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January 16, 2002

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Korea—Staff Report for the 2001 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2001 Article IV consultation with the Republic of Korea, which is tentatively scheduled for discussion on Monday, February 11, 2002. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of the Republic of Korea indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Chopra (ext. 38801) and Mr. H. Ma (ext. 34928).

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Friday, January 25, 2002; and to the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF KOREA

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the 2001 Consultation with the Republic of Korea

Approved by Wanda Tseng and Leslie Lipschitz

January 16, 2002

- The consultation discussions were held in Seoul during October 31–November 13, 2001. The mission comprised Messrs. Chopra (head), Richards, Kang, Ma, and Ms. Liang (all APD); Ms. Mitchell Casselle (MAE); and Mr. Laryea (LEG). The mission was assisted by Mr. Gruenwald, Resident Representative. Mr. Mako, a World Bank specialist in corporate sector issues, joined the team for part of the mission. Ms. Karasulu (MAE) also assisted the mission team. Mr. Cho Won-Dong, Advisor to the Executive Director, participated in the discussions. The consultation mission followed the first FSAP mission (October 22–29).

- The mission met with Deputy Prime Minister and Minister of Finance and Economy, Jin Nyum; Minister of Budget and Planning, Jeon Yun-Churl; Financial Supervisory Commission Chairman Lee Keun-Young; Bank of Korea Governor, Chon Chol-Hwan; Head of the Economic Policy Coordination Committee of the opposition Grand National Party, Yim Tae-Hee; other senior government, central bank, and supervisory officials; and representatives from research institutes, universities, domestic and foreign financial institutions, law firms specializing in bankruptcy issues, labor unions, and rating agencies.

- Korea made its final repayment of Fund credit on August 23, about three years ahead of schedule. At the Board meeting for Post-Program Monitoring in August 2001, Directors commended the authorities for the reorientation and strengthening of the economy since the 1997 crisis. They noted that the easing of macroeconomic policies was appropriate given the weak global economy and stressed the need for firm action to address the continued weaknesses in the corporate and financial sectors.

- Korea's statistical base is adequate to conduct effective surveillance. The ROSC Data Module has recently been completed (SM/01/355, November 29, 2001).

- Korea has accepted the obligations under Article VIII of the Articles of Agreement, and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

- The staff report was prepared by Messrs. Chopra, Richards, Kang, and Ma, and Ms. Liang.

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GLOSSARY OF ABBREVIATIONS AND TERMS

ABS .... Asset-backed security
ADR .... American depository receipt
BOK .... Bank of Korea
CBO .... Collateralized bond obligation
CPI .... Consumer price index
CRV .... Corporate restructuring vehicle
FSC .... Financial Supervisory Commission
FSS .... Financial Supervisory Service
FSAP .... Financial Sector Assessment Program
FTC .... Fair Trade Commission
GDP .... Gross domestic product
IT .... Information technology
ITCs .... Investment trust companies
KCGF .... Korea Credit Guarantee Fund
KOTEC .... Korea Technology Guarantee Fund
KOSDAQ .... Korean Security Dealers Association Index
KOSPI .... Korea Stock Price Index
MSCI .... Morgan Stanley Capital International
MOU .... Memorandum of Understanding
NPF .... National Pension Fund
NPV .... Net present value
OECD .... Organization for Economic Cooperation and Development
OPERA (bond) .... Out-performance equity in any redeemable asset
PCBO .... Primary collateralized bond obligation
q/q .... Quarter-on-quarter
ROSC .... Reports on the Observance of Standards and Codes
p.a. .... Period average
s.a. .... Seasonally adjusted
SDDS .... Special Data Dissemination Standard
SMEs .... Small and Medium Enterprises
ULC .... Unit labor cost
W .... Won
y/y .... Year-on-year

Exchange rate at end-December 2001 US$1 = W 1,314.

EXECUTIVE SUMMARY

Current setting and outlook. The weak global economy and the downturn in the high-tech sector have contributed to a sharp fall in Korea's growth rate. Progress continues to be made in corporate and financial sector restructuring, but corporate malaise continues.

- Growth slowed to about 2½ percent in 2001, following two years of near double digit increases. There are signs of improvement in the outlook, and growth is projected to be about 3¼ percent in 2002. Inflation has fallen and is expected to remain subdued in 2002 in the absence of demand-side pressures.
- The external accounts are strong and the exchange rate appreciated modestly during 2001. The current account surplus is expected to remain healthy in 2002 and foreign exchange reserves are substantial. External vulnerability indicators continue to improve and the risk of an external financing crisis is low.
- After initial hesitation, monetary policy was eased aggressively in the third quarter of 2001. However, the fiscal outturn in 2001 was substantially tighter than budgeted implying a contractionary stance.
- The corporate sector remains highly leveraged and profitability is low. The needed restructuring and asset sales continue to be hampered by creditors' reluctance to accept reductions in claims.
- The soundness of the financial system has improved, and many of the problems that remain are the result of continuing weaknesses in the corporate sector.

Policy issues. There was broad agreement on the policy priorities and the main challenge will be to implement the necessary policies under difficult circumstances.

- Supportive macroeconomic policies remain necessary in light of the weak global outlook for 2002. However, political maneuvering and the tradition of fiscal conservatism have resulted in the adoption of a contractionary budget for 2002. As inflation is not a threat, there is room for more monetary easing if there is evidence of fresh weakness in the economy.
- The authorities agreed that much still needs to be done to strengthen the corporate and financial sectors and entrench the role of market discipline.
  - Reforming the insolvency system is a priority and will be essential to promote the orderly exit of nonviable companies and stimulate operational restructuring. The authorities plan to amend and streamline some of the direct regulations imposed on *chaebol* and recognize that market-based mechanisms of corporate governance also need to be strengthened.
  - The authorities intend to press ahead with bank privatization. The supporting step of raising the limit on individual domestic investors' holdings in banks will need to be complemented with stronger safeguards on connected lending. Creditors need to acknowledge the true health of debtors and it will be important for supervisors to address deficiencies in financial institutions' assessment of asset quality.

I. Introduction

1. **The completion of early repayments to the Fund in August 2001 symbolizes how much Korea has achieved since the crisis that erupted in late 1997**. Reserves now provide substantial insulation against shocks and vulnerability to an external financing crisis is low. A wide range of reforms has also helped address the weaknesses that precipitated the crisis and foster an environment where market discipline plays a more important role.

2. **Yet Korea faced major challenges in 2001 with the combination of a weak global economy and continued weakness in the corporate and financial sectors**. The global downturn in the information technology sector and slower growth in major trading partners imposed a large toll and the situation was further complicated by the impact on the global economy of the September 11 terror attacks. Nevertheless, although growth fell sharply, Korea has outperformed other tech-dependant Asian countries.

3. **The impact of these external shocks is expected to persist into 2002**. There was broad agreement between the authorities and the mission team on the policy imperatives for the period ahead, namely:

- To use macroeconomic policies to support domestic demand and cushion the impact of the cyclical downturn.

- And, to persevere with the remaining agenda of restructuring and reform to strengthen the corporate and financial sectors and entrench the role of market discipline.

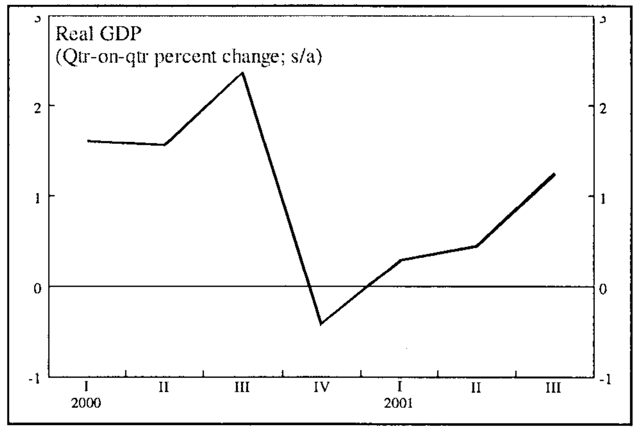
4. **The main challenge will lie in implementing the necessary policies under difficult political circumstances**. President Kim's single term expires in early 2003 and his domestic popularity has fallen. The President's Millennium Democratic Party is now in the minority in the National Assembly and the opposition Grand National Party has substantial control of the legislative agenda. The major parties are making efforts to forge a bipartisan consensus on economic issues, but pre-election political maneuvering has begun in the lead up to local elections in June 2002 and Presidential elections in December 2002. Meanwhile, South Korea's historic rapprochement with North Korea is making little headway.

II. The Current Setting

A. Macroeconomic and Market Developments

5. **Growth perked up in the third quarter of 2001, after an anemic first half**. The economy grew at an average quarterly rate of 0.3 percent (s.a.) in the first half, and preliminary estimates show that q/q growth jumped to 1.2 percent in the third quarter. A part of the strength in the third quarter, however, may be an artifact of the timing of the *Chuseok*

(Harvest Moon) holiday in 2001.[1] In any event, the Korean economy's size and diversification have helped it do better than many other Asian countries facing similar external shocks (Box 1).



- Although the global electronics slump has hurt Korean high-tech exports, other exports have performed reasonably well.

- Domestic demand bounced back starting in Q2, with private consumption a key driver. Consumer spending and confidence have been sustained by steady growth of household income, ample credit to households, and low real interest rates.

- Construction investment has finally rebounded (after three years of decline), but equipment investment has contracted since early 2000 in tandem with the high-tech sector, suggesting that previous overinvestment is being corrected. Capacity utilization still remains low.

- On the supply side, although the downturn in the high-tech sector has restrained industrial production, the service sector (which now accounts for about 45 percent of GDP, up 6 percentage points from a decade ago) has provided an offsetting source of growth.

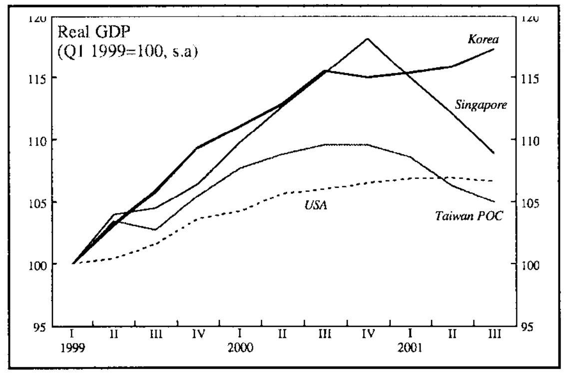
6. **Partial indicators suggest that growth remained positive in the fourth quarter, but perhaps not as strong as the surprisingly healthy third quarter**. Although the September 11 shock was also felt in Korea, the impact appears to have been smaller than initially feared. Indicators such as retail sales, industrial production, inventories, and consumer and business sentiment suggest that the economy has bottomed and the growth outlook is better than initially expected. It is still too early to conclude, however, that a strong and durable recovery is underway. For the full year, GDP growth for 2001 is estimated at about 2½ percent.

[1] As this holiday shifts between the third and fourth quarter in different years, its substantial impact is difficult to capture fully in seasonal adjustment.

Box 1. Korea's Economic Slowdown: The Regional and Global Context

Growth in Korea has been somewhat more resilient than other Asian countries in 2001 (excluding China and India), due in large part to its more diversified export structure and the fact that domestic demand has held up well so far despite one of the worst economic slowdowns in two decades.

External factors continue to play a pivotal role in shaping the business cycles in Korea.[1] Output in Korea has historically been strongly correlated with the output of the United States and the expansion phase of the current cycle occurred amid a boom in the global IT sector, and strong demand for products as semiconductors, electronics, and information and telecommunication equipment. Indeed, the economy appears to have been so tightly tethered to the US IT spending cycle that when spending in that sector declined, Korea felt it immediately, before the slowdown in overall US GDP growth materialized. Specifically, Korea's GDP fell in 2000 Q4 and quarterly growth rates have since been anemic but positive.



Although exports have contracted and contributed to GDP weakness, Korea has been hit less hard by the global slowdown than other export-dependent Asian peers. Korea's relatively diversified export structure has been an important reason for this difference. Exports of IT products have been pivotal in contributing to the vitality of Korea's exports in the expansion phase, but their 17 percent share of GDP (about the same as in Taiwan POC) is substantially below that of Malaysia and Singapore where they account for about 50 percent of GDP. At the same time, some of Korea's other important exports have continued to grow. Most notably, exports of automobiles and ships continued to be strong in 2001, helping to soften the impact of falling IT exports. Further, Korea's trading partners are also relatively diverse. Although the United States remains Korea's largest single trading partner, accounting for 20 percent of exports, China has gradually become its second largest export market, accounting for 10 percent.

Private consumption has provided some support to the economy during the slowdown. With a sharp fall in stock prices and substantial decline in the terms of trade, private consumption growth slowed in the second half of 2000, but saw only one quarter of negative growth at the start of 2001. Confidence indicators began to pick up in the first half of 2001and private consumption returned to positive growth in the second quarter, in striking contrast to electronic exporters such as Taiwan POC and Malaysia where private consumption has plunged. Low real interest rates, banks' increased focus on consumer lending, and the household sector's reasonably strong balance sheet have helped support consumption in Korea.

The global IT weakness has also shown up in falling investment. Equipment investment recorded growth above 30 percent in 1999, largely reflecting buoyant investment in the IT sector. However, equipment spending peaked in the first quarter of 2000—coincident with the peak in the Nasdaq index—and has since contracted markedly (a cumulative decline of about 17 percent), suggesting that previous overinvestment is being corrected. Poor market sentiment due to concerns about the health of the corporate sector has also contributed to weakness. Fortunately, construction investment has begun to pick up in 2001 after a long period of weakness. In particular, construction of residential buildings has recently rebounded, benefiting from low interest rates and government stimulus measures.

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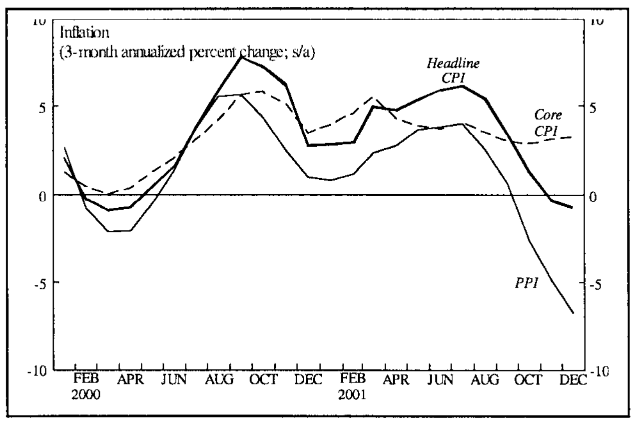
[1] See "Features of Korean Business and Export Cycles" in the forthcoming *Selected Issues* paper.

Indicators of Economic Activity, 2000–01
(Percent change, y / y, unless otherwise indicated)

	2000	2001			2001	
	Q4	Q1	Q2	Q3	Oct.	Nov.
Real GDP 1/	-0.4	0.3	0.4	1.2	…	…
Total domestic demand 1/	-0.9	-1.9	2.1	3.2	…	…
Industry						
Industrial production	7.6	5.0	1.6	-1.7	-1.3	4.9
Capacity utilization rate 2/	75.0	74.7	74.5	73.1	71.5	73.6
Consumption and Investment						
Wholesale and retail sales	3.9	2.5	4.4	4.8	4.6	6.5
Machinery orders	17.1	3.4	-2.8	-5.7	4.2	-0.6
Construction orders	-6.9	-27.4	-2.1	16.4	30.2	80.4
Leading Index	-0.3	-2.3	-0.7	-0.5	1.2	3.8

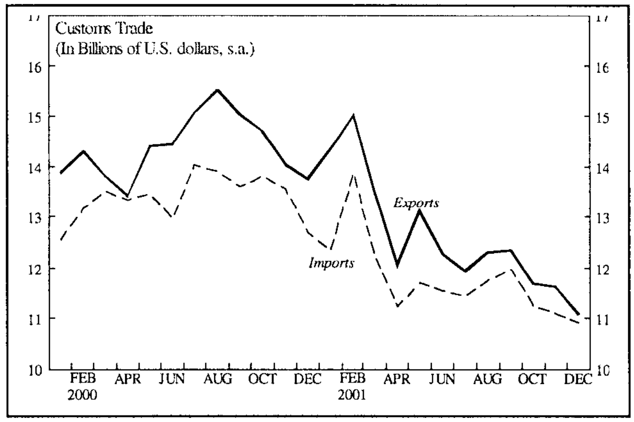
1/ Seasonally adjusted, q/q changes.
2/ In percent.

7. **Inflation has fallen as demand-side pressures have been absent**. Headline CPI inflation peaked at 5.4 percent in May following the depreciation of the won and hikes in public service fees in late 2000 and early 2001. As the impact of these exogenous and temporary factors wore off, and also with the recent easing in oil prices, inflation fell to 3.2 percent (y/y) in December. Core inflation in 2001, however, exceeded the upper bound of the 2–4 percent (p.a.) target range set by the BOK by 0.2 percentage points. Meanwhile, the weakness in manufacturing and falling import prices have resulted in negative PPI inflation in recent months. Despite slower growth, the unemployment rate remains low (3½ percent in November).[2] Wage increases have nevertheless been modest and, although productivity growth has slowed with the cycle, unit labor costs have held steady.



