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EB/CGATT/84/4

October 15, 1984

To: Members of the Committee on Liaison with the CONTRACTING PARTIES to the GATT

From: The Committee Secretary

Subject: Consultations with the CONTRACTING PARTIES to the GATT - Korea, Philippines, and Portugal

The attached memorandum from the staff concerning preparation for forthcoming consultations with the CONTRACTING PARTIES on their consultations with Korea and Portugal is herewith submitted for consideration by the Committee. Consultations are also being held with Bangladesh and the Philippines, but for these countries no statement by the Fund is expected because these are consultations under the simplified procedures agreed by the CONTRACTING PARTIES.

In the absence of objection from a member of the Committee by noon on Monday, October 22, 1984, the memorandum will be deemed approved by the Committee for submission to the Executive Board for consideration on a lapse-of-time basis.

Att: (1)

Other Distribution:
Department Heads

October 12, 1984

To : The Acting Chairman of the Committee on Liaison with the CONTRACTING PARTIES to the GATT

From : The Director
Exchange and Trade Relations Department

Subject: Consultations with the CONTRACTING PARTIES to the GATT

The Fund has been invited to consult with the CONTRACTING PARTIES in connection with their consultations with Bangladesh, Korea, the Philippines and Portugal, to be held in Geneva during October 29-November 2, 1984. The Managing Director has recommended that this invitation be accepted, and that Mr. Shailendra J. Anjaria, Chief, Trade and Payments Division, be designated to represent the Fund during the consultations. This recommendation was approved by the Executive Board on September 12, 1984 (EBD/84/238). In accordance with the procedures set out in EBD/56/102 (8/29/56), the latest Recent Economic Developments papers on the consulting countries have been transmitted to the CONTRACTING PARTIES.

It is expected that the CONTRACTING PARTIES will request the Fund's view with respect to Korea and Portugal. It is recommended that, in reply to such request, the Fund representative should be guided by the statements set forth below.

Korea

After two decades of rapid growth, the Korean economy encountered serious difficulties in the early 1980s. The adverse effects of structural imbalances and excess demand pressures were exacerbated in 1980 by several exogenous shocks, including higher international interest rates and the second oil price increase, and culminated in an acute deterioration in economic conditions. Output declined for the first time in Korea's recent history, inflation soared to 35 percent, and the current account deficit widened to 9 percent of GNP. In response to these developments, the Government implemented an adjustment program supported by two one-year stand-by arrangements from the Fund (March 1980-February 1982). By 1982, substantial adjustment had taken place: the economy grew by about 5 percent, inflation slowed to about 5 percent, and the current account deficit narrowed to $2.6 billion, or 4 percent of GNP.

In late 1982, the repercussions of the international debt crisis placed new demands on economic management in Korea. The authorities sought to limit Korea's vulnerability to shifts in market sentiment by reducing reliance on foreign loans--especially short-term borrowing, which had accounted for 40 percent of total borrowing in 1981-82--while placing the economy on a noninflationary growth path. The policies adopted in support of these objectives formed the basis for a stand-by arrangement from the Fund (SDR 576 million) for the period July 1983 through March 1985.

Economic performance in 1983 was outstanding: output growth nearly doubled to over 9 percent, inflation fell to a historically low level of 2 percent, and the current account deficit was halved to about 2 percent of GNP. Increases in private consumption, exports, and domestic investment accounted, in almost equal proportions, for the rise in aggregate demand. The stimulus provided by domestic demand, which was the main expansionary force in 1982 and early 1983, gradually diminished as a result of tight financial policies, while foreign demand increased. Appropriate demand management, together with low imported inflation, plentiful food supplies, and moderate wage increases, contributed to the reduced domestic inflation.

Financial policies were tightened considerably during 1983. The public sector deficit declined from 4.3 percent of GNP in 1982 to 1.6 percent. While cyclical factors also contributed to the improvement in the fiscal position, the major portion of fiscal adjustment was associated with discretionary measures. Higher indirect taxes were supplemented by a newly imposed 5 percent tariff on imported oil. Central government expenditure growth was slowed, while the deficit of the Grain Management Fund was reduced by freezing import prices for grains. Monetary expansion, which had hovered around 27 percent throughout the previous three years, was reduced to 15 percent in 1983, while the rate of increase in domestic credit declined from about 34 percent to 18 percent in 1983.

