DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

SM/82/54
Correction 1

CONTAINS CONFIDENTIAL INFORMATION

April 27, 1982

To: Members of the Executive Board

From: The Secretary

Subject: Korea - Staff Report for the 1982 Article IV Consultation

The following corrections have been made in SM/82/54 (3/25/82):

Page 6, line 6, "Saving", last column: for "28.8" read "29.6"

line 20, "Per cent of GDP," last column: for "29" read "2.5"

Page 10, para. 2, line 6: for "13 per cent" read "11 per cent"

Page 11, 2nd full para., penultimate line: for "9 percentage"
read "10 percentage"

footnote 1: for "1/ Details...issued shortly."
read "1/ Details of the Plan are provided in Supplement 1 to the associated Recent Economic Developments report (SM/82/70)."

Page 14, 1st full para., line 1: for "about 90 per cent" read "85 to 90 per cent"

footnote 1, line 2: for "12 per cent" read "16 per cent"

Page 18, footnote 1: for "1/ Details...issued shortly."
read "1/ Details of the 1982 tax reform are available in Supplement 1 of the associated Recent Economic Developments report (SM/82/70)."

Corrected pages are attached.

Att: (5)

Other Distribution:
Department Heads

Table 2. Korea: Quantitative Performance Criteria and Actual Developments under the 1981 Stand-By Program

Outstanding at end of period	1981 March	June	September	December
		(In billions of won)		
Total domestic credit of the banking system				
Ceiling	18,350	20,000	21,000	23,000
Actual	17,798	19,037	20,387	22,394
Net credit to the public sector				
Ceiling	1,200	1,400	1,550	1,700
Actual	1,134	1,334	1,170	1,659
		(In millions of U.S. dollars)		
New external loans contracted by the public and private sectors				
1- 12-year maturity				
Ceiling	6,000	6,000	6,000	6,000
Actual	185	917	2,197	3,054
1- 5-year maturity				
Ceiling	1,000	1,000	1,000	1,000
Actual	157	237	263	430

Source: Data provided by the Korean authorities.

SM/82/54
Corrected: 4/26/82

Table 3. Korea: Selected Economic Indicators, 1979-86

	Actual 1979	Actual 1980	Program Projections 1981 Orig.	Program Projections 1981 Rev. 1/	Estimated Outcome 1981	Official Proj. 1982	Fifth Plan Proj. 1986
rowth (change in per cent)							
Real GNP	6.4	-6.2	5.0-6.0	6.0	7.1	6.9	7.6 2/
Agriculture	6.7	-22.0	28.3	28.3	23.0	2.5	2.6 2/
Nonagriculture	6.3	-2.5	2.3	2.3	4.0	7.9	8.6 2/
Manufacturing	9.8	-1.1	4.3	4.8	6.8	7.9	11.0 2/
nvestment and savings (per cent of GNP)							
Fixed investment	32.5	32.7	28.8	32.3	28.3	28.2	30.9
Saving	26.6	19.9	20.1	24.2	20.0	21.9	29.6
rices (change in per cent)							
Wholesale (Dec.-Dec.)	23.8	44.2	24.0	20.0	11.8	10.0	10.1 2/
Consumer (Dec.-Dec.)	21.2	34.6	24.0	20.0	12.6	10.0	
GNP deflator	19.3	25.9	24.0	20.0	17.4	13.0	10.8 2/
ublic [illegible]ce (per cent of GNP)							
Cent[illegible]ernment							
R[illegible]	18.7	19.9	18.6	19.2	20.0	21.0	
Ex[illegible]ture and net lending	20.6	22.4	20.7	21.8	23.5	22.8	
Deficit	1.9	2.5	2.1	2.6	3.5	1.8	
Public sector deficit	1.5 3/	3.4 3/	2.9 3/	3.3	4.9 3/	2.7 4/	1.0 4/
	(1.5) 4/	(3.2) 4/	(...) 4/	(...) 4/	(4.4) 4/		
oney and credit (change in per cent)							
Domestic credit	35.6	36.0	42.0	37.0	32.9	25.2	
Broad money	24.6	26.9	35.0	27.0	25.2	20.0	
alance of payments							
Exports, f.o.b. (US$ bn.)	14.7	17.2	20.8	21.3	20.9	24.4	53.0
Imports, f.o.b. (US$ bn.)	19.1	21.6	26.3	25.5	24.1	27.1	55.5
Current account deficit							
In billions of U.S. dollars	4.2	5.3	5.5	5.5	4.7	3.9	3.6
Per cent of GNP	6.9	9.4	8.2	8.5	7.5	5.5	2.5
Increase in reserves (US$ bn.)	0.9	0.9	0.6	0.4	0.3	0.6	1.2
External debt (per cent)							
Debt/GNP 5/	30.8	42.1	48.3	47.7	47.5	49.3	43.7
Debt service ratio 6/	15.2	18.4	15.6	18.4	19.9	18.3	14.0