[2] Employment in the labor-intensive service sector has increased, and there may also be some labor hoarding. See also "Labor Market Developments in Korea Since the Crisis," in the forthcoming *Selected Issues* paper.

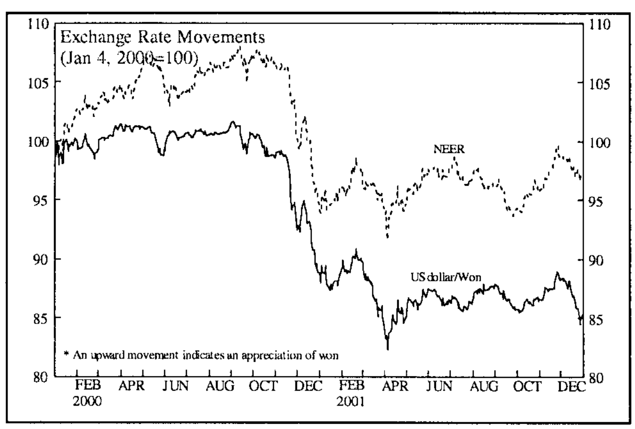
8. **The current account remains strong** with the surplus estimated at $10½ billion (2½ percent of GDP) in 2001, unchanged from the previous year. Export volume growth remained positive at about 2 percent in 2001 (albeit down sharply from 20 percent growth in 2000), with exports of cars, cell phones, and ships offsetting the sharp slide in exports of semiconductors and other electronics. By contrast, import volume contracted by about 7 percent, as slower growth led to weaker imports of capital goods and raw materials. With export prices (notably for semiconductors) sliding more than import prices (notably for oil), the terms of trade deteriorated by 8½ percent in 2001, following a 13 percent fall in the previous year.



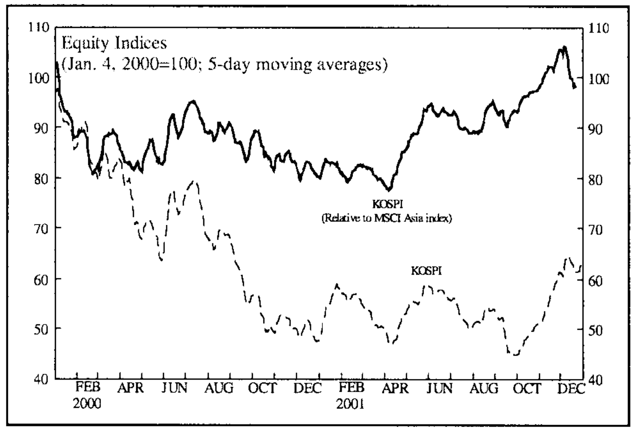
Trends in Export and Import Values
(Percent change, year-on-year)

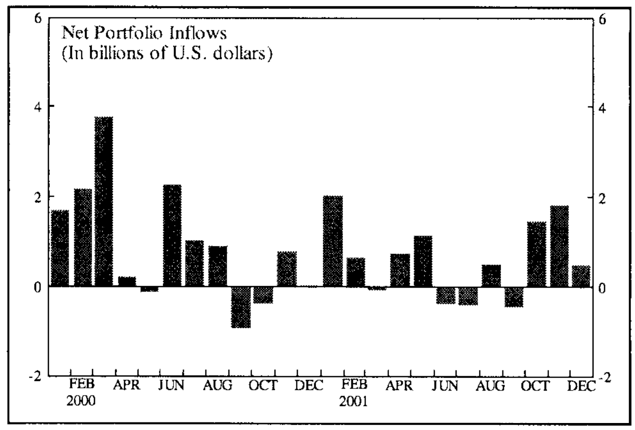
	2000	2001 Jan.–Oct.
Exports (shares in parentheses)		
Semiconductors (12)	13	-41
Telecommunication (8)	68	-15
Automobiles (6)	18	5
Shipbuilding (5)	10	32
Iron and steel (4)	26	-19
Imports (shares in parentheses)		
Raw materials (49)	38	-6
Capital goods (41)	35	-20
Consumer goods (10)	15	2

9. **The won appreciated by about 3 percent in nominal effective terms during 2001**. Following weakness immediately after September 11, the won started to appreciate again, driven up by portfolio inflows and an improved outlook for the economy. The fall in the yen late in the year, however, led to some renewed weakness in the won-dollar exchange rate. At year-end, the exchange rate was about 16 percent below its precrisis level in real effective terms (CPI basis). Official reserves at end-2001 stood at about $103 billion—about twice short-term external liabilities on a remaining maturity basis. The $6½ billion increase in reserves in 2001 was due mainly to interest earnings and valuation gains, as intervention in the foreign exchange market has been limited to only a few occasions when the market was highly volatile and has involved both buying and selling.

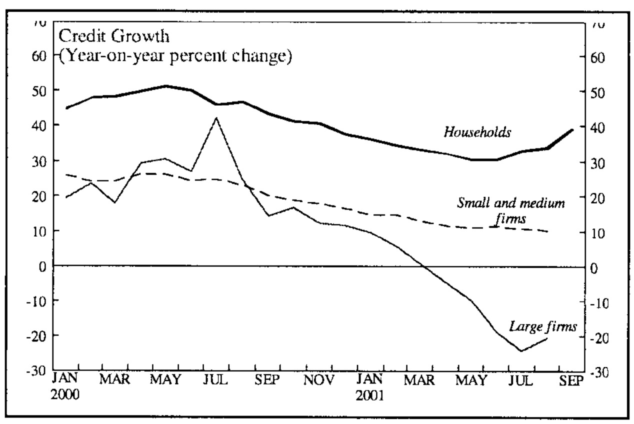


10. **The equity market was strong in late 2001.** At year-end, the KOSPI was 26 percent higher than its September 10 level and up 37 percent for the full year. Foreigners were net purchasers of equity in 2001 ($7¼ billion) and now hold a record high of about 37 percent of market capitalization on the Korea Stock Exchange.[3] For the full year, the KOSPI substantially outperformed the MSCI Emerging Asia index. Meanwhile, sovereign spreads (measured by the EMBI+) have narrowed to 120 basis points (i.e., nearly 100 points below their end-2000 level). In November, Standard and Poor's raised Korea's credit rating to BBB+, citing progress in structural reforms, a strong external liquidity position, considerable fiscal flexibility, and a diverse economy. Subsequently, Moody's (Baa2) changed its outlook from "stable" to "positive."





11. **Bank lending to the private sector has been strong**, as banks have shifted their focus from the troubled *chaebol* to households (including shopkeepers and small retailers) and SMEs, which have traditionally had limited access to credit. Credit to households has jumped from about 16½ percent of GDP in 1999 to 29 percent of GDP in 2001, giving rise to concerns about the quality of this credit.[4] The growth of total financial system credit to the private sector, however, has been weak



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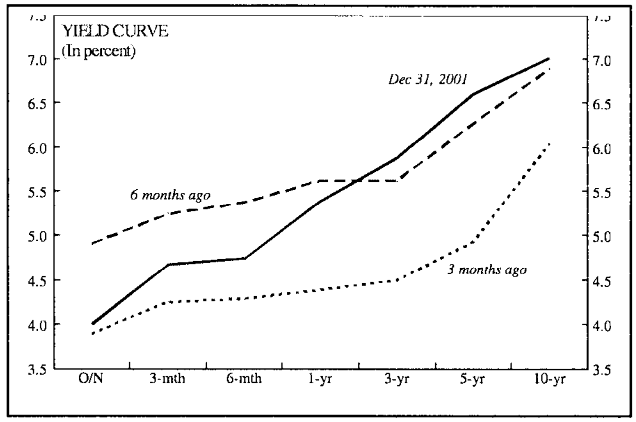
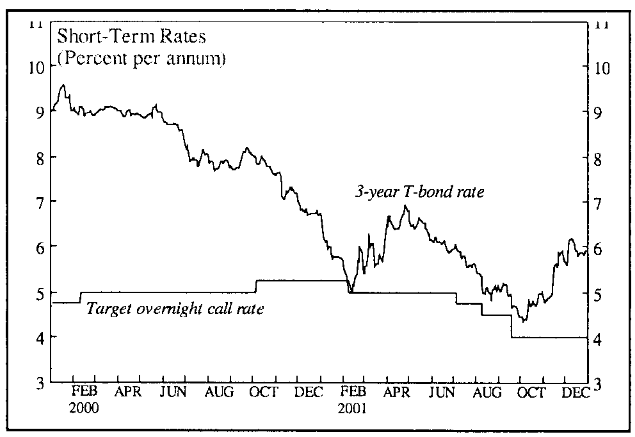
[3] See "Linkages Between Domestic and International Asset Markets: The Korean Case" in the forthcoming *Selected Issues* paper for further information on the Korea discount.

[4] Mortgage lending (where loan-to-value ratios are 60–80 percent) appear to be less of a concern at this point than credit card lending where delinquencies are on the rise.



due to retrenchment by the nonbank sector and the deleveraging of large enterprises.[5] In the bond market, the large hump in corporate bonds due in Q4 2001 was successfully rolled over, with only limited reliance on the government-sponsored schemes involving the Korea Development Bank (KDB) and Korea Credit Guarantee Fund (KCGF). In addition, the arrangement whereby the KDB stood ready to roll over bonds of a few large companies for subsequent sale in government guaranteed collateralized bond obligations was terminated at end-2001 as planned. Further, the spread between high- and low-rated corporate bonds has held steady since March. The yield curve, however, has become more steep, which appears to be due to stronger-than-expected recent output data and expectations that the monetary easing cycle may have reached its end, rather than inflation concerns.

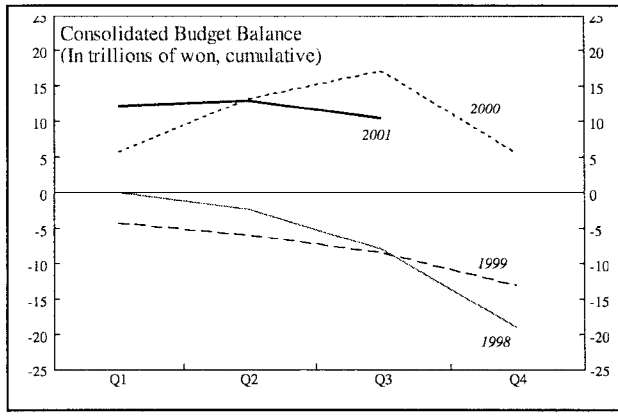
B. Monetary and Fiscal Policies



12. **After initial hesitation, monetary policy has been eased substantially and the call rate is now at a historic low.** Despite the weakness in activity from late 2000, the target overnight call rate was cut only once in the first half of 2001 (by 25 basis points in February) as the Bank of Korea (BOK) was concerned about breaching its inflation target. However, with the worsening external environment, the increased likelihood of a serious slowdown, and the absence of demand-side inflationary pressures, the BOK moved more aggressively in Q3, cutting rates by a total of 100 basis points, including a 50 basis point cut on September 19 in its first ever inter-meeting cut. Since then, it has kept the policy rate unchanged at 4 percent, noting the tentative signs of a turnaround, the beneficial effects of previous cuts, and an improvement in the external environment.

[5] See "Changes in the Structure of Financing in Korea," in the forthcoming *Selected Issues* Paper.

13. **The fiscal outturn for 2001 was substantially tighter than budgeted**. The 2001 budget, including two supplementary budgets, had targeted a consolidated central government deficit (including the National Pension Fund, or NPF) of 1 percent of GDP. Preliminary data indicate, however, that through September the budget outturn was a surplus of 2 percent of full-year GDP. For the year as a whole, the balance is estimated to have been a surplus of about ½ percent of GDP, down only slightly from a surplus of 1 percent of GDP in 2000. The full year estimates indicate the following:



- On the revenue side, automatic stabilizers worked to some extent, as slower growth was associated with an estimated tax revenue shortfall of 1 percent of GDP compared with the revised 2001 budget.

- On the expenditure side, automatic stabilizers are very weak and the attempt to frontload spending to the early part of the year was only partially successful. The non-interest portion of current expenditure fell below target by an estimated 1 percent of GDP. The shortfall in net lending is estimated to have been another 1 percent of GDP.

- The overall surplus reflects the 2½ percent of GDP surplus recorded by the NPF.[6] The authorities, therefore, have also been focusing on the fiscal accounts excluding the NPF, which recorded a deficit of about 2 percent of GDP (compared with an implied deficit target of 3 percent of GDP).

- From an aggregate demand perspective, the comprehensive deficit measure including the NPF is most relevant. The fiscal stance was contractionary in 2001, and there was virtually no change in the stance from the previous year.

[6] The NPF's accounts are consolidated with the central government, and its large surplus reflects Korea's relatively young pension system.

C. Corporate and Financial Sector Developments

14. **Progress continues to be made in corporate and financial sector reform and restructuring, but corporate malaise persists.** Notably:

- Fourteen of the biggest 30 *chaebol* in 1997 have been closed, dismantled, or sold off; debt-equity ratios have been reduced; and steps have been taken to strengthen financial disclosure and corporate governance.

- The soundness of the financial system has also improved. Accomplishments include better provisioning and a reduction in impaired assets, consolidation and recapitalization of the banking system, a marked reduction in the size of the weak nonbank sector, operational restructuring, and strengthened prudential regulations.

Nevertheless, the continued low profitability and high indebtedness of companies make clear that the restructuring of the corporate and financial sectors is far from complete.

Corporate Sector Developments

15. **Progress in corporate restructuring continued in 2001.** As a result of rehabilitation, sell-offs, and liquidations, the number of companies in formal workout programs fell to 26 by September 2001 (from 38 at the end of 2000). In addition, banks have nearly completed their examination of distressed companies targeted for special monitoring and have so far identified 141 firms (with combined bank exposure of W 3½ trillion, or 1 percent of total commercial bank loans) for liquidation. A nonbinding MOU outlining the terms of a partial takeover of Daewoo Motors by General Motors has been signed; complex legal and procedural matters have resulted in delays in closing the deal.

16. **Despite fears that the downturn might weaken restructuring efforts, the government has pressed ahead with new measures.** Priority has been given to the resolution of distress in large companies. A new Corporate Restructuring Promotion Law took effect in September 2001. This law formalizes some aspects of the "out-of-court" workout framework and the authorities hope that it will shift the balance of workouts away from continued provision of new financing and toward more operational restructuring.

17. **Nevertheless, the corporate sector remains highly leveraged and vulnerable.** The most distressed workout *chaebol* continue to make losses and some are close to being insolvent. The average profitability of large listed companies did not improve in 2000 or early 2001, and the gap between good and bad companies has widened (Box 2). Despite low interest rates, nearly one out of three companies is still unable to generate sufficient cash flow to meet interest payments. Yet the needed restructuring and asset sales continue to be hampered by disagreement between creditors over loss-sharing and weak insolvency procedures. In addition, creditors (especially state-owned banks) have been reluctant to accept reductions in their claims, prolonging the liquidation of unviable companies.

Box 2. Korea's Corporate Malaise

Since 1997, efforts to restructure Korea's corporate sector and address corporate distress have resulted in a reduction in debt-equity ratios; some improvement in average profitability; the exit, sale, or dismantling of a number of large *chaebol*; a reduction in the number of affiliates under most *chaebol*; and some large asset sales. However, despite these achievements, the corporate sector remains weak.

The average debt-equity ratio for the manufacturing sector continued to decline in 2001 and is now just below 200 percent. However, since 1999, the stock of corporate debt has risen, indicating that recent improvements in debt-equity ratios are mainly due to increases in equity and retained earnings rather than actual debt reduction. Moreover, much of the new equity has been issued by the healthier larger *chaebol*, implying that medium-sized and small *chaebol* remain heavily indebted. As a result, the corporate sector is constrained in its return to profitability.

Table. Korea: Indicators of Financial Stability and Profitability in Manufacturing, 1997 - 2001
(In percent)

	Korea					U.S.	Japan
	1997	1998	1999	2000	2001 1/	2001 1/	1999
Debt-equity ratio	396.3	303.0	214.7	210.6	198.3	154.4	174.0
Corporate debt (in trill. of won) 2/	788.1	777.5	775.9	800.3	821.2	...	...
(in percent of GDP)	(174%)	(175%)	(161%)	(155%)	(152%)	...	...
Interest-coverage ratio 3/	129.1	68.3	96.1	157.2	170.5	224.9	367.5
(% of comp. with ICR less than 100)	...	...	(33%)	(26%)	(30%)	...	...
Ordinary income to sales	-0.3	-1.8	1.7	1.3	2.6	2.8	2.9

1/ end-June 2001. Comparison with annual figures is not strictly applicable because of different sample size.
2/ Entire corporate sector.
3/ Ratio of operating income to interest payments.
Sources: BOK, Financial Statement Analysis for various years; national sources. Flow of Funds data.

