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December 3, 1997

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Korea—Request for Stand-By Arrangement**

Attached for consideration by the Executive Directors is a paper on the request by the government of the Republic of Korea for a Stand-By Arrangement in an amount equivalent to SDR 15.5 million, which is scheduled for discussion tomorrow, Thursday, December 4, 1997. A draft decision appears on page 17.

Mr. Aghevli (ext. 37177) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

INTERNATIONAL MONETARY FUND

KOREA

**Request for Stand-By Arrangement**

Prepared by the Asia and Pacific Department
(In consultation with other departments)

Approved by Hubert Neiss and Joaquín Ferrán

December 3, 1997

- The Korean authorities have requested a 36-month stand-by arrangement with the Fund, in support of their macroeconomic stabilization and structural reform program.

- Executive Board consideration is being proposed under the emergency procedures and the proposed access entails resort to exceptional circumstances.

- The program supported by the stand-by arrangement was negotiated by a staff team led by Mr. Neiss and Ms. Tseng and comprised Ms. Coorey, Messrs. Gordon, Dekle, Thimann, and Ms. Gobat (all APD), Mr. Hoffmaister (RES), Mr. Moser (PDR), Mrs. Cormier and Mr. Mahar (Assistants, APD). Mr. Kwon (Alternate Executive Director) also participated in the discussions. The staff team was supported by an overlapping MAE team on financial sector restructuring comprising Messrs. Baliño (Head), Hayward, Hardy, Ms. Pazabasioglu, and Ms. Koch (Assistant). Negotiations were held with Deputy Prime Minister and Minister of Finance and Economy Chang-Yuel Lim, Bank of Korea Governor Kyung-shik Lee, and other senior government officials in Seoul during November 26-December 3, 1997. The Managing Director visited Seoul during the final day of negotiations.

- Owing to the critical situation in Korea, and the very short period in which program negotiations had to be completed, it was not possible to fully specify the program. Therefore, emphasis was placed on strong prior actions to demonstrate the government's seriousness to strictly implement its policy commitments.

- The staff team is still in Seoul, working with the Korean authorities to develop more fully the policy measures included in the Memorandum. The full program will be reviewed by the Executive Board in January 1998. The review will expand on the scope of performance criteria and set performance criteria and benchmarks for 1998. Given the need to ensure that the strong package of prior actions is fully implemented, two biweekly test dates are proposed in the interim period before the first review.

- Korea has accepted the obligations of Article VIII, Sections 2, 3, and 4. As of November 30, 1997, there was no Fund credit outstanding to Korea. Annex I describes Korea's relations with the Fund.

- The authors of this Staff Report are Ms. Tseng, Ms. Coorey, Messrs. Gordon, Moser, Dekle, Hoffmaister, Thimann, and Ms. Gobat.

Contents

# I. EMERGENCE OF THE CRISIS AND POLICY DEVELOPMENTS

## A. Background[1]

1. Until the present financial crisis, Korea's macroeconomic performance in 1997 was broadly favorable. Notwithstanding a sharp slowing of domestic demand, real GDP grew by 6 percent during the first three quarters of 1997 and inflation declined slightly to 4 percent. Subdued import demand and rapid growth of exports caused the external current account deficit to begin to narrow in the second quarter; a current account deficit of 3 percent of GDP is expected in 1997 (Table 1). Fiscal policy remained prudent, and despite a large tax shortfall during the year, expenditure cuts were made so as to ensure that the consolidated central government accounts record only a small deficit in 1997. The monetary aggregate (MCT) has edged below the bottom of its target range, in line with the inflation objective.

2. However, since the beginning of the year, an unprecedented number of highly leveraged conglomerates (chaebols) have moved into bankruptcy. The high rate of bankruptcies reflected a number of factors, including excessive investment in certain sectors such as steel and autos, and a weakening in profitability associated with the cyclical downturn. At the same time, the fact that the government has allowed six of the 30 largest chaebols to fail can be seen as indicative of a desire to increase the economy's market orientation.

3. The bankruptcies have, however, severely weakened the financial system and nonperforming loans (defined according to international standards) rose sharply to W32 trillion (7½ percent of GDP) by end-September, about double their level at end-1996. At the same time, the steep decline in stock prices has cut the value of banks' equity and further reduced their net worth. These developments exacerbated the existing weaknesses in the banking system caused by a lack of commercial orientation and limited experience in pricing and managing risk, combined with lax prudential supervision. The weak state of the banking sector has led to successive downgrades of Korean financial institutions by international credit rating agencies and a sharp tightening in the availability of external finance.

## B. Crisis and Policy Response

4. Korea's external financing situation deteriorated markedly in late October following the decline in the Hong Kong stock market on October 23 and a downgrading of Korea's sovereign risk status by Standard and Poor's. New external financing virtually dried up and

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[1]A staff team comprising Mr. Adams (Head), Messrs. Gordon, Dekle, Thimann, Ms. Gobat (all APD), Mr. Hoffmaister (RES), and Mr. Hayward (MAE) visited Seoul during October 6–15 to conduct the 1997 Article IV consultation discussions. Mr. Kwon (Alternate Executive Director) participated in the discussions. However, owing to the dramatic change in the economic situation and outlook since then, the Article IV consultation will now be continued and presented for Board consideration in early 1998, at the time of the first review.

substantial difficulties were experienced in rolling over the relatively large amount of short term debt (estimated at about $100 billion).[2] Gross reserves declined sharply, with a large amount used to finance the repayment of the short-term debt of Korean commercial banks' offshore branches. While the contagion effects of developments in Southeast Asia were a contributing factor, the magnitude and speed of the deterioration owed much to the fundamental weaknesses in Korea's financial and corporate sectors.

Korea: Recent Developments in Usable Reserves

(In billions of U.S. dollars)

| | Oct 31 | Nov. 21 | Nov. 25 | Dec. 2 |
|---|---|---|---|---|
| Official reserves | 30.5 | 23.8 | 24.2 | 23.9 |
| *Of which* | | | | |
| Deposits at overseas branches | 8.0 | 10.8 | 13.4 | 17.9 |
| Usable reserves | 22.5 | 13.0 | 10.8 | 6.0 |
| *Of which* | | | | |
| Net forward/contracts | 5.9 | 6.2 | 6.2 | 6.2 |
| (due this year) | (0.9) | (0.3) | (0.3) | (0.4) |

Source: Bank of Korea

5. The authorities' policy response was piecemeal and failed to calm markets. On August 25, 1997, in response to emerging difficulties in external financing, the government issued a public statement that the "Korean Government will ensure the payment of foreign debt liabilities by Korean financial institutions." However, the legal status of such guarantees was indeterminate as the legal procedure required for government guarantees (approval by the National Assembly) was not taken.

6. In the event, these measures did little to restore market confidence. Market confidence was also affected by the failure of the National Assembly to pass important bills needed for financial sector reform that had been based on the recommendations of the Presidential Commission of Financial Sector Reform.

[2]At end-September 1997, including debt contracted by residents, nonresident branches and affiliates of domestic financial institutions, and offshore banking debt contracted by domestic banks (see Section H below). Table 3 shows external debt on an unconsolidated basis.

7. The conduct of monetary policies in recent weeks has exacerbated exchange market pressures. Although interest rates initially increased by 100-200 basis points in November (Table 2), fears of the effect on the highly-leveraged corporate sector led to liquidity injections that subsequently pushed rates back down. The won began to depreciate in late October, going into free fall on November 19 with the widening of the daily exchange rate band to ±10 percent (from ±2¼ percent) and the authorities' announcement that they would cease to intervene. Between late October and December 3, the won depreciated by 22 percent against the U.S. dollar.

8. Despite the sharp turn for the worse in the external situation in late October, the authorities waited until November 21 to approach the Fund. By this stage, market sentiment had turned overwhelmingly negative, and an increasing share of gross official reserves had become "unusable" as they had been deposited by the Bank of Korea at overseas branches and subsidiaries of domestic banks, which then used the deposits to repay their short-term debt that was not being rolled over. This process led to a sharp depletion of reserves.

## II. Policy Program

### A. Objectives of the Program

9. The macroeconomic objectives of the program (see Table 3) include: building the conditions for an early return of confidence so as to limit the deceleration of real GDP growth to about 3 percent in 1998, followed by a recovery towards potential in 1999; containing inflation at or below 5 percent; and building international reserves to more than two months of imports by end-1998.

10. The government's program is built around: (I) a strong macroeconomic framework designed to continue the orderly adjustment in the external current account; build up international reserves; and contain inflationary pressures, involving a tighter monetary stance and significant fiscal adjustment; (ii) a comprehensive strategy to restructure and recapitalize the financial sector, and make it more transparent, market-oriented, and better supervised; (iii) measures to reduce the high degree of reliance of corporations and financial institutions on short-term debt and allow a better diversification of risk in the economy.

### B. Monetary and Exchange Rate Policy

11. The main objective of monetary policy is to contain inflation to 5 percent in 1998 and limit downward pressure on the won. To demonstrate to markets the government's resolve to confront the present crisis, monetary policy is being tightened immediately to restore and sustain calm in the markets and contain the inflationary impact of the recent won depreciation. In line with this policy, the large liquidity injection in recent weeks is being reversed, and money market rates (call rate, 91-day CD rate, and 3-year corporate bond rate) are being raised sharply and will be maintained at a high level as needed to stabilize markets.

12. The day-to-day conduct of monetary policy will be guided by movements in the exchange rate and short-term interest rates which will be used as indicators of the tightness of monetary conditions. A flexible exchange rate policy will be maintained, with intervention limited to smoothing operations. Monetary and exchange rate policy will be implemented in close consultation with the staff.

13. The inflation target reflects a very limited pass-through of the recent depreciation of the won to the aggregate price level. Financial restructuring and the sharp slowdown in economic growth are expected to slow the demand for money. Hence, in order to achieve the inflation objective, the government will aim to reduce broad money growth (M3) from an estimated 16.4 percent at end-September 1997 to 15.4 percent at end-December 1997, and to a rate consistent with the inflation objective in 1998. This deceleration will be achieved by reducing the growth of reserve money (Table 4). Open market operations will be used to contain the expansion of the net domestic assets of the Bank of Korea within the program limits.

### C. Fiscal Policy

14. Fiscal policy in Korea has traditionally been formulated prudently, and in recent years the consolidated central government budget has been in broad balance, with government savings of around 8 percent of GDP and a low level of public debt. For 1998, a tight fiscal policy will be maintained. The 1998 budget, which passed the National Assembly on November 18, projected a surplus of ¼ percent of GDP (Table 5). However, the budget assumed real GDP growth of over 6 percent. With lower growth and a weaker exchange rate, the budget balance would have worsened by an estimated 0.8 percent of GDP. In addition, it is estimated that about W 24 trillion (5½ percent of GDP) will be necessary to recapitalize the banks so as to meet the Basle minimum capital standard (see Section D below).[3] Since the availability of private funds for such a capital injection seems limited at present, it was assumed that public funds will have to be raised for this purpose and thus the interest costs (W 3.6 trillion or 0.8 percent of GDP) are to be included in the revised budget.

15. The cyclical effects, combined with these interest costs, would have shifted the budget balance from a small surplus to a deficit of 1½ percent of GDP. In order to prevent such a deficit and alleviate the burden on monetary policy in the overall macroeconomic adjustment, fiscal policy will be tightened to achieve at least balance and, preferably, a small surplus. Therefore, the program includes fiscal adjustment measures of about 1½ percent of GDP.

16. These measures (see Box 1 for details) will be distributed evenly between revenues and expenditures. To provide for a visible upfront impact and signal the authorities' commitment to a strong fiscal adjustment, increases in mineral oil taxes and excises yielding about ½ percent of GDP have come into effect. Additional measures would focus on:

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[3]The Basle standard requires bank capital of at least 8 percent of risk-weighted assets.