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

1/ See Korea - Review of Stand-By Arrangement (EBS/81/154, 7/16/81).
2/ Annual rate of increase, 1982-86.
3/ Including telecommunications ([illegible] footnote 2 in Appendix Table II).
4/ Excluding telecommunications.
5/ Private and public short- and long-term debt, including purchases from the Fund.
6/ Debt service payments, including interest payments on short-term debt, as a ratio of exports of goods and services.

3. Balance of payments position

Korea's balance of payments position improved in 1981 (Appendix Table V), and further substantial external adjustment was accomplished. The current account deficit, which reached US$5.3 billion, or 9.4 per cent of GNP in 1980, declined to US$4.7 billion, or 7.5 per cent of GNP, in spite of a further increase in international interest rates and the need to import abnormally large quantities of rice, the additional rice imports were equivalent to about 1 per cent of GNP. The extent of external adjustment was equivalent to approximately 4.5 per cent of GNP (Table 1). With domestic policies shifting toward securing a resumption of growth, external adjustment in 1981 was brought about almost entirely by an increase in exports, reinforced by an expansion of receipts from overseas construction contracts. The actual current account deficit was smaller than the deficit of US$5.5 billion envisaged under the program, as a lower-than-expected increase in average import prices (including oil) more than offset higher interest payments. Export prices also rose less than forecast, but this was offset by a faster growth in volume

In spite of a considerable weakening in the fourth quarter, the volume of exports rose by almost 20 per cent during 1981. This strong performance, which implied a substantial increase in market shares, reflected the lagged response of exports to the gains in competitiveness achieved in 1980 and the results of more vigorous efforts to diversify markets Non-rice imports rose by only about 4 per cent in real terms, mainly because of weak investment demand and also a drawdown of stocks of raw materials. Although there was a further deterioration in Korea's terms of trade of about 3 per cent (against a deterioration of 17 per cent in 1980), the trade deficit still narrowed by more than US$1 billion. Part of this improvement was offset, however, by a widening deficit on the services account, mostly because of a sharp increase in interest payments due to higher international interest rates and the rapid growth of Korea's external debt, which increased from 31 per cent of GNP in 1979 to 48 per cent in 1981. During the same period, the debt service ratio rose by 5 percentage points to 20 per cent.

Gross capital inflows, including bank borrowing but excluding purchases from the Fund, amounted to US$6 billion in 1981, and total new loans contracted reached about the same level. Loan contracts in the 1- to 12-year maturity range amounted to US$3.1 billion, substantially below the program limits, as the Government was able to obtain a larger-than-expected volume of loans with maturities in excess of 12 years. The private short-term capital account swung from an exceptionally large inflow in 1980 to a small net outflow. This turnaround, which occurred mostly in the last quarter of 1981, may have reflected exchange rate expectations since domestic interest rates remained slightly higher than international interest rates (Chart 2).

Largely because of this turnaround in short-term capital flows, the overall balance of payments, defined to include as financing items all external borrowings of the banking system, recorded a deficit of US$2.3 billion, compared with a deficit of US$1.9 billion registered in 1980 and a deficit of US$1.7 billion forecast under the program. Bank borrowing constituted the bulk of the financing, while net use of Fund credit was equivalent to US$628 million. Reserves rose by about US$300 million, but in terms of coverage of imports of goods and services, they declined from 2.8 months at end-1980 to 2.5 months at end-1981.

