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December 9, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Korea - First Review and Request for Modification of
Performance Criteria Under the Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the first review under the stand-by arrangement with Korea and its request for modification of performance criteria. A draft decision appears on pages 26-28. This matter will be brought to the agenda for discussion on a date to be announced.

Mr. R. C. Williams (ext. 7610) or Mr. Marquez (ext. 7180) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

KOREA

Staff Report for the First Review and Request for Modification
of Performance Criteria Under the Stand-By Arrangement

Prepared by the Asian and Exchange and
Trade Relations Departments

(In consultation with the Fiscal Affairs, Legal, and
Treasurer's Departments)

Approved by Douglas A. Scott and Manuel Guitian

December 9, 1985

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I. Introduction

Discussions with the Korean authorities for the first review of the stand-by arrangement were held in Seoul in the period November 1-18, 1985. ^{1/} The staff team met with the Deputy Prime Minister, the Minister of Finance, the President's Senior Secretary for Economic Affairs, the Governor of the Bank of Korea, and other government officials. Mr. Romualdez, Alternate Executive Director for Korea, and Mr. Lee, Advisor to the Executive Director for Korea, attended some of the meetings.

The Korean authorities have requested a modification of the performance criteria in respect of net domestic assets of the banking system (NDA) and overall external debt for December 1985. The authorities have also formulated an economic program for 1986; the policies for the first half of the year have been quantified in performance criteria through June 1986. Both the request for modification of performance criteria and a description of the economic program for 1986 are contained in the attached letter from the Minister of Finance dated December 6, 1985.

The Executive Board approved the stand-by arrangement for Korea on July 12, 1985 (EBM/85/105, 7/12/85) for the period through March 10, 1987. The stand-by arrangement is being financed entirely from ordinary resources. The amount of the arrangement is SDR 280 million (equivalent to 60 percent of quota, or an annualized rate of access of 36 percent), which is being made available in seven equal purchases of SDR 40 million (Table 1). The first purchase was made in August 1985. The second purchase, which was scheduled for the fourth quarter of 1985, was conditional on the observance of September ceilings, but could not be made because the September ceiling on NDA was exceeded (Table 2). The third purchase is conditional on the completion of the first stand-by review, scheduled to take place by March 10, 1986, as well as on the observance of December ceilings. ^{2/} If the Executive Board approves the proposed decisions granting the modification of the December ceilings and completing the first review, Korea will be able to make the second and third purchases following observance of the December performance criteria, including those whose modification is proposed.

As of October 31, 1985, Korea's use of Fund credit under tranche policies stood at 310 percent of Korea's quota of SDR 462.8 million, including 75 percent of quota outstanding under the compensatory

^{1/} The staff team consisted of Mr. R. C. Williams (head, ASD), Mr. Marquez-Ruarte (ASD), Mr. Kronenberg (ETR), Ms. Yoshinari (ASD), and Ms. Lee (secretary, ASD). The staff team was assisted by Mr. Villanueva, the Fund's Resident Representative in Korea.

^{2/} Four additional purchases are scheduled for the period April 1986-March 1987; the second review must be concluded by September 10, 1986.

Table 1. Korea: Fund Position During the Period
of the Arrangement, 1985-87

	Outstanding Oct. 31, 1985	1985 Nov.- Dec.	1986				1987 Jan.- Mar. 10
			Jan.- March	April- June	July- Sept.	Oct.- Dec.	
(In millions of SDRs)							
All transactions, net		-62.2	17.0	-20.2	-7.8	-15.7	-16.0
Purchases		--	80.0	40.0	40.0	40.0	40.0
Repurchases		-62.2	-63.0	-60.2	-47.8	-55.7	-56.0
Transactions under tranche policies, net		-62.2	30.3	-6.9	5.5	-2.4	-2.7
Purchases		--	80.0	40.0	40.0	40.0	40.0
Ordinary resources		(--)	(80.0)	(40.0)	(40.0)	(40.0)	(40.0)
Borrowed resources		(--)	(--)	(--)	(--)	(--)	(--)
Repurchases		-62.2	-49.7	-46.9	-34.5	-42.4	-42.7
Ordinary resources		(-19.7)	(-15.2)	(-4.4)	(--)	(--)	(--)
Borrowed resources		(-42.5)	(-34.5)	(-42.5)	(-34.5)	(-42.4)	(-42.4)
Transactions under special facilities		--	-13.3	-13.3	-13.3	-13.3	-13.3
Purchases		--	--	--	--	--	--
Repurchases		--	-13.3	-13.3	-13.3	-13.3	-13.3
Total Fund credit out- standing (end of period)	1,435.3	1,373.1	1,390.1	1,369.9	1,362.1	1,346.4	1,330.4
Under tranche policies	1,089.2	1,027.1	1,057.4	1,050.5	1,056.0	1,053.6	1,050.9
Special facilities	346.1	346.0	332.7	319.4	306.1	292.8	279.5
(In percent of quota)							
Total Fund credit out- standing (end of period)	310.1	296.7	300.4	296.0	294.3	290.9	287.5
Under tranche policies	235.3	221.9	228.5	227.0	228.2	227.7	227.1
Special facilities	74.8	74.8	71.9	69.0	66.1	63.3	60.4

Source: International Monetary Fund.

Table 2. Korea: Stand-by Arrangement--Quantitative Performance Criteria
for the Period through December 31, 1985

	1984	1985		
	Dec. 31	Sept. 30 Orig. Ceiling	Sept. 30 Actual	Dec. 31 Orig. Ceiling
<hr/>				
	(In billions of won)			
Net credit to the public sector from the banking system	1,973	2,023	1,311	2,268
Net domestic assets of the banking system	32,706	35,324	37,760	36,806
<hr/>				
	(In millions of U.S. dollars)			
Outstanding external debt of all maturities, excluding IMF credit	40,989	43,889	43,125	43,889
Outstanding short-term debt <u>1/</u>	11,425	...	10,340	11,125

Sources: Korean Ministry of Finance; and Fund staff estimates.

1/ Defined as external debt with initial maturity of one year or less.

financing facility. Assuming full use of the present stand-by arrangement, together with scheduled repurchases, Korea's use of Fund credit would be reduced to 287 percent of quota by the end of the stand-by period. Information on Korea's relations with the Fund is provided in Annex I. 1/ Korea continues to avail itself of the transitional arrangements of Article XIV.

II. Performance Under the 1985 Program

1. The economic program for 1985

The 1985 economic program aimed primarily at further strengthening the external position through continued demand restraint and exchange rate flexibility. The external current account deficit was targeted to decline by \$0.5 billion, to \$0.9 billion (1.1 percent of GNP) in 1985, thus permitting a significant slowdown in the rate of growth of overall external debt (Table 3). On the basis of assumptions about the external environment and projections of export receipts, the program envisaged that output growth would be maintained at about 7 percent and inflation (CPI) contained to 2-3 percent in 1985. The economic program called for continued restraint in fiscal and credit policy. The consolidated public sector deficit was to be kept to a modest 1.8 percent of GNP in 1985, while the rate of growth of NDA was projected to decline moderately, to below 13 percent. The program also called for continued flexibility in exchange rate management and further progress in liberalizing both the financial and the trade systems.

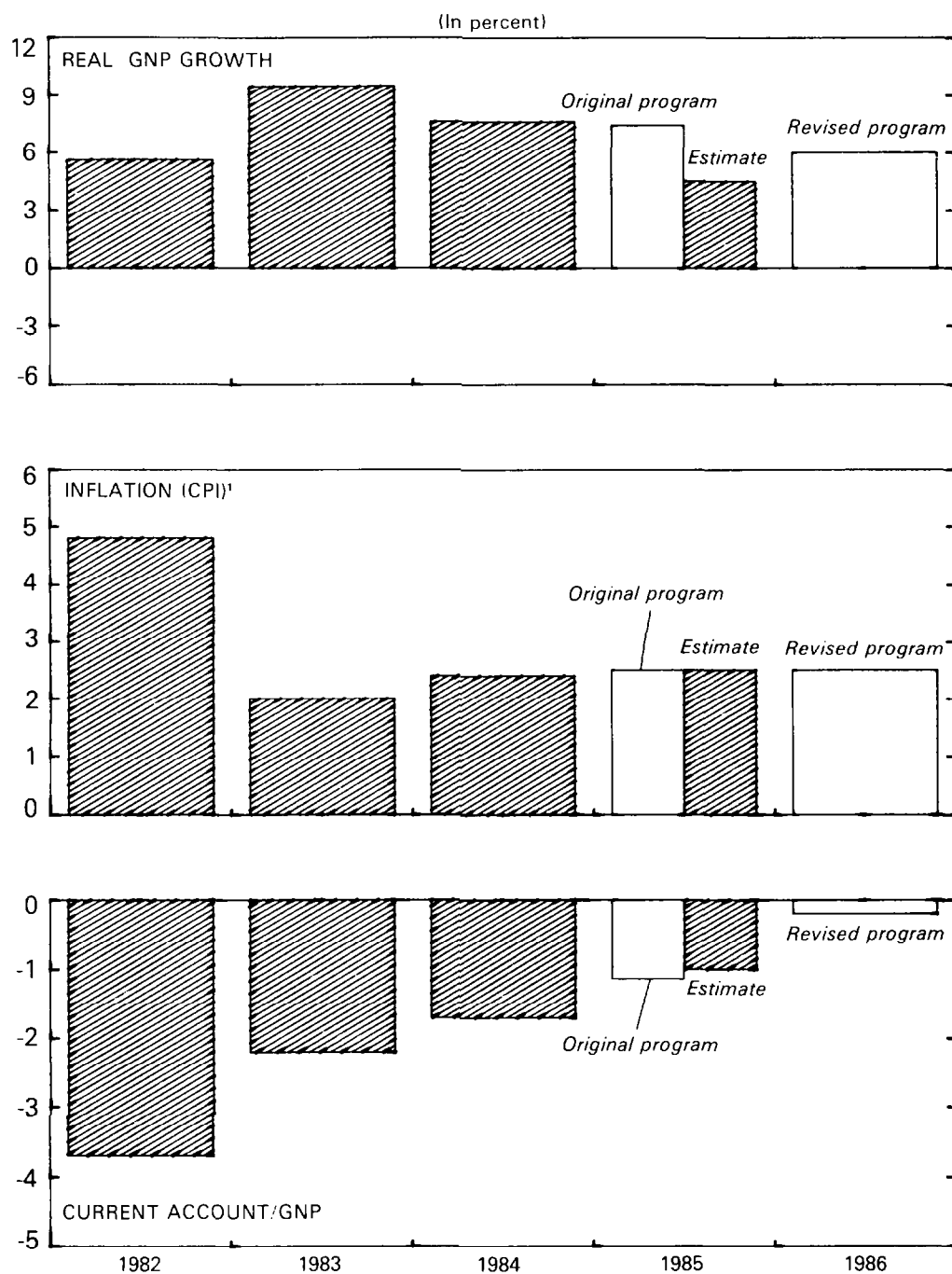
2. Recent developments

The external environment was less favorable to Korea than foreseen when the economic program was developed. In retrospect, the program underestimated the adverse impact of protectionist pressures, competition from other producers, the slowdown in economic activity in the U.S., and the severity of cutbacks in construction activity in the Middle East. All told, the aggregate shortfall in 1985 current account receipts is likely to be as large as \$3.5 billion (equivalent to more than 4 percent of GNP). Nevertheless, the Korean economy recorded a highly satisfactory performance in terms of the external current account and inflation, but growth fell well below the target (Chart 1).

The growth of exports of goods and nonfactor services (at constant prices) dropped from 8 percent in 1984 to less than 3 percent in the

1/ A description of World Bank activities in Korea, with particular emphasis on structural adjustment and financial sector loans, is contained in Annex II.

CHART 1
KOREA
SELECTED ECONOMIC INDICATORS, 1982-86



Source: Data provided by the Korean authorities.
¹Change in consumer price index for year to December.



