

Republic of Korea: 2002 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Korea

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the Article IV consultation with the Republic of Korea, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **October 29, 2002**, with the officials of the Republic of Korea on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on February 7, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **March 3, 2003** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its March 3, 2003 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for the Republic of Korea.

The document(s) listed below have been or will be separately released.

Selected Issues Paper
Financial System Stability Assessment

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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**International Monetary Fund
Washington, D.C.**

INTERNATIONAL MONETARY FUND

REPUBLIC OF KOREA

Staff Report for the 2002 Article IV Consultation

Prepared by Staff Representatives for the 2002 Consultation
with the Republic of Korea

Approved by Wanda Tseng and Michael Hadjimichael

February 7, 2003

- The consultation discussions were held in Seoul during October 16–29, 2002. The mission team comprised Messrs. Coe (head), Beaumont, He, and Zebregs (all APD), and was assisted by Mr. Gruenwald, Resident Representative. Mr. Callaghan, Executive Director, and Mr. Cho Won-Dong, Advisor to the Executive Director, participated in the discussions.
- The mission team met with Deputy Prime Minister and Minister of Finance and Economy, Jeon Yun-Churl; Bank of Korea Governor, Park Seung; Financial Supervisory Commission Chairman, Lee Keun-Young; other senior government, central bank, and supervisory officials; and representatives from research institutes, universities, domestic and foreign financial institutions, the federation of industry, labor unions, and the diplomatic community.
- As part of the Article IV consultation, the draft report of the Financial Sector Assessment Program was presented to the authorities by a team headed by Mr. Baliño (MAE) at the conclusion of the October 2–18 FSAP mission. A follow-up technical assistance mission was held in Seoul during January 9–20, 2003, headed by Ms. Gulde-Wolf (MAE).
- Korea's statistical base is adequate to conduct effective surveillance.
- Korea has accepted the obligations under Article VIII of the Articles of Agreement, and maintains an exchange system free of restrictions on payments and transfers for current international transactions.
- The staff report was prepared by Messrs. Coe, Beaumont, He, and Zebregs, with a contribution from Mr. Laryea (LEG).

	Page
Glossary of Abbreviations and Terms.....	3
Executive Summary	4
I. Introduction.....	5
II. The Current Setting and Prospects.....	6
A. Macroeconomic and Market Developments	6
B. Monetary and Fiscal Policies	9
C. Financial and Corporate Sector Developments.....	12
D. Outlook and Assessment of Risks.....	17
III. Policy Discussions	19
A. Macroeconomic Policies	19
B. Financial and Corporate Sector Policies	25
C. Other Issues.....	28
IV. Staff Appraisal	29
Boxes	
1. Developments in Household Credit.....	11
2. Reprivatization of Financial Institutions.....	13
3. Recovery of Public Funds for Financial Sector Restructuring.....	14
4. Corporate Insolvency Law Reforms	16
5. The DPRK: Recent Developments in Economic Policies	23
6. Financial System Stability Assessment: Findings and Recommendations	26
Tables	
1. Macroeconomic Framework, 1998–2003	32
2. Balance of Payments, 1998–2003	33
3. Consolidated Central Government Operations, 2000–03	34
4. Monetary and Financial Indicators, 2000–02.....	35
5. Medium-Term Projections, 2000–07	36
6. Indicators of External Vulnerability, 1998–2003.....	37
Figures	
1. Activity and Prices	38
2. External Developments	39
3. Financial Market Indicators	40
4. Corporate and Financial Sector Soundness.....	41
5. Housing Price Developments, 1986–2002.....	42
Annexes	
I. Statistical Issues	43
II. Fund Relations	47

GLOSSARY OF ABBREVIATIONS AND TERMS

BOK	Bank of Korea
CEO	Chief Executive Officer
CFO	Chief Financial Officer
DPRK	Democratic People's Republic of Korea
EMBI	Emerging Markets Bond Index
FATF	Financial Action Task Force
FSAP	Financial Sector Assessment Program
FSC	Financial Supervisory Commission
FSS	Financial Supervisory Service
FTA	Free Trade Agreement
FTC	Fair Trade Commission
ICR	Interest Coverage Ratio
IT	Information Technology
ITMCs	Investment Trust Management Companies
IPO	Initial Public Offering
KAMCO	Korean Asset Management Company
KCGF	Korean Credit Guarantee Fund
KDIC	Korean Deposit Insurance Company
KOSDAQ	Korean Security Dealers Association Index
KOSPI	Korea Stock Price Index
MDP	Millennium Democratic Party
MOFE	Ministry of Finance and Economy
MOJ	Ministry of Justice
MPB	Ministry of Planning and Budget
MSB	Monetary Sterilization Bonds
MSCI	Morgan Stanley Capital International
NBFI	Nonbank Financial Institutions
NPF	National Pension Fund
NPL	Nonperforming Loans
q/q	Quarter-on-quarter
p.a.	Period average
PCBO	Primary Collateralized Bond Obligation
s.a.	Seasonally adjusted
SDDS	Special Data Dissemination Standard
SFC	Securities and Futures Commission
SSF	Social Security Funds
W	Won
y/y	Year-on-year

Exchange rate at end-December 2002

US\$1 = W 1,196.9

EXECUTIVE SUMMARY

Current setting and outlook. Korean economic growth recovered in 2002 led by strong domestic demand. Banking system health further improved but problems in some NBFIs remain to be resolved. While overall corporate sector performance strengthened substantially, the performance of financially weak enterprises deteriorated.

- Growth rose to about 6 percent in 2002 from 3 percent in 2001. Buoyant consumption and residential construction spending underpinned the recovery beginning in late 2001. In 2002 exports rebounded strongly despite a weaker-than-expected recovery in the global economy. The current account surplus declined slightly in 2002 and the won appreciated against the U.S. dollar, largely moving in tandem with the yen. Core CPI inflation remained at the center of the target range.
- The fiscal surplus was substantially higher than budgeted, resulting in a contractionary fiscal stance in 2002, and some further fiscal contraction appears likely in 2003. This is broadly offset by the moderately accommodative stance of monetary policy, which has been on hold since a 25 basis point rate hike in May 2002.
- Banks further reduced their NPLs in 2002, and bank privatization advanced notably. Progress in restructuring NBFIs, on the other hand, was relatively slow. While overall debt-equity ratios fell in 2002, corporate debt remains high compared with industrial countries and the operating profits of financially weak companies declined.
- Economic growth is expected to moderate to about 5½ percent in 2003 as increases in domestic demand slow. Inflation is projected to rise slightly, and a further decline in the current account surplus is expected. There are significant downside risks to the near-term outlook related to external demand and oil prices, and potentially to developments in the DPRK.

Policy issues. There was broad agreement on the outlook and risks, with discussions centering on the appropriate response if the downside risks materialize.

- If growth falters substantially, fiscal policy should play the main role in supporting demand given that monetary policy is already moderately expansionary. While the automatic stabilizers will provide some initial support to demand, fast-acting fiscal measures such as bringing forward projects already in the budget, income tax rebates, and reductions in petroleum taxes in case of a sharp rise in oil prices should be considered.
- Once external uncertainties are resolved, it would be appropriate for monetary policy to resume the process of moving to a more neutral stance.
- The authorities should take the opportunity to strengthen fiscal transparency and budget management, especially to avoid systematic expenditure shortfalls that result in a procyclical fiscal stance in an economic slowdown.
- Continued efforts will be needed to consolidate progress in financial and corporate sector restructuring, including by resolving weak NBFIs, utilizing the expected new corporate insolvency procedures to restructure the remaining financially weak companies, and further strengthening corporate governance.

I. INTRODUCTION

1. **Korea's excellent economic performance in 2002 reflects the benefits of the far reaching economic reforms implemented since the 1997–98 crisis.**¹ The rebuilding of the banking system enabled domestic demand to lead the recovery in the face of a sharp decline in external demand in 2001, and to continue to sustain strong growth in 2002. Robust exports in 2002, despite a weaker-than-expected recovery in external demand, also benefited from the substantial restructuring of the corporate sector. Overall, the Korean economy has significantly outperformed other IT-specialized Asian countries in recent years. Medium-term prospects are bright.

2. **The central outlook is for economic growth to moderate somewhat in 2003, but to remain relatively strong.** There are downside risks from weaker global growth or a sharp rise in oil prices. There was broad agreement between the authorities and the mission team on the policy imperatives for the period ahead, namely:

- to be prepared to use macroeconomic policies to cushion the impact of weaker external growth or other shocks; and
- to continue efforts to strengthen the corporate and financial sectors by further entrenching the role of market discipline.

3. **At the Board meeting for the 2001 Article IV consultation in February 2002, Executive Directors considered that macroeconomic policies should remain supportive as there were still uncertainties in the near-term outlook.** With growth then expected to be a modest 4 percent in 2002, Directors advised that fiscal policy should not be allowed to be tighter than budgeted to avoid a contractionary impulse in 2002. They also urged the authorities to address the problems in budget planning, monitoring, and execution. Directors encouraged the authorities to continue to limit foreign exchange intervention to instances of disorderly trading. They welcomed the announced schedule for the sale of government-held bank shares, along with the authorities' intention to undertake comprehensive insolvency reform, and encouraged the authorities to continue their gradual approach to the relaxation of chaebol regulations.

4. **Korean economic policies have largely been consistent with the Fund's recent policy recommendations.** In the Board meeting for the 2001 Article IV consultation, the authorities expressed their view that the 2002 budget targets were appropriate despite the weak economic outlook, and that the front-loading of expenditures in 2002 would provide sufficient stimulus. As the economy strengthened in early 2002, the staff, in a visit in April 2002, revised its growth projection up to 6 percent and considered that a higher-than-budgeted surplus in 2002 would be warranted. While there has been little recent progress on

¹ The reforms are discussed in David T. Coe and Se-Jik Kim, eds., *Korean Crisis and Recovery*, IMF and Korea Institute for International Economic Policy, 2002.

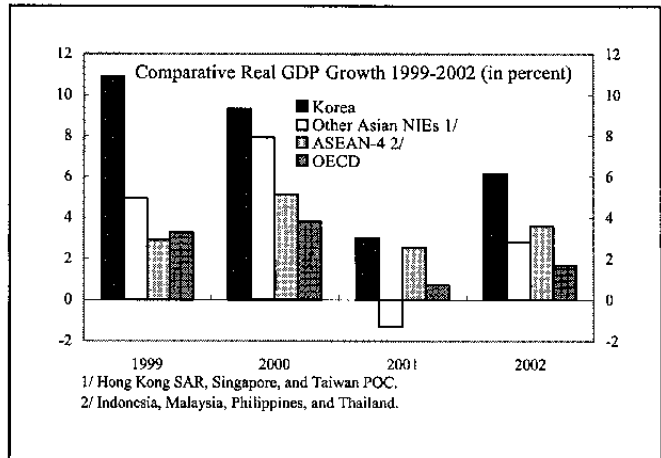
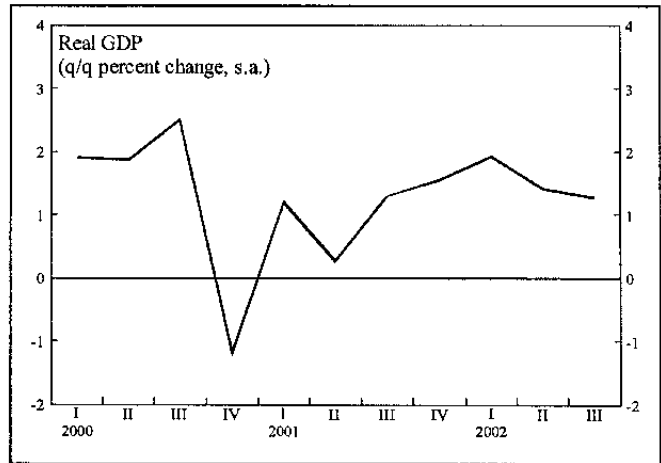
technical assistance recommendations to improve fiscal management and transparency, the authorities have made progress in developing a medium-term fiscal framework. Other policies have also been consistent with the Fund's recommendations.

5. **Mr. Roh, Moo-hyun of the governing MDP was elected President on December 19, 2002 and will be inaugurated on February 25, 2003.** The overall thrust of economic policies is expected to be little changed under the new government, particularly the continuation of corporate and financial sector restructuring, although there may be more emphasis on strengthening the social safety net. President-elect Roh aims to continue the "sunshine policy" toward the DPRK of outgoing President Kim Dae-jung.

II. THE CURRENT SETTING AND PROSPECTS

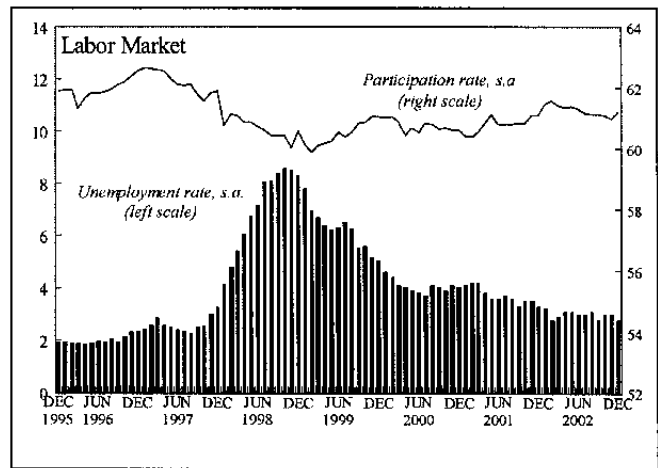
A. Macroeconomic and Market Developments

6. **Korea's economic growth recovered in the second half of 2001 and remained strong in the first half of 2002.** Buoyant consumption and residential construction spending underpinned the recovery, supporting 3 percent real GDP growth in 2001 despite a fall in export volumes (Table 1). A rebound in exports in the first half of 2002 consolidated the recovery. Private consumption has been losing steam since the first quarter, and is expected to slow further as consumer confidence has weakened since mid-year. While industrial output growth has been robust, mainly driven by the IT and related sectors, capacity utilization still remains somewhat below average pre-crisis levels, which has been reflected in a modest growth in equipment investment. For the year as a whole, real GDP is estimated to have increased by 6.1 percent. Korea's growth performance in recent years has compared favorably with OECD and regional economies.

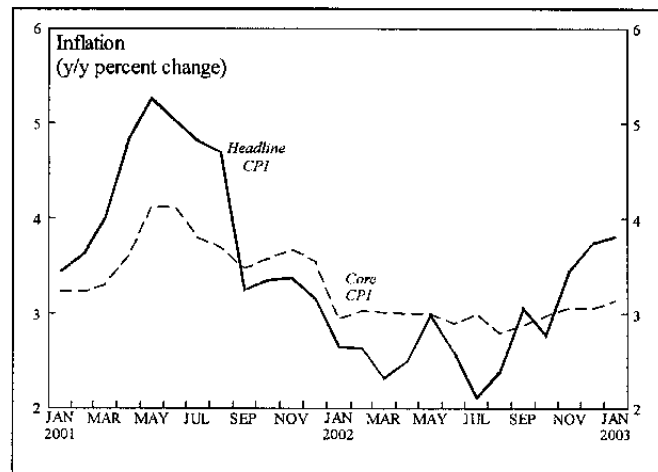


Economic Indicators (Percent change, y/y, unless otherwise indicated)							
	2001	2002	2003	2002			
		Est.	Proj.	Q1	Q2	Q3	Q4
Real GDP	3.0	6.1	5.5	5.8	6.4	5.8	...
Total domestic demand	1.9	6.5	5.9	8.1	7.3	4.2	...
Industry							
Industrial production	1.3	7.3	...	6.8	7.4	5.4	9.5
Capacity utilization, percent	75.1	76.8	...	77.0	76.9	76.4	76.7
Consumption and Investment							
Wholesale and retail sales	4.6	6.6	...	7.9	6.5	5.1	4.5
Equipment investment est.	-2.1	1.2	...	2.3	-0.1	0.1	3.3
Labor market							
Unemployment, s.a., percent	3.7	3.0	3.0	3.0	3.1	3.0	2.9
Employment	1.4	2.5	1.8	4.0	2.4	2.0	1.5
Core CPI	3.6	3.0	3.2	3.0	3.0	2.9	3.0

7. **Unemployment has eased to near pre-crisis levels, while wage rises have been matched by productivity growth.** Strong employment growth in the service sector has reduced the unemployment rate to 3 percent, although labor force participation remains below pre-crisis peaks. Average monthly earnings rose 10½ percent (y/y) in the first three quarters of 2002, up from a 6 percent (y/y) increase in 2001, but manufacturing labor productivity also accelerated to 9.4 percent (y/y) in the first half of 2002.



8. **Core CPI inflation in 2002 was at the center of the 2–4 percent target range.** Headline CPI inflation has been volatile, mostly due to weather-related swings in food prices, especially the impact of a major typhoon in August. Core inflation, however, has been relatively stable at 3 percent (y/y), as increases in housing rents were offset by lower public charges and the initial impact of the won’s appreciation against the U.S. dollar.



9. **External trade rebounded sharply in 2002.** Exports and imports jumped by almost 30 percent (y/y) in December (Table 2). Intra-regional trade, especially with China, was an important contributor to the strong export performance, possibly related to China's accession to the WTO.² The deficit in the services account is estimated to have widened further in 2002, due to rising spending by Koreans traveling abroad, transfers for overseas studies, and royalty payments. Overall, the current account surplus is estimated to have declined from 2 percent of GDP in 2001 to 1.4 percent in 2002.

	2000	2001	2002 ¹
Exports of goods (2002 shares, percent)	21	-14	11
By commodity			
Electronics (35)	35	-24	17
Automobiles (8)	18	3	13
Telecommunication (12)	37	11	25
Shipbuilding (6)	10	18	5
By destination			
Japan (9)	29	-24	-3
Non-Japan Asia (37)	22	-13	16
China (14)	35	-1	27
United States (20)	28	-18	5
Other (33)	11	-5	1

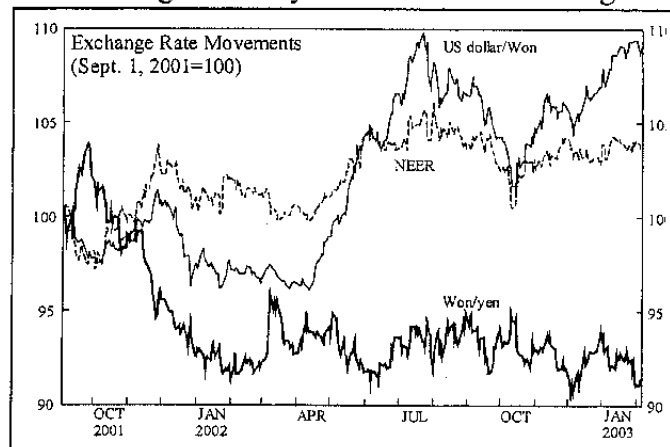
Source: CEIC.
¹ Exports by commodity and destination are up to November 2002.

10. **Foreign borrowing by commercial banks rose sharply in 2002 enabled in part by upgrades of Korea's credit rating, which almost regained pre-crisis levels.** FDI inflows, on a commitments basis, declined by 19.4 percent in 2002, mainly because of reduced mergers and takeovers as corporate restructuring reached an advanced stage. Reflecting redemptions of emerging market funds and profit-taking, net portfolio outflows were US\$1 billion in 2002—a sharp turnaround from the large net inflows of 2001. These outflows were offset by increased short-term borrowing by commercial banks to cover foreign exchange hedging by Korean enterprises, which is matched by off-balance sheet assets, and to finance lending in foreign exchange, with yen-denominated short-term debt rising by US\$2 billion in the first three quarters of 2002. In response to the latter, the authorities have indicated that measures may be needed to curtail the growth in yen-denominated lending.

Upgrades of Korea's credit rating led to Korea being the first country to graduate from the widely used EMBI+ index for emerging markets, although this exit was accompanied by a small rise in Korea's sovereign bond spread.