The improvement in average profitability masked a widening gap between the good and bad performers. Specifically, the interest coverage ratio and other profitability measures have improved steadily since 1998, but the share of companies with insufficient cash flow to meet interest payments remained high at 30 percent in mid-2001. This picture also applies to the top-30 *chaebol* where nine are either in some form of workout or in severe financial straits. In 2000, these sick *chaebol* recorded net losses of W 12½ trillion (2.4 percent of GDP).

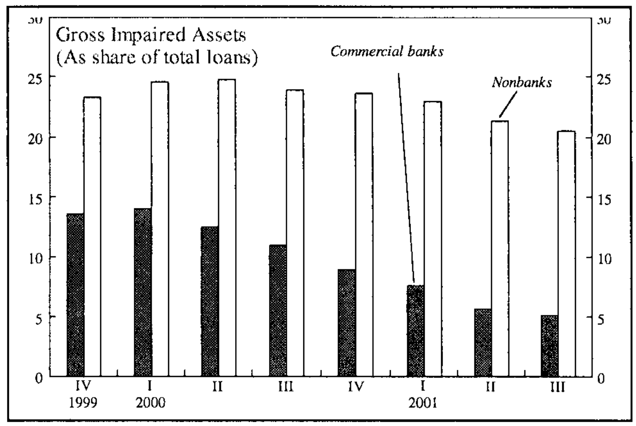
A significant portion of corporate debt can be considered "distressed." In mid-2001, companies with an interest coverage ratio of less than one accounted for 50 percent of total outstanding borrowing (from banks and other sources), up from 45 percent one year earlier. Companies with negative earnings accounted for 21 percent of total borrowing. These figures are face values derived from corporate balance sheets and, although precise data are not available, financial institutions' actual exposure to these distressed companies is likely to be significantly lower on account of write-offs, provisioning, and asset sales to KAMCO and other asset-management companies.

Firm-level analysis confirms a significant negative correlation between profitability and leverage, concentration of shareholder power, and being affiliated with a *chaebol*. An analysis of financial statement of 450 listed companies during 1996–2000 indicates that non-*chaebol* firms in general outperformed *chaebol* firms. Moreover since the crisis, the premium attached to *chaebol* affiliation and high ownership concentration has disappeared and turned negative, suggesting that markets are now valuing companies with sound corporate governance more highly. These issues are discussed in greater detail in "Firm-Level Analysis of the Korean Corporate Sector During 1996–2000" in the forthcoming *Selected Issues* paper.

18. **Hynix Semiconductor is the most visible example of the corporate sector's continuing weakness and the initial intransigence of dissenting creditors**. Hynix has borrowings of $7½ billion (nearly 2 percent of GDP). After prolonged wrangling, creditors agreed on a burden-sharing arrangement in October 2001, which resulted in most banks with relatively small exposure (both private and state-owned) pulling out, while banks with substantial exposure (mainly state-owned) provided new money and participated in a large debt-equity swap. In December, Micron Technology of the United States entered into discussions with Hynix on an alliance or merger. If successful, such steps could help ease overcapacity in the global semiconductor industry and improve Hynix's financial condition.

Financial Sector Developments

19. **Efforts to strengthen the financial system are also continuing**. Commercial banks reduced their impaired loans as a share of total bank loans to 5 percent at end-September from 9 percent at end-2000, owing to loan recoveries, sales, and write-offs. Profitability, loan-loss provisioning, and capital positions also continued to improve for most domestic banks, with capital reported to be 11 percent of risk-weighted assets in June. However, there are still concerns that banks may be understating the true scale of their potential bad debts, particularly against large corporate exposures. Reductions in impaired loans may also be partly cosmetic, as banks typically retain substantial exposure even after selling impaired loans in deals involving asset backed securities. Further, less progress has been made by the nonbank sector (e.g., mutual savings, merchant banks, and insurance companies), where gross impaired assets still account for more than 20 percent of total loans. (The nonbank sector, however, now accounts for only 15 percent of total financial system loans.)



Korea: Asset Quality of All Financial Institutions
(In percent of all loans, unless otherwise indicated)

Percent of all loans	1999 Dec.	2000 Dec.	2001 Sept.
Substandard or below	14.9	10.4	7.3
Of which : commercial banks	13.6	8.9	5.1
Net substandard or below 1/	9.0	4.8	3.7
Of which : commercial banks	8.1	4.1	2.7

1/ (Total substandard or below loans minus loan loss provisions)/(total loans minus loan loss provision).

20. **Financial sector consolidation has gained momentum**. Three newly formed financial groups now account for 50 percent of total bank assets. The government-led Woori financial holding company—which comprises four weak commercial banks and a merchant bank, all state-owned—is now fully operational, but progress has been slow in rehabilitating the banks within the group. The first private financial holding company was formed around

Shinhan Bank in September 2001, and the private merger between Kookmin Bank and Housing and Commercial Bank took place in November.

21. **Progress in the privatization of nationalized financial institutions has been slow.** Talks between the government and Deutsche Bank Capital Partners regarding the sale of Seoul Bank ended in failure. On the positive side, first steps toward the reprivatization of Chohung Bank and Woori commenced in December with the sale of so-called "OPERA" bonds exchangeable into shares.[7] In the nonbank sector: (i) an MOU was signed on the sale of the Hyundai financial affiliates to a consortium led by the American International Group; and (ii) following earlier failed attempts to sell Korea Life Insurance, new potential buyers have tendered letters of intent.

22. **Efforts are being made to upgrade the quality of financial sector supervision.** For example, the FSS is working on improving its risk assessment capabilities, and banks have also taken important steps to improve risk management, lending practices, and the pricing of credit risk. These endeavors are still in the early stages of an ongoing process. Meanwhile, the reorganization of the supervisory structure has not made much headway following the decision in early 2001 to maintain the current organizational arrangement of the FSC and FSS; any action will likely be put off until after the Presidential election.

III. Outlook and Assessment of Vulnerabilities

23. **There is much uncertainty surrounding short-term forecasts at present.** As Korean recoveries have historically been export-led, a return to healthy growth is unlikely until the global economy picks up. However, domestic demand, which has been stronger than anticipated, could this time play a bigger role in leading a recovery, especially if macroeconomic policies are supportive in 2002.

- In the team's baseline scenario, growth is projected to be 3¼ percent in 2002, assuming positive but weak growth in the first half of the year and a more robust recovery in the second half—a similar quarterly profile as major industrial countries. By contrast, the authorities expect a faster world recovery and are projecting growth of about 4 percent, somewhat higher than the December 2001 consensus forecast of 3.6 percent.

- In the team's projection, growth of domestic demand, mainly private consumption and construction investment, would help offset a smaller contribution from net exports. Following a sharp contraction in 2001, equipment investment is expected to remain weak, reflecting the high degree of excess capacity, particularly in the

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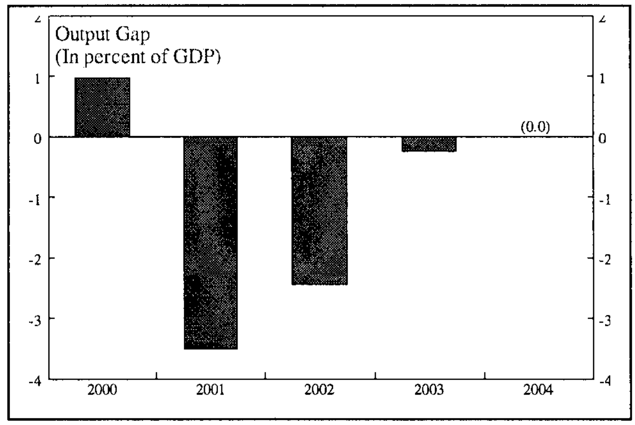
[7] See "Bank Privatization in Korea: Developments and Strategies" in the forthcoming *Selected Issues* paper, which includes a discussion of OPERA bonds (an acronym for "Out-Performance Equity in any Redeemable Asset").

information technology sector. The current account surplus is projected to fall to 1¾ percent of GDP in 2002, with some recovery in exports offset by higher imports.

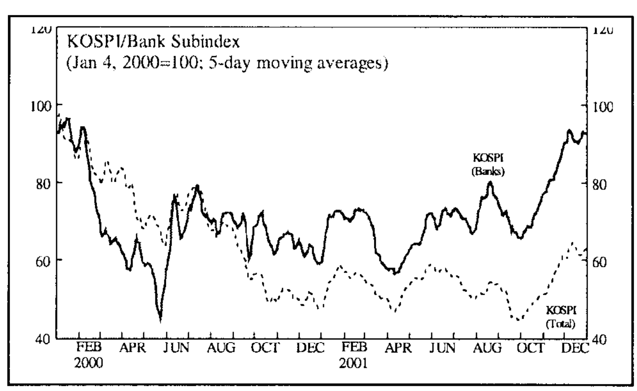


- Wage and demand pressures on prices are likely to remain subdued as a large negative output gap continues in 2002. Headline inflation, therefore, is projected to decrease from 4½ percent (period average) in 2001 to about 2 percent in 2002; core inflation is projected to be about 2½ percent. The output gap would likely not close until 2004.

24. **Over the medium term, growth is projected at about 5½ percent, in line with potential output growth.** This projection is based on total factor productivity growth increasing from 3 percent per year before the crisis to about 4 percent per year over the medium term, while the growth of factor inputs is assumed to be slower than in the past. The productivity improvements will depend critically on further progress in implementing structural reforms. That is, Korea is unlikely to be able to grow out of its structural problems—rather, structural reform will be necessary to underpin future growth. The current account is assumed to be in broad balance over the medium term, which would result in a fall in external debt relative to GDP and is also consistent with empirical studies of the long-run determinants of saving and investment behavior in Korea.

25. **The downside risks to the near-term projections come mainly from the external front.** A further sharp fall in external demand or a prolonged world recession would have an additional negative impact on growth. Similarly, if there was renewed upward pressure on oil prices or a further fall in export prices, the negative impact on the current account could be considerable, with a somewhat smaller impact on growth. These negative shocks, however, are unlikely to result in a severe recession. Annex I provides a sensitivity analysis to external demand and terms of trade shocks using the Oxford Economic Forecasting Model.

26. **Although Korea's corporate and financial sectors remain weak, progress in restructuring has reduced domestic vulnerability.** Further shocks to the global outlook could lead to additional corporate failures, which would hurt the still-weak financial sector, and the outlook for capital inflows and assets sales to foreigners would worsen. Most banks, however, now appear to be in a better financial position to deal with problems arising from



corporate weakness, although there is further work to be done to improve asset classification and provisioning.[8] In addition, the bank sub-index of the KOSPI has outperformed the overall stock market, suggesting increased market confidence in private banks. The main consequence of continued malaise in the corporate sector, therefore, is diminished efficiency and distorted competition. Korea also has considerable flexibility on the fiscal front to deal with potential domestic problems.

27. **These domestic weakness are unlikely to result in a major external crisis in the near term**. Foreign reserves are now at a level that provides substantial insulation against shocks. Short-term external debt has been substantially reduced from levels before the crisis, and Korea has no sovereign borrowing requirements. Further, the exchange rate has been flexible, although many companies (especially smaller ones) reportedly still do not hedge their foreign exchange position leaving them vulnerable to balance sheet losses from a sharp depreciation. These factors imply that the risk of contagion from external financial turbulence is modest. Early warning system models also indicate a low probability of a balance of payments crisis and projections of financing requirements in 2002 suggest that Korea is unlikely to face an external financing crisis even under an adverse scenario. Indeed, many investors view Korea as a safe haven in emerging markets as its external position is considered to be resilient to most foreseeable potential shocks.

IV. Policy Discussions

28. **There was broad agreement on the assessment of the economic situation, risks, and policy requirements**. Specifically, the mission team and authorities concurred that there is scope to use expansionary macroeconomic policies if necessary to support domestic demand and cushion the impact of the cyclical downturn, although the authorities are somewhat constrained in their room for maneuver in part because of political considerations. Further, the authorities acknowledge that much remains to be done to strengthen the corporate and financial sectors and entrench the role of market discipline, and there was agreement on the key priorities for the period ahead in the remaining agenda of structural reforms and restructuring. The authorities also recognize that despite the slowdown in the economy it will be important to accelerate reforms that lead to more speedy restructuring and put Korea in a stronger position to benefit from a rebound in world growth. With broad agreement on the diagnosis and remedies, the main challenge lies in the implementation of the necessary policies under difficult circumstances.

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[8] The post-program monitoring staff report (EBS/01/111, July 5, 2001) presented simulations of the impact of declining credit quality on bank capital, which concluded that the banking system capital ratio would fall only to about 7¾ percent even with relatively extreme assumptions. More thorough stress tests will be conducted under the FSAP.

A. Macroeconomic Policies

29. **Discussions on macroeconomic policies centered on the scope for Korea to respond flexibly to the current global slowdown**. The team noted that subdued inflation, low government debt, and absence of external financing requirements for the government give Korea far more scope for expansionary policies than many other countries, which would allow it to play a positive role in the global and regional recovery. The authorities agreed that macroeconomic policies could be eased further if it proved necessary, but noted that recent data suggests greater strength in the economy than previously expected.

30. **The team urged the authorities to adopt a more expansionary fiscal stance in 2002 than implied in the draft budget**. The estimated fiscal outturn for 2001 indicated that despite the sharp slowing in the economy, fiscal policy had provided no stimulus beyond the automatic stabilizers. The draft 2002 budget (submitted to the National Assembly in September 2001) projected a rise in the consolidated central government surplus to 1 percent of GDP. This budget would be contractionary and was not appropriate given the weaker global and domestic outlook. The team noted that Korea has an admirable tradition of fiscal conservatism, which now provides room for countercyclical policy to support a recovery. Accordingly, the team recommended aiming for a modest deficit in 2002 (e.g., about ½ percent of GDP, which would imply a positive fiscal impulse of about 1¼ percent of GDP).[9] Fiscal stimulus could come mainly from temporary measures, such as increased social safety net expenditure and an acceleration of infrastructure projects.

Korea: Key Budget Aggregates 2000–02
(In percent of GDP)

	2000		2001 1/		2002 1/
	Budget	Actual	Budget 2/	Staff Proj.	Budget
Overall balance	-3.3	1.3	-1.0	0.6	1.1
Excluding NPF balance	-4.6	-0.9	-3.1	-1.9	-1.2
Primary balance	-0.6	2.6	1.6	3.2	3.9
Cyclically neutral balance	0.3	0.3	-0.5	-0.5	-0.3
Fiscal stance	3.6	-1.0	0.5	-1.1	-1.4
Fiscal impulse	0.2	-4.3	1.5	-0.1	-2.1

1/ Assuming real growth rates of of 2.6 percent in 2001, and 3.2 percent in 2002.
2/ Includes the two supplementary budgets.

[9] Research by the Korea Development Institute suggests a government expenditure multiplier of up to unity, which appears plausible under the current circumstances of considerable slack in the economy and low risk of crowding out. This estimate is also in line with estimates for other industrial countries.

31. **Political maneuvering and Korea's tradition of fiscal conservatism, however, have constrained the adoption of a more expansionary budget**. The authorities agreed that the draft budget for 2002 had been overtaken by events, and said that they hoped either to amend it before passage or to formulate a supplementary budget early in 2002. In the event, however, the budget was passed on December 27, 2001 with an unchanged projection of a surplus of 1 percent of GDP. This outcome is not a surprise as the authorities had noted during the November discussions that the opposition party was opposed to even a temporary fiscal expansion and was instead pressing for a permanent cut in the corporate income tax together with offsetting spending cuts.[10] In addition, there was a concern that the budget (excluding the NPF) was already substantially in deficit and that government debt had increased so rapidly after the 1997 crisis that further increases must be avoided. The team commended the authorities for dealing with Korea's long-term needs for retirement income by accumulating a surplus in the NPF, but also noted that government debt (including restructuring bonds) was relatively low at about 36 percent of GDP. Further, the conduct of fiscal policy needed to be viewed in the context of the business cycle. Thus, for 2002, the team suggested that it would have been preferable not to withdraw fiscal stimulus, which would also have been consistent with a sound fiscal position. In view of the protracted debate before the 2002 budget was approved, prospects for a supplementary budget to reduce the projected contractionary impulse appear slim. If one was to be considered, it will be important that it is implemented quickly so that its impact is concentrated in the first half of the year when the economy is likely to be relatively more weak.

32. **The team also noted that it has become increasingly urgent to address problems in the implementation of fiscal policy**. There are still important shortcomings in budget planning (e.g., a tendency to underestimate revenue projections and overestimate expenditure forecasts), monitoring, and execution. Hence, the team urged quick implementation of the key recommendations in the 2001 FAD technical assistance report. Specifically, the budgetary process needs to be reformed to improve the accuracy of fiscal forecasting and to ensure better intra-year budget monitoring. In addition, a more comprehensive medium-term approach to formulate expenditure should be adopted, together with a single definition and revised measure of the consolidated central government sector (to replace the current four different budget balance concepts). The authorities agreed with the need for reforms, but noted these can only be implemented gradually. For 2002 they intend to give priority to introducing a midyear budget review and monthly reports on budget execution by ministries.

