February 2005
IMF Country Report No. 05/49

Republic of Korea: 2004 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

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 2004 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 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 28, 2004, 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 December 29, 2004. 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 January 21, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January 21, 2005 discussion of the staff report that concluded the Article IV consultation.

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

Selected Issues Paper

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF KOREA

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for the 2004 Consultation
with the Republic of Korea

Approved by Wanda Tseng and Michael T. Hadjimichael

December 29, 2004

- **This report is based on discussions held in Seoul during October 13–28, 2004.** The mission team was headed by Mr. Felman, and also comprised Messrs. Beaumont, Senhadji, Zebregs, and Miniane (all APD), Mr. Frydl (MFD), and Mr. Kang (Resident Representative). Mr. Oh Jong-Nam, Executive Director, also participated in the discussions.

- **The team met with a wide range of senior officials and private sector representatives.** The officials included Deputy Prime Minister and Minister of Finance and Economy Lee Hun-Jai; Bank of Korea Governor Park Seung; Financial Supervisory Commission Chairman Yoon Jeung-Hyun; Senior Secretary for Policy Planning Kim Young-Joo; and Fair Trade Commission Chairman Kang Chul-Kyu. The team also met representatives of financial institutions, industry federations, labor unions, NGOs, and the diplomatic and academic communities.

- **At the conclusion of the previous Article IV Consultation in February 2004,** Directors commended the progress that Korea had made in establishing a market-driven economy, but urged the authorities to address the remaining structural problems, including a credit card bust, lingering problems of corporate governance, and an inflexible regular labor market.

- **Korea's statistical base is adequate to conduct effective surveillance.**

- **Korea has accepted the obligations under Article VIII,** and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

- **The authorities have not yet indicated their intention to publish the staff report, and have not yet decided to consent to the Fund's publication of the PIN.**

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GLOSSARY OF ABBREVIATIONS AND TERMS

ASEAN .... Association of Southeast Asian Nations
BAI .... Bureau of Audit and Inspection
BOK .... Bank of Korea
CAR .... Capital Adequacy Ratio
FSC .... Financial Supervisory Commission
FSS .... Financial Supervisory Service
FTA .... Free Trade Agreement
FTC .... Fair Trade Commission
IBK .... Industrial Bank of Korea
ICR .... Interest Coverage Ratio
IT .... Information Technology
ITC .... Investment Trust Company
KAMCO .... Korean Asset Management Company
KCGF .... Korean Credit Guarantee Fund
KCGS .... Korea Corporate Governance Service
KDB .... Korean Development Bank
KDI .... Korea Development Institute
KFB .... Korean Federation of Banks
KDIC .... Korean Deposit Insurance Company
KIC .... Korea Investment Corporation
KOSDAQ .... Korean Security Dealers Association Index
KOSPI .... Korea Stock Price Index
KOTEC .... Korea Technology Guarantee Fund
MOFE .... Ministry of Finance and Economy
MPB .... Ministry of Planning and Budget
NBFI .... Nonbank Financial Institutions
NDF .... Nondeliverable Forward
NPF .... National Pension Fund
NPL .... Nonperforming Loans
PDRP .... Personal Debt Rehabilitation Program
q/q .... Quarter-on-quarter
p.a. .... Period average
s.a. .... Seasonally adjusted
SME .... Small and Medium-size Enterprise
SSF .... Social Security Funds
W .... Won
y/y .... Year-on-year

Exchange rate as of December 29, 2004: \$1 = W1,041

EXECUTIVE SUMMARY

- After a long post-crisis boom, the Korean economy has begun to sputter. Domestic demand has stagnated for the past two years, forcing the economy to rely on exports. These boomed in 2003, but have now slowed, reducing growth to low levels.

- What has gone wrong? The answers are several. Households and SMEs have been unable to spend, as they are repairing their balance sheets following a long credit boom. Meanwhile, corporations have become reluctant to invest domestically, mainly because they are discouraged by the highly regulated labor market.

- Reviving the economy will consequently require restarting the domestic engines of growth: spending by households, SMEs, and larger corporations. To do this, the government needs to provide a macroeconomic spark, while putting in place market-friendly frameworks needed to solve the underlying problems. Specifically, it should:

  - Implement stimulative fiscal and monetary policies, while continuing to pursue a flexible exchange rate policy;

  - Accelerate the resolution of household debt delinquencies, by strengthening the personal bankruptcy system;

  - Revitalize the SME sector, by expanding the sources of private financing while gradually unwinding public credit guarantees; and

  - Promote investment, by modernizing the labor market, easing strict job protection for regular workers while expanding social protection.

I. Introduction

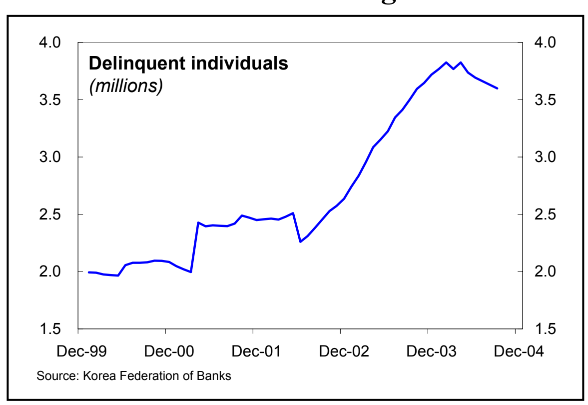
1. **From 1999 to 2002, Korea's economy grew rapidly, by an average of 7¼ percent per annum.** But starting in 2003, the economy began to sputter. Growth suddenly stopped in the first half of the year, leapt ahead in the second half as exports boomed, but then slowed again to an anemic 2¾ percent annualized rate during January-September 2004 as exports decelerated. What explains this pattern of stop-and-go growth? And what can be done to put the economy back on the path of sustained, rapid, expansion? These are the key policy questions facing the Korean economy.

2. **In some sense, the answer to the first question is straightforward.** Growth has slowed because the economy has been dealing with the after-effects of a 2001–02 credit boom, which damaged the balance sheets of households and firms, causing them to slow their spending. But in another sense the issue is deeper. The origins of the credit boom, and the impediments to renewed growth, lie partly in government intervention into the economy, the legacy of decades of a state-directed development strategy. The Article IV consultation discussions consequently focused on ways to overcome this legacy and complete the shift to a market-based framework needed for sustained growth.

II. The Ubiquitous Hand

3. **Since the Asian crisis, Korea has accelerated its shift towards a market-oriented development strategy.** Directed credit has been abolished, protectionist barriers largely eliminated, the exchange rate floated. The bulk of the banking system has been placed in private hands, while the *chaebol* have been restructured and their leverage reduced to U.S. levels. As a result, Korea now has one of the more open and liberal economies in the emerging market universe. Foreign investors, for example, now hold 43 percent of equity market capitalization, the 4th highest share in the world.

4. **Nonetheless, since the crisis Korean governments have continued to intervene in the economy, and the after-effects of these interventions are now holding back a recovery.**[1] The key areas where past interventions have had unintended costs are:



- **The household debt problem.** Since 2002 the number of people in default on their debts has risen sharply, peaking at 3¾ million, one-tenth of the adult population. Delinquencies on credit cards are the

[1] The history of government intervention in Korea and its role in Korea's current structural problems is discussed in Zebregs, "The Ubiquitous Hand: Government Intervention in Korea,", in the forthcoming *Selected Issues*.

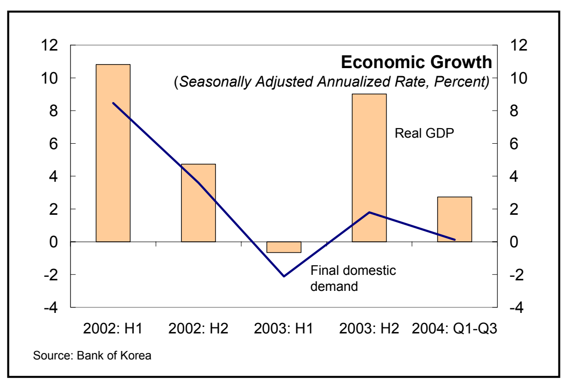
main factor, following a more than five-fold expansion in credit card debts during 2000–02. The primary impetus for this expansion came from the credit card companies themselves, which marketed their product aggressively. But according to an official investigation by the Bureau of Audit and Inspection, the government also contributed to the boom by introducing tax deductions and lotteries for credit card users, as part of a strategy to develop domestic demand and expand the formal economy.[2] Moreover, lax supervision allowed card companies to issue cards without requiring basic information needed to assess credit risk, such as income. There were 31 million cards issued in 2001 alone—in a country with a total population of 48 million.

- **The financial difficulties of SMEs.** To contain the decline in bank loans to SMEs immediately after the Asian crisis, the government sharply expanded its credit guarantees. These emergency guarantees, however, have not been unwound over time. Instead, they have been repeatedly rolled over, contributing to a boom in bank lending to SMEs in 2001–03. As a result, this vital sector—which accounts for 85 percent of employment—is now plagued by over-capacity and poor profitability (Box 1).

- **The reluctance of larger corporations to invest.** In contrast with smaller firms, the position of the larger corporations is generally strong. But they have preferred to use their profits to repay debts, repurchase stock, or invest in China, rather than to expand their domestic investments. One reason is that they are discouraged by the highly regulated domestic labor market: workers with regular contracts in Korea continue to benefit from some of the strictest job protection in the OECD, the legacy of government attempts from the 1960s through the 1980s to provide the security of lifetime employment.

III. An Economy Flying on Just One Engine

5. **With the household and SME sectors facing financial difficulties, and many corporations reluctant to invest, most of Korea's engines of growth have shut down.** Domestic demand has stagnated since early 2003, with private consumption in particular contracting in 5 out of the past 7 quarters as households have focused on paring down their debt burdens, while incomes have been eroded by the sharp rise in world oil prices.[3]



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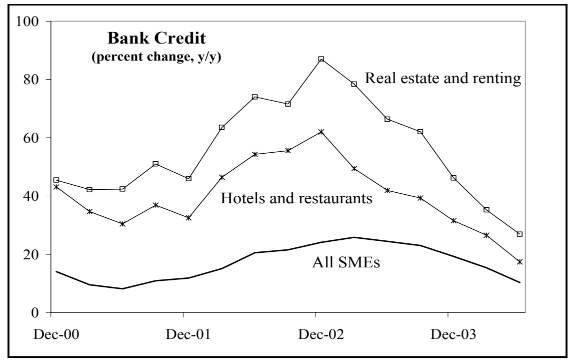
[2] The overall strategy of stimulating domestic demand was welcomed at the time by the IMF.

[3] Domestic petroleum prices are market-determined.

Box 1: Are SMEs the Next Credit Card-Style Problem?



As large enterprises in Korea engaged in financial deleveraging after the crisis, banks turned to SMEs as a new lending opportunity. Starting in 2001, SME loans and housing mortgages surged, with the former substantially collateralized by real estate as well. Lending to SMEs seemed justified at the time by their relative profitability and financial stability, and was certainly aided by a 23 percent increase in government SME credit guarantee provisions.[1] Not all SMEs benefited equally from this credit boom however, with the largest increases concentrated in services sectors.

But weak domestic demand is hurting the SMEs' bottom line. The proportion of loss-making SMEs increased from 17.7 percent in 2002 to 21.3 percent in 2003.[2] Tougher business conditions are also unmasking lingering structural deficiencies in the sector, with many nonviable SMEs reliant on the credit guarantees and other forms of government support. These guarantees account for more than 6 percent of GDP, a much larger share than in comparable economies like Taiwan Province of China.

With SME finances weakened after a period of strong credit growth, some analysts have questioned whether SMEs will be Korea's next mass defaulters. SME loans now constitute more than 40 percent of banks' credit portfolio, and amount to over 30 percent of GDP. A wave of SME defaults would put further pressure on the financial system which is recovering from a credit card boom-bust cycle.

The underlying degree of financial distress remains unclear. SME delinquency ratios have risen little from 2.1 percent in December 2003 to 3 percent in August 2004, but this may partly reflect "evergreening" by banks.[3] Certainly, these ratios appear too low if, as shown by some studies, 6 percent of SMEs have failed to generate enough operating income to cover interest charges for the last three consecutive years.

Relative to credit card loans, potential losses on SME loans are limited by two key factors. First, the combination of real estate collateral and government guarantees secure some 70 percent of SME credit. Even in a pessimistic scenario where all SMEs with an interest coverage ratio below one in 2003 default on their debts, private sector analysts have estimated the unsecured portion of the defaulted debt at slightly more than one year of banks' pre-provisioning profits and less than a fifth of the banks' book value. Second, most SMEs deal with one or two creditor banks, making any restructuring easier than in the case of households with multiple credit cards.

However, there is no room for complacency. Restructuring of the sector needs to begin soon if SMEs are to resume investment and growth.

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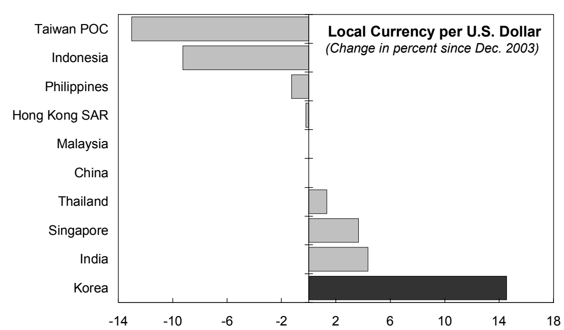
[1] Including SME collateralized bond obligations.
[2] These figures are for manufacturing SMEs only. The services sector may be facing even deeper problems.
[3] Note that credit card delinquency ratios are much higher at 12.5 percent.

6. **Accordingly, the economy has been forced to rely on merchandise exports.** These boomed in the second half of 2003 as the global electronics industry recovered, propelling GDP growth to an annualized rate of 9 percent. But in early 2004 this growth engine began to falter. Exports slowed as the electronics expansion matured, reducing GDP growth in the first three quarters to just 2¾ percent (q/q annualized, Table 1).

7. **The authorities have tried to counter this slowdown by easing macroeconomic policies. In particular:**

- **The fiscal stance was shifted from neutral to mildly expansionary.** As concerns about growth mounted, the government initially frontloaded expenditures into the first half of the year, then adopted a supplementary budget of ½ percent of GDP (Table 2).

- **The monetary policy mix was shifted to favor domestic demand.** The Bank of Korea cut its policy rate by 25 basis points in both August and November, to an historic low of 3¼ percent, easing the burden on domestic debtors (Table 3). Meanwhile, the won was allowed to appreciate, cushioning the impact of higher world commodity prices and helping to sustain household real disposable incomes. Over the course of 2004, the currency climbed by 14½ percent against the U.S. dollar, a 12 percent gain in nominal effective terms—the sharpest rise among Asian currencies. While smoothing this ascent, the authorities accumulated $37 billion in reserves, bringing the total to $196 billion (Table 4).



Source: IMF, *International Financial Statistics*, Bloomberg.
Based on monthly end of period exchange rates through December 29, 2004. A positive value implies appreciation.

8. **On the structural side, the progress of Fund-supported measures was slow for much of the year, partly because the National Assembly was preoccupied by legislative elections.**[4] Now that the President's party has secured a slim majority, however, some of these measures have been advancing. A major corporate governance bill, aimed at discouraging cross-shareholdings and strengthening the firewalls between industrial and financial firms, was approved in December 2004. In addition, the government has sold one of the three large investment trust companies that it controlled at end-2003, and is in the process of selling the other two.

[4] Another factor is that the governing party has been focusing on four major social issues: repealing the anti-communist National Security Law, regulating media monopolies, reforming private schools, and investigating collaboration during Japan's 1910–45 colonial rule of Korea.

Key Structural Policy Advice, 2003 Article IV	Status
• Privatize ITCs	• Hyundai ITC sold; negotiations for Daehan and Korea ITC ongoing.
• Strengthen financial supervision	• Plan to clarify responsibilities of the FSC, FSS, and MOFE.
• Tighten standards for household credit	• Tightened provisioning based on historical losses, but credit information is still weak.
• Privatize LG Card	• Postponed, and further creditor support has been provided.
• Require card firms to recapitalize	• Recapitalization has been gradual, and is not yet complete.
• Pass insolvency reforms	• Bill to be resubmitted to National Assembly
• Ease employment protection	• Under discussion in Tripartite Commission.
• Adopt "comply or explain" system for Corporate Governance Guidelines	• Still under consideration

IV. What Lies Ahead?

9. **Staff expects that domestic demand will finally begin to recover in 2005.** Experience from other countries that have gone through similar credit boom-and-busts suggests that consumption could revive as the process of household balance sheet adjustment advances into its third year (Box 2).[5] Moreover, high capacity utilization ratios and strong manufacturing profitability should ultimately prompt a recovery in facility investment, offsetting a slowdown in construction. With appropriate polices (as described in the following section), growth could gradually accelerate to 4 percent in 2005 and 5½ percent by 2007, before settling down over the medium term to its potential rate of around 5 percent (Table 5).[6]

Gross Domestic Product, 2003-06

(Change in percent)	2003	2004 Proj.	2005 Proj.	2006 Proj.
Real GDP	3.1	4.6	4.0	5.2
Domestic demand	0.1	1.4	2.6	4.9
Consumption	-0.5	0.0	1.7	4.8
Fixed investment	3.6	2.6	2.6	5.2
Net exports, contribution	2.8	3.7	1.4	0.8

Source: Bank of Korea and staff calculations.