Table 3. Korea: Selected Economic and Financial Indicators, 1982-86

	1982	1983	1984 Actual	1985 Prog.	1985 Est.	1986 Proj.
(Annual percentage changes, unless otherwise specified)						
National income and prices						
GNP at constant prices	5.6	9.5	7.6	7.0	4.5	6.0
GNP deflator	7.1	3.0	4.0	2-3	2-3	2-3
Consumer prices (year to Dec.)	4.8	2.0	2.4	2-3	2-3	2-3
External sector ^{1/}						
Exports, f.o.b.	1.0	11.0	13.3	12.2	1.5	10.9
Imports, f.o.b.	-3.4	6.4	9.6	9.5	-1.8	8.2
Export volume	4.6	15.5	9.8	9.0	4.1	7.1
Import volume	4.8	12.1	8.2	7.0	2.3	5.5
Terms of trade	4.3	0.9	1.9	0.5	1.3	1.3
Nominal effective exchange rate ^{2/}	87.6	82.2	83.1	...	...	...
Real effective exchange rate ^{2/}	100.4	93.1	93.3	...	83.5	83.5
Consolidated public sector						
Revenue	8.9	15.1	12.5	6.5	6.6	12.0
Expenditure and net lending	8.3	2.0	11.3	8.6	7.3	14.1
Money and credit						
Net domestic assets ^{3/}	39.0	22.4	15.9	16.2	30.2	18.2
Public sector ^{3/4/}	2.7	-0.7	-0.2	1.2	1.2	1.0
Private sector ^{3/}	32.5	22.4	18.5	16.7	25.4	17.2
Money and quasi-money	27.0	15.2	10.6	13.9	18.2	15.2
Interest rate (end of period, one-year savings deposit)	8.0	8.0	10.0	12.0 ^{5/}	12.0	12.0
(In percent of GNP)						
Consolidated Public sector						
Revenue	19.4	19.9	20.0	19.3	19.9	20.5
Expenditure and net lending	23.7	21.5	21.4	21.1	21.4	22.5
Deficit	-4.3	-1.6	-1.4	-1.8	-1.5	-2.0
Domestic bank financing ^{6/}	0.6	-0.4	-0.1	0.4	0.4	...
Other domestic financing	2.4	1.3	1.0	0.8	0.6	...
Foreign financing	1.3	0.7	0.5	0.6	0.5	...
Gross domestic investment ^{7/}	27.0	27.8	29.9	30.1	...	...
Gross national savings	22.4	24.8	27.4	28.6	...	...
Foreign savings	4.5	2.9	2.3	1.6	...	...
External current account	-3.7	-2.2	-1.7	-1.1	-1.0	-0.2
External debt ^{8/}	50.6	51.9	50.6	51.8	55.0	54.4
Including use of Fund credit	52.4	53.6	52.5	53.4	56.7	56.0
Debt service ratio ^{9/}	22.0	20.3	21.4	20.6	23.0	22.7
Interest payments ^{9/}	12.3	10.1	10.8	10.6	11.7	10.9
(In billions of U.S. dollars)						
External current account	-2.6	-1.6	-1.4	-0.9	-0.8	-0.2
Overall balance of payments	-2.5	-1.3	-1.5	-0.7	-2.7	-1.0
Gross international reserves (months of imports of goods)	3.9	3.6	3.6	3.4	3.7	3.5

Sources: Korean Ministry of Finance; and Fund staff estimates.

^{1/} Based on U.S. dollar values.

^{2/} December position; decline represents depreciation (1980=100).

^{3/} As a percentage of previous year's stock of money and quasi-money (M2 plus other liabilities).

^{4/} Includes Fertilizer Fund.

^{5/} New household savings deposit instrument introduced in April 1985.

^{6/} In terms of monetary accounts.

^{7/} Investment and savings differ slightly because of the statistical discrepancy in the national accounts. Foreign savings exclude private transfers which are included in the external current account.

^{8/} Includes public, publicly guaranteed, and private sector bank and nonbank debt of all maturities.

^{9/} As percent of exports of goods and services; includes interest on short-term debt and excludes service on debt to the Fund.

first three quarters of 1985. ^{1/} The sharp slowdown in foreign earnings led to a considerable weakening of domestic demand and economic activity. As export prospects were scaled down, investment in both fixed capital and inventories faltered. The rate of growth of real investment expenditure dropped from 12 percent in 1984 to 1 percent in the first three quarters of 1985. On the other hand, the growth of real consumption expenditure remained stable at 4 percent, with an acceleration in government consumption just offsetting a deceleration in private consumption.

The slowdown in aggregate demand was reflected in a deceleration in output growth and a sizable decline in imports. The hardest hit domestic sector was manufacturing, which expanded by 4 percent in the first three quarters of 1985, compared with a growth of 14 1/2 percent in 1984. Construction, which had stagnated in 1984, continued to be sluggish, while agricultural production rose sharply after a poor performance in 1984. Including the effect of an increase in net income paid to the rest of the world, the growth of real GNP declined from 7 1/2 percent in 1984 to 4 percent in the first three quarters of 1985. The third quarter of the year showed a marked recovery with respect to the first two quarters, and the recovery is expected to strengthen further in the fourth quarter. On this basis, real GNP is likely to record a growth of about 4 1/2 percent for the year as a whole. With soft domestic demand, and with declines in foreign prices of tradeable goods offsetting the price impact of the depreciation of the won, domestic inflation has remained in the range of 2-3 percent.

The staff has revised its forecast of Korea's balance of payments for the full year 1985, based on data through October and the underlying trends of foreign and domestic demand. The revised estimates envisage that, despite a virtual stagnation in current account receipts, Korea's current account deficit will narrow significantly from \$1.4 billion (1.7 percent of GNP) in 1984 to \$0.8 billion (1 percent of GNP) in 1985 (Table 4). The trade deficit will probably decline by \$0.8 billion, to virtual balance in 1985. Aided by a flexible exchange rate policy, merchandise export volumes are estimated to expand by 4 percent in an external environment characterized by a rise in protectionist measures and sluggish international demand for ships and other major Korean exports. Because of a decline in prices, the value of exports will increase by only 1-2 percent, far below the original program projection of 12 percent.

Tight fiscal policy, exchange rate flexibility, and weak domestic demand are expected to limit the growth in import volume to about 2 percent in 1985, in spite of import liberalization measures adopted in 1984-85. With a decline in import prices, the value of imports will

^{1/} Measured with respect to the level in the first three quarters of 1984.

Table 4. Korea: Balance of Payments, 1983-86

(In billions of U.S. dollars)

	1983	1984	1985		1986	
			Orig. Prog.	Rev. Proj.	Orig. Proj.	Rev. Proj.
Exports, f.o.b.	23.2	26.3	29.5	26.7	31.7	29.6
Volume (percentage change)	(15.5)	(9.8)	(9.0)	(4.1)	(8.0)	(7.1)
Unit value (percentage change)	(-4.2)	(3.2)	(3.0)	(-2.6)	(4.0)	(3.5)
Imports, f.o.b.	-25.0	-27.4	-30.0	-26.9	-33.4	-29.1
Volume (percentage change)	(12.1)	(8.2)	(7.0)	(2.3)	(7.0)	(5.5)
Unit value (percentage change)	(-6.0)	(1.3)	(2.5)	(-3.9)	(4.0)	(2.2)
Net services	-0.4	-0.9	-0.9	-1.1	-0.7	-1.4
Receipts	(7.2)	(7.3)	(7.7)	(7.0)	(8.6)	(7.4)
Payments	(-7.6)	(-8.2)	((-8.6)	(-8.1)	(-9.3)	(8.8)
Transfers (net)	0.6	0.5	0.5	0.5	0.6	0.6
Current account balance	-1.6	-1.4	-0.9	-0.8	-0.4	-0.2
(As a percent of GNP)	(-2.2)	(-1.7)	(-1.1)	(-1.0)	(-0.5)	(-0.2)
Medium- and long-term capital (net)	0.4	1.6	0.8	-0.9	0.8	-0.2
Of which: External borrowing (net)	0.9	1.4	0.9	0.8	...	1.0
Short-term capital (net)	0.9	-0.8)	-0.6	-0.5	-0.6	--
Errors and omissions	-1.0	-0.8)		-0.5		-0.6
Overall balance	-1.3	-1.4	-0.7	-2.7	-0.2	-1.0
Monetary movements ^{1/}	1.3	1.4	0.7	2.7	0.2	1.0
Assets (increase -)	-0.1	-0.8	-0.2	--	-0.4	-0.3
Liabilities	1.4	2.2	0.9	2.7	0.6	1.3
Use of Fund resources (net)	(0.2)	(0.3)	(-0.2)	(-0.2)	(-0.1)	(--)
Other bank liabilities	(1.2)	(1.9)	(1.1)	(2.9)	(0.7)	(1.3)
Memorandum items:						
Gross international reserves	7.5	8.2	8.4	8.2	8.6	8.5
(In months of merchandise imports)	(3.6)	(3.6)	(3.4)	(3.7)	(3.1)	(3.5)

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

^{1/} Including swaps of nondeposit money banks with the Bank of Korea.

contract by almost 2 percent, compared with the originally projected increase of about 10 percent. In contrast to the improvement in the trade balance, the services account deficit is projected to widen to an estimated \$1.1 billion in 1985, from \$0.9 billion in 1984, due mainly to a continued decline in receipts from overseas construction.

The medium- and long-term capital account is expected to swing from a surplus of \$1.6 billion in 1984 to a deficit of \$0.9 billion in 1985. An important factor underlying this turnaround is the repayment by some resident Korean firms (or guarantor banks) of up to \$0.9 billion in foreign debt obligations of their overseas subsidiaries, mainly construction companies operating in the Middle East. Since these repayments were largely financed through foreign borrowing by the domestic banking system, the nonmonetary capital account (and the overall balance of payments) will record an equivalent deterioration. ^{1/} With a further sizable reduction in short-term nonmonetary debt and continued large negative errors and omissions, the overall balance of payments deficit is projected to widen from \$1.4 billion in 1984 to about \$2.7 billion in 1985.

Outstanding external debt, excluding amounts owed to the Fund, is projected to rise to \$44.3 billion at the end of 1985 (Table 5), exceeding the original program ceiling by about \$0.4 billion (0.9 percent), owing in large part to the unprogrammed repayments of debts of foreign subsidiaries, described above. ^{2/} The external obligations of Korean firms residing abroad were approximately \$6 billion in August 1985, virtually the same as at end-1984. Within this total, debts of the overseas construction firms were \$3.5 billion, or \$0.1 billion less than at the end of 1984. The latter debt, and probably the total as well, are expected to have declined in the remainder of the year.

Debt service payments, including interest on short-term debt, rose from 21 1/2 percent of exports of goods and services in 1984 to an estimated 23 percent in 1985. The excess over the ratio projected in the program reflects entirely the effect of the shortfall in current account receipts. Aided by a reduction in import financing requirements, the maturity structure of Korea's external debt improved in line with expectations. Short-term debt, including reserve-related liabilities, is projected to decline by about \$0.4-0.5 billion, to below the program ceiling of \$11.1 billion. The share of short-term debt in total

^{1/} Foreign borrowing by commercial banks is treated as compensatory borrowing in the balance of payments presentation for Korea.

^{2/} External debt statistics in this report include debt of all maturities and cover both public and publicly guaranteed debt and private debt. In accordance with international practices, these statistics exclude foreign borrowings of branches of Korean banks and subsidiaries residing abroad.

Table 5. Korea: External Debt Excluding
Fund Credit, 1982-86 1/

	1982	1983	1984	1985	1986
				Prog. <u>2/</u>	Rev. Proj.
					Proj.
(In millions of U.S. dollars)					
Medium- and long-term	23,432	26,836	29,564	32,764	33,130 <u>3/</u>
Short-term	12,446	12,115	11,425	11,125	10,825
Total external debt (end period)	35,878	38,951	40,989 <u>4/</u>	43,889	44,255
Debt service payments					
Principal, on medium- and long-term debt	2,736	3,121	3,564	3,762	3,841
Interest, including on short-term debt	<u>3,488</u>	<u>3,052</u>	<u>3,611</u>	<u>3,926</u>	<u>3,896</u>
Total debt service	6,224	6,173	7,175	7,688	7,737
In percent of exports of goods and services	(22.0)	(20.3)	(21.4)	(20.6)	(23.0)
(In percent)					
Growth rate of external debt	15.4	8.7	5.2	7.1	8.0
External debt (in percent of GNP)	52.4	51.9	50.6	51.8	55.0
Share of short-term in total debt	34.7	31.1	27.9	25.3	25.1
Gross international reserves/ short-term debt	57.9	61.8	71.9	75.6	73.9
Trade-related/imports	37.6	40.9	30.1	27.3	28.3

Sources: Ministry of Finance; and staff estimates.

1/ Incorporates merchant banks and reclassification of interoffice accounts of branches of foreign bank. Excludes foreign debt of Korean branches and subsidiaries residing abroad; such debt outstanding amounted to \$6.0 billion at end-August 1985.

2/ Constant exchange rate basis for projections on debt outstanding and flows during the year.

3/ At constant exchange rates.

debt would thus decline from 28 percent in 1984 to about 25 percent in 1985, while the ratio of gross international reserves to short-term debt would rise from 72 percent to about 74 percent.

