February 2004
IMF Country Report No. 04/44

Republic of Korea: 2003 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Korea

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 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 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **November 18, 2003,** with the officials of the Republic of Korea on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on February 2, 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 **February 20, 2004** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its February 20, 2004 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the Republic of Korea.

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

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF KOREA

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation
with the Republic of Korea

Approved by Wanda Tseng and Michael T. Hadjimichael

February 2, 2004

- **This report is based on discussions held in Seoul during November 5–18, 2003.** The mission team was headed by Mr. Felman, and also comprised Messrs. Beaumont, He, Zebregs, Tressel (from APD), and Kang (Resident Representative). Also participating in the discussions was Mr. Cho Won-Dong, Advisor to the Executive Director.

- **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 Kim Jin-Pyo; Bank of Korea Governor Park Seung; Financial Supervisory Commission Chairman Lee Jung-Jae; Chief Secretary for National Policy Lee Joung-Woo; and Fair Trade Commission Chairman Kang Chul-Kyu. The team also met representatives of financial institutions, industry federations, labor unions, and the diplomatic and academic communities.

- **At the conclusion of the previous Article IV consultation in March 2003**, Directors encouraged the incoming administration of President Roh Moo-Hyun to enhance the market foundations of the Korean economy. They supported the government's plans to improve market discipline over the corporate sector by reforming accounting practices, strengthening auditing, and expediting insolvency procedures. They also emphasized the need to tackle long-standing weaknesses in nonbank financial institutions, particularly by privatizing the investment trust companies.

- **Korea's statistical base is adequate to conduct effective surveillance.** The coverage, periodicity, and timeliness of key data are adequate, although the coverage and detail of fiscal data should be improved.

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

- **This report was prepared by the mission team.**

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GLOSSARY OF ABBREVIATIONS AND TERMS

BOK ....Bank of Korea
CAR ....Capital Adequacy Ratio
CCC..Credit Card Company
FSC ....Financial Supervisory Commission
FSS...Financial Supervisory Service
FTA ....Free Trade Agreement
FTC ....Fair Trade Commission
ICR...Interest Coverage Ratio
IT..Information Technology
ITC ....Investment Trust Company
KCGS..Korean Corporate Governance Services
KDB ....Korean Development Bank
MOFE ....Ministry of Finance and Economy
MMF ....Money Market Fund
MPB ....Ministry of Planning and Budget
NBFI ....Nonbank Financial Institutions
NPF ....National Pension Fund
NPL ....Nonperforming Loans
q/q ....Quarter-on-quarter
p.a. ....Period average
s.a. ....Seasonally adjusted
SME ....Small- and Medium-scale Enterprises
SSF ....Social Security Funds
W..Won
y/y ....Year-on-year

Exchange rate at end-December 2003 ....US$1 = W 1,192.6

Executive Summary

- Until recently, Korea's economy had been booming, propelled by sweeping structural reforms taken in the aftermath of the Asian crisis. These reforms have created a more competitive system, guided more by market signals and far less by official directives.

- There was nevertheless an unfinished reform agenda, as corporate governance practices remained problematic, some nonbank financial institutions weak, and the labor market dualistic. These problems came to the fore in 2003, derailing the long-standing expansion.

- The economy has already begun to improve, boosted by surging exports. But putting the country on the path of rapid, sustained growth will require policy action. The authorities have already crafted a well-conceived strategy, which the staff broadly supports. The key elements are to:

    - Maintain supportive macroeconomic policies in the initial stages of the recovery, including by front-loading fiscal spending;

    - Strengthen the financial system, by resolving weak nonbank financial institutions and allowing risk to play a greater role in the bond market;

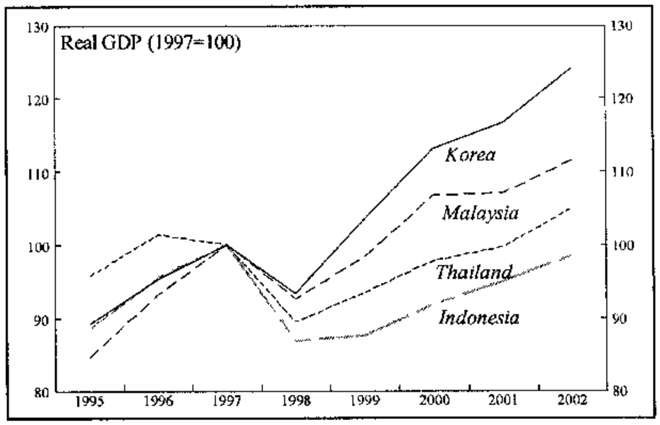
    - Improve corporate governance, by relaxing regulation of conglomerates that improve their business practices, while reinforcing market-based mechanisms for exerting discipline; and

    - Modernize the labor markets, by easing employment protection for regular workers and expanding the social safety net for those less fortunate.

