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Minutes of Executive Board Meeting 12/82-3

11:35 a.m., August 27, 2012

**3. Republic of Korea—2012 Article IV Consultation**

Documents: SM/12/206 and Correction 1, and Correction 2, and Correction 3, and Supplement 1; SM/12/219 and Correction 1

Staff: Khor and Rumbaugh, APD; Arora, SPR

Length: 47 minutes

**Executive Board Attendance**

D. Lipton, Acting Chair

| Executive Directors | Alternate Executive Directors |
|---|---|
| M. Majoro (AE) | |
| | A. Tall (AF), Temporary |
| | V. De la Barra (AG), Temporary |
| | H. Lee (AU) |
| | J. Prader (BE) |
| | M. Arbelaez (BR) |
| | P. Sun (CC) |
| | J. Cova (CE), Temporary |
| | J. Rolle (CO), Temporary |
| | A. Terracol (FF) |
| | S. Meyer (GR) |
| | K. Eapen (IN), Temporary |
| A. Sadun (IT) | |
| | M. Nomura (JA), Temporary |
| | A. Jbili (MD), Temporary |
| A. S. Shaalan (MI) | |
| | Y. Yakusha (NE) |
| B. Andersen (NO) | |
| A. Mozhin (RU) | |
| | F. Alshathri (SA) |
| D. J. Chia (ST) | |
| | K. Sazanov (SZ), Temporary |
| M. Lundsager (UA) | |
| | R. Elder (UK) |

L. Hubloue, Acting Secretary
O. Vongthieres, Summing Up Officer
D. Daly, Board Operations Officer
M. Yslas, Verbatim Reporting Officer

**Also Present**
Asia and Pacific Department: L. Breuer Mojoli, H. Khor, J. Ree, T. Rumbaugh, A. Singh. Monetary and Capital Markets Department: A. Bibolov, S. Iorgova. Strategy, Policy, and Review Department: V. Arora. Executive Director: M. Saho (AE). Alternate Executive Director: T. Shimoda (JA). Senior Advisors to Executive Directors: S. Benk (EC), A. Gerdes (GR), K. Korhonen (NO), T. Reeve (UA), B. Saidy (AE), A. Tolstikov (RU). Advisors to Executive Directors: C. de Resende (CO), C. Fookes (AU), M. Hadzi-Vaskov (NE), M. Perks (UK), D. Vogel (AG), S. Lee (AU), V. Robergeau (BR), J. Szeto (CC), G. Leost (FF).

## 3. REPUBLIC OF KOREA—2012 ARTICLE IV CONSULTATION

The staff representatives from the Asia and Pacific Department submitted the following statement:

> This statement provides additional information that has become available since the circulation of the staff report (SM/12/206, 7/31/12). This information does not change the thrust of the staff appraisal.
>
> Recently released data reinforce the assessment in the staff report that there remain downside risks to the baseline growth projections. External weaknesses have continued to drag down Korea's exports. July trade data show that exports declined by 8.8 percent year-on-year after rising by 1 percent in June, driven by falling exports to China and the European Union. Imports also showed weakness, contracting by 5.4 percent year-on-year in July. Domestic demand indicators also softened in July as retail sales (at the discount chains) declined 8.2 percent year-on-year and domestic car sales fell 2.9 percent.
>
> Inflationary pressures have declined faster than previously anticipated. Headline inflation fell from 2.2 percent year-on-year in June 2012 to 1.5 percent in July, far below market consensus. However, inflation expectations have declined only slightly to 3.6 percent in July 2012, remaining above the central inflation target. As mentioned in the staff report, normalization of the policy rate should resume once the output gap starts to close and this may now happen somewhat later in 2013 than previously expected.
>
> Consistent with the authorities' plan to achieve a "soft landing," the growth of household debt has continued to moderate. Household debt grew by 5.6 percent year-on-year in the second quarter of 2012, slowing from 7 percent in Q1. Even though the growth of household debt has been on a declining path since Q2 2011, the still elevated level of debt remains a concern.
>
> The government announced an average increase in the electricity tariff of 4.9 percent on August 3. The ministry commented that while an increase of more than 10 percent is warranted by the increase in the price of fuel used for power generation, this year's price increase has been restrained by the need to minimize the burden on households and the negative impact on firms, in the face of difficult economic times.

Mr. H. Lee and Mr. Choi submitted the following statement:

We would like to thank staff for a well-written set of papers. Our authorities appreciate the constructive discussions and policy engagement with the Fund. We consider the staff's recommendations as broadly aligned with the authorities' policy stance and directions.

The Korean economy has grown at a slower pace recently, reflecting the intensification of global economic weaknesses, while inflation has stabilized below 2 percent, and job creation has remained strong. The biggest near-term risks to the outlook are spillovers from the euro area crisis and slowdown in Korea's neighboring trading partners. The authorities will manage risks to growth through appropriate monetary policy and full implementation of the budget, while still preserving price stability and fiscal sustainability objectives. In the event of the materialization of a downside scenario, the authorities are prepared to use their ample policy space to respond, particularly on the fiscal side. Over the long term, enhancing social inclusiveness and potential growth, along with addressing population aging, should remain as immediate policy priorities for the authorities.

Recent Developments and Outlook

Real GDP increased just 0.4 percent (advance estimate) quarter-on-quarter in Q2 2012, compared to 0.9 percent in the previous quarter, as headwinds from Europe's debt crisis weakened export demand and machinery investment. The staff's projection of growth at 3 percent for 2012 remains in line with the authorities' forecast.

CPI inflation has continued on its downward trajectory, from 4.2 percent year-on-year in December 2011, to 1.5 percent in July 2012 due in large to stabilization in the prices of agricultural products and oil, as well as the expanded provision of free child care. Core inflation and inflation expectations have also moderated to 1.2 percent and 3.6 percent year-on-year in July, respectively.

Employment increased by 1.8 percent year-on-year in the first seven months of 2012, above the pre-crisis rate of about 1.3 percent year-on-year, leading to an unemployment rate as low as 3.1 percent in July, down from the previous peak of 5 percent in January 2010. Significantly strong job creation is expected to partly offset the negative impact from external shocks on private consumption and debt servicing capacity of low-income households.

As export growth has stagnated since the last quarter of 2011 due to the cooling of global demand, the current account surplus, as a share of GDP, is expected to decline from 4 percent in 2011 to about 1.6 percent in 2012. The authorities agree with the staff's projection that the current account surplus will narrow further to roughly 1 percent of GDP in the medium term.

Fiscal Policy

A history of fiscal prudence allowed Korea to respond resolutely to the 2008 global financial crisis. The consolidated central government budget deficit, excluding social security surplus, recorded 1.1 percent of GDP in 2011, and it is expected to scale down further in 2012. Our authorities are committed to meeting fiscal consolidation targets, envisaged in the five-year National Fiscal Management Plan (NFMP), including the achievement of a balanced budget in 2013 by limiting expenditure growth, broadening the tax base, and reducing tax expenditures. The public debt-to-GDP ratio peaked at 33 percent in 2011, and it is projected to decline to below 30 percent from 2013 onward. This strong fiscal footing will provide the economy with ample room for proactive policy response to future challenges, including population aging and potential reunification.

In the short term, our authorities are seeking to calibrate fiscal policy to support the slowing economy within the existing budget envelope by ensuring that the budget is fully implemented, and that expenditure of government-managed funds is increased with more flexibility than usual. However, if downside risks materialize in force, the authorities will be able to consider additional measures beyond automatic stabilizers in due course.

With regard to the risk of contingent liabilities of state-owned enterprises (SOEs), our authorities put in place a system to closely monitor and manage the risks related to borrowing by SOEs, including coverage expansion of precautionary feasibility assessment of SOE projects and introduction of medium-term financial management plans for large SOEs. Our authorities are also undertaking a gradual but steady approach to normalizing public utility tariffs to encourage public enterprises to operate on commercial bases. It was recently decided to increase the electricity tariff by 4.9 percent on average from September.

Korea's social spending currently stands at less than half of the OECD average. With rapidly aging population and an increasing demand for welfare, our authorities continue to strengthen social safety nets in a targeted manner, while we see scope for streamlining social security expenditures, particularly in healthcare and pension systems. Our authorities continue to attach their priority to improving labor productivity and preserving incentives to work in the process of increasing social spending.

Monetary Policy

The Monetary Policy Committee (MPC) of the Bank of Korea lowered their policy rate by 25 basis points to 3 percent in July 2012. The MPC had been maintaining the policy rate at 3.25 percent since June 2011.

The rate cut was based on the considerations of weaker than anticipated economic growth and intensified downside risks to growth, mainly due to a high degree of uncertainty surrounding the euro area crisis and potential unrest in international financial markets. The forecast that inflation would remain subdued for the time being had also been considered.

We appreciate the staff's view that the current monetary policy stance is appropriate given global weakness and heightened uncertainties. We believe that monetary policy is well tailored in light of the current disinflationary trend and a negative output gap that is expected to remain for a considerable time going forward. As staff rightly noted, the BOK still has room to cut rates further, in the event of a significant downside scenario. However, we also agree with the staff that the timely normalization of the policy rate would help rebuild policy space and enhance credibility of monetary policy.

The BOK is closely monitoring external risk factors and the consequent changes in financial and economic conditions at home and abroad, while also continuing its efforts to lower inflation expectations.

Financial Sector

The financial sector has remained resilient since the onset of the global financial crisis, with strong balance sheets: banks' capital is above regulatory minimum by a comfortable margin at 13.9 percent and the ratio of nonperforming loans remains low at 1.5 percent. The resilience has been improved in some parts by the restructuring of mutual savings banks (MSBs) that had suffered from high exposure to real estate project financing loans. The Financial Service Commission (FSC) decided to suspend the operations of 8 MSBs in early 2011, and after a sector-wide assessment the commission added additional 12 MSBs to the list in May 2012. The authorities are also taking measures, including the creation of a bad bank and the strengthening of MSB supervision.

The level of household debt has increased but remains manageable. As rightly pointed out by staff, measures taken by our authorities, including caps on loan-to-value (LTV) and debt-to-income (DTI) ratios, have succeeded in slowing down growth of household debt. The delinquency ratio of banking sector mortgage loans remains low, at 0.97 percent, as of May 2011, with 153.3 percent of loan loss provisioning ratio at the end of 2011. However, being mindful of the recent increase in lending by non-bank financial institutions (NBFIs), our authorities have announced measures to curb the trend, such as strengthening loan-loss provisioning standard for insurance companies and tightening credit card eligibility criteria for credit card companies.

As an effort to further enhance financial stability, the National Assembly made a revision to the BOK Act in August 2011 to stipulate that the BOK shall pay attention to financial stability in carrying out its monetary and credit policies. Also, to enhance policy coordination and information sharing among financial authorities, quarterly meetings are convened with five organizations: the Ministry of Strategy and Finance (MOSF), the Financial Services Commission (FSC), the Bank of Korea (BOK), the Financial Supervisory Service (FSS), and the Korea Deposit Insurance Corporation (KDIC).

External Sector

We are of the view that the flexibility of the Korean won continues to help absorb external shocks and promote balanced economic growth. The exchange rate has responded to heightened external risks, being under some depreciation pressure. International reserves in Korea are not deliberately accumulated, and the recent changes in reserves were the result of the interest income from investment or valuation effects.

As the staff report notes, external soundness of Korea has further improved due to the authorities' concerted efforts after global financial crisis. A series of macroprudential measures have been effective in diminishing the external vulnerability of the Korean financial system by reducing FX liquidity mismatches and capital flow volatility.

The results of recent stress tests indicate that the risk of FX liquidity shortages is manageable even in the event of sudden deterioration of the euro area crisis thanks to banks' higher FX liquidity buffer and reduced short-term foreign debt. Our authorities announced in July 2012 a three-phase plan to increase the retail FX funding (through savings accounts) in domestic banks by providing the banks with incentives of tax and bank-levy exemptions.

Our authorities still have reservation about the EBA methodology, in particular about controversial determination of the policy and current account “norms,” large margins of error, and undue consideration of country-specific circumstances. We look forward to the pilot ESR becoming much more refined before it is used in practice to enhance the relevance of the Fund surveillance and policy recommendations.

Structural Issues

Greater labor market flexibility, higher female participation, and greater productivity in service and SME sectors will be essential to enhancing potential growth and social inclusiveness. The issues of labor market dualism, low productivity in service and SME sectors, and income inequality are closely interlinked, requiring a comprehensive and structural approach underpinned by strong political support. Our authorities are advancing further labor market reforms, which include the reduction of employment protection for regular workers, and the promotion of the shift toward performance-based pay system, and the encouragement of flexible work hours. The continued authorities’ efforts to open up and deregulate the less competitive sectors will enable Korea to move up the value chain in today’s competitive global economy. As rightly noted in the staff report, the FTAs with the United States and the EU should encourage competition and help support productivity, particularly in the service and SME sectors.

There was good news in June that Korea became the seventh country in the world with over 50 million people among those having over US$20 thousand of per capita income. On the flipside, there must be a sense of urgency to tackle the problem of population aging and the slowing potential growth. Given the lowest fertility rate among OECD member countries, standing at the rate of 1.24 children per woman in 2011 despite slight improvement relative to the previous year, population aging is one of the longstanding challenges for Korea. The five-year master plan on preparations for the aging society (2011-15) includes comprehensive and strategic policy measures. In response to the low fertility rate and the high drop-out rate from labor force among women following childbirth, our authorities will continue to support a “family-friendly work environment,” particularly by increasing childcare services and easing the conditions for maternity leave.

We will also focus on strengthening vocational training and job matching system to expand opportunities for the young and the unemployed to secure productive employment. Continuous advancement in the access to quality education remains a priority to upgrade productivity across the economy and to promote inclusive growth.