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[10] The approved budget includes (i) a one percentage point cut in the corporate income tax rate, reducing the marginal rates to 15 and 27 percent; and (ii) a cut in personal income tax rates (from 40 to 36 percent for the top bracket and 10 to 9 percent for the bottom bracket). These tax cuts are part of a long-term tax rationalization plan rather than explicit stimulus measures.

33. **Monetary policy has successfully balanced the need to cement the credibility of the inflation targeting framework and the need to support the weak economy**. The BOK's aggressive easing in the third quarter of 2001 was appropriate in light of the September 11 shock and evidence of falling inflation. Looking ahead, the BOK agreed with the team that there was room for further rate cuts if there is evidence of renewed weakness in the economy. They also agreed that inflation was not a problem and that an output gap would persist into 2002. In view of relatively strong economic data for the third quarter, they preferred to wait and see the effects of the recent cuts in interest rates, noting that monetary conditions are already quite loose and that there is ample liquidity in the system.

34. **With regard to the inflation targeting framework**, a decision has not yet been made on the team's earlier recommendation to amend the BOK Act to allow a shift to announce only a medium-term target with an indefinite horizon, a step that would make the anchor for policy-making clearer. Meanwhile, for 2002, the BOK agreed with the team's suggestion that the target range for core inflation be left unchanged at 2–4 percent (and not be lowered to be centered on the 2½ percent medium-term target) because (i) lowering the target could be misinterpreted as a premature switch to a tightening bias for monetary policy; and (ii) it would be desirable to provide a margin for more easing if needed, especially in view of the high degree of uncertainty regarding the external environment.

35. **Intervention in the foreign exchange market has appropriately been very limited over the past year**. Estimates suggest that the won remains undervalued relative to its medium-term equilibrium level, although from a cyclical perspective it does not appear to be seriously misaligned. Looking ahead, the possibility of substantial changes in bilateral rates between the major currencies make it important that the authorities look to the effective exchange rate and avoid attempting to hold the won exchange rate constant against any single currency.[11] The authorities confirmed that their policy is to let the exchange be market determined, with intervention only when conditions are exceptionally disorderly. In addition, they believe reserves have reached a comfortable level and do not intend to seek to augment them, though modest increases would occur due to interest earnings or valuation changes. The team commended the steps taken by the FSC/FSS to encourage banks to bolster their monitoring of corporate clients' foreign exchange risk management. Risk management could also be facilitated with further efforts to deepen the foreign exchange market (where turnover has grown 2½ times between 1998 and 2001).

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[11] With regard to the possibility of weakness in the Japanese yen, it is worth noting Japan accounts for only 16 percent of Korea's total trade. Although the two countries compete in third markets in products such as electronics, machinery, cars and ships, during previous episodes of yen weakness Japan did not gain market share at Korea's expense. Recently, the yen's weakness against the dollar has tended to be partly matched by a weakening of the won against the dollar, keeping Korea's effective rate broadly stable.

B. Corporate Sector Restructuring

36. **The team urged the authorities to accelerate reforms to improve corporate health and to resolve the "headline" cases**. Tangible results will further boost market sentiment and could reduce the "Korea discount" (i.e., the low valuations of Korean companies by international standards), thereby facilitating corporate financing and privatization.[12] The banks—especially the state-owned banks that are the lead creditors for many of the problem cases—will play a key role here. The FSC/FSS should press banks to classify and provision rigorously under forward-looking criteria (FLC) and to liquidate companies whose losses cannot be stemmed. Further, the government should refrain from encouraging creditors to continue to provide financing; if banks do not have the required expertise to realize the remaining value in failed companies, they should sell their claims to others that have these skills in order to recoup some value.

37. **Reform of the insolvency system will be critical to promote the orderly exit of the nonviable companies** and the rehabilitation of viable companies that are experiencing temporary difficulties. More generally, an effective insolvency regime is essential in a market-driven economy. The authorities recognize that problems in the current legal framework—most notably with regard to the excessive influence of dissenting creditors and inconsistencies among various statutes—have delayed corporate restructuring and asset sales. The Corporate Restructuring Promotion Law seeks to expedite creditor action on some large companies, but is only a stopgap measure. A more major reform of the insolvency laws is therefore planned within the next year and a task force has been formed to make proposals. The team's advice on the desirable elements of a reform program is summarized in Box 3.[13]

38. **The government recently announced plans to relax some of the regulations imposed on the *chaebol* after the crisis**. A range of regulations (e.g., limits on cross-shareholdings by one *chaebol* affiliate in other affiliates) were placed on the largest 30 *chaebol* in the wake of the crisis to encourage a focus on core businesses, ensure that within-group financial dealings occurred at an arms-length basis, increase transparency of group operations, and reduce leverage and the vulnerabilities stemming from these large and complex groups. The *chaebol* have argued that these controls (and other competition-focused regulations implemented by the Fair Trade Commission) have unduly constrained their operations and competitiveness. Noting that such direct regulations on corporate activity are not generally used in advanced economies, the authorities plan to amend and streamline these

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[12] For example, at the start of 2002, Morgan Stanley estimated Korea's forward-looking price/earning ratio at 9.4 versus 17.3 for all emerging Asia, 14.6 for Hong Kong SAR, and 17.8 for Singapore.

[13] See also "Reform of Korean Insolvency Laws: A Review of Critical Issues" in the forthcoming *Selected Issues* paper.

Box 3. Insolvency Law Reform in Korea

The 1997 crisis provided renewed impetus to reform insolvency laws to expedite the exit of nonviable firms and facilitate corporate restructuring. In February 1998, the insolvency laws were amended to provide a better balance between creditor and debtors' rights and to improve the speed and efficiency of the court system. Time limits were imposed to expedite the reorganization process and a specialized bankruptcy court was created in Seoul District. In April 2001, a form of "pre-packaged" bankruptcy was introduced, which allowed for quicker court approval of a reorganization plan if agreed beforehand by creditors.

However, these reforms have not gone far enough to address the fundamental weakness in the system. There is a significant overhang of insolvent companies for which the insolvency regime has failed to provide an effective exit mechanism. In particular, without the credible threat of bankruptcy, dissenting creditors have been able to block agreement on restructuring plans until their narrow demands have been met. For example in the recent restructuring case for Hyundai Engineering and Construction, dissenting creditors were able to delay agreement on a debt-equity swap, leading to additional losses. In the end, the government stepped in with bond guarantees to bring about an agreement.

The reform of Korea's insolvency system will need to cover several areas:

Creation of a unified insolvency system. Korean insolvency laws are strikingly fragmented. The system contains four separate laws as well as insolvency-related provisions such as the Corporate Restructuring Vehicle Act that unduly complicate the treatment of distressed companies. A unitary insolvency regime would enhance the predictability of the system and ensure that once a corporation enters the system it cannot escape without legal determination of its fate.

Inter-creditor issues. The problem of holdout creditors can be addressed through the enactment of strong "cram down" provisions that authorize court approval of a restructuring plan even where some creditors have voted against the plan. To be effective, the cram down mechanism should differentiate between classes of creditors and provide minimum protection for dissenting creditors, such as guaranteeing at least liquidation value or introducing an "absolute priority rule" to safeguard equity treatment among creditor classes. Care must also be taken to not extend cram down rules too far and weaken creditor rights to the point where the availability of credit in the system is adversely affected.

Debtor and creditor participation. The current Korean insolvency laws are inconsistent on the treatment of incumbent management of the debtor and place an inordinate reliance on the availability of sound trustees to manage a debtor's business during insolvency procedures. In this case, the self-interest of management can be leveraged positively by providing management with the qualified right to operate the business with certain safeguards and subject to trustee oversight. In addition, creditor involvement could be enhanced by requiring debtors to bear the reasonable cost of operating the creditors' committee as an administrative expense and by giving creditors the right to propose their own rehabilitation plan after the exclusive period for the debtor's proposal expires.

Efficiency and predictability. A number of reforms could be adopted to make reorganization proceedings more efficient and predictable, including (i) introducing an automatic stay on creditor enforcement once a party applies for reorganization; (ii) enhancing the "pre-packaged" bankruptcy proceedings to enable "fast-track" approval of a restructuring plan already approved out-of-court, and (iii) imposing time limits on important steps in the proceedings. In addition, it would be helpful to extend the current three-year service period for judges in bankruptcy courts in order to preserve the expertise acquired in insolvency matters.

Law of secured transactions. The Korean law of secured transactions severely limits the taking of security on assets other than land. As a result, the system produces an over-reliance on real estate collateral, prevents collateralization of other valuable assets such as inventory and accounts receivable, and reduces the incentives for sound credit risk assessment. Reform of the law on secured transactions would not only strengthen lending practices in Korea, but also provide an efficient alternative to insolvency proceedings for the recovery of credit claims through the swift and efficient foreclosure of collateral.

rules. For example, the 25 percent limit on cross-shareholding in affiliates would be adjusted so that it does not prevent investment in core areas, and it would be removed for companies that have low leverage ratios.

39. **The team stressed that relaxing the current direct regulations increases the urgency of making progress on market-based mechanisms to control risks**. Some companies may exploit the deregulation by slowing their restructuring and engaging in renewed overexpansion. The authorities agreed that stronger oversight by investors and capital markets, corporate management that focuses on shareholder value, more transparent disclosure and accounting, and continued progress in improving corporate governance will be especially important. This would help reduce investors' distrust of the complex cross-equity holdings within *chaebol.* Fortunately, there are signs of improvement, such as a rise in shareholder activism and the introduction of outside directors. To accelerate the improvement in corporate governance the team recommended that:

- The government's proposal to allow class action lawsuits (beginning April 2002) for enforcing securities laws could be expanded to cover more companies, as the current proposal would cover only about 7 percent of listed companies.

- Cumulative voting for appointing outside directors could be encouraged as a way of giving minority shareholders a greater influence in corporate decision-making.

- Finally, although accounting rules have been upgraded to bring them closer to international best practice, auditing practices need to be strengthened to enhance the credibility of company reports, for example by ensuring that they disclose all within-group payment and debt guarantees, both domestic and foreign.

The authorities agreed with the thrust of the team's suggestions, but are constrained by resistance from *chaebol* and the difficulty in getting legislative changes approved. Even the government's modest proposal on class action law suits is meeting strong resistance. Ultimately, it will be up to small investors to exercise their rights, and up to large investors to realize that strong corporate governance is rewarded by the financial markets.

C. Financial Sector Restructuring and Capital Markets

40. **Although profitability and capital positions have improved, banks have been slow to move on large problem borrowers**. The state-owned banks with substantial corporate exposures, in particular, have sometimes been unwilling to accept reductions in their claims and to push companies into liquidation. In addition, provisioning levels at some banks appear to be inadequate in the case of some large problem companies. The team stressed the need for supervisors to take a more active role in assessing the adequacy of provisioning. Further, where loans do not meet reasonable minimum criteria for assets on banks' balance sheets, supervisors should press banks to sell these claims so that management can devote attention to more appropriate business. The authorities are aware of

the relative weakness of some of the state-owned banks and their reluctance to provision aggressively, which may reflect a desire to keep published capital ratios high in the lead-up to potential mergers. They stressed, however, that there has been no government intervention and that the behavior of these banks with respect to problem borrowers reflects the decisions of bank management.

41. **The sale of the government's shares in financial institutions should remain a high priority**. Until this occurs, some observers will assume—regardless of whether it is true—that government ownership corresponds to government intervention in lending decisions, and investor confidence will be affected. In addition, there are efficiency costs to keeping institutions under state ownership, and there is no guarantee that delaying sales will result in higher prices, especially in terms of discounted present values.

42. **The authorities confirmed that they will press ahead with bank privatization.** They indicated that they would tailor the method of sale to best fit investor demand and the circumstances of the particular bank. With regard to particular institutions:

- The authorities acknowledged the team's reservations about the cumbersome route of selling OPERA bonds exchangeable into shares of Chohung Bank and Woori, but emphasized that this method should be viewed as a first step in their privatization and would be followed by outright sales of government shares.

- In the case of Seoul Bank, where another potential deal with a foreign buyer has fallen through, the team encouraged the authorities to continue to seek privatization rather than a merger with another government-owned bank or inclusion in Woori. The authorities noted that they were beginning negotiations with potential domestic buyers.

- The team suggested that the government should consider selling its minority holdings in the new Kookmin Bank (now merged with Housing and Commercial Bank), taking advantage of the strong demand at the launch of the new bank.

43. **The authorities are in the process of raising the limit on domestic investors' holdings in a bank from 4 to 10 percent** to facilitate privatization and remove the unequal treatment of domestic and foreign investors. The team endorsed this initiative but cautioned that the potential for greater concentration of ownership also raises the risk that major shareholders might exert inappropriate influence to gain unduly favorable access to loans and exploit the banks in which they have invested. Indeed, the experience with *chaebol* ownership of merchant banks and other nonbanks indicates the potential severity of such problems. Accordingly, the team recommended complementing this relaxation with (a) tighter regulations for connected party lending; (b) special vigilance by the FSS in vetting controlling shareholders to see that they are "fit and proper;" and (c) improved governance structures in banks. The authorities noted that the current regulatory framework already contained major safeguards, but that these would be reviewed again and strengthened where necessary.

44. **Although broader issues in financial supervision will be addressed in the FSAP process, the team noted that efforts already in train should be augmented**. Specifically, priority needs to be given to more active supervisory review of asset quality; the intensification of efforts to conduct proper risk assessment and integrate on-site and off-site supervision work; and enhanced scrutiny of lending standards associated with the boom in credit to households. More generally, the FSC/FSS should sharpen its focus on its core mandate of financial supervision and the soundness and safety of the financial system, with greater attention to oversight rather than to influencing market outcomes. In this connection, it will be important to implement an agreement that better defines the appropriate roles, independence, and accountability of the public-sector agencies involved in the financial sector (i.e., FSC, FSS, MOFE, BOK, and KDIC).

45. **The discussions also covered measures that would help the development of the Korean capital market**. Some of these are covered above, including improving corporate governance, privatizing banks, and closing weak companies. The team noted that well-run and healthy institutional investors that are willing and able to carry out risk-pooling and risk-taking functions will also be important for the development of capital markets. The following will be important in this regard:

- The nonbank sector (especially investment trust companies and insurance companies) needs to be strengthened.

- As the National Pension Fund will grow in size over time and could become a major investor in the Korean equity market, it will be important for it to play an independent role as a shareholder and contribute to improving corporate governance.

- There has also been an explosion in the use of asset-backed securities in Korea. This has contributed to the growth of the bond market and created new opportunities, but, as discussed in Box 4, it also entails new risks that will need to be managed.

- Finally, government involvement in capital markets via guarantees, subsidies, and tax breaks should be limited as such measures may: (i) loosen market discipline on weak firms and delay restructuring; (ii) harm market development and replace the market in assessing and pricing risk; and (iii) result in immediate or future liabilities for the government.

D. Other Issues

46. **The first FSAP mission occurred in October 2001, immediately prior to the Article IV mission**. The FSAP discussions covered Korea's observance of the monetary part of the Code of Good Practices on Transparency in Monetary Policy and Financial Policies and of the Core Principles for Systemically Important Payment and Settlement Systems. The FSAP mission also initiated preparatory work for subsequent analysis, including on systemic

Box 4. Asset Backed Securities and Government Guarantees

The growing use of asset-backed securities (ABS) has contributed to the growth of Korea's bond market. Issuance of ABS has been very strong since the first issues in 1999, and in 2000–01 was about twice the issuance of regular corporate bonds. Korea's structured finance market is now the largest among emerging market economies and one of the biggest in the world. Although a wide range of assets and receivables has been securitized, this box focuses on two types of ABS, both linked to past failings of the bond and bank loan markets.

ABS backed by nonperforming loans (NPLs) have amounted to about $15 billion in 2000–01. However, the use of ABS to transform low quality assets into higher quality assets is not without costs and risks. There are three particular concerns in the case of ABS backed by NPLs. First, after selling their NPLs, banks have then bought back the junior tranches of the ABS—since there is no market demand for these—and retain a substantial exposure to the original loans. Second, in some cases, banks have also incurred contingent liabilities (e.g., by providing put-back options) in the process of enhancing the credit quality of the senior tranches. Third, banks typically retain the responsibility of collecting the loans, so that bank management will have to continue to devote resources to loan collection long after banks formally sold the loans.

Primary Collateralized Bond Obligations (PCBOs) were introduced in August 2000 and have amounted to about $12 billion. These are ABS backed by corporate bonds that have been issued specifically for the CBO. The credit quality of the underlying pool of bonds has typically been quite poor, yet the typical PCBO issue has consisted almost entirely of highly rated senior bonds, with only a very small proportion of subinvestment grade junior bonds (which are sold back to the companies issuing bonds). The reason that relatively low quality underlying assets can be transformed into mostly high grade CBOs is that guarantees are provided (at premiums that are probably below-market) by the government-owned Korea Credit Guarantee Fund (KCGF).

