NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/66

3:00 p.m., May 5, 1982

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	H. Alaoui-Abdallaoui, Temporary
	C. Taylor
	M. A. Senior
	O. Üçer, Temporary
	P. D. Peroz, Temporary
	T. A. Connors, Temporary
M. Finaish	
T. Hirao	T. Yamashita
	R. J. J. Costa, Temporary
R. K. Joyce	M. Casey
A. Kafka	J. R. Gabriel-Peña
	F. Yeo T. Y., Temporary
	F. Sangare
	W. Moerke, Temporary
	C. P. Caranicas
	M. K. Diallo, Temporary
	V. K. S. Nair, Temporary
	S. El-Khouri
	D. V. Pritchett, Temporary
	T. de Vries
A. R. G. Prowse	B. Legarda
	J. G. Pedersen, Temporary
	Jiang, H., Temporary

A. Wright, Acting Secretary
L. Collier, Assistant

Also Present

Asian Department: P. R. Narvekar, Deputy Director; U. Baumgartner, W. J. L. Evers, S. Ishii, G. Szapary. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; D. K. Palmer, Deputy Director; D. J. Donovan, C. Puckahtikom. Fiscal Affairs Department: M. J. Fetherston, K. W. O'Connor, M. A. Wattleworth. IMF Institute: Y. Keun-Man, S. J. Kim, M. Z. Mian, Participants. Legal Department: J. K. Oh, J. V. Surr. Middle Eastern Department: A. S. Ray, Deputy Director; A. D. Crockett, F. Drees, S. H. Hitti, H. E. Jakubiak, M. Shadman. Research Department: K.-Y. Chu. Advisors to Executive Directors: S. R. Abiad, M. A. Janjua, S.-W. Kwon, F. A. Tourreilles. Assistants to Executive Directors: E. M. Ainley, A. Halevi, J. A. K. Munthali, J. R. Novaes de Almeida, Y. Okubo, J. Reddy, J. Schuijer, D. I. S. Shaw, H. Suzuki, J. C. Williams, A. A. Yousef.

1. KOREA - 1982 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1982 Article IV consultation with Korea (SM/82/54, 3/25/82; and Cor. 1, 4/27/82), together with a proposed decision concluding the 1982 Article XIV consultation. They also had before them a report on recent economic developments in Korea (SM/82/70, 4/15/82; Cor. 1, 4/27/82; Sup. 1, 4/20/82; and Sup. 1, Cor. 1, 4/27/82).

Mr. Prowse made the following statement:

First, I wish to record the thanks of the Korean authorities to the staff for its fine report. For my own part, I would wish to acknowledge the enormous amount of work done by the staff and the professional standard of the report.

The substance of the staff report begins on page 2 with some background material referring to the expansionary policies of the late 1970s and the 1979/80 increases in oil prices. The expansionary policies of that period are seen as having severely negative effects, and policies of the last two years are described as having been dominated by the need to adjust to these two factors. Yet it is the view of most objective observers that the external environment in the form of depressed and restricted markets for Korean exports, the severe sociopolitical disturbances of late 1979 and 1980, and the disastrous crop season in 1980 were also major elements in the formulation of Korean economic policy. Moreover, when the Board last reviewed the Korean economy, there was considerable approval of the successful adjustment being made to the effects of these severe adverse factors. Indeed, it would not be unfair to say hat from about October 1980 until the end of 1981 the Korean economy was doing pretty well, all things considered, and it is not unreasonable to say that what happened then was to a considerable extent that the world recession--and particularly the U.S. recession and U.S. interest rates--finally caught up with Korea.

It is important to record, and my Korean authorities would certainly want to do so fully, the value of the Fund's assistance over this period and particularly of the stand-by arrangement completed a few months ago. It should be further noted in that regard that Korea, as always in the past, met and indeed more than met all of the performance criteria under the stand-by program.

As to the program targets under the stand-by arrangement, the performance on growth, prices, and the current account was better than originally envisaged. Only the public sector deficit was larger than expected, mainly reflecting the efforts of the Korean authorities to offset to some extent the depressing effects on their economy of the slowdown in world trade. Real GNP grew by about 7 per cent in 1981, compared with a program target of 5-6 per cent, and the volume of exports rose by almost 19 per cent during 1981, despite the decline in Korea's terms of trade by some 20 per cent in 1980 and 1981.

During the past two years, the Korean authorities also initiated several important structural reforms with a view to increasing the productivity and efficiency of the economy, and considerable progress has been achieved in implementing these reforms, many of which are being supported by an IBRD structural adjustment loan approved in December 1981.

These structural reforms involve, among other things, streamlining of the industrial structure in six major heavy industries, a continuing thorough review of industrial and export incentive schemes, the adoption of an energy conservation program that emphasizes full pass-through 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.

A comprehensive set of reforms in the tax system has been implemented in 1982, broadly in line with the recommendations of the Fiscal Affairs Department of the Fund. Importantly, the Government has also initiated a major reform of the financial sector, with the principal objective being to enhance the role of the market mechanism. A major element of this restructuring is the gradual transfer of the Government's share in the ownership of commercial banks to the private sector, the liberalization of financial markets, and a reduction in the differential between preferential and general interest rates.

Additionally, Korea continued to liberalize its import arrangements in 1981, and the proportion of unrestricted categories rose from 69 per cent at the end of 1980 to 75 per cent at the end of 1981. Under the Fifth Five-Year Plan, the goal is to raise this ratio to a level comparable with that of most industrial countries.