Mr. Shaalan and Ms. Abdelati submitted the following statement:

Building on an impressive growth record in the past, the Korean authorities have taken steps to boost the resilience of the financial system and have reduced external vulnerabilities since 2008. We thank staff for the report's quality analysis of the measures introduced to curb risks to financial stability, and we concur with their assessment of remaining and emerging risks. The report rightly focuses on both the challenges related to safeguarding financial stability in an uncertain global environment and enhancing inclusive growth over the longer term.

The authorities are doing a credible job of managing the risks to growth with the combination of accommodative monetary policy and a neutral fiscal stance. This remains appropriate as long as the negative output is below potential. The main risk to the outlook stems from spillovers from an intensification of the euro crisis. Were these to occur, the authorities would have ample scope to respond, particularly on the fiscal side. Paragraph 15 indicates that the authorities also expressed concern over the possible increase in oil prices. Did the authorities' share staff's assessment of a "low" likelihood of a substantial and prolonged spike in oil prices? More generally, we seek clarification if such a risk is assessed equally across the membership or whether its likelihood is considered "low" for some countries and "medium" for others?

We commend the strong commitment to the fiscal consolidation objectives, including a balanced budget by 2013. The government plan on tax reform, to be published this month, should provide a basis for considering further measures to enhance revenue and to broaden coverage to the large informal sector. Given the increasing level of SOE liabilities, we also welcome the plans to improve monitoring of their finances, requiring 5 year plans for the largest firms, and preliminary feasibility studies for all large projects.

The staff report highlights the risk associated with household debt and linkages with the housing market and their impact on the financial sector. We appreciate staffs analysis in this area. We trust that the authorities are convinced of staff's recommendation to rely on market-induced price corrections rather than macro prudential policies in order to prevent excessive household leverage.

Of particular interest is staff's discussion of policies needed to ameliorate income inequality and its links to boosting potential growth. However, further work in this area would be useful in clarifying this link and policies to address both challenges. The staff argues for policies to increase social spending, enhance labor force participation, and improve service sector productivity. Is there a risk, for example, that policies which aim to raise productivity and wages in the service sector might translate into a higher unemployment rate in the medium term which might aggravate inequality? Would the recommended increase in labor participation rate for women increase measured unemployment and place downward pressure on wages? We would welcome comment on whether staff's analysis has considered such possible unintended outcomes.

Mr. Assimaidou submitted the following statement:

The Korean economy continued to grow albeit at a moderate pace due to the impact of the ongoing global financial and economic crisis on investments and exports. Inflation declined, while foreign exchange reserves buffers have been rebuilt.

We commend the Korean authorities' balanced response to immediate challenges facing the economy, including their efforts to reduce Korea's vulnerability to global markets volatility. We also welcome their continued commitment to maintain the pace of medium-term reforms with the view to preserving the economy's competitiveness in the context of a rapid demographic transition, and increasing income inequality.

We support the neutral fiscal stance, and welcome the authorities' pledge to fully use the available fiscal space to support the recovery. Additional reforms will be required going forward in order to provide for increased demands on public finances in the medium term, while preserving fiscal sustainability. In that respect, we support the authorities' plans for fiscal consolidation, as detailed in Messrs. Lee and Choi's helpful buff statement.

Medium-term fiscal reforms should aim both at improving revenue collections, and at rationalizing spending. Hence, we are pleased to note the measures planned to broaden the tax base and cover large informal sector participants. On spending, we note that social spending currently stands at less than half the OECD average and encourage an adequate provision for well-designed social spending as it is critical for an inclusive and sustainable growth path. In this vein, we welcome the authorities' commitment to strengthen the social safety net in order to protect the most vulnerable segments of the population

The accommodative monetary policy path has helped cushion the impact of the crisis by supporting aggregate demand. The authorities' monetary policy has also provided a valuable window for the implementation of measures aimed at reducing Korea's financial systems exposure to wholesale funding risks, as well as the private sector's foreign currency denominated maturities mismatch.

We note the resilience of Korea's financial sector, with the banking system remaining profitable and adequately capitalized. We also commend the authorities for the progress achieved in addressing systemic risks, including through the implementation of an enhanced macro-prudential framework. Looking forward, we encourage continued close monitoring of financial sector developments, given the high indebtedness levels of households, and the relatively high degree of openness of the Korean economy.

On structural reforms, we encourage reforms aimed at enhancing Korea's growth prospects. To that purpose, we welcome labor market reforms promoting higher participation rates of women and the youth. We also support further service sector reforms to increase its productivity, including by fostering competitions, and restructuring SMEs.

Mr. Rojas and Mr. Cova submitted the following statement:

Despite the slow growth recovery prospects, significant worries still remain, particularly focused on a further escalation of the euro area crisis, geopolitical issues in the Middle East that could impact oil prices, and sizable liabilities to foreign banks. These challenges highlight the need for further efforts, particularly in the fields of vigilance and policy commitments. This background also underlines the significance of having in place a clear strategy to deal with the aforementioned challenges.

Policymakers should take into account downside risks to the global economy, with particular emphasis on the potential risks linked to a further deepening of the sovereign debt crisis in the euro area, and its potential spillovers to systemically important economies, which may have adverse impact on Korea's exports. Given the outward-oriented profile of the Korean economy, reducing exposure to future external shocks implies strengthening the role of the non-tradable sector and its contribution to GDP, as well as increasing productivity in the services sector.

A period of stabilization followed by a more dynamic GDP growth in the short run and the coming years could help lay the groundwork for the Korean economy to begin moving to a fully functioning recovery based on a substantial structural rebalancing. Boosting the contribution of the non-tradable sector to total GDP will be instrumental to diversify sources of growth, to reduce vulnerability to external shocks as well as to overcome labor market segmentation and dualism deriving from temporary employment that fuels social and income inequality.

Given the prominent features of Korea's capital markets, the potential knock-on effects of volatile capital flows on the country's economic stability is a source of concern. Dealing with capital flows should be pursued through a continued combination of adequate macroeconomic policies, capital flow management measures, plus a solid macro prudential framework, compounded by a sound institutional set-up.

While the core of the financial system appears resilient, there are vulnerabilities that need to be addressed. The interaction between credit growth to households from NBFIs, housing market dynamics and financial vulnerabilities should be carefully scrutinized with a view to preserve the overall financial sector stability. In particular, MSBs' remaining vulnerabilities require careful attention. Enhancing the supervisory framework, increasing institutional coordination, promoting closely monitoring and improving credit and risk management are more than warranted.

We welcome the accompanying selected issues report, particularly Section III on Social Spending in Korea: Can it Foster Sustainable and Inclusive Growth? The analysis reflects the rising importance of issues such as income inequality, labor market segmentation and job creation. At the same time, it highlights the need for a holistic approach that takes into account not only macroeconomic policies and financial stability, but also their impact on key social indicators.

Mr. Prader and Mr. Benk submitted the following statement:

Although well managed, the Korean economy is currently slowing down as a result of the global economic developments. This slowdown has generated a series of challenges for the authorities. We appreciate staff's comprehensive report and specific analyses on the key issues. We thank Messrs. Lee and Choi for the useful information provided in their buff statement, noting the concurrent views of the authorities with staff. We broadly share staff's recommendations and main policy messages, subject to some specific comments:

One of the major strengths of the economy—open and export-oriented—generates many of the currently existing vulnerabilities through the international spillovers. The impact of a possible intensification of the euro area crisis, both directly and indirectly through China and the United States could be significant. In addition, a slowdown in China per se would generate significant trade spillovers to Korea. In this respect, we find staff's assessment of low risk associated with a Chinese slowdown as too optimistic, especially in light of the high Korean multiplier associated to Chinese investments and real estate (2012 Spillover Report).

Managing the risks to growth with a combination of accommodative monetary policy and a neutral fiscal stance seems appropriate at the current juncture. Should a significant downside scenario materialize, however, we are not entirely convinced that Korea has much scope to respond, especially on the fiscal side, with only limited room left to monetary policy to cut interest rates further. We caution that the apparently existing fiscal space could not be as wide as staff and the authorities coincidentally assess, taking into consideration the short-term extra revenues and long-term implicit liabilities that the currently young workforce generate.

We therefore welcome the authorities' strong commitment to the fiscal consolidation objectives, including a balanced budget by 2013. Increasing revenues, especially by broadening the tax base and extending coverage to the large informal sector is of utmost importance. In addition, the development of a long-term fiscal framework is warranted, which should create the basis of a debt-to-GDP ratio that is sustainable, also in the long run, while responding also to the challenges of the rapid pace of population aging. Such a long-term fiscal framework could target, for instance, a balanced budget excluding the surplus of the Social Security Fund and possibly an additional long-term savings-fund intended to cover the increasing expenses of an aging society. We seek staff's views and recommendations on designing a long-term fiscal framework and any further information on the authorities' intention in this direction.

While the financial system appears resilient and the vulnerabilities have diminished considerably thanks to the series of macroprudential measures adopted since 2008, some vulnerabilities remain to be addressed. The high level of household debt and the rapid expansion of non-bank credit to vulnerable households remain important concerns. The authorities have already taken corrective measures to contain excessive household leverage by regulating the DTI and LTV ratios. However, these measures proved to be counterproductive since they shifted credit demand (especially that of non-creditworthy households) toward less-regulated non-bank credit institutions. The authorities, therefore, should step up their efforts to tighten the regulation of NBFIs to secure a soft landing of household debt.

Raising potential growth in the face of declining labor inputs is particularly challenging. Addressing the low participation rate of women, the youth and the elderly is only a medium-term solution. In the long term, the exceptionally low fertility rate should be addressed by providing adequate incentives. In this respect we welcome the authorities' intention to support a family-friendly work environment, by increasing childcare services and easing the conditions for maternity leave. Beside these measures, increasing social spending related to healthcare, education and social safety nets would also boost potential growth over longer term by raising productivity and human capital.

Mr. Alshathri and Mr. Keshava submitted the following statement:

We thank staff for a well-focused report and Mr. H. Lee and Mr. Choi for their informative buff statement. After rebounding strongly in 2010, the Korean economy grew at a slower pace in 2011 and the first half of 2012 in line with global economic developments. Looking ahead, growth is expected to strengthen in the latter part of 2012 and pick up more strongly in 2013. In this regard, a further intensification of the euro area crisis and a slowdown in Korea's neighboring trade partners remain key risks to the near-term outlook. It is reassuring, however, that the authorities are committed to manage risks to growth, while safeguarding macroeconomic and financial stability. Over the medium term and beyond, Korea faces the challenges of a rapidly aging population with the working age population projected to peak in 2016 and then decline by a quarter by 2050, according to the OECD. Enhancing social inclusiveness and boosting potential growth are also important challenges. Since we are in general agreement with the thrust of the staff analysis and appraisal, we will limit our remarks to the following points.

On the fiscal front, the authorities are to be commended for the prudent policies over the past years that created the necessary space to respond effectively in the wake of the 2008 global financial crisis to support growth. For 2012, the budget strikes an appropriate balance between supporting growth and consolidating the fiscal position. We also welcome the authorities' commitment to meet fiscal consolidation targets, envisaged in the five-year National Fiscal Management Plan for 2011-15, including the achievement of a balanced budget in 2013 by limiting expenditure growth, broadening the tax base, and reducing tax expenditures, as noted in the buff statement. Here, it is worth noting that Korea has ample room to respond forcefully to future challenges with debt to GDP ratio in the range of 30 percent and projected to decline further over the medium term. The authorities' ongoing work on a longer-term fiscal framework is also encouraging in view of the need to increase social spending in a sustainable manner. As regards the rising debt levels of state-owned enterprises (SOEs), it is important to remain vigilant and monitor SOE finances closely.

In the area of monetary and exchange rate polices, lowering of the policy rate in July 2012 was appropriate in view of the weaker-than-expected economic outlook and downside risks to growth, as well as the recent decline in inflation and its benign outlook. Going forward, we are reassured to note in the buff statement that the central bank is closely monitoring external risk factors and changes in financial conditions at home and abroad. On exchange rate policies, we share the authorities' reservations about the new EBA methodology and agree with them that more work is needed to enhance its relevance for Fund surveillance and policy recommendations.

Turning to the financial sector, it is reassuring that banks are well capitalized, and nonperforming loans are low. Furthermore, we welcome the authorities' decisive move to contain the problems in the Mutual Savings Bank (MSB) sector by restructuring insolvent MSBs, as well strengthening MSB supervision. We are also reassured to note that the resilience of the financial system to external shocks has further improved, reflecting higher international reserves relative to short-term debt, lower reliance on external funding for banks, and a reduction in foreign currency maturity mismatches. However, the authorities should remain vigilant as Korea is exposed to volatile capital flows and foreign currency funding risks.

Finally, on structural reforms, we welcome the continued efforts by the authorities aimed at raising productivity in the service sector, enhancing flexibility in the labor market, and addressing the impact of aging. These reforms should help lay the foundation for strong and sustainable long-term growth.

With these remarks, we wish the authorities continued success.

Mr. Mojarrad and Mr. Jbili submitted the following statement:

We thank staff for the high quality report and the interesting SIP and Mr. Lee and Mr. Choi for their insightful statement. We are in broad agreement with the staff appraisal and offer the following comments:

Growth decelerated significantly in 2011 and 2012 reflecting a weakening of global demand in connection with the intensification of the euro area crisis. The economy, however, remained resilient with strong job creation, low inflation, adequate international reserve buffer, and well capitalized banking system.

Going forward, the staff's near-term baseline scenario points to moderate growth with risks sharply tilted to the downside as the economy will remain exposed to a variety of global risks, including a worsening of growth prospects in advanced economies, a sharp rise in commodity prices, and further retrenchment of foreign capital. This underscores the importance of rebalancing growth toward domestic demand, and reducing the economy's vulnerability to global risk factors.