11. **The exchange rate fluctuated largely in line with the yen in 2002.**

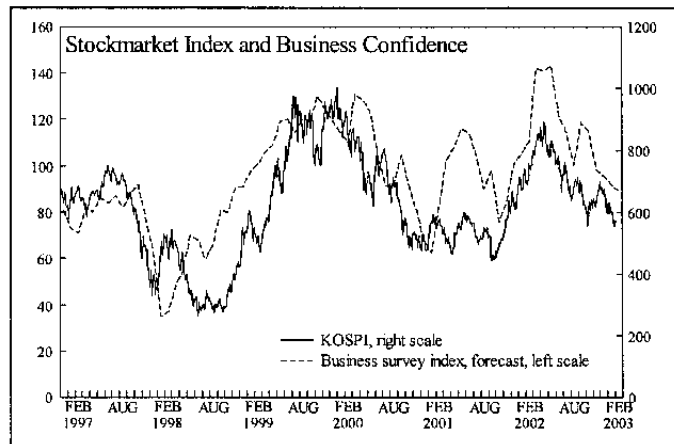
The won appreciated sharply against the U.S. dollar in April–July, but fell back somewhat in the fall, before strengthening again in recent months. Although the won appreciated some 10 percent against the U.S. dollar in 2002, it was quite stable against the yen, and appreciated only 2½ percent



² Korea's exports to China, Hong Kong SAR, and Taiwan Province of China accounted for 25 percent of total merchandise exports in 2002.

on a nominal effective basis and 4½ percent on a real effective basis. Official reserves continued to rise, reaching US\$121.4 billion by end-2002, mainly reflecting interest earnings, valuation gains, loan repayments by banks, and privatization receipts.³

12. **Concerns about the global growth outlook since the second quarter have driven capital market developments, although domestic corporate financing conditions have improved.** Korean equity markets largely moved with regional markets, as the KOSPI rose significantly in the first quarter of 2002 but fell back thereafter. Yields on long-term government bonds moved in a similar fashion. The DPRK's announcement



that it had withdrawn from the Treaty on the Non-Proliferation of Nuclear Weapons in mid-January dented equity markets modestly and put further downward pressure on domestic bond yields, but had a negligible effect on sovereign spreads. Nonetheless, spreads on corporate bonds have remained at the low levels reached earlier in 2002. Official support for the corporate bond market has been virtually eliminated, as the authorities introduced a penalty fee on rollovers of more than 50 percent of maturing PCBOs.⁴ Together with the improved financing conditions, this resulted in a sharp drop in PCBO rollovers to only 7.3 percent of maturing PCBOs in the first three quarters of 2002; PCBOs were less than 6 percent of outstanding corporate bonds in September 2002.

B. Monetary and Fiscal Policies

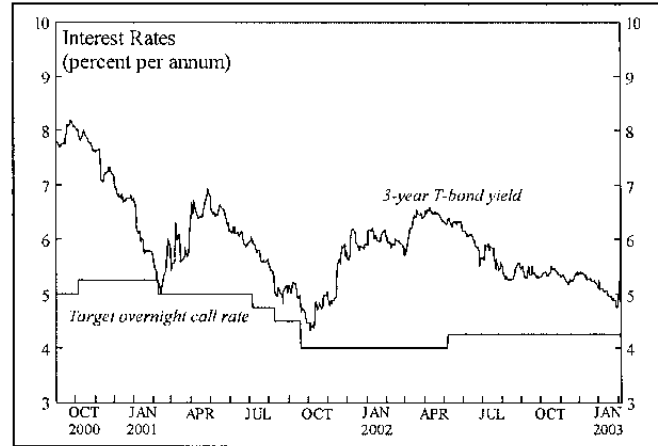
13. **The fiscal surplus for 2002 is expected to be 2 percent of GDP higher than in the original budget** (Table 3). Total revenues are likely to exceed budget projections by 0.3 percent of GDP reflecting the buoyant economy and higher-than-expected transfers from the BOK. Consistent with Korea's conservative budget management practices, current expenditures are anticipated to be 1 percent of GDP lower than budgeted. The shortfall of

³ Since the MOFE is not permitted to hold foreign exchange accounts, it typically sells to the BOK any foreign exchange inflows, including privatization receipts, that are large relative to foreign exchange market volumes.

⁴ PCBOs were introduced in June 2000 to address the bunching of maturing corporate bonds by pooling a set of middle- to lower-rated issuers into an asset-backed security with a partial guarantee from the KCGF.

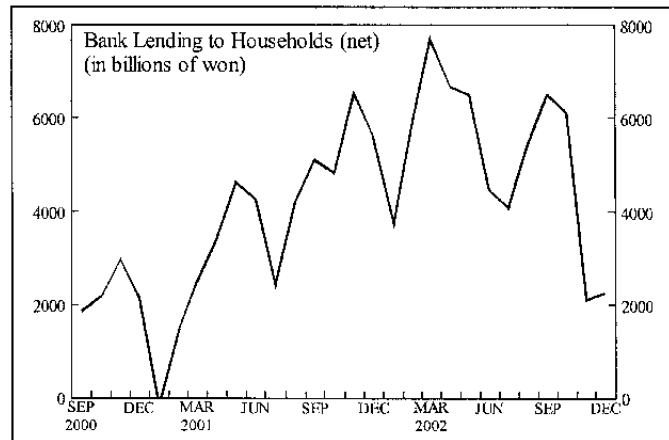
0.6 percent of GDP in non-interest current spending would have been larger were it not for the supplementary budget of W 4.1 trillion (0.7 percent of GDP) approved in September to finance typhoon-related reconstruction.⁵

14. **Monetary policy has been on hold since a 25 basis point tightening in May.** In its May decision the BOK anticipated upward pressure on inflation from oil prices and demand-side pressures, and noted concern about the rapid rise in household lending. But further rate hikes were put on hold due to the instability in international financial markets that emerged around mid-year and the associated uncertainty about external demand prospects, coupled with the appreciation of the won and the continued stability of core CPI inflation.



15. **The rise in household lending and housing prices has slowed since the introduction of prudential measures in October 2002,** easing concerns about a possible real estate bubble and reducing the urgency to tighten monetary policy (Box 1):

- Bank lending to households increased 50.4 percent (y/y) in September 2002 (Table 4), and then fell to about one-third of that pace in November–December.
- Overall house price inflation has been running at 16–18 percent (y/y) since March 2002, led by apartment prices in the southern Seoul area of Gangnam, which rose 43.4 percent (y/y) in September. In October–November, however, the national house price index slowed more than would be expected due to seasonal factors, and price falls were recorded in Seoul, especially in areas like Gangnam. From a longer-term perspective, the level of real housing prices remains relatively low (Figure 5).



⁵ Non-interest expenditures were 1.3 percentage points of GDP lower than budgeted in 2000, and 0.9 percentage points lower in 2001.

Box 1. Developments in Household Credit

High growth in credit to Korean households in recent years has partly reflected a shift in bank lending practices that had previously focused largely on the corporate sector. Household credit rose at an annual rate of 33 percent in the first three quarters of 2002, following high growth in 2000–01. Banking reforms, including the end of directed lending after the 1997–98 crisis, have allowed the banks to increase the share of household loans from 35 percent of total won loans in 1997 to over 50 percent in June 2002, similar to that in other advanced economies. Household

Household Credit Developments				
	1999	2000	2001	2002Q3
	(Annualized growth, in percent)			
Household credit	17	25	28	33
Bank loans	41	43	46	40
Credit card debt	64	109	43	45
<i>Ratios to disposable income</i>	(In percent)			
Household debt	88	93	108	122
Interest payments	10.7	10.0	10.1	...
Net financial wealth	131	133	130	121
<i>Delinquency rate to banks</i>				
Household loans	...	2.1	1.2	1.4
Credit card receivables	...	7.6	7.4	11.4

Source: BOK and FSS.

lending has contributed to the improved profitability of Korean banks, and banks with the lowest initial household exposure have been the most aggressive in competing for new customers. Growth in credit card debt was especially rapid after the introduction of a tax deduction and other measures designed to encourage credit card use and thereby broaden the tax base.

The risks of large financial sector losses or of a sharp retrenchment in household spending do not appear to be substantial. Credit to income ratios have risen to levels comparable to other advanced economies, while the increase over the past decade is close to that in Australia.¹ Despite rising debt levels, the interest payment burden has been stable and household net financial wealth remains above pre-crisis levels. Delinquency rates remain relatively low and stable on household loans. Although there has been a rise in credit card delinquency, credit card debt is only one-sixth of household credit. Most household lending has been to purchase housing, with almost two-thirds of bank loans collateralized. Loan-to-value ratios are modest on average, with most banks close to the revised official guideline of 60 percent.

The authorities adopted a range of measures in 2002 to strengthen prudential supervision of household lending, including a wide range of credit card regulations and on-site examinations of banks' risk management practices for household credit, with agreements on the implementation of planned improvements. Further measures were adopted in October: (i) increases in minimum mandatory loan loss provisioning on household loans, especially credit card debt; (ii) an increased BIS risk-weight on new household loans that are overdue more than 30 days and/or are more than 250 percent of the borrower's income; and (iii) a reduction in the loan-to-value ratio guidelines on housing loans from 70–80 percent to 60 percent, and reductions over time in loan-to-value ratios by those banks that have above average ratios. The authorities have also sought to reduce real estate speculation through a variety of measures, some targeted at the districts of Seoul with the highest house price rises, such as making greater use of market rather than official prices in capital gains taxation, effectively increasing the tax rate in these areas.

The effects of these measures are being monitored closely by the authorities. While data for October-December 2002 suggest some slowdown in the pace of household credit expansion and in house price inflation, the next "moving season" around the turn of the year will be a key test of the effectiveness of these measures.

¹ Chapter IV of the Selected Issues paper provides further analysis of developments in household debt.

C. Financial and Corporate Sector Developments

16. **The health of the banking system in Korea has continued to improve.** The share of commercial bank loans classified as substandard or below fell to 2.5 percent in September 2002, from 3.3 percent at end-2001 and 8.9 percent at end-2000, while the average capital adequacy ratio of the banking system stood at 10½ percent. Profitability has also improved, with the banking system earning a profit (net of provisions) in 2001 for the first time since 1997; operating income also grew strongly in 2002, although increased provisioning on household loans and credit card receivables, as well as on loans to ailing firms including Hynix, dampened the growth in net profits. With the banks' return to profitability, reprivatization has begun in earnest (Box 2).

17. **In contrast to the banking sector, progress in restructuring the NBFIs has been relatively slow.** Most insurance companies and a number of ITCs remain undercapitalized, and there are concerns about the financial strength of nonbank deposit-taking institutions. As a group, credit unions have sustained losses for three consecutive years and close to 30 percent were insolvent as of end-June 2002. To begin addressing this problem, the FSC/FSS suspended operations of 125 credit unions in late 2002 and announced in early 2003 that 107 of them would be liquidated.

18. **The recovery of public funds injected for financial sector restructuring has continued, partly due to renewed momentum in reprivatizing commercial banks.** One-third of the public funds has been recovered, and the government estimates it will collect a total of 56 percent, which compares favorably with the experience of other countries (Box 3). The government has also made progress in privatizing nonfinancial corporations, completing the privatization of Korea Telecom and Korea Tobacco & Ginseng, and opening bidding for one of KEPCO's power generation units.

19. **In the corporate sector, debt-equity ratios have fallen to levels below the United States and Japan, although debt remains high relative to sales.** The recent reduction in debt-equity ratios has partly reflected debt-equity swaps and debt forgiveness for the former Daewoo group companies, along with debt repayments by large healthy companies. Overall, three-quarters of the fall in the debt-equity ratio since the end of 1997 has reflected increased equity financing, with debt reduction accounting for only one-quarter of the fall in the ratio. Operating profitability has improved from 2001, due mainly to lower material prices and higher semiconductor prices. The strongest improvement in profitability was in larger firms, exporters, and firms in the IT sector.

Box 2. Reprivatization of Financial Institutions

The restructuring of the Korean financial sector in the aftermath of the 1997–98 financial crisis resulted in a significant increase in government ownership of banks. Recapitalization with public funds raised average government ownership in commercial banks, weighted by banks' assets, from 17 percent at end-1996 to 58 percent at end-1998.

As part of the effort to recover public funds, and mindful of the inefficiencies associated with public ownership, the government started in 1999 a process of reprivatizing several commercial banks that it acquired fully or partly when it recapitalized the banks during the crisis. As a result, average government ownership in commercial banks declined to 34 percent at end-2001, and average foreign ownership in commercial banks increased from below 10 percent at end-1998 to more than 30 percent at end-2001.

An updated plan for bank privatization was announced in January 2002 that aimed to complete the privatization process over the next three to four years, seek a balance between domestic and foreign investors, and employ diverse sale methods to minimize the effects on financial markets. The primary target of the plan was to reduce government-held stakes to less than 50 percent in Seoul Bank, Chohung Bank, and Woori Bank by the end of 2003:

- In April 2002, 51 percent of Cheju Bank, a small regional bank, was sold to Shinhan FHC for W 22.8 billion.
- In June 2002, 11.8 percent of Woori (W 600 billion) was floated via an initial public offering, followed by Woori's listing on the Korea Stock Exchange. The group also sold convertible bonds to Lehman Brothers, which can be converted into equity stake.
- Seoul Bank was sold to Hana Bank in September 2002 in exchange for shares whose value Hana guaranteed for W 1.1 trillion over the next 18 months. As a result, the government now has a 31 percent stake in the merged bank. Agreement has reportedly been reached on the timing and method for sale of 60 percent of the remaining government shares in the merged bank; the other 40 percent will also be sold within the 18-month price-guarantee period.
- Shinhan FHC was chosen in January 2003 as the preferred bidder to purchase most or all of the government's share in Chohung Bank, although negotiations have not been completed.
- The government has indicated that it will sell its minority stakes in other banks at opportune times, after its stake in Chohung Bank and Woori Bank has been reduced to less than 50 percent. The 2003 budget envisages the sale of its 9.6 percent stake in Kookmin Bank for W 1.6 trillion.

Government Shareholdings in Major Commercial Banks			
	Assets ¹ (W trillion)	Government Ownership (percent)	Foreign Ownership (percent)
Kookmin Bank	161.0	9.6	71.1
Woori Bank	76.8	88.0	...
Hana/Seoul Bank	72.2	31.0	...
Chohung Bank	57.8	80.1	0.3
Shinhan Bank	55.0	0.0	0.0
Korea Exchange Bank	49.2	43.2 ²	34.1
KorAm Bank	32.3	0.0	53.2
Korea First Bank	28.7	49.0	51.0

Sources: FSS; and Fund staff estimates.
¹ As of end-June 2002.
² Held by the Bank of Korea (10.7 percent) and the Export-Import Bank of Korea (32.5 percent).

In addition to banks, the government sold 51 percent of Korea Life to a consortium led by the Hanwha Group for W 824 billion in October 2002. The government has been actively seeking a buyer for two Hyundai Group financial units, Hyundai Investment Trust & Securities and Hyundai Investment Trust & Management. The Korean Development Bank has also announced plans to sell its 39 percent stake in Daewoo Securities in 2003.

Box 3. Recovery of Public Funds for Financial Sector Restructuring

The Korean government has used public funds of W 157 trillion (32 percent of average GDP in 1998–2000) for financial sector restructuring. Of this total amount, about W 60 trillion was used to recapitalize financial institutions, W 39 trillion was used to purchase nonperforming assets, W 26 trillion was used to pay off depositors of closed institutions, and W 32 trillion was used to facilitate purchase and assumption transactions. The bulk of the funds were financed by the issuance of W 104 trillion of government-guaranteed bonds by KDIC and KAMCO.

Good progress has been made in recovering public funds through sale of acquired government shareholdings, collection of NPLs, and sale of assets. The authorities had recovered 32 percent (W 50 trillion) of the total by the end of June 2002, which compares well with the experience of other countries. The government estimates that it will recover a total of 56 percent (W 87 trillion), with W 37 trillion to be realized in the medium term.

For the unrecoverable residual of W 69 trillion, a burden sharing plan has been adopted: 70 percent of the unrecoverable amount will be explicitly recognized as government obligations, with the remaining 30 percent covered by a 0.1 percentage point surcharge in the deposit insurance premium, which went into effect in early 2003 and will be maintained for 25 years.

To implement the plan, W 49 trillion of the KDIC and KAMCO bonds maturing in the next four years will be converted into treasury bonds, and the remaining outstanding KDIC and KAMCO bonds of W 50 trillion will be serviced by increases in the deposit insurance premium and future recoveries of public funds. The budget will no longer provide subsidies to KDIC and KAMCO for interest payments on their bonds. The conversion of KDIC/KAMCO bonds into treasury bonds will raise explicit government debt by 8 percentage points of GDP.

Fiscal Costs of Selected Banking Crises				
	Crisis Period	Gross Outlay (in percent of GDP)	Net Cost	Recovery Rate (in percent)
Chile	1981–83	52.7	33.5	36.4
Finland	1991–93	10.0	7.0	30.0
Indonesia ¹	1997–present	56.4	51.9	8.0
Japan	1997–2000	6.7	5.6	16.4
Korea	1997–2000	32.2	21.9	32.0
Malaysia ²	1997–2001	7.2	4.0	44.4
Sweden	1991	4.4	0.0	100.0
Thailand	1997–present	43.8	34.8	20.5
United States ³	1984–91	3.7	2.1	43.2
Venezuela ⁴	1994–95	15.0	12.4	17.3

Source: Fund staff estimates.

¹ Excludes a 40 trillion rupiah allocation to the deposit guarantee fund in September 2001.

² Losses implied by the merger of two state owned banks (Bank Bumiputra and Bank Simc) with private banks are excluded.

³ Refers only to the Savings and Loans crisis.

⁴ As of end-1998.

Indicators of Financial Stability and Profitability in Manufacturing, 1997–2002								
	Korea						U.S.	Japan
	1997	1998	1999	2000	2001	2002Q3	2002Q3	2000
	(In percent)							
Debt/equity	396	303	215	211	182	130	159	160
Debt/total assets	54	51	43	41	40	33	28	30
Debt/sales	66	63	53	43	43	40	28	33
Interest coverage ratio ¹ (% of companies < 100)	129 ...	68 ...	96 (33)	157 (26)	171 (29)	254 (34)	...	...
Current assets/current liabilities	92	90	92	83	98	103	124	132
Operating income/sales	8.3	6.1	6.6	7.4	5.5	8.1	5.7	3.8
Financial expenses/sales	6.4	9.0	6.9	4.7	4.2	3.2	2.3	0.7
Ordinary income/sales	-0.3	-1.8	1.7	1.3	0.4	7.6	5.0	3.9

Source: Bank of Korea, Financial Statement Analysis.
¹ Operating income to gross interest payments.

20. **However, the proportion of firms in poor health rose and their performance deteriorated, with almost 10 percent of companies exhibiting persistent weaknesses, pointing to the need for restructuring.** The share of companies with operating profits less than interest payments (i.e., with an ICR below 100 percent) rose to 34 percent for the first three quarters of 2002 from 32 percent in same period of 2001, driven by a sharp 5 percentage point rise in the share of companies making operating losses. While the average ICR rose significantly, the ICR of the weakest quarter of firms fell 44 percentage points to only 8 percent. The FSAP mission found that almost 10 percent of companies had an ICR less than 150 percent in each year from 1999–2001; excluding companies under some form of restructuring, this group accounts for about 15 percent of total corporate debt.

21. **A number of steps to strengthen corporate governance and regulation were taken in 2002:**

- **A draft insolvency law was circulated for public comment in November**, and most observers expect the law to be approved by the National Assembly in 2003. While the draft law represents an improvement on the current legal framework, bolder reforms along the lines of staff recommendations could have established an insolvency regime better suited to the needs of the Korean economy (Box 4). Nonetheless, full use of the new law should help resolve the problem of persistently weak companies.

Box 4. Corporate Insolvency Law Reforms

Corporate insolvency law reforms are essential to enhance the efficient allocation of resources within the Korean corporate sector. Although the health of the Korean corporate sector has improved in recent years, a significant proportion of corporations display persistently weak capacity to service their debts. Weak insolvency procedures allow these “zombie” corporations to continue to operate, impairing overall corporate performance by using capital and labor less productively. Weaknesses in Korea’s corporate insolvency framework, and in related procedures on foreclosure of collateral, also adversely affect the financial system by restricting creditor rights and distorting lending practices.¹

The Korean authorities have moved forward with insolvency reform by drafting a single law to replace three overlapping laws. To assist the reform process, Fund staff provided technical assistance through participation in a February 2002 workshop on the design of an effective corporate insolvency framework. Subsequently, the Korean authorities prepared a draft Bankruptcy Act covering both corporate and personal insolvency procedures. When enacted, the draft Bankruptcy Act is likely to improve the efficiency and predictability of insolvency processes.

However, Fund staff considers that the draft Bankruptcy Act does not deal adequately with some key issues. In particular, it suffers from the following shortcomings:

- inconsistencies between the equivalent criteria in liquidation and rehabilitation proceedings, which contribute to the length and complexity of the law and also present opportunities for strategic behavior by debtors and creditors;
- inordinate deference to shareholders and inattention to insider creditor claims, which controvert the basic assumption of corporate finance that shareholders are subordinated in insolvency proceedings, and dilute the accountability of shareholders and insiders;
- cram-down procedures overriding dissenting classes of creditors are consistent with relative priority rather than absolute priority, which reduces the likelihood of approving equitable rehabilitation plans;
- incoherent treatment of secured creditor claims, which diminishes the value of secured credit and thereby constrains the extension of credit; and
- unwarranted opportunities for judicial discretion, which create unpredictability and inefficiency in proceedings that should be based on commercial judgments.

Bolder reforms would have taken fuller advantage of the opportunity to establish an insolvency regime to better serve the current and prospective needs of the Korean economy. Fund staff recognizes that any reform of corporate insolvency law reflects compromises among many interested parties. The dynamics of compromise can result in a tendency to sequence reforms over a number of years, which may also happen in Korea.

¹ The problems with Korea’s insolvency system are discussed in Republic of Korea—Selected Issues, IMF Country Report No. 02/20.

