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October 28, 1987

To: Members of the Executive Board
From: The Secretary
Subject: Korea - Supplementary Background Material for the GATT

The attached paper has been prepared by the staff to supply more recent background information on Korea in connection with the forthcoming consultations between the CONTRACTING PARTIES to the GATT and Korea. In the absence of objection from an Executive Director by noon on Wednesday, November 4, 1987, the paper will be transmitted to the CONTRACTING PARTIES for their information and use.

Ms. W. Tseng (ext. 7308) is available to answer technical or factual questions relating to the paper.

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INTERNATIONAL MONETARY FUND

KCREA

Supplementary Background Material for the GATT

Prepared by the Asian and the Exchange and Trade
Relations Departments

Approved by Hubert Neiss and Eduard Brau

October 27, 1987

This supplement updates the Fund report of September 5, 1986 entitled "Korea--Recent Economic Developments."

Favorable external developments and the legacy of strong adjustment measures during recent years resulted in a remarkable strengthening of the current account and sharply higher growth in 1986 (Table 1). The current account position shifted from a deficit of \$0.9 billion (1 percent of GNP) in 1985 to a surplus of \$4.6 billion (5 percent of GNP) in 1986 (Table 2). The improvement derived from several sources: exports were buoyed by the 22 percent real depreciation of the won between early 1985 and mid-1986 (Chart 1) as well as the coming to fruition of several large, long-term investments in new export products, so that even with a considerable increase in non-oil imports (particularly those for use in export production), the growth of exports net of non-oil imports accounted for 40 percent of the improvement in the current account; savings on oil import payments accounted for another 40 percent of the improvement; and a surge in receipts from tourism, workers' remittances, and private transfers accounted for the remaining 20 percent.

The current account surplus permitted a \$2.3 billion reduction in outstanding external debt, more than half of which affected short-term debt (Table 3). Thus, despite the increase in the dollar value of yen-denominated liabilities, the ratio of external debt to GNP fell from 56 percent in 1985 to 47 percent in 1986, and the proportion of short-term debt in total debt was reduced. Large non-debt-related capital outflows, principally to pay off liabilities of overseas subsidiaries of Korean companies (which are not included in debt), also absorbed a sizable portion of the current account surplus. Gross international reserves, therefore, rose by only about \$0.2 billion, while the import cover fell slightly to 2.7 months.

The strength of the external sector was a major factor in the rebound in domestic activity. GNP growth, supported mainly by foreign demand and export-related investment, rose from a weak (by Korean standards) 5 1/2 percent in 1985 to 12 1/2 percent in 1986 (Table 4).

The unemployment rate fell and despite some concern over a possible overheating of the economy, there was virtually no inflation.