Given the weak near-term growth prospects, and in light of the recent decline in inflation, we support the authorities' accommodative monetary policy. Could staff explain why inflation expectations remain elevated while the negative output gap is not closing?

We have mixed feelings about maintaining a neutral fiscal stance under the 2012 budget when there seems to be ample space for supporting growth without undermining the authorities' medium-term fiscal consolidation objectives. While we agree that a strong fiscal policy response is warranted if a significant downside risk were to materialize, we believe that a measure of fiscal stimulation in the current circumstances could also facilitate an early rebound. Could staff comment on the growth impact of the envisaged fiscal stimulus package (0.3 percent of GDP) to be carried out by government-managed funds?

We welcome the reduction in the external vulnerability of the Korean financial system since 2008, and share staff concerns about remaining vulnerabilities stemming from the banks' high dependence on whole sale foreign funding and the related risk of further deleveraging mainly by euro area banks as highlighted in Chapter 1 of the SIP. The authorities' response to address these risks through macroprudential policies, the establishment of the inter-agency Foreign Exchange Market Stabilization Committee, and the strengthening of international reserve buffers are steps in the right direction.

We also welcome the steps taken to reduce the vulnerabilities stemming from the high level of household debt and the sharp increase in non-bank credit to households. Progress in restructuring the mutual savings banks and strengthening their supervision, as well as the ongoing efforts to improve policy coordination among financial authorities bode well for the success of the authorities' efforts to enhance financial stability.

We understand that the authorities are fully committed to addressing medium-term challenges of raising potential growth and reducing income inequality, as indicated by Mr. Lee and Mr. Choi. This is to be achieved through a combination of policies aimed at reforming the labor market, increasing social spending, strengthening the service sector productivity, and improving the business environment. We support the steps taken in these areas and encourage the authorities to sustain their efforts to achieve higher and more inclusive growth.

Mr. Yakusha and Mr. Hadzi-Vaskov submitted the following statement:

We thank staff for an interesting set of papers and Messrs. Lee and Choi for their helpful statement.

We note that Korea's rapid recovery has decelerated against the backdrop of global economic weaknesses and increasing uncertainties. Commending the authorities for a solid economic performance and for maintaining a sound macroeconomic framework, we emphasize the importance of Korea's strong focus on R&D, innovation, and education excellence, the key pillars of its global competitiveness. In contrast to the rather optimistic assessment of broadly balanced risks to the economic outlook in last year's report, we take note of staff's view that risks to the near-term outlook are tilted sharply to the downside. We see the rationale in the authorities' pursuit of rebalancing the sources of growth toward domestic demand, aimed at ensuring more sustainable and inclusive growth.

We see the importance of fiscal policy aimed at supporting the slowing economy in the short term while ensuring consolidation over the medium term. The front-loading of spending to the first half of the year, combined with a fully implemented budget can provide a non-negligible stimulus within the existing budget envelop. We welcome the authorities' commitment to meeting the fiscal consolidation targets as stated by Messrs. Lee and Choi, including the achievement of a balanced budget in 2013 by limiting expenditure growth, broadening the tax base, and reducing tax expenditures. More guidance from staff on how exactly to boost revenues would be welcome.

We continue to emphasize the importance of close monitoring of state-owned enterprises (SOEs), given their high and increasing level of debt and the associated risk of contingent liabilities. We welcome the measures stated by Messrs. Lee and Choi, including coverage expansion of the precautionary feasibility assessment of projects and the introduction of medium-term financial management plans. Noting the assessment that administrative intervention in public utility pricing is worsening the finances and distorting the efficiency of some SOEs, we are interested in staff's view on the authorities' plan for a gradual approach to normalizing public utility tariffs.

We concur with staff's assessment that the currently accommodative monetary policy stance is appropriate given weaknesses in the global economy and external uncertainties, noting that the recent policy rate cut was implemented in light of weakening growth prospects and quickly moderating inflation. We see potential vulnerabilities in case of interest rate increases for an important portion of loans that have floating rates. Could staff elaborate to what extent interest rate risks related to these loans may impose constraints on monetary policy in the future?

We welcome recent measures aimed at reducing the external vulnerability of the Korean financial sector including strengthening of the international reserves position and adoption of macroprudential measures. Noting staff's assessment of the positive results achieved with these measures, we emphasize the importance of remaining vigilant in view of Korean banks' still high reliance on external funding. Recognizing the need for a longer time horizon to assess their full impact, we welcome a thorough analysis of the effectiveness of these macroprudential measures during the upcoming Financial Sector Assessment Program (FSAP).

The high level of household indebtedness, in combination with the rising share of lending by less strictly regulated non-bank financial institutions, and the large share of mortgage loans with floating rate and/or bullet structures may be an additional source of vulnerability that requires careful monitoring. In this light, we see the importance of including incentives to shift to a fixed rate installment loan structure in the government's strategy for a soft landing of household debt. We welcome staff's view on the progress with the implementation of this strategy, including the timeframe for equalization of regulatory standards for banks and non-banks.

Mr. Chia, Ms. Yeo and Mr. Pokharel submitted the following statement:

We thank staff for a well-written and interesting paper. The Korean economy is slowing amidst external headwinds but the country is on a relatively stronger footing from which to confront downside risks. The external vulnerabilities of its financial system have diminished considerably since 2008. Korea has the fiscal wherewithal to support the economy if needed, whilst taking care not to detract too much from consolidation objectives. The staff also noted that the BOK has room to cut monetary policy rates. Notwithstanding the above, vulnerabilities remain, such as Korea's susceptibility to the vagaries of capital flows and its high household debt, and vigilance is warranted.

As we broadly share the thrust of staff's appraisal, we would limit our comments to the following:

The Korean financial system is now more resilient, thanks to the authorities' concerted efforts such as restructuring mutual savings banks, implementing an array of macroprudential measures and strengthening external buffers. We in particular appreciated Box 2, which is a good example of leveraging on countries' practical experiences to assess the utility and risks of various macroprudential instruments. This Chair has previously suggested that such analyses could be an area where the Fund could meaningfully value-add to the macroprudential policy debate space, and we are pleased to find such instances in this staff report. That said, staff rightly cautioned that weaknesses remain in Korea's financial system, e.g., the rapid expansion of non-bank credit to vulnerable households. On this note, we welcome the update in Mr. H. Lee and Mr. Choi's helpful buff statement that Korea has announced measures to curb this trend, such as strengthening loan-loss provisioning standards for insurance companies and tightening credit card eligibility criteria for credit card companies. The staff also highlighted Korea's high household debt as another source of vulnerability, whilst paragraph 20 assessed that the BOK has room to cut rates further in a downside scenario. Could staff comment on the effects of a rate cut on household borrowing, and what mitigating measures the authorities could take?

The forthcoming FSAP would review, amongst other things, the organizational framework for the conduct of macroprudential policies. The staff argued that a formal institutional set-up would help ensure consistency of such policies and close loopholes, as well as clarify the roles and accountability of various agencies. We would take a more nuanced view on this. The absence of a formal institutional set-up does not necessarily inhibit the effective conduct of macroprudential policy. When assessing such organizational issues, we encourage staff to look beyond the form—whether formal structures and mandates are established, and focus more on substance—how the design and implementation of macroprudential policies are carried out in practice, whether there is meaningful input from different agencies, and the dynamics between them.

On fiscal policy, we agree with staff that the near-term challenge is to support growth whilst maintaining medium-term endeavors to create fiscal space. We also appreciate the government's efforts to resist pressures for populist spending in the current environment, which show their judicious commitment to medium-term consolidation objectives.

We note that the Korean won is assessed to be moderately undervalued under the EBA methodology, and staff observed that the exchange rate has moved flexibility in response to market conditions in the past year. The authorities highlighted that the exchange rate has been under downward pressure amidst heightened global risk aversion, and intervention has been limited to smoothing operations. The foregoing highlights the difficulty of an equilibrium approach to exchange rates, and the difficulty of deriving policy conclusions from a model-based medium term EBA approach alone, without due consideration of complex conjunctural developments and near-term policy objectives. It is commendable that the staff report attempts to bring these complex interactions together, but we would encourage that staff's assessment encompass these multi-faceted considerations, rather than present conclusions primarily based on the EBA. Further, we urge staff to continue engaging the country authorities on such assessments, as it would take time to build the credibility of and familiarity with the new methodology.

Mr. Andersen and Mr. Lindpere submitted the following statement:

We thank staff for an in-depth analysis of the Korean economy and Messrs. Lee and Choi for their informative buff statement. We share the main features of the analysis and staff's appraisal.

Korea's economy is on a slowing course from a strong recovery. The economy is internationally highly integrated and is therefore exposed via various channels to the present risks in the global economy. Combining these circumstances with some Korea specific characteristics set the main stage for policy considerations. The Korea specific characteristics include vulnerabilities in some parts of the financial sector and high level of household debt which both call for close monitoring. Attention should be given to remaining imperfections in the functioning of some parts of the labor market, and we welcome the authorities' focus on ensuring greater labor market flexibility and higher female participation. Addressing these challenges would reduce economic volatility, especially if the external environment is turbulent, and strengthen growth potential. Still, despite all these impediments, the Korean economy is internationally competitive and well set to progress with income level convergence.

We would like to stress the following points:

We share the view that risks to the near term economic outlook are on the downside. Given the first half of the year, the GDP growth forecast for 2012 of 3 percent requires the economy to grow at a rate that is close to potential, i.e. about 1 percent or more in q-o-q terms throughout the second half of the year. Recent demand indicators also appear to be somewhat soft and sentiment has weakened. We would like to invite staff to elaborate on the sources of demand that would allow the economy to expand at this pace.

We share the worries that in case of the adverse event scenario financial vulnerabilities could become a source of concern although convincing evidence is provided that vulnerabilities have recently declined. Therefore steps to make the financial sector more resistant to global sentiment swings and to improve its ability to absorb external shocks are crucial. However, it remains unclear whether the role of the central bank in case of the adverse event scenario should remain limited to the interest rate policy. Moreover, the comparably high inflation expectations may limit the room for maneuver. The staff's comments would be appreciated.

The conjunctural situation in the world economy calls for prudent fiscal policy and we welcome the authorities' emphasis on restoring fiscal policy space and prepare for the challenges of the future. While the sound fiscal track record provides some policy space to react to adverse developments, it is of utmost necessity to progress with fiscal consolidation when solid growth resumes. In this light, we want to give our full support to the government's medium term consolidation commitment.

Mr. Virmani and Mr. Eapen submitted the following statement:

Last year's Article IV consultation had pointed out that the Republic of Korea had made a remarkable recovery in 2010 on the back of booming exports and strong domestic demand, underlined by highly accommodative monetary conditions. The staff's projection was that the growth rate would be 4.5 percent in 2011 before easing to 4.2 percent in 2012, given that the economy was functioning at very high capacity utilization and also after taking into account downside risks mainly due to external factors. However, it is now quite obvious that unexpectedly strong global headwinds have changed this optimistic outlook; further, there is also the short term risk of a further intensification of the euro area crisis and spillover.

Overall Outlook and the Current Context

We now find that the actual growth in 2011 was 3.6 percent and the current projected GDP growth for 2012 is 3 percent (and around 4 percent for 2013 in line with expected recovery in the global economy). While the staff report for the 2012 Article IV consultation and the selected issues papers outline and examine the concerted efforts made by the authorities to increase the resilience of the financial system and to reduce the impact of external shocks (also detailed in the buff statement by Messrs. H. Lee and Choi), the report makes also clear the extreme vulnerabilities to external developments engendered by policies of openness to global trade and international finance during periods of sharply slowing global growth and elevated financial stress. It is now clear that the main risk for Korea is external—from delayed or insufficient policy action escalating the euro area crisis. It is also clear that these risks would be substantial, if weaknesses in Europe spillover to the United States and China. China being Korea's largest trading partner, a substantial slowing down in growth in China will have a strongest impact.

The good news is that slowing activity, falling commodity prices and the expanded provision for child care services has resulted in lowering projected headline inflation for 2012 at slightly below 3 percent. In the current

Korean context, an accommodative monetary policy with a broadly neutral fiscal stance appears appropriate; on the fiscal front, the frontloading of expenditure in first half of 2012 to support the weak economy and the plan to ensure the budget is fully implemented are both correct. We note, however, that the typical experience on budget implementation is of under-spending by 3 percent to 5 percent. The staff mentions that the potential for additional support through temporary (and cautious) use of government-managed funds such as financial funds or projected funds in selected areas also exists; however we agree that their use should be limited and temporary and linked to a severe downside scenario. For the medium term, however, we welcome the plan to enhance revenues to finance social spending by better increasing the coverage of the informal economy.

Monetary Stance and Financial Stability

The cutting of the policy rate by 25 basis points in July 2012 has eased the monetary stance further as the policy rate remains below its historical average in real terms and inflation expectations continue to be elevated. As staff points out, the rate hikes may again need to resume when the economy strengthens and the negative output gap continues to close. Overall, the policy rate needs to be raised above the neutral to bring inflation back within the target band and limit build up of leverage in the nonfinancial private sector.

The above issue is also linked with the larger one of controlling household demand in Korea. The level of household debt in Korea is very high due to housing market policies which have engendered expectations of a steady nominal house price appreciation. It appears that while housing prices appear to be rising in the rest of Korea, they have peaked in Seoul. The authorities appear to be trying to change this scenario. What is the impact of the announcement of the latest relaxed regulations (in May 2012) raising the Loan-to-Value (LTV) and Debt-to-Income (DTI) ratios in high house price districts in Seoul on the housing prices in Seoul? There are enhanced risks for increase in household debt arising from the exposure to interest rate and rollover risks, given the high share of floating rate and bullet structures for mortgage loans in the event of a crisis scenario. In this connection, the steps taken to curb increases in NBFIs's expansion of lending to households, as well by the FSC to suspend operations of some MSBs, are to be welcomed.