- **The coverage of chaebol regulations constraining equity investment in other companies was narrowed to the 12 largest private-sector business groups in the spring of 2002, reflecting corporate sector restructuring.**⁶ The FTC penalized nine groups that had exceeded the limits by prohibiting the exercise of voting rights.
- **The SFC stepped up enforcement of accounting and disclosure standards in 2002, and has drafted an accounting reform bill,** including a requirement that the CEO and CFO certify the accuracy of financial statements. Other reforms include a requirement for board approval and public disclosure of loans made to major shareholders or executives; firewalls between consulting and auditing services within accounting firms; and enhanced supervision of the accounting industry by the SFC and FSS.
- **Aiming to enhance minority shareholder rights,** the government had submitted a bill to allow class action lawsuits in the case of violations of securities laws by large corporations. Although this bill was not approved in 2002, the incoming President has indicated that the new government will aim to enact it in 2003.
- **The resolution of major distressed companies has advanced.** Daewoo Motors was taken over by GM in April 2002. In the same month, however, a takeover offer for Hynix Semiconductor from Micron Technology was rejected by the Hynix Board. Since June, creditors have taken control of Hynix. A further restructuring was approved by creditors in December 2002, including a debt-equity swap of W 1.9 trillion, rescheduling of W 3 trillion in debt, and the sale of assets.

D. Outlook and Assessment of Risks

22. **The outlook is for a moderate slowing of economic growth in 2003 followed by continued robust growth in the medium term.** The projections assume that the global economy recovers in 2003. In the team's baseline scenario:

- **Real GDP growth is projected to slow to 5½ percent in 2003,** mainly on account of weaker domestic demand. This compares with the 6 percent growth assumed in the 2003 budget and the projections of Korean research institutes ranging from 5¼–5¾ percent. In the medium term, growth is expected to average 5½ percent, in line with potential. This estimate assumes somewhat higher growth in total factor productivity than before the

⁶ The regulations on cross-shareholdings and debt guarantees that previously applied to firms affiliated with the top-30 chaebol now focus on 43 companies with assets over W 2 trillion. The additional regulation on equity investments in other companies applies to 19 of these companies with assets exceeding W 5 trillion, of which seven companies are state-owned.

- crisis, reflecting the benefits of structural reforms and the increased outward orientation of the economy, which is partly offset by a lower rate of physical capital accumulation (Table 5).⁷
- **Increases in domestic demand slow in 2003 mainly due to weaker private consumption growth**, which has already begun to taper off as the household savings rate has fallen to historic lows. Measures taken to moderate the rise in household credit may also slow consumption and residential construction. The current account surplus is projected to decline slightly to 1 percent of GDP in 2003, and to near balance in the medium term.
- **Core CPI inflation is projected to increase modestly to 3¼ percent in 2003**, largely reflecting pressure on rents and more typical increases in public service charges. With a negligible output gap, inflation is expected to remain subdued in the medium term.

23. **Risks to the outlook come mainly from the external front and are predominantly on the downside.** International financial market volatility suggests an increased risk of a weaker-than-expected global economic recovery, which could be combined with a spike in oil prices. The impact of weaker external demand on Korean growth would likely be exacerbated by reduced confidence and a cutback in investment. And although a sharp retrenchment of consumption appears unlikely, the rise in household debt levels may magnify the usual response to slower income growth. An intensification of tensions with the DPRK would impair confidence and roil financial markets, likely delaying investment including FDI inflows, but experience suggests that a protracted standoff may not have large adverse effects on domestic demand.

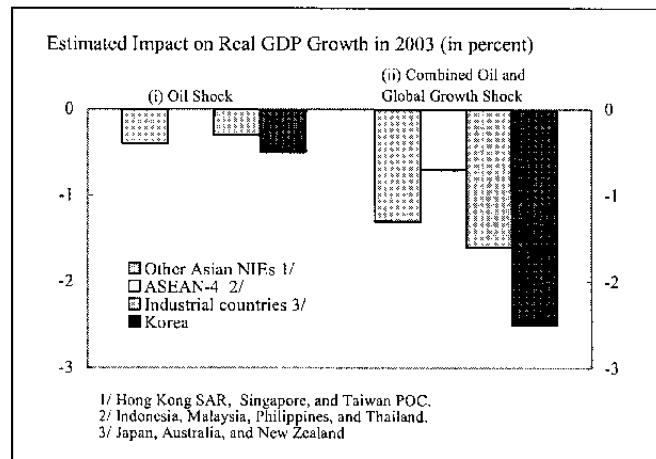
24. **The Korean economy may be more sensitive to these downside risks than other countries in the region** due to the combination of Korea's dependence on oil imports, high level of exports, and relatively strong linkage to international equity price fluctuations, partly reflecting large foreign participation in Korean equity markets.⁸ To illustrate the potential significance of these risks, two scenarios are presented: the first assumes that the world price of crude oil rises to US\$40 per barrel in the first half of 2003 then returns to the WEO baseline of US\$25 per barrel; the second is a worst case scenario where the oil shock is combined with slower global growth and sharp falls in equity markets and confidence.⁹

⁷ Chapter III of the Selected Issues paper discusses potential growth in more detail.

⁸ Korea's gross petroleum product imports were 6¼ percent of GDP in 2001, while net imports were 4½ percent of GDP.

⁹ U.S. and Euro area real GDP growth in 2003 was assumed to be 1½ percentage points lower than the WEO baseline.

- The oil price shock, in isolation, has a modest impact, with real GDP reduced by ½ percentage point.
- **In the worst case scenario, Korean real GDP could be reduced by as much as 2½ percentage points, pushing growth to as low as 3 percent in 2003.**¹⁰ This exceeds the estimated impacts of 1¼–1¾ percent in other economies in the region. The impact on inflation is small because the oil shock is assumed to be temporary, with the inflation impact largely offset by weaker demand.



25. **These scenarios suggest that even in the worst case Korea’s external vulnerability is limited** (Table 6). The external current account balance could shift from a surplus of US\$5 billion to a deficit of up to US\$2 billion in the worst case scenario, but Korea’s ample reserves would more than cover this deterioration. In addition, Korea’s public and external debt ratios are relatively low and are projected to decline in the medium term, making it unlikely that problems associated with debt sustainability would become important, except in the case of an extreme shock such as the collapse of the DPRK government and a rapid unification of the Korean peninsula.

III. POLICY DISCUSSIONS

26. **There was broad agreement on the assessment of the economic situation and risks.** The authorities agreed that both monetary and fiscal policies enjoyed substantial room for maneuver, and discussions on macroeconomic policies centered on the appropriate policy response if the downside risks should materialize.

A. Macroeconomic Policies

27. **The fiscal stance in 2002 was more contractionary than envisaged in the original budget.** The overall fiscal balance (excluding the social security funds, but including privatization receipts) is expected to be a surplus of 0.6 percent of GDP, achieving the government’s objective of restoring a balanced budget a year ahead of schedule. On a cyclically adjusted basis, the overall balance (excluding privatization receipts) is expected to

¹⁰ The Korean economic research institutes have explored similar scenarios, tending to find substantial but somewhat smaller impacts, on the order of 1½ percentage points, such that real GDP growth in 2003 would be unlikely to fall much below 4 percent.

rise by 1.4 percent of GDP in 2002, giving a contractionary impulse. The estimated impact on aggregate demand, allowing for varying multipliers across expenditures and revenue, is similar at negative 1.3 percent of GDP. While this outcome would have been unduly restrictive at the time the budget was formulated, it turned out to be welcome given the stronger-than-expected growth in 2002.

	2001	2002		2003
		Budget	Est.	Budget
Overall balance (incl. privatization)	1.3	1.0	3.3	3.4
Excluding SSF balance	-1.5	-1.5	0.6	0.3
Overall balance (excl. privatization)	0.7	0.1	2.2	2.9
Excluding SSF balance	-2.1	-2.4	-0.5	-0.2
Primary balance (excl. privatization)	3.1	2.8	4.5	4.5
Cyclically adjusted balance (excl. privatization)	1.0	0.3	2.4	2.5 ¹
Fiscal impulse ²	-0.2	0.7	-1.4	-0.1
Demand impact ³	1.2	1.1	-1.3	0.9

¹ In 2003, the cyclically adjusted balance is also adjusted for interest payments of 0.5 percent of GDP on KDIC/KAMCO bonds which are no longer included in the consolidated budget.
² Change in the cyclically adjusted balance excluding privatization receipts.
³ Changes in expenditure and revenue weighted by their respective multipliers, which are assumed to be 1.5 for current expenditure, 1.2 for capital expenditure, 0.7 for net lending, and -0.9 for revenue.

28. **The 2003 budget implies a broadly neutral stance if fully implemented, although some fiscal contraction is likely in view of long-established implementation practices.** The 2003 budget was formulated with the objective of achieving a balanced budget, which implies a neutral fiscal stance as this objective was already reached in 2002. However, if past patterns hold, expenditure may fall significantly short of the budget targets, especially as non-interest current spending is budgeted to rise by 16 percent in 2003 compared with an estimated increase of 6 percent in 2002, which could result in a fiscal contraction on the order of 1 percent of GDP. Such an outturn is likely to be overly contractionary, particularly if the downside risks to the 2003 outlook materialize, a point that the authorities concurred with.

29. **Monetary policy has responded appropriately to changing conditions and uncertainties, leaving monetary conditions moderately accommodative.** During the staff visit in April 2002, the team had supported an early increase in the call rate, with further gradual increases thereafter in view of the strength of the recovery and the expected pick up in inflation. It noted that the degree to which rates should be increased would partly depend on how developments in the exchange rate affected overall monetary conditions. The October Article IV mission team shared the judgment of the BOK that it had been appropriate to postpone further increases in the call rate after the 25 basis point increase in May given the appreciation of the won during April–July and the growing uncertainties about the strength of

the global recovery, which were reflected in volatile international financial markets. With further increases in the call rate on hold, the monetary stance remains moderately accommodative, as indicated by the continuing strength of credit growth and historically low real interest rates.

30. Assuming that expenditure plans in the budget are fully implemented, the overall stance of macroeconomic policies is broadly neutral, which is appropriate given the central outlook for growth and inflation. **Until the current external uncertainties are resolved, therefore, the team recommended a wait-and-see posture for macroeconomic policies, an assessment shared by the authorities.**

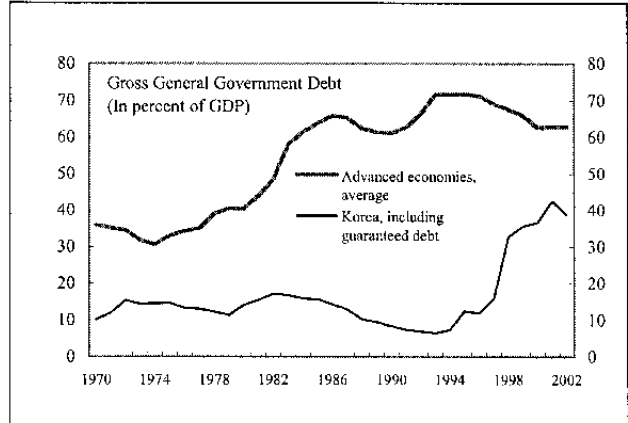
31. **If the downside risks should materialize, the team urged that fiscal policy undertake most, although not necessarily all of the adjustment, given that monetary policy is already moderately expansionary.** While the full operation of the automatic stabilizers will provide an initial buffer against a reduction in growth, they are quite weak in Korea.¹¹ If growth slows markedly, therefore, it may be necessary to consider a discretionary easing of fiscal policy, including timely consideration of a supplementary budget as the authorities did in 2002 when they quickly adopted a supplementary budget to repair typhoon damage. If a supplementary budget is needed in 2003, the team urged the authorities to consider fast-acting measures, which might include bringing forward spending on projects already in the budget, a temporary increase in depreciation allowances for business investment, an expanded investment tax credit, a one-time individual income tax rebate, or a temporary reduction in taxes on petroleum products if world oil prices rose significantly.¹² If discretionary fiscal measures are not sufficient, some easing of monetary policy may also be needed.

32. **A resumption of the process of moving gradually to a neutral monetary stance will be appropriate once external uncertainties are resolved.** The central outlook for a small rise in inflation in 2003, and the expectation that fiscal policy will be broadly neutral in 2004, indicates the need for some further increases in the target call rate to return monetary policy to a more neutral stance. If the global recovery strengthens more than expected, boosting growth in Korea, macroeconomic policies may need to be tightened. In this case, most of the tightening should come from monetary policy.

¹¹ The weakness of automatic stabilizers reflects low revenue relative to GDP and inelastic expenditures given the relatively small social welfare system in Korea, with income transfers of only 3.6 percent of GDP in 2000 compared with an OECD average of 12.8 percent.

¹² In late January 2003, the government announced, as part of a set of emergency energy measures, that some oil import taxes would be lowered if the price of oil increased past a threshold.

33. **A special law on fiscal soundness that aims to achieve a balanced budget and ensure prudent debt management is before the National Assembly.**¹³ It would require that a medium-term fiscal plan be presented to the National Assembly along with the annual budget bill. Considerations are also being given to the revision of the Budget and Account Law to adopt performance-based budget preparation and implementation, and to ensure better provision of information on fiscal



operations. The team urged the authorities to use these opportunities to improve budget formulation and management by implementing the other recommendations of the 2001 FAD technical assistance report. In particular, there is a need to avoid large systematic expenditure shortfalls relative to the budget, which make fiscal policy procyclical during an economic slowdown.¹⁴

34. **The team agreed that maintaining a balanced budget in the medium term would be an effective approach to reducing public debt over time.** There is a political consensus in Korea on the need to reduce public debt, which although low by OECD standards, is at historically high levels. The potentially large future cost of unification of the Korean peninsula is one consideration underpinning this goal (Box 5). Moreover, Korea's demographics imply an especially rapid population aging process, implying that the current pension system is not sustainable.¹⁵ Maintaining a balanced budget excluding the SSF would imply a gradual rise in the overall balance (excluding privatization receipts) from 3 percent of GDP in 2003 to 3½ percent of GDP in 2007 (Table 5), reflecting the expected rise in the

¹³ This law was submitted in 2001 but not approved; it is expected to be resubmitted in 2003.

¹⁴ Chapter II of the Selected Issues paper provides background information on budget formulation and implementation in Korea.

¹⁵ Chapter I of the Selected Issues paper estimates that pension fund assets will be exhausted by about 2035, and that the SSF will run large deficits, on the order of 8 percent of GDP, in the two decades after 2030. The paper argues that reductions over time in the currently high replacement ratio, in conjunction with other reforms, are needed to ensure solvency. Earlier actions would help reduce the ultimate adjustment required.

Box 5. The DPRK: Recent Developments in Economic Policies

The DPRK has undertaken a number of economic reform measures since July 1, 2002 in an apparent effort to improve the incentive structure and stimulate production. Although the available information is patchy and sometimes inconsistent, the main measures appear to be the following:

- ***Official prices have been increased sharply across the board.*** Prices of basic food commodities throughout the Public Distribution System (PDS) have reportedly increased 300- to 550-fold, to bring them broadly in line with the farmers' market prices that are not subject to controls. Price increases for nonfood items have been in the 10- to 100-fold range. Although prices were adjusted, they have not been liberalized.
- ***Wages have been increased sharply.*** The distribution of wage increases has not been uniform, with workers in strategic sectors such as the military and coal mining reportedly receiving larger percentage increases. On average, wages have increased between 15- and 20-fold. For the first time, wages will be allowed to differ across workers performing the same job based on individual effort.
- ***Production planning has been decentralized, and markets for key inputs are now permitted.*** According to reports, the government will continue to stipulate what is to be produced, but factories will be free to determine their own production plans. Moreover, markets for intermediate goods and raw materials are now allowed, so firms can buy and sell these goods at market prices outside of the production "plan." In the agricultural sector, the authorities have reportedly "distributed" land to individuals in the northeastern Hangbuk province, allowing them to grow their own products, while land for private use has been increased almost 10-fold at collectives elsewhere.
- ***Enterprise subsidies are to be eliminated.*** With the adjustment of official prices and the incentives arising from higher and more flexible wages, the government has stated that all enterprises and work units are to be self-sufficient. However, the means of production (land and factories) will continue to be owned by the government.
- ***Key elements of the social safety net will remain in place.*** Free provision of schooling, health services, and child care will be maintained. Some reports indicate that the PDS will continue to ensure that all citizens receive a minimum ration of food staples, but there are conflicting reports that the PDS will be abolished.
- ***The official exchange rate was sharply devalued.*** The government has moved the official exchange rate from won 2.15 per U.S. dollar to won 150 per U.S. dollar. As a result of the official devaluation, foreign exchange certificates, or "blue won," have disappeared. The black market exchange rate is currently around won 200 per U.S. dollar. Subsequently, it was reported that the government required that all U.S. dollars be exchanged for euros.
- ***New taxes may be introduced.*** The authorities are reportedly planning to introduce a 15 percent tax on agricultural and industrial products, and to raise taxes on imported consumer goods.

It is not clear whether the above measures represent the first step toward a major reform of the DPRK's economic model, or a one-off response to the dire economic situation. Although the measures seem geared to raise output, they do not address structural problems in the production and distribution sectors, where energy shortages and poor networks are major bottlenecks. It appears that the higher administered prices have been financed by printing money with highly inflationary consequences: prices in the farmers' market reportedly doubled between July and December 2002.

The ultimate success of these reforms is difficult to predict, and will depend in part on the state of DPRK relations with the rest of the world. Relations have deteriorated recently over the nuclear issue, which led to the termination of fuel oil shipments to the DPRK. President-elect Roh, Moo-hyun has indicated that he will continue the sunshine policy of former President Kim Dae-jung.

surplus of the NPF which builds up the pension fund.¹⁶ The consolidated central government debt—including the government guaranteed bonds issued by KDIC and KAMCO—is projected to decline substantially, from 35½ percent of GDP in 2002 to 23½ percent of GDP in 2007, due to the further recovery of public funds and continued strong economic growth.¹⁷

35. The BOK would like to replace the current one-year inflation target with a medium-term target, which was supported by the mission team. Currently, the Bank of Korea Act requires that the inflation target range be set at the turn of the year for the following year alone. Recognizing that this process is not consistent with the optimal time horizon for monetary policy in Korea, the BOK has also announced a medium-term inflation target to anchor monetary policy.¹⁸ In early 2003, the BOK raised the center of the medium-term target by ½ percentage point, to 2½–3½ percent, coinciding with the center of the 2–4 percent annual inflation target set for 2003, thereby removing the uncertainty about when the annual target would be adjusted in line with the former medium-term target. The staff team considers the slightly higher target to be consistent with a credible commitment to the maintenance of low and stable inflation in the medium term. If the Bank of Korea Act is amended to formally replace the annual target with a medium-term target, as proposed by the BOK, the team encouraged the authorities to follow the practice of other central banks using an inflation targeting framework by measuring core inflation in terms of the 12-month change rather than the annual average change.¹⁹ The BOK was open to this proposal, which would make assessments of performance relative to the target more continuous and less backward-looking, although BOK staff saw little problem with the current approach and a risk that a change could be misinterpreted as implying greater stringency in the inflation targets.

36. The exchange value of the won has been determined by market forces during the past few years, with intervention limited to attempts to smooth disorderly market conditions. In the last two years, foreign exchange intervention by the Korean authorities has

¹⁶ Social security funds include the NPF, Employees Insurance Fund, Casualties Compensation Fund, Teachers' Pension Fund, and the Veteran's Fund. The NPF is the largest, with 70 percent of total revenues of all social security funds in 2001.

¹⁷ Central government debt rises until 2006 due to the conversion of government guaranteed bonds issued by the KDIC and KAMCO into treasury bonds (see Box 3).

¹⁸ Research by the BOK shows that monetary policy impacts on inflation range from two to six quarters ahead. By the second half of each year, therefore, monetary policy decisions should be based on the inflation outlook for the following year, which is beyond the annual target range.

¹⁹ The 2003 inflation target range of 3 percent \pm 1 percent is unchanged from 2002. It is based on the annual rate of core CPI inflation, i.e., the percentage change in the average core CPI index in 2003 from the average core CPI index in 2002.

not been common, and it has been on both sides of the market, such that the cumulative contribution of intervention to the rise in reserves has been small. Intervention has generally been triggered by significant deviations in the won exchange rate from recent trends, thus tending to smooth the pace of such adjustments. This exchange rate policy has contributed to a welcome deepening of the foreign exchange market, and it will continue to serve Korea well in the uncertain period ahead. There is no evidence of exchange rate misalignment, with the external current account in a small and declining surplus, and exports and imports both growing strongly. The current account could shift into a deficit in the next few years given the relative strength of Korean growth.

B. Financial and Corporate Sector Policies

37. **The authorities welcomed the findings of the FSAP mission, and committed to address any deficiencies in a timely manner (Box 6).** The FSAP team commended the authorities on the great strides that had been made in financial and corporate restructuring since the 1997–98 crisis, noting that the Korean financial system has achieved a high degree of compliance with international standards and codes. The team also pointed out that substantial work would still need to be done to complete the reform agenda, as well as to address the challenges posed by domestic and global developments.