4. Exchange rate

Following an initial depreciation of 16.6 per cent in January 1980, the won was untied from the U.S. dollar and a new arrangement was adopted, whereby the exchange rate for the won was to be determined on the basis of a currency basket, with other factors also taken into account. Under this arrangement, the won was allowed to depreciate further in the course of 1980, resulting in a depreciation of 11 per cent in real terms between the last quarter of 1979 and the last quarter of 1980. This approximately restored Korea's external competitiveness to its 1976-77 level (Chart 3).

With exports performing well in the first half of 1981, the policy emphasis of the authorities shifted toward price stability, and the won was allowed to follow the upward movement of the U.S. dollar, resulting in an effective appreciation of 3 per cent in nominal terms between the fourth quarter of 1980 and the third quarter of 1981. With the rate of inflation in Korea higher than in trading partners, the appreciation in real terms amounted to some 13 per cent during this period. Accompanying this loss of competitiveness, there has been a considerable weakening in export orders since mid-1981 and, following the usual lags, the growth of exports has fallen sharply since the third quarter of 1981 (Chart 4), even though import demand in Korea's major trading partners strengthened in the second half of the year.1/ In response to these developments, the won was allowed to depreciate somewhat in nominal terms in November, but subsequently through February 1982, the nominal effective exchange rate appreciated again. Thus, in spite of the sharp deceleration of the rate of inflation, the real effective exchange rate for the won was still an estimated 10 per cent higher at the end of February 1982 than in the fourth quarter of 1980, and both export orders and actual exports had weakened further.

IV. Report on Discussions

Despite the substantial external adjustment achieved over the past two years, the current balance of payments deficit is still high by past standards, and further adjustment is needed in order to alleviate the debt service burden and reduce Korea's vulnerability to external shocks.

1/ The major buyers of Korea's exports are the United States, Japan, Germany, Canada, the United Kingdom, and Middle East countries.

At the same time, there is a need to secure, without rekindling inflation, a smooth recovery of the economy following two consecutive years of falling investment and virtually no growth in aggregate output between 1979 and 1981. Such a recovery is essential to the absorption of a growing labor force and the creation of an investment climate conducive to strengthening the productive base of the economy.

Given the dual objectives of adjustment and growth, exports must continue to play an important role in the Korean economy during the years to come. The authorities recognize this and emphasize that, in view of growing competition from other newly industrializing countries and the sharp increase in the cost of energy, Korea must also restructure its industrial production in line with the country's shifting comparative advantage away from the traditional sectors of relatively labor-intensive products and toward high-technology and high-quality products. At the same time, they underscore the need to reduce the economy's relatively high energy intensity and oil dependency.

The recently published Fifth Five-Year Plan for 1982-86 outlines the Government's medium-term macroeconomic objectives and policies.1/ The principal external goal is to reduce the current account deficit of the balance of payments to about 3 per cent of GNP by 1986 (Table 3), which would permit a reduction of the debt service ratio to 14 per cent. The rate of inflation is targeted at about 10 per cent or less. The Plan also aims at a rate of growth sufficient to provide enough jobs to absorb the expansion of the labor force (projected at 2.8 per cent per annum) and permit a gradual reduction in unemployment from recent relatively high levels. To this end, the Plan aims at an average real growth rate of 7.6 per cent per year, which is projected to generate a 3 per cent annual growth of employment. Between 1981 and 1986, the rate of fixed investment is targeted to rise by 3 percentage points of GNP, and the rate of domestic savings, by nearly 10 percentage points (Table 3).