These achievements and reforms are, of course, consistent with the braod framework of the recently published Fifth Five-Year Plan for 1982-86. The Plan emphasizes prudent demand management, reductions of the public sector deficit, a reduction of direct government intervention in economic activity, and a strengthening of the market mechanism, and as indicated above, it is generally strongly oriented toward structural reform in the industrial system, the tax system, the financial sector, and the structure of import arrangements. The improved profitability envisaged and the associated restrained fiscal policies are designed to foster increases in business and government saving.

The principal external goal of the Plan is to reduce the current account deficit of the balance of payments to 2.5 per cent of GNP by 1986, although I note the staff refers to this objective as "about 3 per cent of GNP" on page 11.

In brief, the objectives of this Plan are, I suggest, worthy of strong endorsement.

Perhaps the main focus for the Board today, however, will be on the management of macroeconomic policy within this broad framework and against the background of developments over recent years. In this regard there is first the question of policy objectives.

The Korean authorities are putting strong emphasis on curbing inflation and eliminating inflationary expectations. They accept wholeheartedly the view endorsed by the Fund itself that such objectives are essential for the long-run health of any economy. In terms of achievement to date, we may reasonably expect that they will achieve this objective. Thus, while prices were rising at a rate of 44 per cent in 1980, the rate was reduced to about 12 per cent in 1981, and for the first three months of 1982 the wholesale price index increased by only 1.4 per cent compared with December 1981. For the same three months the consumer price index rose by about 2 per cent. Given this major achievement, it seems that consumer prices for the year as a whole might not increase by much more than 7 per cent or so above the level of 1981.

This breakthrough in inflation is, of course, the result of deliberate policy as well as developments in the external sector, and deliberate policy will continue to thrust strongly at countering inflation. Thus, the average level of wage settlements will, we expect, be at 10 per cent or less this year; there will be important further measures on the supply side with the rigid enforcement of the Fair Trade Anti-Monopoly Act, import liberalization, the lowering and simplifying of tariff rates, and the encouraging of inflows of foreign investment and technology.

The authorities also note that they will be pursuing tight fiscal and monetary policies through this year.

In regard to fiscal policy, the objective is to reduce the consolidated public sector deficit from the equivalent of 4.4 per cent of GNP in 1981 to about 2.7 per cent in 1982, with about one half financed from outside the domestic banking system.

Monetary policy is intended to be consistent with the inflation objective and the targets for real growth and the balance of payments. Presently the target for M-2 is in the 20-22 per cent range, compared with an outcome of 25 per cent in 1981 and a target of 27 per cent for that year. The ceiling for domestic credit is 25 per cent, compared with 33 per cent in 1981.

The staff expresses some concern about these targets for money growth but, given the sharp deceleration in inflation, it is reasonable to anticipate a reduction in the velocity of money, and it is to be noted that the liquidity of the Korean private sector needs, to some extent, to be rebuilt. More important, perhaps, is the clear recognition of the Korean authorities that they would regard these figures as ceilings rather than objectives and that they would be flexible in a downward direction if it became clear during the year that lower figures were appropriate. It is to be noted in this regard that the Deputy Prime Minister and Minister for Economic Planning, Kim Joon Sung, is on public record that it would be "unthinkable to boost the economy at the cost of price stability," including through monetary expansion, which he has made clear could not provide a fundamental improvement.

The other high policy objective of the Korean Government at present is a continuing favorable adjustment in the balance of payments. The authorities' present expectation is for a current account deficit of $3.6-3.8 billion. This would represent a reduction of $100-300 million in the original projection.

The current account objective, of course, cannot be considered without reference to exchange rate policy. It is quite evident from the staff paper that there is a difference of view about how the exchange rate should be managed in the coming period. As discussion in the Executive Board repeatedly demonstrates, this aspect of economic policy is surely one on which reasonable men can, and often do, differ, but there has been considerable support in the Executive Board's recent discussions for the view that the reduction of inflation and rising productivity should be the means of promoting international competitiveness, with exchange rate management in a relatively subsidiary role. However that may be, it is interesting to note that, in the debate about the appropriate direction of policy, the authorities are propounding what seems to me to be the conservative low-risk path that the Fund would commonly support. This is to be compared with the relatively high-risk prescription of significant devaluation propounded by the staff, which, if it is to be successful, would have to be supported by comprehensive strong domestic policy across the board, and effective penetration of markets that, generally speaking, are not only restricted in access but are also the target of other industrial and industrializing nations, some of which may also be contemplating a policy of downward adjustment.

There are a couple of particular points to keep in mind when considering the possible substantial downward adjustment of the exchange rate as a policy prescription for Korea. First, it is notable that about 70 per cent of Korea's imports are industrial raw materials and that another 20 per cent or so are capital goods. Moreover, devaluation directly affects the cost to domestic industry of its heavy overseas debt. Thus, experience suggests that a depreciation of the Korean won, producing a 10 per cent increase in the domestic price of imports, may be expected to produce approximately a 5 per cent increase in the wholesale price index (see page 21 of SM/82/70).

There is also considerable evidence in the experience of Korean exporters to suggest that the penetration of new markets, quality improvement, the development of new products and new technology, the simplification and improvement of export procedures, and the deliberate development of export promotion activities are all areas in which there is room for greater effort and achievement, and they feel, indeed, that these factors may even be dominant in the present perceived slowing down of Korean export growth.

Of course, the staff has made its measurements and speaks factually about appreciation in relation to Korea's trading partners, but as has been discussed recently in the Board, it may be that the more significant comparison is with Korea's trading competitors. In any case, since the prospect is that Korean inflation could be broadly in line with that in the United States, while at the same time Korean productivity will be rising possibly much faster than in the United States, it could well be the case that Korean competitiveness vis-à-vis the United States will improve within the framework of existing exchange rate policy.