Other macro-prudential measures taken by the authorities in the aftermath of the global financial crisis to curb financial risks (as outlined in Box 2) have clearly been fairly effective in decreasing bank reliance on short term FX funding. However, there are mixed results on curbing excessive household leverage and housing price volatility. In this connection, precisely what are the markets induced price corrections (mentioned in Box 2) that would have prevented the excessive leverage? In addition, the withholding taxes and stability levies to curb capital flow volatility and potential capital flow reversals are said to have had limited effectiveness due to the extensive use of double taxation treaties. While a detailed assessment on the effectiveness of these measures will be there in the forthcoming FSAP, we would welcome a broad indications as to the manner in which the double taxation treaties have worked against these macroprudential policies.

Structural Issues

We welcome the analysis on enhancing inclusiveness and sustainability. Clearly, going ahead, Korea will have to make major efforts to sustain growth in the backdrop of a rapidly aging population. The rapid shift in the age and working population demographics in Korea will throw up huge challenges and it may be required to change the fundamental structure of the economy. The previous Article IV consultation had a staff recommendation for promoting the nontradables sector as a second engine of growth by opening it for more competition, expediting bank led SME restructuring and leveling the playing field with manufacturing that would require action on multiple fronts. The authorities at that time had pointed out that to make the service sector the second engine of growth would require concentrating on improving the investment climate for medical, education, content media and tourism services. The current consultation also mentions this in paragraph 44; however, we missed any discussion about specifics as well as authorities' views. Has the ongoing slowdown postponed the discussion on the structural changes required—particularly for reform in the services sector?

Korea also needs to pay greater attention to increasing social spending, keeping in view long term fiscal sustainability, as this is at a low level compared to OECD peers. Reducing income inequality and economic polarization may require steps beyond labor market reforms, though these are crucial. In this connection we welcome the emphasis on strengthening vocational training and developing a job matching system to expand the opportunities for the young and the unemployed to secure productive employment. Finally, we reiterate that Korea's overseas foreign direct investment has had a major role in developing the manufacturing sector and boosting employment particularly in the larger Asian region. Korea's continued economic progress is therefore important for positive spillover effects across the region.

Mr. Mac Laughlin and Mr. De la Barra submitted the following statement:

Because of the global economic slowdown Korea's economic growth has been affected both in terms of consumption and investment. Risks to the economy are on the downside, due to the persistence of the euro area turmoil which threatens to spillover to neighboring countries. Given such outlook the authorities have appropriately responded with measures mainly focusing on the monetary policy. We positively note that the authorities are ready to apply additional measures on the fiscal policy, as Messrs. Lee and Choi clearly point out in their candid buff statement. In addition to the uncertain global outlook there are important challenges to sustain economic growth in the medium term which relate to the aging population, greater labor participation and income inequality.

Given that the economy appears to remain weak in the short and medium term, fiscal policy measures are to be supportive to growth. We welcome the authorities' decision to make efforts for the full execution of the budget which surely will help the domestic demand. It is also appropriate that the fiscal authorities use the so-called government managed funds for spending in selected areas. As the staff states, these funds may be channeled to projects, which would replicate the experience of 2009 providing temporary stimulus for the economy. It is encouraging that both the staff and authorities share views on Korea's scope and capacity to respond to a significant worsening of the global outlook thorough fiscal policy. On State-Owned Enterprises (SOE), we agree that the authorities should keep monitoring their performance, particularly their indebtedness, although it is commendable that the borrowed funds are being applied to purchasing fixed assets. It is also estimable that the authorities are implementing measures to require feasibility studies for all large SOE projects. We note the concern of the authorities on normalizing tariffs of public utility companies, as Messrs. Lee and Choi mention in their buff.

The monetary policy should remain accommodative as long as domestic demand and inflation trends warrant such policy. Besides, the authorities expect a negative output gap for 2012 and 2013. Fortunately, the Bank of Korea has built a comfortable level of international reserves and Korea can also count on augmented swap lines with China and Japan, which allow the authorities to be prepared in advance to provide liquidity to the financial institutions in case wholesale funding gets restricted, i.e., the situation in the euro zone becomes more critical. The estimated undervaluation of the won may be of temporary nature and it is hard to be conclusive on this issue, given the volatile global economic environment. We note that the discussion on whether or not to include the forward positions as part of the international reserves is relevant. We would appreciate a further elaboration from staff on this discussion.

It is encouraging that the financial system has become more resilient and that its vulnerability is lower, although some weaknesses are still to be addressed. As the staff indicates in their report, Korea is better prepared for shocks since its financial system has reached a stronger financial position and a number of macro prudential measures are in place. We note from the analysis in Box 2 that the macro prudential measures have been effective on reducing banks reliance on FX short-term funding, and curbing capital flow volatility.

However, banks are sill dependant on external wholesale funding but the international reserve balance provides now a strong first line of defense. On the other hand, household lending expansion from non-bank institutions poses a flag on financial supervision. The policies on reducing ratios (Debt-to-Income and Loan-to-Value) seem as though they were not as effective in non-bank institutions as banks at curbing household leverage. We tend to concur that this macro prudential policy should aim mainly at preserving the soundness of financial institutions rather than taking care of house prices. Additionally, it is favorable that the authorities are encouraging banks to shift towards fixed-interest rate loans.

In the medium term, economic prospects are subject to the adoption of structural measures which should aim to recover the potential output Korea enjoyed 15 years ago and reach a more sustainable and inclusive growth. In the selected issues paper the staff makes an interesting analysis on the direct relationship between economic-inclusive growth and social spending from which the staff derives a set of recommendations on increasing labor participation, reducing labor market dualism, lowering income inequality and boosting productivity in the service sector. Although social spending in Korea has increased in recent years, such recommendations are timely and plausible. We note that the authorities are taking measures to increase social spending albeit gradually.

With these comments, we wish the authorities the best in their endeavors.

Mr. Sadun and Ms. Quaglierini submitted the following statement:

We thank Mr. Lee and Mr. Choi for their insightful buff and staff for the interesting set of papers. We broadly agree with staff's analysis and recommendations and we wish to point out a few points.

Outlook

Korea's economic growth has moderated in the recent quarters as a result of the weakening in the external environment, though growth is still expected to remain at around 3 percent in 2012. Inflation has markedly decelerated to below 2 percent although inflation expectations are somewhat higher. At just 3.1 percent of the labor force, unemployment is low and employment growth has been satisfactory. Against this background, growth is projected to pick up towards end-2012 and reach 3.9 percent next year, driven by exports and domestic demand. Though decreasing as a share of GDP, current account surplus has remained in positive territory, due to the strong export sector despite a sizeable energy bill. In the current juncture, risks are mainly tilted to the downside and are related to possible intensification of the European crisis and slowdown in the Asian trading partners.

Economic Policies

After adopting a counter-cycle fiscal policy early this year, authorities are now committed to fiscal consolidation and a balanced budget is expected to be achieved by 2013. Debt-to-GDP ratio is low at around 30 percent. Moreover, in face of weaker-than-expected outlook, last July monetary authorities eased policy rates by 25 basis points to 3 percent. Should downside risks materialize, policy authorities seem to have room to support the economy, especially on the fiscal side.

Financial Sector

Domestic banks are well capitalized and bank soundness indicators are good. However, despite some improvements, bank dependence on foreign bank funding remains relatively high (up to 25 percent of GDP) and foreign funding to non-bank sector is also substantial. Moreover, households' debt-to-disposable income is relatively high compared to other OECD countries while non-banking lending has kept recording sustained growth, despite decelerating bank lending dynamics. In this respect, we welcome measures taken by the authorities to limit household debt and we share the need of close monitoring. In this context, we would appreciate if staff would provide some comments on the main facets of household debt (short/long-term) and possibly on the size of household total (financial and real) wealth.

Medium-Term and Structural Issues

Although decreasing, potential growth remains at around 4 percent. Taken into account the population aging, which is expected to be substantial in Korea, we agree with staff's recommendations that it is important to increase labor market participation, especially female employment, also through the provision of affordable high-quality childcare services. We also support the suggestion of raising the scope of vocational training, so as to boost labor productivity in the services sector. This would also help increase employment prospects of non-regular workers, which mainly work in low—productivity sectors and have limited safety nets, so as to reduce dualism in the labor market. We also agree on the measures which would help foster SMEs ability to innovate and compete. We would like to ask staff whether there are estimates of the size of Korea's informal economy and which possible measures might be adopted to reduce it. We also support staff in the proposals for using social spending to address income inequality and contain relative poverty. In this regard, we see merit in the suggestion of increasing the provision of pre-primary education. Considering Korea's prudent fiscal stance and the contained levels of public expenditure compared to the OECD average, Korea seems to have room to address pressure coming from aging society, also through increased revenue performance.

Mr. Shimoda and Mr. Nomura submitted the following statement:

We are broadly comfortable with the thrust of the staff appraisal. Yet, we would like to comment on the following issues.

Foreign Reserves

It should first and foremost be noted that, in spite of previous enormous efforts made at the IMF and the G20 meetings, no consensus has so far been built regarding the methodologies for assessing reserve adequacy. In particular, we would like to reiterate that, for countries that have no target as to the level of reserves, reserve levels change only as a by-product of other policy measures, including currency interventions, and/or simply as a result of the changes in investment returns from reserve assets or valuation effects, as pointed out by Mr. Lee and Mr. Choi. Additionally, in assessing the reserve adequacy of any country, we would like to emphasize that we need to take into account the overall firepower of the country to safeguard itself against possible external shocks, including the availability of regional safety net mechanisms, such as the CMIM, not just the country's self-insurance of reserves.

Foreign Exchange Policies

We note the staff's assessment that the Korean won is moderately undervalued. We would like to reiterate that, in order to move from the country's current external-demand centric economy to a domestic-demand centric economy, and, thereby, ensure sustainable and balanced growth, it is critically important that the Korean won appreciate in a flexible manner. This would also contribute toward containing inflationary pressures.

According to the authorities, intervention is limited to smoothing excessive volatility. Yet, in the past, Korean foreign reserves sometimes increased even during periods when the Korean won was undervalued in relation to its historical trends, which makes the above-mentioned authorities' view somewhat questionable, or, at least, debatable. Nevertheless, currently it is impossible to examine whether the Korean authorities' intervention is really limited to smoothing operations, because information regarding the authorities' interventions is not published. We would like to encourage the authorities to publish such information. Comments on this point from both the staff and the authorities are welcome.

Fiscal Policy

We note the staff's recommendation that, over time, the Korean authorities increase social spending to the desired levels. At the same time, we wonder how the "desired level" of social spending can be appropriately calibrated. Just comparing social spending levels with those of peer countries, as done in the staff paper, would not generate a definitive answer as to what the desired level of social spending should be. Given the socio-political nature of social spending, we believe that we will not be able to identify the desired level for any country without thoroughly examining country-specific factors.

In light of the anticipated acceleration of population aging in Korea, increases in social spending are inevitable, whether or not the authorities take policy measures toward increasing these. Under these circumstances, the Fund's policy recommendation should better focus on how to contain the anticipated natural increase in social spending and what reforms in the social security system should be carried out by the authorities before the spending pressures actually soar, rather than encouraging the authorities to make efforts to carry out further increases. Against this background, we fully support the authorities' plan to streamline social security expenditures in some areas.

Financial Sector Policies

We note the staff's view that further strengthening macro-prudential organizational frameworks could enhance the existing coordination among responsible regulatory agencies, and that organizational issues are expected to be reviewed more comprehensively in the context of the forthcoming FSAP.

In reviewing the organizational issues, we would like to encourage the staff to bear in mind that there is no one-size-fits-all institutional model for macro-prudential policy frameworks. Indeed, the desirable institutional setting for effective macroeconomic policy management can vary depending on each country's individual circumstances. Every country has its own historical and cultural background that shapes its desirable settings for effective policy coordination, including those required for preventing and controlling systemic financial risks. In addition, it should also be recognized that macro-prudential policy frameworks have emerged only recently, and the effectiveness of existing institutional arrangements has yet to be tested. In this sense, we would like to encourage the staff to fully understand these limitations and refrain from giving any prescriptive guidance to any member countries.

Ms. Terracol submitted the following statement:

We thank staff for an interesting set of papers, as well as Mr. H. Lee and Mr. Choi for their comprehensive and useful buff statement.

While the previous Article IV report stressed the risks of overheating pressures, triggered by a strong economic expansion in 2010, the current report observes an economic slowdown in the context of the global economy's weaknesses. We broadly concur with staff's assessment and recommendations, and would like to emphasize the following points:

The current policy mix seems appropriate in the short run. The deceleration in inflationary pressures is allowing for an accommodative monetary policy, while the fiscal policy remains broadly neutral. In addition, while we agree with staff that Korea has sufficient policy space to respond to a severe downside scenario, we are reassured by the authorities' reaffirmed strong commitment to their medium-term fiscal consolidation objectives.

On the downside risks stressed in this report, we are concerned by the potential impact of a more substantial slowing of China's economic growth than what was already observed. In addition, some domestic weaknesses are sources of concern, like the rapid increase in the indebtedness of state-owned enterprises, which calls for improvements in monitoring and governance, or the high level of household indebtedness, in particular of low-income households.

We agree with staff that while the external vulnerability of the financial system has significantly diminished, the authorities need to remain vigilant. We value the focus on macroprudential policies, for which we requested a more in-depth analysis last year. We note that the adopted measures had some success in containing capital flow volatility, as well as in enhancing banks' external funding profiles. However, the tightening of loan-to-value and debt-to-income limits on lending has had only mixed result in limiting excessive mortgage lending. We hence encourage the authorities to implement their plan for a "soft landing" of household debt, with a specific attention to the non-bank financial institutions, which account for nearly a third of household debt.