The Plan puts emphasis on prudent demand management, reductions of the public sector deficit, and a reduction of direct government intervention in economic activity, together with a strengthening of the market mechanism. Policies are strongly oriented toward structural reforms, including a redesign of industrial incentive schemes, improvements in the tax system, financial sector reform, and import liberalization. About two thirds of the projected increase in domestic saving is to be mobilized through a doubling of the household savings/GNP ratio from the depressed 1981 level, to be promoted through appropriate financial incentives, including maintenance of positive real interest rates and diversification of financial assets. At the same time, improved profitability and restrained fiscal policies are to facilitate moderate increases in business and government saving.

1/ Details of the Plan are provided in Supplement 1 to the associated Recent Economic Developments report (SM/82/70).

Given these medium-term objectives, the discussions focussed on the adequacy of targets and policies for 1982 against the backdrop of the declining trend in exports, they also covered the structural reforms being implemented.

1. Targets and policies for 1982

The authorities' principal macroeconomic targets for 1982 are to limit the rate of inflation to 10 per cent or less, to reduce the current account deficit to approximately US$4 billion, or 5.5 per cent of GNP, and to achieve a real growth rate of about 7 per cent. The targeted reduction in the current account deficit represents a slowdown in the rapid pace of external adjustment obtained in the past two years, but it would be consistent with a smooth recovery of the economy and would also represent progress toward the medium-term goal of reducing the current account deficit to 3 per cent of GNP by 1986. The main policies which the authorities intend to pursue in 1982 are a slowing of domestic credit expansion, the maintenance of a relatively stable exchange rate, fiscal restraint, cost reductions through wage moderation and interest rate cuts, and a drive to improve productivity and efficiency through structural reforms. These policies are expected to lower inflation and help regain some of the competitiveness lost since early 1981. While endorsing the Government's macroeconomic objectives, the staff team considered, as explained below, that both the mix and stance of policies might need to be modified in order to achieve those objectives.

a Exchange rate and monetary policies

The authorities accord top priority to price stability, they want to purge from the economy inflationary expectations which have become deeply entrenched as a result of almost two decades of high rates of inflation. Toward this end, the Government wants to be able to demonstrate further significant progress on the inflation front during 1982. Given these considerations, reliance is not presently being placed on the exchange rate as a principal instrument to improve external competitiveness. The present intention is to permit a relatively modest depreciation of the won against the U.S. dollar in the course of 1982. Emphasis is being placed on the won/U S. dollar relationship because of its importance for Korea's international transactions and because a relatively large amount of debt is denominated in U.S. dollars.

The authorities recognize that Korea's exports have lost competitiveness since end-1980, and believe that the ground lost should be regained through productivity improvements, quality changes, and cost reductions rather than through the easy way' of a depreciation. In this regard, they pointed out that the prospects for significant wage moderation were much better now than in early 1980 when Korea had been experiencing a prolonged period of extremely rapid wage increases, which had made a depreciation unavoidable at that time. Now, however, after two years of economic difficulties, the public had come to appreciate the need for wage restraint, and nominal wage increases were expected not to exceed

10 per cent in 1982. To set an example, the average increase in civil service salaries had been limited to 9 per cent, while the large-scale educational campaign initiated in 1981, which aimed at explaining the adverse economic consequences of excessive wage awards, was being continued. Furthermore, with a view to stabilizing inflationary expectations, private companies were being urged to conclude their wage settlements as early as possible in the traditional round of wage negotiations in early spring. Based on settlements so far concluded, the authorities were hopeful that their wage objectives for 1982 would be achieved.

A drive to improve productivity and upgrade product quality had also been initiated. This was being implemented through an extensive information campaign and financial incentives. Production costs should also benefit from the recent cuts in domestic interest rates, and further reductions were being contemplated. The authorities wished to maintain positive real interest rates and considered that, with the recent decline in the rate of inflation, there was room for further downward adjustment in nominal interest rates.

The Government's monetary program for 1982 envisages a reduction in the rate of growth of broad money (M2) to 20 per cent (25 per cent during 1981) and of domestic credit to 25 per cent (33 per cent during 1981). The authorities believe that these targets will permit limiting the rate of inflation to 10 per cent or less, while also ensuring achievement of the growth and current account targets. With fiscal policy becoming more restrictive, net credit expansion to the public sector is projected to be lower than in 1981, leaving proportionately more room for the credit needs of the private sector. To improve flexibility, the Government in early 1982 eliminated the system of direct credit control which had been operated through establishing credit ceilings for each deposit money bank, henceforth, the banks' ability to expand credit will be controlled solely through the Bank of Korea's rediscount window, open market operations, and changes in reserve requirements.