In the view of the Korean authorities, the anticipated decline in wage increases, the reduction in interest rates, the expected gains in productivity combined with higher capacity utilization, and the helpful effect of relatively stable exchange rates on the cost of foreign-currency-denominated debt will improve both profitability and competitiveness. These factors, together with the anticipated pickup in world demand, should in their view ensure achievement of the target of 10 per cent growth in export volume during 1982 and, therefore, the predicted reduction in the current account deficit as well.

The Korean authorities at any rate are not dogmatic about the exchange rate. As the staff has noted, the authorities agree that with the current exchange rate policy, somewhat lower monetary expansion might be required to accomplish the inflation and balance of payments targets if export growth is slower than they currently project, but they are of the view that it is too early to say whether their policies focusing on wage moderation and productivity improvements and the more direct measures noted above will not be effective. For the present, they are of the view that their package of policies, together with the expected strengthening of world demand, may be sufficient to achieve their macroeconomic objectives. Nevertheless, they agree that economic developments, including the performance of exports, should be closely monitored during coming months and, should external developments be less favorable than they anticipate, exchange rate and monetary policies would be reviewed. That is a reasonable position for the authorities to adopt, and I hope it is one that the Executive Board will feel able to endorse.

The staff recognizes that interest rates must also be appropriate and that in the present state of evolution of the Korean financial structure this cannot be left to the market alone. The staff supports the authorities' stated policy of maintaining positive real interest rates and says that real interest rates are now "slightly" positive. In fact, a comparison of actual interest rates with the current rate of price increase would indicate that real interest rates for Korea are substantially positive at the present time. Moreover, the Korean authorities are fully aware of the need to monitor the relationship between relevant domestic interest rates and those in the international financial markets. In this regard, it is of some guidance that in Korea at present the average interest rate on commercial loans is about 14 per cent, and that as of April 30 the three-month Eurodollar deposit rate in the United Kingdom was 13.63 per cent. There are other markets, of course, and there are other borrowing costs involved in actual transactions, but so far as it goes this comparison does not indicate a serious, adverse differential.

Extending his remarks, Mr. Prowse added that his Korean authorities placed a high value on the advice and guidance on policy that the Fund could provide and, more particularly, on the views that might be expressed in the Executive Board. They had asked that the discussion be reported to them in detail and objectively, and he knew that they would give it serious consideration.

Mr. Hirao commented that the performance of the Korean economy in 1981 had been broadly satisfactory. The growth of GNP had been recorded at 7 per cent, exceeding the targets, owing to the recovery of agricultural production and the buoyancy of exports. At the same time, the inflation rate measured by the wholesale price index had decelerated markedly from 44.2 per cent in 1980 to 11.8 per cent in 1981, reflecting improved food crops and a slowdown in the rise in prices of oil and other raw materials. Meanwhile, the current account deficit had been reduced from 9.4 per cent of GNP to 7.5 per cent, mainly as a result of the strong export performance. However, there had been several developments that required the Board's attention. First, private fixed investment activities had been depressed due to weak business confidence, excess capacity in some industries, and the unfavorable profit position. Second, the public sector deficit had been growing. Third, the debt service ratio had been deteriorating. Against that background, the main task of the authorities in 1982 would be to promote further external adjustment and ensure a smooth recovery of the economy with continued export growth and increased private investment.

With regard to exchange rate and monetary policy, Mr. Hirao noted that, between the fourth quarter of 1980 and the third quarter of 1981, the real exchange rate had been continuously appreciating by as much as 13 per cent, causing a fall in the growth of exports since the third quarter of 1981. Two different approaches to regaining the loss of competitiveness had been discussed. First, the authorities had emphasized productivity improvements, quality changes, and wage moderation. They were not in favor of a depreciation, which might adversely affect price stability, although they had not completely excluded a relatively modest depreciation during the course of 1982. Second, the staff had suggested that the exchange rate be used flexibly to promote external adjustment. That approach was based on the view that price stability should be pursued primarily through appropriate monetary restraints and that wage moderation and productivity improvement, although essential, would alone not be sufficient to bring about the needed reductions in relative costs. The key question was which of those two approaches would serve better to reduce the relative prices of tradable goods. He noted that the authorities' monetary policy was currently geared toward bringing inflation down to 10 per cent in 1982. However, as indicated in Mr. Prowse's statement, actual inflation during the first quarter of 1982 had been below 10 per cent annually; thus, the present monetary target might prove to be a bit expansionary. Against that background, the authorities ought to make monetary policy more restrictive than currently planned or use the exchange rate more flexibly in order to gain a competitive edge over the trading partners. Further tightening of monetary policy was likely to delay the recovery of private investment, and appropriate policy measures would be in order to avoid damaging the long-run prospects for growth.

The staff had commented that real interest rates should be sufficiently positive to increase household savings substantially, Mr. Hirao remarked. Meanwhile, the authorities took the view that with the recent decline in the rate of inflation, there was room for further downward adjustment in nominal interest rates while maintaining positive real rates. He was inclined to agree with the authorities regarding the effect of real interest rates on household savings, and he doubted whether the current level of real interest rates was too low for that purpose. He also wondered whether the increase in disposable income might not have been more important than the level of real positive interest rates in stimulating household savings. Moreover, if nominal interest rates were maintained despite a deceleration in inflation in 1982, the consequent increase in real interest rates might have adverse effects on the autonomous recovery of investment. However, he shared the staff's concern that if nominal interest rates in Korea fell significantly below international interest rates, undue pressures would arise on domestic credit. Therefore, the authorities should keep a close watch on international movements if they reduced interest rates in step with any price deceleration that took place in 1982.