It has now been six years since the Asian crisis. For most of this period, Korea's economy has grown rapidly, the result of favorable cyclical developments and deep structural reforms. But in 2003 this ascent was interrupted. The economy contracted during the first half of the year, after financial institutions reined in household credit and some long-standing structural problems re-emerged. While growth has now resumed, the sudden pause was a reminder that, despite the policy progress of the past half-decade, an unfinished reform agenda still remains. This Article IV consultation provides a timely opportunity to take stock, to see what has been accomplished since the crisis and what remains to be done.

I. How Has Korea Changed Since the Asian Crisis?

1. **Korea has made a stunning recovery from the Asian crisis.** Within one and a half years, output had already regained its pre-crisis level; within five years, the economy was one-quarter larger than before. Meanwhile, international reserves, which were minimal at the depth of the crisis, have been built up to $155 billion as of end-2003, nearly twice the level of short-term external debt on a residual maturity basis. This performance, significantly better than any other Asian crisis country, begs an important question: how did the country do it? Did the recovery merely reflect favorable cyclical developments, or were there deep structural changes, as well? In other words, how has Korea changed?



2. **Certainly, cyclical factors played an important role in the recovery**. Initially, the economy was buoyed by the worldwide IT boom, which unleashed a torrent of demand for the country's advanced electronics products: during 1999–2000, exports increased by 18 percentage points of GDP. Then, as the IT boom faded, domestic demand took off, fuelled by a burst of credit to consumers and SMEs, amounting to nearly 50 percent of GDP during 2000–02. A significant part of this rise in household credit came in the form of credit card lending, which proliferated rapidly after 2000, reaching 12 percent of GDP by late 2002.

3. **Behind the surge in consumer credit—behind the recovery, more generally—lay deep structural reforms that in a few short years have fundamentally altered Korea's economic system**. Consider the following:

- **The banking system has been transformed.** Before the crisis, banks concentrated on lending to the industrial conglomerates (*chaebol*), making it difficult for consumers and SMEs to secure credit. Afterwards, banks strengthened their commercial orientation, allowing them to refocus their activities on their most profitable lending opportunities. Meanwhile, prudential regulations were tightened, forcing major banks to provision carefully and raise their capital adequacy ratios to around 10 percent. The government has also reprivatized most of the bank equity it acquired during the crisis.[1] These changes have had a measurable impact, with the 2003 Financial System Stability Assessment finding that Korean banks are now as sound as those in similar countries (IMF Country Report No. 03/81).

Bank Soundness, 2002
(In percent)

	Korea	Comparator Countries[1]
CAR	10.5	13.0
NPLs	1.9	4.9
ROA	0.7	0.3

Sources: FSS, Moody's, and OECD.
[1] See Chapter VII, Selected Financial Sector Issues, of Korea FSAP Report.

- **Capital markets have been reinvigorated.** With banks diversifying their lending, the *chaebol* have turned to the capital markets for financing, allowing Korea to develop the biggest bond market in Asia outside Japan. The stock market has also grown, largely because it has been opened up to foreigners, who now own 40 percent of the market capitalization, more than in any other Asian country. As this has occurred, financial markets have begun to exercise greater discipline on the *chaebol*.

- **Corporate finances and governance have improved significantly**. Before the crisis, the Korean corporate sector was characterized by high leverage and weak profitability; by 2002, its key financial ratios were comparable to those in other OECD countries. Similarly, while Korea's corporate governance was once among the poorest in Asia, it is now better than average.[2]

Manufacturing Sector Financial Ratios
(In percent)

	Korea 2002	U.S. 2002	Japan 2001
Debt/equity	135	167	163
Debt/sales	30	28	33
Operating profit/interest	260	279	385
Ordinary income/sales	4.7	4.9	2.8

Source: BOK Financial Statement Analysis.