In the authorities' view, the anticipated decline in wage increases, the reduction in interest rates, the expected gains in productivity combined with higher capacity utilization, and the beneficial impact of a relatively stable exchange rate on the servicing of foreign currency-denominated company debt will adequately improve profitability and competitiveness These factors, together with an anticipated pickup in world demand in the second half of 1982, are expected to lead to an acceleration of exports later in the year, which should ensure achievement of the official target of 10 per cent growth in export volume during 1982 and, therefore, the targeted reduction in the current account deficit as well.

Noting the close past relationship in Korea between changes in competitiveness and export performance, the staff expressed concern about the appreciation of the real exchange rate of the won and the sharp weakening of arrivals of export letters of credit (LCs) which has accompanied it. During the six months through February 1982, LC arrivals declined by almost 7 per cent in dollar terms over the same period a year earlier. Since performance during that earlier period was very good, reflecting as it did the former gains in competitiveness, the recent decline in orders may exaggerate the weakening overall trend of exports, nevertheless, this decline did occur against the background of an acceleration of import demand in Korea's trading partners.

In the past, LC arrivals explained 85 to 90 per cent of actual exports with a lag of three to six months. While this relationship has been changing somewhat recently with the growing importance of non-LC exports, such as ships and heavy machinery, the bulk of exports is still being made through LCs. Based on LC arrivals through February 1982, the staff projects that export volume will grow only marginally in the first half of the year, requiring a very sharp acceleration in the second half for the official export target to be realized.1/ Given the outlook for only a modest upturn in world demand and the normal lags involved, such an acceleration is unlikely without a speedy improvement in Korea's competitiveness. With present policies, the staff estimates that exports will fall well short of the official target--which already represents a sharp slowdown from the growth of exports in 1981--so that no significant reduction in the current account deficit seems likely in 1982.2/ Given the present external outlook, staff projections indicate that the current account deficit could reach US$4.6 billion, equivalent to about 6.7 per cent of GNP. This would imply a halt in external adjustment compared with 1981 if the extraordinary rice imports in that year are excluded (Table 1). The overall payments deficit is projected by the staff at US$1.8 billion, compared with US$1.4 billion forecast by the authorities.

While supporting the authorities' objective for price stability, the staff team expressed the view that this goal should be pursued primarily through appropriate monetary restraint and that the exchange rate should be used flexibly to promote external adjustment. In this connection, the staff noted that, owing to the absence of a depreciation in the nominal value of the won to maintain competitiveness, the reduction in inflation in 1981 was partly achieved at the expense of export incentives as the relative prices of tradable goods declined. Wage moderation and productivity improvements were, of course, essential and would help competitiveness, but it was unlikely that such factors alone would be sufficient to bring about the needed reduction in relative costs. Furthermore, they would not ensure a shift of incentives toward the production of tradable goods. Therefore, unless the authorities were prepared to adopt a more restrictive monetary stance, competitiveness

---

1/ Non-LC exports represented 10 per cent of total exports in 1980 and 16 per cent in 1981, the above staff projections assume a significant further increase in this ratio in 1982.

2/ Aside from the difference in exports, the staff projections of the balance of payments for 1982 assume a somewhat lower growth of imports than the official projections, but larger interest payments owing to higher average international interest rates forecast by the staff (15 per cent) than the authorities (13 per cent).

to about 10 per cent. Although this difference will not yet fully cover costs, the authorities' intention is to widen the gap every year so as to eliminate the GMF's deficit by 1986. The deficit of the Fertilizer Fund is also expected to be eliminated by 1986. As a step toward this goal, fertilizer production is being cut and reorganized, with the consolidation of operations into fewer plants.