Going forward, we concur on the importance of enhancing social inclusiveness and growth sustainability. As shown in the selected issue on this matter, targeted social spending can promote sustainable longer-term growth. We see space for gradually increasing social spending without jeopardizing the fiscal objectives or the favorable public debt situation.

Mr. Elder and Mr. Perks submitted the following statement:

We broadly agree with the staff assessment. The economic recovery in Korea has now slowed in line with global developments. The immediate challenge for the authorities is to manage further downside risks, but structural reform also remains a priority to put growth on a more sustainable footing in the medium term. We emphasize the following points:

Given the weaker economic outlook, a relatively supportive fiscal stance in 2012 is warranted. However, delivering a strong and credible medium-term fiscal consolidation plan remains essential. We agree with staff that the 2012 budget target looks appropriate and that the authorities should avoid the 'usual underspend' given the need to support growth. We also note the recent launch of a stimulus package, including increased spending by government managed funds. Could staff provide an early assessment of these measures, in particular whether they are suitably 'temporary and cautious.'

More broadly, we welcome the commitment to medium-term consolidation. In the 2011 Article IV report, staff called for an increase in the specificity of medium-term plans, particularly to clarify how projected expenditure increases will be met. They suggested a range of options including revenue mobilization measures and social security and pension reforms. Could staff comment on whether sufficient progress has been made in this area.

Recent monetary policy easing was appropriate in light of the weaker economic outlook but we agree that tightening will need to resume as the economy strengthens and the output gap begins to close.

The authorities should continue to allow the exchange rate to move flexibly and limit further reserve accumulation. We welcome staff's assessment of the external sector, including the use of the Fund's new EBA methodology and reserve adequacy metric. As box 1 sets out, the Korean won looks to be moderately undervalued based on a number of measures and the level of international reserves appears to be more than adequate to protect against external shocks. We therefore agree that interventions should be limited to smoothing excessive volatility.

The resilience of the financial system has improved but the authorities should continue to monitor and address external and domestic vulnerabilities. We agree with staff that Korea is exposed to volatile capital flows, but note that open capital markets confer benefits as well as generate vulnerabilities. The staff analysis suggests that that the banking system is more resilient than it was in 2008—reserve buffers are larger and FX liquidity management has improved. However, it is not immune to contagion from shocks elsewhere in the global financial system. Exposure to FX funding continues to be a source of external vulnerability, despite the positive impact of recent macroprudential measures. The rising share of household lending provided by non-bank financial institutions is also concerning and we support the regulatory improvements to gradually curb lending by these entities. More generally, we note the recent press articles on the sustainability of household debt levels and would welcome further staff views on this issue. We look forward to a comprehensive assessment of the financial sector in the 2013 FSAP.

Looking further ahead, we agree with the focus on medium-term structural reforms to boost growth potential and reduce inequality. The report sets out a well-established suite of labor market and service sector reforms. Progress has been made since last year, including the agreement of important Free Trade Agreements with the EU and the United States which should deliver important deregulation and improve competition. The authorities should continue to push ahead with this reform agenda. Tackling inequality is likely to require a well-targeted increase in social spending and significant tax reforms to meet the associated costs. Could staff provide any more information on the authorities' forthcoming tax reform plans.

Ms. O'Dea and Mr. Rolle submitted the following statement:

We thank staff for a very helpful set of papers on Korea and Messrs. Lee and Choi for their candid buff statement. We broadly concur with the assessment and welcome the authorities' commitment to prudent policies to manage the risk to growth and preserve macroeconomic soundness, safeguard financial stability, and enhance economic inclusiveness and sustainability. As Korea's output gap closes it is appropriate that the authorities remain dedicated to a gradual path of fiscal consolidation, while being as supportive as warranted to near-term weaknesses and risks. Also, the monetary policy stance, while still accommodating, should pivot towards tightening once demand pressures reemerge. Further, the authorities should continue to bolster institutional frameworks for macro-prudential policies along the lines recommended by staff.

We note the importance of enhanced social spending alongside other initiatives to strengthen the inclusiveness of Korea's economic expansion. Prudently, elevated expenditures should be financed through revenue enhancing measures, so as not to undermine fiscal sustainability. To their credit, the authorities are also embracing labor markets reforms to incentivize greater workforce participation of females and the younger population. This will have the added benefit of dampening the costly longer-term effects of the ageing population.

As an ageing population could also constrain potential growth, compensating policies are also justified to reverse the declining productivity levels. Despite world leading educational outcomes, relative to Asian peers, recent overall productivity growth in Korean has been slower than its pre-crisis rate. While improving service-sector productivity is essential, the authorities may therefore also need to target their efforts more broadly.

The authorities have made significant strides to enhance financial sector resilience, although continued vigilance is needed in this area. Indeed, macro-prudential measures have been effective in reducing banking sector reliance on external wholesale funding, and in curtailing cross-border liquidity risks. As staff notes though, the significant foreign branch presence still leaves the financial sector exposed to funding cutbacks as anticipated deleveraging occurs in other banking centers such as Europe. This may justify further caution in managing domestic credit expansion to allow added build up of liquidity buffers.

On domestic side risks to the financial sector, we encourage strong safeguards against any protracted deleveraging process that might be triggered in the household sector, given the sector's high debt to disposable income ratio of 155 percent. We also urge vigilance against future credit quality deterioration that could manifest itself from the observed strengthening in lending to lower quality borrowers. Any hard landing in prices in the non-Seoul housing market should also be comfortably buffered.

In the external sector the greater flexibility permitted in the exchange rate since the last Article is a positive development, although as staff notes, new currency pressures could materialize once global risk appetites normalize. Export competiveness should be less of an issue in this process, if the authorities make meaningful progress in rebalancing growth more towards domestic demand. As to international reserves, staff noted that the authorities have also made inroads in securing alternative buffers through bilateral swap lines with China and Japan and, as noted above, banks have reduced cross-border liquidity risks. We are, however, somewhat sympathetic to the authorities' more cautious interpretation of reserve adequacy, given the central bank's illiquid classification of forward foreign currency positions.

Ms. Lundsager and Mr. Lindquist submitted the following statement:

Korea's open economy has slowed in the midst of weaker external demand and global financial market volatility related to ongoing tensions in the euro area. Beyond the near-term challenges of calibrating the policy mix to support economic activity and safeguard financial stability, rebalancing the economy to strengthen sources of domestic demand remains a critical goal.

The authorities appropriately adjusted the fiscal and monetary policy mix in the wake of the global financial crisis. This now provides them with policy buffers to support growth. We welcome the authorities' intentions, as highlighted by Messrs. Lee and Choi, to use these buffers, should downside risks materialize. The presence of a credible medium-term fiscal management framework should help to keep the fiscal path anchored should near-term stimulus be necessary.

The inclusion of a more extensive discussion of Korea's reserve adequacy is an improvement to recent staff reports on Korea. We agree with the staff that Korea's reserves have reached an adequate level, and there is no need for further reserve accumulation. Should downside risks emerge and Korea faces a sudden capital outflow, the authorities have adequate reserve buffers to provide liquidity to foreign exchange markets, if necessary.

We also consider the inclusion of an External Sector Assessment to be a step forward for the staff's discussion of external sector issues. We appreciate the discussion of the real effective exchange rate (REER) level under both the CGER and EBA approaches and the inclusion of point estimates for each methodology employed. The inclusion of additional details—such as current account norms and the contribution of "policy gaps" to the current account gap—would have made the discussion even more transparent.

The staff assesses the won REER to be moderately undervalued, and the staff suggests that the authorities acknowledge this conclusion. While current nominal won weakness is related to global financial turmoil, we recall that the won REER has not reached pre-crisis levels at any point over the past few years, despite Korea's strong recovery and periods of substantial capital inflows. Should the won experience appreciation pressures when global risk aversion subsides, intervention should not be used to resist such pressures. We agree with the staff that, in view of the competitiveness of the export sector and the comfortable level of reserves, the currency should be allowed to appreciate in such circumstances.

We appreciate the analysis of Korean banks' external funding needs and efforts to reduce these vulnerabilities. The authorities' response has included a range of macroprudential measures designed to reduce banks' short-term external debt and foreign currency maturity mismatches. However, we would have appreciated additional comment by the staff on the goals of some of these measures. Specifically, does the staff view these measures as macroprudential measures or capital flow management measures (CFMs)? For example, the levy on banks' non-deposit foreign currency liabilities could be perhaps construed as either a macroprudential measure or a CFM, whereas the withholding tax on foreign purchases of treasury and monetary stabilization bonds seems more like a CFM. In addition, we would have appreciated more concrete staff recommendations for policies to manage capital flow volatility. Considering that Korea's REER is assessed to be moderately undervalued, does the staff view the use of CFMs in Korea to be appropriate? In addition, does the staff consider Korea's use of macroprudential tools/CFMs to be a factor in the undervaluation of the currency?

Beyond external vulnerabilities, the high level of domestic household debt remains a concern, in addition to the increasing role of the non-bank financial sector in such lending. The quality of household lending may also be declining, with credit growth increasingly driven by lending to lower-income borrowers with weaker credit scores. We encourage the authorities to monitor closely the activities of non-bank financial institutions in this sector. More broadly, high household debt remains related to household expectations that nominal housing prices will not fall, an expectation that appears related to government policies. How would the staff recommend that the authorities adjust policies to change these expectations, without abruptly disrupting the housing sector?

Finally, the staff report highlights the need for the authorities to rebalance the economy more towards domestic demand, including by increasing productivity in the non-tradables sector. We concur with this message, but we were surprised that the staff did not mention the role of currency appreciation, which would send appropriate price signals for the invigoration of the non-tradables sector over time. We would welcome the staff's comments on this point.

Mr. Meyer (GR) and Ms. Meyer submitted the following statement:

We thank staff for an insightful set of reports. We take note of the recent slowdown of economic activities and commend the authorities for their commitment to prudent and sustainable fiscal policies as well as policies to bolster financial stability. We would like to emphasize the following issues:

We are encouraged by the authorities' commitment to the medium-term fiscal consolidation path and to achieving a balanced budget in 2013 (excluding social security funds). In that context, it is important to keep the right balance between the fiscal stimulus measures planned and already implemented in 2012 and the budgetary target for 2013 so that the credibility of medium-term targets does not suffer from the effect of short-term measures.

As regards monetary policy, we agree with staff that policy rates should be increased as soon as the economy picks up in order to reach a more neutral monetary stance. Even though monthly inflation rates have come down recently, inflation expectations remain on the high side which calls for vigilance to keep inflation within the target range of the Bank of Korea over the medium term. Monetary policy needs to be distinctly geared towards maintaining price stability.

The improved resilience of the Korean financial system to external shocks is encouraging. While macroprudential measures have contributed to the reduction of external vulnerabilities, authorities should continue monitoring closely how risks develop in the financial sector as it is still highly dependent on foreign exchange funding and exposed to volatile capital flows. In addition, the high level of household debt and the increasing importance of lending by less regulated non-bank financial institutions warrant close attention. We look forward to a more in-depth analysis of the effectiveness of macroprudential measures in the context of the upcoming FSAP.

The staff's strong focus on a broadly defined social spending could be misleading and the emphasis should rather be laid directly on labor market reforms and education with a view to target the authorities' desire to reduce income inequalities, address population aging and to increase potential growth. As pointed out in the selected issues paper, Korea's Gini coefficient is below the OECD's average and has even been on a downward trend in recent years. In addition, the gap in social spending to other OECD countries narrows considerably when controlling for the low unemployment rate and public social spending is already on a strong upward trend, as also evidenced by a 20 percent hike in the 2012 budget. Furthermore, the use of 2007 data for comparing Korea's public social spending to GDP ratio with that of other OECD countries may lead to outdated results and it should be borne in mind that in some countries, higher social spending levels are proving unsustainable. Overall, one should focus less on aggregate levels of social spending and pay greater attention to those measures that foster higher labor market participation, the quality and effective targeting of existing social welfare programs and on measures to enhance labor market flexibility. In this regard, we appreciate the authorities' plans, as outlined in Mr. Lee and Mr. Choi's helpful written statement.

Mr. Mozhin and Mr. Tolstikov submitted the following statement:

Growth of the Korean economy has decelerated recently due to the headwinds from the global slowdown, especially from the intensification of the euro area crisis. Inflation pressures have eased. The economy is expected to strengthen slowly in the second half of 2012 and further in 2013. At the same time, being open and export-oriented economy, Korea remains highly vulnerable to spillovers from the euro area crisis or possible adverse developments in other main trading partners. Under present circumstances, a policy mix which includes accommodative monetary policy and a neutral fiscal policy stance remains appropriate. Over the medium-term structural reforms aimed at increasing labor participation and raising productivity in the non-tradable sector are essential to offset the impact of the accelerating ageing process.

Despite sufficient fiscal space, the authorities behave prudently, consolidating fiscal position to prepare for the challenges of the future. We commend the authorities' objective to reach a balanced budget by 2013. Over the medium-term, the need to increase social spending requires a gradual increase in revenue. Taking into account relatively low tax burden, the broadening of the tax base, especially through increasing the coverage of the informal economy, is an appropriate course of action. In case of substantial external shock and taking into account a limited scope for further monetary easing, the fiscal policy should be the primary tool to mitigate the impact of negative spillovers to the Korean economy.

While external vulnerability of the Korean financial system has diminished significantly since 2008, some weaknesses still remain on the domestic side. High level of household debt and rapid expansion of non-bank financial institutions' (NFBI) credit are key concerns. The authorities are commended for their efforts to ensure a "soft landing" of the household debt and to strengthen monitoring of the NFBI lending. We also welcome the progress in restructuring of the mutual savings banks.