3. Policy implementation

The policies pursued by the Korean authorities in 1985 generally adhered to the guidelines of the stand-by program: fiscal policy was kept tight, the exchange rate was managed flexibly, and continued progress was made in regard to financial sector reform and liberalization of imports and restrictions on direct foreign investment. In the areas of domestic credit and external debt, however, developments deviated from the expectations of the program (Chart 2).

a. Fiscal policy

The deficit of the consolidated public sector rose marginally in relation to GNP, from 1.4 percent in 1984 to an estimated 1.5 percent in 1985 (Table 6). 1/ The economic program envisaged that the deficit would rise to 1.8 percent, including the impact (0.2 percent) of a one-time transfer to local governments with the purpose of assisting in the early repayment of their debts to commercial banks. This transfer was in fact delayed to 1986.

Revenue of the consolidated public sector is estimated to have risen by nearly 7 percent in 1985, somewhat faster than foreseen in the program, and the ratio of revenue to GNP is estimated to have remained unchanged at about 20 percent. The revenue increases were broadly based. The lagged effect of income growth in 1984 helped sustain the growth of income tax collections, which were only marginally affected by the introduction, in mid-1985, of various tax incentives for business investment, including a shortening of the depreciation period for machinery and equipment. Taxes on international trade are estimated to have risen strongly owing to the effect of the depreciation of the won on the domestic currency value of trade flows. This factor overshadowed the negative impact of a change in the export duty drawback system, the reduction of the duty on oil imports, and a modest reduction in the average tariff rate.

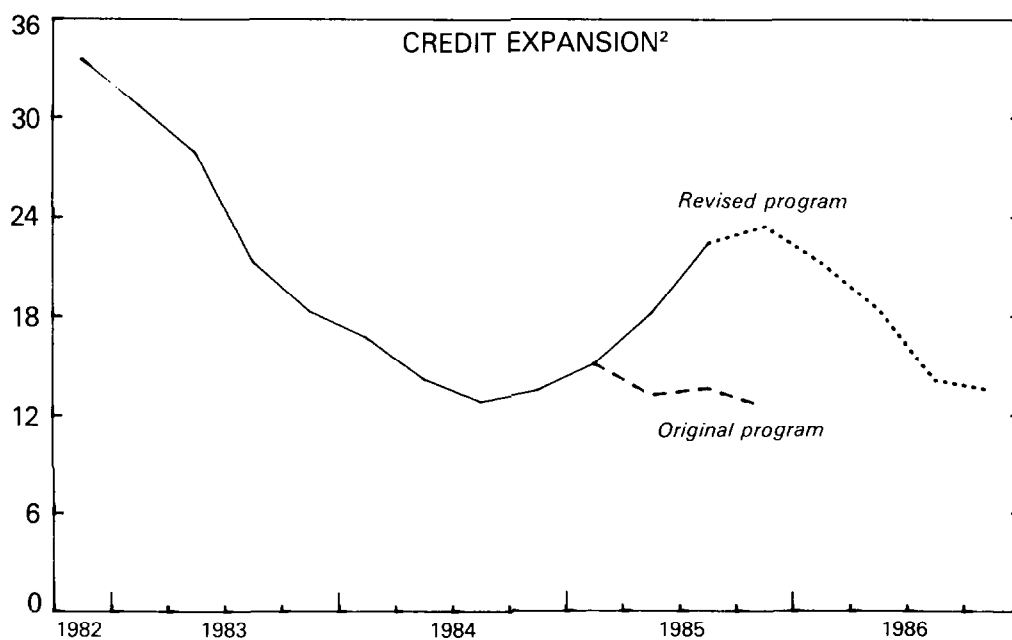
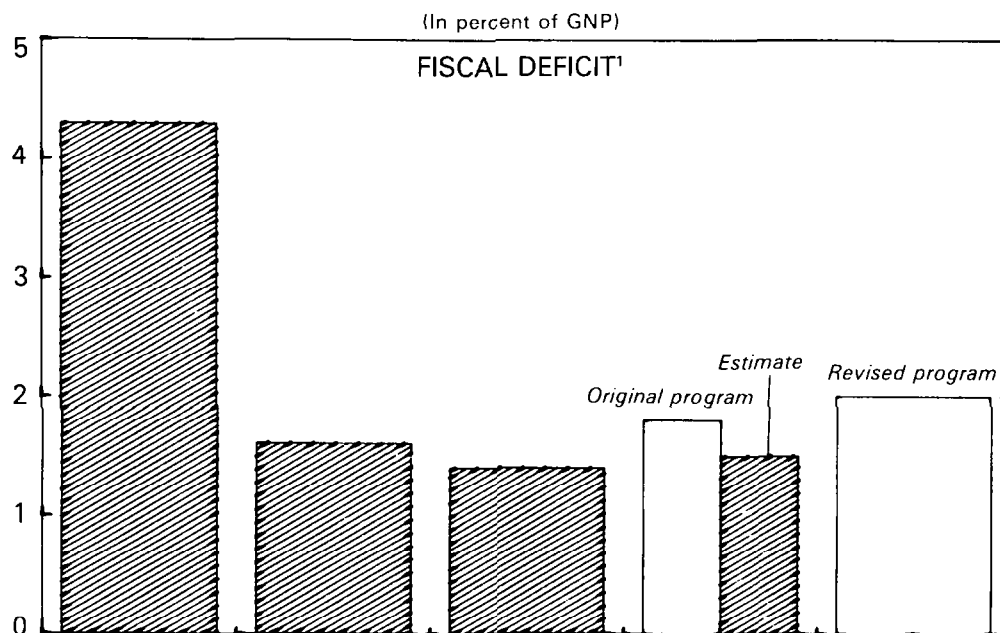
Expenditure of the consolidated public sector (including net lending) increased by an estimated 7 percent in 1985; the increase was smaller than had been envisaged in the program in spite of new spending

1/ Fiscal years coincide with calendar years. The consolidated public sector comprises the Central Government and five public funds--the Grain Management Fund (GMF), the tobacco and ginseng tea monopoly, the national railroad, the post office, and the government procurement organization. Local governments and 19 government-invested enterprises are excluded from this concept.





CHART 2
KOREA
FINANCIAL POLICY DEVELOPMENTS, 1982-86



Source: Data provided by the Korean authorities.

¹The data are actuals and are not corrected for changes in definition. The removal of the Korea Telecommunications Authority from the public sector in 1982 reduced the overall deficit by 0.2 percent points of GNP and the removal of the Civil Servants Pension Fund and special account from the public sector in 1983 reduced the overall deficit by 0.1 percent of GNP.

²Net domestic assets of the banking system.



Table 6. Korea: Public Finances, 1982-86 ^{1/}

(In percent of GNP)

	1982	1983	1984	1985		1986
				Pro-gram	Esti-mate	Proj.
Central Government						
Revenue	19.3	19.7	19.3	19.0	19.6	20.0
Tax	16.5	17.5	17.0	16.7	17.3	...
Nontax	2.8	2.2	2.3	2.3	2.3	...
Expenditure	22.5	20.9	20.6	20.8	21.1	22.0
Current	16.0	15.7	15.6	16.0	16.2	...
Capital	3.5	2.6	2.6	2.5	2.8	...
Net lending	3.0	2.6	2.4	2.3	2.1	...
Net financial transactions between the Central Govern- ment and the public funds ^{2/}	-1.0	-0.5	-0.1	--	--	--
Consolidated public sector						
Revenue	19.4	19.9	20.0	19.3	19.9	20.5
Expenditure and net lending	23.7	21.5	21.4	21.1 ^{3/}	21.4	22.5 ^{3/}
Deficit	-4.3	-1.6	-1.4	-1.8 ^{3/}	-1.5	-2.0 ^{3/}
Memorandum items:						
Deficit of the Grain Management Fund ^{4/}	-0.9	-0.4	-0.8	-0.7	-0.7	-0.4
Operating surplus of government invested enterprises	2.4	3.1	3.0	2.7	...	...
Overall deficit of nonfinan- cial public enterprises	-3.1	-1.9	-1.6	-2.2	...	...

Sources: Ministry of Finance; and staff estimates.

^{1/} The figures for the public sector are not corrected for changes in definition. The removal of the Korea Telecommunications Authority from the accounts in 1982 reduced revenue and expenditure by more than 1 percent of GNP and the overall deficit by 0.2 percent. The removal of the Civil Servants Pension Fund and Special Account in 1983 reduced revenue and expenditure by almost 1 percent of GNP and the overall deficit by 0.1 percent.

^{2/} Includes payments of profits to the Government primarily from the tobacco and ginseng tea monopoly, receipts of subsidies, primarily by the GMF, and capital transfers from the Government.

^{3/} Includes a capital transfer to local governments (0.2 percent of GNP) to assist in the early repayment of their debts to commercial banks.

^{4/} Financed primarily by the Bank of Korea in 1981-83 and by government subsidy in 1984-85.

initiatives adopted since mid-1985. In August, the Government passed a supplementary budget providing for additional expenditure on construction and repair of highways, the expansion of Seoul's international airport, construction of piped water systems, construction of an industrial complex, transfers to rural households, and loans to small businesses and to college students. In order to offset the impact of these additional outlays on the fiscal position, the Government delayed the anticipated one-time transfer to local governments (referred to above) and achieved savings in operating expenses, net lending and other outlays. The ratio of expenditure to GNP is estimated to have remained stable at about 21 1/2 percent.

As regards the financing of the 1985 deficit, foreign borrowing is estimated to contribute the equivalent of 1/2 percent of GNP, somewhat less than that envisaged in the program. Some postponement of capital spending (particularly net lending) and a more cautious attitude towards foreign borrowing--partly due to increased awareness of foreign exchange risk--led to a scaling down of drawings on foreign loans. The distribution of domestic financing between bank and nonbank sources is somewhat uncertain at this time. During the first ten months of the year, the consolidated public sector reduced its indebtedness to the banking system by a sizable amount. Although this development reflected strong seasonal factors, it is estimated that, for the year as a whole, the net use of bank credit by the public sector will be smaller than the level envisaged under the December 1985 subceiling.

b. Monetary policy

Domestic bank credit expansion has deviated significantly from the program guidelines--the September NDA ceiling was exceeded by about 5 percent. During the year ending October, NDA increased by 21 percent compared with the program target of about 13 percent (Table 7). ^{1/} The excess in the rate of credit expansion reflected a decision to increase the availability of credit to the private sector, since net credit to the public sector declined by more than projected for this period. The acceleration of credit expansion during the first ten months of the year was associated both with an acceleration of broad money growth and with a decline of \$2.6 billion in net foreign assets of the banking system, compared with a program target of a \$0.7 billion decline for the year as a whole.

In their discussions with the staff, the authorities indicated that the acceleration of credit reflected, to some extent, the strong response of private sector deposits in commercial banks to the increases in interest rates on bank CDs and savings deposits introduced in April 1985. This development mirrored a slowdown in deposit growth in the

^{1/} About 2 percentage points of the deviation was attributable to changes in accounting exchange rates.

Table 7. Korea: Monetary Survey, 1984-1986

	1984		1985			1986	
	Dec.	Sept.	Oct.	Dec.	March	June	Dec.
	Actual	Actual	Prel.	Prog.	Prog.	Prog.	Proj.
(In billions of won)							
Net domestic assets	32,706	38,467	38,288	40,358	41,258	42,631	45,804
Domestic credit	36,059	40,999	40,718	42,788	43,688	45,061	48,234
Public sector	(1,973)	(1,311)	(760)	(2,268)	(2,250)	(2,150)	(2,568)
Private sector	(34,086)	(39,688)	(39,958)	(40,520)	(41,438)	(42,911)	(45,666)
Net other items	-3,353	-2,532	-2,430	-2,430	-2,430	-2,430	-2,430
M2 plus other liabilities	25,377	28,477	28,070	30,000	30,676	31,524	34,555
Net foreign assets <u>1/</u>	-7,329	-9,990	-10,218	-10,357	-10,582	-11,107	-11,249
(Percentage change)							
Net domestic assets	13.5	22.4	20.7	23.4	21.2	18.4	13.5
Domestic credit	13.2	18.4	17.3	18.7	17.9	16.2	12.7
Private sector	14.3	19.5	18.8	18.9	17.0	14.5	12.7
M2 plus other liabilities	10.6	16.2	14.2	18.2	18.9	18.2	15.2
(In billions of U.S. dollars)							
Exchange rate (won/US\$)	827.4	891.7	892.2	892.2	892.2	892.2	892.2
Net foreign assets <u>1/</u>	-8.86	-11.22	-11.47	-11.61	-11.86	-12.45	-12.61
Change during year (BOP)		-2.36	-2.61	-2.75	-0.25	-0.84	-1.00
At constant exchange rates (W 827.4 = US\$1)	(In billions of won)						
Net domestic assets	32,706	37,760	37,562	39,604			
Ceiling		35,824		36,806			
Excess over ceiling		1,936		2,798			

Sources: Korean authorities; and Fund staff estimates.