[1] See, for example, Chungwon Kang, "From the Front Lines at Seoul Bank: Restructuring and Privatization," IMF Working Paper 03/235, December 2003.

[2] The widely-used index from Crédit Lyonnais Securities Asia indicates that Korea's corporate governance rating has improved to 71 in 2003, compared with an average of 62 in the major Asian emerging markets.

- **Moreover, the SME sector has developed rapidly, helped by banking reforms that improved the allocation of credit**. This sector (defined as firms with less than 300 workers) now accounts for around half of GDP and the bulk of total employment.

Importance of Small- and Medium-Sized Enterprises

	Pre-crisis 1997	Post-crisis 2002
SME share (in percent)		
Employment[1]	74	86
Manufacturing value-added[1 2]	48	52
Bank credit to SMEs (percent of GDP)	20	32
Number of start-ups	21,057	38,972

Source: Small and Medium Business Administration.
[1] Post-crisis year is 2001.
[2] 1998 instead of 1997.

4. **In sum, the Korean economy has changed in profound and important ways**. At the same time, some long-standing structural problems remain. In particular:

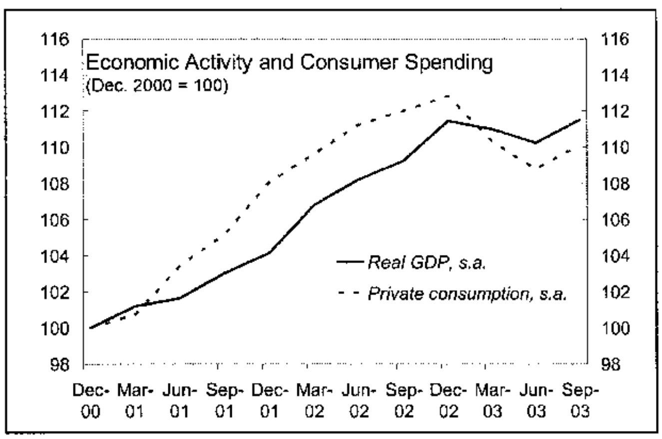
- **Key nonbank financial institutions remain financially weak and vulnerable to shocks**, especially the major investment trust companies (ITCs) and, more recently, some credit card companies.

- **Markets remain wary of Korean corporate governance**. In part, this is because there is a large gap between the ownership and control of conglomerates, with most *chaebol* still being run by founding families, despite their generally small ownership stakes.

- **Meanwhile, the labor market remains sharply divided**. Two-thirds of employees benefit from some of the strongest employment protection in the OECD, but the remaining workers face job insecurity and a limited social safety net.

II. Why Was Korea's Growth Interrupted in 2003?

5. **In early 2003, the long post-crisis expansion suddenly stalled**. In the first two quarters of the year, GDP shifted into reverse, falling by a cumulative 1 percent, as both private consumption and fixed investment declined (Table 1).[3] Part of the problem was that export growth slowed, while in March there was a brief flare up of geo-political tensions with North Korea. But the bulk of the problem was domestic.

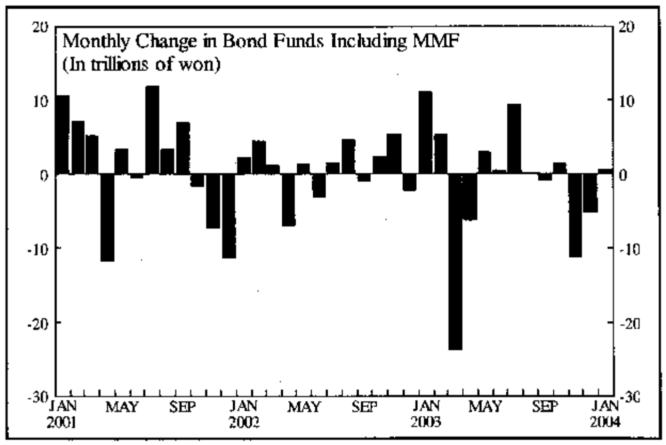


[3] All quarterly figures in this report are seasonally adjusted, but not annualized.