38. **The FSAP team concluded that, substantial progress notwithstanding, some weaknesses in the financial system remained, although they did not present immediate risks to financial stability.** In the short term, the main source of weakness was the inadequate capitalization of nonbank financial institutions. The rapid growth in financial institutions' activity in derivatives markets presents supervisory challenges, and there is uncertainty about the legal enforceability of close-out netting in the event of counterparty bankruptcy, which may hamper management of counterparty risks. Structural impediments to full supervisory independence and adequate market development also need to be addressed to ensure efficiency and stability of the Korean financial system in the medium term. The authorities agreed that the financial condition of nonbank institutions has to be improved. They shared the view that derivatives markets need to be carefully monitored and stated that the legal basis of close-out netting would be clarified. While acknowledging the value of an independent FSC/FSS, the authorities stressed that current arrangements reflect legal and institutional traditions in Korea, and should not be regarded as inconsistent with international best practices, which, in any case, are not clearly defined in this area.

39. **Measures taken to curb the risk of a housing market bubble and excessive household credit growth appear to be having the desired effect.** The very rapid increase in household indebtedness had highlighted potential risks. It was appropriate, therefore, for the authorities to take actions in October to ensure that bank lending to households reflects the increased risks and to discourage speculation in the real estate market. These measures appear to be working in recent months, easing concerns about a possible bubble, and there is no urgency for additional policy measures. However, if household indebtedness continues to

Box 6. Financial System Stability Assessment: Findings and Recommendations¹

Since the 1997–98 crisis, Korea has made major progress in financial and corporate sector reforms: the supervisory and regulatory regime for the financial sector has been substantially strengthened; the problems of nonperforming assets and widespread insolvency have been resolved in the banking sector; and recent reforms have helped achieve a high degree of compliance with international standards and codes. In addition, the financial sector has been opened to foreign participation, with foreign ownership in the banking sector tripling since 1997, and reprivatization of commercial banks is in progress. **While much has been accomplished, there are some remaining areas of weaknesses:**

- Stress tests suggest that the banking system can handle isolated shocks without compromising its soundness, although a combination of shocks could be problematic for at least some institutions. Some banks appear insufficiently provisioned against those Korean firms with persistent weak earnings relative to interest payments on their debt.
- Nonbank deposit taking institutions face soundness problems and seem inadequately supervised. The FSC/FSS should urgently strengthen the oversight of these institutions and promptly resolve insolvent institutions. Tighter supervision of securities houses—particularly to curb excessive risk-taking by weakly capitalized institutions—is warranted. Three investment trust companies are financially weak.
- The insurance sector is financially weak and the capital adequacy requirement needs to be redefined. Most life insurance companies are undercapitalized. Stress tests show that insurance companies would have difficulties absorbing even minor shocks to interest rates and equity prices. Greater transparency of the “quasi-insurance” sector would enhance competition.
- Money, bond, and foreign exchange markets are still less developed than could be expected in a market of Korea’s size and income level. Consolidation of government and government-guaranteed debt will help to enhance transparency and reduce market segmentation. Measures to increase institutional investor participation and more regular and larger issues of long-term bonds would foster market development.
- Although corporate restructuring has made significant progress, a sizeable portion of Korean corporations remain unprofitable and highly leveraged. Corporate governance and disclosure have improved, but further steps are needed: more effective audit committees; improved corporate disclosure, particularly with regard to related party transactions; strengthened shareholder rights; and a clearer role for, and professional training of, outside directors.
- Despite notable progress in prudential supervision, concerns remain about the regulator’s ability to supervise certain risks and respond to new challenges. Examples of such risks include the rapidly growing off-balance sheet activities of banks, the capital position of insurance companies, and the derivative activities of securities firms.
- The division of responsibilities between MOFE, FSC, and FSS, the frequent change in the chair of FSC/FSS, and the fact that staff and senior members of these organizations move from one organization to the other create confusion and help perpetuate the view that nonprudential criteria still play a role in decisions. Moreover, the mix of supervisory and restructuring responsibilities at the FSC/FSS could imply a potential conflict of interest. Steps should be taken to make these arrangements more transparent and reassure markets about the independence of the regulator/supervisor.

¹ See the accompanying FSSA report for further details.

grow at the rapid pace of the past few years, even with the rise in interest rates that may be expected once global uncertainties are resolved, the mission team considered that further prudential steps would be warranted.

40. **Bank privatization made welcome advances in 2002.** The team urged the authorities to maintain the momentum in the privatization process, including by selling as soon as possible the newly-acquired shares in Hana Bank. Measures to strengthen and restructure the credit unions have been taken, and the team urged that steps be taken to address weaknesses in other nonbank financial institutions, such as under-capitalized insurance companies, ITMCs, and mutual savings banks. The authorities recognized the need to restructure the NBFIs, and that this would require a limited amount of additional public funds, which would be financed with the remaining W 2½ trillion in funds already raised and, if necessary, with future recycled funds.

41. **The government's plan to finance the unrecoverable public funds used for financial sector restructuring is balanced and does not threaten the efficiency of financial intermediation** (see Box 3). Moreover, rolling over one-half of the outstanding KDIC/KAMCO bonds into Treasury bonds will help develop the long-term debt market. The availability of long-term assets will be welcomed by life insurance companies and institutional investors, and may also stimulate financial institutions to offer longer-term mortgages. The team suggested that the authorities explore other measures to encourage wider use of longer-term mortgage lending with regular amortization payments, so as to reduce the current reliance on one- to three-year "bullet" loans. These loans do not require principal payments and are typically rolled over at maturity, which could be a source of financial and macroeconomic vulnerabilities if, for example, there was a simultaneous tightening of credit standards by banks.

42. **Recent steps to strengthen the enforcement of accounting and disclosure practices will bolster market discipline and improve corporate governance.** Korean corporate governance will also benefit from the approval of the proposed accounting reforms, and smaller steps such as the establishment of training programs for company directors. Reaching international best practices in corporate governance will require continued efforts in many areas, including: enhancing the rights of minority shareholders, through for example, the introduction of class action lawsuits for securities law violations and wider use of cumulative voting; further strengthening of disclosure requirements, such as complete and timely disclosure of related party transactions and debt and payment guarantees; the explicit codification of directors fiduciary responsibilities to shareholders; use of consolidated financial statements for regular reporting rather than only in the annual report; and requiring nominations for independent directors to be made by committees with a majority of outside directors. Until effective market discipline takes hold and corporate governance improves, the team cautioned that relaxation of chaebol regulations should be gradual.

C. Other Issues

43. **Korea's statistical base is adequate to conduct effective surveillance.** The authorities are planning to release the 2001 International Investment Position by end-March 2003—two test compilations for 1999 and 2000 have been finalized but the results have not been published. SNA93 is being implemented piece by piece. Major parts of the SNA93 are expected to be implemented by end 2003, although there is no timetable for the full implementation. The base year in the national accounts will be changed from 1995 to 2000 by end-2003, which will have important implications for the measurement of the information and communications technology sector where relative price declines have been large.

44. **Since the Uruguay Round, the authorities have taken steps to further liberalize Korea's trade regime, but barriers remain among the highest in the OECD, especially for agriculture.** Korea's trade-weighted average tariff rate is 10.6 percent (down from 10.9 percent in 1996), compared with an OECD average of 5 percent. The trade regime includes particularly high tariffs on selected agricultural and fishery products, tariff quotas on some 70 items, and an import quota on rice. In addition, the government provides substantial support to agriculture, principally through price supports and government purchases of rice. The producer support estimate for agriculture is among the highest in the OECD countries, while the consumer support estimate is negative, representing an implicit tax on consumers.²⁰

45. **Korea finalized a free trade agreement with Chile in October 2002.** FTAs with Japan and Singapore are also being considered.²¹ However, the benefits of the FTA with Chile are limited insofar as sensitive agricultural products were excluded, and seasonal tariffs and emergency safeguards remain in place for many other agricultural products. In October 2002 at the WTO, the EU requested consultations with Korea regarding alleged subsidies to trade in commercial vessels, which included the restructuring of the debts of some Korean shipbuilders undertaken during the IMF program with Korea.

46. **The foreign exchange system continues to be liberalized gradually.** In July 2002, the authorities abolished a procedural restriction to notify the BOK of certain current account transactions, such as donations of more than US\$50,000 and educational expenses of more than US\$100,000. The remaining capital restrictions include a limit of W 1 billion on borrowing by nonresidents in local currency, and limits on short-term foreign borrowing by firms that are deemed "fiscally unsound" by the MOFE. The authorities have announced a

²⁰ OECD calculations of the Producer Support Estimate of 64 percent of gross farm receipts in 2001 are double the OECD average, and little changed from recent years; see OECD (2002), "Agricultural Policies in OECD Countries: Monitoring and Evaluation 2002."

²¹ The Korea Institute for International Economic Policy estimates the benefits from an FTA with Japan alone at 1–4 percent of GDP.

plan to fully liberalize the foreign exchange system by 2011. Over the next six years the government will further ease procedural regulations on foreign exchange transactions and abolish the remaining permission requirements for capital transactions.

47. **Korea is cooperating with international efforts to combat money laundering and the financing of terrorism and also to provide debt relief to HIPC countries.** The FSAP found that Korea has made considerable strides in observing the FATF recommendations on combating money laundering and the financing of terrorism, although some further efforts were warranted, including enactment of the Anti-Terrorism Bill, addressing the limitations on access to customer information to facilitate investigations, and abolishing the threshold for suspicious transactions. In 2002, Korea committed to provide debt relief to Uganda and all other eligible HIPC countries.

IV. STAFF APPRAISAL

48. **Korea has made enormous strides toward an economy based on market discipline in the five years since the Asian crisis.** Before the 1997–98 crisis, banks had limited independence from the government and the chaebol influenced much of the remaining financial sector. The chaebol were considered too-big-too-fail in spite of their weak profitability, often vast debts, and poor corporate governance that allowed them to pursue high risk growth oriented business strategies. The crisis showed that this structure was not sustainable. Korea has since led the Asian region in the difficult task of implementing deep and wide ranging reforms of the financial and corporate sectors. Progress has been such that any remaining weaknesses are no longer considered a source of external vulnerability, highlighted by Korea regaining its “A” credit rating and graduating from a key emerging market index.

49. **These reforms, coupled with sound macroeconomic policies in recent years, have underpinned Korea’s excellent economic performance in 2002.** Korea pursued a steady fiscal consolidation in 1999–2000 as the economy recovered from the crisis, while also successfully adopting an inflation targeting regime. In the face of severe external shocks in 2001, the authorities responded with timely interest rate cuts and two supplementary budgets. Together with greater household sector access to credit, these measures enabled domestic demand to provide a firm cushion for growth in 2001. As growth recovered in 2002, the fiscal stance tightened and a balanced budget was achieved one year earlier than expected. Inflation targets have been met, and monetary policy has been flexible and forward-looking, appropriately postponing further interest rate rises when uncertainties about the global growth outlook emerged after the first tightening step in May 2002.

50. **In the current environment, a wait and see posture for macroeconomic policies is appropriate until the external outlook is clarified.** Prospects for continued robust economic growth are good. The likelihood of a somewhat contractionary fiscal stance in 2003 is broadly counterbalanced by the moderately accommodative monetary stance. There is no urgency to alter the current stance of macroeconomic policies, although it is important for the government to fully implement the expenditure plans in the budget. The external

environment, however, is unusually uncertain with risks predominantly on the downside, potentially having a significant impact on Korean growth in 2003. Fortunately, Korea's strong track record of sound macroeconomic policies means that the authorities have ample room for maneuver to counter the impact of risks in either direction.

51. **If the 2003 growth outlook is reduced substantially, fiscal policy should shoulder the main burden of easing the overall macroeconomic policy stance given the already moderately accommodative monetary conditions.** The automatic stabilizers will provide an initial support, but it may be necessary to adopt a supplementary budget with quick-acting measures such as tax rebates and, in case of a substantial rise in international oil prices, reductions in petroleum taxes. If necessary, there is also scope to ease monetary policy.

52. **The process of gradually moving monetary policy to a more neutral stance should resume once current uncertainties are resolved, and a single medium-term target for inflation should be adopted.** If the global recovery strengthens more than expected, most of the tightening of macroeconomic policies should come from the monetary side. The new administration should revise the Bank of Korea Law to require the setting of inflation targets on a medium-term rather than on an annual basis. The authorities should continue to limit foreign exchange intervention to smoothing purposes, a policy that has served Korea well in recent years.

53. **The authorities should enhance the role of fiscal policy as a macroeconomic policy instrument.** In the short run, steps should be taken to avoid the tendency for fiscal policy to be procyclical during economic downturns due to large systematic expenditure shortfalls. In the medium term, maintaining a balanced budget excluding the social security funds will lower public debt and help prepare for longer-term fiscal challenges, including the aging of the population. It will be essential, however, to allow for cyclical deviations from the medium-term objective when implementing the annual budget.

54. **The authorities acted in a timely manner to ensure that risks associated with the rapid growth in household lending and the sharp rises in housing prices in some areas were adequately recognized and contained.** These measures appear to have been effective in recent months, suggesting that there is no urgency for additional policy measures. Nonetheless, if household indebtedness continues to grow at the rapid pace of the past few years, further prudential steps would be warranted.

55. **Bank privatization has advanced rapidly in 2002, and this progress should be broadened to cover the nonbank financial sector.** The efforts to address weaknesses in the credit unions are welcome, and resolution of any remaining weakness in the nonbank financial sector should be completed in a timely manner to strengthen confidence in capital markets.

56. **Financial supervision has been greatly strengthened, but supervisors will need to continue to keep pace with the rapid development of financial markets.** The FSAP found that the Korean financial system has achieved a high degree of compliance with international standards and codes. There has also been very rapid growth in the derivatives markets in recent years, and these would need to be carefully monitored. A review of the adequacy of supervisory independence and addressing barriers to market development are needed to ensure the efficiency and stability of the Korean financial system in the medium term.

57. **Corporate sector performance has improved in 2002, and approval of the insolvency reform is needed to help complete corporate restructuring.** A significant proportion of Korean corporations that display persistently weak capacity to service their debts impair overall corporate performance. Completing the insolvency reform would promote the resolution of these companies, while also reducing the need for official involvement in corporate restructuring in future.

58. **Efforts to improve corporate governance should continue. As market discipline strengthens, chaebol regulations can be eased gradually.** Further progress toward improved corporate governance has been made in 2002 with stronger enforcement of accounting and disclosure standards. The key features of the proposed accounting reforms should be approved. Reaching international best practices in corporate governance will require continued efforts in many areas, including enhancing the rights of minority shareholders and further strengthening of disclosure requirements. Continued monitoring and regulation of the activities of the largest chaebol will be needed until effective market discipline takes hold.

59. **Progress in trade liberalization, preferably on a multilateral basis, should continue.** The FTA agreed with Chile was a positive step, although the full benefits were not obtained due to the exclusion of sensitive goods. Further progress in trade liberalization, particularly in the context of the current round of multilateral trade negotiations, and especially in agriculture, would be beneficial given the relatively high level of Korea's trade barriers.

60. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Table 1. Korea: Macroeconomic Framework, 1998–2003
(in units indicated)

	1998	1999	2000	2001	2002 Est.	2003 Proj.
Real GDP (percent change)	-6.7	10.9	9.3	3.0	5.5	5.5
Total domestic demand	-19.8	14.7	8.1	1.9	5.2	4.2
Final domestic demand	-14.0	7.6	8.2	2.0	5.3	4.2
Consumption	-10.1	9.4	6.7	3.7	6.5	4.7
Gross fixed investment	-21.2	3.7	11.4	-1.7	2.5	3.1
Stock building 1/	-5.5	5.4	-0.2	0.0	-0.1	-0.1
Net foreign balance 1/	12.5	-1.0	3.1	1.5	0.6	1.1
Nominal GDP (in trillions of won)	444.4	482.7	522.0	545.0	577.0	612.4
Saving and investment (percent of GDP)						
Gross national saving	33.9	32.7	30.8	28.7	26.6	25.3
Gross domestic investment	21.2	26.7	28.2	26.7	25.3	24.6
Current account balance	12.7	6.0	2.7	2.0	1.3	0.7
Prices (percent change)						
CPI inflation (end of period)	4.0	1.4	2.8	3.2	3.7	3.0
Core inflation (average)	5.9	0.3	1.9	3.6	3.0	3.2
GDP deflator	5.1	-2.0	-1.1	1.3	0.3	0.6
Real effective exchange rate	-25.6	13.5	8.1	-5.0	3.9	0.7
Trade (percent change)						
Export volume	19.6	12.6	20.8	-1.1	13.3	10.3
Import volume	-23.1	29.5	18.3	-4.7	16.5	12.3
Terms of trade	-4.0	-2.1	-12.8	-4.5	1.4	-0.2
Consolidated central government (percent of GDP)						
Revenues	21.8	22.4	26.0	26.4	27.1	28.1
Expenditure	26.0	25.7	24.8	25.8	25.0	25.2
Overall balance 2/	-4.3	-3.3	1.3	0.7	2.2	2.9
Money and credit (end of period)						
Overnight call rate 3/	7.0	4.7	5.3	5.0	4.4	4.2
Three-year corporate bond yield 3/	8.3	9.9	8.1	7.1	5.6	5.5
M3 growth	12.5	8.0	7.1	11.6	12.0	10.0
Balance of payments (billion U.S. dollars)						
Exports, f.o.b.	132.1	145.2	175.9	151.4	162.6	179.4
Imports, c.i.f.	90.5	116.8	159.1	138.0	148.4	167.1
Current account balance	40.4	24.5	12.2	8.6	6.1	3.6
Usable reserves (end of period)	48.5	74.1	96.2	102.8	121.4	128.5
in percent of short-term debt 4/	107.5	132.2	153.2	193.3	195.4	191.1
External debt (billion U.S. dollars)						
Total external debt (end of period) 5/	148.7	137.1	131.7	117.7	131.0	131.8
Total external debt (percent of GDP)	46.9	33.8	28.5	27.9	28.4	25.8
Debt service ratio 6/	12.9	23.7	12.1	13.4	9.1	9.2

Sources: Korean authorities; and Fund staff estimates and projections.

1/ Contribution to GDP growth.

2/ Excluding privatization receipts.

3/ Data for 2003 are as of January 14, 2003.

4/ On a residual maturity basis.

5/ Includes offshore borrowing of domestic financial institutions and debt contracted by their overseas branches.

6/ Debt service on medium- and long-term debt in percent of exports of goods and services.

Table 2. Korea: Balance of Payments, 1998–2003
(in billions of U.S. dollars, unless otherwise indicated)

	1998	1999	2000	2001	2002 Est.	2003 Proj.
1. Current account balance	40.4	24.5	12.2	8.2	6.1	3.6
Trade balance	41.6	28.4	16.9	13.5	14.2	12.3
Exports	132.1	145.2	175.9	151.3	162.6	179.4
(growth rate, in percent)	(-4.7)	(9.9)	(21.2)	(-14.0)	(7.5)	(10.4)
Imports	90.5	116.8	159.1	137.8	148.4	167.1
(growth rate, in percent)	(-36.2)	(29.1)	(36.2)	(-13.4)	(7.7)	(12.6)
Services	1.0	-0.7	-2.9	-3.8	-7.5	-8.3
Income	-5.6	-5.2	-2.4	-1.2	0.5	0.7
Current transfers	3.4	1.9	0.7	-0.2	-1.1	-1.1
2. Financial and capital account balance	-8.2	12.3	12.1	2.4	1.5	3.2
Financial account	-8.4	12.7	12.7	3.1	2.6	4.3
Portfolio equity investment, net	3.9	11.8	12.6	9.8	-1.3	6.3
Portfolio debt flows, net 1/	-5.8	-3.1	-0.6	-3.2	1.5	0.0
Direct investment, net	0.7	5.1	4.3	1.1	-0.7	-1.0
Inflows	5.4	9.3	9.3	3.5	2.0	2.0
Outflows	-4.7	-4.2	-5.0	-2.4	-2.7	-3.0
Trade credits, net	-6.2	2.8	3.6	-3.8	-1.6	-1.7
Loans, net	-2.9	1.6	-7.1	-4.4	6.8	0.6
Short term	-13.5	5.9	-4.7	-1.8	9.5	-0.5
Medium and long term	10.6	-4.3	-2.4	-2.6	-2.8	1.1
Currency and deposits	1.6	-2.9	0.5	1.4	-0.4	-0.4
Others	0.4	-2.7	-0.6	2.3	-1.6	0.5
Capital account	0.2	-0.4	-0.6	-0.7	-1.1	-1.1
3. Net errors and omissions	-2.4	-2.0	-2.2	1.7	11.0	4.4
4. Overall balance (1+2+3)	29.7	34.8	22.1	12.3	18.6	11.1
5. Financing	-29.7	-34.8	-22.1	-12.3	-18.6	-11.1
Change in usable reserves (increase -)	-39.4	-25.6	-22.1	-6.6	-18.6	-7.0
Net IMF purchases	5.0	-10.3	0.0	-5.7	0.0	0.0
World Bank/AsDB 2/	4.7	1.0	0.0	0.0	0.0	-4.1
Memorandum items:						
Current account balance (as percent of GDP)	12.7	6.0	2.7	2.0	1.3	0.7
Balance of trade (as percent of GDP)	13.1	7.0	3.7	3.2	3.1	2.4
Usable gross reserves	48.5	74.1	96.2	102.8	121.4	128.5
(in months of imports of goods and services)	5.1	6.2	6.0	7.2	7.9	7.5
External debt	148.7	137.1	131.7	118.8	131.0	131.8
(in percent of GDP)	46.9	33.8	28.5	28.2	28.2	25.6
Short-term external debt (inc. trade credits)	30.7	39.2	47.9	41.0	49.8	52.8
Nominal GDP	316.9	406.0	461.5	422.0	464.8	514.0

Sources: Korean authorities; and Fund staff estimates and projections.