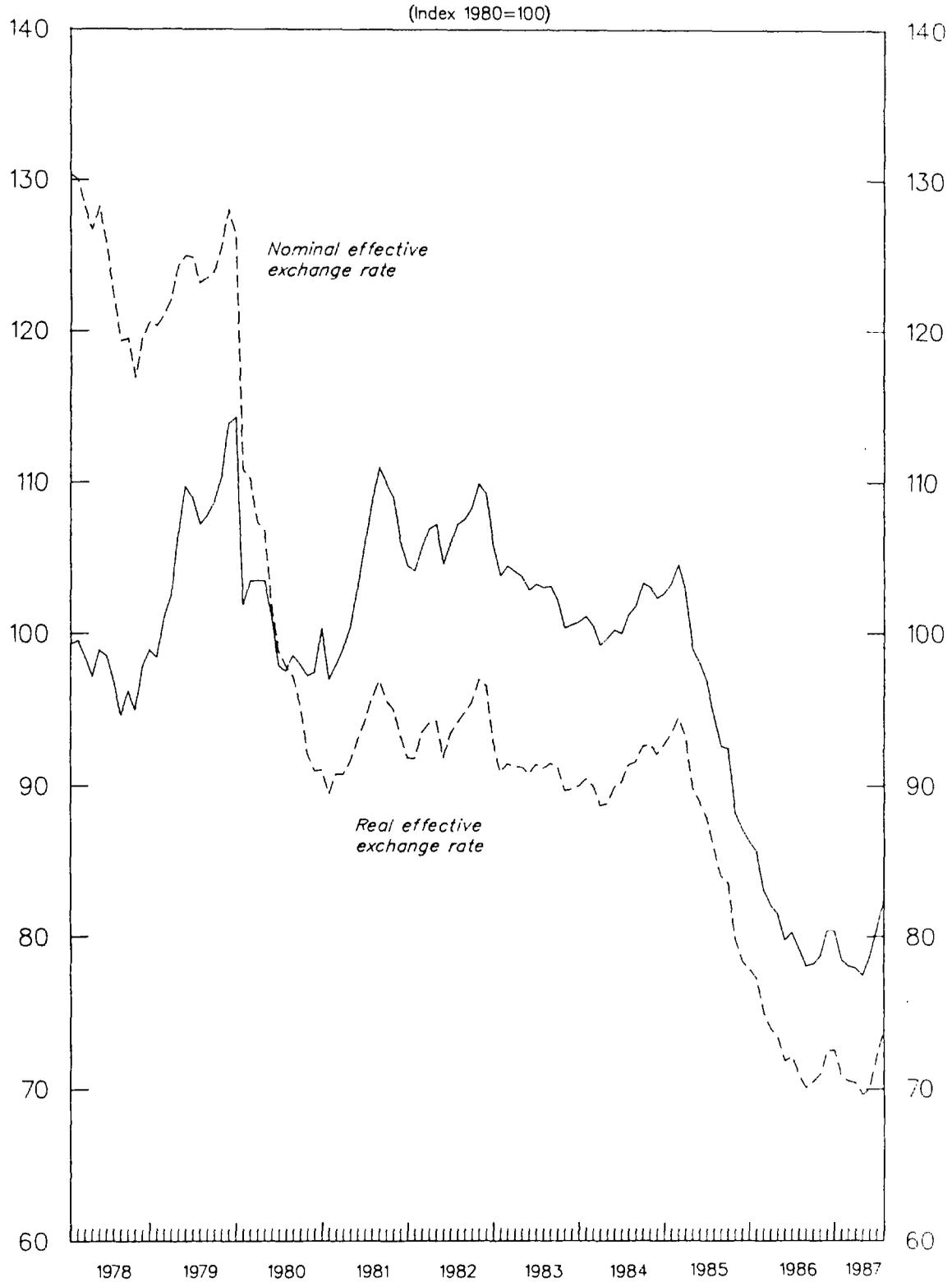
Macroeconomic policies had neutral effects on demand in 1986. Following several years of successfully directing fiscal policy toward reducing the deficit of the central government accounts, the consolidated central government position moved from a deficit of about 1 percent of GNP in 1985 to balance in 1986 (Table 5). Helped by sizable receipts from the taxation of petroleum, revenues rose roughly in line with GNP while the increase in expenditures and net lending fell substantially short of GNP growth. In the context of the cyclical upswing of the economy, the fiscal impulse was neutral. Credit policy was dominated by efforts to prevent the rapid increase in net foreign assets during the latter half of the year from pushing broad money growth above the target band of 15-18 percent (Table 6). Several measures, including an increase in the Bank of Korea's rediscount rate, restrictions on export-related credits, and open market operations, helped to significantly curb net domestic credit growth.

During the first half of 1987, real GNP growth accelerated to 15 percent, unemployment reached a record low of 3 percent, and consumer price inflation remained at less than 3 percent. Owing to sharp increases in exports, tourism receipts, and private transfers, the current account surplus rose to \$5.7 billion in the first eight months of 1987. The surplus has been used mainly to reduce external debt, which amounted to about \$39 billion (33 percent of GNP) at end August. The debt service ratio is about 21 percent. In August, the intensification of labor unrest interrupted production in major export industries. Wages have risen by about 25 percent, resulting in an estimated 16 percent increase in unit labor costs. Supply shortages owing to both the labor stoppages and typhoon damage, have begun to push up prices.

Economic policies have focused on containing the current account surplus to a level consistent with the authorities' debt reduction objective. The surplus management program consists of broadly based market opening measures and the use of exchange rate policy. Market opening measures have included an easing of controls on imports and on services transactions (Table 7), voluntary export restraints, and adjustments in import and export financing. The won, after a small depreciation early in the year, appreciated by 6 1/2 percent between April and July, in real effective terms.

With economic growth substantially in excess of any calculation of potential, there is little scope for expansionary demand management policies in efforts to contain the current account surplus. Accordingly, the 1987 budget is designed to have only a small positive impulse; the consolidated central government position is likely to move from approximate balance in 1986 to a deficit of about 1/2 percent of GNP. Credit policy has remained oriented toward preventing the sharp increase in net foreign assets from undermining monetary control.