1/ Including swaps of deposit money banks with the Bank of Korea.

nonbank financial intermediaries (NBFIs). The annual rate of expansion of deposits in NBFIs declined from 36 percent in March 1985 to 29 percent in October. Credit demand also shifted from the nonbank to the bank market. The annual rate of expansion of domestic credit extended by the NBFIs dropped from 37 percent in March 1985 to 31 percent in October. For the financial system as a whole, the annual rate of expansion of domestic credit increased moderately from 22 percent in March 1985 to 23 percent in October. 1/

The staff recognized that the stand-by program had made insufficient allowance for this factor, and that a substantial part of the expansion of credit in excess of the program target had been financed through additional domestic resources of the banking system. However, the staff pointed out that a significant part had been financed through foreign borrowing by the banking system as well. A slower rate of bank credit expansion, closely in line with the evolving demand for broad money balances, probably could have limited the decline in net foreign assets.

The authorities noted that credit conditions and the balance of payments were also affected by other factors whose importance was not fully foreseen at the time the program was formulated. One factor was an unexpected feature of the ongoing reorganization of the overseas construction industry which aimed at phasing out the weaker firms and improving the prospects for stronger firms. In the process, some Korean firms assumed the repayment of foreign debt obligations of their overseas subsidiaries. The Government supported such action in the interest of protecting Korea's creditworthiness in international capital markets. These transactions led to an increase in domestic bank credit to the parent companies, which the commercial banks funded through foreign borrowing. Another factor was the unanticipated weakness of the export sector, which raised the need to promote export diversification in important industries (including shipping and shipbuilding) by increasing credit allocations for these sectors.

The authorities are cognizant of the need to slow domestic credit expansion, and their credit program for the last two months of the year envisages a significant deceleration in the growth of NDA. The seasonally adjusted annual rate of growth of NDA would drop from 27 percent during April-October 1985 to 16 percent during November-December. The authorities believe that a more pronounced deceleration in domestic credit expansion would be difficult to implement in the final weeks of the year because of the seasonal credit needs of the public sector as well as credit commitments already made to bolster the sectors mentioned above. Failure to deliver such credit commitments would bring to a halt the adjustment in those industries, and compromise the prospects for

1/ The program assumed an expansion of financial system domestic credit of about 20 percent in 1985.

exports in the medium term. Tightening credit for other sectors would run a serious risk of weakening the ongoing economic recovery.

The revised credit program would result in an expansion of NDA of 23 percent for the year as a whole, compared with the expansion of 13 percent foreseen in the original program. ^{1/} Under revised projections of the broad monetary aggregates, which take into account recent trends as well as the historical pattern of the demand for money, the growth of broad M2 would reach about 18 percent for the year as a whole, compared with 14 percent in the program. This outcome would be associated with a marked slowdown in the rate of decline of net foreign assets of the banking system in the last two months of the year, limiting the loss for the year as a whole to about \$2.7 billion.

As regards financial sector reform, in April 1985 the Government increased the maximum rate on term lending by 2 percentage points to 13.5 percent. In addition, two new savings schemes were introduced that offer interest rates of 12 percent per annum on six-month deposits and 13 percent on three-year deposits; the maximum interest rates previously available on savings deposits with such maturities were 6 percent and 10 percent, respectively. Interest rates were also raised on bank CDs, and banks and NBFIs were allowed to offer cash management accounts.

c. External policies

The authorities have continued to manage the exchange rate flexibly. The pace of exchange rate depreciation was accelerated from March 1985 in order to correct Korea's competitive position in relation to non-U.S. markets and certain major competitors. The won depreciated by about 10 percent in real effective terms in the first three quarters of the year. In October, as the won remained relatively stable vis-a-vis the U.S. dollar while the dollar depreciated markedly, the won depreciated by about 5 percent in nominal effective terms (Chart 3).

Korea has continued to liberalize its exchange and trade system at a steady pace, in line with a five-year program announced in early 1984 that aims at reducing the ratio of restricted import items from 20 percent of total items in 1983 to 5 percent by the end of 1988. In July 1985, restraints were lifted on a previously announced list of 203 items, bringing the total number of items freed to date under the program to 585 and lowering the ratio of restricted import items to 12 percent. In order to allow domestic manufacturers adequate time to adjust to a more open trading system, the Government has already made public a list of 603 items to be liberalized during the remaining three years of the program.

^{1/} About 2 percentage points of the deviation is attributable to changes in accounting exchange rates.

The import liberalization program is being supported by a five-year tariff reform program which aims at eliminating excess protection, reducing the dispersion of tariff rates, and lowering the (unweighted) average tariff rates from 22 percent in 1984 to 18 percent in 1988. Implementation of the program remained on schedule in 1985, and the average tariff rate was reduced to 21 percent. To smooth the transitional phase for the import liberalization and tariff reform programs, reliance has been placed on an interim system of emergency and adjustment tariffs. Such tariffs were raised temporarily on four newly liberalized items in 1985, while tariffs on nine items previously liberalized in 1984 were reduced, leaving 11 items subject to temporary surcharges.

Continued progress has also been made in respect of easing restrictions on foreign investment in Korea. Under the Foreign Capital Inducement Act, only those sectors placed on a negative list are prohibited or temporarily restricted from foreign direct investment. Enactment of this law in July 1984 resulted in the opening to foreign investment of 139 new industry sectors, as compared with the old positive list system. A further 102 sectors (55 percent of them in the service area) were removed from the negative list in 1985, bringing the share of liberalized sectors to 76 percent, compared with 60 percent in 1983. In conjunction with these changes, steps have been taken to streamline investment approval procedures.

Measures are also being taken to open the Korean economy gradually to foreign portfolio investment. The total value of investment trusts through which foreign residents can indirectly invest in Korean bonds and equity was raised from \$110 million to \$200 million in 1985. In addition, qualified firms have recently been granted authority to issue abroad convertible bonds and depository receipts in amounts up to 15 percent of the value of their outstanding common stock. These obligations are convertible into equity claims after 18 months from the date of issue. It is expected that restrictions on foreign investment in Korean equity will be lifted by the time the conversion provisions become effective.

d. Modification of ceilings

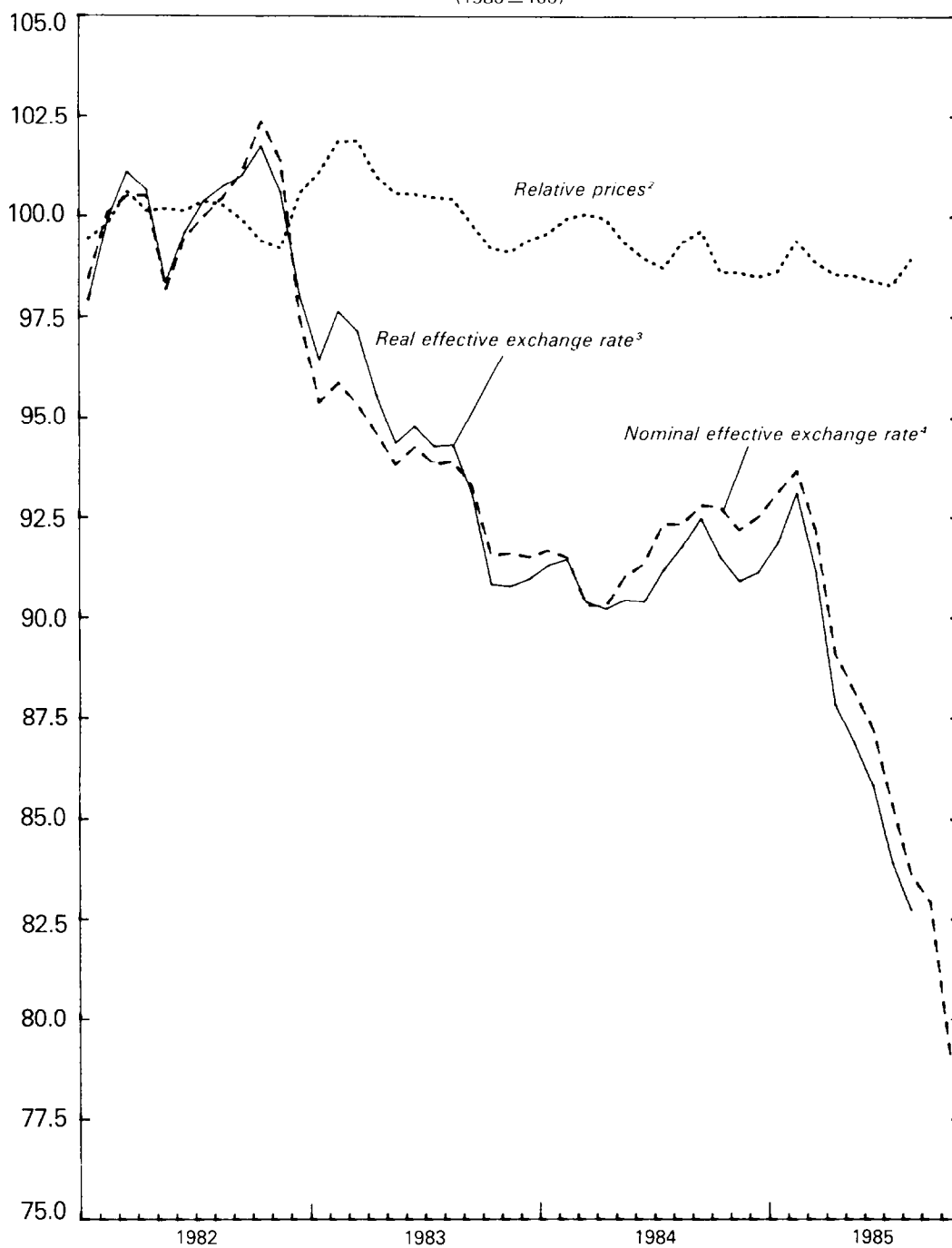
The Korean authorities believe that the achievement of major macroeconomic targets in 1985, in circumstances that were much less favorable than anticipated, indicates that their policy stance remained broadly consistent with the objectives of the stand-by program. The authorities are taking measures to bring about a marked deceleration in credit expansion, which will become more pronounced in 1986. Net foreign borrowing during 1985 is likely to moderately exceed the ceiling under the program, but the rate of growth will be reduced significantly in 1986. The authorities have requested a modification of the December ceilings on NDA of the banking system and overall external debt. The proposed modified ceiling on NDA is approximately 7 percent or

CHART 3

KOREA

EXCHANGE RATE DEVELOPMENTS, 1982-85¹

(1980 = 100)



Sources: IMF, *International Financial Statistics*; and Fund staff estimates.

¹Decline indicates a depreciation of the Korean won.

²The ratio of domestic CPI to foreign CPIs.

³Nominal effective exchange rate adjusted for relative movements in consumer prices.

⁴Trade-weighted basis.



W 2.8 trillion (at constant exchange rates) above the original ceiling. The proposed modified ceiling on overall external debt is \$400 million (0.9 percent) above the original ceiling. The 1986 program takes into account developments in domestic credit and external borrowing during 1985 to ensure that the objectives of the stand-by program are achieved.

III. The Economic Program for 1986

During 1986, the authorities will continue to assign the highest priority to external adjustment. They believe that further progress in this direction can be made while maintaining the growth momentum in a context of low inflation. The external objectives of the authorities include bringing the external current account to near balance in 1986, thus helping to reduce the rate of growth of external debt, and a significant narrowing of the overall balance of payments deficit. On the domestic side, the economic program envisages that the rate of growth of real GNP will rise to 6 percent in 1986, and that inflation will remain in the range of 2-3 percent.

Against the background of present prospects for the external environment, the authorities have formulated a program of economic policies that aim at achieving the short-term objectives stated above and strengthening the foundations for noninflationary growth in the medium term. In broad terms, the major program elements consist of restrained demand management policies, flexible exchange rate policy, and further liberalization of the financial system, of imports, and of foreign investment.

1. Fiscal policy

The fiscal program for 1986 retains the stance of fiscal restraint followed in recent years. The deficit of the consolidated public sector would rise moderately to about 2 percent of GNP in 1986. Approximately two fifths of the increase are attributable to the postponement, from 1985 to 1986, of the one-time transfer to the local governments that was described above; the remainder represents the impact of a limited support by the Government to specific sectors of the economy and to the lower income groups of the population in the form of both outlays and tax concessions.