1/ Bonds and notes, money market instruments, and financial derivatives.

2/ These World Bank and ASDB loans were extended as exceptional financing in the 1997-98 crisis.

Table 3. Korea: Consolidated Central Government Operations, 2000–03

	2000		2001		2002		2003
	Budget	Actual	Budget 1/	Actual	Budget	Est.	Budget 2/
(in trillions of won)							
Revenue	120.8	135.8	142.7	144.0	154.4	156.5	172.1
Tax revenue	79.7	92.9	95.9	95.8	103.6	104.1	113.8
Social security contributions	17.5	14.8	16.0	17.5	18.2	19.1	20.1
Nontax and capital revenue	23.6	28.1	30.8	30.7	32.6	33.4	38.2
Expenditure and net lending	136.2	129.3	150.2	140.5	153.8	144.0	154.1
Current expenditure	101.1	92.8	107.0	107.8	118.9	113.5	126.0
Interest	14.1	12.5	7.6	13.3	15.5	13.4	9.7
Of which: bank restructuring	6.0	5.6	...	6.1	7.3	6.0	3.6
Non-interest	87.0	80.3	99.4	94.5	103.4	100.2	116.3
Capital expenditure	23.1	22.3	25.7	24.9	26.4	25.6	27.8
Net lending	12.0	14.2	17.5	7.7	8.5	4.9	0.3
Balance	-15.4	6.5	-7.6	3.6	0.6	12.5	18.0
Financing	15.4	-6.5	7.6	-3.6	-0.6	-12.5	-18.0
Domestic financing	15.6	-6.1	7.9	-3.2	-0.1	-12.0	-12.5
Of which: Privatization	3.5	0.0	3.0	3.7	5.4	6.7	1.6
External Financing	-0.2	-0.4	-0.3	-0.4	-0.5	-0.5	-5.5
(in percent of GDP)							
Revenue	23.1	26.0	26.2	26.4	26.6	26.9	27.8
Tax revenue	15.3	17.8	17.6	17.6	17.8	17.9	18.4
Social security contributions	3.4	2.8	2.9	3.2	3.1	3.3	3.2
Nontax and capital revenue	4.5	5.4	5.6	5.6	5.6	5.7	6.2
Expenditure and net lending	26.1	24.8	27.6	25.8	26.5	24.8	24.9
Current expenditure	19.4	17.8	19.6	19.8	20.5	19.5	20.4
Interest	2.7	2.4	1.4	2.4	2.7	2.3	1.6
Non-interest	16.7	15.4	18.2	17.3	17.8	17.2	18.8
Capital expenditure	4.4	4.3	4.7	4.6	4.5	4.4	4.5
Net lending	2.3	2.7	3.2	1.4	1.5	0.8	0.0
Balance	-2.9	1.3	-1.4	0.7	0.1	2.2	2.9
Primary balance	-0.2	3.6	0.0	3.1	2.8	4.5	4.5
<i>Alternative measures of overall balance</i>							
<i>(as percent of GDP)</i>							
Including privatization	-3.6	1.3	-0.8	1.3	1.0	3.3	3.4
Incl. privatization but excl. SSF	-6.0	-1.1	-3.1	-1.5	-1.5	0.6	0.3
Incl. privatization, excl. SSF and incl. conversion of KDIC/KAMCO bonds	-6.0	-1.1	-3.1	-1.5	-1.5	0.6	-1.8
Nominal GDP (trillion won)	522.0	522.0	545.0	545.0	581.2	581.2	618.7

Sources: Ministry of Planning and Budget; and Fund staff estimates.

1/ Including supplementary budgets.

2/ From 2003 onward, interest payments on W50 trillion of KDIC/KAMCO bonds will no longer be included in the consolidated budget, amounting to 0.5 percent of GDP in 2003.

Table 4. Korea: Monetary and Financial Indicators, 2000–02

	2000	2001				2002		
	Dec.	Mar.	June	Sept.	Dec.	Mar.	June	Sept.
Bank of Korea								
	(in trillions of won)							
Reserve money	28.2	30.7	27.7	33.1	32.8	33.8	33.1	36.3
Net foreign assets	110.2	113.8	116.7	123.1	131.4	136.3	130.1	135.7
Foreign assets	124.3	133.5	131.2	138.5	145.6	164.2	156.5	160.9
Foreign liabilities	-14.1	-19.7	-14.5	-15.3	-14.2	-27.8	-26.4	-25.2
Net domestic assets	-81.9	-83.1	-89.0	-90.0	-98.6	-102.5	-97.0	-99.4
Public sector	-4.0	-4.0	-4.4	-2.4	-0.2	-1.1	-6.7	-8.2
Private financial sector	19.4	18.8	15.9	14.7	14.4	13.1	11.9	13.1
Monetary sterilization bond	-66.4	-75.1	-72.2	-78.3	-79.1	-82.5	-84.8	-84.7
Other items net	-31.0	-22.9	-28.3	-24.0	-33.7	-32.1	-17.3	-19.6
Monetary survey								
M2 (broad money)	707.7	720.2	737.3	768.7	765.0	805.1	826.5	840.3
Net foreign assets	125.7	130.6	132.1	131.8	129.9	131.2	119.6	120.3
Foreign assets	185.7	196.0	189.3	193.1	208.3	224.1	212.9	215.9
Foreign liabilities	-60.0	-65.4	-57.2	-61.3	-78.4	-92.9	-93.3	-95.6
Net domestic assets	582.0	589.6	605.2	636.9	635.1	673.9	706.9	720.0
Public sector	-23.9	-31.3	-23.6	-18.4	-12.3	-17.3	-21.3	-25.9
Total private sector	816.4	826.5	843.8	876.4	894.9	939.2	967.5	1,002.0
Other items net	210.5	-205.6	-215.0	-221.1	-247.5	-248.0	-239.3	-256.1
Financial survey								
M3	911.6	932.3	961.9	1,004.6	1,017.7	1,069.1	1,092.6	1,118.2
Net foreign assets	117.3	124.9	128.5	129.4	140.5	141.0	129.5	128.4
Foreign assets	183.3	194.6	190.9	195.4	201.1	216.1	207.1	211.3
Foreign liabilities	-66.0	-69.7	-62.4	-66.0	-60.6	-75.1	-77.6	-82.9
Net domestic assets	794.4	807.3	833.4	875.3	877.2	928.1	963.1	989.8
Public sector	118.5	114.1	121.5	133.7	143.9	141.3	132.7	129.9
Private sector	707.7	715.9	741.3	769.7	786.1	827.0	863.5	901.5
Other items net	-31.7	-22.7	-29.4	-28.1	-52.8	-40.2	-33.0	-41.6
Total household credit 1/	266.9	276.2	296.0	316.3	341.7	368.1	397.5	424.3
<i>Memorandum items:</i>								
	(percent change, year-on-year)							
Reserve money	-0.9	23.9	3.7	23.9	16.3	10.0	19.8	9.6
M2 (broad money)	5.2	5.2	7.8	10.2	8.1	11.8	12.1	9.3
M3	7.1	7.8	9.4	12.1	11.6	14.7	13.6	11.3
Private sector credit								
Depository corporations survey	-1.4	1.3	4.3	6.5	9.6	13.6	14.7	14.3
Financial survey 2/	1.7	2.6	6.3	8.3	10.5	13.9	14.7	15.2
Total household credit 1/	25.3	25.0	24.6	25.9	28.0	33.3	34.3	34.1
Interest rates, end period								
	(in percent)							
Call rate target	5.3	5.0	5.0	4.0	4.0	4.0	4.3	4.3
Treasury bond, three year	6.7	6.3	5.9	4.5	5.9	6.4	5.7	5.3
Corporate bond, AA-, three year	8.1	7.2	7.2	6.3	7.1	7.1	6.8	6.1
Deposit rate	6.0	5.2	5.1	4.3	4.0	4.0	4.1	4.0
Household loan rate	9.5	8.8	8.6	7.6	7.3	7.0	7.3	7.1
Enterprise loan rate	8.1	8.0	7.6	7.1	6.8	6.6	6.5	6.5

Source: Bank of Korea.

1/ Covers credit from banks, savings institutions, and insurance, credit card, finance, and merchandise companies.

2/ Adjusted for the sale of nonperforming assets to KAMCO.

Table 5. Korea: Medium-Term Projections, 2000–07
(in units indicated)

	2000	2001	2002	2003	2004	2005	2006	2007
			Est.	Staff Projections				
Real GDP (percent change)	9.3	3.0	5.5	5.5	5.7	5.5	5.3	5.4
Total domestic demand	8.1	1.9	5.2	4.2	6.7	5.9	5.8	5.8
Final domestic demand	8.2	2.0	5.3	4.2	6.6	5.8	5.7	5.7
Consumption	6.7	3.7	6.5	4.7	5.7	5.3	5.3	5.4
Gross fixed investment	11.4	-1.7	2.5	3.1	8.8	7.0	6.5	6.5
Stock building 1/	-0.2	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0
Net foreign balance 1/	3.1	1.5	0.6	1.1	0.2	0.6	0.4	0.5
Prices, period average (percent change)								
Consumer price	2.3	4.1	2.8	3.5	2.3	2.7	2.5	2.5
GDP deflator	-1.1	1.3	0.3	0.6	2.3	2.2	2.0	1.8
Savings and investment (percent of GDP)								
Gross national savings	30.8	28.7	26.6	25.3	25.5	25.4	25.2	24.9
Gross domestic investment	28.2	26.7	25.3	24.6	24.9	25.0	25.1	25.3
Current account balance	2.7	2.0	1.3	0.7	0.7	0.4	0.2	-0.4
Consolidated central government (percent of GDP)								
Revenues	26.0	26.4	27.1	28.1	28.3	28.3	28.5	28.7
Expenditure	24.8	25.8	25.0	25.2	24.9	24.8	24.9	25.1
Balance 2/	1.3	0.7	2.2	2.9	3.4	3.5	3.6	3.6
excl. Social Security Funds	-1.1	-2.2	-0.5	-0.2	0.0	0.0	0.0	0.0
Debt, domestic plus external 3/	19.3	20.8	18.9	19.8	20.1	20.6	20.8	19.3
Government guaranteed restructuring bonds 3.	13.1	17.9	16.8	12.8	9.7	6.9	4.5	3.9
Trade (percent change)								
Merchandise exports	21.2	-14.0	7.4	10.4	9.4	9.7	9.0	9.3
Volumes 4/	20.8	-1.1	13.3	10.3	8.1	8.6	8.1	8.4
Merchandise imports	36.2	-13.3	7.5	12.6	9.8	10.7	10.1	11.2
Volumes 4/	18.3	-4.7	16.5	12.3	11.2	10.8	10.3	10.5
Terms of trade	-12.8	-4.5	1.4	-0.2	2.6	1.1	1.0	0.2
Balance of payments (billion U.S. dollars)								
Current account	12.2	8.6	6.1	3.6	3.7	2.7	1.0	-2.9
Trade balance	16.9	13.4	14.2	12.3	12.9	12.2	11.0	7.8
Merchandise exports	175.9	151.4	162.6	179.4	196.3	215.4	234.7	256.6
Merchandise imports	159.1	138.0	148.4	167.1	183.4	203.1	223.7	248.8
External debt								
In billion U.S. dollars 5/	131.7	117.7	131.0	131.8	134.7	138.6	143.0	149.9
(as percent of GDP)	28.5	27.9	28.4	25.8	24.2	22.8	21.7	21.0
Debt service ratio 6/	12.1	13.4	9.1	9.2	9.5	9.8	9.5	9.2
Memorandum items:								
Nominal GDP (trillion won)	522.0	545.0	577.0	612.4	662.3	714.1	767.2	823.1
Per capita GDP (U.S. dollars)	9,761	8,852	9,597	10,538	11,428	12,331	13,260	14,237
Output gap (percent of potential GDP)	1.4	-1.5	-1.4	-1.0	-0.5	-0.4	-0.5	-0.6

Sources: Korean authorities; and Fund staff estimates and projections.

1/ Contribution to GDP.

2/ Excluding privatization receipts. From 2003 onward, interest rate payments on W 50 trillion of KDIC/KAMCO bonds will no longer be included in the consolidated budget, amounting to 0.5 percent of GDP in 2003.

3/ During 2003–06, W 49 trillion of the outstanding government guaranteed KDIC/KAMCO bonds issued for financial sector restructuring will be converted into treasury bonds.

4/ Customs clearance basis.

5/ Includes IMF and offshore borrowing of domestic financial institutions and debt contracted by their overseas branches.

6/ Debt service on medium- and long-term debt in percent of exports of goods and services.

Table 6. Korea: Indicators of External Vulnerability, 1998–2003
(in percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002 Est.	2003	
						Latest Estimate	Date
Financial indicators							
Total general government debt 1/	32.8	35.6	36.7	42.5	...	...	...
Consolidated central government debt 1/	29.1	31.7	32.4	38.6	35.5	32.3	Proj.
Broad money (M3, percent change, 12-month basis)	12.5	8.0	7.1	11.6	12.6	...	Nov-02
Private sector credit (Fin. survey, percent change, 12 month basis)	-2.6	-0.1	-2.7	11.1	18.1	...	Oct-02
One month call borrowing rate	15.0	4.9	5.3	4.0	4.3	4.3	Jan-03
One month call borrowing rate (real)	7.4	4.1	3.1	0.8	0.6	0.5	Jan-03
External indicators							
Exports (percent change, 12-month basis in US\$) 2/	-4.7	9.9	21.2	-14.0	10.5	27.3	Feb-03
Imports (percent change, 12-month basis in US\$) 2/	-36.2	29.1	36.2	-13.3	12.1	27.4	Feb-03
Terms of trade (percent change, 12 month basis)	-3.9	-2.1	-12.8	-4.5	1.4	0.1	Proj.
Current account balance (projection for full year)	12.7	6.0	2.7	2.0	1.6	1.0	Proj.
Capital and financial account balance (projection for full year)	-1.0	0.5	2.6	-0.8	1.9	0.3	Proj.
<i>Of which</i> : Inward portfolio investment (debt securities etc.)	-0.1	1.7	2.6	2.7	-0.4	2.0	Proj.
Other investment (loans, trade credits etc.)	-2.8	-2.2	-0.3	-4.1	2.7	0.4	Proj.
Inward foreign direct investment in the form of debt or loans	0.2	1.3	0.8	0.8	0.3	0.4	Proj.
Gross official reserves (in US\$ billion)	48.5	74.1	96.2	102.8	121.4	122.9	Jan-03
Central Bank short-term foreign liabilities (in US\$ billion) 3/	...	...	2.6	0.4	-0.3	...	Dec-02
Short term foreign liabilities of the financial sector (in US\$ billion)	18.9	22.5	25.7	19.9	32.2	...	Sep-02
Official reserves in months of imports GS (projection for full year)	5.1	6.2	6.0	7.2	7.6	7.3	Proj.
Broad money(M3) to reserves	13.5	10.1	7.5	7.4	7.9	...	Nov-03
Reserves to total short term external debt (in percent) 4/	107.5	132.2	153.2	193.3	188.1	182.1	Proj.
Total external debt	46.9	33.8	28.5	27.9	27.7	...	Sep-02
<i>Of which</i> : Public sector debt	11.5	7.3	6.1	4.9	4.1	...	Sep-02
<i>Of which</i> : Short-term debt	9.7	9.7	10.4	9.3	11.3	...	Sep-02
Total external debt to exports GS (in percent)	94.3	79.8	63.8	65.0	66.0	...	Sep-02
External interest payments to exports GS (in percent)	5.2	4.9	4.1	3.7	2.5	2.2	Proj.
External amortization payments to exports GS (in percent)	9.0	18.0	8.0	9.5	6.2	6.6	Proj.
Exchange rate (per US\$, period average)	1,402	1,189	1,131	1,291	1,245	1,174	Feb 5, 03
REER appreciation (+) (12-month basis)	-25.7	13.5	8.1	-5.2	4.7	...	Nov-02
Financial market indicators							
Stock market index (KOSPI)	562	1,028	505	694	628	601	Feb 5, 03
Stock market index (KOSPI, percent change, 12-month basis)	49.5	82.8	-50.9	37.4	-9.5	-18.8	Feb 5, 03
Foreign currency debt rating (Moody's/S&P)	Ba1/BB+	Baa2/BBB	Baa2/BBB	Baa2/BBB+	A3/A-	A3/A-	Feb 6, 03
Dollar sovereign bond spread (EMBI Global in bps, end of period)	412	143	264	167	113	98	Jan 31, 03

Sources: Korean authorities, private market sources; and Fund staff estimates.

1/ Including government guaranteed restructuring bonds issued by KDIC and KAMCO.

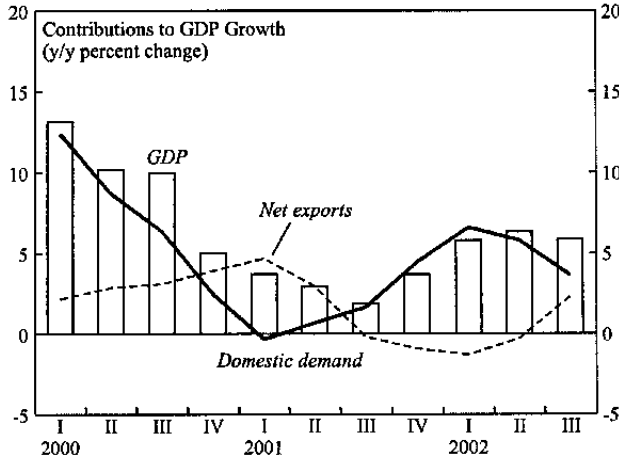
2/ The latest estimates are from customs clearance data.

3/ Excluding IMF repurchase obligations. Reported in the reserves template, which was initiated in May, 2000, as "Predetermined short-term net drains on foreign currency assets." According to the template, the Bank of Korea does not engage in derivatives transactions.

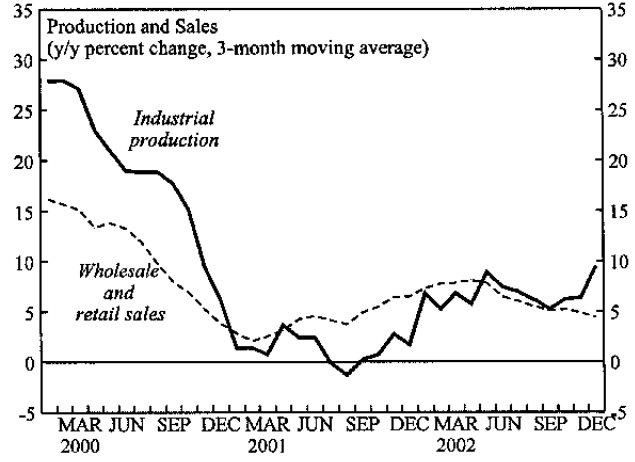
4/ Short-term debt measured on a residual maturity basis.

Figure 1. Korea: Activity and Prices

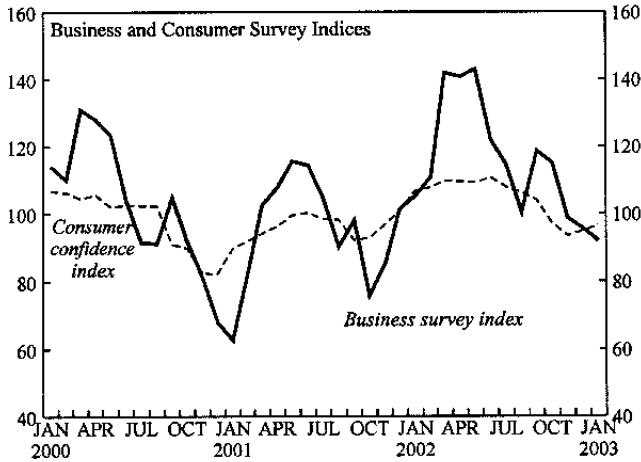
GDP growth recovered in 2002 led by domestic demand.