## Box 1. Korea: Fiscal Adjustment Measures

Fiscal measures of W 7,000 billion (1½ percent of GDP) will be taken in 1998 to provide for the carrying costs of the capital injection into the banking system, and to contain aggregate demand and raise public saving as part of the macroeconomic adjustment. These measures will be distributed evenly between expenditures and revenues, and are estimated to keep the budget of the consolidated central government in balance or achieve a small surplus. Further measures in 1999 will build on the broadening of the bases for VAT as well as corporate and personal income taxes.

| | | |
|---|---|---|
| ***Revenue measures in 1998 with impact in billion won:*** | | ***3,370*** |
| • **Special excise tax** | | **1,380** |
| - Increasing the tax rate on kerosene | | |
| - Increasing the tax rate on LPG | | |
| - Increasing the tax rate on LNG | | |
| - Increasing the tax rate on air conditioners, golf and related accessories, luxury fur goods | | |
| • **Transportation tax (mineral oil taxes)** | | **1,100** |
| - Increasing the tax rate on light heating oil | | |
| - Broadening the tax base by including light oil used by the Korean Electric Corporation | | |
| • **Value-added tax** | | **390** |
| - Broadening the tax base for businesses providing services in private education, sport facilities, etc. | | |
| • **Corporation tax** | | **160** |
| - Increasing withholding tax rate on remuneration for services provided by accounting and law firms | | |
| • **Income tax** | | **340** |
| - Increasing withholding tax rate on remuneration for services provided by account and law firms | | |
| ***Expenditure measures in 1998 with impact in billion won:*** | | ***3,600*** |
| **Current expenditures** | | **2,000** |
| - Material and routine expenditures | 500 | |
| - Transfers to local governments | 900 | |
| - Other current expenditures (including salaries and subsidies) | 600 | |
| **Capital expenditures** | | **800** |
| **Net lending** | | **800** |
| ***Revenue measures in 1999 with impact in billion won:*** | | ***1,800*** |
| **Value-added tax** | | **130** |
| - Broadening the tax base by including services provided by accountants, lawyers, and other professionals | | |
| **Corporation tax** | | **1,090** |
| - Reducing tax exemption and deduction for nonprofit enterprises | | |
| - Reducing the ceilings on reserves for business loss | | |
| - Increasing the alternative minimum tax rate | | |
| - Increasing the tax rate for public corporations | | |
| - Reducing tax credit for facility investment | | |
| **Income tax** | | **580** |
| • Eliminating standard tax deduction for business income | | |
| • Broadening tax base by increasing the range of fringe benefits subject to tax | | |
| • Decreasing capital gains reduction benefits for public-purpose transactions | | |

reducing current expenditures, raising current revenues by broadening tax bases rather than increasing tax rates (with the exception of excise tax increases); and cutting only to a limited extent infrastructure and other capital expenditures.

17. The government has agreed that fiscal adjustment should include all the interest costs of the public (fiscal and quasi-fiscal) support for the financial sector. In the event that part of the support will be borne by public entities outside the consolidated central government (i.e., monetary authorities, public insurance funds, or development banks), the budget would record a correspondingly larger surplus.

18. The government also considered possible contingency measures in the event of a large shortfall in the budget. These could include raising indirect tax rates and excise tax (excluding VAT) by up to 30 percent. Furthermore, the budget contains a contingency fund (¼ percent of GDP) for special circumstances which could be used in the event of a deviation from the program toward the end of the year.

### D. Financial Sector Restructuring

19. The government is committed to a comprehensive restructuring and strengthening of the financial system to make it sound, transparent, and more efficient. The strategy comprises three broad elements: a clear and firm exit policy; strong market and supervisory discipline; and increased competition.

20. The exit policy seeks to ensure the rapid resolution of troubled financial institutions in a manner that minimizes systemic distress and avoids moral hazard. The authorities have moved decisively to suspend 9 insolvent banks. Such merchant banks that are unable to submit appropriate restructuring plans within 30 days will have their licenses revoked. The authorities' policy involves the restructuring and recapitalization of all banks that fail to meet Basle Committee capital standards. In addition to recapitalization by current owners, this policy will include mergers and acquisitions by domestic or foreign institutions. The supervisory authorities will review such mergers and acquisitions to ensure that the new groupings are economically viable. This process will entail losses to shareholders.

21. The deposit guarantee currently in place is intended to facilitate an orderly restructuring of the financial system in the present circumstances. However, in order to enhance market discipline and minimize moral hazard problems, the government is committed to eliminate the guarantee by December 31, 2000 and replace it by a regular deposit insurance system that will only protect small depositors and be financed solely by contributions from the financial sector.

22. In order to improve transparency in the financial sector and upgrade accounting and disclosure standards toward best international practice, large financial institutions will be required to have their financial statements audited by internationally recognized firms. Disclosure standards will require the publication of key data by financial institutions twice a

year (including nonperforming loans, capital adequacy, and ownership structures and affiliations).

23. To strengthen financial sector supervision, the authorities will request urgent passage of a bill to set up an agency that will consolidate the supervisory functions presently distributed among various agencies. The legislation will give the agency operational independence and adequate resources—in line with the Core Principles for Effective Banking Supervision issued by the Basle Committee on Banking Supervision—thereby freeing it from outside interference. The Fund has been invited to comment on the draft bill before it is finalized. The legislation will also allow prompt closure of insolvent financial institutions, the replacement of managements and the dilution of shareholders' equity when appropriate. Prudential standards will be upgraded to meet Basle Core Principles fully, and as rapidly as possible. In particular, banks will be required to present a detailed timetable to meet or exceed Basle minimum capital adequacy standards, following international provisioning and loan classification guidelines. Furthermore, supervisory authorities will closely review financial institutions' internal procedures for credit analysis and risk monitoring, and will require corrective action when needed. These reviews and requirements will also apply to overseas branches of Korean banks, inadequate supervision of which has been a major contributing factor to the current financial crisis.

24. To improve the liquidity of international reserves, and maintain an arms-length relationship with commercial banks, the BOK's international reserve management will be reviewed with the intention to bring it closer to international practice. Financial institutions will be encouraged to improve their risk assessment and pricing procedures, and to strengthen loan recovery; actions in these areas will be reviewed as part of prudential supervision.

25. The policy of noninterference with banks' business decisions, except for prudential reasons, requires an independent central bank. To this end, the government will seek early passage of legislation that will make the Bank of Korea independent and with price stability as its overriding mandate. The government has committed to take into consideration the comments of the Fund on the draft legislation. Finally, to promote competition and efficiency in the financial sector, the authorities will allow foreigners to establish bank subsidiaries and brokerage houses by mid-1998.

## E. Trade and Capital Account Liberalization

### Trade liberalization

26. The government has undertaken substantial trade liberalization since the early 1980s which has resulted in the removal of quantitative restrictions on all but a few items and lowered the average tariff rate on manufactured goods to around 6 percent. Nevertheless, further liberalization will help enhance domestic competition. At the time of the first review, a timetable will be set in line with WTO commitments to eliminate trade-related subsidies,

restrictive import licensing and the import diversification program. Steps will also be taken to streamline and improve the transparency of the import certification procedures.

**Capital account liberalization**

27. The government plans to accelerate substantially its ongoing capital account liberalization program. The government has announced that the ceiling on aggregate foreigners' ownership of listed Korean shares would be increased from 26 percent to 50 percent by end-1997 and to 55 percent by end-1998. The ceiling on individual foreign ownership will be increased from 7 percent to 50 percent by end-1997. By end-February 1998, the present timetable for capital account liberalization will be accelerated by taking steps to liberalize other capital account transactions, including those restricting foreigners' access to domestic money market instruments and the corporate bond markets, and by further reducing restrictions on foreign direct investment by simplifying approval procedures.

28. The traditional policy of channeling international borrowing through domestic financial institutions for onlending to the corporate sector—rather than allowing or encouraging the corporate sector to borrow directly on international capital markets—has served to make the financial system more vulnerable to changes in conditions in international capital markets and shifts in international investor sentiment regarding Korea. In order to instil market discipline a timetable will be set by end-February 1998 to eliminate restrictions on foreign borrowing by corporations.

## F. Corporate Governance and Corporate Structure

29. Korea's current financial difficulties owe much to the system of directed lending and the close relationship that exists between corporations and the banking sector. The latter has resulted in ambitious investment decisions being subject to scrutiny only by bank managers whose appointment has traditionally been influenced by government. The sweeping reforms slated for the financial sector, whereby the government will refrain from directing commercial banks' lending decisions and bank managers will become more answerable to shareholders, are intended to make banks operate on commercial grounds. This should reduce the large conglomerates' heavy reliance on bank financing and ensure more efficient investment decisions. The easing of restrictions on foreign borrowing by Korean corporations will also facilitate the switch away from bank financing, as will the opening of the domestic bond market to foreign investment.

30. An effective system of corporate governance and deregulated capital markets are essential ingredients to ensure an efficient allocation of resources in the future. A set of measures will be introduced aimed at improving the pricing of corporate risk. To raise the attractiveness of the equity market, restrictions on mergers and acquisitions will be eased and the accounting standards of listed companies will be brought in line with generally accepted practices. Listed companies will be required to subscribe to full disclosure, independent external audits and provision of consolidated statements. These measures should better able

the market to monitor the performance of corporate management. Moreover, the system of mutual loan guarantees among conglomerates' affiliates, which tends to inflate debt financing, will be made more transparent by introducing consolidated balance sheets. To restore market discipline and remove pervasive moral hazard problems, the bankruptcy provisions under Korean law will be allowed to operate without government interference. The government will break from its past policies of providing support and tax privileges to bail out individual companies and from forcing mergers between sound and unsound companies.

### G. Labor Market and Other Structural Reforms

31. To facilitate the ability of the Korean labor market to respond to changing economic conditions, labor market flexibility will be enhanced by easing dismissal restrictions under mergers and acquisitions and corporate restructuring, which continue to rely on time-consuming court rulings. To ease the burden of layoffs and to expedite reemployment, the employment insurance system will be strengthened and active labor market policies will be promoted by allowing for private job placement agencies and temporary employment agencies.

32. To enhance the transparency of financial transactions and reduce scope for corruption, the "real name" system in financial transactions will be maintained, although with some possible revisions.

### H. External Position and Financing Issues

33. Korea's external current account deficit is expected to decline markedly in 1997, reflecting the recovery in the export sector and a slowdown in import demand. The expected slowing of growth in 1998 combined with the impact of the recent sizable depreciation of the won is projected to lead to a further narrowing of the current account deficit in 1998, to about ½ percent of GDP, compared with 3 percent in 1997 (Table 6).

34. Notwithstanding the narrowing of the current account deficit, Korea's external position has come under intense pressure with financial institutions facing severe difficulties in rolling over short-term external debt. Given the very high level of external short-term debt (Table 7) the recent precipitous decline in access to short-term lines of credit has overwhelmed the capacity of financial institutions to repay. In the event, the government has in recent weeks provided increasing large amounts of foreign currency support by depositing the foreign exchange at the overseas branches of Korean financial institutions to cover debt falling due. These reserve outflows are estimated to have amounted to $9 billion in November, roughly equal to the estimated decline in the stock of domestic financial institutions' short-term external debt. Thus, despite the continued improvement in the external current account, large capital outflows precipitated a sharp decline in usable official reserves of $15 billion in November, bringing gross usable reserves to just $7 billion (0.5 months of imports) by the end of the month.

35. It is difficult to estimate with any certainty the likely developments in capital flows over the program period, given the uncertainty surrounding the rolling over of private sector short-term debt and the recent further collapse in market confidence, which has further reduced access to external credit. The working assumption is that, on the basis of the beneficial effects on market confidence of the announced program and the large financing package, the bulk of the short-term debt will be rolled over. Under this scenario, the purpose of the exceptional financing would be largely to reconstitute reserves. For this outcome to materialize, it is critical that the financing package provided is adequately large and the program is perceived to be strong to reassure markets that Korea would be able to weather the nonrollover of a significant volume of short-term debt. By providing this reassurance, the Fund and other official creditors make an important contribution to ensuring that the debts will in fact be rolled over.

36. It is anticipated that a comprehensive financing package of about $55 billion will be provided on a multilateral and bilateral basis. A critical component of the financing strategy would be to provide a large share of the resources at an early stage, with the view to allaying investors concerns and stabilizing the situation quickly. Under this scenario, the Fund could provide $21 billion over a three-year period, with sizable purchases in the first six months, complemented by quick disbursing structural adjustment support from the World Bank (up to $10 billion) and the Asian Development Bank ($4 billion). In addition, in the event that circumstances warrant, a number of countries—including at this stage, Australia, Canada, France, Germany, Japan, the United Kingdom, and the United States—are prepared, to provide supplemental financing in support of Korea's program with the Fund. This second line of defense is expected to be in excess of $20 billion.

### I. Data Provision and Information Issues

37. In recent weeks, the opacity of Korea's financial data has added to foreign market concerns about the extent of the current problems. To improve transparency and allow market participants to make informed assessments of economic developments, the publication and dissemination of key economic data will be improved.

38. A key issue is the need for greater transparency in reporting data on international reserves. Reported gross reserves include deposits held at overseas branches of Korean financial institutions. Hence, the recent shifting of the Bank of Korea's foreign currency deposits to these institutions for liquidity support purposes is not apparent in the official reserve data. In addition, the Bank of Korea maintains some $20–30 billion in foreign currency deposits with domestic banks, which are to a large degree illiquid. The reporting of Korea's international reserve position would be made more transparent by including only deposits held at foreign monetary institutions and high quality short-term foreign government securities as gross reserves. Reserves data that separately identifies the forward position will be reported fortnightly under the program. In addition, data on short-term external debt will be published quarterly.