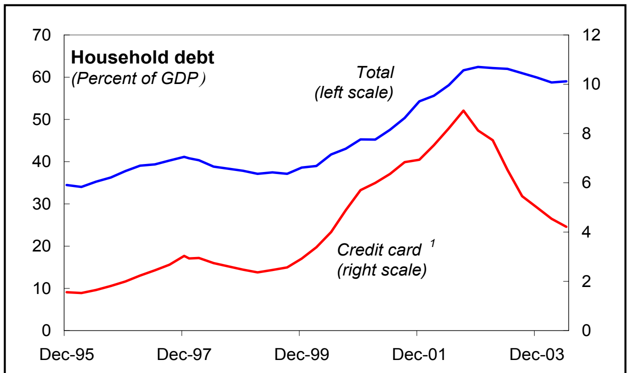
[5] See Senhadji, "Balance Sheet Effects on Household Consumption," *Selected Issues,* forthcoming.

[6] On an annual basis, however, growth would slow, because output in 2004 was boosted by the export-driven growth spurt at the end of 2003.

Box 2. When Will Private Consumption Recover?

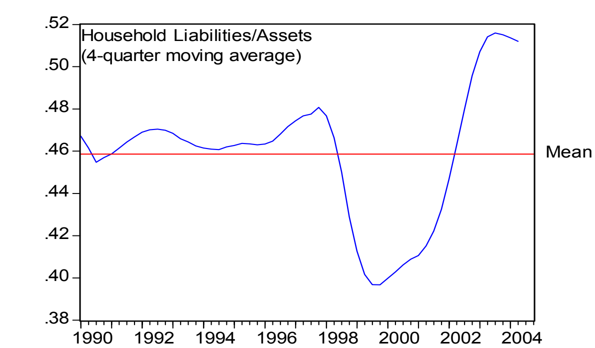
A revival in private consumption is the key to a broader economic recovery. But when will this occur? The question is impossible to answer with certainty, but analysis suggests that a revival may begin in 2005.

Growth in private consumption averaged 6½ percent during 2000–02 before becoming negative in 5 out of the 7 past quarters. The persistent weakness in private consumption has resulted, to a large extent, from the bursting of the consumer credit bubble in 2003, especially the "plastic bubble" (the consumer credit bubble associated with credit cards), leaving many households with crushing debts and high delinquency rates. Credit card debt grew from less than 2½ percent of GDP in early 1999 to about 9 percent by the third quarter of 2002 before declining to less than 4¼ percent by mid-2004. Similarly, total household debt increased from 37 percent of GDP in early 1999 to 62½ percent by the last quarter of 2002 before falling to 59 percent in mid-2004.



1/ Data on credit from NBFIs is used as a proxy for credit card debt.

Staff econometric analysis finds that Korean households are quite sensitive to the health of their balance sheet. Faced with a negative shock to their net wealth, they will reduce their consumption. An increase in household gearing ratio—the ratio of household liabilities to household assets—by one percentage point will reduce consumption by 2¾ percent (see chapter II of the *Selected Issues*).



Therefore, achieving sustainable growth in private consumption will depend crucially on the amount of adjustment needed by households to repair their balance sheets. This will depend on the degree to which the substantial increase in households' gearing ratio has been excessive and needs to be unwound, and the extent to which it has reflected fundamental factors, such as financial innovation and low interest rate environment. Prior to the Asian crisis the gearing ratio had been relatively stable around 46 percent. If the gearing ratio were to revert to its mean, significant adjustment remains ahead.

Some clues on how long this adjustment might take can be found in other emerging and industrial economies which went through boom-bust episodes. A recent WEO study (Chapter IV, April 2004) finds that the average duration of a boom, fueled by rapid credit growth, is 2 years followed by a bust of 1½ years during which private consumption declines by about 12 percent. In Korea, econometric evidence shows that, on average, it takes 6 to 8 quarters for consumption to adjust to a negative shock unrelated to household balance sheets, while it takes about 3½ years to fully adjust to a negative shock to household balance sheets. Since the adjustment started in late 2002, this suggests that consumption could begin to revive in 2005.

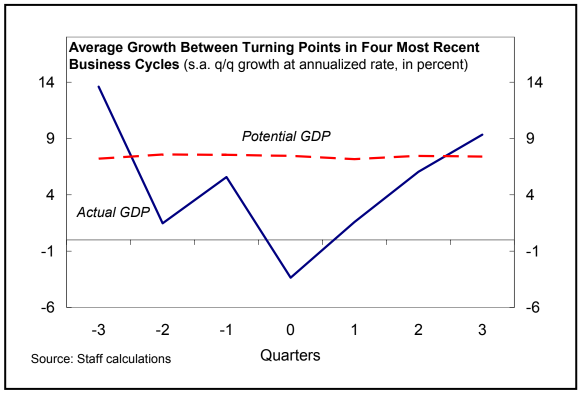
Household Debt Growth Rate by Income Level

Income (percentiles)	99	00	01	02	03
0–20	9.1	15.3	23.5	23.6	5.6
21–40	7.1	13.2	19.6	21.4	4.7
41–60	6.0	10.6	18.4	22.8	3.7
61–80	6.3	10.7	18.2	26.9	2.9
81–100	13.3	13.8	25.3	32.9	7.4
91–100	14.0	17.0	32.1	37.3	0.9
Overall	8.5	12.4	21.1	26.7	5.0
Apartment Price	8.5	1.4	14.5	22.8	9.6

Source: Authorities and staff calculations

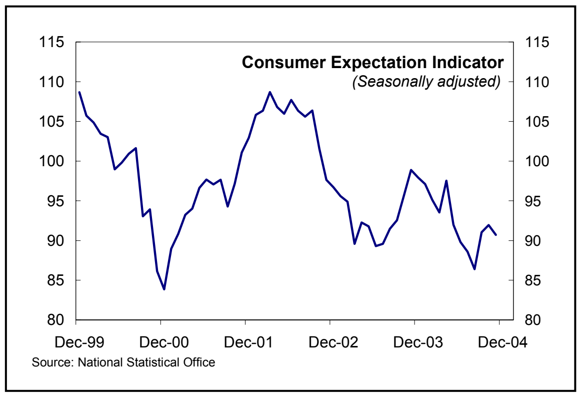
The adjustment of households' balance sheet is unlikely to be uniform across households as the most rapid debt growth has been registered at the lowest and highest income levels. While the latter seem to have borrowed heavily to invest in real estate, low income households did so for consumption, which has increased their gearing ratio significantly, reducing substantially their capacity to service their debt as demonstrated by the significant increase in delinquency rates in 2003.

10. **There are both upside and downside risks to this baseline projection:**



- **The recovery in domestic demand could be much more vigorous than projected, especially as Korean recoveries have often been swift and sharp.**

- **On the other hand, the external environment could prove harsher than expected.** With exports accounting for nearly half of GDP, the projected recovery could be undermined if OECD growth falters or there is a significant downturn in the volatile electronics sector, which alone accounts for one-third of Korean exports. Moreover, with the country dependent on imported oil for the bulk of its energy needs, growth in 2005 could be cut significantly if oil prices prove higher than the WEO assumption of $43 per barrel, since the central bank estimates that GDP falls by 0.2 percentage points for every 10 percent increase in oil prices.



- **Balance sheet adjustments could prove more protracted than expected, especially if flagging confidence fails to recover.**

- **Which brings us to the most critical assumption: that government policies will be sufficiently strong to restore confidence and restart the economy.**

11. **Under any scenario, however, Korea's vulnerability to crisis is very low.** The fundamental pillars of the economy are solid: the balance sheets of the *chaebol* are healthy on average, while banks remain well capitalized despite their recent losses (Table 6). Moreover, the cushions are considerable, with external reserves now exceeding external debt and government debt amounting to only 30 percent of GDP (Table 7). As a result, vulnerability analysis shows that the economy is robust even to severe shocks (Annex I).

12. **There are, nonetheless, problems in particular sectors.** As already noted, households and SMEs are over-indebted. Moreover, while credit card companies have rebuilt their capital adequacy ratios, a substantial fraction of rescheduled delinquent loans has fallen into arrears again, suggesting that further losses are yet to be recognized. Also, failures among the 226 mutual savings banks are eroding the reserves of the KDIC, a symptom of the fact that

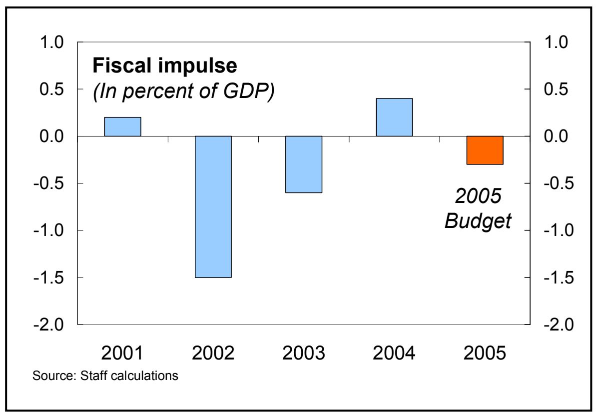
one-fifth of their loans are overdue.[7] Finally, without corrective action, the National Pension Fund is likely to slip into a substantial deficit over the longer-term.

V. How Can Korea Start the Stalled Engines of Growth?

Reviving the economy will require restarting the stalled domestic engines of growth—spending by households, SMEs, and larger corporations. But how can this be done? The first step would be to provide a macroeconomic spark, by implementing stimulatory fiscal and monetary policies. But the heart of the strategy would need to involve addressing the structural problems: the household debt overhang, the SMEs' financial difficulties, and the reluctance of corporations to invest. In all of these areas, the challenge will be to find ways of developing market-friendly frameworks that reduce the need for heavy-handed government interventions. It is this policy challenge that formed the crux of the mission's discussions with the authorities.

A. Providing a Macroeconomic Spark

13. **The mission and authorities agreed that some macroeconomic stimulus was necessary to spark the awaited recovery.** The 2005 budget submitted to the National Assembly contains some expansionary measures, including reductions in income tax rates, increases in tax deductions for SMEs, and the abolition of excise taxes on a range of luxury items. There are also plans to again front-load spending, as was done in 2003 and 2004. Nevertheless, the budget as a whole is essentially economically neutral, since the deficit target (excluding social security funds) of 1 percent of GDP is close to the projected deficit in 2004. The reason is institutional: Korea has a strong tradition of fiscal conservatism, starting as far back as the 1970s oil shocks and maintained in recent years to ensure the country can cope with rising demographic pressures and the potential costs of reunification.



14. **Accordingly, the authorities intend to supplement the budgeted spending with a "General Investment Plan for Economic Revitalization."** At the time of the mission, the package was still being finalized, but the initial plan involved new spending of around 1 percent of GDP, targeted on infrastructure projects and involving private sector participation in combination with funding from the National Pension Fund and other nonbudget sources.

15. **While welcoming the plan for additional fiscal stimulus, the mission noted that it faced a number of challenges.** To begin with, maintaining fiscal transparency might be

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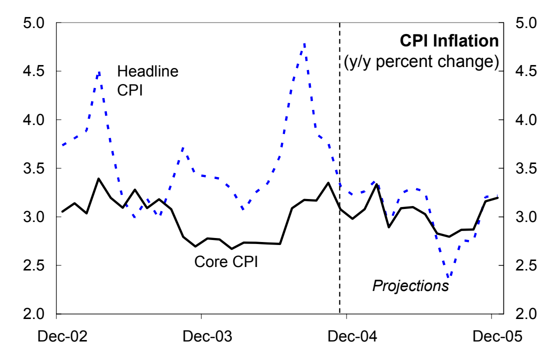
[7] Chapter IV of IMF Country Report 04/45 discusses the health of the NBFIs in more detail.

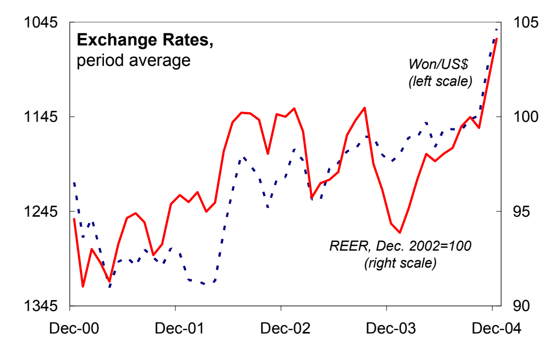
difficult, as the public sector outlays involved would need to be identified and added to the consolidated central government accounts. It will also be a challenge to make these projects as commercial as possible, ensuring that the entities providing financing receive an adequate cash rate of return while simultaneously containing the extent of contingent fiscal liabilities. For this reason, the projects may take time to materialize.

16. **There is consequently a risk that fiscal policy could fall short in providing the needed stimulus.** Accordingly, the team strongly supported the plans to front-load fiscal spending, and recommended the adoption of a supplementary budget, with additional social spending. The authorities responded that they would evaluate the need for a supplementary budget in mid-2005.

17. **In the meantime, the mission noted, the task of macroeconomic management would fall mainly on monetary policy.** In mid-2004, the sharp increase in international commodity prices caused headline inflation to increase. But core inflation has remained within the 2½ to 3½ percent target range, while longer-term interest rates have fallen to unusually low levels, suggesting that inflationary expectations remain firmly under control. Already, headline inflation has receded below 3½ percent, and staff projects that it will continue to fall, as output remains below potential.[8] For all these reasons, the team suggested there was scope for further reductions in interest rates to provide support to the real economy. And, indeed, after the mission's departure the central bank cut its policy rate, noting it would monitor the economy closely to see if a further easing were necessary.



Source: National Statistical Office and staff calculations

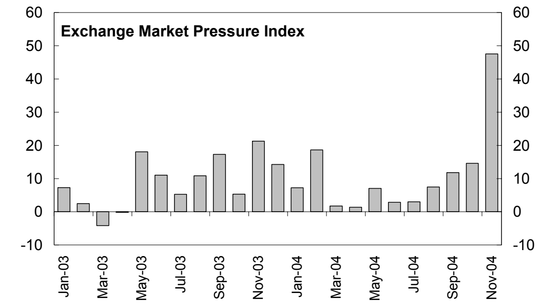


Source: Information Notice System

18. **Regarding the exchange rate, the mission commended the authorities for allowing the won to appreciate, consistent with their flexible exchange rate policy.** It noted that this policy, adopted at the time of the Asian crisis, had served the country well, encouraging firms to hedge their foreign exchange exposures while simultaneously ensuring that exports remained competitive. Such a policy was also consistent with efforts to resolve the problem of global current account imbalances.

[8] These inflation projections are based on the models in Chapter II of IMF Country Report 04/45.

19. **The authorities stated that they remained committed to allowing the won's external value to reflect market fundamentals.** At the same time, they would continue to intervene to smooth the currency's path when it came under speculative pressure, as had occurred on a number of occasions during 2003-04. During the most recent episode, starting in mid-October, the pressure had been so intense that, merely by trying to smooth the sharp appreciation, they had accumulated considerable additional reserves.



Source: Staff calculations
Defined as the sum of the change in the dollar/won rate in percent (a positive value implies appreciation) and the ratio of the change in gross reserves over reserve money in percent.

B. Reviving Household Spending

20. **While macroeconomic stimulus can provide a spark for the economy, achieving sustained strong growth will require addressing the underlying structural difficulties.** This will require, first and foremost, addressing the household delinquency problem.

21. **The staff team strongly endorsed the government's basic policy approach toward debt delinquencies.** It commended the decision to stand firm against calls for an interventionist approach, noting that a mandated debt amnesty scheme would only generate moral hazard, make financial institutions more reluctant to lend to households in the future, and trigger calls for government bail-outs in other sectors. Instead, government efforts have appropriately focused on establishing a market-friendly framework within which debtors and creditors can work to resolve their problems (Box 3). Already, a number of programs have been created for different groups of debtors, allowing one-sixth of the delinquencies to be resolved in the short period since many of the schemes were established.

22. **Even so, the bulk of delinquencies remains to be resolved, including many of the most difficult cases.** In other countries, those debtors who have little chance of repaying their debts in full would seek refuge in the bankruptcy courts. But such a course is less likely in Korea because a strong social stigma is attached to being bankrupt, exemplified by provisions in over 100 laws mandating discrimination against such persons. In addition, the terms of bankruptcy are relatively onerous, with debtors having to live on minimum incomes for 8 years, compared to 3-5 years in the United States and Japan. As a consequence, very few debtors apply for bankruptcy, while creditors are extremely reluctant to exercise their legal rights: there are only 18 recorded cases of creditor-initiated bankruptcy proceedings. In such circumstances, the team noted, the personal bankruptcy system is not only failing to serve those unable to pay, it is failing to serve as a standard that would motivate others to enter the various out-of-court schemes.

23. **For these reasons, the team strongly supported the personal bankruptcy reforms submitted to the National Assembly in November 2004.** These reforms would expand asset exemptions, increase minimum living incomes, and raise the debt ceiling for use of a simplified

Box 3: How Much Progress is Being Made in Resolving Credit Card Debts?