Revenue of the consolidated public sector is projected to rise somewhat faster than GNP in 1986 owing to the high income elasticity of tax revenue (about 1.2), renewed import growth, and improved profitability of the Government Monopoly Fund. Discretionary tax measures introduced in 1985 will detract from the underlying growth of revenues by the equivalent of about 0.2 percent of GNP. These measures include the reduction in the import duty on petroleum and tax incentives for facility investment, already discussed above, as well as additional tax measures introduced in late 1985. The latter consist of the following:

an adjustment of income taxes on dividends in order to promote self-financing of enterprises; changes to the corporate tax system to encourage enterprises to improve their capital-debt structure; a tax reduction on interest earned on small savings; and tax incentives on property acquisition by workers. Partly offsetting the revenue effect of such measures, rates will be raised on special excise taxes on electronic appliances. With nontax revenues projected to rise at the rate of nominal GNP, aggregate revenue of the consolidated public sector will rise by 12 percent in 1986, resulting in a small increase in the ratio to GNP, to 20 1/2 percent.

The 1986 spending plan calls for a moderate increase in expenditures on defense, salaries, and education. There would be a substantial increase in transfers to local governments reflecting the payment of the one-time transfer that would be delayed from 1985. The fiscal plan contains new spending initiatives aimed at social and economic development, including low-cost housing construction, support for agriculture and fisheries, support for the poor and improvement of social welfare, spending on science and technology, and support for small and medium-sized industry. The policy of assisting housing construction and certain soft sectors of the economy (such as shipbuilding) through off-budget lending would be continued in 1986.

The increases in outlays described above will be partly offset by a reduction in government subsidies to the Grain Management Fund (GMF) and by savings in operational and other outlays. The deficit of the GMF is programmed to fall sharply, on account of a marked scaling down of the operations of the fund. However, the gap between official purchase and sales prices will not be narrowed. In their letter of intent, the authorities indicate that, in order to contain the deficit of the consolidated public sector to about 2 percent, they will cut expenditure in nonpriority areas. In view of the prospects for revenues, the staff estimates that the growth of expenditure and net lending of the consolidated public sector will need to be contained to about 14 percent in 1986. The ratio of expenditure to GNP would rise to 22 1/2 percent.

As regards the 19 nonfinancial government-invested enterprises, the government's policy since 1984 has consisted of granting them greater autonomy for their management, although the government continues to exercise close supervision on pricing and wages. Annual guidelines are issued for the management of the enterprises, which call for improvement in their profit positions and rationalization of their investment. Bonuses to management and employees are tied to the results of annual performance evaluations. At present, the authorities are making an effort to improve the frequency and timeliness of financial reporting by the government-invested enterprises. Progress in this direction, as well as the performance of the government-invested enterprises, will be discussed at the time of the second review.

2. Monetary policy

During 1986, the conduct of monetary policy will be aimed at bringing about a substantial slowdown in the rate of decline of net foreign assets of the banking system, while continuing to support the growth momentum in a context of price stability. This objective will be pursued both through enhancing the ability of the commercial banks to compete for domestic resources and through containing the expansion of bank loans to a level commensurate with the banks' domestic resources. The factors that complicated credit policy during 1985 are not likely to be nearly as important in 1986. In particular, the transactions relating to the reorganization of the overseas construction industry are expected to decline sharply in scope in 1986.

Against this background, the credit program calls for a reduction in the rate of growth of NDA to about 14 percent in 1986. The limits already set for March and June (performance criteria) are consistent with a seasonally adjusted rate of growth of NDA of about 14 percent in the first half of the year. Precise NDA limits for September and December will be established at the time of the second review of the stand-by arrangement. Reflecting seasonal factors, the limits on net bank credit to the public sector (performance criteria) provide for some decline in net credit during the first half of the year, although the program envisages a moderate increase in net credit for the year as a whole.

The credit program for 1986 is expected to limit the decline in net foreign assets during the year to \$0.7-1.0 billion, in the light of the prospective flows of domestic resources into the banking system. Taking into account the anticipated growth of output and prices, as well as some lagged impact of the April 1985 financial reform measures, the growth of broad M2 is likely to slow somewhat in 1986, to about 15 percent. The absorption of domestic resources by the banking system is likely to be enlarged, and the loss of net foreign assets reduced, by measures enhancing the competitive position of the banking system. The authorities intend to improve the competitive position of commercial banks through further deregulation of bank lending and deposit rates. Such progress will be in the context of the ongoing process of financial reform. In this area, the authorities also intend to reduce the gap between the Bank of Korea's rediscount rates and market rates.

3. External policies

The program foresees that the authorities will continue to manage the exchange rate flexibly, and will continue to implement the phased program of import liberalization introduced in 1984. As noted above, the Government has already made public a list of 603 items scheduled for liberalization during 1986-88; of these, 302 items will be liberalized in 1986. The authorities also intend to make further progress in respect of easing restrictions on foreign direct and portfolio investment.

A major policy concern of the Government is the growth and maturity structure of external debt. During 1985, the management of external debt was greatly complicated by the transactions relating to the repayment of foreign debt of overseas subsidiaries. The persistence of such kind of transactions--albeit at a much reduced amount--in 1986 raises important policy questions. In the view of the staff, to the extent that the additional external borrowing demanded by the repayments is not reflected in a reduction in the foreign debt of overseas subsidiaries, Korea's standing in international capital markets could be adversely affected. Therefore, it would be appropriate to aim at limiting the increase of external debt in 1986 to below the rate of growth now envisaged in the preliminary estimates of the authorities--i.e., about 6 percent.

The authorities accept that the transactions relating to the overseas subsidiaries should, of course, give rise to an added degree of caution in external debt management. Their policy guidelines for the medium term call for growing surpluses in the external current account. In their view, the guidelines represent an adequate trade-off between the need to slow the increase of external debt and the growth requirements of the country. They noted that a marked slowdown in Korea's economic growth could itself lead to a deterioration of Korea's perceived creditworthiness in international capital markets. They also believed that the rapid swing to sizable external surpluses could intensify protectionist pressures against Korea in foreign markets.

The Government's external current account target for 1986 is a deficit of below \$200 million, a significant decline from the estimated 1985 outcome and well below the original program guideline for the year. With the expected marked decline in the transactions relating to the foreign debt of overseas subsidiaries, it would appear to the staff that the growth of external debt could be kept to 5 percent, or perhaps less during 1986. The ceilings on external debt set for the first half of 1986 are consistent with such expectations. As noted, ceilings for the second half of the year will be set at the time of the second stand-by review, at which time the external borrowing program for the year, and developments relating to foreign debt of overseas subsidiaries, will be examined in depth. As regards short-term debt, the authorities are committed to improving the maturity structure during 1986. The ceiling set for the first half of 1986 calls for a decline in short-term debt to about \$0.1 billion below the December 1985 ceiling.

In light of more recent developments and a reassessment of external prospects, the staff has revised the medium-term projections for Korea's balance of payments that were presented in the staff report for the 1985 Article IV consultation. At that time, the staff concluded that the country would remain fairly dependent on international financial markets and would thus remain vulnerable to possible shifts in financial market attitudes. Therefore, Korea's objective of shifting to a surplus external current account position in the period to steadily slow the

growth of external debt and debt service in relation to relevant economic aggregates was considered to be a prudent policy course.

The revised medium-term projections take account of the unanticipated severity of the external environment in 1985 by adjusting downward the paths for merchandise exports for the remainder of the projection period (Table 8). Largely because of this adjustment, the debt service ratios are higher than those in the original projections by about 2 percentage points. Still, the debt service ratios decline steadily through 1990 to a level of about 20 percent. In broad terms, the revised projections support the conclusions reached by the staff in the earlier report: the program for 1986, and the evolution of the external current account and external debt which would result from continuation of broadly similar macroeconomic and structural policies in the period beyond, would yield a sustainable medium-term balance of payments path.

IV. Staff Appraisal

In spite of a number of unforeseen external and domestic developments which complicated economic management in 1985, the Korean authorities maintained the fundamental policy orientation underlying the stand-by arrangement, performance under which was generally favorable. The external current account deficit has been reduced to below the program target, inflation remains low, and growth is picking up. On the policy side, the deficit of the consolidated public sector and its borrowing from the banking system will be within the program targets, exchange rate policy has remained appropriately flexible, the maturity profile of the external debt has been strengthened, and import and foreign investment liberalization and financial sector deregulation policies have been implemented as foreseen in the program. However, domestic credit policy and external borrowing have deviated from the original program limits, and net foreign assets have declined by considerably more than projected.

The deviations from program ceilings and the much larger than programmed overall balance of payments deficit, as well as the inter-relationship among these developments, are best evaluated in the context of the unforeseen circumstances which arose during the course of the year and the overall policy response. In 1985, Korea faced external demand conditions that were much softer than envisaged. The weakness in exports, together with growing protectionism abroad, was the major factor underlying the unexpectedly strong decline in economic growth in the first half of the year, from which the economy has begun only recently to recover. In responding to these developments, the Korean authorities sought a policy course designed to secure the major external objectives of the program in a setting of price stability and to promote export diversification and structural reforms in certain sectors to strengthen the prospect for attainment of medium-term growth objectives.

Table 8. Korea: Medium-Term Scenario, 1985-90

	1985	1986	1987	1988	1989	1990
(In billions of U.S. dollars)						
Summary balance of payments						
Current account balance	-0.8	-0.2	0.1	0.1	0.3	0.4
(In percent of GNP)	(-1.0)	(-0.2)	(0.1)	(0.1)	(0.2)	(0.3)
Trade balance	-0.2	0.5	0.5	0.5	0.6	0.7
Exports, f.o.b.	26.7	29.6	33.0	36.9	41.4	46.5
Imports, f.o.b.	-26.9	-29.1	-32.5	-36.4	-40.8	-45.8
Net services	-1.1	-1.3	-1.0	-1.0	-1.0	-1.0
Transfers (net)	0.5	0.6	0.6	0.6	0.7	0.7
Capital account (net) 1/	-1.9	-0.8	0.3	0.2	0.2	0.3
Overall balance	-2.7	-1.0	0.4	0.3	0.5	0.7
Gross international reserves	8.2	8.5	8.9	9.1	9.8	11.0
(In months of imports)	(3.7)	(3.5)	(3.3)	(3.0)	(2.9)	(2.9)
External borrowing requirement	7.3	6.9	7.0	7.6	8.5	9.7
MLT borrowing	7.8	7.2	7.0	7.6	8.5	9.7
By financial institutions	(4.9)	(4.1)	(3.6)	(3.9)	(4.5)	(5.5)
Others	(2.9)	(3.1)	(3.4)	(3.9)	(4.0)	(4.2)
Short-term (net)	-0.5	-0.3	--	--	--	--
Net MLT borrowing	3.6	2.5	2.0	1.7	2.1	2.6
Debt and debt service 2/						
External debt outstanding	45.6	47.9	49.9	51.5	53.6	56.2
(In percent of GNP)	(56.7)	(56.0)	(53.2)	(49.9)	(47.1)	(44.7)
Debt service	8.2	8.8	8.9	9.9	10.4	11.2
Amortization	4.2	4.6	4.9	5.8	6.2	6.8
Interest	4.0	4.2	3.9	4.1	4.2	4.4
Fund obligations (in percent debt service)	(6.1)	(4.3)	(4.7)	(4.7)	(3.3)	(2.8)
Debt service ratio	24.4	23.7	21.9	22.0	20.8	20.2
(Percentage change unless indicated otherwise)						
Memorandum items:						
Exports	1.6	10.8	11.6	11.8	12.1	12.3
Volume	(4.1)	(7.1)	(7.3)	(7.5)	(7.8)	(8.0)
Unit value	(-2.6)	(3.5)	(4.0)	(4.0)	(4.0)	(4.0)
Imports	-1.7	7.8	11.8	12.2	12.2	12.2
Volume	(2.3)	(5.5)	(7.5)	(7.8)	(7.8)	(7.8)
Unit value	(-3.9)	(2.2)	(4.0)	(4.0)	(4.0)	(4.0)
World trade volume		5.0	5.0	5.0	5.0	5.0
Average interest cost (percent per annum)	9.1	9.0	8.0	8.0	8.0	8.0
Real GNP	4.5	6.0	6.5	7.0	7.0	7.0

Source: Staff projections.

1/ Includes net errors and omissions.

2/ Includes Fund credit.