CHART 1
KOREA
EXCHANGE RATE DEVELOPMENTS,
JANUARY 1978 TO JULY 1987



Source: Staff estimates.

Credit growth had been curtailed directly through restrictions on exporters' access to preferential credit and indirectly through large open-market operations.

Barring a renewal of labor unrest, the external current surplus is projected to be about \$7 billion in 1987. In the second half of 1987, export growth should decelerate due to the strikes and also because the lagged effects of the earlier depreciation of the won will dissipate and export restraint measures will be intensified. However, import growth should also decelerate, and the surplus on account of services and transfers is likely to rise. Although output growth should slow somewhat in the second half, growth for the whole year is projected to be about 11 percent. Large monetary inflows, together with rising wages, could lead to inflationary pressures.

Table 1. Korea: Summary Economic Indicators, 1983-87

	1983	1984	1985	1986	1987 Proj.
	<u>(Percent change over previous year)</u>				
Real GNP	11.9	8.4	5.4	12.5	10-11
Consumer prices (average)	3.4	2.3	2.5	2.3	4-5
Broad money (M2 plus CDs)	15.2	10.6	16.8	18.6	21
	<u>(In percent of GNP)</u>				
Gross domestic investment	29.9	31.9	31.1	30.2	31
Gross national savings	25.3	27.9	28.6	32.8	35
Consolidated central government balance	-1.6	-1.3	-0.8	0.1	-0.4
External current account	-2.1	-1.7	-1.1	4.9	6
	<u>(In billions of U.S. dollars)</u>				
External current account	-1.6	-1.4	-0.9	4.6	7
Overall balance of payments	-1.3	-1.4	-2.5	2.6	3
Debt service payments	6.4	7.7	7.9	10.4	11
Of which: prepayment of medium- and long-term debt	--	--	--	1.2	3
	<u>(In percent)</u>				
External debt/GNP ratio	53.1	52.3	55.8	46.8	35
Debt service ratio	20.9	22.9	23.8	24.7	21

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

Table 2. Korea: Balance of Payments, 1983-87 ^{1/}

(In billions of U.S. dollars)

	1983	1984	1985	1986	1987 Proj.
Trade balance	-1.8	-1.0	--	4.2	4.8
Exports	23.2	26.3	26.4	33.9	43.5
Imports	-25.0	-27.4	-26.4	-29.7	-38.7
Services	-0.4	-0.9	-1.4	-0.6	1.0
Receipts	7.1	7.3	6.7	8.1	10.1
Payments	-7.6	-8.2	-8.1	-8.7	-9.1
Transfers (net)	0.6	0.5	0.6	1.0	1.0
Current account balance	<u>-1.6</u>	<u>-1.4</u>	<u>-0.9</u>	<u>4.6</u>	<u>6.9</u>
Capital account	<u>1.3</u>	<u>0.9</u>	<u>-0.7</u>	<u>-1.5</u>	<u>-3.7</u>
Debt-related flows	<u>1.9</u>	<u>0.6</u>	<u>0.6</u>	<u>-0.7</u>	<u>-2.3</u>
Medium- and long-term capital	1.1	1.5	1.1	-0.3	-2.3
Short-term capital	0.8	-0.9	-0.5	-0.4	--
Other asset transactions	-0.6	0.3	-1.3	-0.8	-1.4
Medium- and long-term capital	-0.7	0.2	-1.2	-0.8	-1.4
Short-term capital	0.1	0.1	-0.1	--	--
Errors and omissions	-0.9	-0.9	-0.9	-0.5	-0.6
Overall balance	<u>-1.3</u>	<u>-1.4</u>	<u>-2.5</u>	<u>2.6</u>	<u>2.6</u>
Financing	<u>1.3</u>	<u>1.4</u>	<u>2.5</u>	<u>-2.6</u>	<u>-2.6</u>
Assets	0.1	-0.8	--	-0.2	-0.4
Liabilities	1.2	2.2	2.5	-2.4	-2.2
Memorandum items:					
Gross international reserves	7.5	8.2	8.4	8.6	9.0
In months of imports of goods and services	2.8	2.8	2.9	2.7	2.3
Current account/GNP	-2.1	-1.7	-1.1	4.9	6.0
Export volume (percent change)	15.5	9.8	4.3	26.4	20.4
Import volume (percent change)	11.6	8.2	1.0	19.9	19.3

Sources: Monthly Statistical Bulletin; data provided by the Korean authorities; and staff estimates.