Korea is dealing with an unprecedented rise in household loan delinquency following an unchecked expansion of credit card lending in 2000–2002. Some 3.7 million persons, or 10 percent of the adult population, are classified as being delinquent, up from about 2 million prior to the credit card boom. Most delinquents are younger people, typically with lower incomes—half are under 40 and almost 20 percent are under 30.

Financial institutions and the government have established a number of channels for resolving household debts. These channels offer varying terms depending on the size of debts and whether the debts are to single or multiple creditors.

Workout vehicle	Who qualifies?	What is offered?
Private workout. Includes programs of individual financial institutions, and a credit recovery program jointly operated by LG Card and KDB.	Individuals with: • Delinquent debts with a single institution; • Relatively small debts.	Debt rescheduling with an extended repayment schedule of up to 5 years.
Hanmaeum Finance, Inc (the "bad bank"). Established in May 2004 by KAMCO to help overcome creditor coordination failures.	Individuals with, as of March 10, 2004: • Delinquent debts to more than two creditor institutions; • At least one debt more than 6 months overdue; • Total debt of less than W50 million.	Upon payment of 3 percent of principal the debtor: • Is immediately removed from creditors' black list; • Has up to 8 years to repay the loan interest-free, provided payments remain current.
The Credit Counseling and Recovery Service (CCRS). A consortium of financial companies, running an "Individual Workout Program" for personal delinquents.	Individuals with: • Delinquent debts to more than two creditor institutions; • Total debt of less than W300 million.	• Debt forgiveness of up to one-third of total delinquent debt through rescheduling. • Repayment period of up to 8 years.
Personal Debtor Rehabilitation Program (PDRP). New rehabilitation procedure for personal delinquents operated by the courts as of September 2004.	Individuals with: • A regular income and/or assets; • Collateralized debt of less than W1 billion or uncollateralized debt of less than W500 million.	• Debt rescheduling according to ability to repay. • Repayment period of 3-8 years. • At the end of the period court will exempt performing debtors from remaining debts.
Personal bankruptcy. Court settlement	Insolvent individuals with virtually no income and few assets.	A package comparable to PDRP, but with additional sanctions such as being barred from certain jobs.

So far, about 15 percent of the total number of delinquent borrowers have resolved their debts. For the many deeply insolvent debtors with multiple debts rescheduling is not sufficient to achieve resolution, while the sanctions under personal bankruptcy are considered overly harsh. Thus, rather than participating in these resolution channels, many delinquents appear to be waiting for some kind of debt amnesty.

Creditors lack the information and sanctions that would be needed to prevent such delays by debtors. For example, credit card companies indicate that up to 40 percent of their delinquent borrowers have not provided current addresses or phone numbers. Moreover, creditors are reluctant to use bankruptcy, as is done in other countries, due to the strong social stigma that is attached to it in Korea.

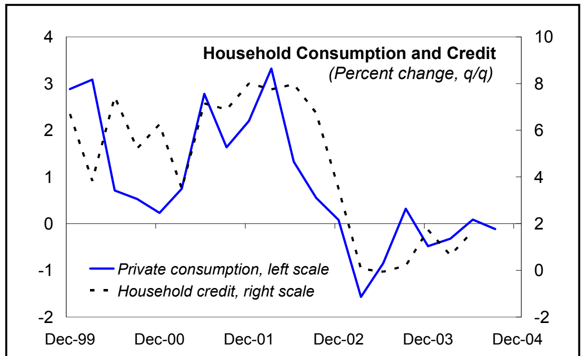
Number of Rescheduled Cases (September 2004)

Bad bank	
(multiple small debts)	131,000
CCRS	
(multiple large debts)	170,000
Private workouts	
(single debts)	255,000
PDRP	
(single and multiple debts)	1,250[1]
Personal Bankruptcy System	7,900[1]
Total	**565,150**

[1] As of October 22, 2004.

bankruptcy process 2½ times to W500 million (around $500,000). Over time, the mission considered, these measures should be extended, notably by shortening the repayment period and reducing official discrimination against bankrupt persons.

24. **In addition, the team supported efforts to streamline the new Personal Debt Rehabilitation Program (PDRP), which allows court-supervised debt restructuring outside of bankruptcy.** The Supreme Court has already begun to simplify the PDRP, reducing the documentation requirements and shortening the standard repayment period to 3-5 years. But further efforts may be needed: a possible model is the Individual Voluntary Arrangements system, an informal but court-supervised mechanism, which has proved a helpful way to deal with consumer debt problems in the United Kingdom and Hong Kong SAR.[9]



Source: Bank of Korea

25. **At the same time as efforts are made to accelerate debt resolution, it would also be important to lay the groundwork for households to regain access to credit.** This would require building up positive credit bureaus. Currently, financial institutions do not widely share positive credit information (i.e., information about loans that have been serviced on time, as opposed to delinquencies) with credit bureaus, making it difficult for lenders to obtain a complete picture of their loan applicants' credit standing. If this situation were changed, the team stressed, credit bureaus would be able to provide comprehensive reports whenever financial institutions need them. These institutions could then begin to tailor their lending to their applicants' credit standing, enabling those with less-than-perfect records to still get access to funds, provided they are willing to pay higher interest rates—just as occurs in other advanced countries.

26. **Building such an efficient system of positive credit bureaus will take time, and will require a supportive regulatory framework.** Based on Mexico's experience, the team considered that two basic regulations were needed.[10] First, financial institutions submitting information to credit bureaus should be required to submit the same information, at the same

[9] Under the Individual Voluntary Arrangements, debtors and creditors submit their debt restructuring proposals to arbitrators, usually accountants experienced in insolvency issues, who decide what plans would be appropriate. Then, to give the plans legal status and afford creditors some protection against any relapses into delinquency, they are ratified by the courts. Thus, those debtors who subsequently default could be sent into bankruptcy for a final resolution.

[10] See Frydl, "Digging Out From Under the Credit Card Collapse", forthcoming *Selected Issues*.

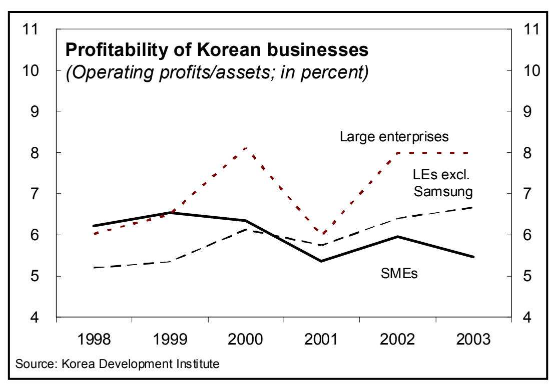
fee, to all other licensed credit bureaus. Second, financial institutions should be encouraged to obtain credit reports, for example, by requiring them to provision more heavily on loans for which reports were not obtained.

27. **Beyond restoring access to credit, it will also be important to address problems on the asset side of households' balance sheets.** This will involve housing policy. The government's anti-speculative measures of October 2003 have succeeded in engineering a "soft landing", with national housing prices declining by a modest 2½ percent in the subsequent year.[11] However, the impact on transactions has been profound, with nationwide housing turnover falling by 31 percent y/y in the first 9 months of 2004, especially in the areas designated as "speculative zones" that cover over half of Seoul. As a result, the main asset of households—accounting for more than 80 percent of their wealth—has been rendered less liquid, giving them further reasons to build up their precautionary savings, rather than consume. One way to address this problem, the team suggested, would be to rebalance the tax burden on property by reducing transactions and capital gains taxes when the new wealth tax on property is introduced in 2005.

28. **The authorities welcomed the team's recommendations.** They appreciated the suggestions for streamlining the debt resolution programs and agreed that the credit information system needed to be improved, expressing hope that a new entrant, sponsored by the largest banks and credit card companies, could provide a catalyst for change. As for the housing market, they noted that the proposed law introducing a comprehensive real estate holding tax would reduce the total tax rate on property transactions. In addition, they announced that seven more areas in Seoul would be removed from the list of "speculative zones" in November, following the removal of eight areas in August.

C. Revitalizing the Small and Medium Enterprises

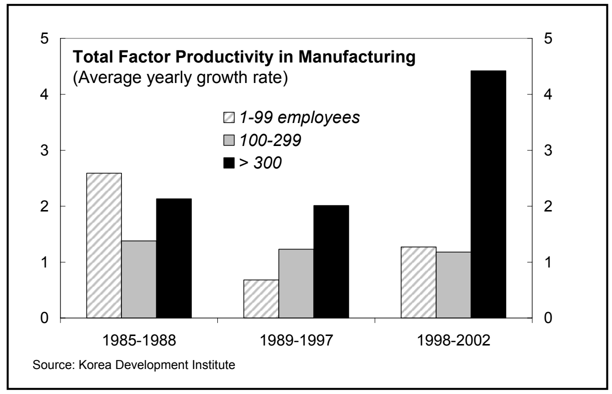
29. **In addition to addressing the difficulties of households, Korea also needs to resolve a growing problem in the SME sector, which accounts for half of manufacturing output.** Around one-fifth of manufacturing SMEs are now incurring losses, with more than one-third failing to generate enough operating income to cover their interest expenses. Indeed, these figures likely understate the extent of the sector's problems



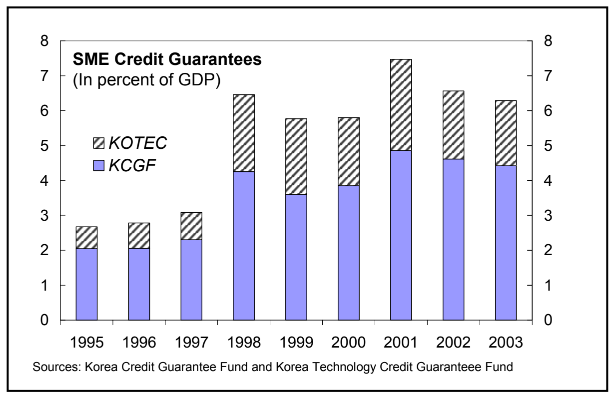
[11] The measures included increasing tax rates on property holding and capital gains, especially for owners of multiple properties. In "speculative zones", the cost of transactions and capital gains taxes have risen substantially, the result of shifting the tax base to actual market values.

because the bulk of SMEs are in services, where firms' financial difficulties are apparently worse. In response, banks have been slowing their credit to SMEs, even as delinquency rates on these loans remain modest.

30. **To a certain extent, the sector's problems are cyclical.** Many firms have been hit hard by the slowdown in domestic demand, and as demand recovers, so too will their financial position. But the problems go beyond mere cyclical difficulties: there are profound structural problems, as well. While profitability of SMEs improved during the early 1990s, it has been declining steadily since the 1998 crisis, in marked contrast to the experience of large firms. Part of the reason is that SMEs have made much less progress than large firms in operational restructuring, as can be seen from their lagging productivity growth.



31. **A telling contrast can be found in Taiwan Province of China.** There, as in Korea, the SME sector plays a very important role, and is also highly exposed to growing foreign competition. Yet profitability has remained strong. The main reason is that this sector is considerably more dynamic, with entry and exit rates much higher than in Korea.[12]



32. **What explains this difference?** A key factor is government loan guarantees. In Taiwan Province of China, guarantees amount to only 1½ percent of GDP, compared with 6¼ percent in Korea. As a result, Taiwanese banks cannot rely on them to guide their lending: they instead need to evaluate credit themselves, and take risks accordingly. In contrast, in Korea resources tend to flow to the SMEs that can secure guarantees, which are overwhelmingly well-established firms. Moreover, the average length of KCGF guarantees is now around five years, implying that most of the firms benefiting from this program are the ones originally selected in 1998 when guarantees were expanded in the wake of the crisis. In this way, the program has been preserving existing firms and raising barriers to entry, thereby limiting the dynamism of the sector.

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[12] See Kang and Miniane, "Too Small To Fail? Revitalizing the SME Sector in Korea", *Selected Issues,* forthcoming.

33. **The government has recognized this problem, and in July 2004 formulated a plan to deal with it.** Under this plan, guarantees would be directed away from well-established firms toward start-ups and new technology companies. In addition, a government-run credit bureau for SMEs will be established, to provide banks with the information they need to undertake risk-based—rather than guarantee-based—lending.

34. **The team welcomed these steps, but recommended that the government go further in this direction.** To encourage banks to do more credit analysis, the loan coverage of guarantees could gradually be reduced from the current typical level of 85 percent to around 50 percent, which is more consistent with international practice. And to limit the risk of firms "monopolizing" guarantees, the fee structure could be altered to impose higher rates on firms rolling over loans; currently, these rates only rise by 5 basis points for each rollover.

35. **Fundamentally, though, what is needed is a new framework for the sector, in which the private sector plays a dominant role in allocating capital.** This will require winding back the levels of the guarantees. The reduction could be gradual, perhaps by 1 percent of GDP per year for the next five years. It could also be preannounced, to give time for banks and enterprises to adjust. But it should also start now, the team stressed, because postponing the necessary task of restructuring will only increase the eventual costs.

36. **At the same time, measures could be taken to provide direct help to SMEs, especially start-ups.** The team recommended relaxing Korea's strict rules on venture capital firms; amending the Civil Code to allow for the registration of property rights and security interests on a wide range of assets, to make it easier for SMEs to borrow on the basis of their receivables and other intangible collateral; reducing the minimum capital requirement for incorporation; and providing a more efficient way for SMEs to reorganize or exit by approving the long-awaited unified insolvency bill.

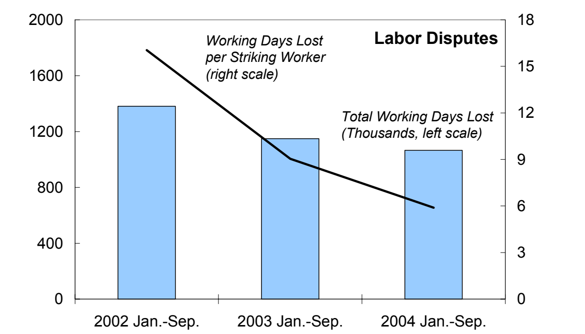
37. **The authorities agreed with the team's proposals, but were concerned that changing the SME framework at the current juncture could trigger a credit crunch that would worsen the macroeconomic situation.** The team, however, considered such risks to be small, primarily because any unwinding of guarantees would be gradual. More to the point, the team considered that the risks of inaction were greater. Currently, SMEs are not investing because they are not in a financial position to do so. Thus, SME investment will not revive until creditors force them to accelerate—or begin—the process of restructuring.

D. Unleashing Corporate Investment

38. **In addition to reviving the household and SME sectors, Korea also needs to unleash corporate investment.** The decline in investment is not just cyclical: facility investment has been declining for more than a decade, from a peak of 14 percent in 1995 to a projected 9½ percent of GDP in 2004. In part, this decline has been a natural consequence of moving from a government-directed system that encouraged over-investment toward one that places more emphasis on economic returns. But another reason why so few investments are now profitable is that structural problems are raising the cost of capital, and the projects themselves. These problems—including a relatively rigid regular labor market, lingering

problems with corporate governance, and an underdeveloped bond market—have become particularly pressing in recent years, as Korea's economy has begun to integrate with that of China, forcing firms to consider carefully what production should take place domestically, and what should be outsourced.

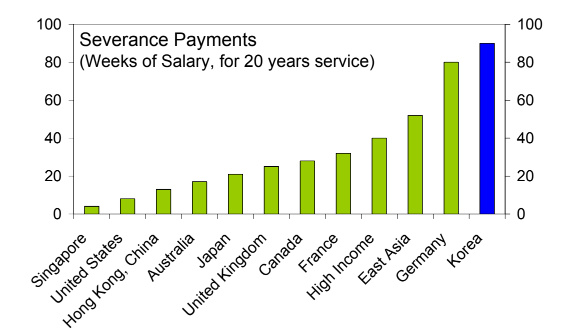
39. **As with the other structural challenges, making Korea an attractive place to invest will require a further reduction in government regulation and intervention.** Most important would be a modernization of the labor market.



Source: Korea Labor Institute

40. **The team welcomed the progress in improving industrial relations.** In 2004, the government's stance of refraining from intervention in disputes, apart from enforcing labor laws, has had notable success. Strikes, though still numerous, are being settled relatively quickly, with less disruption to the overall economy.

41. **But the fundamental labor market problem, the team noted, remains: the strict employment protection for regular workers.** [13] With the legal criteria for dismissal being difficult to satisfy, firms must often offer high voluntary severance payments to those workers they wish to dismiss. Larger companies, for example, typically offer 2¼ months of salary for each year of employment, twice as high as in other advanced countries. Such high costs of adjusting the labor force deter risky investments. They have also led employers to hire a growing number of nonregular workers—now accounting for half of the nonself-employed labor force—who face large gaps relative to regular workers in wages, conditions, and job security.



Source: World Bank, Doing Business in 2004

42. **Seeking to narrow these gaps, the government has proposed two bills to protect nonregular workers by prohibiting "unreasonable discrimination."** The team recognized this objective, but warned that the law would need to be designed carefully, to ensure that it does not further reduce labor market flexibility.

43. **The case of Spain, first raised during the previous Article IV consultation, was a pertinent example, the team noted.** During the 1990s, Spain initially tried to increase

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[13] See Chapter III of IMF Country Report 04/45 for a more detailed discussion.

protection to nonregular workers, but employers responded by reducing their hiring of all workers, and unemployment increased. Subsequently, the country tried the opposite approach: it introduced a new type of employment contract with less job protection, reducing opposition by "grandfathering" existing contracts for regular workers. This new contract has proved highly successful in generating jobs and helping unify the labor market.