The policies pursued by the authorities led to a decline in the current account deficit from $2.6 billion in 1982 to $1.6 billion in 1983. The volume of merchandise exports rose by 15 percent in 1983, led by a rapid growth in the exports of ships, electronic products, and footwear. Exports were buoyed by the recovery in industrial countries and a 7 percent depreciation of the currency in real effective terms. Import growth was also very high (13 percent in volume terms), reflecting the rapid expansion of economic activity, particularly exports. The trade balance improved by $1.0 billion in 1983, recording a deficit of $1.6 billion. Service receipts from overseas construction fell sharply, owing to a retrenchment of investment by Middle Eastern countries. However, this loss was offset by increases in other receipts and a large reduction in services payments (particularly interest payments). These developments, combined with a small net capital inflow, resulted in an overall deficit of $1.3 billion. Outstanding external debt rose to $40.2 billion at the end of 1983. Debt service payments, including interest on short-term debt, declined from 23 percent of exports of goods and services in 1982 to 22 percent in 1983. During the year, the authorities improved the maturity structure of Korea's external indebtedness.

Korea's external trade environment has been characterized by protectionism abroad and trade liberalization at home. Intensification of restrictive measures against Korean exports continued in 1983. According to official information, as of December 1983, industrial countries were applying protectionist measures against 165 export items (based on the four-digit classification of the Customs Cooperation Councils Nomenclature), up from 152 items at the end of 1982. These items accounted for 42 percent of exports in 1983, up from 36 percent in 1982. Korean exports to developing countries have also been subjected to protectionist measures, particularly counterpurchase agreements.

As regards Korea's import policy, the trend has been toward liberalization. During 1981-83, 838 items were transferred from the list of restricted imports to the list of automatically approved items, leaving only 20 percent of the items on the restricted list, compared to 31 percent in 1980. Emergency tariffs, which prevent, on a temporary basis, excessive imports of goods that have been liberalized, were imposed on 12 additional items in mid-1983, raising the total of affected items to 104--less than 15 percent of the items liberalized during 1981-83. At the end of 1983, emergency tariffs were imposed on 11 new items, while tariffs on 77 items were eliminated.

Turning to developments in the current year, economic performance has remained strong during the first half of 1984. The economic boom of last year has continued, as output has increased by about 9 percent. Exports and domestic demand, especially private consumption, have contributed about equally to the expansion in aggregate demand. Investment in plant and equipment has picked up, more than offsetting a decline in investment in residential construction and infrastructure investment. Domestic inflation has remained about 2 percent. Financial policies have been tightened further in 1984. The public sector recorded a surplus of 0.5 percent of GNP during the first half of the year, compared to a deficit of 1.2 percent during the same period in 1983. Revenues have been rising in line with the growth in nominal GNP, while expenditures growth has been held to about half that rate (5 percent). Monetary policy has also been restrained. Credit expansion slowed to 15 percent during the 12-month period ending July 1984.

In the first seven months of the year, exports rose by 16 percent (annual rate) as foreign demand continued to be robust. Textiles, machinery, and electronics led the export expansion. Despite the strong export performance, the balance of payments has come under some pressure as imports have also grown rapidly (14 percent), owing to a surge in imports of raw materials and capital goods. As a result, the trade deficit was $1.2 billion, or unchanged from the same period in 1983. The current account deficit also remained unchanged, at $1.3 billion. Smaller net capital inflows, however, resulted in an overall deficit of $1.4 billion during the first seven months of the year, compared to $0.9 billion during the same period in 1983.

Notwithstanding Korea's somewhat more difficult external situation, the authorities remain committed to liberalizing Korea's exchange and trade system. Early in 1984, the Government made public its intention to follow a five-year plan of import liberalization. Under this plan, the import liberalization ratio (i.e., the ratio of items on the automatically approved list to all import items) would be raised to 95 percent by 1988. The Government also announced the list of items currently scheduled for liberalization in 1985 and 1986. The advance announcement of the liberalized items is designed to provide domestic manufacturers with adequate time to adapt to greater competition from imports. To further smooth the adjustment process, tariffs on certain liberalized items have been raised temporarily; the authorities have announced that these tariffs will be reduced over a period of 3-5 years.

The Government undertook a comprehensive tariff reform by amending the Tariff Act (effective January 1, 1984). The amendment aims at eliminating excess protection, reducing the dispersion of tariff rates, and lowering tariffs on raw materials. The authorities have also announced that they will reduce nontariff barriers by ensuring that enforcement of regulations is focused on their original purpose (e.g., protection of public health, safety, and national security).