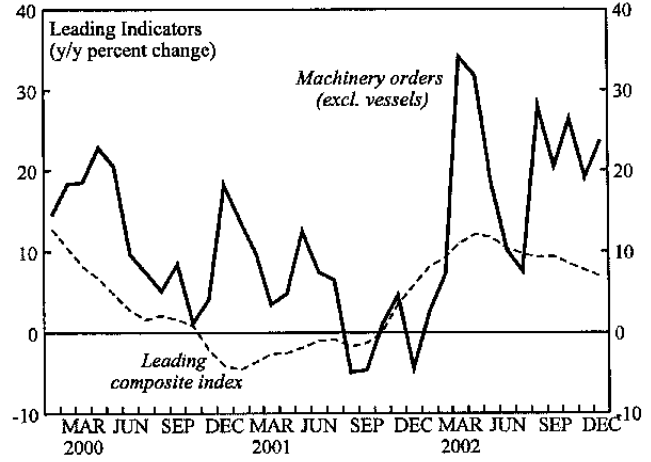
Production is strong but domestic sales growth is tapering off.



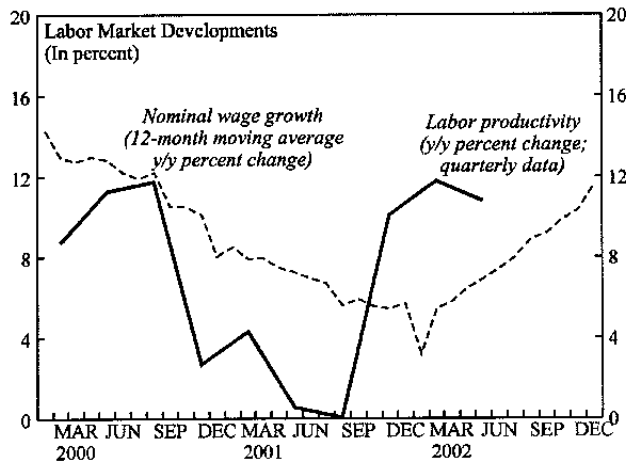
Business and consumer confidence have declined...



...although leading indicators still suggest a favorable outlook.



Wages are catching up with productivity gains.



Inflation remained subdued as declines in public charges balanced rising rents.

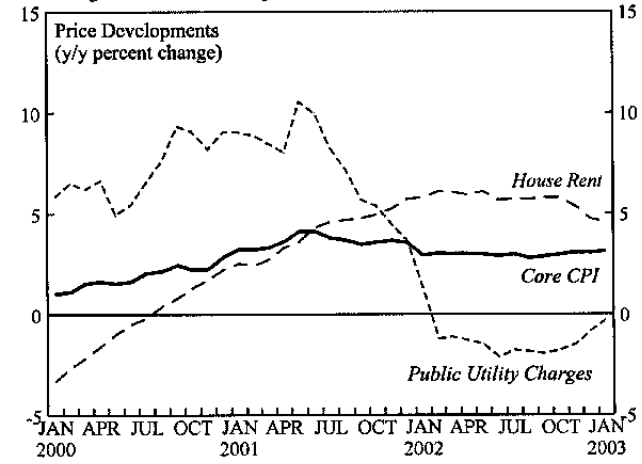
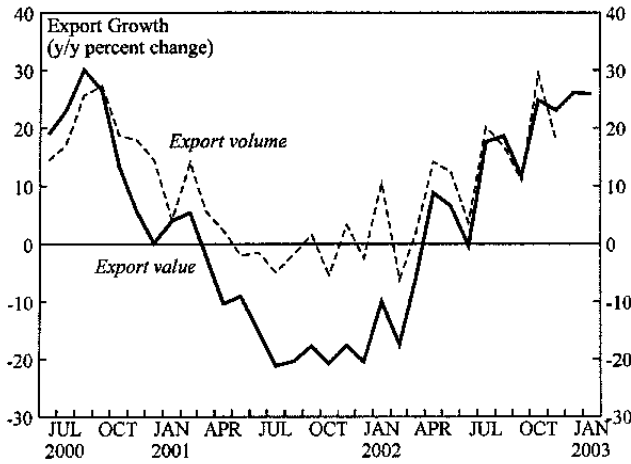
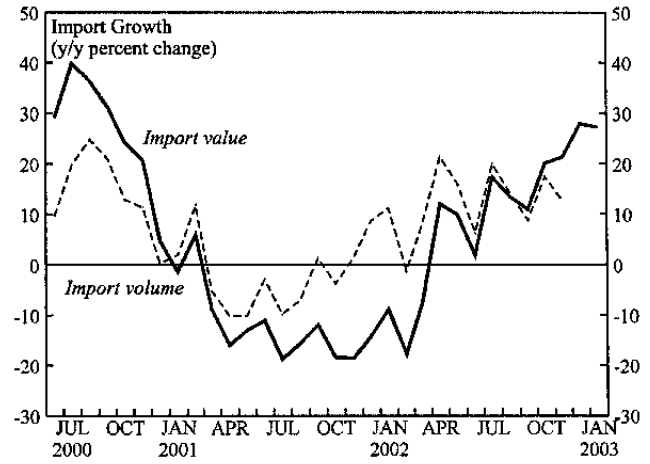


Figure 2. Korea: External Developments

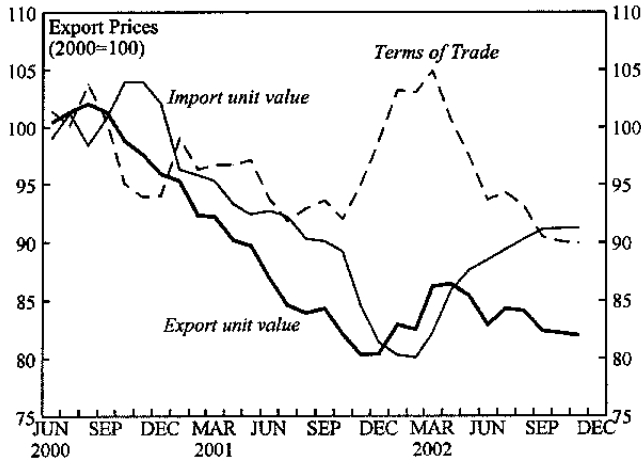
Korean exports have recovered sharply...



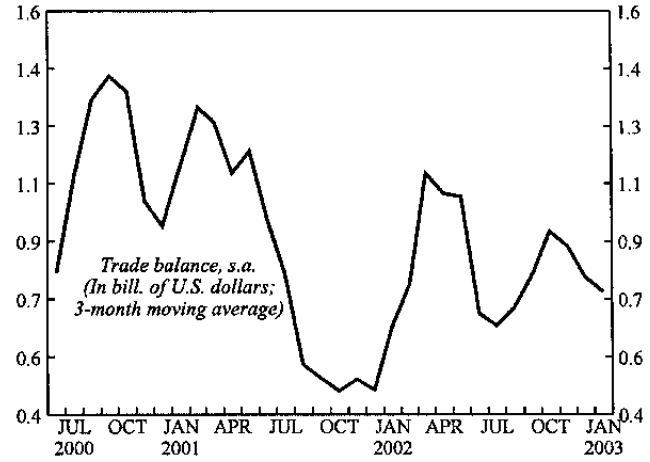
...and the economic recovery has boosted imports.



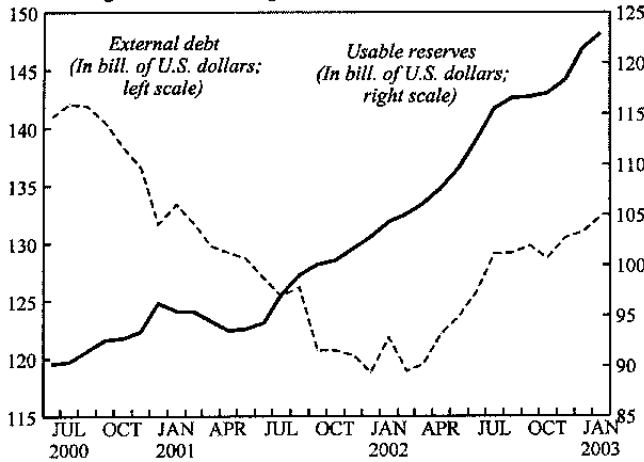
Rising import prices outweighed a recovery in export prices...



...contributing to a lower surplus in the trade balance.



Usable reserves are healthy, but external debt has begun to increase again.



The won appreciated modestly in 2002.

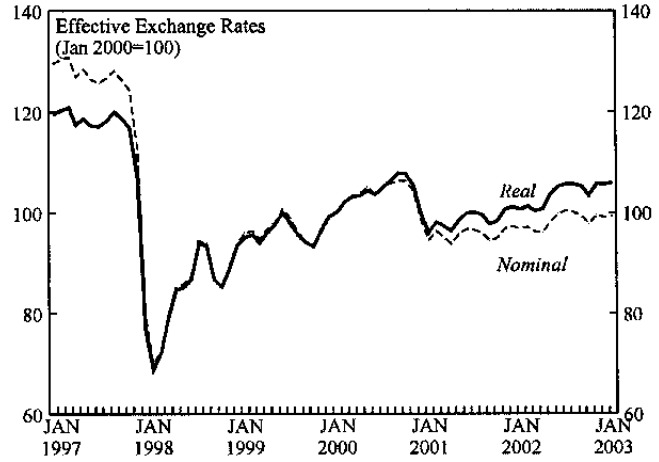
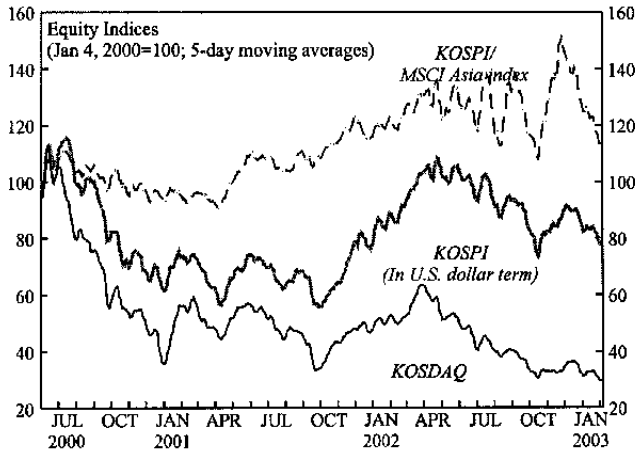
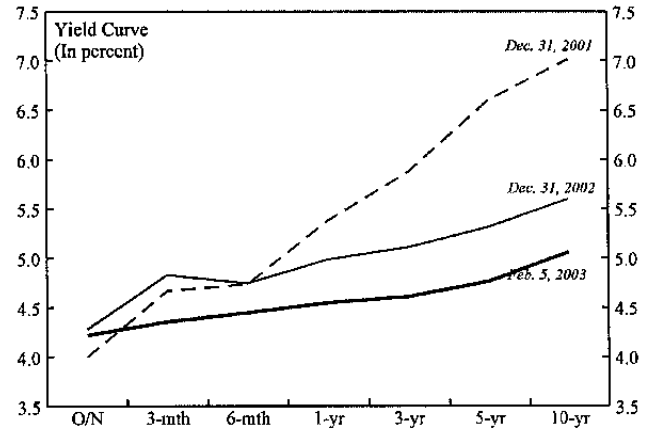


Figure 3. Korea: Financial Market Indicators

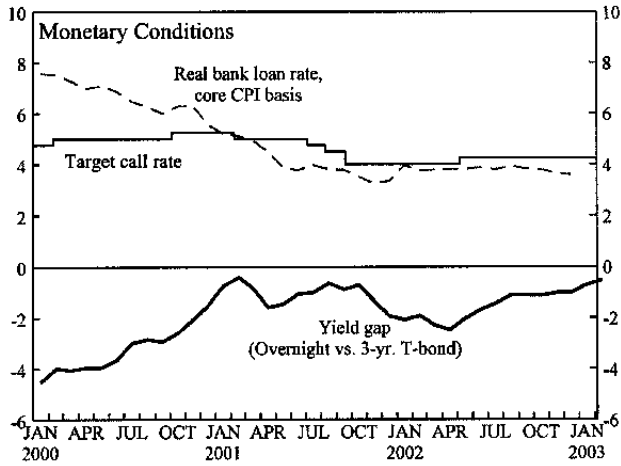
Equity prices moved with regional fluctuations...



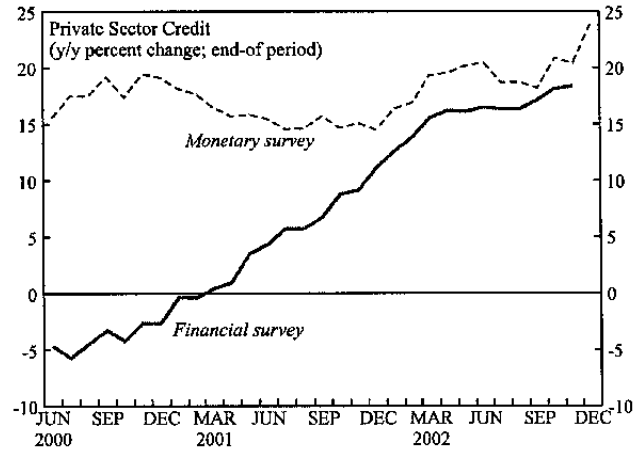
...and longer-term yields fell.



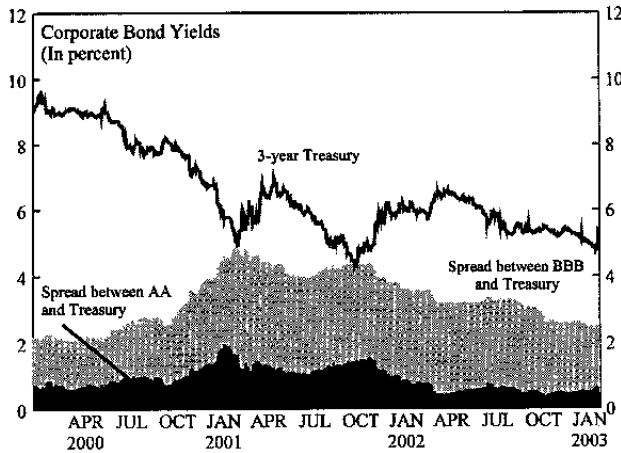
Real interest rates are low...



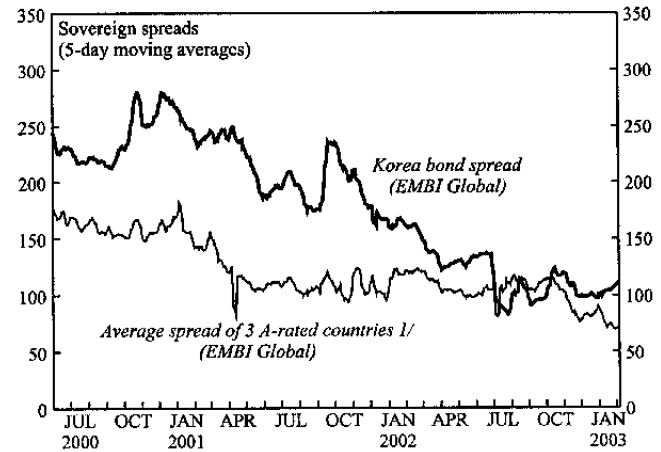
...and lending to the private sector is growing strongly.



Corporate bond spreads have tightened...

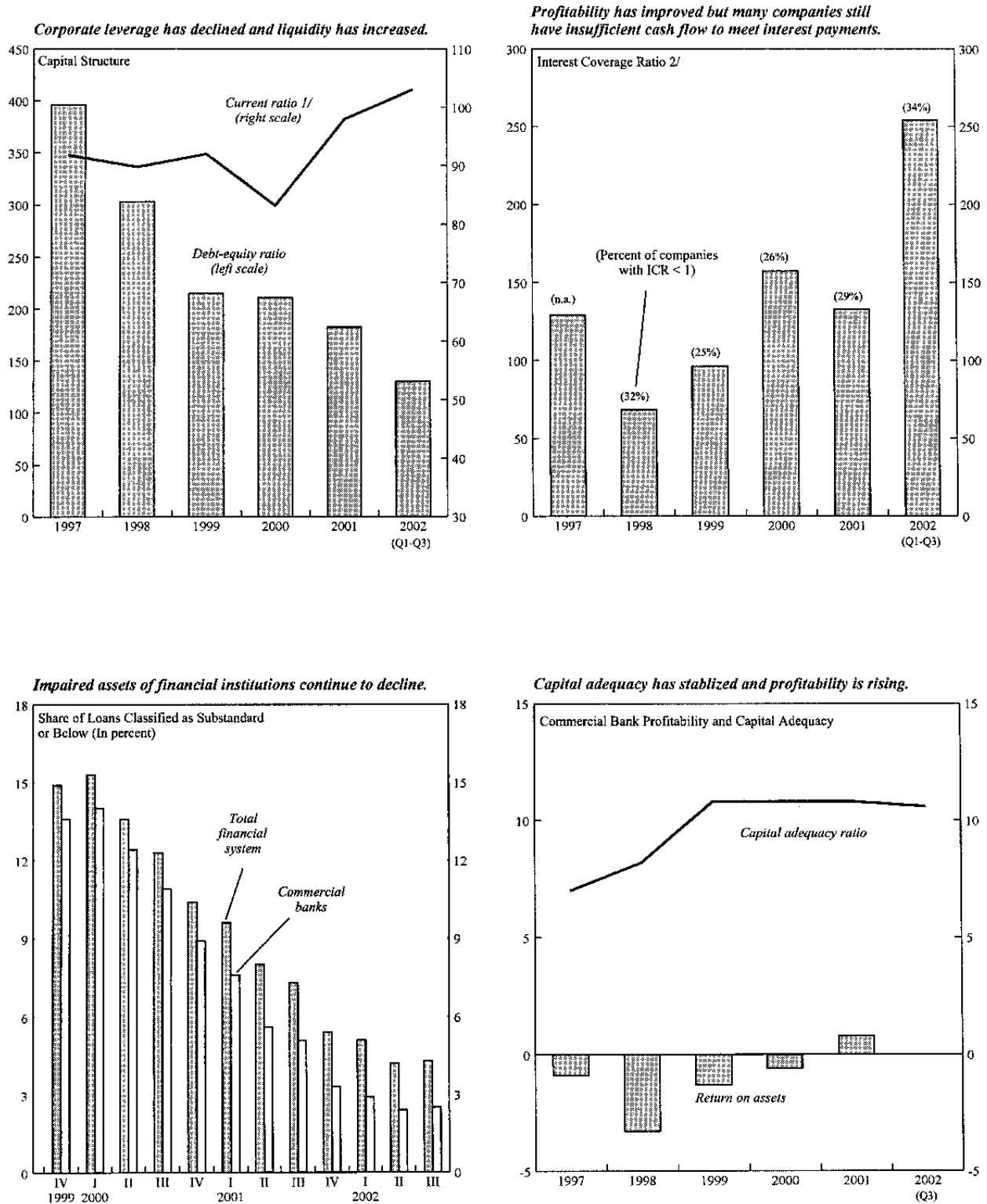


...and Korean sovereign spreads have fallen.



Sources: Korean authorities, CEIC database; and Fund staff calculations
1/ Countries include China, Hungary and Poland.

Figure 4. Korea: Corporate and Financial Sector Soundness

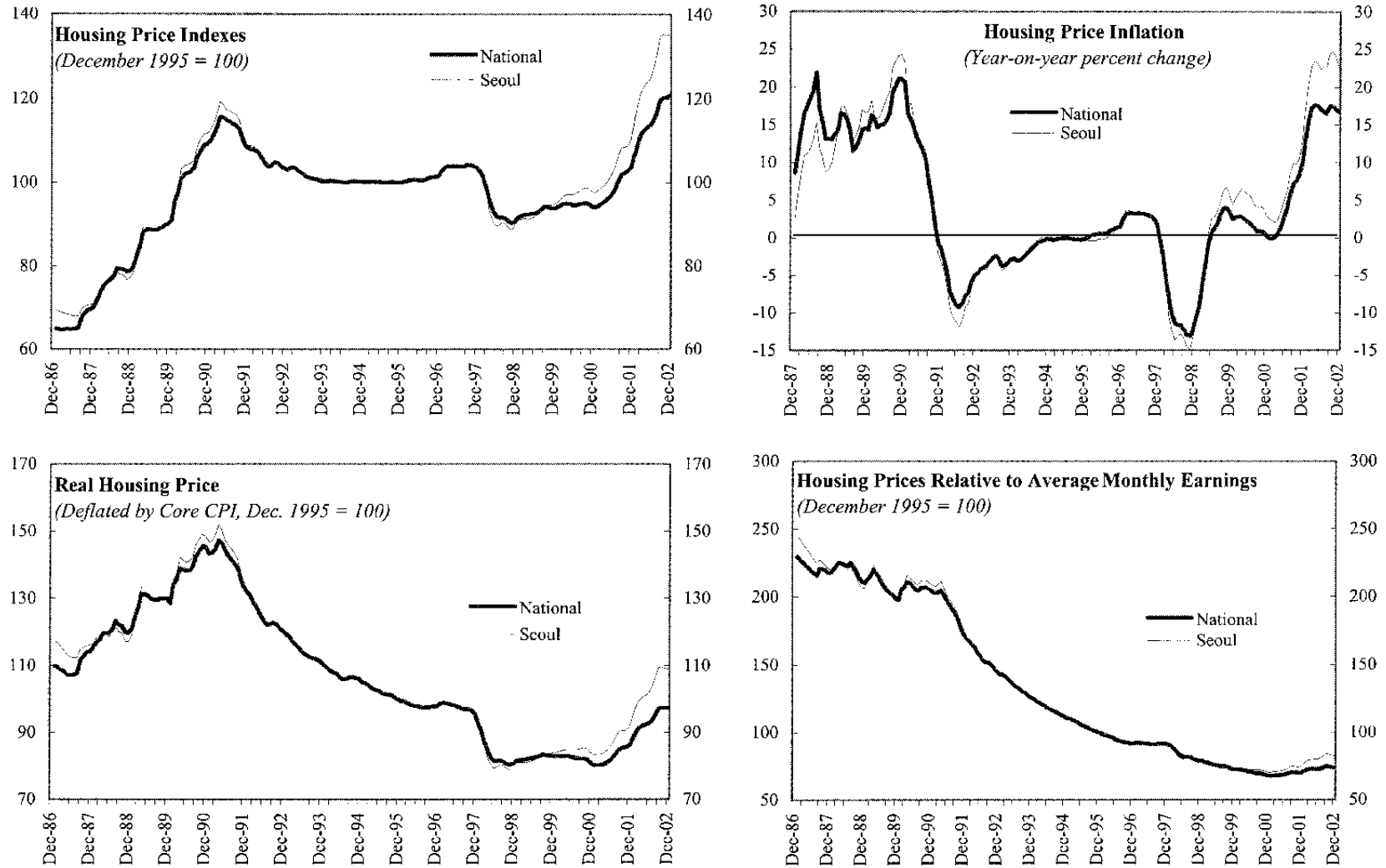


Source: Bank of Korea and Financial Supervisory Service.