44. **For this reason, the team welcomed the Tripartite Commission's consideration of the example of Spain's labor market reform strategy, among others, to see if it can be applied to Korea.** The team also proposed exploring whether more flexible contracts for regular workers can be adopted in certain firms or industries, and then expanded if successful. Furthermore, the mission endorsed the government's plans to lay the groundwork for increased labor market flexibility by expanding the social safety net, especially eligibility for unemployment insurance and basic livelihood protection.

45. **Even as labor market flexibility is increased, it would also be important, the team emphasized, to improve corporate governance.** This remains a priority because, for all the progress that has occurred in recent years, there remains a "Korea discount" on share prices, increasing the cost of equity capital.[14] For this reason, the team supported the Fair Trade Commission's bill (approved after the mission) to strengthen corporate governance. This bill provides incentives for *chaebol* to bring their governance up to adequate levels, by granting exemptions to the cross-shareholding limits to those which improve their internal checks and balances or adopt more transparent vertical holding company structures. At the same time, the bill strengthens the firewalls between industrial and financial firms.[15]

46. **To supplement these measures, the team suggested developing more market-based mechanisms for enforcing corporate discipline.** The government has already taken a welcome step in this direction, by allowing class action lawsuits for securities violations, starting in 2005. In addition, the team again recommended that the government encourage the Korea Stock Exchange to adopt a "comply or explain" regulation for its Code of Best Practices in Corporate Governance, which would set out a short list of good governance practices and ask listed companies to comply with the individual measures or explain why they haven't done so.

47. **Enhancing the functioning of Korea's corporate bond market can also facilitate investment.**[16] While Korea has the second largest corporate bond market in Asia after Japan, the market lacks liquidity and credit spreads are compressed. To overcome these problems and

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[14] The price/earnings ratio for Korean shares averaged 7.6 in 2003, compared to 14.6 in Taiwan Province of China and 18.8 in Japan. Even Thailand had a higher price/earnings ratio at 9.7.

[15] Specifically, the measure tightens restrictions on the voting rights of *chaebol's* financial affiliates in related industrial firms.

[16] See Soueid and Zebregs, "Development of the Corporate Bond Market in Korea," and Kang, Kim, and Rhee, "Developing the Government Bond Market in Korea: History and Challenges," forthcoming *Selected Issues*.

develop the market as a ready source of capital for a larger group of domestic firms, the team recommended that the government break with the tradition of rescuing of bond investors when companies incur financial difficulties.[17] Instead, the team suggested, the government should facilitate market-led debt work outs by passing corporate insolvency reforms, thereby giving market participants incentives to do proper risk management.

48. **The government agreed that the team's proposals would help improve the investment climate, and noted that steps would be taken in all of these areas.** Labor market reform would take place gradually, once agreement had been reached with all parties involved, including unions. Meanwhile, the bill to improve conditions for nonregular workers, the authorities clarified, was not intended to require equal pay or working conditions for nonregular workers. (The team encouraged them to make this intention clear to the courts.) In relation to the revised insolvency law, they hope to have this approved shortly, while they were still considering the "comply or explain" proposal.

E. Other Issues

49. **The team also discussed a number of other important issues:**

- **Korean Investment Corporation (KIC).** The bill to establish the KIC, which will be charged with investing a portion (initially $20 billion) of the country's reserves, has now been introduced to the National Assembly. The team commented that the bill should provide the agency with more specific objectives, stronger independence, and greater transparency, to ensure that public funds are managed efficiently and are not used to bolster specific firms or markets. The authorities responded that some of these issues would be addressed in the Presidential Decree, while the risks of market distortion would be limited since the KIC would invest its foreign assets offshore. They also noted that the assets entrusted by the Bank of Korea would be invested in liquid assets and remain readily available to the central bank, so they could continue to be considered as reserves.

- **Financial supervision.** In the 2002 FSAP, the Fund recommended a unified and independent supervisor. And an official investigation has recently concluded that the overlapping responsibilities of the three agencies involved in financial supervision (the FSC, the FSS, and MOFE) had indeed contributed to the credit card crisis. However, the authorities see a major impediment to unification, since they believe that a private body such as the FSS could not have the legal authority to impose sanctions. Accordingly, they are instead planning to clarify each agency's responsibilities.

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[17] For example, when LG Card was rescued in 2003, bond holders were made whole, while other creditors were required to convert debt into equity. As a result, LG Card is still rated as investment grade despite having negative capital.

- **Population aging.** Korea's population is aging rapidly, a process which could propel the National Pension System into sizeable deficit by 2030.[18] The team therefore encouraged the authorities to press ahead with long-standing plans to increase contribution rates and reduce income replacement rates over time.

- **Trade.** Korea's trade barriers remain high by OECD standards, especially in the agricultural sector. Out-of-quota tariffs for agricultural products averaged 50 percent in 2003; agricultural support is almost double the OECD average; and domestic rice prices are more than three times the world level. Accordingly, the team argued that the government can demonstrate leadership—internationally, as well as domestically—by further opening up its agricultural sector. The authorities responded that they are planning to do this, but gradually. In particular, they are considering doubling the rice import quota from its current level of 4 percent of consumption and allowing foreign rice to be sold for the first time directly from retail outlets, provided partners agree to extend the 10-year WTO exemption from tariffication of rice that expires at end-2004. Also, in November, Korea signed its second FTA, with Singapore—a relatively comprehensive agreement that includes financial services, investment, and government procurement.

- **Data.** Korea's provision of data is broadly satisfactory for surveillance purposes. A vast array of high-quality statistics is published, with short time lags, providing a strong base for policy assessment. The team welcomed the authorities' plans to build on this base by developing more comprehensive data on the financial and fiscal sectors.

VI. Staff Appraisal

50. **After a long post-crisis boom, Korea's economy has begun to sputter.** One by one over the past two years, the domestic engines of growth have shut down. Spending by households and SMEs have slowed sharply because they accumulated too much debt during the boom years, while corporations have become reluctant to invest. As this has occurred, the economy has been forced to rely on merchandise exports, which boomed in late 2003, but have now slowed, reducing Korea's growth to low levels.

51. **Reviving the economy will consequently require restarting the domestic engines of growth.** To a certain extent, they are ready to restart on their own. Experience from other countries that have experienced credit boom-and-busts suggests that consumption should begin to revive in 2005. Moreover, the high rate of capacity utilization suggests that ultimately investment will recover, as well.

52. **The key policy challenge facing the authorities, then, is ensuring that this recovery will be strong and sustainable.** How can this be done? The first step would be to provide a macroeconomic spark, by implementing stimulative fiscal and monetary policies. In the staff's assessment, the 2005 budget submitted to the National Assembly as a whole is economically neutral. Moreover, while there are plans for additional investment spending, these involve

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[18] Chapter I of IMF Country Report No. 03/80 provides projected pension balances.

private-public partnerships which may take some time to materialize. (But when they do, the public sector outlays should be recorded transparently in the fiscal accounts.) Consequently, staff supports the authorities' plans to front-load budgetary spending, and urges the adoption of a supplementary budget, with additional social safety net spending.

53. **In the meantime, the task of macroeconomic management will fall mainly on monetary policy.** With core inflation remaining within the target range and inflation expectations under control, the staff believes there is scope for the central bank to provide support to the real economy. It consequently supports the recent reduction in interest rates, as well as Bank of Korea's plan to stand ready in case further reductions are required. Staff also commends the authorities' decision to allow the won to respond to market forces, noting that Korea's flexible exchange rate policy has served the country well, encouraging financial market development while maintaining external competitiveness.

54. **While macroeconomic stimulus can provide a spark for the economy, achieving sustained strong growth will require addressing the underlying structural difficulties.** This will require, first and foremost, addressing the household delinquency problem. The staff strongly supports the government's decision to stand firm against calls for a mandated debt reduction scheme, and instead establish a market-friendly framework within which debtors and creditors can work together to resolve their problems.

55. **The linchpin of such a framework, however, needs to be a working bankruptcy system, to provide a final resolution for those who cannot repay their debts and a standard for others, so as to encourage them to settle out of court.** For this reason, the staff endorses the plans to make bankruptcy a viable option, and suggests that the government go further in this direction by shortening the repayment period and reducing official discrimination against bankrupt persons. Staff also endorses the efforts to streamline the Personal Debt Rehabilitation Program. Most importantly, these reforms should be enacted speedily, for accelerating the pace of debt restructuring is critical for hastening the advent of the recovery. Meanwhile, to restore households' access to lending, staff recommends that the authorities promote the information sharing needed for an efficient system of competing credit bureaus.

56. **The second engine that needs to be restarted belongs to the SMEs.** For too long, resources flowing to these firms have tended to be allocated on the basis of government guarantees, mainly to businesses first identified in 1998. This has stifled the dynamism of the sector, taking a severe toll on its overall financial health.

57. **In the staff's view, reviving the SMEs requires a fundamental reform: the current government-led framework needs to be replaced by one where the private sector allocates resources, funding the firms with the most promising futures.** To do this, the amount of guarantees should be unwound in the medium-term, while the share of each loan covered by guarantees should be reduced, and the cost of rollovers increased. At the same time, to help SMEs grow, staff recommends measures to broaden the range of security for loans, expand the availability of venture capital, reduce start-up costs, and improve the efficiency of exits—the last, by passing the long-awaited unified insolvency law.

58. **Restarting the third engine of growth—spending by larger corporations—requires improving the investment environment.** And the key to doing this is modernizing the labor

market. Staff welcomes the recent improvement in industrial relations, but this still leaves a fundamental problem: strict employment protection for regular workers, which deters risky investments and has prompted a growing use of nonregular workers. These problems can only be resolved in one way, by reducing employment protection for regular workers. Accordingly, staff welcomes the plans to consider Spain's reform of introducing a new regular labor contract, with less protection. It also encourages trials of more flexible contracts in particular firms or industries. Meanwhile, the staff welcomes the plans to lay the groundwork for increased flexibility by expanding the coverage of the social safety net.

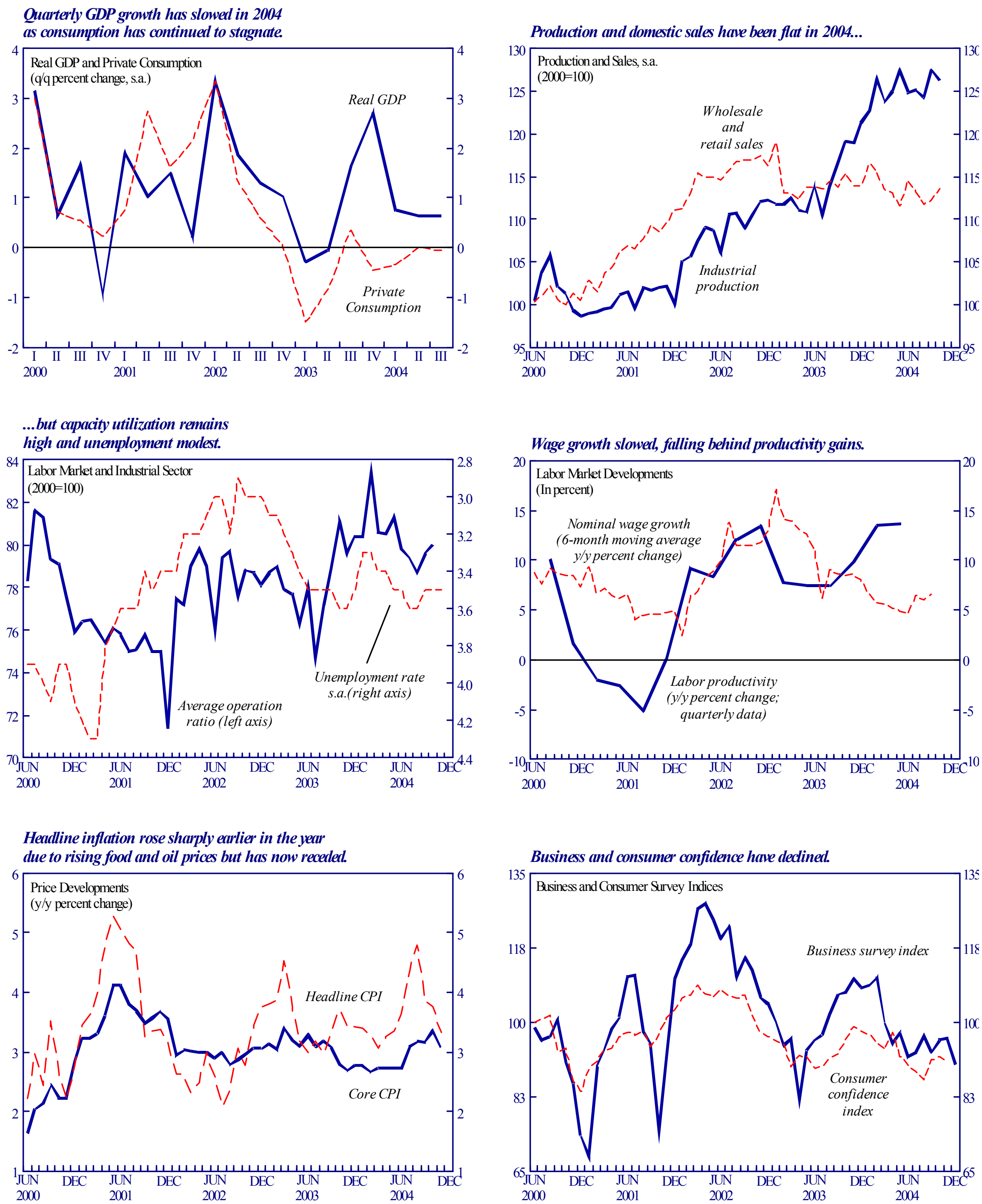
59. **Promoting investment also requires improving corporate governance and developing the bond market, so as to encourage markets to provide more financing, to more firms, at lower costs.** Accordingly, the staff welcomes the amendments to the Fair Trade Act, aimed at encouraging the *chaebol* to improve their governance. It also welcomes the introduction of class action lawsuits for securities law violations and encourages additional steps to reinforce market discipline on corporate governance, such as adopting a "comply or explain" system for the Code of Best Practices in Corporate Governance. In the bond market, what is needed most is for the government to refrain from bailing out investors, which has distorted the balance between reward and risk, stifling market development.

60. **Two final points.** First, the staff urges the government to play a leadership role in advancing global trade liberalization, including by further opening up Korea's heavily protected agricultural sector. Second, to build the credibility of the proposed Korea Investment Corporation, its objectives should be clarified, to ensure they are based on sound economic principles. These objectives should be supported by well-defined governance, transparency and accountability arrangements, to allow the public to confirm that the organization's activities are indeed consistent with its mandate.

61. **While this structural reform agenda is ambitious, staff remains fundamentally optimistic about Korea's economic prospects.** Time and again, the Korean authorities have demonstrated the willingness and ability to take decisive measures to address the economy's problems. In particular, ever since the Asian crisis, they have been dismantling the state-directed economic framework at an accelerated pace. By enacting this reform agenda, the authorities will go a long way toward completing this task, the task of building the comprehensive market-based framework that is the *sine qua non* for a return to sustained and rapid growth.