The priority given to those objectives is reflected in the adherence to the restrained fiscal stance embodied in the stand-by program. The fiscal response to the new circumstances was essentially limited to some discretionary tax reductions and expenditure reallocation without, however, providing general stimulus to domestic demand. This policy stance, in conjunction with a flexible management of the exchange rate, permitted the external current account to adjust in line with program objectives in spite of the marked shortfall in external current account receipts. This was the policy course suggested by Executive Directors on the occasion of the Executive Board meeting for the 1985 Article IV consultation with Korea, and one for which, in the staff's view, the Korean authorities should be commended.

Domestic bank credit expansion has considerably deviated from the original program, and the authorities have requested a modification of the net domestic assets ceiling for end-1985. The effective overall economic policy implementation and the results achieved in 1985, together with the restrained credit program for 1986, provide assurance that the proposed modification is consistent with the attainment of the objectives of the stand-by program and, therefore, is warranted. A significant part of the unprogrammed increase in domestic bank credit was financed by an increase in the demand for broad money--associated with the financial sector deregulation measures effected in April 1985--which went beyond the magnitude foreseen when the net domestic assets targets were formulated. To that extent, the larger expansion of banking system credit did not conflict with program objectives. In this regard, it should be noted that the acceleration of credit through the financial system--i.e., including that of the nonbank financial institutions--was considerably less than that for the commercial banking sector alone. Developments in the external current account and in domestic prices, in the authorities' view, indicate that domestic credit developments in the period did not provide any significant stimulus to domestic demand. However, they affected the evolution of net foreign assets, which was substantially weaker than programmed.

In this connection, behind the unplanned decline in net foreign assets were a greater reduction in short-term trade credits than foreseen owing in part to the lower import levels, a decline in net drawings on longer-term commercial and public sector loans--associated with the downturn in domestic investment activity--and the repayment of foreign debt obligations of several offshore construction companies which had or were expected to encounter financial difficulties. These latter operations, which were effected in part to help preserve Korea's own perceived creditworthiness in international capital markets, not only were reflected in a decline in net foreign assets but were, in effect, largely funded through the domestic banking system.

It is clear, however, that a slowing of domestic credit flows to other sectors to compensate for these credit flows likely would have resulted in a smaller decline in net foreign assets. The authorities'

concern was that such a policy response to circumstances viewed as essentially temporary might have threatened the emerging economic recovery and the industrial restructuring process underway, with potentially high costs in relation to medium-term economic objectives. The staff believes that a prompt tightening of credit policy is warranted and welcomes the measures taken in recent weeks to slow the pace of bank credit expansion. The modified net domestic asset ceiling for December 1985 implies a significant decrease in the seasonally adjusted rate of credit expansion for the last two months of the year. The staff endorses the credit program for 1986, which involves a continued deceleration of domestic credit expansion to bring about a sharp reduction in the overall balance of payments deficit in 1986.

In view of Korea's position as a major debtor in the private international financial markets, it is understandable that the Korean authorities have sought to facilitate the prompt repayment of the external obligation of Korean firms offshore which were encountering financial difficulties. Given the continuing uncertainties in the international environment and the perceived linkage between the obligations of subsidiaries of Korean companies offshore and Korea's own creditworthiness in the markets, Korea has a stake in helping to ensure that such borrowing operations overseas are adequately supervised. In the staff's view, the Korean authorities not only should themselves monitor closely developments in this "overseas debt" but ensure through the bank supervisory process that Korean banks follow adequate prudential standards in extending guarantees to such operations. The aggregate debt of these offshore companies was equivalent to \$6 billion at the end of 1984 and was at the same level at the end of August 1985; within this total, debts of construction companies had declined by about \$100 million, to about \$3.5 billion. The latter debt, and probably the total as well, is expected to have declined further in the remainder of the year. In the staff's opinion, such a declining trend would also be appropriate for 1986. Developments in this area will be reviewed in mid-1986 at the time of the staff visit to Korea in conjunction with the 1986 Article IV consultations and second review of the stand-by arrangement.

Policies in the coming year are geared to a more rapid reduction in the current account deficit for 1986 than originally targeted. This factor, together with the absence of many of the special factors operating in 1985, suggests that the increase in external debt may be limited to below the 6 percent figure that is given--as a broad order of magnitude--in the Korean authorities' policy memorandum for 1986, thus compensating for the additional increase in debt now foreseen for 1985. On this basis, the staff believes that the proposed modification of the end-1985 ceiling is warranted. The need to manage carefully Korea's external debt is a major external aim to which economic management has been oriented in recent years. This policy aspect will be further evaluated in the context of the second review of the stand-by arrangement in conjunction with which the external debt guidelines will be quantified for the second half of 1986.

The broad guidelines for fiscal management for 1986, and the quantitative targets for credit to the consolidated public sector for the first half of the year, are consistent with the external objectives of the program and the continuation of the economic recovery, in an environment of stable prices. The proposed budget for 1986 signals the continuation of the restrained fiscal policy stance evident in recent years, which the staff strongly endorses. The budget reflects the impact of discretionary tax reductions made in 1985, which should help to further strengthen the savings and investment effort in the period ahead. On the expenditure side, the budget signals clearly the intention to continue to pursue the priorities assigned to social and economic development, including housing construction, in particular for low-income families, support for the poor and improvement of social welfare, and structural adjustment.

Apart from the budget's macroeconomic parameters, the staff believes that considerably more effort should be devoted to reducing the deficit of the Grain Management Fund (GMF), which continues to divert sizable scarce resources from priority uses. In this regard, the authorities should increase the GMF sales prices of rice and cereal grains in early 1986 to reduce the gap between purchase and sales prices and formulate a comprehensive medium-term plan to reduce drastically the GMF deficits, perhaps by transferring its marketing functions to cooperatives and/or private entities, a process already underway.

The demand management policies for 1986 in conjunction with continuation of flexible exchange rate management and with further progress in import and financial sector liberalization are well designed to achieve the macroeconomic targets for 1986, while strengthening medium-term growth prospects. Given the uncertainties in the international environment, these targets represent challenging policy objectives. Nevertheless, they are both appropriate and feasible if the authorities are steadfast in implementing the policies described in their policy memorandum. Those policies, in a medium-term context, appear to be consistent both with Korea's major domestic economic objectives and with the evolution of a sustainable balance of payments position.

V. Proposed Decision

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

1. Korea has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement for Korea (EBS/85/151, Supplement 2) and paragraph 3 of the letter dated May 17, 1985 from the Minister of Finance of Korea, in order to review the progress made by Korea in implementing its program and reach understandings on appropriate policies and suitable performance criteria for the subsequent period of the stand-by arrangement.
2. The letter dated December 6, 1985 from the Minister of Finance of Korea shall be annexed to the stand-by arrangement for Korea; and the letter dated May 17, 1985, with annexed memoranda, shall be read as supplemented and modified by the letter of December 6, 1985.
3. Accordingly, paragraph 4(a) through (d) of the stand-by arrangement for Korea shall be amended to read:
"(a) during any period until September, 1986, in which the data for the preceding performance testing date indicate that:
 - (i) the ceiling on net credit to the public sector from the banking system, described in paragraph 1 and Table 1 of the Technical Memorandum annexed to the attached letter, as modified by the letter of December 6, 1985, has been exceeded; or

- (ii) The ceiling on net domestic assets of the banking system, described in paragraph 2 and Table 2 of the Technical Memorandum annexed to the attached letter, as modified by the letter of December 6, 1985, has been exceeded; or
- (b) during any period until September 10, 1986, if Korea fails to observe the limits on outstanding disbursed external debt described in paragraph 4 and Table 4 of the Technical Memorandum annexed to the attached letter, as modified by the letter of December 6, 1985; or
- (c) after March 10, 1986 until understandings have been reached between Korea and the Fund on appropriate policies and suitable performance criteria have been established in consultation with the Fund pursuant to the first review as contemplated by paragraph 3 of the attached letter, as modified by the letter of December 6, 1985 or, after such performance criteria have been established, while they are not being observed; or
- (d) after September 10, 1986, until understandings have been reached between Korea and the Fund on appropriate policies and suitable performance criteria have been established in consultation with the Fund pursuant to the second review contemplated in paragraph 3 of the attached letter, as modified by the letter of December 6, 1985 or, after such performance criteria have been established, while they are not being observed; or"

4. The Fund decides that the first review provided for in paragraph 4(c) of the stand-by arrangement for Korea is completed and that Korea may proceed to make purchases under the stand-by arrangement upon observance of the performance criteria for December 1985.

Korea - Fund Relations
(As of October 31, 1985)

(Amounts in millions of SDRs,
unless otherwise indicated)

I. Membership status

- (a) Date of membership: August 26, 1955
(b) Status: Article XIV

(A) Financial Relations

II. General Department

- (a) Quota: SDR 462.8 million
- | | <u>Amount</u> | <u>Percent of quota</u> |
|---------------------------------------|-----------------|-------------------------|
| (b) Total Fund holdings of Korean won | 1,897.4 | 410.0 |
| (c) Fund credit: | 1,435.3 | 310.1 |
| Of which: Credit tranches | 79.4 | 17.2 |
| CFF | 346.1 | 74.8 |
| SFF | 434.0 | 93.8 |
| EAR | 575.8 | 124.4 |
| (d) Reserve tranche position: | SDR 0.7 million | |
| (e) Current Operational Budget: | Not included | |
| (f) Lending to the Fund: | None | |

III. Recent stand-by and special facilities

- (a) Current stand-by arrangement
- (1) (i) Duration: July 12, 1985 to March 10, 1987
 (ii) Amount: SDR 280 million
 (iii) Utilization: SDR 40 million
 (iv) Undrawn balance: SDR 240 million
- (b) Previous stand-by arrangements during the last 10 years
- (1) (i) Duration: October 22, 1975 to June 30, 1976
 (ii) Amount: SDR 20 million
 (iii) Utilization: SDR 9 million
 (iv) Undrawn balance: SDR 11 million
- (2) (i) Duration: May 6, 1977 to December 31, 1977
 (ii) Amount: SDR 20 million
 (iii) Utilization: --
 (iv) Undrawn balance: SDR 20 million

- (3) (i) Duration: March 3, 1980;
cancelled February 13, 1981
- (ii) Amount: SDR 640 million
- (iii) Utilization: SDR 320 million
- (iv) Undrawn balance: SDR 320 million
- (4) (i) Duration: February 13, 1981
to February 12, 1982
- (ii) Amount: SDR 576 million
- (iii) Utilization: SDR 576 million
- (iv) Undrawn balance: --
- (5) (i) Duration: July 8, 1983 to March 31, 1985
- (ii) Amount: SDR 575.775 million
- (iii) Utilization: SDR 575.775 million
- (iv) Undrawn balance: --

- (c) Special facilities in last 2 years
Compensatory financing:

SDR 279.7 million related to export shortfall and cereal import excess, approved by the Executive Board on June 8, 1984 and purchased on June 13, 1984.

IV. <u>SDR Department (as of October 31, 1985)</u>	<u>Amount</u>	<u>Percent of allocation</u>
(a) Net cumulative allocation:	72.9	100.0
(b) Holdings:	2.1	2.9
(c) Current Designation Plan:	--	--

V. Administered accounts

- (a) Trust Fund Loans: Not eligible
- (b) SFF Subsidy Account: None

VI. Overdue obligations to the Fund: None

(B) Nonfinancial Relations

VII. Exchange rate arrangement

The exchange rate is determined daily on the basis of a currency basket; middle rate of US\$1 = W 892.2 on October 31, 1985.

VIII. Last Article IV consultation

Staff discussions were held during March 25-April 12, 1985; the staff also reviewed performance under the 1983-85 stand-by arrangement, and negotiated an economic program in support of which Korea requested the current stand-by arrangement. The Staff Report (EBS/85/151) was discussed by the Executive Board on July 12, 1985. This consultation was conducted after a 13-month cycle. The following decisions were adopted:

Article IV Consultation

1. The Fund takes this decision in concluding the 1985 Article IV consultation with Korea, in light of the 1985 Article IV consultation with Korea conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).
2. The existing restrictions on payments and transfers for current international transactions are maintained by Korea in accordance with Article XIV. The Fund welcomes the progressive liberalizations by Korea of restrictions on payments for current international transactions and encourages the authorities in their determination to remove remaining restrictions as Korea's external position improves.

Stand-by Arrangement

1. The Government of the Republic of Korea has requested a stand-by arrangement for the period July 12, 1985 to March 10, 1987 for an amount equivalent to SDR 280 million.
2. The Fund approves the stand-by arrangement attached to EBS/85/151.
3. The Fund waives the limitation in Article V, Section 3(b)(iii).

IX. Technical assistance

1. CBD: A visit to discuss monetary and external debt statistics took place in January-February 1985.
2. STA: A money and banking statistics mission took place in January-February 1985.
3. FAD: A tax review mission took place in May 1985.