While the Korean economy remains highly internationally competitive, over the longer term sustaining economic growth may become increasingly difficult due to the anticipated acceleration of the ageing process, which will be the most rapid in the OECD area. In parallel, the rising inequality may further increase social tensions. Facing such challenges, the authorities should develop a program of structural reforms, aimed at boosting potential growth by raising productivity, investing in education and increasing labor force participation. More flexible labor-market conditions should reduce the duality of the Korean labor market and improve the conditions for non-regular workers. We welcome the first steps in this area made recently and encourage the authorities to proceed with further reforms.

Finally we have noted that fiscal data in the staff report are mostly related to the "central government" or to "consolidated central government." The recent tendency in the Article IV reports is to provide the general government fiscal data, which better reflects the overall fiscal situation of the country. Could staff comment on the reasons for limiting the scope of fiscal data to the central government's operations?

Mr. Weber and Mr. Sazanov submitted the following statement:

Continued effort to reduce the dependence of the very open financial sector on external wholesale bank funding is warranted. Given the challenging situation of euro area banks and its repercussions on U.S. and U.K. banks, reliance on funding from foreign banks continues to be a key source of vulnerability for the Korean financial sector. While so far mainly euro area banks have reduced their claims on Korea, it cannot be excluded that banks from other regions such as the United States will follow in shedding supposedly risky foreign exposures. In addition, as the re-leveraging by foreign banks in the first quarter of 2012 is at least partially attributable to the ECB's LTROs, it is likely to be a temporary phenomenon.

The high level of domestic household debt and the increasing reliance on non-bank lending need to be addressed. With a household debt-to-disposable-income ratio of 135 percent at end-2011, household debt in Korea is larger than in most OECD countries. Steadfast implementation of the authorities' strategy for a "soft landing" of household debt is thus important. The rapid increase in household lending by non-bank financial institutions (NBFIs)—their share in household credit increased by 5 percentage points to 29 percent over the past four years—also warrants close attention. Already in the 2011 Article IV consultation, staff mentioned government efforts to tighten regulation on non-bank-lending for households. However, such lending continues to increase unabatedly. Could staff update us on the development of household debt to disposable income for this year and provide more detail on the nature of the NBFIs responsible for rapidly increasing household debt? What are the authorities' concrete steps to improve regulation of NBFIs?

Enhancing labor market inclusiveness is crucial for future productivity growth. Given Korea's rapidly aging population and declining productivity growth, further per capita income growth is likely to be challenging. We thus support the staff's view that increasing the share of female labor is key to solving the problem. Korea's female labor force participation rate is currently the third lowest in the OECD. The main reasons for this, such as the gender wage gap and the lack of affordable, high-quality childcare services, should be addressed by the authorities. In addition, labor market duality continues to be a problem. As staff notes, Korea's share of temporary workers is among the highest in the OECD, and it is rising. Labor law rigidities appear to be a major reason for this trend. Given that Korea's public social spending is very low in OECD comparison, policies to improve labor market inclusiveness while preserving medium-term fiscal consolidation objectives will be essential to ensure future productivity growth.

Finally, we strongly encourage the authorities to consent to a timely publication of the staff report. Could staff indicate why the authorities have not yet consented to the publication of the report?

Mr. Majoro submitted the following statement:

We note that the strong economic rebound in Korea has stalled due largely to the weakness in global economic developments. There are expectations that the economy will gradually regain momentum in the second half of 2012. However, fragilities in the global economy as well as the longstanding uncertainty associated with North Korea pose risks going forward. These factors point to a growth of the Korean economy below its potential trends of the recent past. In this regard, we urge the authorities to implement an appropriate macro policy mix that would strengthen the resilience of the economy and create an environment for sustained and inclusive growth.

We also note that Korea's traditionally healthy public finances made it possible for the economy to transit from recovery to strong economic growth. In this regard, we concur with staff advice for the authorities to consolidate the fiscal position to enhance public finances and prepare for the challenges ahead. Meanwhile, we encourage the authorities to fully implement the budget for this year to support output growth in the second half of the year. In the outer years, the authorities are encouraged to implement fiscal measures that better link medium-term fiscal targets to future liabilities (including pension liabilities). Also, to increase social spending, it is advisable to strengthen revenue performance over the medium term by broadening of the tax base and bringing more of the informal sector into the tax net.

We acknowledge that the current monetary policy framework of the Bank of Korea is serving its objective of maintaining price stability while at the same time supporting the authorities' recovery efforts. However, we encourage the monetary authorities to stand ready to transit to a more restrictive monetary policy once the recovery transitions to a full-blown economic expansion. This will help contain inflation and also prevent future large rate increases which could hurt households given their high levels of indebtedness. In addition, the authorities' exchange rate policy should continue to be market determined with limited interventions to smooth excessive volatility.

In the financial sector, the authorities are encouraged to continue with the restructuring of financially weak mutual savings banks to boost confidence and safeguard the stability of the financial system. Accordingly, efforts should be made to write off debts that are not recoverable and fully provision the remaining non-performing loans while recovery is being pursued. Additionally, the authorities are urged to closely monitor the increase in lending activities of the non-bank sector and ensure that they comply with all prudential regulations and strengthen their credit and risk management strategies. Moreover, the authorities should encourage banks to depend more on domestic funds than wholesale funds to reduce the vulnerability of the financial sector to global financial crisis.

Finally, we encourage the authorities to implement structural reforms to create the enabling environment to sustain growth against the backdrop of a fast aging population and reduce income inequality. In this respect, we urge the authorities to continue with the labor market reforms to increase labor force participation among women, the lowly skilled and the elderly.

With these remarks, we wish the authorities success in their endeavors.

Mrs. Arbelaez, Ms. Florestal and Mr. Robergeau submitted the following statement:

Korea has weathered well the global and European slowdown thus far. Additionally, fiscal and external positions seem to be sufficiently strong to withstand a further decrease in growth in Europe and prolonged slack in global recovery. With a growth rate of 3.6 percent in 2011, the strong expansion registered in 2010 has not been replicated owing to the anemic global recovery. However, despite a new weakening of exports and fixed investments, a healthy 3.0 percent is projected for 2012 with an estimated long term potential of around 4.0 percent.

The Korean economy's openness and close integration in global trade and international capital markets has engendered vulnerabilities. In the recent past, inflation increased because of pressures from international commodity price hikes and challenges to the near-term outlook stem mainly from the potential protraction of the euro area debt crisis and its spillover effects as well as the risk of a modest recovery of the U.S. economy and/or a substantial slowing down of China's growth, Korea's largest trade partner. Structural reforms implemented after the 2008 global financial crisis have put Korea in a better position to face a new sudden stop in capital flows while remaining vulnerable to volatile foreign exchange funding. Mismatches in foreign exchange liquidity have been reduced and the reserve buffer has been strengthened. Rightly the staff report also underscores the recent diversification of the foreign investment base in the government bond market.

Over the medium term, the rapid aging of Korean population and the service sector's deficient productivity constitute impediments to overcome in order to underpin more sustainable and inclusive growth. On the upside, the authorities seem to be mindful of the potential challenge to economic performance of the rapid aging of Korean population. Social spending is expected to increase gradually over the medium term and revenues will be enhanced accordingly. In spite of constraints to increase funding incrementally, policies to encourage greater female labor market participation in line with other OECD countries need not be timid. Sustained efforts will also have to be made to reduce the economy's reliance on external demand. Policies that increase social benefits to non-regular workers have the potential to raise productivity in the services sector and to reduce income inequality. Thus, they are instrumental to support sustainable and inclusive growth.

On current macro policy mix, we support the authorities' decision to front-loading 60 percent of the spending to the first half of the year to respond to global weakness. We tend to concur with staff's view that (a) ensuring the budget is fully implemented would be appropriate and (b) that some additional albeit cautious support through the use of government managed-funds might be needed to address social concerns while preserving consolidation objectives. The authorities' efforts to increase the oversight and governance of State Owned Enterprises (SOEs) are also welcome.

Regarding monetary policy, the recent July cut of the policy rate reflects, in our view, the Bank of Korea's concerns about the downside risks to the outlook due to the unsettled global situation. However, this is not unique to Korea as monetary authorities elsewhere including in the region have also cut rates recently. In addition to the accommodative stance, the rate cut might also limit the impact of a sudden increase in capital inflows on the value of the won. Given that inflation pressures have abated, the rate cut might support private consumption by reducing debt service burden for the household sector which is highly leveraged. The free market determination of the exchange rate with intervention limited to smoothing is also an important element in the policy mix particularly for the competitiveness of the export sector.

On the resilience of Korea's financial system, we thank staff for the insightful papers documenting the impact of the foreign banks' deleveraging on Korea and the interaction between Korean banks' foreign exchange (FX) liquidity mismatches and exchange rate volatility during the global financial crisis. International banks have been identified as a key channel of transmission of financial stress during global volatility bouts and some evidence has been found supporting the view that the resilience of the financial system has increased following the authorities' concerted actions at the macro prudential level. We find that the difficult trade-offs Korea encountered as a recipient country when faced with the surges in capital inflows is well underscored.

Although Korea appears to be better prepared to cope with volatile capital flows, caution and vigilant monitoring are required for the near-term. We are looking forward to the conclusions of the upcoming FSAP as it relates to the effectiveness of the recently adopted macro prudential measures. A strategy for the soft landing of household debt seems to be in place. However, an article dated August 22nd in the Financial Times paints a more alarming view of the household debt situation. We wonder nevertheless what would be the likelihood of a hard landing to be faced by domestic demand-related industries in the second half of the year. The staff's comments would be welcome.

Mr. Sun and Ms. Szeto submitted the following statement:

We thank staff for the report and Mr. Lee and Mr. Choi for their helpful buff statement. Growth in Korea is slowing due to the external headwinds, but ample policy space would allow for a strong policy response, as needed, to mitigate the negative spillovers. Given the open nature of Korea's capital account as well as the role played by external financing in the financial sector, it is important to closely monitor and proactively address any potential risks stemming from the uncertain external environment. Over the medium term, labor market and service sector reforms should help boost the growth potential. We agree with the thrust of the staff assessment and would limit our comments to the following.

We concur with staff that Korea's present policy mix is appropriate given the global slowdown. The authorities' intention to fully implement the budget is welcome, as is their readiness to consider additional measures beyond automatic stabilizers should the situation warrant. On monetary policy, the accommodative policy stance should provide support to economic growth but vigilance is needed, especially given relatively elevated inflation expectations.

While the authorities have taken decisive measures to strengthen financial sector resilience, we encourage continued close monitoring to safeguard financial stability. The high level of household debt and the growth in lending by non-bank financial institutions could present risks further down the road. In this regard we welcome the authorities' efforts to facilitate a soft landing of household debt and to strengthen regulation over the non-bank sector. Also, while the financial sector's dependence on external wholesale financing has declined, continued vigilance is needed, and operational contingency plans should be put in place to safeguard the system against potential liquidity risks.

To boost the growth potential over the medium term, we agree with staff that the authorities should implement labor market reforms and enhance competition in service sectors. While the relatively low level of social spending in Korea as compared to other OECD countries suggests room for boosting such spending to enhance inclusiveness, this should be done in the context of a longer-term fiscal framework. Reducing tax expenditures and broadening the tax base would help generate some of the fiscal space to finance social spending.

With these remarks, we wish the authorities every success with their endeavors.

Mr. Lee noted that the authorities required more time to decide whether to publish the staff report, but that the decision was expected to be made shortly. He noted that Moody's Investors Service had recently upgraded Korea's sovereign credit rating by one notch to Aa3. The key drivers of the rating action were: strong fundamentals, a high degree of economic resilience and competitiveness, the reduced external vulnerability of the banking sector, and the continuation of the status quo in South Korean and North Korean geopolitics. With the upgrade, Korea had recovered its highest credit rating despite persistent external headwinds.

Mr. Meyer (GR) encouraged the authorities to publish the report.

The staff representative from the Asia and Pacific Department (Mr. Khor), in response to questions and comments from Executive Directors, made the following statement:[1]

Several questions from Directors were related to monetary policy. The first question concerned inflation expectations, namely why expectations

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

remain elevated despite a negative output gap. Inflation expectations have been declining with a lag but remain elevated compared with headline inflation, which has fallen much faster. The stickiness may reflect high oil prices, and the public may be also be building expectations of a possible removal of subsidies on public services and a hike in utility tariffs.

However, part of it may also stem from the perception that the Bank of Korea (BOK) was slow to normalize rates in the first half of 2011, allowing inflation to remain above 4 percent for most of the year. Consequently, there is a need to rebuild policy credibility to firmly anchor inflation expectations. This is why the staff recommends that the BOK should start normalizing rates once the economy begins to strengthen and the negative output gap begins to close.

There was a question about the extent to which interest rate risks related to housing loans with floating rates may impose a constraint on the conduct of monetary policy in the future. At this juncture, monetary policy is maintaining an easing bias that provides support for the weak economy and rate cuts that work toward boosting activity and lowering the debt service burden of households.

However, as the economy strengthens and the output gap starts to close, monetary policy normalization should commence to maintain inflation within the target band. Although an increase in interest rates may hurt some marginal borrowers, the average household should be better off because of the strengthened economy and rising incomes. Moreover, the increase should be appropriately timed and paced, taking into consideration the need to maintain financial stability so as not to jeopardize the economic recovery.

There was a question about whether the rate cut could affect household borrowing and what mitigation measures could be taken. At this stage, policy rate cuts are unlikely to lead to any significant increase in household borrowing given the weak economic outlook, high risk aversion, and continued weakness in property prices, especially in the Seoul area.

In addition, the government has undertaken wide-ranging measures to restrain lending to households, including strengthening asset classification and provisioning rules applied to nonbank financial institutions. Such government initiatives should serve to restrain household credit growth despite low interest rates. The BOK conducted a study of the impact of this rate cut on household debt in early July, when it reduced its rate by 25 basis points. The BOK's assessment was that the impact was likely to be small.