6. **To begin with, the long household credit boom finally came to an end, depressing consumption**. During the course of 2002, the authorities had become increasingly concerned about the rapid growth of household lending, especially by the aggressively expanding credit card companies (CCCs, Box 1). By the end of the year, with household lending growth rates approaching 30 percent (y/y) and delinquency rates beginning to rise, they decided to clamp down, tightening provisioning and other prudential regulations. In response, the CCCs began cutting credit lines, pulling down private consumption by a cumulative 3½ percent in the first half of 2003.

7. **Meanwhile, Korea's unresolved structural problems took their toll on investment**. During the year, a corporate governance scandal exposed weakness in the financial sector, labor unrest increased, and the political situation became increasingly difficult. All of this undermined business confidence, causing machinery and equipment investment to fall by 9 percent in the first three quarters of the year, while foreign direct investment commitments declined by 29 percent for the year as a whole.

8. **The problems started in March, when prosecutors announced that SK Global—an affiliate of SK Group, the third-largest *chaebol*—had hidden debts, implying that its net equity was actually negative**. Bond fund investors reacted by seeking redemptions from the Investment Trust Companies, which held SK Global paper as part of their investment portfolios. The ITCs, in turn, attempted to meet this run by selling bonds issued by the CCCs, but the rapid rise in credit card delinquencies made this paper illiquid. Calm was soon restored to the market, after the CCCs agreed to inject additional capital. Nonetheless, for the remainder of the year, risk aversion toward corporate bonds remained high, especially for lesser-rated companies, constraining investment.



9. **Moreover, the underlying problems at the CCCs proved far worse than initially expected**. Despite energetic efforts by the companies, impaired assets (including rescheduled loans) rose during the year to 34 percent, equivalent to around 3 percent of GDP. As a result, by January 2004, the largest CCC, LG Card—which had issued credit cards to one-third of the population—stood on the brink of collapse. After creditors balked at assuming control, the authorities, worried about the effect that a failure would have on other CCCs and the capital markets, cleared the way for the government-owned Korea Development Bank to take over the company.[4]

[4] CCC debt accounts for about one-fifth of Korea's outstanding commercial paper.

Box 1. The Credit Card Boom and Bust

- **Korea's credit card industry expanded rapidly from 1999 to 2002, driven by aggressive marketing and official support through tax deductions.**[1] Over this short period, the number of cards issued by credit card companies (CCCs) more than doubled to over 100 million, an average of four cards for every Korean adult. These cards were used intensively: annual usage increased six-fold to 114 percent of GDP.

- **The CCCs tried to contain risks by requiring holders to settle their balance in full every month.** However, as consumers began to acquire multiple cards, they were able to create de facto revolving credit by shifting debts between cards. It has been estimated that close to one million card holders have been "kiting" their payments from one company to another. Nonetheless, the CCCs remained confident, since profits were high and estimated future defaults (based on past experience) were low. Supervisors, lacking experience with CCCs, also underestimated the risks, especially as the companies appeared well capitalized.

- **This boom has now come to an abrupt end.** Already in 2002, delinquency rates had begun to rise, while credit bureaus began accumulating information about the debts of clients to multiple CCCs. As the worrisome signs multiplied toward the end of the year, the authorities tightened prudential regulations and the CCCs began cutting credit lines and selling impaired assets.

- **The industry's problems were further aggravated in March 2003, when the SK Global scandal triggered a collapse of the market for CCC bonds.** The immediate problem was resolved when the industry convinced creditors to roll-over their exposures, by promising to secure new capital. Nonetheless, bond market access remained tenuous, because the nonperforming asset problem continued to deteriorate. By November 2003, total impaired assets, including rescheduled loans, reached 34 percent, and 2.3 million card borrowers were delinquent, representing 6 percent of the population aged 15 or more.