1/ Current assets divided by current liabilities.

2/ Operating profits divided by interest payments.

Figure 5. Korea: Housing Price Developments, 1986-2002



Sources: CEIC database and IMF staff calculations.

Statistical Issues

Korea's macroeconomic statistics and statistical base are adequate to conduct effective surveillance. Nevertheless, the recent ROSC mission identified shortcomings in some statistical practices that have the potential for detracting from the accurate and timely analysis of economic and financial developments and the formulation of appropriate policies.

Real Sector

- The overall structure of the **national accounts** mainly follows the *1968 System of National Accounts (1968 SNA)*. The delineation of the economy, the valuation rules, and the production and asset boundaries are in line with the *1968 SNA*. However, the classifications used are broadly in accordance with those recommended in the *1993 SNA*. The existing data collection program is not being fully used to compile the national accounts and new measures have yet to be implemented to improve the surveys used to collect the data perceived as unfit. One omission from the accounts is the informal activity in the unrecorded economy, the size of which is not known. Informal activities, including some illicit activities, are expected to be reflected in the next revision of the national accounts. Although GDP data are produced in accordance with international practice, the national accounts could be improved by shifting to the *1993 SNA*. The BOK plans to implement the shift at the time of the next rebasing to take effect during 2003–04. Also, the commodity flow technique could be improved by moving to the Supply and Use Table framework. The BOK intends to produce such a framework in 2004, but there are currently difficulties with obtaining the basic data required.
- The **Consumer Price Index (CPI)** is based on internationally endorsed standards and uses classifications compatible with internationally recommended systems. Concepts and definitions used for the compilation of the CPI are in line with the recommendations of the International Labor Organization (ILO). The scope of the CPI covers urban areas, but excludes single person, farm and fishing households. The CPI is compiled using sound procedures and methods which, however, could be improved by also including single-person households, and by having the prices of missing seasonal items imputed by similar items within their group. The coverage gaps can be a potential problem with the level of the indices, while the absence of good imputation procedures can potentially introduce a bias in short-term price trends and affect inflation monitoring. New weights and a new market basket using the 2000 Household Income and Expenditure Survey were introduced in the CPI for January 2002.
- The **Producer Price Index (PPI)** is also based on internationally endorsed standards and recommendations. Concepts and definitions used for the compilation of the PPI are in line with the *1993 SNA*. The scope of the PPI covers all domestic industrial activities and a large segment of service activity, as well as free trade zones and bonded warehouses. The PPI is compiled using sound procedures and methods but could be improved by imputing missing prices from other similar commodities, rather than being simply carried forward using the last reported price.

Fiscal Sector

- Consolidated statistics on the **general government** aligned with internationally recognized standards are not compiled. Statistics following these standards only cover the central government, which accounts for about 75 percent of total general government. National concepts and definitions differ from those internationally recognized. Therefore, two sets of government finance statistics are compiled for the central government, using national definitions and using internationally recognized standards. Concepts and definitions used in the latter set of central government finance statistics generally follow the recommendations of the *1986 Government Finance Statistics Manual (GFSM 1986)*. The data cover the budgetary units of the central government (including social security funds owned and/or managed by the government) and the extrabudgetary funds owned or managed by these units.
- **Central government** statistics aligned with internationally recognized standards are produced from the National Financial Information System (NAFIS), which integrates the preparation of budget data, accounting reports, and the generation of fiscal statistics on a monthly basis. The NAFIS provides for automatic crosschecks at different levels of the compilation process.

Monetary Sector

- The overall quality of Korea's **monetary statistics** is generally sufficient for informing the policy process. The data ROSC mission to Korea identified several areas that are not in line with international guidelines. The revised monetary aggregates, which have been compiled since early 2002, address many of the identified data issues and now almost fully comply with the Monetary and Financial Statistical Manual (MFSM 2002).
- The analytical usefulness of data relating to foreign assets and foreign liabilities is affected by the BOK valuing its financial assets and financial liabilities at book value (rather than at market value) and revaluing its foreign currency denominated assets and liabilities twice yearly (rather than on a monthly basis). Also, some banks are using nationality rather than residency to distinguish between resident and nonresident individual and household accounts.
- The Bank of Korea has made a substantial effort over the past year to bring monetary statistics into closer conformity with the framework set out in the IMF's *Monetary and Financial Statistics Manual (2000)*.

Balance of Payments

- The overall quality of **balance of payments** data is good. The Bank of Korea implemented the fifth edition of the IMF's *Balance of Payments Manual (BPM5)* in early 1998, but some deviations remain in the classification and sectorization of balance of payments transactions.
- Following liberalization, the coverage of the balance of payments statistics has become less comprehensive, as residents were permitted to conduct transactions via accounts with banks abroad. There is also incomplete coverage of transactions via intercompany accounts, via nonresident won-denominated accounts with domestic banks, and noncash transactions. The BOK is preparing to implement new collections to improve coverage. The BOK has developed an array of statistical techniques and collections to improve the coverage, classification, and timeliness of source data, including timing and valuation adjustments to trade statistics compiled from customs documents, grossing of certain services transactions, and recording long-term construction contracts under direct investment.
- Timely monthly external debt statistics are disseminated, albeit with a limited sectoral breakdown. Moreover, data on gross external "debt assets" are disseminated along with external debt liabilities, which provide a significant amount of information on Korea's **international investment position (IIP)**. These statistics, together with monthly trade statistics and monthly data on international reserves and foreign currency liquidity, provide users with a considerable amount of timely information on external sector developments. The bank of Korea is planning to release an IIP for 2001 by end-March 2003.
- The quality of **external debt** statistics has greatly improved since the financial crisis. However, the statistics are not compiled on a residency basis, and certain external liabilities are excluded from the disseminated data. Hence, the external debt statistics are not comparable with the balance of payments statistics, nor with external debt data disseminated by other countries. In September 2003, Korea is planning to release external debt statistics for June 2003 on a residency basis according to the SDDS methodology.
- Data dissemination on international reserves, foreign currency liquidity, and external debt generally meets the **SDDS specifications** for periodicity, timeliness, and advance release calendars. However, as discussed above, debt compilation is inconsistent with the methodology set out in *BPM5*. Also, Korea does not publish a debt service schedule.

Korea: Survey of Reporting of Main Statistical Indicators 1/
(As of January 29, 2003)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money (M3)	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP	External Debt/ Debt Service
Date of latest Observation	01/29/03	01/29/03	12/02	11/02	11/02	01/29/03	12/02	12/02	11/02	10/02	Q3 2002	11/02
Date Received	01/29/03	01/29/03	01/03	12/02	12/02	01/29/03	12/02	01/03	12/02	12/02	11/02	01/03
Frequency of Data	D	D	M	M	M	D	M	M	M	M	Q	M
Frequency of Reporting	D	D	M	M	M	D	M	M	M	M	Q	P
Source of Data	A	A	N	N	N	A	N	N	N	A	A	N
Mode of Reporting	M	M	M	M	M	M	M	M	M	M	M	M
Confidentiality	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of Publication	D	D	M	M	M	D	M	M	M	M	Q	M

1/ The codes are explained below.

Frequency of data: D – daily, M – monthly, Q – quarterly.

Frequency of reporting: D – daily, M – monthly, Q – quarterly, P – periodically (upon request).

Source of data: A – direct reporting by authorities, N – official publications and websites.

Mode of reporting: E – electronic data transfer, M – mail, F – fax, R – press report.

Confidentiality: C – unrestricted use, D – embargoed for a specific period, and for unrestricted use thereafter.

Korea: Fund Relations
(As of December 31, 2002)

I. **Membership Status:** Joined August 26, 1955; Article VIII

II.	General Resources Account:	SDR Million	% Quota
	Quota	1,633.60	100.0
	Fund Holdings of Currency	1,249.73	76.5
	Reserve Position in Fund	383.99	23.5
	Financial Transaction Plan transfers (net)	50.00	

III.	SDR Department:	SDR Million	% Allocation
	Net cumulative allocation	72.91	100.00
	Holdings	8.68	11.91

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

V. **Financial Arrangements:**

<u>Type</u>	<u>Approval Date</u>	<u>Expiration Date</u>	<u>Amount Approved (SDR Million)</u>	<u>Amount Drawn (SDR Million)</u>
Stand-by	12/04/1997	12/03/2000	15,500.00	14,412.50
Of which: SRF	12/18/1997	12/17/1998	9,950.00	9,950.00
Stand-by	07/12/1985	03/10/1987	280.00	160.00
Stand-by	07/08/1983	03/31/1985	575.78	575.78

VI. **Projected Obligations to the Fund:** None

VII. **Exchange Rate Arrangement:**

Korea's exchange rate system is classified as "independently floating." Previously, the exchange rate against the U.S. dollar was allowed to float only within specified margins around the previous day's weighted average exchange rate in the interbank market. The margins were widened five times between March 1990 and November 1997 (most recently to +/-10 percent), and on December 16, 1997 were eliminated altogether. On December 31, 2002, the exchange rate was W 1,186.2=US\$1.

VIII. **Last Article IV Consultation:**

Korea is on a 12-month consultation cycle. Staff discussions for the 2002 Article IV consultation were conducted on a mission to Seoul during October 16–29, 2002.

IX. FSAP and ROSC Participation:

MAE: The final FSAP mission was conducted during October 2–18, 2002. The mission completed the FSAP by assessing the short-term vulnerability of the financial sector to macroeconomic and sectoral shocks and analyzing overall financial sector soundness and developmental challenges, including issues arising from the draft standards assessments.

STA: A ROSC data dissemination mission visited Seoul in April 2001, and the report was circulated to the Executive Board in November 2001, SM/01/355. The authorities have not yet consented to its publication.

FAD: Discussions on fiscal transparency were held in Seoul during June 2000, and a report was drafted and finalized in November 2000, with input from APD staff. The report has been published (SM/01/22) and is available on the web through the following link: <http://www.imf.org/external/np/rosc/kor/fiscal.htm>

X. Technical Assistance:

MAE: An FSAP follow-up technical assistance mission on derivatives was conducted during January 9–20, 2003. The mission assessed recent developments of derivatives markets and reviewed the institutional and supervisory framework for such markets.

FAD: A technical assistance mission visited Seoul during January 8–19, 2001 to evaluate current practices in budgeting and public expenditure management and to provide advice on setting up a medium-term fiscal framework.

MAE: A mission conducted a high-level technical seminar during May 16–22, 2000 on the development of the foreign exchange market. Jointly with the authorities and market participants, the mission analyzed the current state of the foreign exchange market and identified possible areas for improvement. The seminar covered issues in supervision, market monitoring, derivatives instruments, and market microstructure.

STA: A technical assistance mission visited Seoul during March 29–April 12, 2000 to provide advice on balance of payments and external debt statistics, with a view toward improving the recording of financial derivatives and developing an international investment position statement.

MAE: A high-level technical seminar on monetary policy implementation was held during July 15–19, 1999 at the Bank of Korea.

FAD: A technical assistance mission visited Seoul during March 31–April 16, 1999 to provide advice on tax policy issues, aimed at simplifying and modernizing the tax system.

XI. Resident Representative:

The resident representative office in Seoul was opened in March 1998. Mr. Paul Gruenwald has been the Resident Representative since September 2001.

Statement by the IMF Staff Representative on the Republic of Korea
March 3, 2003

1. This statement provides additional information that has become available since the circulation of the staff report. This information does not change the thrust of the staff appraisal.

2. **Recent data suggest that domestic demand growth is slowing, consistent with the macroeconomic assessment in the staff report:**

- Bank lending to households declined in January—typically a month with low lending—reducing the year-over-year rise to 35 percent from around 50 percent in mid-2002. Early reports suggest a moderate pace of bank lending to households in February.
- Consumer and business confidence indicators have declined or remain at relatively low levels in recent months as geopolitical uncertainties have dampened the global economic outlook. Tensions with North Korea may have exacerbated this weakness.
- In January, wholesale and retail sales increased 4.5 percent (y/y), the same relatively slow pace as in 2002 Q4, and estimated facility investment contracted 7.7 percent (y/y).
- Industrial production growth slowed to 3.6 percent (y/y) in January, from 9.5 percent (y/y) in December 2002, mainly due to special factors boosting production in January 2002 and reduced working days during the Lunar New Year.
- In February, the headline CPI rose by 3.9 percent (y/y), reflecting higher oil prices, while the core CPI rose by 3.0 percent (y/y). Housing prices fell slightly in January, easing overall housing price inflation to 13½ percent (y/y).
- Merchandise exports and imports each rose 27½ percent (y/y) in January 2003, led by a 76½ percent (y/y) rise in exports to China and a 54 percent (y/y) rise in semiconductor exports.

3. **Heightened tensions with North Korea have so far not had major impacts on financial markets, although there are reports that the tensions may have contributed to delays in investment:**

- In mid-February, Moody's changed the outlook on Korea's sovereign rating from positive to negative because of heightened security concerns stemming from North Korea's nuclear weapons program. Partly in response, Korea's sovereign bond spread has risen by about 20 basis points since end-2002 to 119 basis points on February 27, 2003, similar to its average level in 2002.

- The Korean won has appreciated against the U.S. dollar by ¼ percent from end-2002, to reach won 1,193.7 per U.S. dollar on February 28, 2003.
- The tensions have been reflected in increased volatility in equity prices relative to regional indices. The level of the KOSPI index relative to the MSCI Asia index, however, is not significantly below its average level in 2002. Inflows of foreign portfolio investment continued during October–January, although there were small outflows in February.

4. **The 2002 fiscal surplus was somewhat higher than estimated in the staff report and the authorities have recently adopted some stimulatory fiscal measures.** The preliminary 2002 consolidated budget balance was a surplus of 2.6 percent of GDP, which is 0.4 percentage points larger than estimated in the staff report, due to smaller-than-estimated spending. Measures to respond to rising international oil prices were recently adopted, including a reduction in tariffs on crude oil from 5 percent to 3 percent and steps to economize on oil consumption. The government is also planning to frontload spending within 2003, with 52 percent of budgeted expenditure to be implemented before June.

5. **The Financial Supervisory Service (FSS) has recently announced a reorganization aimed at more effective supervision of the rapidly growing derivatives market.** It has established a dedicated team responsible for derivatives market supervision, which will aim to strengthen the monitoring of derivatives markets and to encourage financial institutions to improve risk management practices in derivatives operations.

6. **Recent reports indicate that the economic situation in North Korean continues to deteriorate.** Market prices for staple foods have reportedly surged by as much as 400 percent since July 2002; and the black market exchange rate is reported to be about 700 per U.S. dollar compared with about 200 in late 2002. Food shortages are acute, with the UN's World Food Program—which feeds 6.4 million people or 28 percent of the population—estimating an 86 percent shortfall in the total food requirement to implement its program. Power supply has fallen from already low levels, with reports of a 30 percent drop in electricity available for heating.



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March 06, 2003

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700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with Korea

On March 3, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Korea.¹

Background

Korea's excellent economic performance in 2002 reflects the benefits of the far reaching economic reforms implemented since the 1997–98 crisis. The rebuilding of the banking system enabled domestic demand to lead the recovery in the face of a sharp decline in external demand in 2001, and to continue to sustain strong growth in 2002. High export growth in 2002 also benefited from the substantial restructuring of the corporate sector. Overall, the Korean economy has significantly outperformed other IT-specialized Asian countries in recent years. Medium-term prospects are bright.

Economic growth rose to about 6 percent in 2002 from 3 percent in 2001. Buoyant consumption and residential construction spending underpinned the recovery beginning in late 2001, then in 2002 exports rebounded strongly in spite of a weaker-than-expected recovery in the global economy. Unemployment has eased to near pre-crisis levels, while wage rises have been matched by productivity growth. Core CPI inflation remained at the center of the target range of 2–4 percent, although headline CPI inflation has been volatile, mostly due to weather-related

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

swings in food prices. The current account surplus declined slightly from 2 percent of GDP in 2001 to 1.3 percent of GDP in 2002 and the won appreciated against the U.S. dollar by some 10 percent, largely moving in tandem with the yen.

In terms of macroeconomic policies, the fiscal surplus was substantially higher than budgeted, resulting in a contractionary fiscal stance in 2002. This was broadly offset by the moderately accommodative stance of monetary policy, which has been on hold since a 25 basis point rate hike in May 2002. The rise in household lending and housing prices has slowed in recent months, following prudential measures introduced in October 2002, reducing concerns about the development of a residential real estate bubble.

The outlook is for growth to moderate to about 5½ percent in 2003, as domestic demand growth eases, mainly due to private consumption. Inflation is projected to increase slightly, and a further decline in the current account surplus is expected. Risks to the outlook come mainly from the external front and are predominantly on the downside. Volatility in international financial markets suggests an increased risk of a weaker-than-expected global economic recovery, which could be combined with a spike in oil prices. The impact of a weaker external demand on Korean growth would likely be exacerbated by reduced confidence and a cutback in investment. Over the medium term, growth is expected to average 5½ percent, in line with potential, with somewhat higher growth in total factor productivity than before the crisis—reflecting the benefits of structural reforms and more foreign investment—partly offsetting a slower pace of physical capital accumulation.

The health of the banking system in Korea has continued to improve. The share of loans classified as substandard or below was sharply down to 2.3 percent in December 2002, while the average capital adequacy ratio stood at 10½ percent. Profitability has also improved, with the banking system earning a profit (net of provisions) in 2001 for the first time since 1997; operating income also grew strongly in 2002, although increased provisioning on household loans and credit card receivables, as well as on loans to ailing firms, dampened the growth in net profits. In contrast to the banking sector, progress in restructuring the nonbank financial institutions has been relatively slow. The government has recently started to address problems in the nonbank financial sector by suspending operations of 125 credit unions. The recovery of public funds injected for financial sector restructuring has continued, partly due to renewed momentum in reprivatizing commercial banks. One-third of the public funds has been recovered, and the government estimates it will collect a total of 56 percent, which compares favorably with the experience of other countries in the region.

In the corporate sector, debt-equity ratios have fallen to levels below the United States and Japan—although debt remains high relative to sales—and aggregate profitability has improved. However, the proportion of firms in poor health rose and their performance deteriorated, with almost 10 percent of companies exhibiting persistent weaknesses that point to the need for restructuring. A number of steps to strengthen corporate governance and regulation were taken in 2002, including the publication of a draft insolvency law, an updated coverage of chaebol regulations, and stepped-up enforcement of accounting and disclosure standards.

Executive Board Assessment

Executive Directors commended the Korean authorities for their sustained implementation of deep and wide ranging reforms in the financial and corporate sectors during the five years since the financial crisis. Together with sound macroeconomic policies, these reforms have produced a remarkable economic recovery and transformation of the Korean economy, and have contributed to a strong economic performance in 2002—in a difficult external environment. Korea is therefore a clear example of how quickly strong reforms can pay off. Building on these achievements, Directors encouraged the new administration to continue to implement reforms that will enhance the market foundations and growth potential of the Korean economy, and to further strengthen the medium-term framework for macroeconomic policy, while remaining vigilant to downside risks in the global environment.

Directors considered that prospects for continued robust growth of the Korean economy are good, while the track record of sound macroeconomic policies provides the authorities with room for maneuver to respond to changes in the outlook. Directors therefore saw no urgency to alter the current stance of macroeconomic policies, although they urged the authorities to fully implement the expenditure plans in the budget, and to be prepared to respond promptly to a deterioration in external conditions.