There were several questions on household debt itself. The first question is whether the household debt is sustainable. The staff statement notes that household debt remains high. Recently released data have shown a moderation in household debt since the second quarter of 2011, but the level remains high and should be reduced over time. The government is aware of the risks and has adopted a strategy for a soft landing for the household debt.

The staff does not foresee an imminent crisis from household debt because of the current low interest rates, the absence of a bubble in housing prices, strong overall household balance sheets, conservative loan-to-value (LTV) ratios, and the debt-to-income (DTI) regulations on housing loans.

There was a question on how the authorities should adjust policy to change household expectations of housing prices without causing disruptions to this sector. The staff had argued in its previous consultation that the authorities should not use macroprudential policy to support house prices. The staff recommended allowing house prices to move flexibly according to market conditions so as not to create the expectation that prices will only rise. This expectation has weakened recently with the moderation of prices in Seoul, especially in the Gangnam area, reflecting the large unsold housing stock.

The staff expects the orderly correction of house prices to continue in light of the government strategy for a soft landing for household debt combined with a likely increase in interest rates over time. These factors should lead to a further change in household expectations.

Turning to macroprudential policy and the exchange rate, there was a question about the goal of macroprudential policies and whether these are macroprudential measures or capital flow management measures. As noted in the staff report, the main purpose of the measures is to strengthen the resilience of the economy and financial system to shocks.

The measures are primarily macroprudential in nature, as they are targeted at reducing the external vulnerabilities of the financial system. The measures are aimed at limiting banks' short-term debt, reducing banks' non-core funding needs, and addressing maturity mismatches in the banks' balance sheets.

None of the measures in Korea differentiate between domestic and foreign residents. For example, the introduction of the withholding tax in

January 2011 eliminated the preferential treatment of foreigners to address potential negative financial stability repercussions from speculative inflows.

There was a question about whether the use of these measures is appropriate given that the exchange rate is moderately undervalued, and whether the use of the macroprudential measures could have been a factor in the undervaluation of the exchange rate. As noted in the staff report, the measures are mainly macroprudential in nature and are designed to strengthen banks' balance sheets by reducing their reliance on short-term debt.

Although the measures have affected the composition of capital flows to some extent, they have not significantly affected the volume of capital flows and the valuation of the exchange rate. As pointed out in one of the staff's studies, the reduction in external vulnerability has contributed to a reduction in the volatility of the exchange rate to shocks, and has supported the exchange rate in the current climate of risk aversion. The current undervaluation of the exchange rate is primarily a reflection of risk aversion in the market, and the exchange rate is likely to appreciate once risk appetite returns and capital flows resume.

Moving on to questions on fiscal policy, there was a question about the fiscal stimulus measures and whether they are temporary and cautious. Given the looming downside risks to the global and Korean economies, the authorities have adopted a stimulus package in the second half of 2012 of about W 4 trillion, representing about 0.3 percent of GDP.

This stimulus will mainly come from fuller implementation of the budget and high outlays from government-managed funds on projects and public investment through state-owned enterprises (SOEs) and public-private partnerships. The stimulus package is suitably temporary and cautious. It provides some support to the economy without jeopardizing the authorities' consolidation commitments.

Directors asked whether the staff could provide more guidance on how to boost revenue and the authorities' forthcoming tax reform plans. The authorities have expressed a preference to increase revenue by further broadening the tax base, which the staff fully supports. On August 8, the authorities announced the 2012 Tax Code Revision Plan, which elaborated on several measures to increase the transparency of tax sources, together with measures geared at capturing a greater share of the informal economy. In the event that tax rate increases are needed, it would be best to raise taxes on consumption and energy.

There was a question about the authorities' plan for a gradual approach to normalizing the public utility tariff. In early August the government approved a 4.9 percent increase in the electricity tariff. The government recognized that the adjustment was only partial and insufficient to fully absorb the increase in generation costs. The government rationalized the increase by the need to support the weak economy. The authorities plan to continue increasing the tariff until the utility company is able to fully recover costs.

Directors asked whether significant progress has been made in social security and pension reform. The last pension reform initiative was the Korean National Pension Plan of 2007. This reform delayed the depletion of the pension fund assets by about 10 to 15 years. There is a need for further pension reform, which would be usefully informed by the longer-term fiscal framework that is currently under way.

This leads to the question of the long-term fiscal framework, how it should be designed, and the authorities' intention in this regard. A long-term fiscal framework should seek to reconcile a credible commitment to long-term fiscal prudence with the need for flexibility to deal with short-term macroeconomic issues in a transparent fashion.

In the case of Korea, an important consideration will be to identify long-term fiscal issues arising from the aging population, such as rising health care costs and contingent liabilities from the social security system. The authorities already closely track their fiscal policies through the Medium-Term Fiscal and Debt Plan. Furthermore, plans are under way for a longer-term fiscal framework covering the next 50 years, which would take into consideration an aging population and liabilities owing to pension, health care, and education outlays.

There was a question about why fiscal data is limited to central government operations. Reports for local government accounts are available with a substantial lag and reporting is less reliable in contrast to central government accounts. However, the authorities are transitioning to the Government Finance Statistics Manual 2001 (GFSM 2001) framework, which would further facilitate the consolidation of local and central government accounts.

Turning to structural reform and social policy issues, there was a question about whether policies that raise productivity and wages in the service sector might lead to higher unemployment in the medium term, which may aggravate inequality. Directors also asked whether the recommended increase in the labor force participation rate for women might increase unemployment and put downward pressure on wages.

There is a risk that improvement in productivity and wages in the service sector would lead to job losses in some industries in the short run. However, this is likely to be temporary, reflecting a restructuring of the service sector and the reallocation of labor from one industry to another. The authorities' social spending programs that focus on vocational training and other policies designed to promote workfare should help facilitate the restructuring of this sector and reduce the risk of a permanent increase in the unemployment rate.

Korea faces a rapidly aging population, implying a trend reduction in labor inputs over time. Increasing labor force participation by women, which is relatively low by OECD standards, will help offset the trend decline in labor supply from the aging population. Hence, the higher participation rate for women should not result in an increase in the unemployment rate, nor a reduction in wages.

There was also a question about whether the current slowdown has affected the discussion on structural changes required in the service sector. The downside risk associated with the global recovery has heightened awareness of the need to expedite structural reforms in the service sector, to catalyze growth, and make the Korean economy more resilient to external shocks. In this context, the staff does not see a slackening in the efforts to address structural issues in the labor market and service sector.

Finally, there was a question about whether currency appreciation would boost the nontradable sector. As articulated in the previous staff report, an appreciation of the real exchange rate will facilitate the rebalancing of growth toward domestic demand. A stronger currency will improve the relative return to the nontradable sector and encourage development.

The staff representative from the Strategy, Policy, and Review Department (Mr. Arora), in response to questions and comments from Executive Directors, made the following statement:

I will answer two questions on international reserves. There was a question on whether to include forward positions as part of international reserves. On the treatment of forward positions, the staff does not necessarily expect that a country series for international reserves should always include forward positions, but the staff strongly encourages members to report their forward positions clearly. The staff does encourage members to report this transparently, because forward positions can have an impact on countries' abilities to prevent or mitigate external shocks.

In terms of how to report forward positions, the Fund's Reserves Data Template in the Special Data Dissemination Standard (SDDS) provides a guide to the circumstances under which forwards are classified; for example, as part of reserves, as a predetermined drain on reserves or as a contingent drain on reserves.

There was a related question on whether countries should publish information on foreign exchange intervention. The staff encourages the authorities to be transparent. But staff recognizes that the authorities can only be transparent up to a point, given the sensitivity of the information. For example, the Reserves Data Template under the SDDS was designed for the purpose of increasing transparency of foreign currency holdings and liquidity. However, the Board at the time noted that there was no expectation that intervention would be reported item by item or as a line item because such information is highly sensitive—too much disclosure could reduce the effectiveness of exchange market intervention, and could impose a large reporting burden on the authorities.

Ms. Lundsager made the following statement:

I am not quite sure I understood the staff's point that capital flow measures were aimed at containing short-term external debt. The staff noted that it did not seem likely that they affected the exchange rate.

How does the staff know that? How does the staff determine whether these types of macroprudential or capital flow measures affect the exchange rate? What are the kinds of metrics the staff looks at in determining that these measures have not affected the exchange rate?

It is interesting because of the point Mr. Lee made about the Moody's upgrade; I would think the risk aversion would be decreasing and Korea would seem more attractive. I would expect some resumption in capital flows, and also to get a sense of how that is handled in terms of capital flows that purchase official debt. I presume that those flows go through the banking sector as well.

In terms of transparency and the point about the guidelines on reserves, the template does not include that. Perhaps that is something that should be looked at again. Mr. Shimoda and Mr. Nomura raised this point in their preliminary statement, and I agree with them. I do not know what our schedule is in terms of looking at these various reporting metrics, but it strikes me that it is not a reporting burden. I cannot imagine it would be that difficult of a reporting burden in this day and age. It may be sensitive, but the reporting can be done with a quarterly lag.

Perhaps that is something that should be discussed on a more general level. It would be good to have foreign exchange interventions reported transparently.

Finally, I have every confidence that the authorities will consent to publication and I look forward to seeing the report on the website.

Mr. Nomura made the following statement:

This chair raised the question of the need to increase the transparency of currency interventions, and I fully share the views expressed by Ms. Lundsager.

I fully understand that the disclosure of information regarding interventions is not required by the Fund's SDDS, but our chair is not arguing that the Korean authorities have breached any legal obligation under the SDDS. Rather, our gray statement expresses our strong interest on this issue and we have asked for the publication of such information.

Korea is an advanced country. It has a competitive export sector and now it is a large trade partner for many countries. This inevitably implies that its foreign exchange policies have non-negligible international effects, at least on the regional level. Many countries have a legitimate interest in knowing more about the interventions by the Korean authorities.

At the same time, disclosing such information would also be beneficial to the Korean authorities, because the authorities would be able to get greater confidence in their foreign exchange policies by increasing transparency.

I would appreciate if our message is recognized by the Korean authorities and by the staff as not just a request for information, but also as a friendly suggestion from the oldest neighbor of Korea.

Mr. Mozhin made the following statement:

> I would like to return to the presentation of fiscal accounts in the staff's report. We have heard a response from the staff, which we appreciate, but the data presented in the staff report only covers the consolidated central government and not the consolidated fiscal accounts.
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> The staff noted that the fiscal data for local authorities is less reliable and takes more time to be released, but perhaps there may be some extrabudgetary funds as well, like pension funds, which we would want to see as part of the consolidated fiscal accounts.
>
> We have checked how the fiscal data on Korea are presented in other Fund publications, such as the World Economic Outlook (WEO) and the Fiscal Monitor. What is presented in those publications is only consolidated central government data. This is unusual. I wonder if the staff could share some estimate or assessment of the overall fiscal size in Korea, because the provided data only covers the central government.

Mr. Eapen noted that Box 2 indicated that levies had limited effectiveness in curbing capital flow volatility due to the extensive use of double taxation treaties. He asked the staff to elaborate on how such treaties had gone against the capital flow measures.

The staff representative from the Asia and Pacific Department (Mr. Khor), in response to further questions and comments from Executive Directors, made the following additional statement:

> On whether macroprudential measures had affected the exchange rate, they are aimed at improving banks' balance sheets by reducing dependence on wholesale borrowing. In that context, they may have changed the composition of capital flows.
>
> However, the volume of total flows has not been affected significantly. Because of that, it has not affected the valuation of the exchange rate. If anything, the Korean won seems to be a high beta currency, which means that it collapses every time there is a shock. During the Lehman crisis, the won fell by 35 percent. The volatility has declined over time, partly because external vulnerability has been reduced due to other macroprudential measures that the authorities have taken.
>
> Macroprudential policy, to the extent it has affected the exchange rate, would have helped support the exchange rate. However, in this current climate

of risk aversion, it is hard to say whether the currency should be stronger or weaker. It is moderately undervalued, but it should appreciate when risk appetite returns.

On the fiscal account, the staff would be happy to share what data it has. Unfortunately, the staff does not have much data. One reason why it is not an issue is that the local government account is relatively small. Once it gets smaller than a certain size, there is no requirement for the authorities to report it on a high-frequency basis, but they do report it on an annual basis. The authorities are moving toward GFSM 2001, and in a few years' time they should be able to report the consolidated data.

Regarding the withholding tax, when the authorities introduced the withholding tax, they intended to introduce a wedge to make it less lucrative to have speculative inflows. Unfortunately, because of the double taxation treaty, the withholding tax is only fully effective on countries that have no double taxation treaty with Korea.

For the countries with the double taxation treaty, it has to be adjusted according to the agreement in the double taxation treaty. In that sense, it reduces the effectiveness of the wedge. This wedge becomes smaller depending on the particular terms of the treaty. There is still some marginal impact. However, the volume of total flows does not seem to have changed by much, which is why the staff does not think it is effective.

Mr. Lee made the following concluding statement:

I would like to express my deep appreciation to the Korean mission team guided by the leadership of Mr. Khor, the outstanding management from Mr. Rumbaugh, and also with insightful guidance from Ms. Jain-Chandra, Mr. Lee, Mr. Elekdag, and Ms. Iorgova. The team has shown sincere and dedicated efforts in communicating with the authorities and in preparing valuable reports during the entire Article IV consultation process. Because the staff has already provided detailed answers to Directors' questions, I will limit my remarks to the key issues touched upon by Directors.

First, on fiscal policy, we agree with Mr. Prader and Mr. Alshathri that the development of a long-term fiscal framework is warranted. Although Korea's fiscal policy is guided mainly by the Five-Year National Fiscal Management Plan, the National Fiscal Act also provides fiscal rules as long-term guidelines for public finances, including local governments and

SOEs. As for the National Pension Fund, a long-term financial recalculation has been exercised every five years according to the National Pension Act.