39. While the Korean authorities publish a substantial amount of data, reporting could be improved in a number of other areas. Comprehensive data on financial institutions, including on nonperforming loans, capital adequacy, and ownership structures and affiliations will be published regularly under the program. There is also a need to improve the timeliness of data on consolidated central and local government finances, and progress in this area will be reviewed in mid-1998. In addition, by end-March 1998, Korea will post its meta data on the Fund's Special Data Dissemination Standards.

### J. Monitoring the Program

40. The proposed three-year stand-by arrangement for SDR 15.5 billion (1939 percent of quota) incorporates two quarterly quantitative performance criteria (Annexes A and B of the Memorandum on the Economic Program) that have been set for end-December 1997: (i) a floor on the net international reserves of the Bank of Korea; and (ii) a ceiling on the net domestic assets of the Bank of Korea (Table 8). In addition, a continuous performance criterion sets a floor on the interest rate charged by the Bank of Korea on foreign exchange injections to Korean commercial banks and overseas branches. Indicative targets have been incorporated on: (i) reserve money; (ii) broad money; and (iii) the consolidated central government balance. It is anticipated that additional quantitative performance criteria will be established at the time of the January 1998 review. The customary clauses on overdue financial obligations to the Fund, no accumulation of external payment arrears, and on exchange restrictions, multiple currency practices, bilateral payments agreements inconsistent with Article VIII, and import restrictions for balance of payments purposes apply as performance criteria.

41. The first full review under the stand-by arrangement and under emergency procedures, tied to end-December 1997 performance criteria set out in Annexes A and B in the Memorandum on the Economic Program, will be completed by February 15, 1998. The review will focus on interest rate and exchange rate policy, implementation of the financial restructuring measures, progress in establishing an independent central bank and an autonomous supervisory agency, capital account liberalization, and publishing of transparent data on official reserves and financial institutions. Performance criteria for March and June 1998 and indicative targets for September and December 1998 will be set at the time of the first review. The first year of the arrangement will include three more quarterly reviews tied to end-March, end-June, and end-September performance criteria, respectively.

### K. Exceptional Circumstances

42. The proposed access under the stand-by arrangement is substantially in excess of the normal limit and is heavily front-loaded in light of the exceptional circumstances surrounding Korea's external crisis. The justification for such a large access is Korea's need for a substantial amount of emergency financing, in light of depleted levels of official reserves, to facilitate the rollover of short-term external debt, and the strength of the authorities' adjustment program. The authorities have also agreed to implement a strong economic

program comprising tight macroeconomic policies and fundamental structural reforms to increase the market-orientation of the financial and corporate sectors. The early availability of a large external financing package combined with a strong reform package would help allay market concerns about Korea's ability to service its debt and is, therefore, essential for a resumption of the rollover of short-term external debt. This, in turn, would have beneficial effects in the Asian region and help calm emerging financial markets across the world.

## III. Capacity to Repay the Fund

43. If all purchases are made under the proposed stand-by arrangement, outstanding obligations to the Fund would rise by the year 2000 to SDR 15.5 billion (1,939 percent of quota) or 3.9 percent of GDP (Tables 9 and 10). Total payments to the Fund, including repurchases and charges, would peak at SDR 7,546 billion in year 2002 or 4.2 percent of exports of goods and nonfactor services.

44. The last stand-by arrangement between Korea and the Fund was effective during the period July 12, 1985 through March 10, 1987. SDR 280 million of the Fund's resources were committed under the arrangement and SDR 160 million was drawn. The last purchase by Korea under the arrangement occurred in June 1986 when it drew SDR 40 million of credit tranche resources. Korea made its final repurchase under the arrangement in December 1988. Korea has a strong track record in meeting financial obligations to the Fund. Also, though the proposed access under the stand-by arrangement is exceptionally high, there is a clear expectation that Korea will not need to fully draw on the facility and that, once market confidence has returned, repurchases will be made.

## IV. Staff Appraisal

45. Korea's policy package has been formulated in the context of an urgent need to deal with a financial crisis. The rapid deterioration of confidence, while partly attributable to the contagion effects of developments in Southeast Asia, fundamentally reflects structural weaknesses and inadequate market discipline in Korea's corporate and financial sectors and political constraints on the authorities' ability to take early and decisive action. Moreover, the lack of transparency, particularly regarding data on international reserves and the state of the financial sector, hampered effective surveillance.

46. The bold actions already undertaken by the government, and expeditious implementation of the government's announced policy package should provide a solid basis for the early return of confidence. Sustaining a strong macroeconomic stance is essential for restoring calm to markets and providing the stable financial conditions to support much needed structural reforms. It will also be critical for the major political leaders, who have pledged their support for the policy package, to garner public support for the program.

47. The tightening of monetary policy at this juncture is particularly important to help stabilize the won and achieve orderly external adjustment. The authorities' upfront action to

sharply raise short-term interest rates is, therefore, entirely appropriate. The staff attaches great importance to the authorities' commitment to avoid a premature easing of monetary policy. Therefore, interest rate and exchange rate policies will need to be closely monitored: for this purpose, the program contains safeguards, including biweekly reviews in the initial period of the program.

48. A strong fiscal policy should be maintained to alleviate the burden on monetary policy and to provide for the substantial costs of restructuring the financial sector. Given the expected sharp downturn in the economy, the programmed fiscal measures in 1998—of about 1½ percent of GDP—are appropriate. Some upfront measures have been taken to implement this fiscal adjustment, but it will be important to follow through in implementing additional measures. Furthermore, the authorities should be prepared to undertake further fiscal adjustment in the event that the costs of financial restructuring exceed present estimates.

49. A comprehensive strategy to restructure the financial sector is the centerpiece of the program. The authorities have moved swiftly to suspend the operations of 9 insolvent institutions. Prompt implementation of an orderly exit strategy for unviable institutions, improved supervisory and regulatory standards, increased transparency, and elimination of government interference in bank management and lending decisions will lay the basis for a sound financial system. An essential element of the strategy to reform and restructure the financial sector is the greater openness to foreign investment. It will also be important to enact the legislation necessary to establish an independent central bank and a consolidated and autonomous supervisory authority. The Bank of Korea should strengthen substantially its reserve management practices and internal controls, as well as its monitoring of the operations of overseas branches of domestic financial institutions.

50. Significant liberalization of the capital account is envisaged under the program, and early action in several key areas will be taken, notably liberalization of foreign investment in the financial sector as well as in the equity and bond markets. It is important to follow through on the government's policy commitments to accelerate liberalization in other areas.

51. There is an urgent need to improve corporate governance and the corporate structure. In this area, the program rests upon the twin pillars of improving transparency and creating a level playing field for all private enterprises. Greater transparency will require the adoption of improved accounting standards, independent external audits, provision of consolidated financial statements, and enhanced disclosure requirements. The second pillar will involve the prompt elimination of directed lending as well as avoidance of government intervention in lending decisions or subsidies and tax privileges to bail out individual corporations.

52. Korea's trade system is becoming more liberal. The authorities are committed to setting a timetable, by the time of the February review, for putting in place additional measures. The focus will be on eliminating trade-related subsidies and restrictive import licensing, as well as the import diversification program.

53. The recent experience has amply demonstrated the importance of accurate and timely economic information for undertaking timely corrective policies as well as for effective surveillance and maintaining market confidence. Consequently, it will be imperative to move ahead with the timely and regular publication of information on foreign exchange reserves, composition of reserves and the net forward position, short-term external debt, and financial sector conditions.

54. In the present environment of financial market turbulence and political uncertainty, there are clear risks to the realization of the program's objectives. The authorities have taken difficult measures, but need to sustain implementation of their policy commitments. Policy slippages would undermine market confidence, compound short-term rollover problems, and worsen an already critical situation. The present broad reform and liberalization program, supported by appropriately tight macroeconomic policies, represents a strong beginning, but its strict and sustained implementation will be key to building the financial and corporate sectors that are needed for Korea to meet the challenges of globalization.

55. The proposed arrangement with the Fund is being submitted to Executive Directors under the emergency financing procedures, with access under the exceptional circumstances clause. The staff believes that the strength of the proposed policy program and the size of the financing requirement justify the requested access. In view of Korea's very low international reserves, the arrangement is frontloaded to bolster market confidence and facilitate the rollover of Korea's large external short-term debt. Resources from the Fund, together with those from the other official sources, will provide appropriate support for Korea's adjustment effort. It is important that resources from these other sources be committed without delay.

56. The risks to the program have been significantly reduced by the prior actions taken and the authorities' commitment to rapidly broaden and implement their reform program. In this context, the program contains important safeguards in the form of frequent reviews and prior understandings on the necessary corrective policies. Korea's impressive record of economic performance and its earlier adjustment efforts in the face of adverse external developments bode well for the success of this program. While staff sees a degree of risk, Korea's capacity to repay the Fund remains sound, particularly in view of its moderate level of external debt in relation to its foreign exchange earnings. In light of all of these considerations, the staff recommends approval of Korea's request for a stand-by arrangement in support of its adjustment program.

**Proposed Decision**

The following decision is proposed for adoption by the Executive Board:

1. Korea has requested a stand-by arrangement for a period of three years in an amount equivalent to SDR 15,500 million.

2. The Fund approves the stand-by arrangement set forth in EBS/97/222.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Table 1. Korea: Macroeconomic Framework, 1995–98 1/

| | 1995 | 1996 | Program Projections 1997 | 1998 |
|---|---|---|---|---|
| Real GDP growth (percent change) | 8.9 | 7.1 | 6.0 | 2.5 |
| Consumption | 7.2 | 6.9 | 5.1 | 1.4 |
| Gross fixed investment | 11.7 | 7.1 | -3.0 | -14.2 |
| Stockbuilding 2/ | -0.5 | 0.9 | -3.0 | 1.2 |
| Net exports 2/ | 0.5 | -0.3 | 7.0 | 5.4 |
| Saving and investment (in percent of GDP) | | | | |
| Gross domestic investment | 37.0 | 38.2 | 36.0 | 33.5 |
| Gross national saving | 35.1 | 33.3 | 32.9 | 32.9 |
| Current account balance | -2.0 | -4.9 | -3.1 | -0.6 |
| Prices (percent change) | | | | |
| Average CPI inflation | 4.5 | 4.9 | 4.3 | 5.0 |
| End-period CPI inflation | 4.7 | 4.9 | 4.2 | 5.2 |
| GDP deflator | 5.6 | 3.4 | 3.0 | 4.1 |
| Real effective exchange rate | 1.2 | 3.6 | -10.0 | ... |
| Trade (percent change) | | | | |
| Export volume | 23.8 | 18.9 | 24.8 | 9.6 |
| Import volume | 21.1 | 12.6 | 7.5 | -3.6 |
| Terms of trade | -3.5 | -11.7 | -7.9 | -3.7 |
| Consolidated central government (in percent of GDP) | | | | |
| Revenues | 20.7 | 21.9 | 21.6 | 23.6 |
| Expenditures (excluding bank restructuring costs) | 20.3 | 21.6 | 22.1 | 22.6 |
| Balance | 0.3 | 0.3 | -0.5 | 1.0 |
| Balance after bank restructuring costs | 0.3 | 0.3 | -0.5 | 0.2 |
| Money and credit (end of period) | | | | |
| M3 growth | 19.1 | 16.7 | 15.4 | 9.0 |
| Reserve money growth | 16.3 | -12.2 | -9.5 | 9.0 |
| Call rate | 11.0 | 12.5 | 15.8 3/ | ... |
| Three-year corporate bond yield | 11.7 | 12.6 | 18.7 3/ | ... |
| Balance of payments (in billions of US$) | | | | |
| Exports, f.o.b. | 123.2 | 128.3 | 138.6 | 143.8 |
| Imports, f.o.b. | -128.0 | -143.6 | -145.1 | -137.4 |
| Current account balance | -8.9 | -23.7 | -13.8 | -2.3 |
| Reserve cover 4/ 5/ | 2.5 | 2.0 | 0.8 | 2.4 |
| External debt (billions of US$) | | | | |
| Total external debt 4/ | 78.4 | 104.7 | 101.5 | 126.8 |
| *Of which* | | | | |
| Short-term 4/ | 45.3 | 61.0 | ... | ... |
| External debt in percent of GDP | 17.2 | 21.6 | 22.9 | 30.7 |
| Debt-service ratio 6/ | 5.4 | 5.8 | ... | ... |

Sources: Bank of Korea; and Fund staff estimates.

