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IMF Concludes Post-Program Monitoring Discussion on Korea

On August 1, 2001, the Executive Board of the International Monetary Fund (IMF) concluded a Post-Program Monitoring discussion on Korea.[1]

Background

Korea's three-year stand-by arrangement with the IMF expired on December 3, 2000. Korea continues to make early repurchases according to a schedule that will eliminate all Fund credit outstanding by end-August 2001.

After two years of growth averaging about 10 percent, the economy is experiencing a harder landing than expected in 2001. Domestic demand is weak and exports, a major driving force of growth in 1999 and 2000, have also slowed sharply. IMF staff project GDP growth of 3½ percent in 2001, but there are significant downside risks. The downturn in the global electronics cycle, last year's sharp fall in Korea stock prices and rise in oil prices, and weak sentiment over the slow pace of corporate restructuring have all hurt the domestic economy.

Inflation has picked up, but is largely driven by temporary supply-side factors; slow growth has kept down demand and wage pressures. The Bank of Korea has cut its target for the overnight call rate twice by a total of 50 basis points in the current cycle, and the call rate is now 4¾ percent. Following the strong outturn in 2000 (a surplus of 1 percent of GDP), the 2001 budget was designed to be mildly expansionary with a consolidated central government deficit target of 0.2 percent of GDP. This target has now been raised to 1 percent of GDP with the supplementary budget recently presented to the National Assembly. The actual fiscal balance in Q1 was a surplus of 2.2 percent of GDP, although this in part reflects the typical seasonal

[1] Post-Program Monitoring provides for more frequent consultations between the Fund and members whose arrangement has expired but that continue to have Fund credit outstanding, with a particular focus on policies that have a bearing on external viability. There is a presumption that members whose credit outstanding exceeds 100 percent of quota would engage in Post-Program Monitoring.

pattern. A high-level inter-ministerial monitoring committee has been set up to ensure that the budget's expenditure allocations will be fully implemented.

The current account surplus is projected at about 2¾ percent of GDP in 2001, with slowing import demand more than offsetting the weakness in exports. Since mid-April, the won has strengthened after a bout of weakness earlier in the year. In addition, with ample liquidity, market apprehensions have subsided and corporate fund-raising conditions have continued to improve.

The focus on corporate restructuring has been on a few high profile cases, which include the two weakest Hyundai affiliates. Further, legislation on prepackaged bankruptcy and mergers and acquisitions has been passed. Overall, however, corporate restructuring continues to be hampered by disagreements among creditors over burden sharing and weak insolvency procedures. Financial consolidation has also received a boost with the formation of the Woori Holding Company, which groups four weak commercial banks and a merchant bank, all of which have been recapitalized with public funds. In the financial sector, provisioning for loans has improved, and impaired loans have declined, from a system-wide 15 percent at end-1999 to 9½ percent at end-March 2001, owing to securitization, write-offs, and loan recovery.

Executive Board Assessment

Executive Directors commended the authorities for the reorientation and strengthening of the structure of the economy since the 1997 crisis, and noted that external vulnerability has been sharply reduced. The weak global economy, however, has taken a toll on Korea, while domestic demand remains sluggish. In light of this, Directors welcomed the authorities' recent steps to ease macroeconomic policies, but they also stressed the need for firm action to address the continued weaknesses in the corporate and financial sectors, in order to maintain confidence in the restructuring effort and increase the sustainable growth rate.

In view of the slowdown, Directors noted, in particular, that it will be important to achieve the desired degree of fiscal stimulus in 2001, and urged the authorities to work toward meeting the revised target for the consolidated central government deficit. More generally, Directors noted that a fundamental reorientation of budget practices will be necessary to address the shortcomings in the implementation of fiscal policy, and, in this regard, they welcomed the authorities' consideration to implementing the recommendations of the Fund's recent technical assistance report.

Directors observed that monetary policy has so far succeeded both in building credibility in the inflation targeting framework and in responding to the economic downturn. They noted that the recent increase in inflation is largely due to temporary or exogenous factors, that weak economic activity has kept demand and wage pressures down, and that the most recent inflation data suggest that any breach in the inflation target this year will be small. In view of these conditions, Directors endorsed the Bank of Korea's recent decision to lower its overnight call rate target, and generally supported the use of the scope for some further easing, if necessary. However, they noted that such easing would have to be well explained to the public so as to ensure that progress toward establishing the credibility of the inflation targeting framework remains intact. Directors also welcomed the flexibility in the exchange rate and the decline in the frequency of foreign exchange market interventions. They also reiterated that intervention should be limited to instances where trading is exceptionally disorderly.