Credit Card Delinquencies[1]

	2002	2003			
	Dec.	Mar.	Jun.	Sept.	Nov.
	(in percent of total receivables)				
I. Overdue receivables	6.0	9.4	9.4	11.2	13.5
II. Rescheduled loans (excluding overdue)	5.2	8.0	13.2	20.7	20.7
III. Total nonperforming loans (I+II)	11.2	17.4	22.6	31.9	34.2

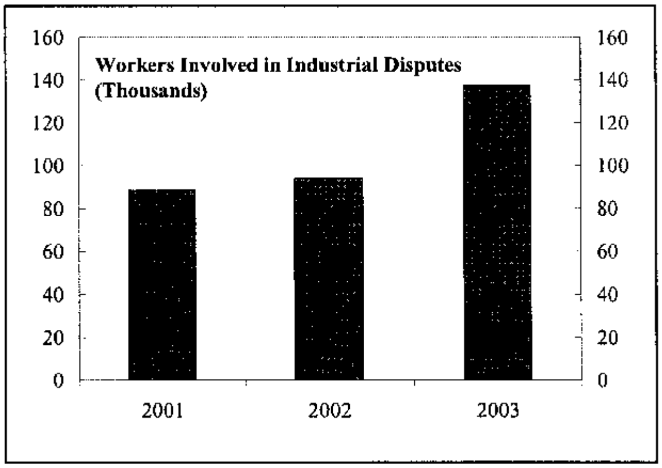
[1] CCCs excluding Kookmin Card.

- **In December, the largest company, LG Card, lost access to the capital market, creating a liquidity crisis.** Creditors responded by requesting an audit, which found that liabilities exceeded assets, leading them to balk at assuming control of the company. In the end, the government-owned Korean Development Bank (also a major creditor) stepped in to rescue the company, averting the threat of bankruptcy, which, owing to the practice of "kiting," could have cascaded through the entire sector. The authorities were also concerned that a failure could have resulted in ratings downgrades for the other firms, triggering early repayment clauses on their bonds.

- **The industry is now facing formidable challenges.** Some CCCs are being absorbed by their well-capitalized parent banks, but stand-alone companies (such as LG Card) need to secure additional equity to cushion them against continuing defaults. All firms need to develop their capacity to recover loans. Moreover, all firms need to improve their risk management practices by relating credit card lines to borrowers' income, and ensuring that credit management bureaus provide complete information on borrowers' debts.

[1] More information on the credit card boom is presented in Chapter IV of the 2003 Selected Issues paper (IMF Country Report No. 03/80).

10. **Meanwhile, labor strife intensified.** When the new government of President Roh Moo-Hyun assumed office in early 2003, it announced a policy of "dialogue and compromise." But strike activity nonetheless increased by nearly 50 percent (as measured by the number of workers involved) as unions pressed key economic sectors for wage increases, greater employment protection, and a shorter working week.



11. **At the same time, the political situation grew increasingly complex.** In September, President Roh's party split, leaving his forces in a small minority in a National Assembly that had from the start been controlled by the opposition. Around the turn of the year, political attention focused on an investigation into political fund-raising practices, which encompassed the main political parties as well as a number of *chaebol*. And as 2004 progressed, the April legislative elections began to loom large.

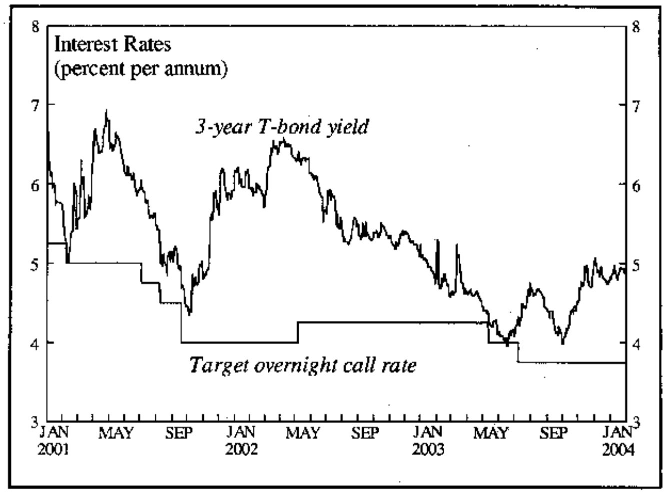
12. **Despite these obstacles, the government was able to advance its structural reform agenda, in line with Fund recommendations.** Indeed, many of the priorities identified in last year's staff report were acted upon in 2003. In particular, to spur further improvements in corporate governance, new accounting and auditing bills were passed, which will increase the amount of information provided to investors, and help ensure that this information is accurate. At the same time, to ensure that investors can enforce their legal rights in cases where the information does prove misleading, class action lawsuits were legalized in cases of securities violations.