By adopting an export-led growth strategy, Korea has been successful in utilizing its comparative advantage and circumventing the constraint imposed by the size of its domestic market. The authorities are making serious efforts to elevate living standards in Korea, which are still relatively low. The Fund believes it would be unfortunate if the attainment of Korea's growth and external objectives were to be obstructed by the imposition of trade barriers in its export markets. The Fund welcomes Korea's progress toward relaxation of restrictions and hopes that, with the continued pursuit of appropriate economic policies and the cooperation of its trading partners, the liberalization process can be further accelerated.

Portugal

Portugal's current account balance deteriorated from a situation of near equilibrium in 1979 to deficits equivalent to 11.5 percent of GDP in 1981 and 13.2 percent of GDP in 1982 as a result of adverse external developments and of an accommodating stance of financial policies. In the same period, the rate of inflation remained considerably above the OECD average. During the first few months of 1983, the unsatisfactory economic situation, coupled with prolonged political uncertainties, contributed to significant financing difficulties in the international capital markets, resulting in sizable losses of official reserves.

The new government that took office in June 1983 quickly embarked on a stabilization program supported by a new stand-by arrangement with the Fund. The main objective of the program was the reduction of the current account deficit of the balance of payments to the equivalent of 9 percent of GDP in 1983 and 6 percent of GDP in 1984. The improvement in the external position targeted by the Portuguese authorities was based on a comprehensive policy effort designed to reduce domestic demand and to promote foreign exchange earnings. The policy strategy in support of the external adjustment objective included: (a) a 12 percent devaluation of the escudo in June 1983, followed by a continuation of the policy of a "crawling peg" depreciation against a basket of currencies; (b) increases in August 1983 of 2 percentage points in interest rates on time deposits and 2 1/2 percentage points in nominal bank lending ratio; (c) a package of tax measures equivalent to about 1 percent of GDP, sharp increases in administered prices of essential goods and of public services, efforts to contain public consumption and cuts in the public investment program; (d) a monitoring and reduction in the deficit of the public sector enterprises; and (e) a marked deceleration in the growth of total financing to the economy.

Performance under the program, especially in the external sector, was generally satisfactory in 1983. The current account deficit was contained below US$1.7 billion, namely, 8 percent of GDP, or about US$300 million, less than the program target. Total external debt remained well below the program ceiling, and its short-term component in particular recorded a sizable (US$650 million) decline, leading to a significant improvement in the maturity structure of the debt. On the other hand, despite a 7 percent decline in real domestic demand, inflation accelerated to 34 percent by the end of 1983, largely as a result of adjustments in administered prices and a sizable devaluation of the escudo. Real GDP fell by only 0.5 percent, thanks to a strong performance of exports. The combined borrowing requirements of the general government and the public enterprise declined significantly from 22.2 percent of GDP in 1982 to 15.2 percent of GDP in 1983.

Preliminary indications through the first half of 1984 point to a continuing recession in domestic demand, which, in conjunction with a continued rapid growth of exports, is very likely to contribute to an improvement in the balance of payments beyond the program's target. Results of the first quarter indicate that the current account balance recorded a deficit that was 40 percent lower than the corresponding period of 1983, and preliminary figures on merchandise trade through June substantiate the view that the 1984 target for the current account deficit (6 percent of GDP) will in all likelihood be undershot. Moreover, a moderate decline in the deficit of the enlarged public sector is expected in 1984. However, the rate of inflation shows little sign of abating, and is likely to exceed the year-end target of 24 percent.

Faced with the sharp deterioration in the balance of payments in 1981-82, Portugal at the beginning of 1983 raised the 10 percent import surcharge initially introduced in 1978 to 30 percent, pending the introduction of more fundamental adjustment policies. There was also some indication of a tightening of the administration of import licenses during this period of deterioration in the balance of payments. Following the substantial improvement in its external position in both 1983 and 1984, Portugal rolled back the import surcharge from the 30 percent level to 10 percent in March 1984. The authorities have indicated their intention to liberalize the administration of the import licensing system by making the granting of licenses virtually automatic except for selected products. The Fund hopes that the authorities will proceed speedily in the implementation of this intention, and will reduce further reliance on trade restrictions for balance of payments purposes as the country introduces fundamental structural changes to complement its recent adjustment policies.