^{1/} Components may not add to totals due to rounding.

Table 3. Korea: Outstanding External Debt by Maturity
and Borrower, 1983-87

(In millions of U.S. dollars)

	1983	1984	1985	1986	1987 June
Medium- and long-term debt	28,263	31,628	36,030	35,254	31,631
Maturity over three years	26,353	29,612	33,684	33,568	29,999
Financial institutions	(8,400)	(10,719)	(14,367)	(14,048)	(...)
Of which:					
Interoffice "A" account	(1,044)	(1,276)	(1,500)	(1,678)	(...)
Public sector	(10,292)	(11,056)	(11,376)	(11,250)	(11,111)
Private sector	(6,307)	(6,267)	(6,433)	(6,725)	(...)
Use of Fund credits	(1,354)	(1,570)	(1,508)	(1,545)	(1,473)
Maturity over one and up to three years	1,910	2,016	2,346	1,686	1,632
Interoffice "A" account	(837)	(801)	(863)	(1,213)	(1,095)
Other	(1,073)	(1,215)	(1,483)	(473)	(537)
Short-term debt	12,115	11,425	10,732	9,256	8,715
Private nonbank sector	4,947	4,126	3,640	3,289	...
Trade credit	(4,114)	(3,025)	(2,727)	(2,445)	(...)
Loans for oil imports	(584)	(804)	(637)	(498)	(...)
Advance receipts of exports, and others	(249)	(297)	(276)	(346)	(...)
Banking sector	7,168	7,299	7,092	5,967	...
Interoffice "A" account	(1,474)	(1,798)	(1,737)	(2,105)	(...)
Refinance	(4,740)	(4,444)	(3,903)	(2,066)	(...)
Nonresident deposits	(163)	(218)	(298)	(223)	(...)
Other	(791)	(839)	(1,154)	(1,573)	(...)
Total	40,378	43,053	46,762	44,510	40,346
Memorandum items:					
Trade-related short-term debt ^{1/}	9,438	8,274	7,267	5,009	...
Nontrade-related short- term debt	2,677	3,151	3,465	4,247	...
Borrowings of nonresident Korean entities ^{2/}	5,710	5,976	6,076	5,619	...
Trade financing	(1,887)	(2,167)	(2,175)	(2,534)	(...)
Construction financing	(3,672)	(3,631)	(3,560)	(2,722)	(...)
Other	(151)	(178)	(341)	(363)	(...)

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

^{1/} Comprises trade credit, loans for oil imports, and refinances.

^{2/} External borrowing of Korean branches or subsidiaries residing abroad, not included in total external debt.

Table 4. Korea: Gross National Product by Expenditure
at Constant Prices, 1983-87 1/

(Percent change)

	1983	1984	1985	1986	1987 Proj.
Consumption	7.2	5.2	5.1	6.7	7.0
Private	7.4	5.9	4.8	6.3	6.6
Government	5.3	0.5	6.4	9.3	10.2
Investment	17.5	18.6	1.6	10.5	11.6
Gross fixed capital formation	17.2	10.7	4.4	15.0	11.5
Change in stocks <u>2/</u>	-0.7	1.9	0.8	-0.6	-0.6
Aggregate domestic demand	10.1	9.3	4.0	8.0	8.6
Net foreign demand <u>2/</u>	-1.3	-1.3	0.3	3.5	4.5
Exports of goods and services	15.5	10.0	2.1	26.6	20.3
Imports of goods and services	10.9	10.1	-1.7	18.6	18.2
Gross national product	11.9	8.4	5.4	12.5	10.0

Source: Data provided by the Korean authorities.

1/ Statistical discrepancy and net factor income from abroad are omitted.

2/ Contributions to GNP growth.

Table 5. Korea: Summary of the Consolidated
Central Government, 1/ 1984-87

	1984	1985	1986	1987 Budget
	(In billions of won)			
Revenue	13,351	14,755	16,656	18,141
Expenditure and net lending	14,214	15,320	16,571	19,323
Overall balance	-863	-565	85	-1,182
Financing	863	565	-85	1,182
Domestic	553	125	61	1,139
Bank	-100	171	441	485
Nonbank	653	-46	-380	654
Foreign	310	440	-146	43
	(In percent of GNP)			
Revenue	20.1	20.4	19.9	19.6
Expenditure and net lending	21.4	21.2	19.8	20.9
Overall balance	-1.3	-0.8	0.1	-1.3
Financing	-1.3	0.8	-0.1	1.3
Domestic	0.8	0.2	0.1	1.2
Bank	-0.2	0.2	0.5	0.5
Nonbank	1.0	-0.1	-0.5	0.7
Foreign	0.5	0.6	-0.2	--
Memorandum items:				
Fiscal impulse	-0.11	-0.99	-0.04	1.02
GNP	66,408	72,317	83,833	92,571

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

1/ Includes General Account, Special Accounts, Government Funds, Public Enterprise Funds, and the Petroleum Business Fund (PBF).