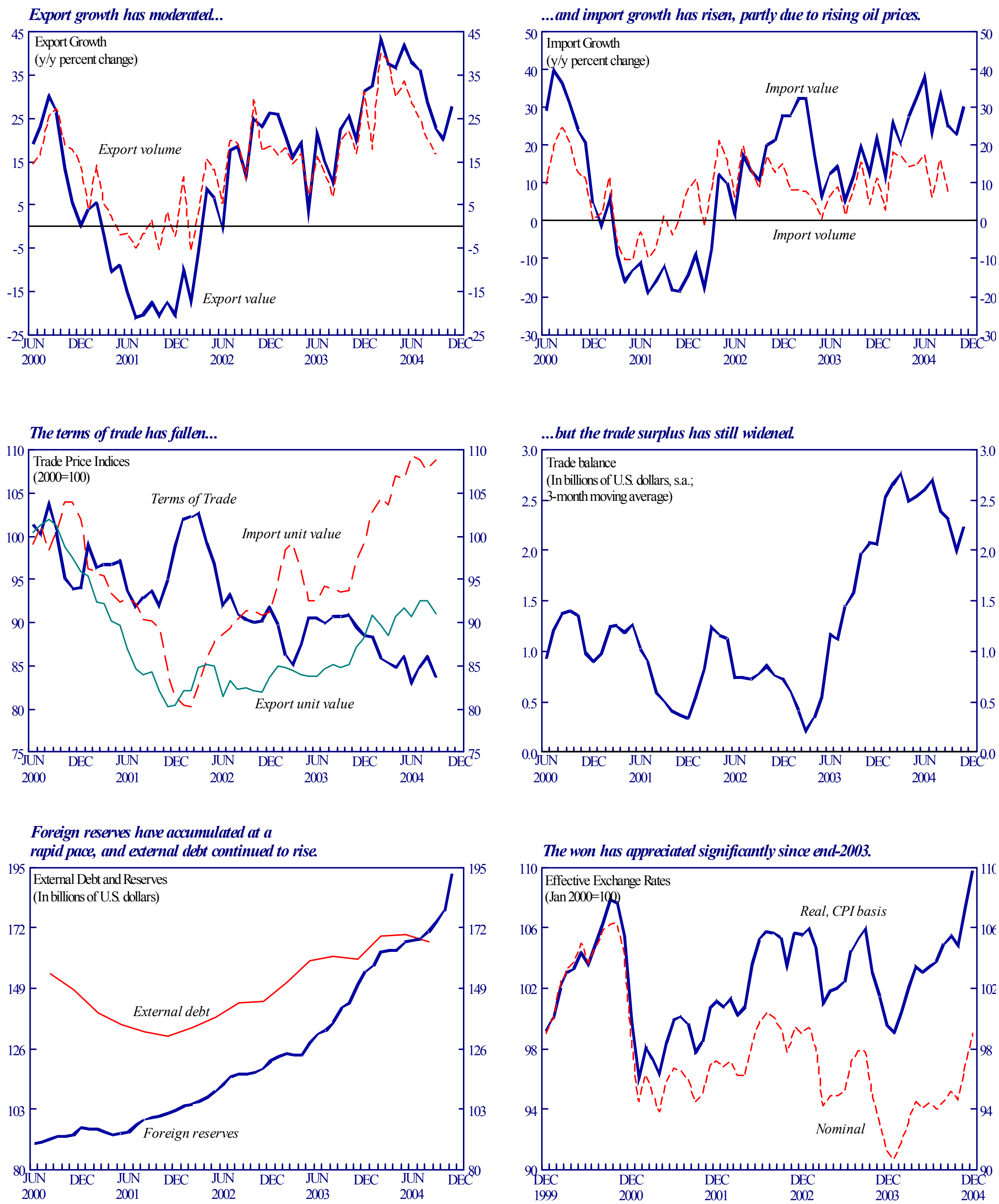
62. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Figure 1. Korea: Activity and Prices



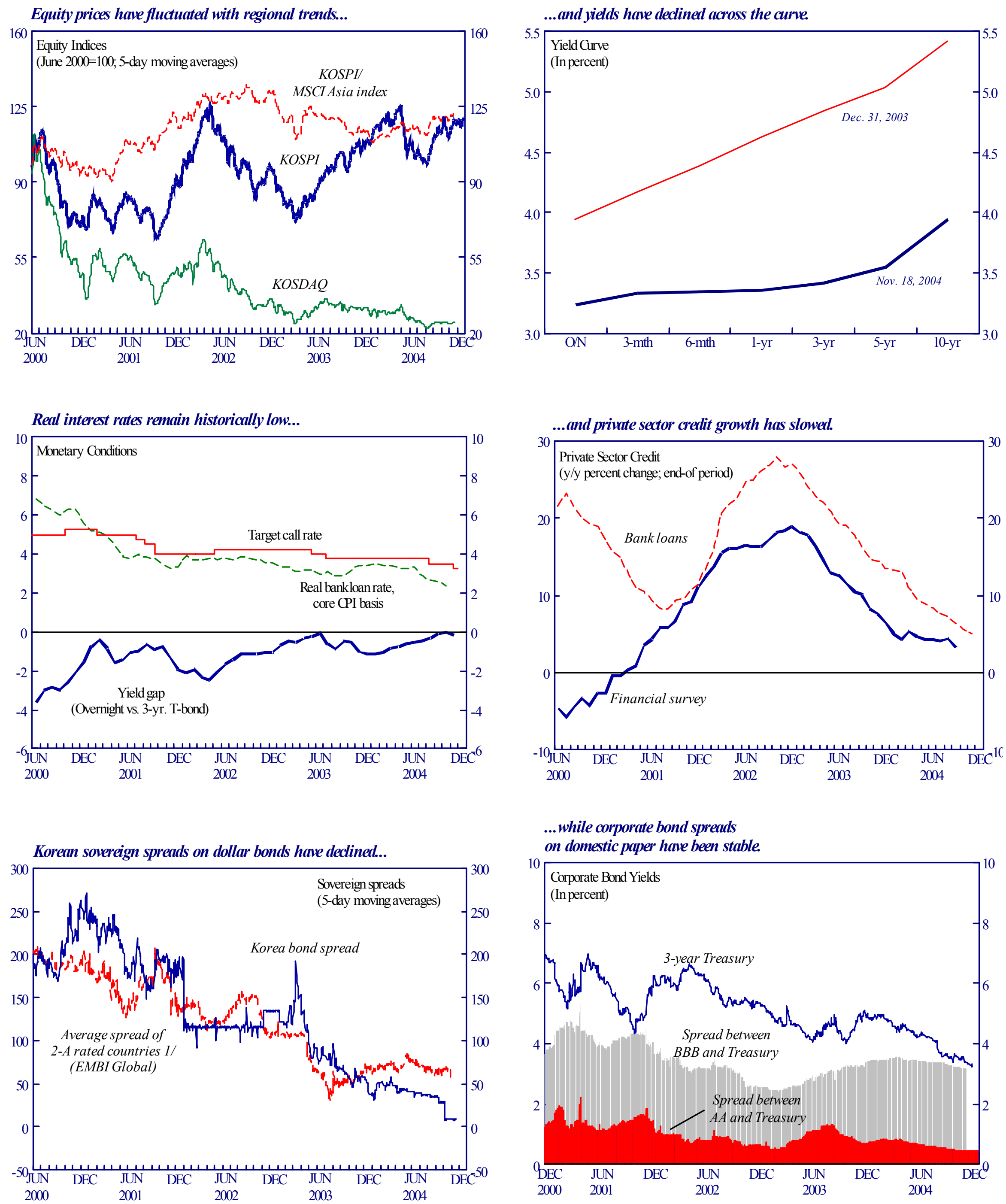
Sources: Korean authorities, CEIC database; and Fund staff calculations

Figure 2. Korea: External Developments



Sources: Korean authorities, CEIC database; and Fund staff calculations

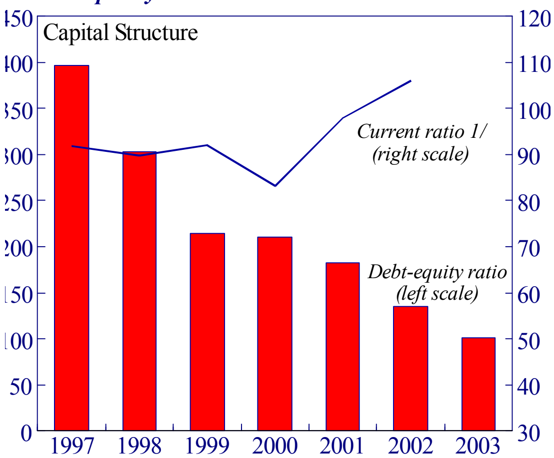
Figure 3. Korea: Financial Market Indicators



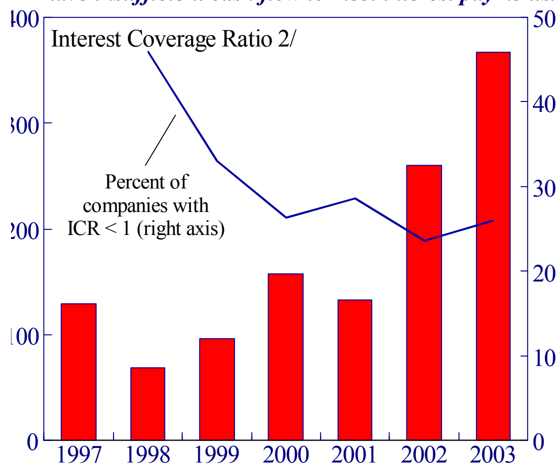
Sources: Korean authorities, CEIC database; and Fund staff calculations

Figure 4. Korea: Corporate and Financial Sector Soundness

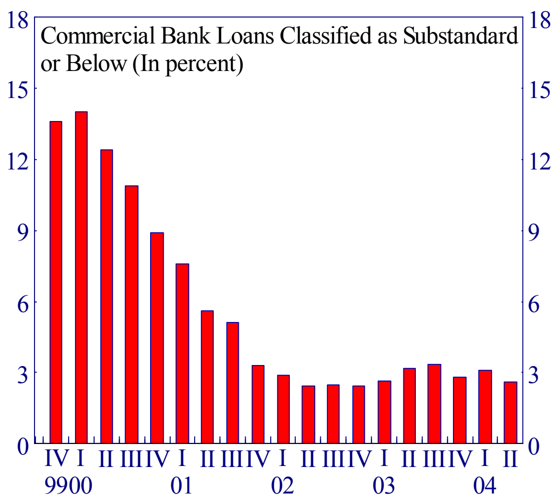
Corporate leverage has declined and liquidity has increased.



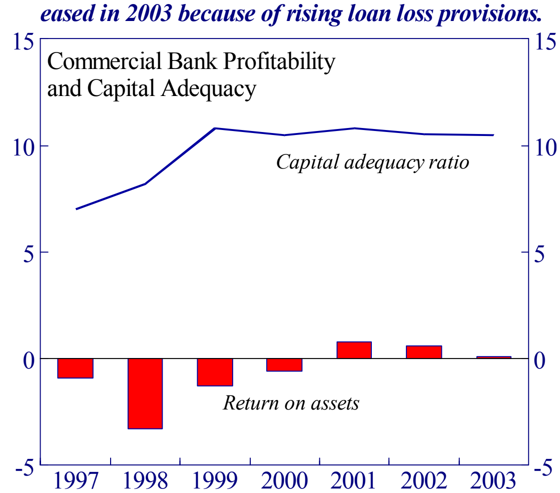
Profitability has improved but many companies still have insufficient cash flow to meet interest payments.



Impaired assets of commercial banks were stable in 2004.

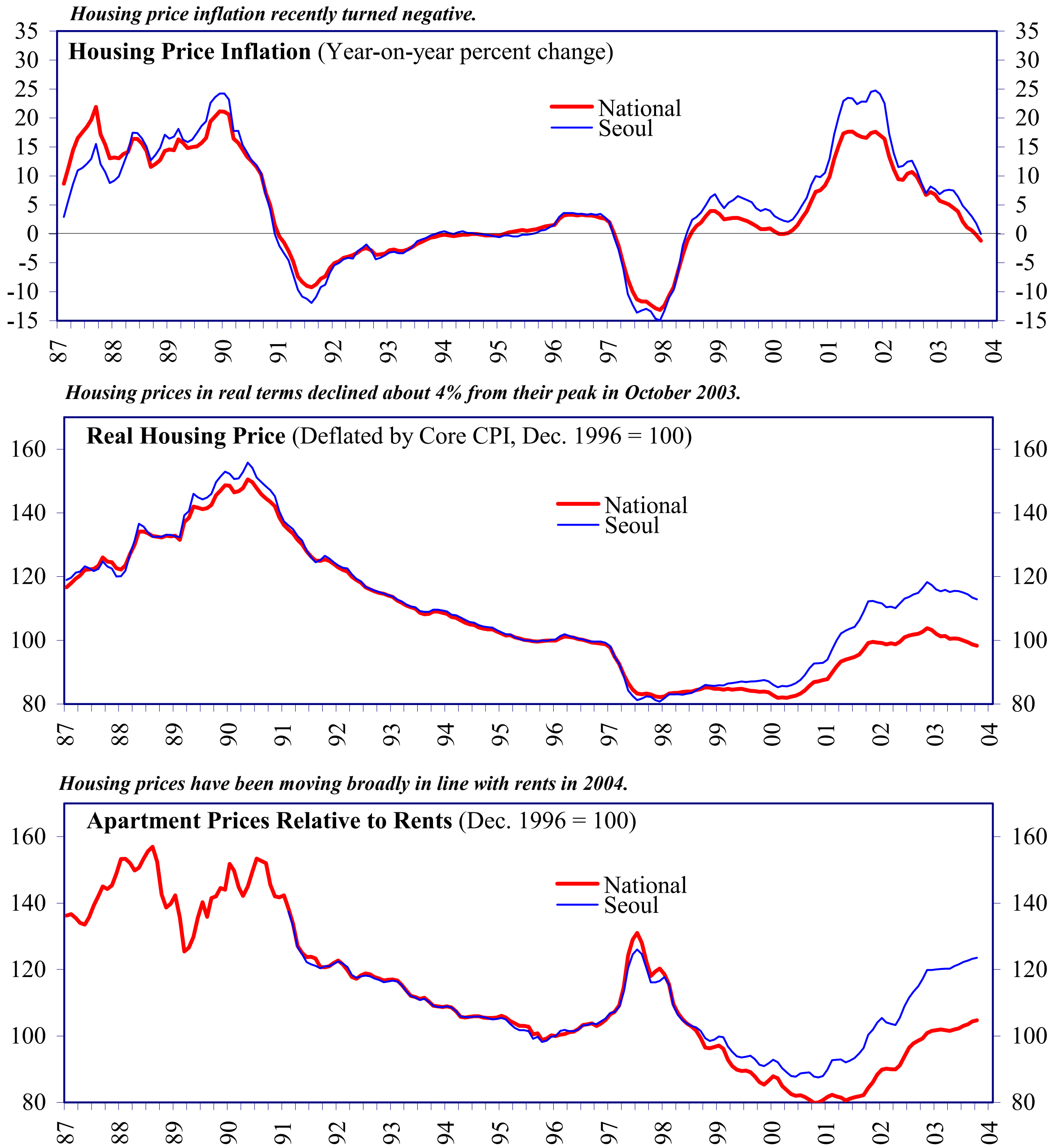


Capital adequacy has been stable but profitability eased in 2003 because of rising loan loss provisions.



Source: Bank of Korea and Financial Supervisory Services.
1/ Current assets divided by current liabilities.
2/ Operating profits divided by interest payments.

Figure 5. Korea: Housing Price Developments



Source: CEIC database and IMF staff calculations.

Table 1. Korea: Selected Indicators, 2000–05
(In units indicated)

	2000	2001	2002	2003	2004 Proj.	2005 Proj.
Real GDP (percent change)	**8.5**	**3.8**	**7.0**	**3.1**	**4.6**	**4.0**
Total domestic demand	8.2	3.3	7.0	0.1	1.4	2.6
Final domestic demand	8.7	3.3	7.3	0.8	0.8	2.0
Consumption	7.1	4.9	7.6	-0.5	0.0	1.7
Gross fixed investment	12.2	-0.2	6.6	3.6	2.6	2.6
Stock building [1]	-0.4	0.0	-0.2	-0.6	0.5	0.5
Net foreign balance [1]	0.3	0.5	-0.2	2.8	3.7	1.4
Nominal GDP (in trillions of won)	**578.7**	**622.1**	**684.3**	**721.3**	**780.1**	**836.4**
Saving and investment (in percent of GDP)						
Gross national saving	33.4	31.0	30.1	31.4	32.2	33.0
Gross domestic investment	31.0	29.3	29.1	29.4	28.4	29.1
Current account balance	2.4	1.7	1.0	2.0	3.8	3.9
Prices (percent change)						
CPI inflation (end of period)	2.8	3.2	3.7	3.4	3.2	3.2
Core inflation (average)	1.9	3.6	3.0	3.1	2.9	3.0
GDP deflator	0.7	3.5	2.8	2.3	3.4	3.1
Real effective exchange rate	8.1	-5.0	3.9	-1.4	-0.9	1.0
Trade (percent change)						
Export volume	20.7	-1.1	12.9	17.9	20.8	8.7
Import volume	18.3	-4.8	12.0	8.3	15.3	7.5
Terms of trade	-12.8	-4.5	-0.5	-6.1	-1.8	-1.5
Consolidated central government (in percent of GDP)						
Revenues [2]	23.5	23.2	23.2	23.8	23.9	23.9
Expenditure [2 3]	22.3	22.6	20.9	21.1	22.0	21.8
Overall balance [2 3]	1.1	0.6	2.3	2.8	2.0	2.1
excl. Social Security Funds [2]	-1.0	-1.9	-0.2	0.0	-0.9	-1.0
Fiscal impulse [2 4]	-3.3	0.2	-1.5	-0.6	0.4	-0.3
Money and credit (end of period)						
Overnight call rate [5]	5.3	4.0	4.3	3.8	3.5	…
Three-year corporate bond yield [5]	8.1	7.1	5.9	5.6	4.0	…
M3 growth	7.1	11.6	13.6	4.7	7.0	…
Balance of payments (in billion U.S. dollars)						
Exports, f.o.b.	176.2	151.5	163.4	197.6	250.6	275.1
Imports, c.i.f.	159.3	138.0	148.6	175.5	216.2	238.4
Oil imports	25.2	21.4	19.2	23.1	…	…
Current account balance	12.3	8.0	5.4	12.3	25.6	27.8
Usable reserves (end of period)	96.1	102.8	121.3	155.3	196.8	217.0
In percent of short-term debt [6]	153.1	193.1	195.2	196.9	256.5	275.3
External debt (in billion U.S. dollars)						
Total external debt (end of period)	148.5	130.8	144.0	159.8	171.5	183.4
Of which : short-term (end of period)	49.4	41.9	50.1	55.3	57.3	59.3
Total external debt (in percent of GDP)	29.0	27.2	26.3	26.4	25.7	25.5
Debt service ratio [6]	12.6	13.7	10.0	8.1	10.4	8.4

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

[1] Contribution to GDP growth.
[2] Refer to budget plan for 2005.
[3] Excluding privatization receipts and rollover of KDIC/KAMCO bonds.
[4] Change in the cyclically adjusted overall balance (excluding net lending in 2003). A negative impulse implies a contractionary stance.
[5] Data for 2004 are as of September 21, 2004.
[6] Debt service on medium- and long-term debt in percent of exports of goods and services.