1/ With program implementation.
2/ Contribution to GDP.
3/ December 3.
4/ End of period; excluding debt contracted by offshore entities.
5/ Months of imports of goods and nonfactor services; excludes Bank of Korea deposits at overseas branches and subsidiaries of Korean banks.
6/ Medium- and long-term debt; in percent of exports of goods and nonfactor services.

Table 2. Korea: Daily Financial Indicators, 1997

| | 30-Sep | 31-Oct | Mon. 17-Nov | Tues. 18-Nov | Wed. 19-Nov | Thurs. 20-Nov | Fri. 21-Nov | Mon. 24-Nov | Tues. 25-Nov | Wed. 26-Nov | Thurs. 27-Nov | Fri. 28-Nov | Mon. 1-Dec | Tues. 2-Dec | Wed. 3-Dec |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Market interest rates | | | | | | | | | | | | | | | |
| Call rate 1/ | 14.4 | 13.4 | 15.0 | 14.3 | 14.7 | 14.5 | 14.5 | 15.4 | 15.7 | 15.7 | 15.7 | 13.9 | 12.4 | 12.6 | 15.8 |
| Yield on CD (91-day) | 13.4 | 13.8 | 14.1 | 14.2 | 14.5 | 14.7 | 14.9 | 15.5 | 15.2 | 17.0 | 16.5 | 15.5 | 15.0 | 15.5 | 15.5 |
| Yield on corporate bond (3-year) | 12.6 | 12.6 | 13.4 | 13.7 | 14.0 | 14.3 | 14.5 | 16.1 | 17.6 | 18.6 | 17.3 | 15.6 | 17.5 | 18.2 | 18.7 |
| Bilateral exchange rates | | | | | | | | | | | | | | | |
| Won per $ | 914.4 | 964.6 | 990.6 | 1,012.8 | 1,035.5 | 1,139.1 | 1,145.0 | 1,085.0 | 1,122.0 | 1,110.0 | 1,119.5 | 1,170.0 | 1,187.0 | 1,235.0 | 1,196.0 |
| Percent change (+ appreciation) | -1.4 | -5.2 | ... | -2.2 | -2.2 | -9.1 | -0.5 | 5.5 | -3.3 | 1.1 | -0.8 | -4.3 | -1.4 | -3.9 | 3.3 |
| Yen per $ | 121.0 | 120.0 | 125.4 | 125.5 | 126.1 | 126.7 | 126.8 | ... | 127.7 | 127.1 | 127.0 | 127.0 | 128.3 | 128.7 | 128.6 |
| Percent change (+ appreciation) | -1.3 | 0.8 | ... | -0.1 | -0.4 | -0.5 | -0.1 | ... | -0.7 | 0.5 | 0.1 | 0.0 | -1.0 | -0.3 | 0.1 |
| Nominal effective exchange rate index | 94.7 | 89.3 | 88.7 | 88.3 | 86.6 | 84.4 | 77.1 | 78.5 | 80.1 | 79.0 | 79.3 | 79.5 | 76.1 | ... | ... |
| Stock market index | 647.1 | 470.8 | 497.0 | 494.7 | 502.6 | 488.4 | 506.1 | 450.6 | 439.6 | 438.7 | 433.1 | 411.9 | 393.2 | 376.9 | 379.3 |
| Percent change | -8.1 | -27.2 | 5.6 | -0.5 | 1.6 | -2.8 | 3.6 | -11.0 | -2.4 | -0.2 | -1.3 | -4.9 | -3.6 | -4.1 | 0.6 |

Sources: Bank of Korea; and Fund staff estimates.

1/ Weighted average of the daily interbank call rate brokered by the Korea Money Trade Corporation.

## Table 3. Korea: Medium-Term Outlook, 1996-2002

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|---|
| | | Projections | | | | | |
| | | | | (Percent change) | | | |
| Growth and inflation | | | | | | | |
| Real GDP growth | 7.1 | 6.0 | 2.5 | 5.0 | 6.6 | 6.6 | 6.4 |
| CPI inflation (average) | 4.9 | 4.3 | 5.0 | 4.3 | 4.0 | 3.5 | 3.1 |
| Savings and investment | | | | | | | |
| National savings | 33.3 | 32.9 | 32.9 | 34.0 | 34.5 | 35.0 | 35.5 |
| Domestic investment | 38.2 | 36.0 | 33.5 | 34.7 | 34.8 | 34.9 | 35.2 |
| | | | | (In percent of GDP) | | | |
| Consolidated central government accounts | | | | | | | |
| Revenue | 21.9 | 21.6 | 23.6 | 23.5 | 23.5 | 23.5 | 23.5 |
| Expenditure and net lending | 21.6 | 22.1 | 22.6 | 22.5 | 22.5 | 22.5 | 22.5 |
| *Of which* | | | | | | | |
| Capital | 6.9 | 6.5 | 6.6 | 6.6 | 6.6 | 6.6 | 6.6 |
| Overall balance | 0.3 | -0.5 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 |
| Bank restructuring costs 1/ | ... | ... | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 |
| Overall balance including bank restructuring costs | 0.3 | -0.5 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| | | | | (In billions of U.S. dollars) | | | |
| Balance of payments | | | | | | | |
| Current account balance | -23.7 | -13.8 | -2.3 | -2.8 | -1.4 | 0.4 | 1.7 |
| (In percent of GDP) | -4.9 | -3.1 | -0.6 | -0.6 | -0.3 | 0.1 | 0.3 |
| Trade balance | -15.3 | -6.5 | 6.4 | 6.9 | 8.9 | 11.3 | 13.0 |
| Merchandise exports 2/ | 3.7 | 8.1 | 3.8 | 7.7 | 10.9 | 11.2 | 10.2 |
| Merchandise imports 2/ | 11.3 | 1.1 | -5.3 | 7.8 | 10.1 | 10.3 | 9.9 |
| Overall balance | 0.0 | -17.0 | 23.0 | 14.0 | 5.1 | 4.2 | 5.6 |
| Reserves and debt (end of year) | | | | | | | |
| Official reserves 3/ | 29.4 | 12.4 | 35.4 | 49.4 | 54.5 | 59.7 | 65.3 |
| (In months of imports) | 2.0 | 0.8 | 2.4 | 3.2 | 3.2 | 3.2 | 5.2 |
| Total external debt | | | | | | | |
| (In percent of GDP) | 21.6 | 22.9 | 30.7 | 32.1 | 30.6 | 28.7 | 26.8 |

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

1/ Interest cost of long-term bonds.
2/ Percent change in dollar value.
3/ Excluding Bank of Korea deposits at the overseas branches and subsidiaries of Korean banks.

Table 4. Korea: Reserve Money and Financial Survey, 1995-98

(In billions of won; end of period)

| | 1995 | 1996 | 1997 | | | | 1998 |
|---|---|---|---|---|---|---|---|
| | | | Mar. | Jun. | Sept. 1/ | Dec. 1/ Prog. | Dec. Proj. |
| Bank of Korea | | | | | | | |
| Net foreign assets | 22,707 | 24,858 | 18,028 | 22,626 | 20,553 | 9,982 | 33,082 |
| Assets | 23,356 | 25,488 | 18,986 | 23,817 | 21,692 | 11,121 | 34,221 |
| Liabilities | 649 | 630 | 958 | 1,191 | 1,139 | 1,139 | 1,139 |
| Net domestic assets | 6,598 | 864 | 2,437 | -1,886 | 1,721 | 13,290 | -7,711 |
| Public sector 2/ | -4,307 | -3,991 | -4,614 | -5,098 | -5,491 | -5,491 | -5,491 |
| Private financial sector | 37,233 | 34,164 | 27,564 | 28,752 | 29,409 | 14,852 | -6,148 |
| Other items | -26,327 | -29,308 | -20,513 | -25,541 | -22,197 | 3,928 | 3,928 |
| *Of which:* | | | | | | | |
| FX deposits at DMB branches abroad | 2,712 | 3,290 | 7,177 | 7,105 | 7,304 | 34,925 | 34,925 |
| Reserve money | 29,306 | 25,722 | 20,466 | 20,739 | 22,274 | 23,271 | 25,371 |
| Financial survey 3/ | | | | | | | |
| Net foreign assets | 5,198 | -711 | -10,931 | -9,398 | -10,562 | -24,396 | -5,641 |
| Net domestic assets | 521,819 | 615,672 | 645,723 | 666,670 | 699,320 | 734,172 | 779,447 |
| Public sector | 8,979 | 9,616 | 4,263 | 4,170 | -1,059 | 11,098 | 12,099 |
| Private sector | 528,981 | 628,444 | 657,189 | 686,705 | 724,584 | 747,278 | 791,552 |
| Other items | -16,141 | -22,387 | -15,729 | -24,205 | -24,205 | -24,205 | -24,205 |
| Total liquidity (M3) | 527,017 | 614,962 | 634,792 | 657,272 | 688,757 | 709,775 | 773,806 |
| Memorandum items: | | | | | | | |
| Reserve money | | | | | | | |
| Twelve-month percent change | 16.3 | -12.2 | -24.7 | -12.4 | -21.8 | -9.5 | 9.0 |
| Quarterly percent change | ... | ... | -59.9 | 5.5 | 33.1 | 4.5 | ... |
| M3 | | | | | | | |
| Twelve-month percent change | 19.1 | 16.7 | 16.5 | 15.6 | 16.7 | 15.4 | 9.0 |
| Quarterly percent change | ... | ... | 13.5 | 14.9 | 20.6 | 12.8 | ... |
| Money velocity (M3) 4/ | -4.1 | -4.4 | -6.0 | -5.1 | -6.6 | -5.0 | -1.4 |

Sources: Bank of Korea, *Monthly Statistical Bulletin*; and Fund staff estimates and projections.

1/ Program and projections based on the assumption of no emergency financing. Net foreign assets at the Bank of Korea will be lower and net domestic assets will be higher with the availability of emergency financing package (see Annexes A and B of the Memorandum on the Economic Program).

2/ Comprises net claims on government and other official entities.

3/ The data for September 1997 are estimates.

4/ Twelve-month percent change.

Table 5. Korea: Summary of Consolidated Central Government Operations, 1995-98

| | 1995 | 1996 | 1997 Budget | 1997 Est. Outcome | 1998 Budget | 1998 Projection Without Measures | 1998 Program |
|---|---|---|---|---|---|---|---|
| | | | (In trillions of won) | | | | |
| **Total revenue** | **72.8** | **85.5** | **96.3** | **92.2** | **107.2** | **103.8** | **107.2** |
| Central government revenue | 72.1 | 84.2 | 95.7 | 91.6 | 105.8 | 102.4 | 105.8 |
| Tax revenue | 56.8 | 65.0 | 74.0 | 70.5 | 78.7 | 75.8 | 79.2 |
| Social security contributions | 5.4 | 7.4 | 8.4 | 7.9 | 12.5 | 12.0 | 12.0 |
| Nontax revenue and capital revenue | 9.9 | 11.8 | 13.3 | 13.2 | 14.6 | 14.6 | 14.6 |
| Public enterprises' special accounts revenue | 0.7 | 1.3 | 0.6 | 0.6 | 1.4 | 1.4 | 1.4 |
| **Expenditures** | **71.6** | **84.4** | **97.1** | **94.1** | **106.2** | **106.4** | **102.8** |
| Central government expenditures | 71.1 | 82.4 | 94.4 | 91.5 | 102.6 | 102.8 | 99.2 |
| Current expenditures | 49.9 | 55.4 | 65.2 | 63.9 | 71.0 | 71.2 | 69.4 |
| Capital expenditures and net lending | 21.2 | 27.0 | 29.2 | 27.5 | 31.6 | 31.6 | 29.8 |
| Public enterprises' special accounts expenditure | 0.5 | 2.0 | 2.7 | 2.7 | 3.6 | 3.6 | 3.6 |
| Central government balance | 1.0 | 1.8 | 1.3 | 0.1 | 3.2 | -0.4 | 6.6 |
| **Consolidated central government balance** | **1.2** | **1.1** | **-0.8** | **-1.9** | **1.0** | **-2.6** | **4.4** |
| Bank restructuring costs 1/ | --- | --- | --- | --- 2/ | --- | 3.6 | 3.6 |
| **Balance after restructuring costs** | **1.2** | **1.1** | **-0.8** | **-1.9** | **1.0** | **-6.2** | **0.8** |
| Financing | -1.2 | -1.1 | 0.8 | 1.9 | -1.0 | 6.2 | -0.8 |
| Domestic | -0.9 | -0.8 | 1.1 | 2.2 | -0.7 | 6.5 | -0.5 |
| Foreign | -0.3 | -0.3 | -0.3 | -0.3 | -0.3 | -0.3 | -0.3 |
| | | | (In percent of GDP) | | | | |
| **Total revenue** | **20.7** | **21.9** | **22.6** | **21.6** | **22.7** | **22.8** | **23.6** |
| Central government revenue | 20.5 | 21.6 | 22.5 | 21.5 | 22.4 | 22.5 | 23.3 |
| Tax revenue | 16.1 | 16.7 | 17.4 | 16.6 | 16.7 | 16.7 | 17.4 |
| Social security contributions | 1.5 | 1.9 | 2.0 | 1.9 | 2.6 | 2.6 | 2.6 |
| Nontax revenues and capital revenue | 2.8 | 3.0 | 3.1 | 3.1 | 3.1 | 3.2 | 3.2 |
| Public enterprises' special accounts revenue | 0.2 | 0.3 | 0.1 | 0.1 | 0.3 | 0.3 | 0.3 |
| **Expenditures** | **20.3** | **21.6** | **22.8** | **22.1** | **22.5** | **23.4** | **22.6** |
| Central government expenditures | 20.2 | 21.1 | 22.2 | 21.5 | 21.7 | 22.6 | 21.8 |
| Current expenditures | 14.2 | 14.2 | 15.3 | 15.0 | 15.1 | 15.7 | 15.3 |
| Capital expenditures and net lending | 6.0 | 6.9 | 6.9 | 6.5 | 6.7 | 7.0 | 6.6 |
| Public enterprises' special accounts expenditure | 0.1 | 0.5 | 0.6 | 0.6 | 0.8 | 0.8 | 0.8 |
| Central government balance | 0.3 | 0.5 | 0.3 | 0.0 | 0.7 | -0.1 | 1.4 |
| **Consolidated central government balance** | **0.3** | **0.3** | **-0.2** | **-0.5** | **0.2** | **-0.6** | **1.0** |
| Bank restructuring costs 1/ | --- | --- | --- | --- 2/ | --- | 0.8 | 0.8 |
| **Balance after restructuring costs** | **0.3** | **0.3** | **-0.2** | **-0.5** | **0.2** | **-1.4** | **0.2** |
| Memorandum item: | | | | | | | |
| Nominal GDP (in trillion won) | 352.0 | 390.0 | 425.8 | 425.8 | 471.8 | 454.6 | 454.6 |
| (Growth rate in percent) | 15.0 | 10.8 | 9.2 | 9.2 | 10.8 | 6.6 | 6.6 |