Regarding monetary policy, we share the view of Mr. Elder, Mr. Meyer (GR), Mr. Andersen, and Mr. Virmani in noting the importance of timely normalization of the policy rate. While our authorities are closely monitoring inflation expectation data from the survey of 2,200 households, they are mindful of taking a comprehensive approach in assessing inflation expectations rather than relying on the survey, which has some data limitations.

On the issue of the exchange rate, I reiterate that it is determined by market supply and demand, and its flexibility has helped the economy absorb external shocks and promote balanced growth. To elaborate on this point, I will recall the recent trend of the Korean won.

In the aftermath of the Lehman collapse, the Korean won fell sharply against the U.S. dollar by 29 percent. Since the low, it has come to rise by 14 percent within a single day on the back of the Korea-U.S. currency swap deal made in end-October 2008. In July 2011, the Korean won recovered to pre-Lehman levels, reflecting Korea's strong economic fundamentals. However, from August 2011, the weak Korean won returned due to re-elevated global risk aversion.

The government has focused mainly on curbing excessive depreciation pressures, including through currency swap arrangements with China and Japan. This is the short story of the Korean won since the global financial crisis, and it shows that the exchange rate has recently responded to heightened external risks.

Regarding the comments of Ms. Lundsager and Mr. Nomura on publishing the information about FX market intervention, my authorities believe that the disclosure of detailed information about smoothing operations is premature at this stage, given Korea's small FX market size relative to its economy, high openness to capital flows, ongoing geopolitical risks, and its exposure to speculative movements.

We would carefully draw lessons from other countries' experiences in managing their transition to a fuller information disclosure after their adoption of the floating exchange rate system, including the case of Japan. We would take steps in a measured pace toward international good practices.

Regarding foreign reserves, my authorities have strong reservations about the inclusion of forward positions when assessing reserve adequacy. Forward positions are monetary authorities' claims on domestic residents and they are not readily available assets. In that sense, the inclusion of forward positions is not sensible. Furthermore, this is the first time that the Korea Article IV staff report made reference to forward positions. We have concerns that such a reference would have significant implications for market sensitivity.

Mr. Assimaidou, Mr. Elder, Mr. Mojarrad, Ms. O'Dea, Mr. Sadun, Mr. Sun, Mr. Mac Laughlin, Mr. Majoro, and Mr. Yakusha noted the foreign currency funding risk stemming from domestic banks' reliance on foreign currency wholesale funding. Our authorities have preemptively taken steps since 2011 to safeguard against a possible extension of the crisis in the euro area.

The authorities are guiding domestic banks to accumulate enough extra foreign currency liquidity to last for three months if all foreign liquidity supply came to a sudden stop. Furthermore, the authorities in July put in place measures to encourage domestic banks to increase foreign currency retail funding. The Korean economy has fully learned how to avoid repeating the same mistakes that were made before the Asian crisis, and also to remain vigilant about spillovers from external shocks.

With respect to macroprudential measures, they have been effective in reducing foreign currency mismatches and mitigating capital flow volatility. However, there has been insufficient time to reach a conclusive assessment since the implementation. I ask the staff for further analysis of this issue in the 2013 Financial Sector Assessment Program (FSAP).

Regarding the need for a formal institutional setup for macroprudential policies, we concur with Mr. Shimoda and Mr. Chia that there is no one-size-fits-all solution and that actual implementation of policies between the relevant agencies is more important than the organizational formality. I look forward to an in-depth study of this issue in the upcoming FSAP.

Turning to financial sector issues, I would like to explain some features of household debt in Korea. Because most of the debt results from real estate purchases, the sustainability of the debt is closely related to real estate, particularly the housing market. Given the relatively small increase in house prices in Korea before the crisis and the low unemployment combined with strong wage growth, the collapse of house prices remains a remote possibility.

However, as Mr. Mozhin, Ms. O'Dea, Ms. Terracol, Mr. Weber, Ms. Arbelaez, Mr. Sun, and Mr. Yakusha suggested, our authorities are pursuing a soft landing of household debt, including by strengthening loan loss provisioning and asset classification criteria for nonbank financial institutions. In this regard, Ms. Lundsager, Mr. Prader, Mr. Rojas, and Mr. Virmani highlighted the importance of strengthening the regulation and monitoring of nonbank financial institutions. We fully agree with that point.

Finally, I acknowledge in Mr. Meyer's (GR) insightful comments that we should focus more on the quality and effective targeting of social spending and labor market reform measures rather than sticking to the aggregate levels of social spending per se. Small and medium enterprises, short-term contract workers, and nontradable service sectors are key policy targets in promoting sustainable and inclusive growth. The authorities will continue their efforts to strengthen social safety nets in a targeted and fiscally sustainable fashion while preserving incentives to work and keeping unemployment low.

I thank management and the staff again for their constructive engagement, and for the close working relationship with the authorities, which has been conducted in a candid and professional manner. All the gray statements and the Board discussion will be conveyed to my authorities.

The Acting Chair (Mr. Lipton) remarked that the transparency of reserve-related transactions was not a new issue in Korea. He noted that the Fund was not necessarily recommending including those transactions in the reserves number, but rather the Fund was advocating for more transparency about those transactions as they were relevant to judging Korea's position.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for adjusting macroeconomic policies and strengthening the resilience of the financial system in response to global headwinds and financial stress. Growth has decelerated and is projected to remain below potential for 2012, while inflationary pressures have receded. Directors noted that the near-term challenge is to manage the escalating downside risks to the outlook, particularly those related to a possible further intensification of the euro area crisis and its spillover.

Against this background, Directors considered that the current macroeconomic policy mix is appropriate. They supported the front-loading of budget spending in 2012 and the recent fiscal stimulus package, and welcomed the authorities' commitment to implement the budget fully while maintaining the medium-term consolidation objectives. Directors also agreed that monetary policy should continue to be accommodative, but stressed that, in light of the elevated inflation expectations, normalization should resume once the economy strengthens and the negative output gap starts to close.

Directors noted that, in the event of a severe downside scenario, Korea has policy space to respond, especially on the fiscal side, including through limited and temporary use of government-managed funds and additional discretionary spending. Korea's flexible exchange rate and ample international reserves would also help cushion against external shocks. Noting that the won is assessed to be moderately undervalued in real effective terms, Directors welcomed the authorities' intention to limit intervention to smoothing exchange rate fluctuations.

Directors welcomed progress in reducing external vulnerabilities in the financial system—external buffers have been strengthened, short-term debt has declined, and banks have reduced their reliance on wholesale funding. They noted nonetheless that the financial system remains subject to large swings in capital flows and funding risks. This calls for continued vigilance and efforts to enhance the effectiveness of macroprudential policies, including through improved coordination among regulatory agencies.

Noting the still high level of household debt, Directors called on the authorities to follow through with their strategy for a "soft landing," especially by strengthening asset classification and provisioning rules for non-bank financial institutions. They welcomed the progress in restructuring insolvent mutual savings banks, and encouraged the authorities to monitor remaining balance sheet weaknesses closely. Directors looked forward to a comprehensive assessment of Korea's financial system in the upcoming FSAP.

Directors underscored the need to address the medium-term challenges of rapid population aging and rising income inequality, and to boost potential growth. They supported the government's plan for a targeted increase in social spending over time, which will likely require a strengthening of revenue performance, mainly by broadening the tax base. They also encouraged further efforts to improve the oversight and governance of state-owned enterprises. Continued labor market reforms should focus on enhancing workforce and creating a more conducive environment for female participation. Directors also recommended boosting service sector productivity by enhancing competition through deregulation, further SME restructuring, and creating a more level playing field for the tradable and non-tradable sectors.

It is expected that the next Article IV consultation with the Republic of Korea will be held on the standard 12-month cycle.

APPROVAL: May 1, 2014

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Economic Outlook

1. *What are the sources of demand that would allow the economy to expand at the projected pace?*

- The staff projects growth at 3 percent for 2012.The assumption underlying the projection is that the economy will have bottomed out in Q2 and strengthen during the second half of the year. Private consumption growth is expected to rebound in the second half due to lower oil prices, stronger wage growth, and falling unemployment. On the external side, export growth is expected to recover in line with the projected global recovery. As noted in the staff report, there are downside risks to this baseline projection.

2. *Are there estimates of the size of Korea's informal economy and which possible measures might be adopted to reduce it?*

- The size of the informal economy is inherently difficult to estimate. However, indirect approaches have been utilized and provide some indication of how large it is. A recent paper finds that the size of Korea's informal economy was around 27 percent of official GDP on average during 1999—2007, and has been on a declining trend[2].

3. *Did the authorities' share staff's assessment of a "low" likelihood of a substantial and prolonged spike in oil prices? Is such a risk assessed equally across the membership or is the likelihood considered "low" for some countries and "medium" for others?*

- While the authorities are worried about the impact of an oil price spike, they agreed that the probability was "low" at that time. The risk is assessed uniformly across the membership, but the impact would vary for different countries depending on specific circumstances. For example, countries that are heavily dependent on oil imports would be more severely affected by an oil price spike than those that are relatively less dependent. Overall, the RAM reflects risks around the baseline and reflects staff's views on the source of risks and overall level of concerns as of the time of discussions with the authorities.

[2] For further details, please refer to Schneider, F, A. Buehn, and C. Montenegro, 2010, "New Estimates for the Shadow Economies All Over the World," International Economic Journal, Vol. 24, No. 4, pp. 443-61.

Fiscal Policy

4. *What is the growth impact of the envisaged fiscal stimulus package to be carried out by government-managed funds?*

- The stimulus package adopted by the authorities in the second half of 2012 included an increase in spending by government-managed funds of W 2.3 trillion, which corresponds to 0.17 percent of GDP. Based on multipliers derived from the IMF's Global Macroeconomic Fiscal and Monetary Model, this would add about 0.1 percentage point to growth.

5. *What are the authorities' forthcoming tax reform plans?*

- On August 8, the government announced its 2012 Tax Code Revision Plan, which focuses on (i) job creation and growth (ii) supporting domestic demand and low income households (iii) continuing fiscal prudence and (iv) improving the design of the tax system. In line with objectives noted in the staff report, the plan includes several measures to increase transparency and reduce the underground economy (e.g., systems to increase tax agency coverage of overseas financial assets, and reducing avoidance of inheritance tax through bank accounts with borrowed names).

Financial Sector

6. *What are the main facets of household debt and can staff comment on the size of household wealth?*

- At end-June 2012, the outstanding amount of Korea's household loans was W 868 trillion, about half of which was owed to commercial and specialized banks and the rest to NBFIs. Mortgage loans amounted to W 395 trillion, or 46 percent of total household loans. More than 90 percent of the mortgage lending (outstanding stock) was in floating rate terms, with about 80 paying interest only (40 percent in bullet form, 40 percent in installment form).

- According to a Bank of Korea/Financial Supervisory Services joint survey of 10,000 Korean households across the nation, average total household assets (both real and financial assets) amounted to W 298 million, which is six times the average total household liabilities (W 52 million).

7. *How has the level of household debt to disposable income developed for this year? What is the nature of the NBFIs responsible for rapidly increasing household debt? What are the authorities' concrete steps to improve regulation of NBFIs?*

- Data for disposable income are available only on an annual frequency; meaning that we will be able to update changes in the household debt-to-disposable income ratio only in early 2013. However, as noted in the staff statement, the growth of household debt has continued to moderate in 2012. In the second quarter, household debt grew by 5.6 percent year-on-year (an increase of W 10.9 trillion), slowing from 7 percent in Q1.

- The nature of NBFIs in Korea cannot be characterized easily, given that it includes a wide array of heterogeneous entities, from insurance companies to money lenders. The rapid growth in NBFI debt has been largely driven by mutual credits and certain non-deposit taking NBFIs (particularly insurance companies), which have grown very rapidly and accounted for 30 percent (mutual credits) and 18 percent (insurance companies) of non-bank credit in Korea at end-June 2012. However, at 8.4 percent, growth is very strong across all types of NBFIs against only 3 percent for banks.

8. *What is the status of the soft landing strategy for household debt including the timeframe for the equalization of regulatory standards for banks and non-banks?*

- The government's strategy for a soft landing of household debt plans to gradually strengthen asset classification and provisioning rules applied to mutual credit banks starting from July 2013 in three stages, with a view to equalizing regulatory standards across institutions types. In February 2012, the government further expedited the implementation schedule by requesting voluntary early compliance to the regulatory requirements. While it is too early to definitively assess the progress with the implementation, recent data suggest that the growth of household debt has moderated in line with the soft-landing strategy.

9. *What is the impact of the announcement of the latest relaxed regulations (in May 2012) on the housing prices in Seoul?*

- As mentioned in the staff report, the Korean government has lowered LTV and DTI ratios applied to three high-house price districts in the *Gangnam* area to 40 percent from 50 percent (equalizing it to other districts in *Seoul)*, given the recent stabilization of house prices in *Gangnam*. As shown in the in-text graph in the staff report (page 6), the impact of this relaxation is not visibly evident, with a stabilizing price trend continuing. However, it is too early to make a statistically meaningful assessment.

10. *What are the market induced price corrections (mentioned in Box 2) that would have prevented excessive leverage?*

- The point referred to in Box 2 is with respect to the relatively frequent adjustment of housing-related macroprudential measures—including debt-to-income (DTI) and loan-to-value (LTV) limits for mortgages—over the course of the cycle. This tends to contribute to stability in housing prices and encourages households to invest in housing. Looking ahead, persistently high levels of household debt and long-term demographic trends point to a secular decline in the demand for housing, forces that if left alone would gradually curb excessive household leverage.