Table 2. Korea: Consolidated Central Government Operations, 2001-05

	2001	2002	2003	2004		2005
	Actual	Actual	Actual	Budget [1]	Proj.	Budget
			(In trillions of won)			
Revenue	**144.0**	**158.7**	**171.7**	**185.3**	**186.6**	**199.9**
Tax revenue	95.8	104.0	114.7	122.1	122.1	130.6
Social security contributions	17.5	19.7	20.7	24.8	24.8	28.5
Nontax and capital revenue	30.7	35.0	36.4	38.4	39.8	40.8
Expenditure and net lending	**140.5**	**142.7**	**151.9**	**166.2**	**171.4**	**182.3**
Current expenditure [2]	107.8	113.2	123.9	134.6	138.0	151.1
Interest [3]	13.3	13.8	7.8	9.3	9.4	9.5
Of which: bank restructuring	6.1	6.9	3.2	3.1	3.1	2.9
Non-interest	94.5	99.4	116.1	125.3	128.7	141.6
Capital expenditure	24.9	29.4	30.6	26.3	26.6	24.4
Net lending [4]	7.7	0.2	-2.6	5.3	6.7	6.8
Balance	**3.6**	**16.0**	**19.8**	**19.1**	**15.3**	**17.6**
Financing	**-3.6**	**-16.0**	**-19.8**	**-19.1**	**-15.3**	**-17.6**
Domestic financing	-3.2	-15.5	-13.9	-15.9	-12.1	-14.3
Of which : Privatization	3.7	6.7	1.3	0.0	0.0	0.0
External Financing	-0.4	-0.5	-5.9	-3.2	-3.2	-3.3
			(In percent of GDP)			
Revenue	**23.2**	**23.2**	**23.8**	**23.8**	**23.9**	**23.9**
Tax revenue	15.4	15.2	15.9	15.6	15.6	15.6
Social security contributions	2.8	2.9	2.9	3.2	3.2	3.4
Nontax and capital revenue	4.9	5.1	5.0	4.9	5.1	4.9
Expenditure and net lending	**22.6**	**20.9**	**21.1**	**21.3**	**22.0**	**21.8**
Current expenditure	17.3	16.5	17.2	17.3	17.7	18.1
Interest	2.1	2.0	1.1	1.2	1.2	1.1
Noninterest	15.2	14.5	16.1	16.1	16.5	16.9
Capital expenditure	4.0	4.3	4.2	3.4	3.4	2.9
Net lending	1.2	0.0	-0.4	0.7	0.9	0.8
Balance	**0.6**	**2.3**	**2.8**	**2.4**	**2.0**	**2.1**
Excluding Social Security Funds	**-1.9**	**-0.2**	**0.0**	**-0.4**	**-0.9**	**-1.0**
Excluding Social Security Funds and net lending	**-0.7**	**-0.2**	**-0.3**	**0.2**	**-0.1**	**-0.2**
Primary balance	**2.7**	**4.3**	**3.8**	**3.6**	**3.2**	**3.2**
Memorandum items:						
Privatization receipts	0.6	1.0	0.2	0.0	0.0	0.0
Conversion of KDIC/KAMCO bonds	0.0	0.0	-1.8	-1.5	-1.5	-1.4
Fiscal impulse [5]	0.2	-1.5	-0.6	-0.1	0.4	-0.3
Nominal GDP (trillion won)	622.1	684.3	721.3	780.1	780.1	836.4

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

[1] Original budget, excluding supplementary budgets.

[2] The conversion of KDIC and KAMCO bonds is excluded, amounting to W13 trillion in 2003, and W12 trillion annually thereafter.

[3] From 2003 onward, interest payments on W49 trillion of KDIC/KAMCO bonds will no longer be included in the consolidated budget, amounting to 0.6 percent of GDP in 2003 and 0.4 percent of GDP in 2004.

[4] Excludes privatization receipts.

[5] Change in cyclically adjusted fiscal balance (including net lending).

Table 3. Korea: Monetary and Financial Indicators, 2001–04

	2001	2002	2003	2004			
				March	June	Sept.	Nov.
Bank of Korea			(In trillions of won)				
Reserve money	**32.8**	**38.0**	**40.7**	**38.8**	**42.3**	**41.8**	…
Net foreign assets	136.7	146.0	186.3	197.5	193.1	200.9	…
Foreign assets	145.6	158.1	196.6	229.0	216.1	223.8	…
Foreign liabilities	-8.9	-12.1	10.3	31.5	23.1	22.9	…
Net domestic assets	-103.9	-108.0	-145.5	-158.7	-150.7	-159.1	…
Public sector	-1.8	-6.2	0.5	2.3	5.1	4.7	…
Private financial sector	29.3	28.3	43.1	44.9	43.5	48.5	…
Monetary stabilization bond	-79.1	-84.3	-105.5	-119.6	-125.4	-124.7	…
Other items net	-52.2	-45.8	-83.6	-86.2	-73.9	-87.6	…
Depository Corporations Survey							
M2	**765.0**	**872.1**	**898.1**	**913.9**	**927.9**	**940.2**	…
Net foreign assets	129.9	118.2	151.8	167.7	171.6	182.5	…
Foreign assets	208.4	210.3	255.8	297.0	290.1	300.8	…
Foreign liabilities	-78.4	-92.1	104.0	129.3	118.5	118.3	…
Net domestic assets	635.0	753.9	746.2	746.3	756.3	757.8	…
Public sector	-12.3	-19.5	-19.0	-13.9	-10.2	-13.6	…
Nonfinancial private sector	734.6	887.1	930.1	945.4	949.4	956.4	…
Corporations	456.2	525.8	523.4	530.8	522.8	523.1	…
Households	278.4	361.3	406.7	414.6	426.6	433.4	…
Other items net	-87.2	-113.6	-164.9	-185.3	-182.9	-185.1	…
Financial survey							
M3	**1017.7**	**1155.7**	**1,209.8**	**1,234.1**	**1,256.3**	…	…
Net foreign assets	140.5	130.1	161.8	176.3	180.1	…	…
Foreign assets	201.1	211.7	253.4	292.5	283.7	…	…
Foreign liabilities	-60.6	-81.6	91.6	116.3	103.6	…	…
Net domestic assets	877.2	1025.7	1,047.9	1,057.8	1,076.2	…	…
Public sector	143.9	139.4	131.0	129.5	133.3	…	…
Private sector	786.1	935.2	995.2	1,013.9	1,015.0	…	…
Of which: Foreign currency	22.6	40.0	42.9	43.7	44.9	…	…
Other items net	-52.8	-48.9	-78.2	-85.6	-72.2	…	…
Household credit [1]	341.7	439.1	447.6	450.5	458.0	…	…
Memorandum items:			(Percent change, year-on-year)				
Reserve money	16.3	15.7	7.3	1.7	13.5	7.5	…
M2	8.1	14.0	3.0	2.9	5.2	6.7	…
M3	11.6	13.6	4.7	5.4	6.5	…	…
Private sector credit	11.1	19.0	6.4	5.3	4.4	…	…
Household credit [1]	28.0	28.5	1.9	2.5	4.3	…	…
Interest rates, end period			(In percent)				
Call rate target	4.00	4.25	3.75	3.75	3.75	3.50	3.25
Treasury bond, 3 year	5.91	5.11	4.82	4.50	4.24	3.53	…
Corporate bond, 3 year	7.11	5.88	5.61	5.37	4.91	4.10	…
Deposit rate	3.98	4.69	4.12	3.90	3.83	3.51	…
Household loan rate	7.26	7.12	6.31	6.11	6.00	5.66	…
Enterprise loan rate	6.75	6.41	6.18	6.13	6.08	5.77	…

Source: Bank of Korea.

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

Table 4. Korea: Balance of Payments, 2000–05

(In billions of U.S. dollars, unless otherwise indicated)

	2000	2001	2002	2003	2004 Proj.	2005 Proj.
1. Current account balance	12.3	8.0	5.4	12.3	25.6	27.8
Trade balance	17.0	13.5	14.8	22.2	34.4	36.7
Exports	176.2	151.5	163.4	197.6	250.6	275.1
(growth rate, in percent)	(21.2)	(-14.0)	(7.9)	(20.9)	(26.8)	(9.8)
Imports	159.3	138.0	148.6	175.5	216.2	238.4
(growth rate, in percent)	(36.2)	(-13.4)	(7.7)	(18.1)	(23.2)	(10.3)
Services	-2.8	-3.9	-8.2	-7.6	-6.6	-6.7
Income	-2.4	-1.2	0.4	0.6	0.7	0.7
Current transfers	0.6	-0.4	-1.6	-2.8	-2.9	-2.9
2. Financial and capital account balance	12.1	2.3	5.9	13.8	5.1	-5.1
Financial account	12.7	3.0	7.0	15.1	6.5	-3.7
Portfolio equity investment, net	12.6	9.8	-1.1	12.2	12.0	6.0
Portfolio debt flows, net	-0.6	-3.2	1.4	5.7	4.5	2.5
Direct investment, net	4.3	1.1	-0.2	-0.2	2.5	1.0
Inflows	9.3	3.5	2.4	3.2	7.5	6.0
Outflows	-5.0	-2.4	-2.6	-3.4	-5.0	-5.0
Trade credits, net	3.6	-3.9	2.8	4.1	2.8	3.0
Loans, net	-7.1	-4.4	6.7	-7.1	-12.0	-13.0
Short term	-4.7	-1.8	9.4	-3.3	-10.5	-11.5
Medium and long term	-2.4	-2.6	-2.7	-3.8	-1.5	-1.5
Liabilities	-3.9	-3.3	-3.1	-3.3	0.0	0.0
Assets	1.5	0.7	0.5	-0.5	-1.5	-1.5
Currency and deposits	0.5	1.4	-0.3	-0.8	-0.3	0.0
Others	-0.6	2.3	-2.3	1.2	-3.0	-3.3
Capital account	-0.6	-0.7	-1.1	-1.4	-1.4	-1.4
3. Net errors and omissions	-0.6	2.9	0.5	0.4	1.0	0.0
4. Overall balance (1+2+3)	23.8	13.3	11.8	26.4	31.7	22.7
5. Financing	-23.8	-13.3	-11.8	-26.4	-31.7	-22.7
Change in usable reserves (increase -)	-23.8	-7.6	-11.8	-25.8	-30.5	-20.2
Net IMF purchases	0.0	-5.7	0.0	0.0	0.0	0.0
World Bank/AsDB [1]	0.0	0.0	0.0	-0.6	-1.2	-2.5
Memorandum items:						
Current account balance (in percent of GDP)	2.4	1.7	1.0	2.0	3.8	3.9
Trade balance (in percent of GDP)	3.3	2.8	2.7	3.7	5.2	5.1
Gross reserves	96.1	102.8	121.3	155.3	196.8	217.0
(in months of imports of goods and services)	6.0	7.2	7.9	8.6	9.1	9.1
External debt	148.5	130.8	144.0	159.8	171.5	183.4
(in percent of GDP)	29.0	27.2	26.3	26.4	25.7	25.5
Short-term external debt (inc. trade credits)	49.4	41.9	50.1	55.3	57.3	59.3
Nominal GDP	511.6	481.8	546.9	605.4	666.7	718.5

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

[1] These World Bank and Asian Development Bank loans were extended as exceptional financing in the 1997-98 crisis.

Table 5. Korea: Medium-term Projections, 2002–09
(In units indicated)

	2002	2003	2004	2005	2006	2007	2008	2009
		Est.	Staff Projections					
Real GDP (percent change)	**7.0**	**3.1**	**4.6**	**4.0**	**5.2**	**5.5**	**5.3**	**5.2**
Total domestic demand	7.0	0.1	1.4	2.6	4.9	5.6	5.4	5.4
Final domestic demand	7.3	0.8	0.8	2.0	4.9	5.7	5.4	5.4
Consumption	7.6	-0.5	0.0	1.7	4.8	6.1	5.7	5.7
Gross fixed investment	6.6	3.6	2.6	2.6	5.2	4.8	4.8	4.8
Stock building [1]	-0.2	-0.6	0.5	0.5	0.0	0.0	0.0	0.0
Net foreign balance [1]	-0.2	2.8	3.7	1.4	0.8	0.5	0.5	0.3
Prices, period average (percent change)								
Consumer price	2.8	3.5	3.6	3.0	3.0	3.0	3.0	3.0
GDP deflator	2.8	2.3	3.4	3.1	2.5	2.3	2.4	2.4
Savings and investment (percent of GDP)								
Gross national savings	30.1	31.4	32.2	33.0	32.9	32.1	31.5	30.7
Gross domestic investment	29.1	29.4	28.4	29.1	29.6	29.6	29.6	29.6
Current account balance	1.0	2.0	3.8	3.9	3.3	2.5	1.9	1.1
Consolidated central government (in percent of GDP)								
Revenues	23.2	23.8	23.9	23.9	23.8	23.7	23.6	23.6
Expenditure	20.9	21.1	22.0	21.8	21.1	20.8	20.5	20.2
Balance [2]	2.3	2.8	2.0	2.1	2.7	2.9	3.1	3.4
excl. Social Security Funds	-0.2	0.0	-0.9	-1.0	-0.6	-0.4	0.0	0.3
Debt, domestic plus external [3]	18.5	22.0	23.0	24.0	24.2	24.0	23.4	21.6
Government guaranteed restructuring bonds [3]	13.9	10.7	8.1	5.7	3.6	1.7	0.0	0.0
Trade (percent change)								
Merchandise exports	7.9	20.9	26.8	9.8	10.0	11.4	11.5	11.4
Volumes [4]	12.9	17.9	20.8	8.7	9.8	10.7	10.5	10.4
Merchandise imports	7.7	18.1	23.2	10.3	12.2	14.0	13.7	13.8
Volumes [4]	12.0	8.3	15.3	7.5	10.6	12.4	12.0	12.1
Terms of trade	-0.5	-6.1	-1.8	-1.5	-1.3	-0.8	-0.6	-0.6
Balance of payments (billion U.S. dollars)								
Current account	5.4	12.3	25.6	27.8	25.4	21.3	17.1	10.8
Trade balance	14.8	22.2	34.4	36.7	35.1	32.0	28.9	23.8
Merchandise exports	163.4	197.6	250.6	275.1	302.5	336.8	375.5	418.1
Merchandise imports	148.6	175.5	216.2	238.4	267.4	304.8	346.6	394.4
External debt								
In billion of U.S. dollars [5]	144.0	159.8	171.5	183.4	196.5	212.2	228.8	246.1
(as percent of GDP)	26.3	26.4	25.7	25.5	25.2	25.1	25.0	24.8
Debt service ratio [6]	10.0	8.1	10.4	8.4	7.9	7.2	6.4	6.3
Memorandum items:								
Nominal GDP (trillion won)	684.3	721.3	780.1	836.4	901.7	973.5	1,049.9	1,131.0
Output gap (percent of potential GDP)	1.4	-0.8	-1.0	-1.4	-1.0	-0.5	-0.2	0.0

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

[1] Contribution to GDP.

[2] Excluding privatization receipts and conversion of KDIC/KAMCO bonds into treasury bonds.

[3] During 2003-06, W49 trillion in government guaranteed KDIC/KAMCO bonds 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: Financial Soundness Indicators, 1997-2004

	1997	1998	1999	2000	2001	2002	2003	Latest Available	Date
Financial Sector				(In percent)					
Total loans/GDP	…	…	111.6	107.4	103.6	119.5	...	...	
Commercial banks	…	…	62.0	62.5	60.9	67.9	69.2	66.2	Sep-04
Other financial institutions	…	…	49.6	44.9	42.6	51.6	...	...	
Commercial banks									
Capital adequacy ratio	6.7	8.2	10.8	10.5	10.8	10.5	10.5	10.9	Jun-04
Tier 1 capital ratio	4.7	…	…	6.3	6.7	5.7	6.2	6.7	Jun-04
Precautionary or below loans, share	…	…	21.2	14.0	7.9	5.7	6.0	5.9	Jun-04
Substandard or below loans, share	…	…	13.6	8.9	3.3	2.4	2.8	2.4	Sep-04
Return on assets	-1.0	-3.3	-1.3	-0.6	0.8	0.6	0.1	...	
Net interest margin	…	…	2.9	2.7	3.0	2.9	2.8	2.8	Sep-04
Corporate Sector									
Corporate debt/GDP	140.0	143.9	123.9	118.0	114.2	107.2	105.8	103.5	Jun-04
Enterprise delinquency ratio to banks	…	8.9	4.4	3.4	2.1	2.0	2.1	2.4	Sep-04
Debt ratio to:									
equity	396.3	303.0	214.7	210.6	182.2	135.4	123.4	...	
total assets	54.2	50.8	42.8	41.2	39.8	31.7	28.3	...	
sales	66.4	62.7	52.8	42.7	40.1	29.8	26.6	...	
Interest coverage ratio [1]	129.1	68.3	96.1	157.2	132.6	260.3	367.1	...	
Percent of companies < 100	41.4	45.8	32.6	26.3	28.6	23.5	26.2	...	
Current assets/current liabilities	91.8	89.8	92.0	83.2	97.9	106.1	109.8	...	
Operating income/sales	8.3	6.1	6.6	7.4	5.5	6.7	6.9	...	
Financial expenses/sales	-6.4	-9.0	-6.9	-4.7	-4.2	-2.6	-1.9	...	
Ordinary income/sales	-0.3	-1.9	1.7	1.3	0.4	4.7	4.7	...	
Household Sector									
				(In percent of GDP)					
Household credit	41.1	37.9	38.6	45.3	54.3	62.5	59.9	58.9	Sep-04
Of which : Commercial Bank	10.8	10.9	13.8	18.2	24.9	31.6	34.0	34.3	Sep-04
Delinquency ratio				(In percent)					
Bank loan	…	…	2.4	2.5	1.3	1.5	1.8	1.9	Sep-04
Credit card debt	…	…	…	…	…	6.0	14.1	11.6	Sep-04
Including re-aged loans	…	…	…	…	…	5.2	21.5	22.8	May-04
				(In million persons)					
Deliquent individuals	…	…	…	2.08	2.45	2.63	3.72	3.69	Jun-04
Of which : Credit card related	…	…	…	0.80	1.04	1.51	2.40	2.52	Jun-04
Housing prices, percent change	2.0	-12.3	3.4	0.4	9.9	16.4	5.7	-2.4	Nov-04
Of which : Seoul	2.0	-13.2	5.5	3.0	13.0	22.5	6.8	-1.6	Nov-04
Ratio of housing price to rent	100	108	95	86	81	86	92	94	Nov-04
Of which : Seoul apartment	100	110	93	87	84	99	112	116	Nov-04

Sources: BOK, FSS, Korean Federation of Banks, Kookmin Bank.