X. Resident Representative

The position has been held by Mr. D. Villanueva since October 1982. Mr. D. Villanueva's term ends on January 31, 1986 and Mr. R. Baban has been appointed to replace him.

Activities of the World Bank Group

During 1980-83, macroeconomic issues were at the core of the World Bank's dialogue with Korea, with heavy reliance on structural adjustment lending. Since that time, the country strategy has been focused increasingly on major sectoral issues, particularly financial sector, energy, agricultural, transport, and urban development policies. The balance between sector and project lending in each area is influenced strongly by a judgment on how Bank resources can be used to help the Government implement policy changes.

The First Structural Adjustment Loan encompassed structural reform programs related to energy saving and improvements in industrial efficiency. Key components of the energy program included adjustments on retail prices for gasoline, diesel fuel, and coal; studies of electric power tariffs and petroleum product pricing; energy diversification in the form of liquefied natural gas (LNG); and analyses aimed at industrial and building energy conservation. With respect to industrial policy, the Government undertook a program to restructure and rationalize certain industries, withdraw gradually from investment decision making at the firm level, and foster competition through fiscal incentives, and import liberalization.

The Second Structural Adjustment Loan continued to support the Government's comprehensive adjustment program in the areas of industry, energy, and public sector efficiency. In industry, the program included import liberalization, reforms in import tariffs, liberalization of foreign investment and restructuring of the fertilizer industry. In energy, the program included measures to improve pricing and investment planning in the electric power sector; pricing, taxation, and regulatory reforms in the petroleum and coal sectors; the introduction of LNG as an alternative energy source; and the fostering of energy conservation. In the public sector, measures were aimed at augmenting resource mobilization, reducing budget deficits, and increasing efficiency of the public enterprises. Both structural adjustment loans are now fully disbursed and a completion report has been prepared.

The Industrial Finance Loans were designed to support the Government's long-range program of financial liberalization. The reforms are expected to improve resource allocation and raise efficiency in financial intermediation through enhancing the role of market forces in interest rate determination, increasing competition within the financial sector, and reducing the role of the Government in credit allocation. Priorities in the second loan include enhancing the underlying strength of the commercial banking sector, and constraining the indebtedness and improving the structure of the debt of the corporate sector. Measures to influence the price, composition, and quantity of debt include interest rate adjustment and a reduced role for preferential

credit. Measures to provide a more prominent role for equity capital include incentives to promote shareholding and less regulation of the securities market.

The Bank staff's assessment of progress under the various loans is that Korea's overall economic performance in recent years has been impressive despite the downturn in exports in early 1985. Most major economic indicators, including GNP growth, the balance of payments, price behavior, and the public sector deficit, have shown significant improvement, reflecting both short-term stabilization and medium-term structural policies. Overall implementation of the program of macroeconomic reform has been careful, well-balanced and successful. It has been associated with a broad process of liberalization in the areas of trade, foreign investment, and financial sector policies. The Government's policy signals have been consistent and its actions faithful to the announced reforms. Further measures continue to enjoy strong support from policymakers.

Lending of the World Bank Group
(As of September 30, 1985)

	<u>IBRD</u>	<u>IDA</u>	<u>Total</u>	<u>Percent</u>	<u>Undisbursed</u>
Commitments	(In millions of U.S. dollars)				
Agriculture and social development	623.0	32.8	655.8	10.9	28.71
Education	268.5	35.1	303.6	5.0	97.70
Development finance corporations	1,504.5	--	1,504.5	25.0	318.03
Industry	390.0 ^{1/}	--	390.0	6.4	217.76
Population	30.0	--	30.0	0.5	18.46
Power	115.0	--	115.0	1.9	--
Program lending/SAL	725.0	--	725.0	12.0	--
Tourism	25.0	--	25.0	0.4	--
Transportation	1,419.5	51.7	1,471.2	24.4	358.87
Urbanization	383.0	--	383.0	6.4	161.49
Water supply and sewerage	<u>426.5</u>	<u>--</u>	<u>426.5</u>	<u>7.1</u>	<u>193.28</u>
Total	5,910.0	119.6	6,029.6	100.0	1,394.30
Repayments	955.33	8.08	963.41		
Total outstanding (including undisbursed):	4,826.90 ^{2/}	107.50 ^{3/}	4,934.40		
Commitments for FY 1985	556.0	--	556.0		

Structural adjustment loans: A loan of \$250 million, approved in December 1981, was fully disbursed by January 1983. A second loan of \$300 million, approved in November 1983, was fully disbursed by September 1984.

Financial sector loans: A first industrial finance project loan of \$255 million to support financial sector liberalization was approved in June 1983. A second loan of \$222 million was approved in June 1985.

^{1/} Includes \$111.0 million for a small and medium industry project approved on April 16, 1985, but not yet signed.

^{2/} Adjusted for cancellations, sales and exchange rate fluctuations.

^{3/} Adjusted for cancellations.

Recent economic work:

The Economic Report entitled "Korea's Development in a Global Context" was issued on June 21, 1984. A mission to prepare a Country Economic Memorandum focusing on industrial policies is scheduled to visit Korea in early December 1985.

IFC activity:

As of September 30, 1985, total loan and equity commitments amounted to \$165.5 million of which \$122.0 million has been cancelled, terminated, repaid or sold. \$5.1 million remains undisbursed.

Technical assistance:

The IBRD has provided technical assistance to Korea through its standard lending operations for projects. In addition, the IBRD acted as the executing agent for a UNDP Planning Assistance Project for the preparation of the Fifth Five-Year Plan, and for the UNDP project for task forces set up under the IBRD structural adjustment loans. The IBRD is also acting as executing agent for a UNDP Planning Assistance Project for the preparation of the Sixth Five-Year Plan.

Aid consultative group:

The final meeting of the Consultative Group for Korea was held under the Chairmanship of the IBRD in Seoul on July 16, 1984.

Korea--Summary of the Economic Program, 1985-86

I. Targets

1. Real GNP is projected to increase by about 4.5 percent and 6 percent in 1985 and 1986, respectively, and the inflation rate, measured by the CPI, is expected to remain in the range of 2-3 percent in both 1985 and 1986.
2. The current account deficit is projected to decline from \$1.4 billion (1.7 percent of GNP) in 1984 to \$0.8 billion (1.0 percent of GNP) in 1985 and \$0.2 billion (0.2 percent of GNP) in 1986. The overall balance of payments deficit is projected to rise from \$1.5 billion in 1984 to \$2.7 billion in 1985 and decline to \$1.0 billion in 1986.

II. Assumptions

1. Export unit values are expected to decline in terms of the U.S. dollar by about 3 percent in 1985 and rise by about 4 percent in 1986. World trade volume, weighted in relation to Korea's trading partners, is projected to increase by about 5 percent in 1985 and 1986. Export volume is estimated to increase by about 4 percent in 1985 and 7 percent in 1986, assuming no marked intensification of trade restrictions on Korea's exports and that the competitiveness of the export sector is maintained.
2. Import unit values are expected to decline in terms of U.S. dollars by close to 4 percent in 1985 and to rise by 2 percent in 1986. Import volume is projected to increase by roughly 2 percent in 1985 and by 5.5 percent in 1986, based on the expected growth in export volume, domestic investment, and manufacturing production.
3. The average interest cost on Korea's external debt is assumed to be 9 percent in 1985-86.
4. The income velocity of money, defined as the ratio of nominal GNP to average broad money including other liabilities, is projected to decline, reflecting the continued moderation of inflationary expectations and a further narrowing of the gap between interest rates in the bank and nonbank financial sectors.

III. Principal Elements of the Program

1. Public sector policies

a. Public sector revenue is expected to rise by close to 7 percent in 1985, roughly equal to the projected growth of nominal GNP, partly reflecting low levels of imports and the modification in the duty drawback system for exports. Following a policy of fiscal restraint, expenditure is projected to increase by somewhat more than revenue in 1985. In 1986, public sector revenue and expenditure are expected to increase by about 12 percent and 14 percent, respectively, mainly due to the pick-up of economic growth and imports on the revenue side, and the introduction of some new spending initiatives. The public sector deficit is estimated at 1.5 percent of GNP in 1985 and will rise only moderately to about 2 percent of GNP in 1986.

b. In the program period, the combined operating surpluses of the nonfinancial public enterprises will be increased as a result of improved management efficiency. Progress in obtaining these objectives is being monitored and supported by performance evaluations.

2. Money and credit

a. Net domestic assets of the banking system are subject to quarterly ceilings through June 1986 as performance criteria. The increase in net domestic assets during 1985 is limited to 21.1 percent. During the first six months of 1986, the annual rate of growth of net domestic assets (seasonally adjusted) will decline to 14 percent. The Government will conduct their reserve money management operations and closely monitor the activities of nonbank financial institutions in order to ensure that the envisaged degree of overall credit expansion from the financial system remains consistent with domestic and external objectives. Quarterly ceilings for the net domestic assets of the banking system for the rest of 1986 will be set at the time of the second review.

b. Outstanding credit to the public sector from the banking system is subject to quarterly subceilings through June 1986 as performance criteria. The permissible increase in outstanding net credit to the public sector in 1985 is equivalent to 1.2 percent of the stock of broad money at the end of 1984. Taking into account seasonal factors, the ceiling at end-June 1986 envisages a decline from the ceiling set for end-1985. Quarterly ceilings on outstanding credit to the public sector from the banking system for the rest of 1986 will be set at the time of the second review.

c. Further progress will be made in liberalizing lending and deposit rates in the banking system and in reducing the gap between the Bank of Korea's rediscount rates and market rates. Several new deposit instruments with attractive rates of interest are being introduced to

strengthen the competitive position of the banking system. These steps are expected to stimulate private sector savings.

3. External sector

a. Exchange rate policy will be managed flexibly to preserve the present level of competitiveness of Korean exports.

b. External debt of all maturities, excluding IMF credit, will not increase by more than \$3,300 million during 1985, so that such debt outstanding will not exceed \$44,300 million on December 31, 1985. Ceilings for end-March and end-June 1986 have been established at \$45,800 million. Ceilings for the rest of 1986 will be set at the time of the second review.

c. The stock of outstanding short-term external debt with initial maturity of one year or less will be reduced by at least \$300 million by December 31, 1985; the stock of such debt was \$11,425 million on December 31, 1984. The subceiling for short-term debt is set at \$11,000 million for June 1986, and limits for the rest of 1986 will be set at the time of the first review.

d. The target for gross international reserves at end-1986 has been established for an increase in the range of \$200 million to \$300 million.

e. Progressive liberalization of import restrictions will be continued. In July 1985, import restrictions were lifted on 233 items, raising the liberalization ratio to 87.7 percent. A further 603 items are scheduled for liberalization during the period 1986-88, of which 302 items are scheduled for 1986. At end-1986, the liberalization ratio will rise to 91.6 percent.

f. Since July 1984, foreign direct investment has been permitted in all sectors except those specifically identified on a negative list. During 1985, 102 sectors were removed from the negative list, bringing the share of liberalized sectors to 76 percent. Measures are also being taken to allow foreign portfolio investment in certain companies.

Ministry of Finance
Seoul, Korea

December 6, 1985

Dear Mr. de Larosière:

1. The stand-by arrangement approved by the Fund on July 12, 1985 supports a comprehensive economic program that aims at achieving, in the near future, a viable balance of payments position while sustaining growth with low inflation. Although several unanticipated factors led to departures from some of the quantitative policy guidelines of the program, substantial progress was made toward the achievement of the program's major objectives, in particular the external current account and domestic price objectives, during 1985. The Government's policies for 1986 will consolidate the gains achieved in 1985 and further strengthen the external accounts to a sustainable position during the course of 1986. The broad objectives and policy guidelines for 1986, and the quantifications of those policies for the first half of the year, are described further below.

2. Against this background, the Government of Korea requests a modification of the performance criteria relating to net domestic assets and overall external debt for December 1985 contained in the Technical Memorandum annexed to my letter of May 17, 1985. The attached table shows the proposed modified limits for December 1985, as well as the quantitative guidelines for March and June 1986 in respect of net domestic assets, net credit to the consolidated public sector, overall external debt, and short-term external debt.