2. Structural reforms

During the past two years, the authorities have initiated several important structural reforms with a view to increasing the productivity and efficiency of the economy. Considerable progress has been achieved so far under these reforms, many of which are being supported by an IBRD structural adjustment loan approved in December 1981. The salient elements of these reforms are summarized below.

a. Industrial and energy policies

During the past year, industrial structure was streamlined through government-directed mergers and rationalization of capacity in six major heavy industries which had suffered from an overexpansion of capacity. Currently, a thorough review of industrial and export incentive systems is being undertaken so as to ensure that incentives will be offered on a more uniform and, hence, less distortionary, basis than in the past. New incentives for technological development are being provided in the form of a tax credit for expenditure to upgrade technology and through increased availability of finance for high-technology projects.

The energy conservation program emphasizes full passthrough to domestic prices of any increases in energy costs and efforts to reduce through government-sponsored energy audits the relatively high energy-intensity of industrial production.1/ Furthermore, to reduce oil dependency, increased financial support is being provided for switching from oil to coal. Supply-side energy measures center on the construction of nuclear power plants and government support for the expansion of domestic coal production. Through these measures, the proportion of imported oil in total energy consumption is targeted to decline from approximately 60 per cent in 1981 to less than 50 per cent by 1986 and about 40 per cent by 1991.

b. Tax and financial sector reforms

As a continuation of past efforts to improve the tax system, a comprehensive set of reforms has been implemented in 1982, which is broadly in line with the recommendations of the Fiscal Affairs Department of the Fund. To improve equity and efficiency, important changes were made in the rates, structure, deductions, and exemptions applying

---

1/ During 1975-79, the elasticity of energy consumption with respect to growth of GNP was 0.96, compared with 0.42 in the U.S., 0.34 in France, and 0.30 in Japan.

to corporation tax, personal income tax, capital gains tax, inheritance tax, and the special excise tax. Modifications were also made in the tax exemption and deduction system, reducing the number of industries eligible for special tax favors and moving away from direct tax exemptions based on specific industries toward indirect investment incentives defined by function.1/ Increased deductions and lower tax rates for individual income taxpayers will have a negative revenue impact, but this will be more than offset by the positive effects of other tax changes. For the coming years, the intention is to make the necessary discretionary changes to rationalize the tax system further and o ensure that tax effort rises continuously through the medium term. Specifically in 1982, the authorities are studying, again with technical assistance from the Fiscal Affairs Department, reforms of the value-added tax system to be implemented in 1983.

As an integral part of the industrial and tax reforms, the Government has initiated a reform of the financial sector, with the principal objective of enhancing the role of the market mechanism in the financial system. The main elements of this reform are a gradual transfer of the Government's share in the ownership of commercial banks to the private sector, the liberalization of markets, and a reduction in the differential between preferential and general interest rates. In all these areas, significant measures were introduced in 1981, including the transfer of one nationwide commercial bank to the private sector and the partial liberalization of the commercial paper market. During the coming year, the authorities intend to simplify the system of preferential loans and reduce their scope, to narrow further the gap between interest rates on preferential and general loans, and to review the interest rate differential between bank and nonbank financial institutions.

As a result of the extensive use of preferential loans in the past and the relatively less-developed state of the domestic equity market, the structure of company finance in the manufacturing sector features a ratio of debt to equity that is exceptionally high by international standards, with a significant proportion of debt denominated in foreign currencies. The staff noted that company profitability was, therefore, highly sensitive to changes in interest rates and to the effects of exchange rate changes. To some extent, these factors might have inhibited the flexible management of interest rate and exchange rate policies. The authorities indicated that, to improve balance sheet positions and alleviate these constraints, the Government had directed firms to dispose of their nonbusiness assets, such as speculative land holdings, and use the proceeds to reduce their debt to commercial banks. Land sales under this program, which had been initiated in late 1980, were expected to increase significantly in 1982. A recent easing of restrictions on foreign investment was also regarded as a measure that would strengthen company finances over the medium term, as well as encouraging technological transfers.

1/ Details of the 1982 tax reform are available in Supplement 1 of the associated Recent Economic Developments report (SM/82/70).