[1] Operating income to gross interest payments. Operating income treats depreciation as a expense, so this 'ratio is lower than calculations using earnings before interest, taxes, and depreciation allowance (EBITDA).

Table 7. Korea: Indicators of External Vulnerability, 1999-2004
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	2004 Date
Financial indicators							
Total general government debt [1]	30.6	31.0	35.3	33.5	…	...	
Consolidated central government debt [1]	28.9	29.2	33.8	32.4	32.7	31.1	Proj.
Broad money (M3, percent change, 12-month basis)	8.0	7.1	11.6	13.6	4.7	7.2	Sep-04
Private sector credit (Fin. survey, percent change, 12 month basis)	-0.1	-2.7	11.1	19.0	6.4	6.0	Aug-04
One month call borrowing rate	4.9	5.3	4.0	4.3	3.8	3.2	Nov-04
One month call borrowing rate (real)	4.1	3.1	0.8	0.6	0.3	-0.5	Oct-04
External indicators							
Exports (percent change, 12-month basis in US$)	9.9	21.2	-14.0	7.9	20.9	20.1	Oct-04
Imports (percent change, 12-month basis in US$)	29.1	36.2	-13.4	7.7	18.1	23.3	Oct-04
Terms of trade (percent change, 12 month basis)	-2.1	-12.8	-4.5	-0.5	-6.1	-3.1	Sep-04
Current account balance (projection for full year)	5.5	2.4	1.7	1.0	2.0	3.8	Proj.
Capital and financial account balance (projection for full year)	0.4	2.4	-0.7	1.1	2.2	0.8	Proj.
Of which : Inward portfolio investment in the form of debt	-1.2	-0.2	0.3	0.7	1.2	1.3	Proj.
Inward other investment (loans, trade credits etc.)	-2.0	-0.3	-3.6	0.8	0.0	0.5	Proj.
Gross official reserves (in US$ billion)	74.1	96.2	102.8	121.4	155.4	192.6	Nov-04
Central Bank short-term foreign liabilities (in US$ billion)	1.2	1.1	1.3	1.4	1.4	1.8	Jun-04
Short-term foreign liabilities of the financial sector (in US$ billion)	33.8	37.7	32.4	40.6	46.0	47.1	Jun-04
Official reserves in months of imports GS (projection for full year)	6.2	6.0	7.2	7.9	8.6	9.1	Proj.
Broad money(M3) to reserves	10.1	7.5	7.4	7.9	6.5	6.4	Sep-04
Reserves to total short-term external debt (in percent) [2]	125.6	153.2	193.3	195.3	197.0	256.5	Proj.
Total external debt	34.4	29.0	27.2	26.3	26.4	25.7	Proj.
Of which : Public sector debt	7.3	6.0	4.8	4.1	3.0	2.7	Jun-04
Total external debt to exports GS (in percent)	89.0	71.8	72.5	75.1	69.4	59.4	Proj.
External interest payments to exports GS (in percent)	3.5	3.8	2.9	1.7	1.0	1.0	Proj.
External amortization payments to exports GS (in percent)	18.0	8.0	9.6	6.4	5.3	8.2	Proj.
Exchange rate (per US$, period average)	1,189	1,131	1,291	1,251	1,193	1,090	Nov 24, 04
REER appreciation (+) (12-month basis)	13.5	8.1	-5.0	3.9	-1.4	-1.7	Oct-04
Financial market indicators							
Stock market index (KOSPI)	1,028	505	694	628	811	877	Nov 24, 04
Stock market index (KOSPI, percent change, 12-month basis)	82.8	-50.9	37.4	-9.5	29.2	10.3	Nov 24, 04
Foreign currency debt rating (Moody's/S&P)	Baa2/BBB	Baa2/BBB	Baa2/BBB+	A3/A-	A3/A-	A3/A-	Nov 24, 04
Global bond spread (Source: Bloomberg, in bps, end of period)	157	241	197	135	36	8	Nov 24, 04

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

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

[2] Short-term debt measured on a residual maturity basis.

DEBT SUSTAINABILITY ANALYSIS

Korea has relatively low public and external debt, and its debt dynamics are robust to most shocks, although population aging casts a cloud over the longer-run fiscal outlook. Korea's external debt/GDP ratio is estimated at 25¾ percent in 2004 and the central government debt/GDP ratio at 23 percent. This annex outlines the main assumptions and results of an analysis of Korea's public and external debt sustainability.

Korea's remaining structural problems in the household and SME sectors expose it to a domestic demand shock. SME failures could trigger a decline in property prices, reducing consumption and investment, which would further reduce SME profitability.

The country-specific scenario used in the sustainability analysis includes such a domestic demand shock. Korean growth has a high standard deviation in the last 10 years at 4.8 percent, so a shock of one standard deviation would imply a 0.8 percent decline in real GDP in 2005. The scenario also assumes that the exchange rate depreciates by 5 percent. The primary fiscal balance would fall as revenues decline while primary spending is unchanged in real terms, but the current account surplus would rise as imports decline.

Public debt remains below 50 percent of GDP even in the face of extreme shocks (Annex I, Table A1). In the baseline, public debt remains broadly stable as a ratio to GDP, as the central government budget returns to balance (excluding the accumulation of social security funds) in 2008 in line with the government's medium-term fiscal plan, and as GDP growth offsets the increase in debt due to the planned rollover of guaranteed bonds into treasury bonds amounting to 8 percent of GDP (Box 3, IMF Country Report 03/79). The shock to real GDP (B2) has the greatest impact, lifting public debt to 46 percent of GDP by 2009, but the shock is extreme, with a permanent GDP fall of 18 percent below its historical average, and the primary deficit rising by 4 percentage points of GDP. Public debt rises to 34¾ percent of GDP with variables at their historical average (A1), but this is because the social security surplus was small in the past and because of the impact of the 1997–98 crisis on the fiscal balance. Under the above country-specific scenario, public debt rises modestly, to 25¾ percent of GDP.

External debt is most sensitive to exchange rate shocks, but shocks of the assumed magnitude appear very unlikely (Annex I, Table A2). Korean external debt is projected to remain about 25 percent of GDP in the baseline, as the current account surplus declines toward balance and as net nondebt creating inflows decline from the high levels after the crisis. Most shocks have a relatively modest impact on the external debt path, but the two exchange rate shocks have a substantial impact:

- a 30 percent exchange rate depreciation (B6) lifts the external debt ratio to 42¾ percent;
- a two standard deviation shock (B3) lifts the external debt ratio to 62½ percent—the exchange rate falls by 55 percent given the 13.5 percent standard deviation of the exchange rate due to the volatility in 1997–98.

Such large permanent shocks to the real exchange rate seem highly unlikely for a manufactured goods exporting country like Korea.

In the longer-run, Korea faces a rapid aging of its population, presenting a major risk to fiscal sustainability. The National Pension System is projected to swing into deficits of as much as 8 percent of GDP after 2030.[1] In 2003 the authorities proposed to phase in reforms over time, including lowering the income replacement rate to 50 percent by 2008 from the current 60 percent, and raising the contribution rate to 16 percent by 2030 from the current 9 percent. The authorities estimate that the proposed reforms will avoid exhaustion of the NPF, which would otherwise occur by 2047. However, the National Assembly has not approved these reforms, largely due to union resistance to these additional measures on top of the reforms that were adopted in 1998. The opposition party has drafted an alternative plan and a Presidential committee is working on another alternative plan, so the nature and timing of pension reforms is currently unclear.

[1] See Gruenwald, 2003, "Options for Pension System Sustainability in Korea," *Selected Issues*, IMF Country Report No. 03/80.

Table A1. Korea: Public Sector Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

		Actual							Projections						
		1999	2000	2001	2002	2003			2004	2005	2006	2007	2008	2009	
									I. Baseline Projections						**Debt-stabilizing primary balance 11/**
1	**Public sector debt 1/**	16.9	17.4	18.2	18.5	22.0			**23.0**	**24.0**	**24.2**	**24.0**	**23.4**	**21.6**	**-0.2**
	o/w foreign-currency denominated	4.5	4.3	4.1	3.4	2.4			2.0	1.6	1.4	1.1	0.9	1.0	
2	Change in public sector debt	2.2	0.5	0.7	0.3	3.5			1.0	1.0	0.2	-0.2	-0.6	-1.8	
3	Identified debt-creating flows (4+7+12)	0.2	-3.1	-2.6	-6.3	-2.4			-2.5	-2.4	-3.2	-3.5	-3.7	-5.0	
4	Primary deficit	1.2	-3.3	-2.7	-4.3	-3.8			-3.2	-3.2	-4.2	-4.5	-4.7	-4.8	
5	Revenue and grants	20.4	23.5	23.2	23.2	23.8			23.9	23.9	23.8	23.7	23.6	23.6	
6	Primary (noninterest) expenditure	21.6	20.2	20.4	18.8	20.0			20.8	20.7	19.6	19.2	18.9	18.7	
7	Automatic debt dynamics 2/	-0.4	0.2	0.1	-1.0	-0.4			-0.9	-0.6	-0.3	-0.2	-0.2	-0.2	
8	Contribution from interest rate/growth differential 3/	-0.2	-0.2	-0.1	-0.7	-0.3			-0.9	-0.6	-0.3	-0.2	-0.2	-0.2	
9	Of which contribution from real interest rate	1.1	1.1	0.6	0.5	0.2			0.1	0.3	0.9	1.0	1.0	0.9	
10	Of which contribution from real GDP growth	-1.3	-1.3	-0.6	-1.2	-0.5			-0.9	-0.9	-1.2	-1.2	-1.2	-1.1	
11	Contribution from exchange rate depreciation 4/	-0.3	0.5	0.2	-0.4	0.0			...	...	...	...	...	...	
12	Other identified debt-creating flows	-0.6	0.0	0.0	-1.0	1.8			1.5	1.4	1.3	1.2	1.1	0.0	
13	Privatization receipts (negative)	-0.6	0.0	0.0	-1.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	1.8			1.5	1.4	1.3	1.2	1.1	0.0	
15	Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3) 5/	2.0	3.6	3.3	6.6	5.9			3.4	3.4	3.4	3.3	3.2	3.2	
	Public sector debt-to-revenue ratio 1/	83.1	74.3	78.5	79.8	92.5			96.0	100.4	101.5	101.2	99.2	91.7	
	Gross financing need 6/	3.0	-1.1	-0.6	-2.3	-2.8			-2.0	-2.1	-2.7	-2.9	-3.1	-3.4	
	in billions of U.S. dollars	13.5	-5.8	-2.8	-12.8	-16.7	10-Year Historical Average	10-Year Standard Deviation	-13.1	-15.1	-20.9	-24.5	-28.8	-33.3	Projected Average
	Key Macroeconomic and Fiscal Assumptions														
	Real GDP growth (in percent)	9.5	8.5	3.8	7.0	3.1	5.4	4.8	4.6	4.0	5.2	5.5	5.3	5.2	5.0
	Average nominal interest rate on public debt (in percent) 7/	8.2	7.7	7.1	6.1	3.6	6.5	1.2	4.0	4.4	6.6	7.0	6.9	6.7	5.9
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	8.3	6.9	3.6	3.2	1.3	2.5	3.1	0.5	1.3	4.1	4.7	4.5	4.3	3.2
	Nominal appreciation (increase in US dollar value of local currency, in percent)	5.8	-10.0	-3.7	9.7	1.4	-1.0	22.3	...	...	...	...	...	...	...
	Inflation rate (GDP deflator, in percent)	-0.1	0.7	3.5	2.8	2.3	4.0	2.6	3.4	3.1	2.5	2.3	2.4	2.4	2.7
	Growth of real primary spending (deflated by GDP deflator, in percent)	5.3	2.8	5.2	-0.8	6.0	7.4	4.7	8.4	2.5	-0.8	3.2	3.6	4.1	3.5
	Primary deficit	1.2	-3.3	-2.7	-4.3	-3.8	-1.1	2.4	-3.2	-3.2	-4.2	-4.5	-4.7	-4.8	-4.1
									II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 11/**
	A. Alternative Scenarios														
	A1. Key variables are at their historical averages in 2005-09 8/								**23.0**	**26.0**	**28.9**	**31.4**	**33.7**	**34.8**	**-1.0**
	A2. No policy change (constant primary balance) in 2005-09								**23.0**	**24.9**	**26.5**	**28.0**	**29.3**	**29.5**	**-0.3**
	A3. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation 9/								**23.0**	**27.6**	**28.6**	**28.5**	**27.8**	**25.8**	**-0.2**
	B. Bound Tests														
	B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006								**23.0**	**25.6**	**26.9**	**26.6**	**26.1**	**24.2**	**-0.2**
	B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**23.0**	**28.1**	**35.8**	**40.1**	**43.9**	**46.1**	**-0.4**
	B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006								**23.0**	**31.0**	**39.0**	**38.7**	**38.0**	**36.1**	**-0.3**
	B4. Combination of B1-B3 using one standard deviation shocks								**23.0**	**30.4**	**38.3**	**38.4**	**38.1**	**36.4**	**-0.3**
	B5. One time 30 percent real depreciation in 2005 10/								**23.0**	**25.0**	**25.1**	**24.9**	**24.4**	**22.5**	**-0.2**
	B6. 10 percent of GDP increase in other debt-creating flows in 2005								**23.0**	**34.0**	**34.1**	**33.8**	**33.1**	**31.2**	**-0.3**

1/ Central government debt. Includes projected conversion of publicly guaranteed debt of KDIC and KAMCO into treasury bonds, see Box 3 of IMF Country Report 03/79.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes. The large residual is due to asset accumulation of the National Pension Fund.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ The implied change in other key variables under this scenario is discussed in the text.
10/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
11/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.