Sources: Data provided by the Ministry of Finance and Economy; and Fund staff estimates and projections.

1/ Bank restructuring costs reflect the interest cost on the capital injection into the banking system.

2/ Government assistance to the financial sector in late-1997 was off-budget.

Table 6. Korea: Balance of Payments and Financing Requirements, 1995-98

(In millions of U.S. dollars)

| | 1995 | 1996 | Q1 1997 | Q2 1997 | Q3 1997 | Prog. Q4 1997 | Prog. 1997 | Prog. 1998 |
|---|---|---|---|---|---|---|---|---|
| Current account balance | -8,948 | -23,716 | -7,419 | -2,784 | -2,174 | -1,435 | -13,811 | -2,342 |
| Trade balance | -4,747 | -15,306 | -5,407 | -692 | 157 | -549 | -6,491 | 6,438 |
| Exports | 123,203 | 128,303 | 30,610 | 35,570 | 34,693 | 37,714 | 138,586 | 143,840 |
| (Growth rate) | 31.5 | 4.1 | -3.0 | 9.3 | 16.7 | 9.4 | 8.0 | 3.8 |
| Imports | 127,949 | 143,609 | 36,017 | 36,261 | 34,536 | 38,263 | 145,077 | 137,402 |
| (Growth rate) | 32.1 | 12.2 | 5.7 | 1.7 | -2.2 | -0.8 | 1.0 | -5.3 |
| Services and transfers (net) | -4,201 | -8,410 | -2,012 | -2,092 | -2,330 | -886 | -7,320 | -8,780 |
| Capital account balance | 15,987 | 23,741 | -872 | 6,954 | -722 | -16,485 | -11,126 | 3,342 |
| Direct investment | -1,880 | -1,981 | -441 | -199 | -292 | -500 | -1,432 | -1,000 |
| Portfolio investment | 8,518 | 11,207 | 2,566 | 4,417 | 3,996 | -3,300 | 7,679 | 678 |
| Trade credits | 3,096 | 4,310 | 591 | 714 | 104 | -1,000 | 409 | -112 |
| Deposit money banks 1/ | 4,014 | 5,721 | -4,353 | 1,299 | -560 | -11,850 | -15,463 | 2,976 |
| Other | 3,685 | 3,490 | 2,068 | 905 | -1,555 | -1,141 | 277 | 800 |
| Errors and omissions | -1,446 | 994 | -1,303 | -182 | -2,417 | -1,694 | -5,596 | 0 |
| Overall balance | 7,039 | 25 | -8,291 | 4,170 | -2,896 | -20,920 | -27,937 | 1,000 |
| Financing | -7,039 | -25 | 8,291 | -4,170 | 2,896 | 20,920 | 27,937 | -1,000 |
| Change in reserves (- increase) 2/ | -7,039 | -25 | 8,291 | -4,170 | 2,896 | 9,920 | 16,937 | -23,000 |
| Financing gap | 0 | 0 | 0 | 0 | 0 | 11,000 | 11,000 | 22,000 |
| Possible IMF funding | 0 | 0 | 0 | 0 | 0 | 9,000 | 9,000 | 10,000 |
| Remaining financing gap | 0 | 0 | 0 | 0 | 0 | 2,000 | 2,000 | 12,000 |
| Memorandum items: | | | | | | | | |
| Current account balance (as a percent of GDP) | -2.0 | -4.9 | ... | ... | ... | ... | -3.1 | -0.6 |
| Gross international reserves | 32,712 | 33,237 | 29,146 | 33,316 | 30,420 | 44,150 | 44,150 | 67,150 |
| Useable gross reserves 2/ | 29,412 | 29,437 | 21,146 | 25,316 | 22,420 | 12,400 | 12,400 | 35,400 |
| Useable reserve cover (months of imports of goods and nonfactor services) 2/ | 2.5 | 2.0 | 1.4 | 1.7 | 1.5 | 0.8 | 0.8 | 2.4 |

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

1/ Adjusted upward to include the impact of foreign currency liquidity support by the Bank of Korea to overseas branches of DMBs.
2/ Adjusted to exclude the impact of foreign currency liquidity support by the Bank of Korea to overseas branches of DMBs.

Table 7. Korea: External Debt by Maturity and Borrower, 1993–97

(In millions of U.S. dollars)

| | 1993 | 1994 | 1995 | 1996 | Sept. 1997 |
|---|---|---|---|---|---|
| Medium- and long-term debt 1/ | 24,705 | 26,458 | 33,137 | 43,711 | 54,071 |
| Financial institutions | 13,034 | 13,897 | 19,612 | 27,693 | 35,075 |
| Nonbank financial institutions | 9,043 | 10,388 | 13,590 | 17,524 | 22,625 |
| Commercial banks | 3,991 | 3,509 | 6,022 | 10,169 | 12,450 |
| *Of which* | | | | | |
| Interoffice "A" account 2/ | 1,858 | 1,576 | 1,858 | 3,268 | 3,844 |
| Public sector | 3,828 | 3,551 | 3,031 | 2,412 | 2,112 |
| Private sector | 7,843 | 9,010 | 10,494 | 13,607 | 16,884 |
| Short-term debt 1/ | 19,165 | 30,391 | 45,301 | 60,984 | 65,626 |
| Financial institutions | 11,369 | 19,406 | 29,670 | 38,976 | 39,868 |
| Interoffice "A" account 2/ | 4,835 | 7,699 | 9,210 | 11,295 | 12,411 |
| Refinance | 20 | 193 | 663 | 1,425 | 1,684 |
| Nonresidents' deposits | 126 | 138 | 203 | 287 | 352 |
| Other | 6,388 | 11,376 | 19,594 | 25,969 | 25,421 |
| Private nonbank sector | 7,796 | 10,985 | 15,631 | 22,009 | 25,758 |
| Trade credits | 4,245 | 6,196 | 9,448 | 14,095 | 15,661 |
| Loans for oil imports | 1,697 | 2,252 | 2,835 | 4,410 | 4,346 |
| Advance receipts of exports, and others | 1,854 | 2,537 | 3,348 | 3,504 | 5,751 |
| Total 1/ | 43,870 | 56,849 | 78,438 | 104,695 | 119,697 |
| Memorandum items: | | | | | |
| Borrowings of nonresident nonfinancial entities 3/ 4/ | 18,764 | 22,503 | 32,456 | 46,220 | 51,282 5/ |
| Trade financing | 9,935 | 11,249 | 16,157 | 22,250 | 23,243 5/ |
| Construction financing | 2,760 | 3,139 | 3,734 | 4,920 | 5,277 5/ |
| Other | 6,069 | 8,115 | 12,565 | 19,050 | 22,571 5/ |
| Domestic banks' offshore borrowing 4/ | ... | 7,500 | 12,650 | 21,240 | 21,600 |
| Borrowing by overseas bank branches 4/ | ... | 46,800 | 54,000 | 65,600 | ... |
| Debt/GDP ratio | 13.3 | 14.7 | 17.2 | 21.6 | ... |
| Net debt/GDP ratio 6/ | 2.2 | 2.6 | 4.1 | 7.2 | ... |

Source: Data provided by the Bank of Korea.

1/ Contracted onshore.

2/ External debt of branches of foreign banks.

3/ External borrowing of branches or subsidiaries of Korean corporations residing abroad.

4/ Some amount of this debt could be included in external debt contracted onshore (i.e., double counted). There is also likely to be double counting between the three different categories of debt contracted outside Korea; however, a time series of consolidated debt data is not available.

5/ End-June 1997.

6/ Gross debt less foreign assets of the banking system.

Table 8. Korea: Quarterly Performance Criteria, 1997

| | Sep. 1997 Actual | Dec. 1997 Program |
|---|---|---|
| | (In billions of won) | |
| Net domestic assets of the Bank of Korea (limit) 1/ | 1,721 | 10,950 |
| Reserve money (indicative target) | 22,275 | 23,270 |
| Broad money (indicative target) | 688,760 | 709,775 |
| Consolidated government balance (indicative limit) 2/ | ... | -2,000 |
| | (In billions of U.S. dollars) | |
| Net international reserves (floor) | 21.1 | 11.2 |

1/ Limit on the net domestic assets of the Bank of Korea and on net international reserves will be adjusted as described in Annexes A and B to the Memorandum on the Economic Program.
2/ 1997.

Table 9. Korea: Schedule of Purchases Under the Stand-By Arrangement

| Date | Amount of Purchase (SDR billion) | In Percent of Quota 1/ | Conditions |
|---|---|---|---|
| December 4, 1997 | 4.1 | 513 | Board approval |
| December 18, 1997 | 2.6 | 325 | Observance of continuous performance criterion regarding foreign exchange injections by the Bank of Korea.<br><br>Completion of first biweekly review<br>• Compliance with understandings between the Korean authorities and the Fund regarding the implementation of interest rate policy. |
| January 8, 1998 | 1.5 | 188 | Observance of end-December 1997 performance criteria.<br><br>Observance of continuous performance criterion regarding foreign exchange injections by the Bank of Korea.<br><br>Completion of second biweekly review<br><br>• Call a special session of the National Assembly shortly following the Presidential elections in December to pass the following reform bills: a revised Bank of Korea Act that provides for central bank independence, with price stability as its main mandate; a bill to consolidate bank supervision; and a bill requiring that corporate financial statements be prepared on a consolidated basis and be certified by external auditors (as discussed in paragraph 16 of the Memorandum on the Economic Program).<br><br>• Submit legislation concerning hostile takeovers to harmonize Korean legislation on abuse of dominant positions in line with industrial countries' standards.<br><br>• Publication of foreign reserve data.<br><br>• The Bank of Korea's deposits with nonresident branches and affiliates of domestic financial institutions will not be increased after end-December 1997. |

Table 9. Korea: Schedule of Purchases Under
the Stand-By Arrangement (continued)

| Date | Amount of Purchase (SDR billion) | In Percent of Quota 2/ | Conditions |
|---|---|---|---|
| February 15, 1998 | 2.6 | 325 | Observance of end-December 1997 performance criteria and completion of first full review |
| May 15, 1998 | 1.8 | 225 | Observance of end-March 1998 performance criteria review and completion of second full review |
| August 15, 1998 | 0.725 | 91 | Observance of end-June 1998 performance criteria and completion of third full review |
| November 15, 1998 | 0.725 | 91 | Observance of end-September 1998 performance criteria and completion of fourth full review. |
| February 15, 1999 | 0.18125 | 23 | Observance of end-December 1998 performance criteria and completion of fifth full review. |
| May 15, 1999 | 0.18125 | 23 | Observance of end-March 1999 performance criteria. |
| August 15, 1999 | 0.18125 | 23 | Observance of end-June 1999 performance criteria. and completion of sixth full review. |
| November 15, 1999 | 0.18125 | 23 | Observance of end-September 1999 performance criteria. |
| February 15, 2000 | 0.18125 | 23 | Observance of end-December 1999 performance criteria and completion of seventh full review. |
| May 15, 2000 | 0.18125 | 23 | Observance of end-March 2000 performance criteria. |
| August 15, 2000 | 0.18125 | 23 | Observance of end-June 2000 performance criteria and completion of eighth full review |
| November 15, 2000 | 0.18125 | 23 | Observance of end-September 2000 performance criteria. |
| Total 1/ | 15.5 | 1,939 | |

1/ Purchases amounts in percent of quota may not sum to the total due to rounding.