In 1981 fiscal policy had played a countercyclical role to offset weak private investment demand, Mr. Hirao observed, and consequently, the consolidated public sector deficit had increased from 3.2 per cent in 1980 to 4.4 per cent in 1981. The authorities aimed to reduce the consolidated deficit to 2.7 per cent of GNP both by increasing tax efforts and by restraining expenditure. The target seemed to be an appropriate one, especially as there reportedly had been some crowding out of the private sector, as reflected by a sharp rebound in interest rates in the second half of 1981. Furthermore, because budget estimates had been made on the basis of a higher nominal GNP growth than expected, it was likely that there would be a shortfall of about 2 per cent in revenue. He welcomed the authorities' intention to make cuts in budgeted expenditure if revenue collection fell short of the target in order to achieve the original aim of reducing the deficit.

Like the staff, he welcomed the progress that had been made on structural reforms, Mr. Hirao said. First, in early 1982, the authorities had implemented a comprehensive tax reform that would improve efficiency and liquidity through changes in the rate structure, deductions and exemptions in personal income tax, corporate taxes, and the like. The authorities would have to continue their efforts to maintain the elasticity of the tax system over the medium term. Second, the authorities aimed to enhance the role of the market mechanism in the financial system. In line with that basic policy, ownership of one nationwide commercial bank had been transferred from the Government to the private sector, and the interest rates in the commercial paper market had been partly freed from official control. He hoped that progress in liberalizing the financial system would not only improve the efficiency of the system but also contribute to increased household savings. Third, in the area of import liberalization, he strongly supported the authorities in their intention to raise the ratio of unrestricted imports to total imports to a level comparable to that of most industrial countries by the end of 1986. Beginning in 1982, the timetable for import liberalization would be announced in advance. Such a procedure should prove effective in forcing affected industries to rationalize and reduce their costs, while giving them sufficient time to adjust.

Mr. Casey, commenting on the related issues of competitiveness and exchange rate policy, recalled that the authorities had effected a real depreciation in 1980, thereby helping the balance of payments in 1981, especially by increasing exports. It seemed surprising that the authorities had subsequently abandoned, or toned down, the flexible exchange rate policy, and he wondered why such a change of attitude had occurred. How much of the 35 per cent inflation rate in 1980 did the authorities attribute to the exchange rate action? Presumably, it was inflationary implications that had led to the change of attitude on exchange rates. There were, of course, arguments on both sides of the exchange rate question, and it was a matter of fine judgment. If the Korean authorities could restore competitiveness by other means--for example, demand management, wages, and productivity--a devaluation might not be needed, and the inflationary impact of the devaluation could be avoided. But such a strategy would be risky, and it would involve tight policy measures, perhaps tighter than currently envisaged. On balance, he tended to side with the staff on the exchange rate question, although it was not a clear-cut issue by any means. The potential benefit of a devaluation was not just that it improved competitiveness generally; it also shifted incentives to the tradable sector. Currently, exporters seemed to be suffering from depressed profits and a high debt-to-equity ratio. Exporters and potential exporters needed better price incentives to persuade them to invest and to increase the volume of exports in what was essentially an export-dependent economy. Competition from other newly industrializing countries was clearly intense, and he noted that orders for Korean exports had recently been weakening.

The current external deficit would amount to almost 7 per cent of GNP in 1982, Mr. Casey noted. In addition, the external debt burden had increased. Although the debt service ratio did not seem high, the import content of exports was quite high so that the denominator of the debt service ratio had to be interpreted with some caution. He did not wish to exaggerate the problem of competitiveness, to which, indeed, the staff seemed to have devoted a disproportionate amount of space. It was, after all, a recent development and should not obscure the enormous strides made by Korea in export-led growth over the years. But, looking further ahead, he noted that in the Fifth Plan the authorities did not foresee the inflation rate falling below 10 per cent a year. The competitiveness issue therefore might become more problematic in the future, and he wondered whether the authorities would still be reluctant to use exchange rate movements in such circumstances. To some extent, Mr. Prowse had answered that question by saying that his authorities were not dogmatic. In any case, they would need to adopt a flexible and prudent approach if the rather ambitious balance of payments objectives of the Fifth Plan were to be achieved by 1986.

He welcomed the authorities' intention to reduce the public sector deficit from 4.4 per cent of GNP in 1981 to 2.7 per cent of GNP in 1982, Mr. Casey continued. The latter figure was presumably fairly tentative, given the major restructuring of public sector expenditure and the widespread reform of the tax system described in SM/82/70. The authorities would have to monitor the fiscal deficit more as the year progressed if they wished to reach the goal under the Fifth Plan of reducing it to 1 per cent of GNP. It might prove difficult to make that adjustment in the light of the optimistic real GNP growth targets of the Fifth Plan and the drive for increased social expenditure. However, there should be reasonable scope for widening the tax base, since currently only one third of wage and salary earners were liable for income tax.