Table A2. Korea: External Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	1999	2000	2001	2002	2003			2004	2005	2006	2007	2008	2009	
								I. Baseline Projections						**Debt-stabilizing non-interest current account 7/**
1 **External debt**	34.3	29.0	27.2	26.3	26.4			**25.7**	**25.5**	**25.2**	**25.1**	**25.0**	**24.8**	**-1.8**
2 Change in external debt	-13.1	-5.3	-1.9	-0.8	0.1			-0.7	-0.2	-0.3	-0.1	-0.1	-0.2	
3 Identified external debt-creating flows (4+8+9)	-19.9	-10.0	-2.1	-4.0	-6.6			-7.1	-5.8	-5.1	-4.6	-4.0	-3.3	
4 Current account deficit, excluding interest payments	-5.5	-4.3	-3.2	-2.2	-3.1			-4.8	-4.9	-4.3	-3.5	-2.9	-2.2	
5 Deficit in balance of goods and services	-6.2	-2.8	-2.0	-1.2	-2.4			-4.2	-4.2	-3.6	-2.8	-2.2	-1.4	
6 Exports	38.6	40.4	37.5	35.1	38.0			43.3	44.0	44.5	45.5	46.7	47.8	
7 Imports	32.3	37.7	35.5	33.9	35.6			39.1	39.8	40.9	42.7	44.5	46.5	
8 Net non-debt creating capital inflows (negative)	-3.7	-3.2	-2.2	0.3	-2.0			-2.1	-1.0	-0.6	-0.8	-0.9	-1.0	
9 Automatic debt dynamics 1/	-10.7	-2.6	3.3	-2.0	-1.5			-0.1	0.0	-0.2	-0.3	-0.2	-0.1	
10 Contribution from nominal interest rate	0.0	1.9	1.5	1.2	1.1			1.0	1.0	1.0	1.0	1.0	1.1	
11 Contribution from real GDP growth	-3.5	-2.5	-1.2	-1.7	-0.7			-1.1	-1.0	-1.2	-1.3	-1.2	-1.2	
12 Contribution from price and exchange rate changes 2/	-7.2	-1.9	3.0	-1.6	-1.8			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	6.8	4.7	0.2	3.1	6.6			6.4	5.6	4.8	4.4	3.9	3.1	
External debt-to-exports ratio (in percent)	89.1	71.8	72.5	75.1	69.4			59.4	58.0	56.7	55.2	53.6	51.9	
Gross external financing need (in billions of US dollars) 4/	14.5	46.7	58.7	48.8	49.8			53.3	48.9	53.4	59.8	66.1	77.0	
in percent of GDP	3.3	9.1	12.2	8.9	8.2			8.0	6.8	6.9	7.1	7.2	7.8	
Key Macroeconomic Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	9.5	8.5	3.8	7.0	3.1	5.4	4.8	4.6	4.0	5.2	5.5	5.3	5.2	5.0
GDP deflator in US dollars (change in percent)	17.8	5.9	-9.3	6.1	7.4	0.8	13.5	5.3	3.6	3.0	2.8	2.9	2.9	3.4
Nominal external interest rate (in percent)	0.0	6.3	5.0	5.2	4.6	2.1	2.8	4.0	4.2	4.3	4.2	4.3	4.7	4.3
Growth of exports (US dollar terms, in percent)	8.9	20.4	-12.7	6.2	20.1	10.0	13.1	25.3	9.4	9.6	11.0	11.1	11.0	12.9
Growth of imports (US dollar terms, in percent)	25.2	33.8	-11.3	8.4	16.5	10.6	21.0	20.9	9.6	11.5	13.2	13.0	13.1	13.5
Current account balance, excluding interest payments	5.5	4.3	3.2	2.2	3.1	2.2	4.6	4.8	4.9	4.3	3.5	2.9	2.2	3.7
Net non-debt creating capital inflows	3.7	3.2	2.2	-0.3	2.0	1.4	1.4	2.1	1.0	0.6	0.8	0.9	1.0	1.1
								II. Stress Tests for External Debt Ratio						**Debt-stabilizing non-interest current account 7/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2005-09 5/								**25.7**	**27.8**	**29.0**	**29.7**	**30.0**	**29.5**	**-2.5**
A2. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation 6/								**25.7**	**30.3**	**30.5**	**30.3**	**30.1**	**29.9**	**-2.1**
A3. Selected variables are consistent with market forecast in 2005-09								**25.7**	**25.3**	**24.9**	**24.8**	**24.6**	**24.4**	**-1.8**
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006								**25.7**	**26.3**	**26.8**	**26.7**	**26.5**	**26.3**	**-1.8**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**25.7**	**28.2**	**31.4**	**31.9**	**32.2**	**32.4**	**-2.2**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006								**25.7**	**37.8**	**56.2**	**59.1**	**61.2**	**62.6**	**-4.0**
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006								**25.7**	**37.3**	**47.8**	**46.8**	**45.9**	**45.0**	**-2.5**
B5. Combination of B1-B4 using one standard deviation shocks								**25.7**	**39.9**	**57.6**	**56.6**	**55.7**	**54.9**	**-3.3**
B6. One time 30 percent nominal depreciation in 2005								**25.7**	**38.8**	**40.1**	**41.3**	**42.2**	**42.7**	**-2.8**

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ The implied change in other key variables under this scenario is discussed in the text.

7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and both non-interest current account and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Statistical Issues

Korea's macroeconomic statistics and statistical base are adequate to conduct effective surveillance and the country subscribes to the Special Data Dissemination Standard (SDDS).

Nevertheless, the April 2001 data 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 those surveys perceived as being 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 gradually over time. Also, the commodity flow technique could be improved by moving to the Supply and Use Table framework, 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 extra-budgetary 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 2000)*.

- 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, affecting the accurate measurement of net foreign assets of the banking sector.

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.

- The quality of **external debt** statistics has greatly improved since the financial crisis. However, until September 2003, the statistics were not compiled on a residency basis, and certain external liabilities are excluded from the disseminated data. Hence, the external debt statistics were not comparable with the balance of payments statistics, nor with external debt data disseminated by other countries. In September 2003, the BOK started to release external debt statistics on a residency basis according to the SDDS specifications; a debt service schedule, an encouraged item in the SDDS, is not disseminated. The BOK has also released data on Korea's **International Investment Position** (IIP) for 2001, 2002 and 2003.

- Data dissemination on international reserves, foreign currency liquidity, and external debt generally meets the **SDDS specifications** for periodicity, timeliness, and advance release calendar.

Korea: Survey of Reporting of Main Statistical Indicators 1/
(As of November 19, 2004)

	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	11/19/04	11/15/04	9/04	10/04	9/04	11/19/04	10/04	10/04	9/04	9/04	Q3 2004	Q2 2004
Date Received	11/19/04	11/15/04	11/04	11/04	11/04	11/19/04	10/31/04	10/31/04	10/04	10/04	11/19/04	9/17/04
Frequency of Data	D	BM, M	M	M	M	D	M	M	M	M	Q	Q
Frequency of Reporting	D	BM, M	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	M	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, BM – Bi-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.

FUND RELATIONS
(As of October 31, 2004)

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

II. **General Resources Account**:

	SDR Million	% Quota
Quota	1,633.6	100.0
Fund Holdings of Currency	1,125.9	68.9
Reserve Position in Fund	507.7	31.1

III. **SDR Department**:

	SDR Million	% Allocation
Net cumulative allocation	72.9	100.0
Holdings	19.1	26.2

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

V. **Latest Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
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

VI. **Projected Obligations to the Fund**
(SDR million; based on existing use of resources and present holdings of SDR's):

	2004	2005	2006	2007	2008
Principal					
Charges/Interest	0.27	1.11	1.11	1.11	1.12
Total	0.27	1.11	1.11	1.11	1.12

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 29, 2004, the exchange rate was W1,041=US$1.

VIII. **Last Article IV Consultation**:

Korea is on a 12-month consultation cycle. Staff discussions for the 2003 Article IV consultation were conducted on a mission to Seoul during November 5–18, 2003. The

Article IV consultation was concluded by the Executive Board on February 20, 2004. In addition, a Staff Visit took place during May 18–25, 2004.

IX. **FSAP and ROSC Participation**:

MFD: The final FSAP mission was conducted during October 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. A follow-up technical assistance mission on the supervision of derivatives markets was held in Seoul during January 9–20, 2003. The Financial System Stability Assessment report has been published (IMF Country Report No. 03/81) and is available on the web through the following link: http://www.imf.org/external/np/fsap/fsap.asp

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 and is available on the web through the following link: http://www.imf.org/external/np/rosc/kor/fiscal.htm

STA: Discussions on Korea's data dissemination practices against the IMF's Special Data Dissemination Standard (SDDS) were held in Seoul during April 2001, and a report was drafted and finalized on November 28, 2001. The report has been published and is available on the web through the link: http://www.imf.org/external/pubs/ft/scr/2003/cr03127.pdf

X. **Technical Assistance**:

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.

MFD: 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.

XI. **Resident Representative**:

The resident representative office in Seoul was opened in March 1998. Mr. Kenneth Kang has been the Resident Representative since September 2003.

Statement by the IMF Staff Representative
January 21, 2005

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

2. **Recent data confirms the weakness of domestic demand.** Service industry output fell by 1.6 percent (y/y) in November, the fifth consecutive monthly decrease. Meanwhile, consumer confidence slipped to a four-year low in December, as the National Statistical Office's index fell to 85.1 from 86.6 in November.

3. **At the same time, however, there has been some significant progress in restructuring household debt.** As of end-2004, the total number of restructurings was estimated to have reached 750,000, compared with 556,000 as of end-September, as reported in the staff report. Consequently, restructurings now account for more than 20 percent of total credit delinquents.

4. **The Bank of Korea kept its key interest rate unchanged at 3¼ percent in its mid-January meeting.** The Bank said it was waiting to better judge the effects of its latest cuts in August and November 2004, noting also that it continued to expect consumer demand to revive in the second half of 2005.

5. **The exchange rate has appreciated by 0.4 percent against the U.S. dollar so far in 2005, bringing the cumulative appreciation since end-2003 to 15½ percent.**

INTERNATIONAL MONETARY FUND

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EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/13
FOR IMMEDIATE RELEASE
February 4, 2005

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

IMF Executive Board Concludes 2004 Article IV Consultation with Korea

On January, 21, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Korea.[1]

Background

From 1999 to 2002, Korea's economy grew rapidly, by an average of 7¼ percent per annum. But starting in 2003, the economy has begun to sputter. Growth suddenly stopped in the first half of the year, leapt ahead in the second half as exports boomed, but then slowed again to an anemic 2¾ percent annualized rate during January-September 2004 as exports decelerated.

In effect, for the past two years, the economy has been dependent on export growth, because the domestic engines of growth have shut down. Households and SMEs have been unable to spend, as they are repairing their balance sheets following a long credit boom. Meanwhile, corporations have become reluctant to invest, in large part because they are discouraged by the highly regulated domestic labor market.

The authorities have been countering this slowdown by easing macroeconomic policies. The fiscal policy stance has been shifted from neutral to mildly expansionary. At the same time, the monetary policy mix has been shifted to favor domestic demand. The policy interest rate has been reduced to an historic low of 3¼ percent, easing the burden on debtors, while the won has

[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.

been allowed to appreciate, cutting the cost of imports and thereby boosting real household incomes. Over the course of 2004, the won climbed by 14½ percent against the U.S. dollar, a 12½ percent gain in nominal effective terms. While smoothing this rise, the authorities accumulated $44 billion in reserves, bringing the total to $199 billion.

Staff expects that domestic demand will finally begin to revive in early 2005, supporting yearly growth of 4 percent. Experience from other countries that have gone through similar booms and busts suggests that consumption could revive as the process of balance sheet adjustment advances into its third year. Moreover, high capacity utilization ratios and strong manufacturing profitability should ultimately prompt a recovery in facility investment, offsetting a slowdown in construction.

There are both upside and downside risks to this baseline projection. On the upside, the recovery in domestic demand could be much more vigorous than projected, especially as Korean recoveries have often been swift and sharp. On the downside, the projected recovery could be undermined if OECD growth falters or there is a significant downturn in the volatile electronics sector. Moreover, with the country highly dependent on imported oil, growth could be cut significantly if oil prices rise significantly from current levels. Most importantly, the strength and sustainability of the recovery will depend heavily on government policies, especially in tackling the ongoing structural difficulties.

Despite these challenges, Korea's vulnerability to crisis remains very low. The fundamental pillars of the economy are strong: the balance sheets of the chaebol are healthy on average, and banks have preserved their capital strength despite recent loan losses. Moreover, the cushions against shocks are ample: the external position is more than comfortable, with reserves now exceeding the level of gross external debt, while government debt is only 30 percent of GDP.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the Korean authorities' basic policy approach, especially the accelerated dismantling of the state-directed economic framework, in recent years. These efforts, Directors considered, have paid handsome dividends, creating a relatively open and liberal economy and touching off a long economic boom.

More recently, however, Directors noted, the Korean economy has begun to slow down. While noting that this has occurred because the economy has been dealing with the after-effects of a 200l–02 credit boom, Directors emphasized that the more fundamental problem is the remaining legacy of a state-directed development strategy. Accordingly, they stressed that completing the shift to a market-based framework would be the key to restoring sustained and rapid growth.

Directors agreed that stimulative fiscal and monetary policies would be appropriate to provide a macroeconomic spark. Directors welcomed the authorities' plans to adopt a pro-active approach by front-loading budgetary spending, and urged the adoption of a supplementary budget with additional social safety net spending. They also welcomed the Comprehensive Investment Plan, which aims to stimulate additional investment spending through public-private partnerships, but noted that these projects may take some time to materialize, and will need to be recorded transparently in the fiscal accounts when they do.

Directors believed that, with core inflation remaining within the target range and inflation expectations under control, there is scope for the central bank to provide support to the real economy. They consequently supported the reduction in interest rates in November, as well as Bank of Korea’s plan to stand ready in case further reductions are required.
Directors commended the authorities’ decision to allow the won to respond to market forces, noting that Korea’s flexible exchange rate policy has served the country well, encouraging financial market development while maintaining external competitiveness.

Directors emphasized that achieving sustained strong growth will require addressing the underlying structural difficulties. This will require, first and foremost, addressing the household delinquency problem. Directors strongly supported the government’s decision to stand firm against calls for a mandated debt reduction scheme and instead establish a market-friendly framework within which debtors and creditors can work to resolve their problems.
Directors stressed that the linchpin of such a framework, however, needs to be a working bankruptcy system, to provide a final resolution for those who cannot repay their debts and a standard for others, so as to encourage them to settle out of court. For this reason, they endorsed the plans to make bankruptcy a viable option, and suggested that the government go further in this direction by shortening the repayment period and reducing official discrimination against bankrupt persons. Most importantly, these reforms should be enacted speedily, as accelerating the pace of debt restructuring is critical to hastening the advent of the recovery. Meanwhile, to restore households’ access to lending, Directors recommended that the authorities promote the information-sharing needed for an efficient system of competing credit bureaus.

Reviving the SMEs is another important priority. Directors noted that resources flowing to these firms have tended to be allocated on the basis of government guarantees, mainly to businesses first identified during the Asian crisis. This has distorted competition and stifled the dynamism of the sector, taking a severe toll on its overall financial health. Fundamental reforms are consequently needed: the current government-led framework needs to be replaced by one where the private sector allocates resources, funding the firms with the most promising futures. Directors recommended that the amount of guarantees be scaled back over the medium term, while the share of each loan covered by guarantees should be reduced, and the cost of rollovers increased. At the same time, to help SMEs grow, Directors recommended measures to broaden the range of security for loans, expand the availability of venture capital, reduce start-up costs, and improve the efficiency of exits.

Directors considered that improving the investment environment would require modernizing the labor market. They welcomed the recent improvement in industrial relations, but noted that a fundamental problem still remains: the strict employment protection for regular workers, which deters risky investments and has prompted a growing use of nonregular workers.

The only way to resolve these problems, Directors considered, would be by reducing employment protection for regular workers. Accordingly, they welcomed the authorities' plans to consider introducing regular labor contracts with less protection, while simultaneously expanding the social safety net.

Promoting investment also requires improving corporate governance and developing the bond market, so as to encourage markets to provide more financing, to more firms, at lower cost. For this reason, Directors welcomed the amendments to the Fair Trade Act, aimed at encouraging the chaebol to improve their governance. They also welcomed the introduction of class action lawsuits for securities law violations, and encouraged additional steps to reinforce market discipline on corporate governance, such as adopting a "comply or explain" system for the Code of Best Practices in Corporate Governance. In the bond market, Directors recommended that the government refrain from bailing out investors, which has distorted the balance between reward and risk, stifling market development.

Directors urged the government to play a leadership role in advancing global trade liberalization, including by further opening up Korea's heavily protected agricultural sector. On the proposed Korea Investment Corporation, Directors urged that its objectives be supported by well-defined governance, transparency, and accountability arrangements.

While recognizing that the structural reform agenda is ambitious, Directors remained fundamentally optimistic about rekindling the dynamism of the Korean economy. The Korean authorities have time and again demonstrated the willingness and ability to take decisive measures to address the economy's problems. Moreover, by enacting the reform agenda, Korea will advance considerably toward achieving a comprehensive market-based framework that is needed for a return to sustained rapid growth.

It is expected that the next Article IV consultation with Korea will take place on the standard 12-month cycle.

Korea: Selected Economic Indicators

	2001	2002	2003	2004 Estim.	Actual As of	2005 Staff Proj.
Real GDP (percent change)	3.8	7.0	3.1	4.6		4.0
Consumption	4.9	7.6	-0.5	0.0		1.7
Gross fixed investment	-0.2	6.6	3.6	2.6		2.6
Net foreign balance 1/	0.5	-0.2	2.8	3.7		1.4
Prices (percent change)						
Consumer prices (end of period)	3.2	3.7	3.4	3.0	Dec.	3.2
GDP deflator	3.5	2.8	2.3	3.4		3.1
Labor market (in percent)						
Unemployment rate	3.8	3.1	3.4	3.5	Dec.	...
Wage growth, manufacturing	6.6	12.1	9.4	8.7	Oct.	...
Consolidated central government (In percent of GDP)						
Revenues 2/	23.2	23.2	23.8	23.9		23.9
Expenditure	22.6	20.9	21.1	22.0		21.8
Balance 2/	0.6	2.3	2.8	2.0		2.1
Money and interest rates (In percent)						
Overnight call rate	4.0	4.3	3.8	3.3	Dec.	...
M3 growth	11.6	13.6	4.7	7.0		...
Yield on corporate bonds	7.1	5.9	5.6	3.8	Dec.	...
Balance of payments						
Current account balance (In billions of U.S. dollar)	8.0	5.4	12.3	25.6		27.8
Current account balance (In percent of GDP)	1.7	1.0	2.0	3.8		3.9
Won per U.S. dollar (Period average)	1,291	1,251	1,190	1,145	Dec.	...

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

1/ Contribution to GDP growth.
2/ Excluding privatization receipts and rollover of KDIC/KAMCO bonds.