Similar to equivalent institutions in other countries, the primary business of the KCGF, along with the Korea Technology Guarantee Fund (KOTEC), is to provide credit guarantees for liabilities of small and medium-sized companies that lack collateral to obtain funds. Initial indications were that there would be a sharp increase in 2001 in guarantees for CBOs due to the expected corporate bond rollover problem. However, new guarantees for PCBOs have been relatively modest, reflecting the better-than-expected conditions in the corporate bond market, limited demand for the relatively expensive funding provided by PCBOs, and limited investor demand for PCBOs (and a preference for more conventional bonds).

Stock of Guarantees by KCGF and KOTEC
(trillions of won)

	1997	1998	1999	2000	Oct. 2001
KCGF	11.3	21.5	19.6	22.6	30.2
Of which:					
CBOs	--	--	--	2.3	6.7
KOTEC	5.7	11.3	11.3	12.5	15.6

Assessment. The use of ABS has forced banks to recognize losses and enabled them to reduce their reported NPL ratios. The FSC/FSS appropriately requires banks to value their holdings of the junior tranches at levels that reflect their poor credit quality, and also to allocate capital for any contingent liabilities they have incurred. Nonetheless, the true level of nonperforming assets that banks are managing may be substantially higher than portrayed in standard NPL ratios, and supervisors will need to remain vigilant to the accompanying risks.

With regard to the KCGF and KOTEC, the recent growth in guarantees (from 7.4 percent of GDP in 2000 to 9.4 percent of GDP in 2001) may not be surprising considering the slowing of the economy. However, it will be important that the guarantee funds are not used to prolong the life of nonviable companies or as a mechanism for the public sector to "pick winners" or influence market outcomes. Further, there is a risk that underpricing by these state institutions may discourage development of private insurance for such risks. Finally, the magnitude of the contingent liabilities from guarantees should be published regularly in the fiscal accounts.

liquidity issues and stress tests. These discussions proceeded well and follow-up missions are scheduled for April and October in 2002. The Financial System Stability Assessment report summarizing the FSAP conclusions will be prepared for the 2002 Article IV consultation.

47. **The authorities confirmed their lack of interest in applying for a CCL**. This reflects their strong reserve position, the bilateral swap arrangements that have been put in place with other countries in the region, and the possible misinterpretation of Korea's situation by the public if the authorities were to seek a CCL.

48. **Korea's statistical base is adequate to conduct effective surveillance**. The coverage, periodicity, and timeliness of key data meet the SDDS specifications and have improved considerably since the crisis (see Annex III). The ROSC data module has been completed (SM/01/355, November 29, 2001) and the authorities have decided against publication at this time.

49. **The authorities have supported a new WTO round**. They have also welcomed China's accession to the WTO. Although there has been some press discussion of possible trade competition from China, the authorities have noted the likely benefits to Korea from greater trade and stronger economic growth in the North-East Asian region. Negotiations for a free trade area with Chile continue, while arrangements with Japan, New Zealand and Thailand are being studied.

50. **Liberalization of the foreign exchange system continued in 2001**. The ceiling on external payments by residents (e.g. donations, overseas travel and education, and emigration) has been eliminated. In addition, nonresidents can now borrow up to W 5 billion in stocks from residents through brokerage houses without approval or reporting to the authorities.

51. **Korea has an effective investor relations program**. This program includes frequent contact with investor groups, roadshows to major financial centers, and wide dissemination of major policy developments and economic news. The team suggested improvements in some areas (e.g., dissemination of information on budget proposals).

52. **Korea has taken steps against bribery and money laundering**. The OECD Anti-Bribery Convention was ratified in 1998 and implementing legislation was passed in 1999. In December 2000, Korea hosted a conference (jointly with the Asian Development Bank and OECD) on combating corruption in the Asia-Pacific area. Two anti-money laundering bills were also passed in September 2001, and the Korea Financial Intelligence Unit was established in December 2001.

V. Staff Appraisal

53. **Good macroeconomic fundamentals and reforms over the last four years have strengthened Korea's ability to weather the global economic downturn**. Although the severe external shocks have caused a sharp fall in growth, the Korean economy has been more resilient than many other countries. Monetary policy has been eased to stimulate the economy without compromising the credibility of the inflation targeting framework. Efforts have also been made to loosen fiscal policy with the passage of two supplementary budgets, albeit with less success. Further, the slowdown in the economy has not diminished the authorities' commitment to press ahead with reforms and a number of important initiatives are in train. External vulnerability indicators also continue to improve and the risk of an external financing crisis is low. With these accomplishments, Korea was recently rewarded with an upgrade of its sovereign rating and improved market sentiment.

54. **Yet challenges remain as Korea continues to face a weak global economy, which could aggravate the fragility of the corporate sector**. This, in turn, increases risks for the financial sector as it struggles to improve its soundness. Accordingly, it will be important to continue to press ahead with reforms that lead to more speedy restructuring. Continued reforms will also put Korea in a stronger position to benefit from a rebound in world growth. As it moves ahead with these tasks, the government's role should be scaled back to regulation and enforcement, and it should take a hands-off approach to business decisions and outcomes and ensure a level playing field for all companies and financial institutions.

55. **Supportive macroeconomic policies remain necessary in light of the weak global outlook for 2002**. The authorities took steps in 2001 to stimulate the economy and should stand ready to do more if necessary to insure against weaker outcomes. Subdued inflation, low government debt, and the absence of external financing requirements for the government provide Korea far more scope for expansionary policies than many other countries. This favorable position provides scope for Korea's macroeconomic policy to play a positive role in the global and regional recovery.

56. **Problems in the formulation and implementation of fiscal policy have prevented it from providing needed stimulus to support domestic demand**. The 2002 budget is contractionary and hence not appropriate for Korea's current circumstances. A modest supplementary spending bill could be considered, but only if it can be agreed and implemented quickly to avoid the risk of being procyclical. More generally, Korea's tradition of fiscal conservatism is admirable, but if taken too far it could contribute to a procyclical fiscal policy that worsens downturns in the economy. Rather than aim for a surplus in every year, a medium-term perspective should be adopted and the objective should be to aim for a surplus over the business cycle, thus dealing with Korea's long-term needs for retirement income. There is also an urgent need to improve budget planning, monitoring, and execution to address the persistent problems in implementing fiscal policies.

57. **Following aggressive interest rate cuts in 2001, the Bank of Korea's current wait-and-see attitude is appropriate**. A negative output gap is projected to persist for some time and inflation is expected to remain subdued. Accordingly, there is scope for more monetary easing if there is evidence of fresh weakness in the economy. Regarding the exchange rate, it will be important to continue to allow market forces to determine the level of the won.

58. **Korea's weak corporate sector remains its Achilles heel**. Despite earlier progress in reducing leverage and improving profitability, the corporate sector is still beleaguered by the continued operation of loss-making companies. Such firms divert resources from healthy companies and cause further losses for creditors. It will therefore be important to accelerate the orderly exit of nonviable "zombie" companies. State-owned banks, in particular, need to accept reductions on their claims, including by allowing a company to be liquidated if losses become unmanageable. Further delays will make matters worse, possibly including the buildup of systemic risk. More generally, to improve profitability and reduce debt levels, companies need to undertake deeper operational restructuring, close loss-making operations, and sell noncore assets.

59. **Further reform of insolvency laws will be critical to help accelerate corporate restructuring and entrench market discipline**. The partial reforms of the insolvency system over the last four years did not go far enough, and getting the basic legal framework right is indispensable to overcome the weakness in the corporate sector. The government's plan for comprehensive reform of the bankruptcy framework within the next year is therefore most welcome. A number of complex issues will need to be addressed, including harmonizing the different bankruptcy codes, encouraging greater participation in reorganization plans, and addressing the problem of dissenting creditors. The success of insolvency law reform also depends on strong enforcement of prudential regulations and efficient and predictable mechanisms in the court system, including the swift disposal of collateral.

60. **Over time, the direct regulations imposed on the *chaebol* will need to be removed and replaced by more market-based mechanisms**. Corporate management acting in the best interest of all shareholders and effective monitoring by creditors and capital markets, within a framework of strong corporate governance, will be especially important. As these mechanisms are not yet fully in place, some of the old direct regulations may need to be retained for the time being. The authorities' gradual approach to the relaxation of *chaebol* regulations is therefore prudent and appropriate. It will also be essential to accelerate the development of the market-based mechanisms to control the risk that companies exploit deregulation and engage in renewed overexpansion without regard to profitability. To this end, it will be essential for investors to exercise their rights and for management and owners to recognize that strong corporate governance is rewarded by financial markets. The rise of shareholder activism and appointment of outside directors are encouraging signs. Further steps—such as improved accounting and disclosure practices and new laws that permit class action lawsuits—would be very helpful to enhance accountability of management.

61. **Although much has been done to stabilize the financial system, more needs to be done before its soundness is firmly established**. Many of the problems that remain in the financial system are the result of continuing weaknesses in the corporate sector. The ongoing FSAP will provide a comprehensive analysis of the priorities for reform and restructuring. In the interim, the emphasis should be on:

- **Privatizing nationalized financial institutions**. A market-driven corporate restructuring process will only be truly feasible if it is led by sound and privately-owned banks. Further, there are efficiency costs to keeping institutions under state ownership, and there is no guarantee that delaying sales will result in higher prices. Private ownership will help these banks to run more efficiently and dispel the notion that the government is interfering in bank lending decisions.

- **Tightening safeguards on connected lending**. With the proposal to relax the limit on domestic ownership of banks, safeguards will be needed to prevent exploitation by major shareholders. The experience with *chaebol* ownership of merchant banks and other nonbanks highlights the potentially large costs of such abuse. Thus, it will be important for the FSC/FSS to take steps to strengthen the safeguards on transactions involving connected parties and improve disclosure and corporate governance practices in the banks so that the markets can provide an adequate check against potential abuse.

- **Strengthening the effectiveness of supervision**. Conducting proper risk assessment and integrating on-site and off-site work will be essential. Deficiencies in assessing asset quality should be remedied and creditors should be pressed to acknowledge the true health of debtors. Stronger oversight of consumer lending will also be important, as experience in many countries shows that periods of rapid expansion are when most lending mistakes are made. The FSC/FSS should also narrow its focus to its core mandate of financial supervision and soundness and safety of the financial system.

62. **The challenges facing the Korean authorities are complex**. Implementing the remaining structural agenda will be a matter of years not months, but it will be important to maintain sufficient momentum over the coming year to sustain confidence and ensure that Korea is put on a growth path driven by competition and productivity.

63. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Table 1. Korea: Macroeconomic Framework, 1997–2002

	1997	1998	1999	2000	2001	2002
					Staff Est./Proj.	
Real GDP (percent change)	5.0	-6.7	10.9	8.8	2.6	3.2
Total domestic demand	-0.8	-19.6	14.5	6.7	0.8	3.3
Final domestic demand	1.2	-13.8	7.4	7.7	0.8	3.3
Consumption	3.2	-9.8	9.1	6.2	2.4	3.3
Gross fixed investment	-2.2	-21.2	3.7	11.0	-2.6	3.3
Stockbuilding 1/	-2.0	-5.5	5.4	-0.9	0.0	0.0
Net foreign balance 1/	5.7	12.3	-0.8	3.5	2.1	0.2
Nominal GDP (in trillions of won)	453.3	444.4	482.7	517.1	540.1	563.4
Saving and investment (percent of GDP)						
Gross national saving	32.5	33.9	32.7	31.1	29.0	27.4
Gross domestic investment	34.2	21.2	26.7	28.7	26.5	25.7
Current account balance	-1.7	12.7	6.0	2.4	2.5	1.7
Prices (percent change)						
CPI inflation (average)	4.4	7.5	0.8	2.3	4.3	2.0
CPI inflation (end of period)	6.6	4.0	1.4	3.2	3.2	2.6
Core inflation (average)	3.4	5.9	0.3	1.9	4.2	2.6
GDP deflator	3.1	5.1	-2.0	-1.6	1.8	1.1
Real effective exchange rate	-6.0	-25.6	13.5	4.5	...	...
Trade (percent change)						
Export volume	17.2	19.5	12.6	20.6	1.5	3.5
Import volume	4.1	-23.1	29.5	18.4	-7.5	5.4
Terms of trade	-11.4	-3.9	-2.1	-12.8	-8.6	-0.2
Consolidated central government (percent of GDP)						
Revenues	20.6	21.8	22.4	25.8	25.8	27.5 7/
Expenditure 2/	22.3	26.0	25.7	24.8	25.2	26.3 7/
Overall balance 3/	-1.7	-4.3	-3.3	1.1	0.6	1.1 7/
Money and credit (end of period)						
M3 growth	13.9	12.5	8.0	7.1	8.0	...
Reserve money growth	-12.5	-8.1	37.6	-0.9	...	...
Balance of payments (billion U.S. dollars)						
Exports, f.o.b.	138.6	132.1	145.2	175.8	150.0	148.5
Imports, f.o.b.	141.8	90.5	116.8	159.2	135.6	136.9
Current account balance	-8.2	40.4	24.5	11.0	10.3	7.4
Usable reserves 4/	9.1	48.5	74.1	96.2	102.5	107.1
Short-term debt cover	0.1	1.6	1.9	2.2	2.8	2.9
External debt (billion U.S. dollars)						
Total external debt 4/ 5/	159.2	148.7	137.2	136.3	118.3	114.2
Of which: short-term 4/ 5/	63.6	30.7	39.2	44.2	36.1	36.8
Total external debt (percent of GDP)	33.4	46.9	33.8	29.8	28.3	26.2
Debt service ratio 6/	8.9	12.9	23.7	12.3	12.7	12.2

Sources: Korean authorities; and Fund staff estimates and projections.

1/ Contribution to GDP growth.
2/ Including bank restructuring costs and additional unemployment-related expenditures agreed under the Tripartite Accord.
3/ Excluding privatization receipts. For 2000, includes the civil service pension fund.
4/ End of period.
5/ Includes offshore borrowing of domestic financial institutions and debt contracted by overseas branches of domestic financial institutions.
6/ Debt service on medium- and long-term debt in percent of exports of goods and services.
7/ Official budget for 2002 submitted to the National Assembly in September 2001.

Table 2. Korea: Balance of Payments, 1998-2002
(In billions of U.S. dollars, unless otherwise indicated)

	1998	1999	2000	2001	2002
				Staff Est./Proj.	
1. Current account balance	**40.4**	**24.5**	**11.0**	**10.3**	**7.1**
Trade balance	41.6	28.4	16.6	14.4	11.3
Exports	132.1	145.2	175.8	150.0	149.3
(growth rate, in percent)	(-4.7)	(9.9)	(21.1)	(-14.7)	(-0.4)
Imports	90.5	116.8	159.2	135.6	138.0
(growth rate, in percent)	(-36.2)	(29.1)	(36.3)	(-14.8)	(1.8)
Services	1.0	-0.7	-4.0	-3.7	-3.5
Income	-5.6	-5.2	-2.2	0.0	-0.2
Current transfers	3.4	1.9	0.6	-0.4	-0.5
2. Financial and capital account balance	**-7.2**	**12.9**	**9.7**	**-0.8**	**-2.5**
Financial account	-7.3	13.3	10.2	-0.2	-2.0
Portfolio equity investment, net	3.9	11.8	12.5	6.9	5.5
Portfolio debt flows, net 1/	-5.8	-3.1	-0.4	-1.7	-2.0
Direct investment, net	0.7	5.1	3.5	1.3	1.0
Inflows	5.4	9.3	8.7	2.9	3.0
Outflows	-4.7	-4.2	-5.3	-1.6	-2.0
Trade credits, net	-6.2	2.8	2.0	-5.5	-2.4
Loans, net	-2.9	1.6	-5.5	-6.7	-1.7
Short term	-13.5	5.9	-3.7	-2.6	3.1
Medium and long term 2/	10.6	-4.3	-1.8	-4.1	-4.8
Currency and deposits	1.6	-2.9	0.4	1.0	1.0
Others	1.4	-2.1	-2.3	4.4	-3.4
Capital account	0.2	-0.4	-0.5	-0.5	-0.5
3. Net errors and omissions	-3.5	-3.5	1.4	2.5	0.0
4. Overall balance (1+2+3)	**29.7**	**33.8**	**22.1**	**12.0**	**4.6**
5. Financing	**-29.7**	**-33.8**	**-22.1**	**-12.0**	**-4.6**
Change in usable reserves (increase -)	-39.4	-25.6	-22.1	-6.3	-4.6
Net IMF purchases	5.0	-10.3	0.0	-5.7	0.0
World Bank/AsDB	4.7	2.0	0.0	0.0	0.0
Memorandum items:					
Current account balance (as percent of GDP)	12.7	6.0	2.4	2.5	1.6
Balance of trade (as percent of GDP)	13.1	7.0	3.6	3.5	2.6
Usable gross reserves	48.5	74.1	96.2	102.5	107.1
(as months of imports of goods and services)	5.1	6.2	6.0	7.3	7.6
External debt (in billions of U.S. dollars)	148.7	137.2	136.3	118.3	114.2
(as percent of GDP)	46.9	33.8	29.8	28.4	26.2
Short-term external debt (in billions of U.S. dollars) 3/	30.7	39.2	44.2	36.1	36.8
Debt-service ratio 4/	12.9	23.7	12.3	12.7	12.2

Sources: Korean authorities; and Fund staff estimates and projections.