The techniques of monetary management had been improved in several respects, Mr. Casey observed. The target of 20 per cent growth of broad money in 1982 and 25 per cent growth in domestic credit seemed on the liberal side, in view of the nominal growth in GNP; however, if fiscal policy was tightened as planned, the consequences for inflation should not be serious. There might be an accommodating change in the velocity of circulation, and a risk of crowding-out in the private sector. He wondered why the narrower monetary aggregate, M-1, had not been discussed in the staff paper. Growth in the narrower aggregate seemed to have been more modest than in the others, but perhaps the staff felt that, because of a shift from one aggregate to another, the M-1 variable was not entirely meaningful. He would appreciate some clarification on that point. He agreed with the staff that further cuts in nominal interest rates should be avoided. Otherwise, the capital side of the balance of payments might suffer, and the ambitious targeted increase in domestic savings might be jeopardized.

The authorities were to be commended for several other measures, Mr. Casey stated, including the liberalization of imports--although perhaps more needed to be done there--a sound energy policy, the achievement of modest wage settlements inside and outside the public sector, various structural reforms, and the sharp reduction in the inflation rate.

Mr. de Vries, commenting on budgetary policy, welcomed the more restrictive stance that was proposed for 1982 and agreed with Mr. Casey and Mr. Hirao that it would be important for that stance to be maintained. Progress had been made against inflationary tendencies, but he did not consider a 10 per cent inflation rate full success; the authorities should keep careful watch if they wished to maintain their present policy intentions.

He found Mr. Prowse's statement on the question of exchange rate policy to be quite interesting, but not fully convincing, Mr. de Vries stated. The Korean authorities seemed to argue that they should have some rate other than the equilibrium exchange rate in order to promote internal purposes. Why should the present rate be the right one? He found it difficult to understand why countries argued both that devaluation would be harmful on the domestic front and that their present exchange rates should be maintained. If those arguments were true, the exchange rate should be appreciated because all the beneficial effects of maintaining the overvalued exchange rate would also flow from further overvaluation. As the argument might be more about timing than about the substance of the matter, he was quite willing to leave that tactical judgment to the Korean authorities. Given the present exchange rate policy, monetary policy became crucial. It seemed unlikely that inflation would remain at 10 per cent with a 20-22 per cent expansion in the money supply; the authorities should pursue a cautious monetary policy.

He wished to congratulate the Korean authorities for a number of positive developments, Mr. de Vries commented. Inflation had been brought down; difficult adjustments to fundamental shocks had been made; and the Korean development strategy was being adapted to the current situation.

Mr. Taylor commended the authorities for meeting all the performance criteria under the recently expired stand-by arrangement and for the success of their adjustment policies in 1981. The economy had performed better than originally expected in several key areas. Real growth had recovered strongly, the current account deficit had been somewhat reduced despite adverse external conditions, and the rate of consumer price inflation had fallen markedly, although possibly assisted by weaker import prices. Despite those achievements, the need for further adjustment remained: growth had been uneven, private investment was weak, inflation was still above the average of Korea's main competitors, and the current account deficit was high by previous standards. The authorities were aware of those problems, as demonstrated by the extensive structural reforms that had been initiated in the context of the Fifth Development Plan. They should go a long way toward promoting sustainable growth and reducing the economy's vulnerability to external shocks in the medium term; however, they would take time to produce results. For the immediate future he strongly endorsed the authorities' objective of reducing inflation further and decreasing the current account deficit. Moves to raise productivity and encourage continued wage moderation were important steps in the right direction; export performance was clearly central to the achievement of the current account targets, and the recent slowdown in that sector was a cause for concern.

There was a difference of view, Mr. Taylor observed, between the staff, which had underlined the need for a rapid restoration of competitiveness, and the Korean authorities, who were evidently reluctant to take what they called the easy way out of exchange rate depreciation. He supported a flexible approach to managing the exchange rate, although he had considerable sympathy with the authorities in their determination to avoid jeopardizing gains that they had made on the inflation front. The issue was far from simple; competitiveness was probably not the only factor behind the weakness of export orders in recent months. The weakness of exports had been shared by many countries in the region, including Japan, suggesting that declining markets were factors as well. Nevertheless, looking at the latest figures for Korean exports, in the fourth quarter of 1981 there had been quite marked disparities between different sectors: exports of chemical and manufactured goods had fallen marginally in value, while exports of machinery and transport equipment and miscellaneous manufactures, accounting for about half of the total, had risen substantially in value.

Given the importance of Japan in Korea's trade, together with Japan's price performance and the weakness of the yen, it seemed probable that a significant part of the won's appreciation in real terms actually reflected movement against the yen, Mr. Taylor considered. If that was so, many countries would have experienced a loss of competitiveness in the recent period, at least in relation to Japan, and the remedy of devaluation by individual countries would perhaps carry the risk of stimulating competitive depreciations. It was also noteworthy that, although export performance had remained weak in the first two months of 1982, the current account deficit had still been less than half of the figure for the equivalent period of 1981. Declining oil prices were presumably a major factor in the fall in import values over the period, and he wondered whether the recent reduction in oil prices was sufficiently favorable to constitute the sort of exogenous improvement in conditions that the staff was looking for to enable the authorities to achieve the current account target without tightening or changing existing policy. The present policy of permitting only a gradual depreciation of the won against the dollar involved a number of risks, particularly if it was associated with a relatively relaxed monetary policy. Generally, the pursuit of a fairly strong exchange rate with a view to reducing inflation was a tenable objective if accompanied by appropriate monetary and fiscal policies. But such a strategy would be less tenable if accompanied by insufficiently firm financial policies entailing a persistent current account deficit, the financing of which required substantial external borrowing. The domestic policy should be sufficiently stringent to merit pursuing a relatively strong exchange rate. The complex exchange rate issue needed to be sorted out and a clear policy adopted before any new arrangement with the Fund was entered into.