Key Structural Policy Advice, 2002 Article IV	Status
• Privatize banks.	• Significant holdings divested.
• Resolve weak nonbank financial firms.	• Major ITCs are being privatized.
• Strengthen accounting/ auditing standards.	• New laws to improve accounting and auditing practices.
• Improve corporate disclosure.	• Three-year Roadmap for Market Reform announced.
• Allow securities class action law suits.	• New law allowing class action law suits.
• Improve insolvency system.	• Pending in National Assembly.
• Strengthen independence of FSC/FSS.	• No action taken.

13. **In addition, further progress was made in financial sector privatization.** During 2003, the government sold stakes in three large banks, leaving its 87 percent stake in the Woori Group as its only sizeable holding remaining—and even in this case, it initiated procedures to sell down its shares. The government also arranged to sell the largest investment trust company, Hyundai ITC, to a foreign securities firm, facilitated by a large injection of public funds.

14. **Furthermore, the government used macroeconomic policies to support the economy**:

- **Monetary policy was eased.** With core inflation gradually receding below the 3 percent mid-point of the authorities' target range, the policy rate was cut to an historic low of 3.75 percent (Table 2).



- **The fiscal stance was also eased.** As the economy slowed, the authorities front-loaded spending and adopted two supplementary budgets, thereby averting the traditional underspending of the budget targets, which would have imparted a significant contractionary impulse (Table 3).[5]

- **The authorities resisted pressures for an exchange rate appreciation.** With portfolio inflows exceptionally large, they stepped up their foreign exchange purchases, contributing to a $34 billion increase in reserves (Table 4).[6] These actions limited the won's appreciation against a weakening dollar; the average won/dollar exchange rate during 2003 was 4.5 percent higher than in 2002, keeping the average nominal effective rate essentially unchanged.[7]

III. What Lies Ahead?

15. **Despite the difficulties encountered during 2003, the economy started to revive toward the end of the year**. The reason was soaring overseas demand. Exports increased by 11 percent (q/q) in the third quarter, and by a further 10 percent (q/q, estimated) in the fourth,

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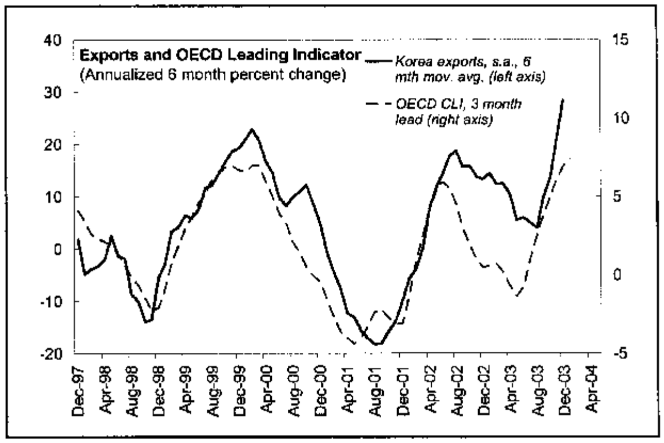
[5] These expenditure shortfalls are discussed by He, 2003, "Budget Formulation and Implementation in Korea: A Macroeconomic Perspective," Selected Issues, IMF Country Report No. 03/80. See also Chapter I of the forthcoming *Selected Issues* paper.

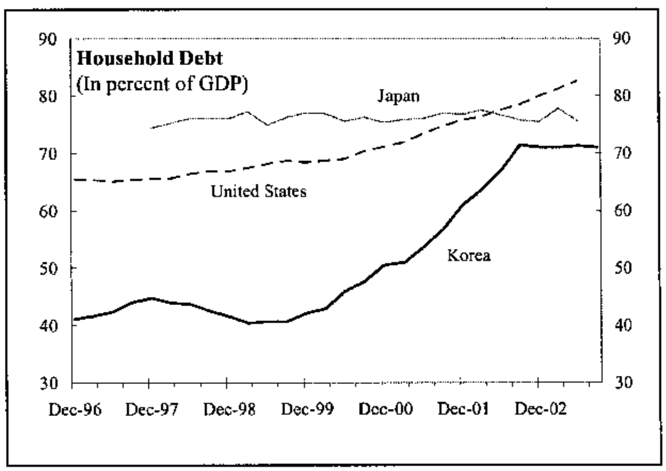
[6] The foreign exchange purchases were sterilized, in accordance with the authorities' objective of using interest rates as their policy tool, allowing broad money growth to slow to 8 percent in 2003.

