total debt service	6,224	6,173	7,175	7,688	7,737	8,408
In percent of exports of goods and services	(22.0)	(20.3)	(21.4)	(20.6)	(23.0)	(22.7)
(In percent)						
Growth rate of external debt	15.4	8.7	5.2 <u>4/</u>	7.1	8.0	5.0
External debt (in percent of GNP)	52.4	51.9	50.6	51.8	55.0	54.4
Share of short-term in total debt	34.7	31.1	27.9	25.3	25.1	23.3
Gross international reserves/ short-term debt	57.9	61.8	71.9	75.6	73.9	78.3
Trade-related/imports	37.6	40.9	30.1	27.3	28.3	27.0

Sources: Ministry of Finance; and staff estimates.

1/ Incorporates merchant banks and reclassification of interoffice accounts of branches of foreign bank. Excludes foreign debt of Korean branches and subsidiaries residing abroad; such debt outstanding amounted to \$6.0 billion at end-August 1985.

2/ Constant exchange rate basis for projections on debt outstanding and flows during the year.

3/ At constant exchange rates.

4/ At constant exchange rates, the increase was equivalent to 6.9 percent.

debt would thus decline from 28 percent in 1984 to about 25 percent in 1985, while the ratio of gross international reserves to short-term debt would rise from 72 percent to about 74 percent.

3. Policy implementation

The policies pursued by the Korean authorities in 1985 generally adhered to the guidelines of the stand-by program: fiscal policy was kept tight, the exchange rate was managed flexibly, and continued progress was made in regard to financial sector reform and liberalization of imports and restrictions on direct foreign investment. In the areas of domestic credit and external debt, however, developments deviated from the expectations of the program (Chart 2).

a. Fiscal policy

The deficit of the consolidated public sector rose marginally in relation to GNP, from 1.4 percent in 1984 to an estimated 1.5 percent in 1985 (Table 6). ^{1/} The economic program envisaged that the deficit would rise to 1.8 percent, including the impact (0.2 percent) of a one-time transfer to local governments with the purpose of assisting in the early repayment of their debts to commercial banks. This transfer was in fact delayed to 1986.

Revenue of the consolidated public sector is estimated to have risen by nearly 7 percent in 1985, somewhat faster than foreseen in the program, and the ratio of revenue to GNP is estimated to have remained unchanged at about 20 percent. The revenue increases were broadly based. The lagged effect of income growth in 1984 helped sustain the growth of income tax collections, which were only marginally affected by the introduction, in mid-1985, of various tax incentives for business investment, including a shortening of the depreciation period for machinery and equipment. Taxes on international trade are estimated to have risen strongly owing to the effect of the depreciation of the won on the domestic currency value of trade flows. This factor overshadowed the negative impact of a change in the export duty drawback system, the reduction of the duty on oil imports, and a modest reduction in the average tariff rate.

Expenditure of the consolidated public sector (including net lending) increased by an estimated 7 percent in 1985; the increase was smaller than had been envisaged in the program in spite of new spending

^{1/} Fiscal years coincide with calendar years. The consolidated public sector comprises the Central Government and five public funds--the Grain Management Fund (GMF), the tobacco and ginseng tea monopoly, the national railroad, the post office, and the government procurement organization. Local governments and 19 government-invested enterprises are excluded from this concept.