Table 6. Korea: Monetary Survey, 1983-87

End of Period	1983	1984	1985	1986	1987 May
(In billions of won)					
Net foreign assets, including swaps with nondeposit money banks	<u>-5,945</u>	<u>-7,425</u>	<u>-10,030</u>	<u>-7,694</u>	<u>-5,333</u>
Net domestic assets	<u>28,883</u>	<u>32,802</u>	<u>39,669</u>	<u>42,842</u>	<u>42,736</u>
Domestic credit	<u>31,847</u>	<u>36,059</u>	<u>42,561</u>	<u>48,694</u>	<u>50,637</u>
Public sector	(2,013)	(1,973)	(2,013)	(2,037)	(365)
Private sector	(29,834)	(34,086)	(40,548)	(46,657)	(50,272)
Net other items	-2,964	-3,257	-2,892	-5,852	-7,901
Of which: Open market operations <u>1/</u>	(-1,018)	(-1,525)	(-528)	(-3,088)	(-5,490)
Broad money plus CDs	<u>22,938</u>	<u>25,377</u>	<u>29,639</u>	<u>35,148</u>	<u>37,403</u>
(Annual percentage change in relation to the stock of broad money) <u>2/</u>					
Net foreign assets, including swaps with nondeposit money banks	<u>-7.6</u>	<u>-6.5</u>	<u>-10.2</u>	<u>7.9</u>	<u>15.7</u>
Net domestic assets	<u>22.8</u>	<u>17.1</u>	<u>27.0</u>	<u>10.7</u>	<u>3.7</u>
Domestic credit	<u>21.7</u>	<u>18.4</u>	<u>25.6</u>	<u>20.7</u>	<u>20.6</u>
Public sector	(-0.7)	(-0.2)	(0.1)	(0.1)	(-2.4)
Private sector	(22.4)	(18.6)	(25.5)	(20.6)	(23.0)
Net other items	1.1	-1.3	1.4	-10.0	-16.9
Of which: Open market operations <u>1/</u>	(-4.4)	(-2.2)	(3.9)	(-8.6)	(-15.0)
Broad money plus CDs	<u>15.2</u>	<u>10.6</u>	<u>16.8</u>	<u>18.6</u>	<u>19.4</u>
(Annual percentage change)					
Net domestic assets	18.7	13.5	20.9	8.0	2.8
Private sector credit	17.6	14.3	19.0	15.1	14.6

Source: Data provided by the Korean authorities.

1/ Monetary Stabilization Bonds issued by the Bank of Korea and Exchange Equalization Fund Bonds issued by the Government.

2/ Stock at the beginning of the period.

Table 7. Korea: Market Opening Measures, 1983-88

	1983 Actual	July 1, 1986 Actual	July 1, 1987 Original	July 1, 1987 Accelerated	July 1, 1988 Scheduled
A. Trade Liberalization					
	(Number of items) 1/				
Restricted items	1,482	670	512	503	370
Agricultural products	363	280	275	278	273
Other	1,119	390	237	225	97
	(In percent)				
Ratio of restricted to total items	19.6	8.5	6.5	6.4	4.7
Agricultural products	26.8	20.3	19.9	20.1	19.8
Other	17.9	6.0	3.6	3.4	1.5
	(Number of items) 1/				
Items on surveillance list	165	106	...	[53]	...
	(In percent)				
Items on surveillance list in percent of total CCCN items	2.2	1.3	...	[0.7]	...
	1983 Actual	Jan. 1, 1986 Actual	Jan. 1, 1987 Actual	July 1, 1987 Accelerated	Jan. 1, 1988 Scheduled
B. Tariff reductions					
	(In percent)				
Average unweighted tariff rate	23.7	19.9	19.3	19.0	18.1
Agricultural products	31.4	27.1	26.4	...	25.2
Other	22.6	18.7	18.2	...	16.9

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

1/ Based on eight-digit Customs Cooperation Council Nomenclature (CCCN) classification.