1/ Bonds and notes, money market instruments, and financial derivatives.
2/ Excluding IMF obligations.
3/ Including trade credits.
4/ Medium- and long-term debt; as percent of exports of goods and services.

Table 3. Korea: Consolidated Central Government Operations, 1999–2002

	1999	2000 Jan-Sept.	2000 Year Budget	2000 Year	2001 Jan-Sept. Prel.	2001 Year Budget 1/	2001 Year Staff Proj.	2002 Year Budget
				(In trillions of won)				
Total revenue	**112.9**	**107.8**	**129.0**	**135.8**	**106.3**	**142.1**	**139.2**	**154.7**
Tax revenue	75.7	74.6	87.5	92.9	69.7	95.9	91.0	104.2
Social security contributions	16.9	11.1	18.0	15.8	13.3	16.0	17.0	18.1
Nontax and capital revenue	20.3	22.0	23.5	27.1	23.3	30.2	31.2	32.4
Total expenditure and net lending	**131.1**	**89.2**	**146.2**	**129.3**	**95.8**	**147.5**	**136.1**	**148.3**
Current expenditure	87.8	62.9	101.6	82.9	74.8	106.8	101.4	111.8
Interest	9.9	9.1	14.4	6.9	...	14.0	14.0	15.4
Of which: Bank restructuring	4.0	4.2	6.0	5.5	...	...	...	...
Non-interest	78.0	55.1	87.2	76.0	...	92.7	87.4	96.4
Capital expenditure	24.4	13.7	23.1	26.6	15.9	25.4	25.4	26.1
Net lending	18.8	12.6	21.5	19.8	5.2	15.4	9.2	10.4
Balance	**-18.3**	**18.5**	**-17.2**	**6.5**	**10.4**	**-5.4**	**3.2**	**6.4**
Total financing	**18.3**	**-17.2**	**17.2**	**-6.5**	**-10.4**	**5.4**	**-3.2**	**-6.4**
Domestic financing	17.3	-17.0	17.2	**-6.1**	...	...	...	...
Of which: Privatization	3.1	0.0	3.5	0.0	...	3.0	3.0	3.0
External Financing	1.0	-0.2	0.0	-0.4	...	...	...	...
				(In percent of GDP)				
Total revenue	**23.4**	**20.8**	**24.9**	**26.3**	**19.7**	**26.3**	**25.8**	**27.5**
Tax revenue	15.7	14.4	16.9	18.0	12.9	17.8	16.9	18.5
Social security contributions	3.5	2.2	3.5	3.1	2.5	3.0	3.1	3.2
Nontax and capital revenue	4.2	4.3	4.5	5.2	4.3	5.6	5.8	5.8
Total expenditure and net lending	**27.2**	**17.3**	**28.3**	**25.0**	**17.7**	**27.3**	**25.2**	**26.3**
Current expenditure	18.2	12.2	19.6	16.0	13.8	19.8	18.8	19.8
Interest	2.0	1.8	2.8	1.3	...	2.6	2.6	2.7
Non-interest	16.2	10.7	16.9	14.7	...	...	...	...
Capital expenditure	5.1	2.6	4.5	5.1	2.9	4.7	4.7	4.6
Net lending	3.9	2.4	4.2	3.8	1.0	2.8	1.7	1.8
Balance	**-3.8**	**3.6**	**-3.3**	**1.3**	**1.9**	**-1.0**	**0.6**	**1.1**
Primary balance	**-1.7**	**5.3**	**-0.6**	**2.6**	**...**	**1.6**	**3.2**	**3.9**
Memorandum items:								
Overall balance (incl. privatization)	-15.2	18.5	-13.7	6.5	...	-2.4	6.2	9.4
(as percent of GDP)	-3.1	3.6	-2.6	1.3	...	-0.5	1.1	1.7
GDP (at current prices)	482.7	517.1	517.1	517.1	540.2	540.2	540.2	563.5

Sources: Ministry of Finance and Economy; and staff estimates.

1/ Including the supplementary budget.

Table 4. Korea: Medium-Term Projections, 1999–2006
(In units indicated)

	1999	2000	2001	2002	2003	2004	2005	2006
			Staff Projections					
Real GDP (percent change)	10.9	8.8	2.6	3.2	4.6	5.5	5.5	5.5
Total domestic demand	14.5	6.7	0.8	3.3	3.7	5.2	5.4	5.4
Final domestic demand	7.4	7.7	0.8	3.2	3.7	5.1	5.2	5.2
Consumption	9.1	6.2	2.4	3.2	3.4	4.0	4.4	4.4
Gross fixed investment	3.7	11.0	-2.6	3.3	4.3	7.5	7.1	7.0
Stock building 1/	5.4	-0.9	0.0	0.0	0.0	0.0	0.0	0.0
Net foreign balance 1/	-0.8	3.5	2.1	0.3	1.5	1.2	1.1	1.1
Prices, period average (percent change)								
Consumer price	0.8	2.3	4.3	2.0	2.5	2.5	2.5	2.5
GDP deflator	-2.0	-1.6	1.8	1.1	1.3	1.4	1.7	1.7
Savings and investment (percent of GDP)								
Gross national savings	32.7	31.1	29.0	27.5	26.7	26.0	25.4	24.9
Gross domestic investment	26.7	28.7	26.6	25.9	25.8	25.7	25.6	25.3
Current account balance	6.0	2.4	2.5	1.6	0.9	0.2	-0.2	-0.4
Trade (percent change)								
Merchandise exports	9.9	21.1	-14.7	-0.4	9.5	9.3	9.8	9.7
Volumes 2/	12.6	20.6	1.5	3.5	7.9	8.0	8.1	8.0
Merchandise imports	29.1	36.3	-14.8	1.8	12.0	11.5	11.1	10.5
Volumes 2/	29.5	18.4	-7.5	5.4	8.0	9.1	9.4	9.3
Terms of trade	-2.1	-12.8	-8.6	-0.4	-2.2	-1.0	0.0	0.5
Balance of payments (billion U.S. dollars)								
Current account	24.5	11.0	10.3	7.1	4.3	1.2	-1.0	-2.6
Trade balance	28.4	16.6	14.4	11.3	8.9	6.4	4.7	3.7
Merchandise exports	145.2	175.8	150.0	149.3	163.4	178.7	196.1	215.2
Merchandise imports	116.8	159.2	135.6	138.0	154.5	172.3	191.4	211.5
External debt (billion U.S. dollars) 3/	137.2	136.3	118.3	114.2	120.0	123.5	128.0	134.5
(percent of GDP)	33.8	29.8	28.4	26.2	25.7	24.4	23.2	22.5
Debt service ratio 4/	23.7	12.3	12.7	12.2	11.9	12.1	11.5	10.7
Public debt (percent of GDP)								
Consolidated central government debt 5/	20.1	17.7	16.7	15.7	15.1	14.6	14.4	14.7
Government guaranteed restructuring bonds	13.1	13.2	19.1	18.3	17.3	16.2	15.1	14.0
Memorandum items:								
Nominal GDP (trillion won)	482.7	517.1	540.2	563.5	597.1	638.7	685.3	735.5
Per capita GDP (U.S. dollars)	8,665	9,670	8,754	9,060	9,627	10,368	11,178	12,051
Output gap (percent of potential GDP)	-1.5	1.0	-2.8	-1.7	-0.5	0.0	0.0	0.0

Sources: Korean authorities; and Fund staff estimates and projections.

1/ Contribution to GDP.

2/ Customs clearance basis.

3/ Including IMF, offshore borrowing of domestic financial institutions and debt contracted by overseas branches of domestic financial institutions.

4/ Medium- and long-term debt; in percent of exports of goods and nonfactor services.

5/ Includes domestic and external debt. Excludes bonds issued outside the budget for bank restructuring in 1998 and 1999, and the global bond issue in April 1998.

Table 5. Korea: Monetary and Financial Aggregates, 2000–01

	2000				2001		
	March	June	Sept.	Dec.	March	June	Sept.
	(End of period stocks; in trillions of won)						
Bank of Korea							
Reserve money	**24.8**	**26.7**	**26.7**	**28.2**	**30.7**	**27.7**	**33.1**
Net foreign assets	85.3	90.6	93.4	110.2	113.8	116.7	123.1
Foreign assets	102.4	110.4	114.1	124.3	133.5	131.2	138.5
Foreign liabilities	-17.1	-19.8	-20.7	-14.1	-19.7	-14.5	-15.3
Net domestic assets	-60.5	-63.9	-66.7	-81.9	-83.1	-89.0	-90.0
Public sector	-5.6	-13.4	-12.4	-4.0	-4.0	-4.4	-2.4
Private financial sector	26.3	21.7	18.1	19.4	18.8	15.9	14.7
Other items net	-81.2	-72.3	-72.4	-97.3	-97.9	-100.5	-102.2
Monetary survey							
M2	**350.6**	**379.9**	**392.8**	**413.0**	**413.5**	**434.9**	**457.8**
Net foreign assets	94.4	100.7	103.0	122.5	126.7	129.5	130.8
Foreign assets	143.9	149.7	152.6	168.0	176.8	173.6	178.9
Foreign liabilities	-49.5	-49.0	-49.6	-45.5	-50.1	-44.2	-48.1
Net domestic assets	256.2	279.2	289.8	290.5	286.9	305.4	327.0
Public sector	39.3	32.9	33.7	46.0	38.3	45.9	49.9
Total private sector	357.2	374.4	400.2	405.6	416.1	432.2	463.0
Nonfinancial private sector	334.9	356.0	374.5	381.2	388.1	405.9	427.9
Other financial institutions	22.2	18.4	25.7	24.3	28.0	26.3	35.2
Other items net	-140.2	-128.2	-144.0	-161.0	-167.5	-172.7	-185.9
Financial survey							
M3	**865.1**	**879.4**	**895.9**	**911.6**	**932.3**	**961.9**	**1004.6**
Net foreign assets	83.2	87.6	94.2	117.3	124.9	128.5	129.4
Foreign assets	155.2	161.3	165.1	183.3	194.6	190.9	195.4
Foreign liabilities	-72.0	-73.6	-70.9	-66.0	-69.7	-62.4	-66.0
Net domestic assets	781.9	791.8	801.6	794.4	807.3	833.4	875.3
Public sector	101.1	98.6	104.2	118.5	114.1	121.5	133.7
Private sector	713.1	710.4	721.2	707.7	715.9	741.3	769.7
Other items net	-32.2	-17.2	-23.8	-31.7	-22.7	-29.4	-28.1
Memorandum items:							
	(12-monthly percent change, unless otherwise indicated)						
Reserve money	10.7	24.4	7.6	-0.9	23.9	3.7	23.9
M2	26.0	37.7	28.3	25.4	17.9	14.5	16.5
M3	5.4	5.6	6.3	7.1	7.8	9.4	12.1
M3 velocity	5.8	5.9	3.9	0.0	-2.1	-4.2	-6.7
M3 money multiplier (ratio)	34.9	33.0	33.5	32.3	30.3	34.8	30.3
Private sector credit							
Monetary survey	11.5	15.6	19.2	19.1	16.5	15.5	15.7
Financial survey	-6.1	-4.6	-3.3	-2.7	0.4	4.3	6.7
Financial survey 1/	-1.2	0.0	0.3	1.7	2.6	6.3	8.3

Sources: Bank of Korea; and Fund staff estimates and projections.

1/ Adjusted for the sale of nonperforming assets to KAMCO.

Table 6. Korea: Indicators of External Vulnerability, 1997-2001
(In percent of GDP, unless otherwise indicated)

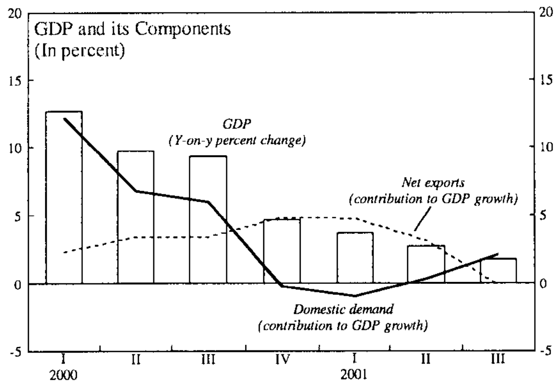
	1997	1998	1999	2000	2001 Latest Estimate/ Projection	2001 Date
Financial indicators						
Public sector debt	44.7	57.4	56.8	37.0	...	...
Consolidated central government debt 1/	12.7	24.7	33.2	30.8	35.8	Dec-01
Broad money (M3, percent change, 12-month basis)	13.9	12.5	8.0	7.2	11.4	Oct-01
Private sector credit (Fin. survey, percent change, 12 month basis)	18.9	-2.6	-0.1	-2.2	6.7	Sep-01
One month call borrowing rate	13.7	15.0	4.9	5.3	4.0	Dec-01
One month call borrowing rate (real)	9.3	7.4	4.1	3.1	0.8	Dec-01
External indicators						
Exports (percent change, 12-month basis in US$) 2/	6.7	-4.7	9.9	21.1	-19.6	Dec-02
Imports (percent change, 12-month basis in US$) 2/	-2.2	-36.2	29.1	36.3	-14.1	Dec-02
Terms of trade (percent change, 12 month basis)	-11.4	-3.9	-2.1	-12.8	-5.6	Oct-02
Current account balance (projection for full year)	-1.7	12.7	6.0	2.4	2.5	Dec-01
Capital and financial account balance (projection for full year)	0.3	-1.0	0.5	2.6	0.1	Dec-01
Of which: Inward portfolio investment (debt securities etc.)	2.6	-0.1	1.7	2.6	1.8	Dec-01
Other investment (loans, trade credits etc.)	-2.3	-2.8	-2.2	-0.3	-2.0	Dec-01
Inward foreign direct investment in the form of debt or loans	-0.3	0.2	1.3	0.8	0.7	Dec-01
Gross official reserves (in US$ billion)	9.1	48.5	74.1	96.2	102.5	Dec-01
Central Bank short-term foreign liabilities (in US$ billion) 3/	...	...	...	2.6	0.1	Nov-01
Short term foreign liabilities of the financial sector (in US$ billion)	42.4	18.9	22.5	23.8	21.0	Nov-01
Official reserves in months of imports GS (projection for full year)	0.6	5.1	6.2	6.0	7.3	Dec-01
Broad money(M3) to reserves	45.4	13.5	10.1	7.5	7.5	Dec-01
Total short term external debt to reserves 4/	8.3	0.9	1.0	0.6	0.4	Dec-01
Total external debt	33.4	46.9	33.8	29.8	28.4	Nov-01
Of which: Public sector debt	4.7	11.5	7.3	6.1	4.9	Nov-01
Total external debt to exports GS	0.97	0.6	0.5	0.5	0.7	Nov-01
External interest payments to exports GS	0.04	0.1	0.0	0.0	0.1	Nov-01
External amortization payments to exports GS	0.07	0.1	0.2	0.1	0.1	Nov-01
Exchange rate (per US$, period average)	951	1,402	1,189	1,131	1,293	Dec 31, 01
REER appreciation (+) (12-month basis)	-6.0	-25.6	13.5	8.1	-4.7	Nov-01
Financial market indicators						
Stock market index (KOSPI)	376	562	1,028	505	694	Dec 31, 01
Stock market index (KOSPI, percent change, 12-month basis)	-42.2	49.5	82.8	-50.9	37.4	Dec 31, 01
Foreign currency debt rating (Moody's/S&P)	Ba1/B+	Ba1/BB+	Baa2/BBB	Baa2/BBB	Baa2/BBB+	Dec 31, 01
Dollar sovereign bond spread (EMBI+ in bps, end of period)	324	359	142	218	121	Dec 31, 01

Sources: Korean authorities, private market sources, and Fund staff estimates.

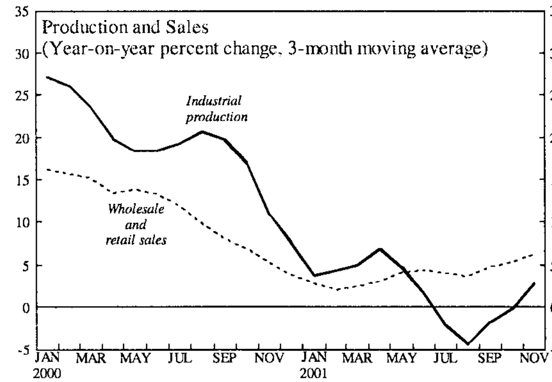
1/ Including government guaranteed restructuring bonds issued by KDIC and KAMCO.
2/ The latest estimates are from customs clearance data.
3/ Excluding IMF repurchase obligations. Reported in the Reserves template, which was initiated in May, 2000, as "Predetermined short-term net drains on foreign currency assets." According to the template, the Bank of Korea does not engage in derivatives transactions.
4/ Short-term debt measured on a residual maturity basis.