He agreed with the staff that a restrictive fiscal stance was appropriate for the rest of 1982, Mr. Taylor remarked, and he welcomed both the authorities' intention to review fiscal objectives in light of export performance, and their moves to reduce expenditures in response to the likely shortfall in budgeted revenue. With regard to monetary policy, interest rates had actually been reduced further since the discussions had taken place and, although they seemed to have remained appreciably positive in real terms, he shared the staff's concern about the pace of interest rate reductions, particularly given the need to reduce domestic expenditure and to mobilize a firm policy stance. There were also disturbing signs that monetary growth had accelerated again. For example, the year-to-year growth in broad money in February had been 27 per cent, well above the target for 1982 as a whole, which in itself seemed on the high side for an appropriately firm policy stance. If those disturbing monetary trends persisted, exchange rate and monetary measures would have to be reconsidered as a matter of some urgency.

The Korean experience showed that there were no easy answers and no quick fixes for adjustment in the current economic climate, Mr. Taylor concluded. With the assistance of the Fund, the authorities had made significant progress, and, on the basis of that record, he did not doubt their ability to respond adequately and flexibly to their current problems.

Mr. Connors observed that Korea had made considerable gains in the area of external adjustment and, on the whole, the Korean economic performance had been good. As others had pointed out, the staff and the authorities had different views on the role of the exchange rate in improving external competitiveness. The staff feared that restoring competitiveness through means other than the exchange rate might be too slow a process, while the authorities feared that any change in the exchange rate would have adverse economic consequences. While it was too early to tell whether the staff's or the authorities' arguments would prove correct, he was persuaded by the staff's discussion on pages 13 and 14 of SM/82/54, which referred to the sharp weakening of arrivals of export letters of credit, along with the appreciation of the real exchange rate of the won. Because letters of credit had served as the leading indicator of exports, it was a worrisome development, especially as the decline in letters of credit had occurred against the background of an acceleration of import demand by Korea's trading partners. It was encouraging that the Korean authorities were not dogmatic about the exchange rate; they merely wanted more evidence before reaching a decision on the issue. He urged the authorities to pursue policies that would moderate the inflationary impact of any exchange rate change, including a relatively tight monetary and fiscal stance and policies designed to encourage wage moderation and gains in productivity.

Korea had shown substantial progress in adjusting its external position since 1979, Mr. Connors commented. The Korean authorities, the staff, and the Executive Board would surely agree with the statement in the staff appraisal that progressive reductions in the current account deficit were called for in order to alleviate the debt service burden and reduce Korea's vulnerability to external shocks.

Mr. Yeo stated that it was quite clear from the report that the Korean authorities had made a conscientious effort to adjust to the external disequilibrium, which, in 1979-80, had been aggravated by a higher oil import bill, amounting to about 6 per cent of GNP. The external adjustment problem had been temporarily compounded in 1981 by the 30 per cent drop in rice output in late 1980 attributable to adverse weather. Table I of SM/82/54 illustrated the extent of Korea's adjustment efforts in 1980 and 1981. Korea had met all the performance criteria under the recent stand-by program. The growth, price, and current account performance had all been better than originally envisaged. Korea's efforts reflected its determination to complete the required external adjustment within a reasonable time span.

The immediate problem remained the unsustainable level of the current account deficit, Mr. Yeo noted. The direction of effort to deal with the problem was clearly set out in the Fifth Plan for 1982 and 1983. The Plan intended to reduce considerably the reliance upon foreign savings for the financing of investments, which would require a determined resource mobilization effort to increase the ratio of domestic savings from 20 per cent of GNP in 1981 to about 30 per cent in 1986. To achieve that aim, a successful effort to accelerate the growth of Korea's exports would be needed. The staff considered that exchange rate policy could provide the thrust to stimulate the required export performance. On the other hand, the Korean authorities felt constrained both by the fear of generating a new wave of inflationary expectations, and by the higher domestic costs of servicing the already high level of foreign debt. They preferred to use domestic measures to reduce costs and to increase labor productivity to stimulate export growth. He sympathized with the authorities' assessment that in the present mix of the elements in the Korean situation, it would be more appropriate to use domestic measures rather than to resort to the exchange rate instrument in the first instance, particularly when the import content of exports was as high as it was for Korea. He would appreciate some elaboration from the staff on that point.

Mr. Sangare said that the performance of the Korean economy in 1981 had been remarkable, with real output growth of 7.1 per cent after a decline of 6.2 per cent in 1980. The authorities expected that the growth would be sustained in 1982 and in the medium term. Meanwhile, there had been a drop in the rate of price increases, although inflation remained a problem. The level of unemployment had also dropped in 1981, while the current account of the balance of payments had improved somewhat in 1981 as the result of strong export performance. The overall deficit had widened, reflecting largely the sharp turnaround in short-term capital movements. The authorities recognized the need to continue their adjustment program in the framework of the Fifth Development Plan, which provided a basis for sustainable growth, and they continued to emphasize the development of the export potential of the country, including high-technology products.

Fiscal operations were being restrained through a reduction in the public sector deficit from 4.4 per cent of GNP in 1981 to 2.7 per cent in 1982, with a target of 1 per cent at the end of the Plan period in 1986, Mr. Sangare remarked. The authorities expected to achieve that reduction through improved tax effort and expenditure restraint. They also intended to make some of the state corporations, such as the Grain Management Fund, self-sustaining by eliminating their deficits through price adjustment. In the monetary field, the restraint of the growth of the money supply was consistent with the need to contain inflation, expected to reach 10 per cent in 1982. The measures taken to reduce direct control in the monetary system were in the right direction, and he welcomed the intention to maintain real interest rates, which should encourage the mobilization of domestic financial resources.