Table 10. Korea: Indicators of Debt Service to the Fund, 1997-2006

(In millions of SDRs)

| | | Projections | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Overdue | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
| Debt service 1/ | | | | | | | | | | | |
| Charges 2/ | 0.0 | 33.5 | 532.4 | 707.3 | 744.4 | 691.8 | 384.7 | 97.4 | 29.2 | 6.1 | 0.0 |
| Repurchases | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 5,428.1 | 7,160.9 | 2,095.3 | 589.1 | 226.6 | 0.0 |
| Total debt service | | 33.5 | 532.4 | 707.3 | 744.4 | 6,119.9 | 7,545.6 | 2,192.7 | 618.3 | 232.7 | 0.0 |
| In percent of exports of goods and nonfactor services | 0.0 | 0.0 | 0.4 | 0.5 | 0.5 | 3.7 | 4.2 | 1.1 | 0.3 | 0.1 | 0.0 |
| In percent of official reserves 3/ | 0.0 | 0.4 | 2.1 | 2.0 | 1.9 | 14.3 | 16.3 | 4.4 | 1.1 | 0.4 | 0.0 |
| In percent of quota | 0.0 | 4.2 | 66.6 | 88.5 | 93.1 | 765.4 | 943.7 | 274.2 | 77.3 | 29.1 | 0.0 |
| Credit outstanding | | 6,700.0 | 14,050.0 | 14,775.0 | 15,500.0 | 10,071.9 | 2,911.0 | 815.7 | 226.6 | 0.0 | 0.0 |
| In percent of GDP | | 2.2 | 4.3 | 4.1 | 3.9 | 2.3 | 0.6 | 0.2 | 0.0 | 0.0 | 0.0 |
| In percent of total external debt | | 9.1 | 15.3 | 14.2 | 14.3 | 9.1 | 2.6 | 0.7 | 0.2 | 0.0 | 0.0 |
| In percent of official reserves 3/ | | 74.6 | 54.8 | 41.3 | 39.6 | 23.6 | 6.3 | 1.6 | 0.4 | 0.0 | 0.0 |
| In percent of quota | | 837.9 | 1,757.1 | 1,847.8 | 1,938.5 | 1,259.6 | 364.1 | 102.0 | 28.3 | 0.0 | 0.0 |

Sources: Based on data provided by the Korean authorities; and Fund staff estimates.

1/ The service charge on each individual purchase has been included in the projected charges; the calculation of charges and epurchases are based on the current policies regarding charges and repurchases.

2/ Projections are based on current rates of charge, including burden-sharing charges where applicable, for purchases in the GRA, and on current interest rates for SAF, ESAF, and Trust Fund. The current SDR interest rate is assumed for net use of SDRs.

3/ Excluding Bank of Korea deposits at overseas branches and subsidiaries of Korean banks.

## I. Korea—Fund Relations
(As of November 30, 1997)

I. **Membership Status:** Joined 8/26/55; Article VIII

| II. General Resources Account: | SDR Million | Percent of Quota |
|---|---|---|
| Quota | 799.60 | 100.0 |
| Fund holdings of currency | 355.89 | 44.5 |
| Reserve position in Fund | 443.71 | 55.5 |

| III. SDR Department: | SDR Million | Percentage Allocation |
|---|---|---|
| Net cumulative allocation | 72.91 | 100.0 |
| Holdings | 99.22 | 136.1 |

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

V. **Financial Arrangements:**

| Type | Approval Date | Expiration Date | Amount Approved (SDR mn.) | Amount Drawn (SDR mn.) |
|---|---|---|---|---|
| Stand-by | 7/12/85 | 3/10/87 | 280.00 | 160.00 |
| Stand-by | 7/08/83 | 3/31/85 | 575.78 | 575.78 |
| Stand-by | 2/13/81 | 2/12/82 | 121.69 | 121.69 |

VI. **Projected Obligations to Fund (SDR million; based on existing use of resources and present holdings of SDRs):** None

VII. **Exchange Rate Arrangement:**

Effective March 2, 1990, the exchange rate against the U.S. dollar is allowed to float within specified margins around the previous day's weighted average exchange rate in the interbank market. The margins have been widened five times since March 1990, most recently to +/-10 percent on November 19, 1997. On December 3, 1997, the exchange rate was W 1,196 = US$1.

VIII. **Last Article IV Consultation:**

Staff discussions for the 1997 Article IV consultation with Korea were held during October 6–15. Board discussion is scheduled for early 1998.

IX. **Other Fund Missions:**

**APD:** A fact-finding mission visited North Korea, September 6–13, 1997.

**RES:** The capital markets mission to Asia visited Seoul during April 17–21, 1997.

**FAD:** A mission to discuss intergovernmental fiscal relations and public expenditure management visited Seoul during May/June 1996.

**MAE:** A mission to discuss financial sector reform visited Seoul during October/November 1992. A mission to discuss foreign exchange liberalization visited Seoul in May 1994.

**BCS:** A mission to provide assistance in establishing a data base at the Bank of Korea visited Seoul in November 1992.

**Korea: Stand-By Arrangement**

Attached hereto is a letter from the Deputy Prime Minister/ Minister of Finance and Economy and the Governor of the Bank of Korea dated December 3, 1997 (the "Letter"), with attached memorandum (the "Memorandum"), requesting a stand-by arrangement and setting forth:

(a) the objectives, policies and measures that the authorities of Korea intend to pursue for the period of this stand-by arrangement; and

(b) understandings of Korea with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Korea will pursue for the period of this stand-by arrangement.

To support these objectives and policies the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For a period of three years from December 4, 1997, Korea will have the right to make purchases from the Fund in an amount equivalent to SDR 15,500 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. (a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 4,100 million until December 18, 1997, the equivalent of SDR 6,700 million until January 8, 1998, the equivalent of SDR 8,200 million until February 15, 1998, the equivalent of SDR 10,800 million until May 15, 1998, the equivalent of SDR 12,600 million until August 15, 1998, the equivalent of SDR 13,325 million until November 15, 1998, the equivalent of SDR 14,050 million until February 15, 1999, the equivalent of SDR 14,231.25 million until May 15, 1999, the equivalent of SDR 14,412.5 million until August 15, 1999, the equivalent of SDR 14,593.75 million until November 15, 1999, the equivalent of SDR 14,775 million until February 15, 2000, the equivalent of SDR 14,956.25 million until May 15, 2000, the equivalent of SDR 15,137.5 million until August 15, 2000, and the equivalent of SDR 15,318.75 million until November 15, 2000.

(b) None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Korea's currency subject to repurchase beyond 25 percent of quota.

3. Korea will not make purchases under this stand-by arrangement that would increase the Fund's holdings of Korea's currency subject to repurchase beyond 25 percent of quota:

(a) during any period in which the data at the end of the preceding period indicate that

(i) the limit on the net domestic assets of the Bank of Korea described in Annex A to the Memorandum, or

(ii) the floor on the minimum level of net international reserves of the Bank of Korea described in Annex B to the Memorandum

is not observed; or

(b) if, at any time prior to the completion of the second review specified in the Letter, the interest rate charged by the Bank of Korea on foreign exchange injections to Korean commercial banks or their overseas branches specified in Annex D of the Memorandum does not exceed the floor set forth in such Annex; or

(c) if, at any time during the period of the arrangement, the Korean authorities accumulate external payments arrears; or

(d) after December 17, 1997, January 7, 1998, February 14, 1998, May 14, 1998, August 14, 1998, November 14, 1998, February 14, 1999, August 14, 1999, February 14, 2000, and August 14, 2000, until the respective reviews contemplated in the Letter have been completed; or

(e) if, at any time during the period of the stand-by arrangement, Korea

(i) imposes or intensifies restrictions on the making of payments and transfers for current international transactions; or

(ii) introduces or modifies multiple currency practices; or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII; or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Korea is prevented from purchasing under this stand-by arrangement because of this paragraph 3, purchases will be resumed only after consultation has taken place between the Fund and Korea and understandings have been reached regarding the circumstances in which such purchases can be resumed.

4. Korea will not make purchases under this stand-by arrangement during any period in which Korea has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation (a) in respect of a noncomplying purchase pursuant to Decision No. 7842-(84/165) on the Guidelines on Corrective Action, (b) in respect of a purchase in support of debt and debt service reduction operations pursuant to Decision No. 9331-(89/167), as amended, (c) pursuant to subparagraph 16(a) or 33(a) of Decision No. 8955-(88/126), as amended, on the Compensatory and Contingency Financing Facility, or (d) pursuant to section 2, paragraph (f) of the Guidelines for Fund Support for Currency Stabilization Funds.

5. Korea's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Korea. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Korea and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, unless, at the request of Korea, the Fund agrees to provide SDRs at the time of the purchase.

7. Korea shall pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

8. (a) Korea shall repurchase the amount of its currency that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Korea's balance of payments and reserve position improves.

(b) Any reductions in Korea's currency held by the Fund shall reduce the amounts subject to repurchase under this paragraph in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

9. During the period of the stand-by arrangement, Korea shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Korea or of representatives of Korea to the Fund. Korea shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Korea in achieving the objectives and policies set forth in the Letter and Memorandum.

10. In accordance with the Letter, Korea will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the government or whenever the Managing Director requests consultation because any of the criteria in paragraph 3 above have not been observed or because the Managing Director considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Korea has outstanding purchases in the upper credit trenches, the government will consult with the Fund from time to time, at the initiative of the government or at the request of the Managing Director, concerning Korea's balance of payments policies.

Seoul, Korea
December 3, 1997

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Camdessus:

1. The attached Memorandum on the Economic Program outlines the policies that Korea intends to implement over the next three years to address the fundamental causes of its current financial difficulties, thereby restoring and sustaining market confidence and returning the economy to a path of strong sustainable growth. In support of this program, Korea hereby requests a three-year stand-by arrangement from the International Monetary Fund in an amount equivalent to SDR 15.5 billion.

2. As the circumstances did not permit a full specification of the program, the government has implemented strong prior actions to demonstrate its seriousness to strictly implement its policy commitments. A full specification of the program will be put together with the assistance of an IMF team. The program will be reviewed by the Executive Board in December 1997 and January 1998. The latter review will expand the scope of performance criteria, set performance criteria for March and June 1998, and set structural benchmarks. The main focus of the four additional quarterly reviews (in February, April, July, and November) during the first year of the program will also be determined at that time. The review under the emergency procedures will be combined with the review under the arrangement in January 1998. There will be semi-annual reviews in 1999 and 2000.

3. We believe that the policies outlined in the attached Memorandum will serve to quickly restore market confidence. We are putting in place a comprehensive policy package to deal with insolvent and weakened financial institutions, to further liberalize the Korean economy, and to improve corporate governance. These reforms will be supported by prudent monetary and fiscal policies.

4. Accordingly, in the event the situation stabilizes, as we expect it will, Korea intends to forego some of the subsequent purchases and make advance repurchases as soon as conditions permit. Furthermore, the Korean authorities are aware that a new facility, called for at the Manila summit of Asian Finance and Central Bank Deputies, on November 19, for the provision of short-term financing to augment a stand-by arrangement, is being prepared for consideration by the Executive Board of the International Monetary Fund. As soon as such a facility becomes available to members, Korea intends to request that its stand-by arrangement be amended so as to permit the associated resources remaining to be purchased to come both

from the credit tranches and from the facility, in a manner consistent with the purposes and modalities of the facility.

5. The Korean government is firmly committed to implement the policies outlined in the attached memorandum and will ensure that the policies are adequate to achieve the objectives of the program. The Korean government remains firmly committed to take any additional measures that may be necessary for this purpose. During the period of the proposed stand-by arrangement and thereafter, Korea will consult with the Managing Director of the Fund on the adoption of any measures that may be appropriate, at the initiative of either the Korean authorities or the Managing Director, in accordance with the Fund's policies on such consultations. We will also provide the Fund with such information that it requests on the progress made in policy implementation and achievement of program objectives.