Figure 1. Korea: Activity and Prices

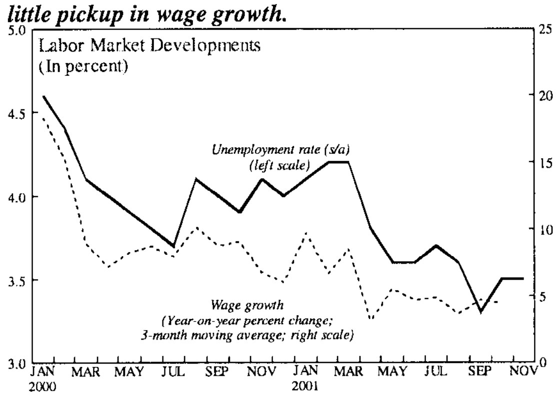
After a steady slide, domestic demand has picked up.



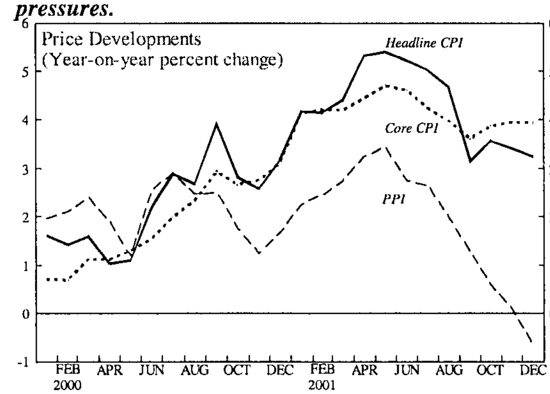
Production and sales may also have bottomed out.



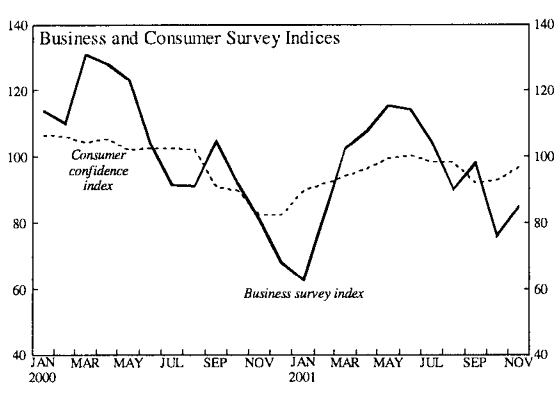
Unemployment remains low although there has been little pickup in wage growth.



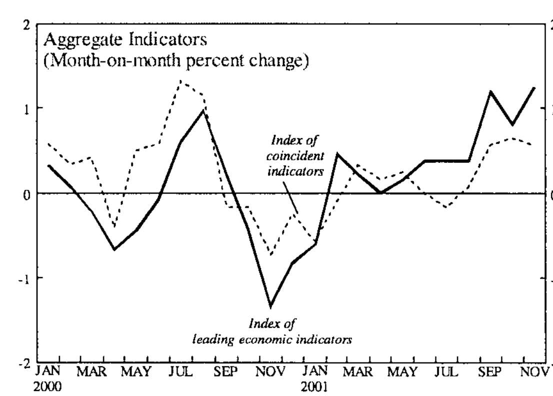
Inflation has eased, in the absence of demand pressures.



Business and consumer confidence remained mixed...



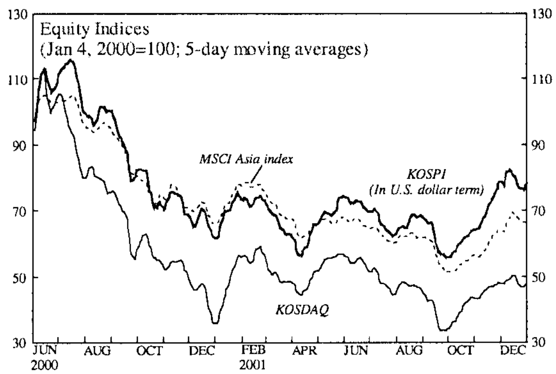
...but broader indicators suggest a positive outlook.



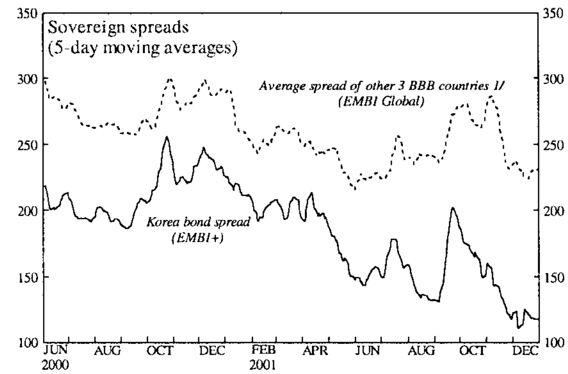
Sources: Korean authorities, CEIC database; and Fund staff calculations.

Figure 2. Korea: Financial Market Indicators

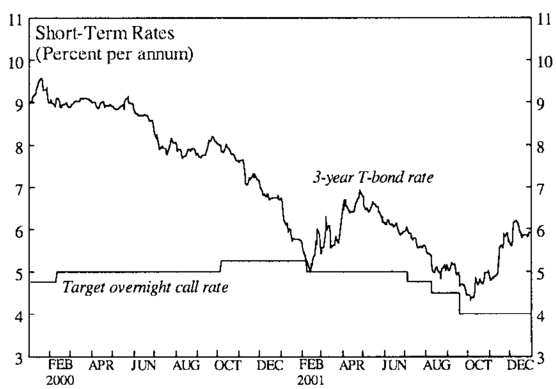
Equity prices bounced back in 2001...



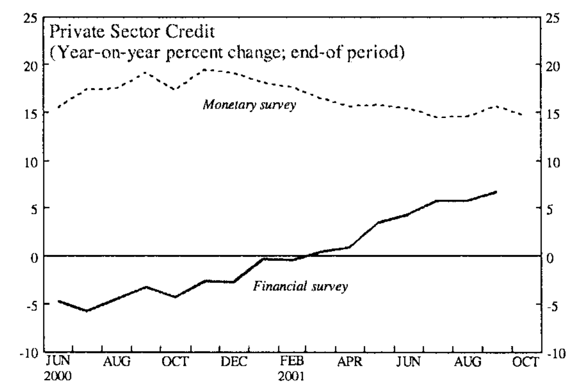
... and Korean sovereign spreads have fallen.



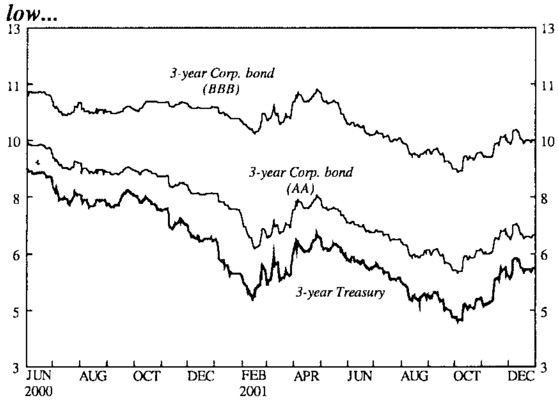
Short-term rates have eased...



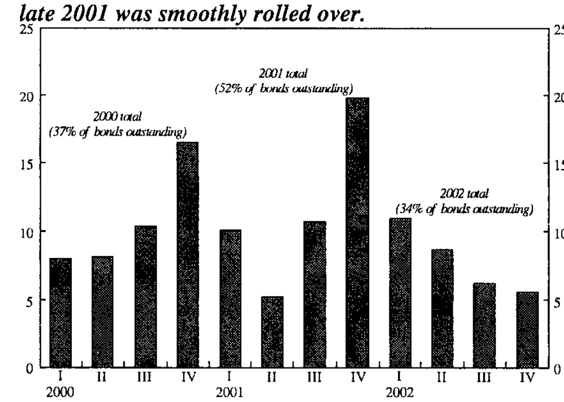
... and lending to the private sector is healthy.



Monetary easing in late-2001 helped keep bond rates low...



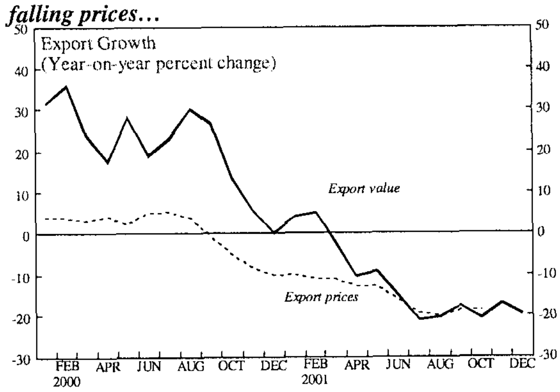
...and the overhang of corporate bonds maturing in late 2001 was smoothly rolled over.



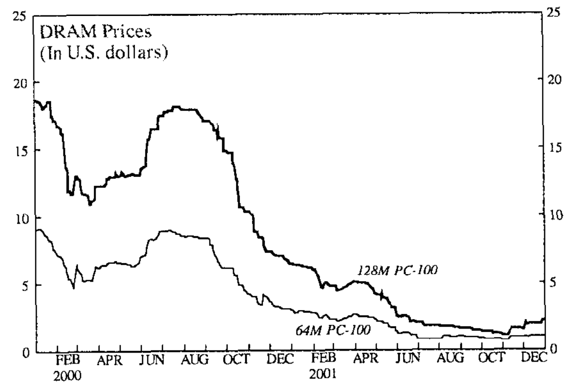
Sources: Korean authorities, CEIC database; and Fund staff calculations.
1/ Countries include Malaysia, South Africa and Turkey.

Figure 3. Korea: External Developments

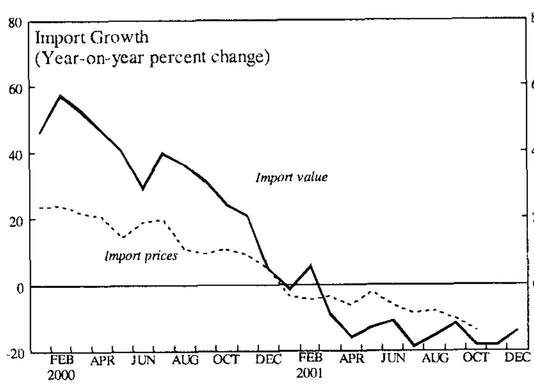
Korean exports were hit by slow volume growth and falling prices...



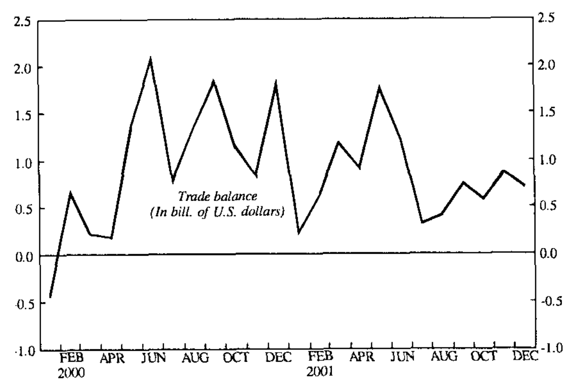
...especially of semiconductors.



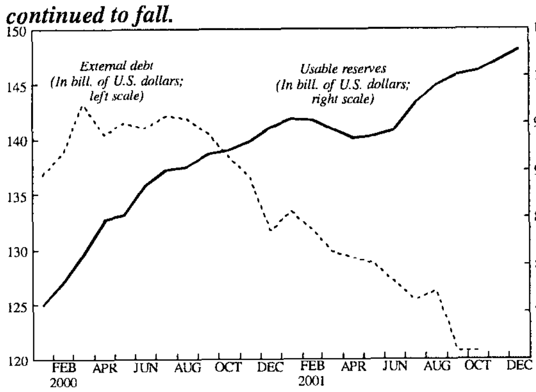
But the weak economy depressed imports even more...



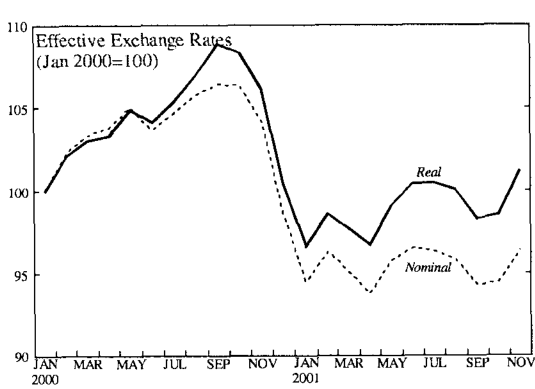
...and the trade balance remained in surplus.



Usable reserves are healthy, and external debt has continued to fall.



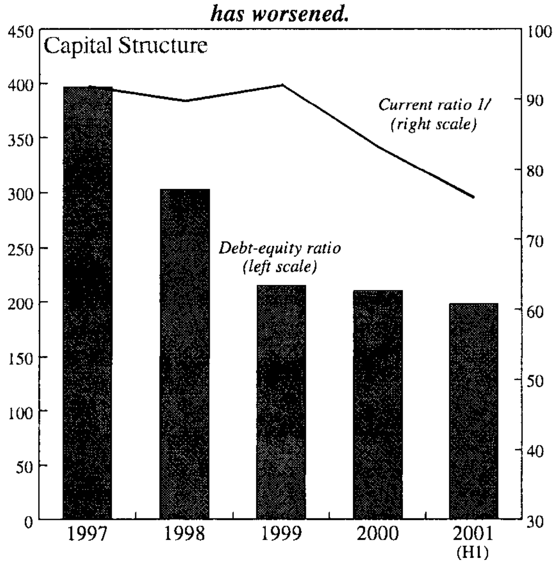
The won appreciated in 2001.



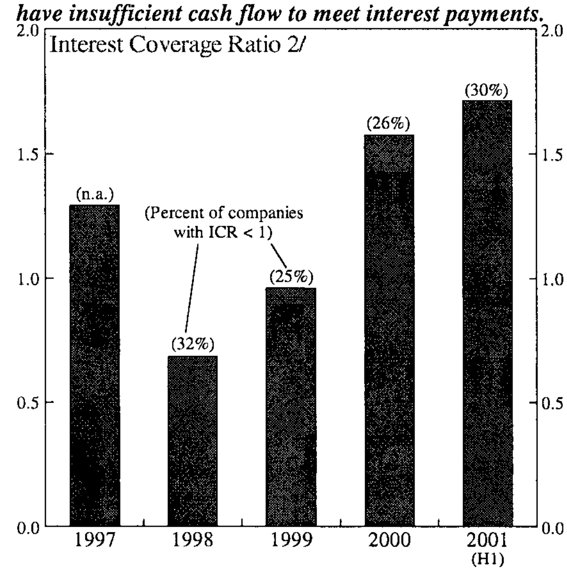
Sources: Korean authorities, CEIC database, Bloomberg; and Fund staff calculations.

Figure 4. Korea: Corporate and Financial Sector Soundness

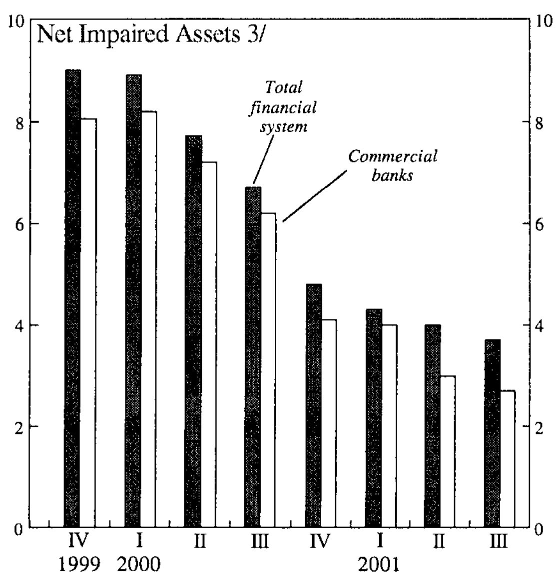
Although corporate leverage has declined, liquidity has worsened.



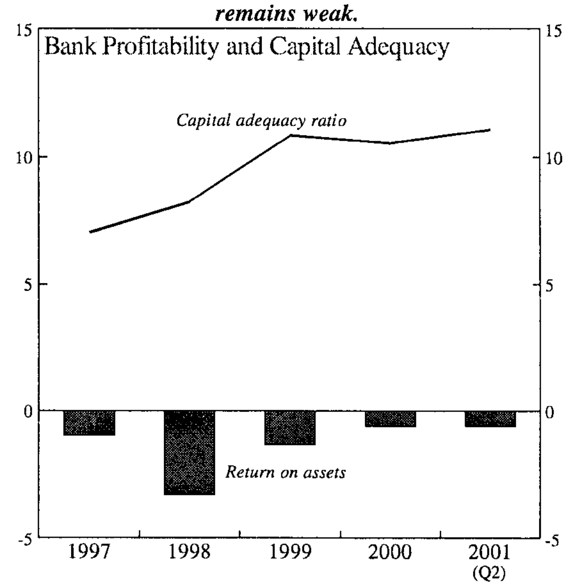
Profitability has improved but many companies still have insufficient cash flow to meet interest payments.