He noted the staff's concern about the exchange rate policy, which allowed the won to move in sympathy with the U.S. dollar, Mr. Sangare said. The result had been the appreciation of the won in real terms by 13 per cent between the fourth quarter of 1980 and the third quarter of 1981. As indicated by Mr. Prowse, the Korean authorities were aware of the difficulty of bringing about a growth of exports; but, in order to avoid a resurgence of inflationary pressures, they were reluctant to take exchange rate action. The authorities had however expressed a willingness to review their position should the balance of payments outcome become less favorable. Meanwhile, his chair sympathized with the Korean authorities and believed that domestic measures could be sufficient.

Mr. Pritchett noted that all the performance criteria under the stand-by arrangement with the Fund during the previous two years had been met, an important point in considering whether the adjustment process had been successful. For 15 years real GNP had grown at an average rate of 10 per cent a year; yet by 1979-80 internal forces combined with external factors had led to high inflation and a need for adjustment.

The authorities had taken several steps, Mr. Pritchett recalled. First, in 1980 the won had been depreciated by 11 per cent in real terms; the authorities had tightened monetary policy considerably by slowing the growth of monetary aggregates; and some energy conservation measures had been adopted. In addition, the authorities had introduced several structural reforms. The initial result was that real GNP had dropped by 6 per cent in 1980 and the current account deficit had increased to 9.4 per cent of GNP. As expected, however, there had been a significant improvement in the performance of the economy in 1981. Real GNP had increased by 7 per cent, and the current account deficit had declined to 7.5 per cent of GNP. The 1982 projections both by Korean officials and by the Fund staff showed a further significant improvement in the real output and in the current account/GNP ratio. In addition, after averaging 28 per cent in 1979-80, inflation had dropped to 12 per cent, with a further significant decline in early 1982.

The successful application of appropriate policies by the Korean authorities over the previous few years served as a good example of the adjustment process for other countries, Mr. Pritchett observed. The rapid adjustment had been helped by a high domestic savings rate and a sizable level of domestic capital formation; it was the continued world recession that was making the adjustment process difficult for Korea, as for other countries. Other measures being implemented were the encouragement of high-technology projects to improve productivity and efficiency, the reform of the tax system, the enhancement of the role of the market mechanism in the financial system, and the liberalization of import policy. It was hoped that progress in those areas, as described in the Five-Year Plan, could be sustained.

Regarding the exchange rate issue, Mr. Pritchett recalled that Mr. Prowse had raised questions in his statement about the structure of Korea's exports, the effect that a depreciation would have on inflation, and the measurement of exchange rate movements; he would be most interested in the staff's comments on those points. It seemed appropriate for the authorities to wish to observe the effect of the current mix of policies on the balance of payments before evaluating the policies themselves. He was glad to note that the authorities were keeping an open mind regarding the exchange rate issue and the appropriate stance of monetary policy.

The staff representative from the Asian Department, replying to the question on the relationship between exchange rate adjustment and the rate of inflation in 1980, noted that out of the 45 per cent increase in the wholesale price index in 1980, about 15 per cent had been due to the exchange rate change, leaving 30 per cent due to other factors. The staff report explained that, against a background of good export performance, the policy emphasis of the authorities had shifted toward a focus on price stability rather than external competitiveness in 1981.

It had been mentioned that other competitor countries were also suffering a decline in exports as a result of weak external demand, the staff representative said. The most recent World Economic Outlook and independent staff estimates indicated that Korea's exports had started to weaken in the fourth quarter of 1981, and the concern that the deterioration in the export performance had been related to an appreciation of the exchange rate was valid. In that same period Korea had lost competitiveness vis-à-vis every individual major export competitor; Korea's share in the imports of its major customers also had declined. Given the previous relationship between competitiveness and exports, there was evidence that the weakening of exports had been related to a loss of competitiveness.

The question of profitability of enterprises and how an exchange rate adjustment affected profitability had been examined, the staff representative continued. Taking into account an import content of exports of about 23 per cent and also taking into account the debt service burden and the impact of depreciation on costs, the staff estimated that for enterprises producing essentially for export, a 10 per cent depreciation would mean about a 5 per cent increase in profitability.

The question had been asked whether a decline in the current account deficit due to oil price decreases would be regarded by the staff as adequate adjustment, the staff representative recalled. If there was an improvement in the current account in 1982, as envisaged by the authorities, it would essentially be due to an improvement in the terms of trade, mainly as a result of the decline in oil prices. Whether recent oil price developments were permanent, thereby signaling a reduction in the need for external adjustment, was still an open question. In any event, further adjustment was needed. Adequate export incentives were necessary, not only to maintain current adjustment efforts but also to provide a basis for sustained growth and further adjustment after 1982.

The staff looked at M-2 rather than M-1, the staff representative from the Asian Department said, because M-1 had exhibited volatile movements in the recent past for a number of reasons. In 1980, the authorities had increased interest rates on savings deposits substantially, resulting in a shift into those deposits, while in 1981 the authorities introduced interest rates on household checking accounts, resulting in a shift of funds to those accounts. As a result, there was no constant relationship between M-1, inflation, and growth. M-2 was the most relevant factor in explaining changes in those variables, and it was also traditionally what the authorities looked at.