Yours sincerely,

/s/
Kyung-shik Lee
Governor
Bank of Korea

/s/
Chang-Yuel Lim
Deputy Prime Minister and
Minister of Finance and Economy

Attachment

Seoul, Korea
December 3, 1997

## Korea—Memorandum on the Economic Program

### I. BACKGROUND

1. For the past several decades, prudent macroeconomic policies and continuing structural reforms have propelled Korea along a path of rapid economic development. With per capita GDP rising at an annual average rate of nearly 7 percent, the once poor agrarian economy has been transformed into an advanced industrial economy. At the same time, in the process of development, the limitations of Korea's system of detailed government intervention at the micro level have become increasingly apparent. In particular, the legacy of government intervention has left an inefficient financial sector and a highly leveraged corporate sector that lack effective market discipline.

2. In recent years, the government has implemented structural reforms in a wide range of areas, particularly the financial sector. However, the present financial crisis demonstrates that a more comprehensive and rapid pace of reforms is required to achieve a strong and transparent financial system which operates free of political interference and according to the rules and practices of the advanced industrial countries. Such a financial system is essential for the Korean economy to meet the challenges of globalization and return to a path of rapid sustained growth.

3. Until the present financial crisis, macroeconomic performance in Korea was broadly favorable. During the first three quarters of 1997, real GDP grew by about 6 percent and consumer price inflation declined slightly to 4 percent, while the external current account deficit is expected to narrow to less than 3 percent of GDP in 1997. Fiscal policy has remained prudent, with the budget for 1997 projected to record a small deficit. The monetary aggregate (MCT) has edged down to the bottom of its target range in line with the inflation objective.

4. However, since the beginning of the year, an unprecedented number of highly leveraged conglomerates (chaebols) have moved into bankruptcy. The high rate of bankruptcies reflected a number of factors, including excessive investment in certain sectors, weakening export prices, and the government's greater willingness to allow troubled chaebols to fail. The bankruptcies spilled over into a sharp increase in nonperforming loans (defined according to international standards) to W 32 trillion (7 percent of GDP) by end-September, about double their level at end-1996.

5. The present difficulties in the financial sector stem from a lack of market orientation in financial institutions combined with lax prudential supervision. Financial institutions have priced risks poorly and have been willing to finance an excessively large portion of investment plans of the corporate sector, resulting in high leveraging. At the same time, the dramatic

decline in stock prices has cut the value of banks' equity and further reduced their net worth. These developments have led to successive downgrades of Korean financial institutions by international credit rating agencies and a sharp tightening in the availability of external finance.

6. Korea's external financing situation deteriorated sharply after October 23, following the decline in the Hong Kong stock market and the downgrading of Korea's sovereign risk status by Standard and Poor's. New external financing has virtually dried up and substantial difficulties are being experienced in rolling over the relatively large amount of short-term debt (estimated at $100 billion).[1] The won depreciated by about 20 percent against the U.S. dollar through November 30; the stock market index fell by some 30 percent to a ten-year low. Gross official reserves declined sharply, with a large amount used to finance the repayment of short-term debt of Korean commercial banks' offshore branches. While the contagion effects of developments in Southeast Asia contributed to the current crisis, the magnitude and speed of the deterioration in the financial situation owed much to the fundamental weaknesses in Korea's financial and corporate sectors.

## II. THE POLICY FRAMEWORK

7. The government has put in place a comprehensive policy package to address decisively and promptly the structural weaknesses that are at the root cause of the present difficulties so as to restore market confidence and arrest the decline of the won. Tighter monetary and fiscal policies will provide the macroeconomic conditions to support comprehensive structural reforms.

8. The government's economic program is built around: (i) a strong macroeconomic framework designed to continue the orderly adjustment in the external current account and contain inflationary pressures, involving a tighter monetary stance and substantial fiscal adjustment; (ii) a comprehensive strategy to restructure and recapitalize the financial sector, and make it more transparent, market-oriented, better supervised and free from political interference in business decisions; (iii) measures to improve corporate governance; (iv) accelerated liberalization of capital account transactions; (v) further trade liberalization; and (vi) improve the transparency and timely reporting of economic data.

9. The principal macroeconomic objectives of the program include: building the conditions for an early return of confidence so as to limit the deceleration of real GDP to about 3 percent in 1998 followed by a recovery toward potential in 1999; containing inflation at or below 5 percent; and building international reserves to more than two months of imports by 1998.

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[1]At end September 1997, including debt contracted by residents, nonresident branches and affiliates of domestic financial institutions, and offshore banking debt contracted by domestic banks.

## A. Macroeconomic Policies

**Monetary policy and exchange rate policy**

10. The main objective of monetary policy is to contain inflation to 5 percent in 1998 and limit downward pressure on the won. To demonstrate to markets the government's resolve to confront the present crisis, monetary policy will be tightened immediately to restore and sustain calm in the markets and contain the inflationary impact of the recent won depreciation. In line with this policy, the large liquidity injection in recent weeks will be reversed, and money market rates[2] will be allowed to rise sufficiently and will be maintained at that level or higher as needed to stabilize markets.

11. The day-to-day conduct of monetary policy will be guided by movements in the exchange rate and short-term interest rates which will be used as indicators of the tightness of monetary conditions. A flexible exchange rate policy will be maintained, with intervention limited to smoothing operations. Monetary and exchange rate policy will be implemented in close consultation with the staff.

12. The inflation target reflects a very limited pass-through of the recent depreciation of the won to the aggregate price level. Financial restructuring and the sharp slowdown in economic growth are expected to reduce the demand for money. Hence, in order to achieve the inflation objective, the government will aim to reduce broad money growth (M3) from an estimated 16.4 percent at end-September 1997 to 15.4 percent at end-December 1997, and to a rate consistent with the inflation objective in 1998. This deceleration will be achieved by reducing the limits on reserve money. Open market operations will be used to contain the expansion of the net domestic assets of the Bank of Korea within the program limits.

## B. Fiscal Policy

13. Fiscal policy in Korea has traditionally been formulated prudently, and in recent years the consolidated central government budget has been in broad balance, with government savings of around 8 percent of GDP and a low level of public debt. For 1998, a tight fiscal policy will be maintained to alleviate the burden on monetary policy and to provide for the still uncertain costs of restructuring the financial sector. The 1998 budget of the consolidated central government provided for a small surplus (¼ percent of GDP). However, the slowdown in growth is projected to worsen the 1998 balance by about 0.8 percent of GDP. In addition, the interest costs of financial sector restructuring are presently estimated at 0.8 percent of GDP. Offsetting measures amounting to about 1½ percent of GDP will be taken to achieve at a minimum budget balance and, preferably, a small surplus.

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[2]Call rate, 91-day CD, and three-year corporate bond rates.

14. The program's targeted fiscal adjustment would be achieved with measures on both revenues and expenditures. Upfront fiscal action comprising an increase in the transportation tax and the special excise tax has already been taken to demonstrate the government's commitment to implement the program strictly. Other measures on the revenue side are likely to include widening the basis of the corporate tax, income tax, and the VAT. On the expenditure side, specific plans will be formulated to reduce current expenditures and net lending, and to reduce low priority capital expenditure.

## C. Financial Sector Restructuring

15. The centerpiece of the program is a comprehensive restructuring and reform plan for the financial sector. The government recognizes that left uncorrected, problems in a limited number of financial institutions could affect the health of the entire system and undermine confidence in Korea's financial system. Therefore, the government is taking bold and decisive action to address the problem of troubled financial institutions and to open the financial sector to foreign investment. Prompt action will also be taken to enact the necessary legislation to set up a strong and independent supervisory agency, strengthen and consolidate prudential supervision, and increase transparency. This will be followed by time-bound action plans for the orderly exit of nonviable institutions as well as for procedures and policies to deal with weak, but viable financial institutions, and measures to improve the commercial orientation and risk management of the financial sector.

16. Shortly following the Presidential elections in December, a special session of the National Assembly will be called to pass the following financial sector reform bills:

- A revised Bank of Korea Act, which provides for central bank independence, with price stability as its main mandate.

- A bill to consolidate supervision of all banks (including specialized banks), merchant banks, securities firms, and insurance companies in an agency with operational and financial autonomy, and with all powers needed to deal effectively with troubled financial institutions.

- A bill requiring that corporate financial statements be prepared on a consolidated basis and be certified by external auditors.

17. Troubled financial institutions will be restructured and recapitalized within a specified time frame and according to a transparent and well coordinated strategy. A credible and clearly defined exit strategy will involve requiring troubled institutions to present a viable rehabilitation plan, and closing of insolvent financial institutions and those failing to carry out their rehabilitation plans within specified periods. Restructuring could also involve mergers and acquisitions by domestic and foreign institutions, provided the viability of the new groupings is assured. Clear principles on sharing of losses among equity holders and creditors will be established. A timetable will be set for all banks to meet or exceed Basle standards.

The disposal of nonperforming loans will be accelerated. All forms of assistance to banks, including through the Korean Asset Management Corporation (KAMC) and the deposit insurance funds will be provided only as part of viable rehabilitation plans. All support to financial institutions, other than Bank of Korea liquidity credits, will be recorded transparently in the fiscal accounts. Market-oriented terms and conditions will be established for any support to financial institutions. In addition, the present blanket guarantees will be phased out and replaced by a limited deposit insurance scheme.

18. The operations of nine technically insolvent merchant banks were suspended on December 2, 1997 with depositors fully protected. These banks' foreign exchange operations will be transferred to other institutions. The consolidated deposit insurance corporation, to be created after the National Assembly passes the necessary legislation before the end of the year, will issue bonds to provide the funds to meet the deposit insurance obligations. The government will guarantee these bonds and bear the interest costs.

19. The government announced its plans to propose an amendment of the related laws to the first session of the National Assembly immediately after the elections, to allow foreign financial institutions to participate in mergers and acquisition of domestic financial institutions in a friendly manner and on equal principle. For merchant banks, foreign participation is allowed up to 100 percent.

20. The government began a first round of cleaning up the financial sector by implementing the following measures:

21. The nine merchant banks were immediately placed under the control of the MOFE and have been required to submit a rehabilitation plan within 30 days. If the MOFE fails to approve such plans, the institution will have its license revoked. Without approved rehabilitation plans, these banks will not be eligible to participate in the KAMC program of bad asset purchases or receive any financing from the deposit insurance fund. Until the rehabilitation plan has been approved, the control officer appointed by the MOFE will cease lending by the institution to any new borrowers (including interbank lending), permit no increase in the institution's off balance sheet exposure (i.e., extension of guarantees), and prohibit the purchase of any securities other than those guaranteed by the government. The control officer may continue to allow limited additional lending to existing borrowers on a case-by-case basis. Rehabilitation will be monitored in close consultation with the Fund. If the head of the supervisory authority concludes that rehabilitation has not been successful within three months, the institution will be closed.

22. Remaining merchant banks are required to present a program of recapitalization/ downsizing by December 31, 1997 that will allow them to meet at least a 4 percent capital requirement ratio by March 31, 1998, 6 percent by June 30, 1998, and 8 percent by June 1999. Those ratios would be computed after applying the provisioning requirements set for

commercial banks. Failure to obtain supervisory approval of the program or to meet the schedule will lead to suspension of foreign exchange business and could lead to revocation of license.

23. Two commercial banks in distress are required to prepare a plan, in about two months, to meet the Basle capital standards within four months after approval of the plan. Until that plan has been approved by the supervisory authorities, these banks will be subject to the intensive supervision by the supervisory authorities. That plan could initially include merger with another financial institution or disposal of some or all of their banking business, to restore their profitability to an acceptable level and meet the minimum solvency requirements set by the supervisory authorities. Rehabilitation will be closely monitored in cooperation with the Fund. If the head of the supervisory authority concludes that rehabilitation has not been successful within four months, the institution will be closed.

24. Other commercial banks are required to make full provisioning for their impaired assets and for their securities losses by end-March 1998. They will agree a timetable with the supervisory authority by June 1998 to achieve current minimum capital standards within a time frame of six months to two years. The program will include a precise implementation schedule. Until such recapitalization is achieved, they will be prevented from distributing dividends, their senior management remuneration will be frozen, and significant expansions of their operations will be subject to prior approval of the supervisory authorities.

25. The rehabilitation plans submitted to supervisory authorities by financial institutions will specify the sources and amounts of new capital, a clear schedule to meet Basle capital adequacy standards and provisioning requirements, and confirmation from the supplier of funds; indicate changes in management and ownership if that is the intention; present a business plan that defines the activities on which the institution will concentrate and those that it will desist from, and set out measures to reduce costs; and detailed steps to improve internal governance, risk assessment and pricing, and loan recovery. When and if the plan is approved by the relevant supervisory authority, the institution will enter into a managerial contract or memorandum of understanding, which will include a schedule for implementation. In case an institution's plan is rejected by the supervisory authority as not credible, or is not implemented as agreed, the institution will be taken under the direct control of the supervisory authority until final disposition of its business.