Impaired assets continue to decline.



Capital adequacy has improved but profitability remains weak.



Source: Korean authorities.
1/ Current assets divided by current liabilities.
2/ Manufacturing sector.
3/ Net of provision; as percent of total loans.

Near-Term Scenarios—Sensitivity Analysis

Simulations were run, using the Oxford Economic Forecasting Model (OEF, October 2001 vintage) to examine the impact of a further deterioration of the external environment. Two shocks are considered: a worsening of the terms of trade and a reduction in external demand. The focus is on Korea's growth, current account, and inflation in 2002 and 2003. The table below shows that the staff and OEF baseline scenarios are broadly comparable, especially for 2002. For consistency, the discussion below is based on the OEF baseline and the shock simulations.

The terms of trade (TOT) worsen by 5 percentage points

- The TOT shock is assumed to be equally split between higher import prices and lower export prices.

- The shock, by depressing purchasing power and corporate profits, lowers private consumption and equipment investment spending, thus reducing GDP growth. However, the negative impact to domestic demand and higher import prices would depress import volumes, while lower export prices would stimulate export volumes. Thus, there would be an offsetting boost to real GDP growth through net exports. The simulation shows that, the net impact on growth of these two impulses is negligible.

- The current account surplus in 2002 would fall from 2 percent of GDP in the baseline to about ½ percent of GDP. For 2003, the ripple effects of the shock would turn the current account surplus into a deficit of about ½ percent of GDP.

- Inflation would be basically unchanged between the baseline and the shock simulation.

External demand drops by 2 percentage points

- Under this scenario, for every quarter in 2002, the growth in world demand for Korea's exports of nonfuel goods would be 2 percentage points lower than under the baseline scenario. Hence, for the full year, world demand would grow by 3 percent, compared to 5 percent under the baseline.

- Given the importance of exports to the economy, the impact of a negative shock to external demand on private consumption and equipment investment would be larger than that of a terms of trade shock. As with the first simulation, the negative impact on growth would be cushioned to some extent by a drop in imports caused by lower domestic demand.

- Under this simulation, GDP growth in 2002 is projected to drop to about 2½ percent, and the current account surplus to fall only slightly (to 1¾ percent of GDP). The shock would carry through to 2003, reducing GDP growth to 5 percent and the current account to 1¼ percent of GDP.

- As with the first shock simulation, the impact on inflation would also be negligible.

	2002			2003		
	GDP growth (% pa)	Current account (% of GDP)	Inflation (% pa)	GDP growth (% pa)	Current account (% of GDP)	Inflation (% pa)
Staff baseline	3.2	1.6	2.0	4.6	0.9	2.5
OEF baseline	3.1	2.0	3.0	5.5	1.5	4.2
	Differences between OEF baseline and OEF shock simulations					
TOT shock	0.1	-1.4	0.1	0.3	-1.9	0.2
Demand shock	-0.6	-0.2	0.0	-0.5	-0.2	0.0

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

Public Information Notice (PIN) No. 02/--
FOR IMMEDIATE RELEASE
February --, 2002

IMF Concludes 2001 Article IV Consultation with Korea

On February 11, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Korea.[1]

Background

The completion of early repayments to the Fund in August 2001 symbolizes how much Korea has achieved since the crisis that erupted in late 1997. Reserves are now at a level that provides substantial insulation against shocks. A wide range of reforms has also helped to address the weaknesses that precipitated the crisis and foster an environment where market discipline is beginning to play a more important role. In November 2001, Korea's sovereign credit rating was upgraded, driven in large part by its record on structural reform. Yet major challenges remain for Korean policymakers as the country now faces the risky combination of a weak global economy and continued weakness in the corporate and financial sectors.

In 2001, growth is estimated to have slowed to about 2½ percent down from 9 percent in the previous year. Although Korea was hit hard by the global downturn in information technology and slower growth in major trading partners, its economy has suffered less than other export-dependent Asian countries, largely on account of its relatively diversified export structure and steady consumer spending. After peaking in May, headline CPI inflation has fallen steadily

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the February 11, 2002 Executive Board discussion based on the staff report.

reaching 3.2 percent (y/y) in December. Although core inflation in 2001 exceeded by a small margin the upper bound of the 2–4 percent (period average) target range set by the Bank of Korea (BOK), it is projected to decline further this year as a result of subdued wage and demand pressures and the large output gap. The external position remains healthy. The current account surplus is estimated at $10½ billion (2½ percent of GDP) in 2001, unchanged from the previous year, with the impact of slower export volume growth and sharply lower semiconductor prices offset by lower import volumes and oil prices.

In an effort to support domestic demand, macroeconomic policy has shifted to a more expansionary stance. The BOK cut its overnight call rate target by a total of 100 basis points in the third quarter of 2001 to a historic low of 4 percent, including a 50 basis points on September 19 in its first ever inter-meeting cut. Fiscal policy, however, in 2001 provided little stimulus beyond automatic stabilizers, with an estimated consolidated central government surplus of about ½ percent of GDP in 2001, down from a surplus of 1 percent of GDP in 2000.

In the IMF's latest World Economic Outlook, Korea's growth rate in 2002 is projected to be 3¼ percent with considerable uncertainty arising from the external environment. Growth is expected to be positive but weak in the first half of the year with a more robust recovery starting in the second half—a profile similar to those of other major industrial countries. Domestic demand, mainly private consumption and construction investment, is projected to offset a smaller contribution from net exports. Over the medium-term, growth is projected to return to 5½ percent, in line with potential output growth. Productivity increases needed to reach this growth rate will depend critically on further progress in implementing structural reforms.

Progress in corporate restructuring continued in 2001. A number of companies in formal workout programs were either rehabilitated, sold, or liquidated. Debt-equity ratios also continue to fall. Nevertheless, the corporate sector remains weak and vulnerable. Although average profitability has improved, a large proportion of companies still are unable to generate sufficient cash flow to meet their interest payments. Needed restructuring and asset sales have been hampered by disagreement between creditors over loss-sharing and weak insolvency procedures, and creditors' reluctance to write down losses has prolonged the liquidation of unviable companies. A Corporate Restructuring Promotion Law was passed in September 2001 with the aim of addressing some of these impediments.

Strides were also made in strengthening the financial system in 2001. Commercial banks have reduced their impaired loans as a share of total bank loans to 5 percent at end-September, from 9 percent at end-2000, and profitability, loan-loss provisioning, and capital positions have improved for most banks. Consolidation also continued with the launch of a private financial holding company and the creation of the largest commercial bank in Korea through private merger. However, progress has been slow in rehabilitating and privatizing the nationalized financial institutions.

Executive Board Assessment

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Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation 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.

Statistical Issues

Korea's macroeconomic statistics and statistical base are adequate to conduct effective surveillance. Nevertheless, the recent ROSC Data Module mission identified shortcomings in some statistical practices that have the potential for detracting from the accurate and timely analysis of economic and financial developments and the formulation of appropriate policies.

Real Sector

- The overall structure of the **national accounts** mainly follows the *1968 System of National Accounts* (*1968 SNA*). The delineation of the economy, the valuation rules, and the production and asset boundaries are in line with the *1968 SNA*. However, the classifications used are broadly in accordance with those recommended in the *1993 SNA*. The existing data collection program is not being fully used to compile the national accounts and new measures have yet to be implemented to improve the surveys used to collect the data perceived as unfit. One potential omission from the accounts is the informal activity in the unrecorded economy, the size of which is not known. Although GDP data are produced in accordance with international practice, the national accounts could be improved by shifting to the *1993 SNA*. The BOK plans to implement the shift at the time of the next rebasing to take effect during 2003–04. Also, the commodity flow technique could be improved by moving to the Supply and Use Table framework. The BOK intends to produce such a framework in 2004, but there are currently difficulties with obtaining the basic data required.

- The **Consumer Price Index** (CPI) is based on internationally endorsed standards and uses classifications compatible with internationally recommended systems. Concepts and definitions used for the compilation of the CPI are in line with the recommendations of the International Labor Organization (ILO). The scope of the CPI covers urban areas, but excludes single person, farm and fishing households. The CPI is compiled using sound procedures and methods which, however, could be improved by also including single-person households, and by having the prices of missing seasonal items imputed by similar items within their group. The coverage gaps can be a potential problem with the level of the indices, while the absence of good imputation procedures can potentially introduce a bias in short-term price trends and affect inflation monitoring.

- The **Producer Price Index** (PPI) is also based on internationally endorsed standards and recommendations. Concepts and definitions used for the compilation of the PPI are in line with the *1993 SNA*. The scope of the PPI covers all domestic industrial activities and a large segment of service activity; however, it excludes free trade zones and bonded warehouses. The PPI is compiled using sound procedures and methods but could be improved by imputing missing prices from other similar commodities, rather than being simply carried forward using the last reported price.

Fiscal Sector

- Consolidated statistics on the **general government** aligned with internationally recognized standards are not compiled. Statistics following these standards only cover the central government, which accounts to about 75 percent of total general government. National concepts and definitions differ from those internationally recognized. Therefore, two sets of government finance statistics are compiled for the central government, using national definitions and using internationally recognized standards. Concepts and definitions used in the latter set of central government finance statistics generally follow the recommendations of the *1986 Government Finance Statistics Manual* (*GFSM 1986*). The data cover the budgetary units of the central government (including social security funds owned and/or managed by the government) and the extrabudgetary funds owned or managed by these units.

- **Central government** statistics aligned with internationally recognized standards are produced from the National Financial Information System (NAFIS), which integrates the preparation of budget data, accounting reports, and the generation of fiscal statistics on a monthly basis. The NAFIS provides for automatic crosschecks at different levels of the compilation process.

Monetary Sector

- The overall quality of Korea's **monetary statistics** is generally sufficient for informing the policy process. Nevertheless, the recent data ROSC mission to Korea identified several areas that are not in line with international guidelines.

- The analytical usefulness of data relating to foreign assets and foreign liabilities is affected by the BOK valuing its financial assets and financial liabilities at book value (rather than at market value) and revaluing its foreign currency denominated assets and liabilities twice yearly (rather than on a monthly basis). Netting procedures in the monetary statistics also distort the analytical usefulness of data on foreign assets and foreign liabilities. Also, some banks are using nationality rather than residency to distinguish between resident and nonresident individual and household accounts.

- The sectorization of claims on residents deviates from international standards. In particular, claims on official entities includes units (public corporations, local government, and the Korean Deposit Insurance Corporation) that belong to different economic sectors. Moreover, borrowings by banks from the central government, are indistinguishably included as part of net credit to government.

- The compilation of both liquidity and institutional based monetary aggregates means that a common definition of the money holding and money issuing sectors does not exist across Korea's monetary aggregates, necessitating particular care in interpreting developments in the aggregates and the relationships between the aggregates.

Balance of Payments

- The overall quality of **balance of payments** data is good. Although the Bank of Korea implemented the *BPM5* in early 1998, there are important deviations in the classification and sectorization of balance of payments transactions.

- Following liberalization, the coverage of the balance of payments statistics has become less comprehensive, as residents were permitted to conduct transactions via accounts with banks abroad. There is also incomplete coverage of transactions via intercompany accounts, via nonresident won-denominated accounts with domestic banks, and noncash transactions. The BOK is preparing to implement new collections to improve coverage. The BOK has developed an array of statistical techniques and collections to improve the coverage, classification, and timeliness of source data, including timing and valuation adjustments to trade statistics compiled from customs documents, grossing of certain services transactions, and recording long-term construction contracts under direct investment.

- At present, a statement of Korea's **international investment position** (IIP) is not disseminated. However, timely monthly external debt statistics are disseminated, albeit with a limited sectoral breakdown. Moreover, data on gross external "debt assets" are disseminated along with external debt liabilities, which provide a significant amount of information on Korea's IIP. These statistics, together with monthly balance of payments trade statistics, and monthly data on international reserves and foreign currency liquidity, provide users with a considerable amount of timely information on external sector developments.

- The quality of **external debt** statistics has greatly improved since the financial crisis. However, the statistics are not compiled on a residency basis, and certain external liabilities are excluded from the disseminated data. Hence, the external debt statistics are not comparable with the balance of payments statistics, nor with external debt data disseminated by other countries.

Korea: Survey of Reporting of Main Statistical Indicators 1/
(As of December 31, 2001)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money (M3)	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP	External Debt/ Debt Service
Date of latest Observation	12/31/01	12/31/01	11/01	11/01	09/01	12/31/01	11/01	11/01	11/01	09/01	Q3 2001	10/01
Date Received	12/31/01	12/31/01	12/01	12/01	12/01	12/31/01	12/01	12/01	12/01	11/01	11/01	12/01
Frequency of Data	D	D	M	M	M	D	M	M	M	M	Q	M
Frequency of Reporting	D	D	M	M	M	D	M	M	M	M	Q	P
Source of Data	A	A	N	N	N	A	N	N	N	A	A	N
Mode of Reporting	C	M	M	M	M	C	M	M	M	M	M	M
Confidentiality	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of Publication	D	D	M	M	M	D	M	M	M	M	Q	M

1/ The codes are explained below.

Frequency of data: D – daily, M – monthly, Q – quarterly.
Frequency of reporting: D – daily, M – monthly, Q – quarterly, P – periodically (upon request).
Source of data: A – direct reporting by authorities, N – official publications and websites.
Mode of reporting: E – electronic data transfer, M – mail, F – fax, R – press report.
Confidentiality: C – unrestricted use, D – embargoed for a specific period, and for unrestricted use thereafter.

Korea: Fund Relations
(As of December 31, 2001)

I. **Membership Status**: Joined August 26, 1955; Article VIII

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	1,633.60	100.00
Fund Holdings of Currency	1,424.89	87.22
Reserve Position in Fund	208.72	12.78
Financial Transaction Plan transfers (net)	161.00	

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	72.91	100.00
Holdings	2.66	3.64

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
Stand-by	12/04/1997	12/03/2000	15,500.00	14,412.50
Of which: SRF	12/18/1997	12/18/1998	9,950.00	9,950.00
Stand-by	07/12/1985	03/10/1987	280.00	160.00
Stand-by	07/08/1983	03/31/1985	575.78	575.78

VI. **Projected Obligations to the Fund**: None

VII. **Exchange Rate Arrangement:**

Korea's exchange rate system is classified as "independently floating." Previously, the exchange rate against the U.S. dollar was allowed to float only within specified margins around the previous day's weighted average exchange rate in the interbank market. The margins were widened five times between March 1990 and November 1997 (most recently to +/-10 percent), and on December 16, 1997 were eliminated altogether. On December 19, 2001, the exchange rate was W 1,292.2=US$1.

VIII. **Last Article IV Consultation**:

Korea is on a 12-month consultation cycle. Staff discussions for the 2001 Article IV consultation were conducted on a mission to Seoul during October 31–November 13, 2001.

IX. **FSAP and ROSC Participation**:

MAE: The first FSAP mission was conducted during October 22–29, 2001. The mission completed the assessment of the observance of the *Code of Good Practices on Transparency in Monetary and Financial Policies* and the *Core Principles for Systemically Important Payment Systems*, and initiated an analysis of systemic liquidity developments and policies. Further missions are scheduled for 2002.

STA: A mission conducted the Statistics ROSC in Seoul during April 2001. A draft of the ROSC Data Module was sent to the authorities for comment and the report is now being finalized.

FAD: Discussions on fiscal transparency were held in Seoul during June 2000, and a report was drafted and finalized in November 2000, with input from APD staff. The report has been published (SM/01/22) and is available on the web through the following link: http://www.imf.org/external/np/rosc/kor/fiscal.htm

X. **Technical Assistance**:

FAD: A technical assistance mission visited Seoul during January 8–19, 2001 to evaluate current practices in budgeting and public expenditure management and to provide advise on setting up a medium-term fiscal framework.

MAE: A mission conducted a high-level technical seminar during May 16–22, 2000 on the development of the foreign exchange market. Jointly with the authorities and market participants, the mission analyzed the current state of the foreign exchange market and identified possible areas for improvement. The seminar covered issues in supervision, market monitoring, derivatives instruments, and market microstructure.

STA: A technical assistance mission visited Seoul during March 29–April 12, 2000 to provide advice on balance of payments and external debt statistics, with a view toward improving the recording of financial derivatives and developing an international investment position statement.

MAE: A high-level technical seminar on monetary policy implementation was held during July 15–19, 1999 at the Bank of Korea.

FAD: A technical assistance mission visited Seoul during March 31–April 16, 1999 to provide advice on tax policy issues, aimed at simplifying and modernizing the tax system.

FAD: A technical assistance mission visited Seoul during January 30–February 12, 1999 to assist the authorities in developing tax administration reform plans.

XI. **Resident Representative**:

The resident representative office in Seoul was opened in March 1998. Mr. Paul Gruenwald has been the Resident Representative since September 2001.