Mr. Prowse recalled that the devaluation of 1980 was estimated to have caused about one half of the ensuing inflation. An inflation rate of 40 per cent was remarkable in an economy that had comparative stability, and the social implications could not be overlooked. It was for that reason that the authorities gave absolute priority to crushing inflationary expectations at present when they saw an opportunity to do so. They were inclined to think that there was a grave danger of starting a cycle, with devaluation leading to a surge in exports, generating higher domestic costs and price inflation, and reducing competitiveness, which was then used as an argument for further devaluation, and so on. A major devaluation had been undertaken not long previously and another significant devaluation at present would in their view certainly risk the community coming to the conclusion that there was something like a spiraling trend. Executive Directors seemed generally to have come to the conclusion that it was a question of timing. The authorities had stated that they wanted more time to assess the evidence before reviewing the comprehensive package of policies that they had set in train.

Some speakers had asked the basic question of what was a sustainable current account deficit, Mr. Prowse noted. The Five-Year Plan stated that the sustainable current account deficit would be 2.5 per cent of GNP. He agreed that other countries' experience suggested that 2.5 per cent could be sustained for a considerable period, especially by a country that was short of capital and yet capable of high performance. That sort of deficit could be sustained by an inflow of investment and entrepreneurial capital, and his authorities hoped that in the period of the Five-Year Plan an increasing share of the necessary capital to finance their current account deficit would come through private sector investment capital flows. They had completed a comprehensive study reviewing prospects in that regard.

He had been impressed by the remarkable balance and thoughtfulness of the Executive Directors' comments, Mr. Prowse concluded. Generally, the view seemed to be that there was a reasonable case for suspending judgment on the present package of policies until there was time to see how effectively the current policies would work.

The Chairman made the following summing up:

Executive Directors expressed broad support for the thrust of views expressed in the appraisal for the 1982 Article IV consultation with Korea. They noted with satisfaction that all performance criteria under the recent stand-by arrangement had been observed and that the major macroeconomic objectives of the program had been achieved.

Directors observed that the resumption of economic growth in 1981 had been due in part to a moderate fiscal stimulus and rapid export growth in the first three quarters of 1981. But it was noted that with depressed profits, excess capacity, and high inventory levels continuing, the business climate had shown little improvement, and real investment had declined for the second consecutive year. Directors were encouraged by the remarkable progress achieved in reducing inflation but felt that the present level of inflation was still high compared with that of the main trade partners of Korea. With regard to the balance of payments, Directors commended the authorities on the improvement in the external position and the further liberalization of imports. On the basis of the strength of export growth in the first three quarters of 1981, the current account deficit had declined, in spite of relatively high imports and the adverse impact of higher international interest rates on the services account. With higher interest rates and the rapid accumulation of external debt since 1979, the debt service ratio and the ratio of debt to GNP had reached historically high levels in 1981.

Directors emphasized that the balance of payments deficit on current account was still high by Korea's past standards and that further external adjustment was needed in order to alleviate the growing debt service burden and reduce Korea's vulnerability to external shocks. Therefore, Directors were encouraged that the Korean authorities were aiming at a further reduction of the current account deficit. Directors also supported the authorities' objectives of achieving a further reduction in inflation and resuming sustained economic growth. To meet the twofold need of securing a resumption of sustained growth and further external adjustment in 1982 and beyond, continued strong export growth was required.

Directors centered many of their comments on exchange rate policy, considering that it presented difficult issues of analysis, policy, and timing. Directors were aware of the price effects of a depreciation of the currency and of the international context in which trade movements are taking place and noted the reliance of the authorities on wage moderation and productivity improvements to restore export competitiveness; they agreed that these factors were indeed essential ingredients to further progress in external adjustment. But doubts were also expressed whether these factors alone would be sufficient to provide the required boost to exports given the recent developments in export orders. While most Directors felt that a flexible exchange rate policy would be helpful in providing adequate export incentives and ensuring that Korea benefited from the expected upswing in external demand, they also noted that the timing question was an important one. The preponderant view was that a restoration of competitiveness could in any case require a more restrictive monetary policy than the one currently in place. This would also help to dampen the price effects of a possible further move in the exchange rate.

With regard to the authorities' target for monetary growth for 1982, Directors commented that it was probably on the high side for the time being and that, hence, a tightening would be needed to achieve the inflation target, especially if growth were to be lower than projected because of a shortfall in exports. In this context, Directors expressed support for the more restrictive fiscal stance envisaged for 1982 and advised against a relaxation in the course of the year, while stressing the need for close monitoring of the situation. Several Directors noted that real interest rates were positive but stressed the importance of maintaining positive real interest rates to ensure the availability of sufficient domestic financial resources given, inter alia, the envisaged reduction in the use of foreign savings in the next few years. Executive Directors commended the authorities on the recent tax reform and their pursuit of a number of structural adjustment measures. They also stressed the importance of proceeding with the structural reforms and in particular the financial reform. Directors welcomed the authorities' intention to review policies in the course of the year in light of developments in the economy, in particular the performance of exports. The authorities were also commended for their efforts to improve the performance of public enterprises, including, in some cases, by divestiture.

The Executive Board then took the following decision:

Decision Concluding 1982 Article XIV Consultation

1. The Fund takes this decision in concluding the 1982 Article XIV consultation with Korea, in the light of the 1982 Article IV consultation with Korea conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction the recent elimination of the advance deposit requirements for imports and the progress made in 1981 toward reducing other exchange restrictions on imports. The existing restrictions on payments for current international transactions are maintained by Korea in accordance with Article XIV. The Fund encourages the authorities to remove the remaining exchange restrictions in line with the improvement in Korea's external position.

Decision No. 7109-(82/66), adopted
May 5, 1982

APPROVED: October 20, 1982

JOSEPH W. LANG, JR.
Acting Secretary