Directors recommended that—given already moderately accommodative monetary conditions—a judicious fiscal easing would be the preferred first line of defense in the event of a significant weakening of the growth outlook. While the automatic fiscal stabilizers will provide an initial support to activity, most Directors encouraged the authorities to stand ready to use the available scope for discretionary spending or revenue measures if needed, although it was stressed that the impact of such measures should be largely temporary.

Going forward, Directors encouraged the authorities to further enhance the role of the budget as a macroeconomic policy instrument, and they welcomed, in this regard, the authorities' plans to formally introduce a medium-term fiscal strategy. Efforts should aim at improving budgetary transparency, and at addressing the procyclical bias of fiscal policy during economic downturns caused by large expenditure shortfalls. Some Directors encouraged the authorities to further develop the social safety net, which would also strengthen the automatic stabilizers. A few Directors also saw scope for reviewing the effectiveness of the tax system. Directors supported the authorities' medium-term goal of maintaining a balanced budget excluding the social security funds—while allowing for cyclical deviations—which will lower public debt and help prepare for longer-term fiscal challenges, including the aging of the population. They also welcomed the priority which the authorities intend to give to pension reform. Directors encouraged the authorities to consider the inclusion of collective action clauses in future sovereign debt issuances.

Directors commended the authorities' skillful management of monetary policy in the face of an uncertain external environment. While flexibility will continue to be warranted in the period immediately ahead, they agreed that, once these uncertainties are resolved, gradually moving monetary policy to a more neutral stance would be appropriate. If the global recovery should be

stronger than expected, a tightening of macroeconomic policies should come from the monetary side. To give monetary policy a more transparent anchor, many Directors saw merit in a revision of the Bank of Korea Law, which would formally replace the current one-year inflation target with a medium-term target. However, some Directors noted that the benefit of revising the horizon of the formal inflation targets needs to be carefully assessed against the possible cost of reopening an arrangement which is currently working well in practice. Directors encouraged the authorities to continue to limit foreign exchange intervention to smoothing purposes, a policy that has served Korea well in recent years.

Directors commended the authorities for their timely adoption of prudential measures to ensure that risks associated with the rapid growth in household lending and the sharp rises in housing prices were adequately recognized and contained. Continued close monitoring of developments in household indebtedness is, however, warranted, and the authorities should consider further prudential steps if needed.

Directors welcomed the progress made in bank privatization in 2002, and supported the priority which the new economic team is according to maintaining the momentum in this area. This will help recover public funds used in financial restructuring, while restoring private ownership of the banking system. They also welcomed recent steps to address problems in the credit unions, but emphasized the need for broader efforts to resolve weaknesses in the nonbank financial sector in a timely manner.

Directors welcomed the findings of the Financial Sector Stability Assessment (FSSA), which confirm the high degree of compliance with international standards and codes that has been achieved by recent reforms, as well as the substantial strengthening of financial supervision. They encouraged the authorities to follow through with the early implementation of FSSA recommendations, and to ensure that supervision continues to keep pace with new developments in financial markets. In this respect, Directors supported the authorities' recent initiatives to enhance the monitoring of the rapidly growing markets in derivatives. To ensure the efficiency and stability of the Korean financial system in the medium term, Directors encouraged the authorities to review the adequacy of the arrangements for supervisory independence, and to address the remaining barriers to financial market development, including the development of longer-term debt markets and mortgages. Directors commended Korea's participation in the international effort to combat money laundering and the financing of terrorism, and looked forward to the enactment of the Anti-Terrorism Bill.

Directors observed that overall corporate sector performance has continued to improve in 2002. A significant proportion of Korean corporations nevertheless display persistently weak capacity to service their debts. Directors underscored, in this context, the importance of approving the insolvency reform to help complete corporate restructuring, although some Directors regretted the shortcomings remaining in the draft legislation. Directors welcomed the strengthened enforcement of accounting and disclosure standards and supported the ongoing efforts towards achieving compliance with international best practices in corporate governance. This will include the adoption of the proposed accounting reforms, the enhancement of the rights of minority

shareholders, and the further strengthening of disclosure requirements. Directors agreed that special monitoring and regulation of the activities of the largest chaebol should continue until effective market discipline is sufficiently strong.

Directors welcomed Korea's progress toward trade liberalization, including the recent finalization of a bilateral free trade agreement with Chile. They noted, however, that Korea's trade barriers remain relatively high—especially for agriculture—and urged the authorities to seek further progress in trade liberalization, particularly in the context of the current round of multilateral trade negotiations. Directors welcomed Korea's participation in the Heavily Indebted Poor Countries initiative.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Korea: Selected Economic Indicators

	1999	2000	2001	2002 Staff Est.	2003 Staff Proj.
Real GDP (percent change)	10.9	9.3	3.0	6.1	5.5
Consumption	9.4	6.7	3.7	6.5	4.7
Gross fixed investment	3.7	11.4	-1.7	2.5	3.1
Net foreign balance 1/	-1.0	3.1	1.5	1.2	1.1
Prices (percent change)					
Consumer prices (period average)	0.8	2.3	4.1	2.8	3.5
GDP deflator	-2.0	-1.1	1.3	0.5	0.6
Labor market (in percent)					
Unemployment rate 2/	6.4	4.2	3.8	3.1	3.1
Wage growth, manufacturing	14.7	8.6	6.4	10.5	...
Consolidated central government (percent of GDP)					
Revenues 3/	22.4	26.0	26.4	26.9	27.9
Expenditure	25.7	24.8	25.8	24.8	25.0
Balance 3/ 4/	-3.3	1.3	0.7	2.2	2.9
Money and interest rates (in percent)					
M3 growth	8.0	7.2	11.6	13.6	10.0
Yield on corporate bonds 2/	8.9	9.4	7.1	6.6	5.5
Balance of payments					
Current account balance (billion US\$)	24.5	12.2	8.6	6.1	4.4
Current account balance (in percent of GDP)	6.0	2.7	2.0	1.3	0.9
Won per U.S. dollar (period average)	1,189	1,131	1,291	1,251	...

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

1/ Contribution to GDP growth.

2/ Latest available data for 2003.

3/ Excluding privatization receipts.

4/ Prior to 2000, the civil service pension fund is excluded.

**Statement by Michael J. Callaghan, Executive Director for the Republic of Korea
and Wong-Dong Cho, Advisor to Executive Director
March 3, 2003**

Key Points

- Sweeping economic and structural reforms over the past five years have resulted in Korea recovering from crisis to become one of the fastest growing economies in the world.
- The new administration of President Roh, Moo-Hyun is committed to ensuring there is no complacency in the ongoing reform effort.
- The authorities are well placed to respond to any downside risks to the outlook for the Korean economy posed by an uncertain global environment.
- The restructuring of the financial sector is continuing and, while consumer credit has been expanding significantly, it does not pose a threat to the financial system. The authorities are mindful of problems in the insurance sector and pension reform remains a high priority for the new administration.
- Improvements in corporate governance have been significant and are being reflected in stock prices.
- Korea is confident that the dividend from the sweeping changes to the economy that are underway will not only see it maintain its high potential growth rate, but increase it.

Ongoing reform under the new administration

The rapid recovery of the Korean economy from the brink of bankruptcy to one of the fastest growing economies in the world continues to surpass most expectations, including even those of Koreans themselves. The sweeping changes go beyond macroeconomic indicators or various performance indices of the corporate and financial sectors. The factor-intensive growth strategy, which often led to over-investment in the past, is no longer pursued. Consumer credit, which was previously discouraged so that the country's high saving could be pipelined into industry, has now become the main input to private consumption that has, in turn, become a key source of growth. Even the five-day-a-week work system, which would have been unthinkable in the past, is now being publicly discussed and, in fact, is starting to be introduced within the government. This is the outcome of five years of reform and restructuring, with the assistance of the Fund, and was recently described in *The Economist* as "the clearest example of how quickly reforms can produce results". The new administration of President Roh, Moo-Hyun, who was inaugurated on February 25, fully recognizes these hard-won lessons and has made it clear that there will be no stoppage or complacency in carrying forward economic reforms.

The new administration has underscored that its economic policies, including its “East Asia Hub” vision, will be fully embedded in fair and transparent market principles. In particular, the painstaking efforts of enhancing the soundness of the financial sector and improving corporate governance will continue.

This year’s Article IV consultation has provided a valuable input to the economic strategy for the new administration at the start of its five-year term. Our authorities would like to thank the Article IV team for their excellent work. In addition, they would like to thank the FSAP team’s two-year-long comprehensive effort which was instrumental in identifying the remaining reform agenda in the financial and corporate sectors, including valuable advice in coping with the new challenges arising from ever-being sophisticated market practices. Our authorities would also like to thank the First Deputy Managing Director for her recent visit to Korea, which was very timely and provided the opportunity for discussions with key policy makers, including then President elect Roh, Moo-Hyun.

Macroeconomic Outlook and Policy Responses

Our authorities broadly agree with the staff’s outlook for the economy. Economic growth in 2003 will be a little slower than last year, in the range of 5 percent and broadly in line with the economy’s potential growth. This easing in growth has a lot to do with the slower-than-expected recovery in the world economy but it also reflects a slowing in private consumption growth, which was a major driving force behind the very strong economic growth last year.

The main downside risks come from weaker external conditions, as indicated in the staff’s worst case scenario. As the staff note, Korea is more sensitive to external shocks than other countries in the region given its dependence on imported oil and exposure to international financial flows. Nevertheless, Korea’s vulnerability should be weighed against its demonstrated resilience to adverse external conditions which reflects in part the ever-increasing diversity of its exports, both in terms of destination and product composition.

That said, our authorities are prepared to take the necessary policy actions if the downside risks eventuate. On the fiscal front, the response would include the front-loading of fiscal spending with the target of overall fiscal balance. Given relatively weak automatic stabilizers, modulation on the speed of spending has been the major fiscal policy, coupled with a timely supplementary budget.

Last year about 60 percent of the budget was allocated for expenditure in the first half of the year but implementation was soon slowed as the economy revealed early signs of faster-than expected growth. As the staff acknowledge, this was an appropriate adjustment.

The authorities’ target this year is to spend 51.6 percent (62 percent on the budget allocation basis) of the budget in the first half of the year, as compared with the out-turn of 47.2 percent last year. Staff note that non-interest current spending, which was under-spent last year, is budgeted to rise by 16 percent this year. Non-interest current spending is, however, the appropriate

expenditure for the discretionary operation of fiscal policy. Furthermore, while the authorities do not see any need for a supplementary budget at this stage, it remains a policy option.

As for interest rates, the Bank of Korea (BOK) has maintained an accommodative stance. With core inflation comfortably within the target range and the beneficial impact of the appreciation in the exchange rate still to come, there is no immediate need for a policy change. Nevertheless, the authorities are mindful of staff's advice about the objective of monetary policy moving to a neutral stance.

The free-floating exchange regime, introduced in 1977, has now been entrenched and still serves the economy well, although the shallowness in the foreign exchange market has to be overcome. Exchange rate intervention has remained minimal, as noted by the staff.

Longer-term policy issues

The authorities are determined to formally introduce a medium-term fiscal strategy under the auspices of a special law on fiscal soundness, which is currently pending before the National Assembly. This is not a new concept, a notable example being the Medium-Term Fiscal Plan which was announced with the first budget after the 1997 crisis. However, the formalization of a medium-term budgetary framework, including fiscal targets, is expected to be the main channel of communication by the authorities with the National Assembly on a yearly-rolling basis. Other policy recommendations in the 2001 FAD technical assistance report require substantial changes in budget-related laws and the possibility of revisions to these laws will continue to be studied.

Staff have recommended legislative changes to the inflationary targeting system. However, the medium-term target approach has already been formally in operation in Korea. The BOK regularly announces medium-term targets in parallel with annual targets following the decision of the Monetary Policy Committee. While there may be some concern as to confusion over the link between an annual and a medium-term target in Korea, the public is accustomed to yearly economic plans. In fact, the public may still require an annual target in order to fully grasp a medium-term objective of price stability.

To ensure consistency between annual and medium-term targets, the BOK sets the annual target such that the mid-point is within the range of the medium-term target. Currently, the annual target for 2003 is 3 ± 1 percent, while the medium-term target is 2.5-3.5 percent. Importantly, the current BOK Act which stipulates the inflation target, was a very difficult compromise over the jurisdiction of related agencies in terms of monetary policy and financial supervision. Against this background the benefit of revising the inflation targeting arrangement needs to be offset against the political cost of reopening this whole issue.

Pension reform is another high priority area for the new administration. The authorities are well aware that the initial round of reform did not ensure long-term sustainability of the National Pension System (NPS), as well as other occupational pensions in the public sector. Under the law, the public pension system is under policy review every five years and for almost a year an independent panel has been preparing the first review which will be completed this year. While

there are some other studies on this matter which tend to be less pessimistic than staff's diagnosis on the long-term prospects of the NPS, the authorities appreciate the staff's efforts which will provide valuable input to the forthcoming policy debate.

Sources of Growth

The authorities' estimate for the economy's potential growth rate is in the range of 5 percent. Maintaining high growth is not easy as an economy matures. In particular, demographic change is taking place in Korea and it may soon move from an "aging society" to an "aged society". Nevertheless, the new administration is confident that Korea will be able to not only maintain its current potential growth rate, but will enhance it. The envisaged sources of growth include the following.

- The most important source will be efficiency gains from structural reform. The better functioning of the financial market should improve efficiency in resource allocation, which to date has contributed to the expansion of a creative and flexible SMEs sector after the crisis. In fact, a large share of the 1 million jobs created since the crisis are attributed to SMEs.
- The authorities are well aware of the importance of technical progress in enhancing the country's growth potential. In the pursuit of technical development, they have put a high emphasis on ways to make the most of Korea's existing strength as an information- and knowledge-based society.
- Foreign direct investment has been a major contributor to the rapid growth achieved since the crisis. The total amount of FDI inflows over the past five years is around eight times the accumulated total since Korea opened itself to FDI from 1962 till 1997. Inflow did fall last year but this was against the background of a global downturn in FDI.
- While there is a limit to labor force growth, there still remains an under-utilized sector of the workforce; namely, females. The new administration is determined to encourage greater female participation in the workforce.

The authorities are mindful of foreign investors' concern over uncertainty in the area of industrial relations. But Korea's labor market has proved to be much more flexible than might have been perceived given the attention that some militant labor unions have attracted. However, the union movement is below 10 percent of the workforce and even the unions have accepted the necessity for lay-offs in the face of business difficulties. The administration is confident that encouraging dialogue between employers and employees, supported by fair and speedy mediation through the Tripartite Committee that is composed of labor, management and government representatives, will ensure even sounder labor-management relations.

Financial Sector

The new administration will continue the task of restructuring or "normalizing" the financial sector. In this respect, "reprivatization" of commercial banks that were nationalized as part of

overcoming the crisis is expected to gain speed. Currently, the sale of the government's share of Chohung Bank has priority. It was hoped that negotiations with the preferred bidder would have been completed by the previous administration. However, with the task now being handed over to the new administration, it is recognized that progress on this front will be a litmus test for the new economic team.

Another milestone decision by the previous administration was the financing of the unrecoverable public funds used for financial restructuring. As Box 3 in the staff paper summarizes, 70 percent of the unrecoverable residual of 69 trillion won will be borne by the budget eventually, after converting previous KDIC and KAMCO bonds, which mature in the next few years, into Treasury bonds, and 30 percent will be repaid by the financial sector collectively. The government has set up a special fund for this purpose in order to ensure transparency and accountability.

This decision puts to rest uncertainty regarding the government's contingent liability associated with the use of the sovereign guarantee in underwriting financial sector restructuring. The decision will also facilitate the development of the domestic bond market, since the new bond will have a maturity of more than five years which has been rare to date.

The authorities' response to the FSSA report is self-explanatory but we would highlight the following points.

- The expansion of consumer loans requires continuous careful monitoring, although this does not pose a serious threat to the financial system. Moreover, prompt actions by the authorities, both in terms of prudential regulation and targeted taxation measures, has brought the expansion of consumer credit under control.
- The authorities are mindful of problems in the insurance sector. On top of the asset price fall suffered by most insurance companies worldwide, Korean insurance companies are struggling with a mismatch of liabilities with a long maturity and a short maturity asset portfolio. This mismatch may cause credit difficulties, but it is not likely to provoke a liquidity crisis. Furthermore, the introduction of a sovereign bond with long-term maturity, as mentioned previously, will contribute to the resolution of this problem by offering insurance companies an efficient way of re-balancing their asset portfolio.
- Non-performing loans of non-bank deposit taking institutions remains a problem. The authorities took prompt corrective action last year and continue to be watchful of this sector. That said, non-bank deposit institutions play only a minor role in the country's financial system. Furthermore, there are some early signs that things are improving. The credit union group is estimated to have recorded a surplus after three consecutive years of losses. Smaller scale mutual savings banks also recorded profits in the first half of 2002.
- Derivative transactions are a fast growing business. Korea was number one in 2001 in terms of the number of derivative contracts largely as a result of its state-of-the-art

internet transaction system. Nevertheless, as noted by the recent Fund mission in this area, the risks remain controllable in terms of the amount of exposure.

Corporate Sector

An important conclusion of the staff's stress test on the banking sector's exposure to the corporate sector is that it is now under control. Staff highlight the substantial improvements in debt-equity ratios and in corporate governance. The market reaction to these developments is important. Stock prices are reflecting good corporate governance and there appears to be a "chaebol discount" rather than "chaebol premium" in that the share price of chaebol affiliates tends to be lower than if they were not associated with a chaebol.

That said, our authorities fully recognize that there is no place for complacency. In fact, the new administration has emphasized that it will be pushing even harder in pursuit of good governance in the corporate sector, including the passage of a number of new laws proposed by the previous administration, such as the law regarding class action lawsuits. These laws remain on the top of the corporate law reform agenda.

The authorities also share the staff's emphasis on advancing corporate insolvency law reform. The government's proposal for a unified corporate insolvency system (equivalent to combining Chapter 7 and 11 in the US insolvency system) is now ready for debate in the National Assembly. While there is still scope for improvements to this bill, as noted by staff in Box 4, it does reflect the most comprehensive attempt to reform corporate insolvency and is a significant advance over the four revisions of the same laws in the past five years and will strengthen the incentive for creditors to take the initiative in corporate restructuring.

As regards the references in the staff report to the interest coverage ratios (ICR) of Korean firms, we would emphasize the following:

- the ICR of the corporate sector has improved substantially and there is an ever-increasing gap between "good" and "bad" companies;
- the figures quoted for companies with ICRs below 100 percent are based on the number of companies, not on the size of their debts, and their recent increase is mainly due to difficulties in small-scale firms, particularly those producing electronic parts;
- the reference to unsatisfactory performance of ICRs of lower-end firms should not be seen as questioning the soundness of prudential standards within the banking sector. ICR is one factor for individual banks to consider in their loan classification under the country's forward-looking criteria (FLC) system, but there are many others.

Other issues

On trade issues, Korea participated actively in the opening of the Doha Round and will continue to be active in forthcoming DDA negotiations. While Korea has been categorized by the OECD as maintaining higher producer support for agricultural products, this is mainly due to price

protection in the politically sensitive area of rice. The authorities are prepared to discuss the further opening of the agricultural market and will consider replacing price subsidies with more market-neutral direct compensation to rice farmers.

Korea intends to pursue FTAs with other countries, building on the momentum generated by the recent signing of the FTA with Chile. Regarding the EU's request for consultation in the context of the WTO's dispute settlement mechanism of alleged government subsidies to Korean trade shipbuilders, we would note that the staff made a statement at the WTO's Working Group on Trade, Debt and Finance to the effect that: (i) the use of public funds was the key element in Korea's implementation of conditionality under the Fund-supported program; (ii) under this program, the Korean government committed to avoid direct lending; and (iii) the injection of public funds into banks did not include targeted financial assistance to any specific sector. (See attachment to EB/CWTO/03/1.)

On statistical issues, the BOK applied for the late submission of the International Investment Position under the SDDS. Two test compilations for 1999 and 2000 were completed and the BOK is checking their consistency. The BOK is determined to keep the deadline on this matter and plans to publish IIP as of the end-2001 by end March this year and IIP data for 2002 by end June. In addition, the BOK has agreed to publish the ROSC on data module, having addressed the technical problems noted in the report.

To conclude, we would add our observation to the staff's description of recent developments in the DPRK. In our view, the introduction of "market" prices is the most significant economic reform that DPRK has made and the implications of this development should not be taken lightly, for it cultivates the sense of "money" in the economy. There are signs that people are responding to this development, although not all of them are encouraging. For example:

*"Salaries have not increased in line with price changes (...). This is bound to make for some unhappy labor campers, especially given reports that many companies are unable to pay the salaries. Farmers were reportedly content with the changes as it meant more side income for produce raised on allotments."*¹

As people's experience with money and the concept of the market develops, their sense of ownership and involvement in the economy will intensify. Accordingly, it would be very difficult to reverse the process since, as one analyst has observed, "the bus has left the station".

¹ Quotes are from the CLSA market study report on N. Korea by Messrs Breen and Lucas (Dec. 2002).