On the corporate front, Directors expressed concern that large distressed companies and the presence of nonviable firms continue to be a drag on the economy and a source of vulnerability. They observed that the successful resolution of these and any new cases of financial distress will reduce vulnerability and help boost market confidence. Directors stressed that the resolution of these cases is largely a matter for creditors and investors, and that it would be important that the government not intervene and not provide support to nonviable companies. They cautioned that temporary solutions, such as an increase in government guarantees of corporate bonds, or further delays in addressing corporate weaknesses could create larger problems that will prove more difficult and costly to resolve later. Directors therefore welcomed the authorities' intention to terminate the Korea Development Bank corporate bond underwriting scheme by end-2001.

Directors highlighted further insolvency reform as essential for accelerating needed restructuring. Although the voluntary out-of-court workout process should remain an avenue for restructuring, they noted that weaknesses in the insolvency framework have held up agreement on workout programs and delayed the sale of some distressed assets. Directors therefore considered strengthening of the bankruptcy law—including giving greater power to senior creditors—to be a high priority, and urged the authorities to move quickly to prepare the necessary amendments. They also noted that, although corporate governance has improved in Korea, it remains important for the authorities to press ahead with further improvements to bring it up to international best practices.

Directors noted that much progress has been made in restructuring the financial sector, but that problems remain largely as a result of continuing weaknesses in the corporate sector. They expressed concern that the role of the government as part-owner and supervisor of financial institutions, coupled with a significant role as a guarantor of corporate debt, would hinder the pace of restructuring and risk impeding the development of a sound commercial banking system and a thriving capital market. Directors therefore welcomed the authorities' intention to reprivatize nationalized financial institutions and noted that such action would help accelerate corporate reform. They urged the authorities to carry out the planned privatization of Seoul Bank and to accelerate the privatization of other bank holdings. The need for further strengthening of the operational capacity and risk management of banks was also highlighted.

Directors welcomed the forthcoming Financial Sector Assessment Program, which should help to assess the progress made both in restructuring the financial sector and strengthening the supervisory process over the last three years, and in identifying the remaining shortcomings.

Finally, Directors welcomed the early repurchases made by Korea to the Fund, noting that all Fund credit outstanding would be repaid by the end of August 2001. Directors urged the government to continue their steadfast pursuit of the remaining restructuring and reform agenda, which will contribute to an economy that is stronger, more flexible, and less vulnerable to a financial crisis, as well as help ensure higher medium-term growth.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation or IMF Board Post-Program Monitoring discussion for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Korea: Selected Economic Indicators

	1997	1998	1999	2000	2001 Staff Proj.
Real GDP (percent change)	5.0	-6.7	10.9	8.8	3.5
Consumption	3.2	-9.8	9.1	6.2	2.5
Gross fixed investment	-2.2	-21.2	3.7	11.0	3.5
Stock building 1/	-2.0	-5.5	5.4	-0.9	0.0
Net foreign balance 1/	5.7	12.3	-0.8	3.5	1.1
Consumer prices (average)	4.4	7.5	0.8	2.3	4.5
GDP deflator	3.1	5.1	-2.0	-1.6	4.3
Unemployment rate	2.6	6.8	6.3	4.1	...
Wages, manufacturing (annual percent change)	5.1	-3.1	14.7	8.6	...
Revenues 2/	20.6	21.8	22.4	25.8	25.3
Expenditure	22.3	26.0	25.7	24.8	25.5
Balance 2/ 3/	-1.7	-4.3	-3.3	1.1	-0.2
M3	13.9	12.5	8.0	8.8	8.5
Yield on corporate bonds	13.4	15.1	8.9	10.0	...
Current account balance	-8.2	40.4	24.5	11.0	9.2
Current account balance (in percent of GDP)	-1.7	12.7	6.0	2.4	2.1
Won per U.S. dollar	951.3	1,402.1	1,188.9	1,131.1	...

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

1/ Contribution to GDP growth.
2/ Excluding privatization receipts. The projections for 2001 are based on the original budget and do not incorporate the supplementary budget recently submitted to the National Assembly.
3/ Prior to 2000, the civil service pension fund is excluded.