3. The external environment in 1985 has been significantly more difficult than anticipated at the time of my letter of May 17, 1985, particularly in respect of export demand. Although timely exchange rate action has helped restore and safeguard Korea's competitive position, the sharp slowdown in the U.S. economy and the notable intensification of protectionism in several industrial countries brought about a significant deceleration in export growth. Moreover, the contraction of investment in the Middle East resulted in a sharp decline in receipts from overseas construction. As a result of these factors, current account receipts fell short of the original projections for 1985 by \$3.5 billion (10 percent). Balance of payments and external debt management were further complicated by an unexpected feature of the ongoing reorganization of the overseas construction industry. As part of the reorganization process, several foreign subsidiaries of Korean companies closed their operations abroad. Their foreign debt obligations, which would have been rolled over in the normal course of events, were repaid by their parent companies in 1985. These repayments, which had not been foreseen at the time Korea requested the current stand-by arrangement with the Fund, raised both domestic credit needs and foreign borrowing requirements.

4. In spite of the large shortfall in current account receipts, the external current account deficit was reduced, beyond the expectations of the program, to \$700 million (0.9 percent of GNP) as imports fell sharply. Because of the weakness of both exports and domestic demand, output growth decelerated to less than 5 percent in 1985, compared with the program target of 7.5 percent. The impact on domestic prices of the depreciation of the won was in part offset by a decline in import prices, and domestic inflation remained below 3 percent. This macro-economic outcome reflects the high priority assigned by the Government to achievement of external adjustment and to price stability, which it views as a prerequisite to sustainable growth over the medium term.

5. In line with these policy priorities, the Government maintained a restrained fiscal policy stance throughout 1985. While budget expenditure was reallocated during the course of the year in order to stimulate exports and to assist some sectors, such as construction, which were severely affected by the growth slowdown, the Government refrained from imparting an overall fiscal stimulus to support weakening domestic demand. Present estimates of the financial position of the consolidated public sector point to a deficit of 1.5 percent of GNP in 1985, about the same as in 1984 and below the original program target for 1985 (1.8 percent). It is expected that this strong fiscal performance will permit the consolidated public sector to stay below the quantitative limit on net borrowing from the banking system in order to help accommodate the legitimate credit needs of the private sector.

6. Monetary policy in 1985 has been conducted against the background of the important initiatives adopted by the Government in the area of financial deregulation. The introduction, in April 1985, of high-yielding savings instruments issued by the commercial banks induced a marked acceleration in the growth of M2 and other bank liabilities at the expense of the nonbank financial intermediaries and the unorganized financial sector. Since credit expansion through the nonbank financial sector slowed considerably, there was a marked shift in credit demand toward the banking system, which, if left unsatisfied, would have added to the recessionary pressures in the economy. The quantitative guidelines contained in the Technical Memorandum made allowance for these developments, but underestimated the strength of the relative shift of financial resources toward the banking system.

7. Domestic bank credit developments also reflected the unexpected repayment of foreign obligations of overseas construction companies, mentioned above. To facilitate these transactions, which were necessary in order to safeguard Korea's perceived creditworthiness among foreign lenders, domestic commercial banks frequently extended credit to the parent companies involved and funded the repayment of the external obligations through foreign borrowing. Another factor bearing on credit conditions was a limited expansion of loan facilities by the monetary authorities designed to enhance export prospects and to support specific sectors that had been seriously affected by the marked economic slowdown.

8. The combined influence of the factors described in paragraphs 6 and 7 resulted in an increase in the net domestic assets of the banking system beyond the quantitative guidelines contained in the Technical Memorandum for the month of September 1985. Although the expansion of credit in excess of the guidelines has not proved inflationary, it has proceeded concurrently with an overall balance of payments deficit (decline in net foreign assets) of \$2.6 billion in the first ten months of 1985, well beyond that foreseen in the economic program. The authorities recognize that the rate of domestic credit expansion should be slowed significantly in the period ahead in order to arrest the deterioration of the net foreign asset position and to preserve price stability. However, a sharp tightening of credit conditions in the remaining weeks of the year, besides being difficult to implement, would run a serious risk of undercutting the prospects for economic recovery with only a limited favorable impact on the balance of payments in 1985. Therefore, the rate of expansion of net domestic assets will remain elevated during the remainder of the year, and the quantitative guidelines in respect of net domestic assets for December 1985 will be exceeded. Modified quantitative guidelines for December 1985, consistent with the anticipated credit developments over the next few weeks, are shown in the attached table. The authorities expect that the growth of the monetary aggregates will accelerate substantially in the final weeks of the year, and that the overall balance of payments deficit for the year as a whole will be limited to \$2.7-2.8 billion.

9. External debt management has also been hampered by the unanticipated repayment of foreign debts of overseas subsidiaries, which were not obligations of Korean residents. These transactions, which are expected to reach about \$900 million by the end of the year, have required foreign borrowing by Korean banks beyond the levels envisaged in the Technical Memorandum. Although developments in some other items, notably in the current account, are more favorable than earlier anticipated and would likely reduce borrowing requirements, in the aggregate the net increase in external debt (excluding IMF credit) is likely to exceed the quantitative guidelines on overall external debt by about \$400 million in December 1985. Accordingly, the authorities have revised their borrowing program for 1985. Even with the revisions the increase in overall external debt will be limited to approximately 7 percent in 1985, about the same as in the previous year. Moreover, it is expected that the reduction in Korea's short-term external debt will exceed the amount foreseen in the Technical Memorandum.

10. During 1986, the authorities will continue to afford the highest priority to the attainment of the external objectives, including the attainment of approximate balance in the external current account and a significant slowdown in the rate of growth of external debt, together with a substantial reduction in the overall balance of payments deficit. The authorities believe that achievement of these objectives is consistent with continued low inflation and with a recovery of output growth to 6-7 percent. In conformity with these objectives, and in order to promote sustainable growth over the medium term, the authorities will

pursue a flexible exchange rate policy and will make further progress in the areas of trade and financial sector liberalization, as well as implementing restrained demand management policies.

11. The 1986 budget presented to the National Assembly contains new spending initiatives which aim at assisting the lower income sectors of the population and creating additional employment opportunities. A significant increase is also projected in expenditure for social and economic development, particularly for low-cost housing construction and for the support of agriculture and fisheries. Central Government revenue will rise only slightly in relation to GNP under the influence of tax measures adopted in 1985 which reflect the Government's desire to keep the tax burden at a level that does not undermine the incentives to save, invest, and produce. Instead, in order to contain the deficit of the consolidated public sector, the Government will cut expenditure in nonpriority areas. In addition, the deficit of the Grain Management Fund should decline in 1986, in spite of some increase in the gap between the purchase and sales prices of rice, owing to a projected reduction in the volume of rice purchases.

12. Reflecting the spending control measures described above, even with the full revenue impact of discretionary tax reductions effected in 1985, the deficit of the consolidated public sector is projected to rise only moderately from an estimated 1.5 percent of GNP in 1985 to about 2.0 percent in 1986. Therefore, the fiscal program for 1986 will represent a continuation of the policy of fiscal restraint followed in recent years. Such restraint will be reinforced by continuing efforts to improve the financial position of the government-invested enterprises. Guidelines were issued recently for the management of these enterprises during 1986. The guidelines aim at increasing the operating surplus of the government-invested enterprises and rationalizing their investment. Progress in attaining these objectives is being monitored and supported through annual performance evaluations.

13. Monetary policy for 1986 will be formulated to be consistent with the continuing recovery of the economy described above while narrowing the overall balance of payments deficit to a range of \$0.7-1.0 billion, compared with a projected deficit of \$2.7-2.8 billion in 1985. Achievement of these objectives will be pursued by enhancing the ability of the commercial banks to attract domestic deposits, while reducing the rate of expansion of bank credit to a level commensurate with those resource flows. The authorities intend to make further progress in the liberalization of lending and deposit rates in the banking system and will reduce the gap between the Bank of Korea's rediscount rates and market rates. In the light of an assessment of the likely growth of bank liabilities, the authorities will conduct their reserve money management operations with the aim of limiting the expansion of domestic bank credit to levels consistent with the target for net foreign assets of the banking system referred to above.

14. The authorities have set quantitative guidelines in respect of net domestic assets of the banking system and net bank credit to the public sector for March and June 1986, as shown in the attached table. The guidelines take into account the seasonal pattern of the balance of payments as well as the lagged effect of the financial deregulation measures adopted in 1985. In accordance with those guidelines, the annual rate of growth of net domestic assets will decline gradually from 23 percent in December 1985 to 18 percent in June 1986. Reflecting seasonal patterns, the ceilings on net credit to the public sector for March and June 1986 have been set at levels that are below the December 1985 ceiling.

15. The exchange rate correction initiated in March 1985 was largely completed by the third quarter of 1985. In the view of the authorities, this action reversed the gradual erosion of competitiveness that had taken place vis-a-vis non-U.S. markets and certain major competitors. The authorities will continue to manage the exchange rate flexibly to ensure that the competitiveness of the export sector is consistent with the balance of payments objective.

16. In order to promote a better allocation of domestic resources, the Government will continue to liberalize the import regime, notwithstanding the recent trends in and threat of further restrictions against Korean exports in foreign markets. In July 1985, import restraints were lifted on 233 items, lowering the ratio of articles subject to restriction from 15 percent to 12 percent. In addition, the Government has already made public a list of 603 items scheduled for liberalization during 1986-88. By the end of 1988, restricted import items will account for less than 5 percent of the total and imports of virtually all manufactured goods will be free from restrictions. Continued progress will be made also in respect of easing restrictions on foreign direct and portfolio investment in Korea.

17. The repayment of certain foreign debts of overseas subsidiaries of a few Korean firms, mainly in the construction sector, was an important factor contributing to the growth of external debt during 1985. Since construction activity in the Middle East is likely to remain depressed, the ongoing reorganization of the overseas construction industry will continue in the period ahead. In these circumstances, Korean firms will have to assume some additional repayments of foreign debts of their overseas subsidiaries in 1986 as well, although the amounts involved will be significantly smaller than those estimated for 1985. The authorities believe that this process will improve the prospects for the stronger companies continuing to operate overseas in this sector, as well as their capacity to effectively manage their external obligations. Ensuring that the external obligations of firms returning to Korea are cleared promptly, as well as prudent debt management by firms that remain offshore, will serve to help protect Korea's own perceived creditworthiness in international capital markets. The authorities continue to monitor closely the borrowing abroad by Korean firms operating offshore, which is subject to broad policy direction. The

external obligations of firms abroad were \$6 billion in August 1985, virtually the same as at end-1984. Within this total, debts of the construction firms were \$3.5 billion, some \$90 million less than at the end of 1984. This would be expected to decline further in the remainder of the year.

18. The authorities expect that the policies described above will limit the external current account deficit to below \$200 million in 1986, compared with a projected deficit of \$700 million in 1985. This outcome, together with a smaller repayment of foreign debts of overseas subsidiaries, should provide scope for increasing gross international reserves by \$200-300 million while reducing the rate of growth of external debt to about 6 percent during 1986. The lower foreign borrowing requirements will also facilitate a further improvement in the maturity structure of external debt through continuous cautious management of short-term debt. The attached table shows the quantitative guidelines in respect of overall external debt and short-term debt established for March and June 1986.

19. The Government of Korea believes that the policies and measures described in this letter are adequate to achieve the objectives of the program, but will take any additional measures that may become appropriate for this purpose. During the remaining period of the arrangement, the Government will periodically consult with the Fund, in accordance with the Fund's policies on such consultations, about the progress being made in the implementation of the program and any policy adaptations judged to be appropriate for the achievement of its objectives. In particular, in accordance with paragraph 3 of my letter of May 17, 1985, Korea will conduct with the Fund prior to September 10, 1986 a second review of progress under the program and in the context of that review will reach understandings on suitable performance criteria for September and December 1986. The Government wishes to assure you at this time that these performance criteria will be fully consistent with the broad policy guidelines for 1986 described above and with the fulfillment of the objectives of the program.

Sincerely yours,

(signed)
Mahn-Je Kim
Minister of Finance

Attachment

Mr. J. de Larosiere
Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

Korea: Quantitative Guidelines, December 1985-June 1986 1/

	1985 December	1986 March	June
<u>(In billions of won)</u>			
Ceilings			
Net domestic assets of the banking system <u>2/</u>	40,360	41,260	42,630
Net credit to the public sector from the banking system	2,268 <u>3/</u>	2,250	2,150
<u>(In millions of U.S. dollars)</u>			
Outstanding disbursed external debt of all maturities, excluding IMF credit <u>4/</u>	44,300	45,800	45,800
Outstanding short-term debt <u>4/</u>	11,125 <u>3/</u>	...	11,000

1/ Definitions of items in this table are the same as in the Technical Memorandum annexed to the letter of the Minister of Finance dated May 17, 1985, unless otherwise indicated.

2/ Measured at the constant exchange rate of October 31, 1985, which was W 892.2 per U.S. dollar.

3/ This is the same figure contained in the Technical Memorandum of May 17, 1985.

4/ Measured at the constant exchange rates of December 1984.