26. In consultation with the Fund, the government will prepare a comprehensive action program to strengthen financial supervision and regulation in accordance with international best practice standards. To carry out this program the government will seek technical assistance from the Fund and other international institutions. The government will consult with the Fund regarding progress in implementing this action program at the time of review in mid-1998.

27. Specialized banks and development institutions are to be subject to the same prudential standards that apply to commercial banks, and their financial statements are to be subject to external audits under the same rules applicable to other financial institutions.

28. The government is convinced of the need not only to address the immediate problems of the financial system, but more fundamentally to set the basis for a strong domestic financial system. To do this, efforts will be made to increase market discipline, strengthen prudential supervision, and regulation in accordance with international best practice standards, increase the manpower needed for effective supervision, and strengthen the legal framework. Accounting standards and disclosure rules will be strengthened according to institutional best practices. Financial statements of large financial institutions will be audited by internationally recognized firms. Prudential standards will be upgraded to meet Basle core principles. Financial institutions will be encouraged to refine their risk assessment and pricing procedures, and to strengthen loan recovery; actions in these areas will be reviewed as part of prudential supervision.

29. Borrowing and lending activities of overseas branches of Korean banks will be closely monitored to ensure that they are sound. New injections of foreign exchange by the Bank of Korea to Korean commercial banks or their overseas' branches will carry a penalty rate of 400 basis points above LIBOR. This penalty rate will be periodically reviewed. The Bank of Korea's deposits with nonresident branches and affiliates of domestic financial institutions will not be increased after end-December 1997 but will be gradually reduced as soon as circumstances permit. Moreover, Bank of Korea's international reserves management practices will be reviewed with the aim of bringing them in line with international best practices.

## D. Other Structural Measures

### Trade liberalization

30. The government has undertaken substantial trade liberalization since the early 1980s which has resulted in the removal of quantitative restrictions on all but a few items and lowered the average tariff rate on manufactured goods to around 6 percent. Nevertheless, further liberalization will help enhance domestic competition. At the time of the first full review, a timetable will be set in line with WTO commitments to eliminate trade-related subsidies, restrictive import licensing and the import diversification program. Steps will also be taken to streamline and improve the transparency of the import certification procedures.

**Capital account liberalization**

31. To increase competition and efficiency in the financial system, the schedule for allowing foreign entry into the domestic financial sector will be accelerated. Foreign financial institutions will be allowed to participate in mergers and acquisitions of domestic financial institutions in a friendly manner and on equal principles. By mid-1998, foreign financial institutions will be allowed to establish bank subsidiaries and brokerage houses. Effective immediately foreign banks' will be allowed to purchase equity in domestic banks without restriction, provided that the acquisitions contribute to the efficiency and soundness of the banking sector. Legislation will be submitted to the first special session of the National Assembly to harmonize the Korean regime on equity purchases with OECD practices.

32. The government plans to accelerate substantially its ongoing capital account liberalization program. The government has announced that the ceiling on aggregate foreigners' ownership of listed Korean shares would be increased from 26 percent to 50 percent by end-1997 and to 55 percent by end-1998. The ceiling on individual foreign ownership will be increased from 7 percent to 50 percent by end-1997 (excluding hostile takeovers). Legislation concerning hostile takeovers will be submitted to the first special session of the National Assembly to harmonize Korean legislation on abuse of dominant positions in line with other industrial countries' standards. By end-February 1998, the present timetable for capital account liberalization will be accelerated by taking steps to liberalize other capital account transactions, including those restricting foreigners' access to domestic money market instruments and the corporate bond markets, and by further reducing restrictions on foreign direct investment by simplifying approval procedures.

33. The traditional policy of channeling international borrowing through domestic financial institutions for onlending to the corporate sector rather than allowing or encouraging the corporate sector to borrow directly on international capital markets has served to make the financial system more vulnerable to changes in general conditions in international capital markets and shifts in international investor sentiment regarding Korea. Moreover, the guarantees extended by the government to the financial sector have, in effect, made much of Korea's external borrowing a contingent liability of the government. Therefore, a timetable will be set by end-February 1998 to eliminate restrictions on foreign borrowing by corporations.

**Corporate governance and corporate structure**

34. The government recognizes the need to improve corporate governance and the corporate structure. Toward that end, transparency of corporate balance sheets (including profit and loss accounts) will be improved by enforcing accounting standards in line with generally accepted accounting practices, including through independent external audits, full disclosure, and provision of consolidated statements for business conglomerates. The commercial orientation of bank lending will be fully respected and the government will not intervene in bank management and lending decisions (except for prudential regulations).

Directed lending will be eliminated immediately. While policy lending (e.g., agriculture, small business, etc.) will be maintained, the interest subsidy will be borne by the budget.

35. To strengthen market discipline, bankruptcy provisions according to Korean law will be allowed to operate without government interference. No government subsidized support or tax privileges will be provided to bail out individual corporations.

36. To ensure the transparency of financial transactions and reduce scope for corruption, the "real name" system in financial transactions will be maintained, although with some possible revisions.

37. With the assistance of international and regional multilateral financial organizations, a plan will be formulated by late 1998 to encourage the restructuring of corporate finances, including measures to reduce the high debt to equity ratio of corporations, develop capital markets to reduce the share of bank financing by corporations, and change the system of cross guarantees within conglomerates. These will be reviewed in the first full review.

**Labor market reform**

38. The capacity of the new Employment Insurance system will be strengthened to facilitate the redeployment of labor, in parallel with further steps to improve labor market flexibility.

**Information provision and program monitoring**

39. To improve transparency and allow market participants to make informed assessment of economic developments, the publication and dissemination of key economic data will be improved. Beginning January 1, 1998, data on foreign exchange reserves, including the composition of reserves and net forward position will be published monthly with a two weeks delay initially, and data on financial institutions, including nonperforming loans, capital adequacy, and ownership structures and affiliations will be published twice yearly. Data on short-term external debt will be published quarterly. Efforts will also be made to improve the timeliness of data on local government finances, and progress in this area will be reviewed in mid-1998. In addition, by end-March 1998, Korea will post its meta data on the Fund's Special Data Dissemination Standards.

40. During the period of the arrangement, the government will not accumulate any new external payments arrears, and will not impose new or intensify existing restrictions on payments and transfers for current international transactions, or introduce or modify multiple currency practices, or conclude bilateral payments agreements that are inconsistent with Article VIII of the Fund's Articles of Agreement, or impose new or intensify existing import restrictions for balance of payments reasons.

41. The following quarterly quantitative performance criteria will be set to monitor progress under the program: (i) a ceiling on net domestic assets of the Bank of Korea and (ii) a floor on net international reserves of the Bank of Korea. There will also be an indicative floor on the consolidated central government budget surplus on a cash basis (including the carrying cost of financial sector support). These quantitative performance criteria, indicative targets, and precise definitions of quantitative variables monitored under the program are set out in attached Annexes A-C. Other performance criteria and benchmarks are given in Annexes D and E. There will be two biweekly reviews in December 1997 and January 1998 and four full quarterly reviews under the arrangement during the first year in February, April, July, and November 1998.

42. To ensure effective program monitoring, the government will request the opening of a resident representative office of the IMF in Seoul.

ANNEX A

**Monetary Sector**

| Outstanding stock as of: | Limit (In trillions of won) |
|---|---|
| Net domestic assets 1/ | |
| End-September 1997 | 1,721 |
| End-December 1997 (performance criterion) | 10,950 |
| Reserve money | |
| End-September 1997 (actual) | 22,275 |
| End-December 1997 (indicative limit) | 23,270 |
| Broad money (M3) | |
| End-September 1997 (projected) | 688,760 |
| End-December 1997 (indicative limit) | 709,775 |

1/ Net domestic assets is defined as the difference between reserve money and the won equivalent (converted at program exchange rates) of net adjusted international reserves as defined in the program.

Reserve money is defined as the bank notes and coins issued plus reserve deposits of domestic money banks.

M3 is defined as M2 plus deposits of other financial institutions, debentures issued, commercial bills sold, "deposits of credit unions", mutual credits of the National Federation of Fisheries, "Community Credit Cooperatives", Mutual Savings and Finance Cooperatives situated in local and reserve life insurance company, certificates of deposit, repurchase agreements, and cover bills. M2 is defined as currency in circulation, plus deposit money (demand deposits at monetary institutions, time and savings deposits, and resident's foreign currency deposits at monetary institutions.)

The ceiling on net domestic assets and the indicative limit on reserve money will be increased (decreased) for any increase (decrease) in required reserve ratios.

ANNEX B

**Net International Reserves of the Bank of Korea (BOK)**

| | Floor (In billions of U.S. dollars) |
|---|---|
| End-September 1997 (actual) | 21.1 |
| End-December 1997 (performance criterion) | 11.2 |

For monitoring purposes, net international reserves of Bank of Korea (NIR) is defined as the sum of (i) the U.S. dollar value of gross foreign assets in foreign currencies minus gross liabilities in foreign currencies, and (ii) reserves against foreign currency deposits.

Gross foreign assets will include all foreign currency-denominated claims of BOK, including monetary gold, holdings of SDRs, and the reserve position in the IMF. Excluded from gross foreign assets will be participation in international financial institutions, as well as holdings of nonconvertible currencies, claims on residents, and deposits of the BOK at overseas branches and subsidiaries of Korean banks. Gross foreign liabilities are all foreign currency denominated liabilities of contracted maturity up to and including one year plus the use of Fund credit. All assets and liabilities will be valued at program exchange rates.

The net forward position is defined as the difference between the face value of foreign currency-denominated BOK off-balance sheet (forwards, swaps, options, and any futures market contracts) claims on nonresidents and foreign currency obligations to both residents and nonresidents.

The floor on NIR will be adjusted:

(i) downward by the U.S. dollar equivalent (converted at the program exchange rate) of the increase in foreign liabilities of the BOK associated with the emergency financing package.

(ii) upward by the amount of financing under the emergency financing package in excess of the program baseline (and downward by any shortfall).

(iii) upward by the amount by which deposits of the BOK at overseas branches and subsidiaries of domestic financial institutions are below the baseline specified in the program.

(iv) upward for any increase in the net forward position over the end-November position of US$6.2 billion.

ANNEX C

**The Consolidated Central Government Balance**

| | Limit (In trillions of won) |
|---|---|
| Balance for 1997 (indicative floor) | -2.0 |

The consolidated central government balance is defined as the consolidated balance of the central government (comprising the general accounts, and the special budgetary funds) and the public enterprises special accounts. The balance is the difference between total revenues and the sum of total expenditures and net lending. Expenditures include all interest costs associated with the restructuring of the financial sector borne by the public sector (including monetary authorities and public banks).

ANNEX D

**Interest rate on foreign exchange injections by the Bank of Korea to Korean commercial banks or their overseas branches**

Through the period to the completion of the second biweekly review, the interest rate charged by the Bank of Korea on foreign exchange injections to Korean commercial banks or their overseas branches shall not be below 400 basis points above LIBOR. This will be a performance criterion.

This floor shall be reviewed at the time of the second biweekly review of the program and a new performance criterion may be set for the period after January 8, 1998.

ANNEX E

## Reviews

All reviews will examine developments under the program, particularly (bot not exclusively) in the monetary and foreign exchange areas, and whether the program is on track to achieve its objectives, as well as compliance with any applicable performance criteria.

In addition, the following benchmarks have been set:[1]

a. **First biweekly review** (to be completed on or about December 18, 1997)

- Compliance with understandings between the Korean authorities and the Fund regarding the implementation of interest rate policy.

b. **Second biweekly review** (to be completed on or about January 8, 1998)

- Call a special session of the National Assembly shortly following the Presidential elections in December to pass the following reform bills: a revised Bank of Korea Act that provides for central bank independence, with price stability as its main mandate; a bill to consolidate bank supervision; and a bill requiring that corporate financial statements be prepared on a consolidated basis and be certified by external auditors (as discussed in paragraph 16 of the Memorandum on the Economic Program).

- Submit legislation to the first special session of the National Assembly to harmonize the Korean regime on equity purchases with OECD practices.

- Submit legislation concerning hostile takeovers to harmonize Korean legislation on abuse of dominant positions in line with industrial countries' standards.

- Publication of foreign reserve data.

- The Bank of Korea's deposits with nonresident branches and affiliates of domestic financial institutions will not be increased after end-December 1997.

[1]Additional benchmarks will be added at the time of reviews, for subsequent reviews.