[7] In January 2004, as a further step to moderate upward pressure on the won, the authorities limited the size of the positions that domestic financial institutions could take in the nondeliverable forward market, the offshore market frequently used by foreign investors to take positions on the Korean currency.



boosting annualized GDP growth to around 3½ percent by the fourth quarter. Moreover, leading indicators suggest this trend is likely to continue well into 2004. Export orders are climbing rapidly, as the global IT industry is accelerating again, while China—now Korea's largest trading partner—is continuing to boom.

16. **Typically, such export rebounds have produced very quick and strong recoveries.** With exports accounting for some 42 percent of GDP, rising overseas shipments have normally flowed through rapidly into new investment and growing consumption. But this time, domestic demand is likely to remain weak. In particular:



- **Consumption could be weighed down by heavy household indebtedness, which now exceeds 70 percent of GDP.** Households may wish to—or be forced to—increase their saving further to pay down their debts, especially as the recovery proceeds and interest rates begin to rise, aggravating debt service burdens.[8] This risk is particularly great if the CCCs' financial difficulties persist for a prolonged period, risk aversion by banks grows, or there is a correction in property prices, all of which could constrain household credit.

- **Investment could be dampened if firms continue to take a "wait and see" attitude, pending improvements in the labor or political situation.** Moreover, risk aversion in the bond market may persist, impairing the ability of lower-grade firms to secure bond financing.

17. **On balance, the staff expects a moderate recovery.** Under current projections, GDP growth would rise to around 5½ percent this year, which is relatively modest for the first year of a Korean recovery. Subsequently, growth would remain around the potential rate of 5–5½ percent, as domestic demand gradually revives while exports slow to a more sustainable

[8] Around 1 in 10 Koreans over the age of 15 had delinquent loans in November 2003.

pace (Table 5). There is some upside potential to the 2004 forecast, as export performance may continue to be exceptionally strong, and may flow through more strongly into domestic demand. But there are also downside risks, in particular if structural reforms fail to gain momentum after the elections and the needed adjustments, especially to household balance sheets, prove to be more prolonged than expected.

Components of GDP
(In percent)

	2002	2003 Proj.	2004 Proj.	2005 Proj.
Real GDP	6.3	2.9	5.5	5.3
Domestic demand	5.7	-0.4	2.7	5.1
Consumption	6.2	-0.7	2.7	4.9
Fixed investment	4.8	2.5	3.0	5.1
Foreign balance [1]	2.0	3.8	3.6	1.3

[1] Contribution to GDP growth.

18. **Over the medium term, Korea's economy is robust to the standard sustainability analysis** (Annex I). Short-term external debt has increased significantly in recent years, to around $60 billion (12 percent of GDP), but this presents little risk, since it is more than covered by reserves. (Table 6). A further cushion is provided by the low level of public debt, at just over 20 percent of GDP, and by the moderate levels of corporate debt (Table 7). This combination of low debt and high reserves allowed Korean borrowers to continue rolling over their obligations at modest spreads through 2003, even at the height of the SK Global scandal.[9]

19. **While Korea faces little risk of an external crisis, the country's remaining structural problems nonetheless represent a source of concern**. As the events of 2003 demonstrated, these weaknesses have the potential to interrupt growth. They also run the risk of constraining the economy's medium-term growth, for example, if weak corporate governance leads to sub-optimal investment decisions. Consequently, to ensure that future growth is both rapid and sustained, Korea needs to address the unfinished structural reform agenda.

IV. Report on the Discussions

20. *The authorities' longer-term strategy is to double the country's per capita income to $20,000, partly by developing Korea into an economic hub for Northeast Asia, providing financial and logistical services to the region. To do this, the authorities and team agreed that the unfinished structural reform agenda would need to be addressed. But the strategy would need to begin with measures to encourage the incipient economic recovery.*

[9] Despite the domestic difficulties, the government successfully placed a $1 billion 10-year global bond in May, with a spread of just 92 basis points over U.S. treasuries. The inclusion of collective action clauses had no noticeable effect on the pricing.

A. Supporting the Recovery

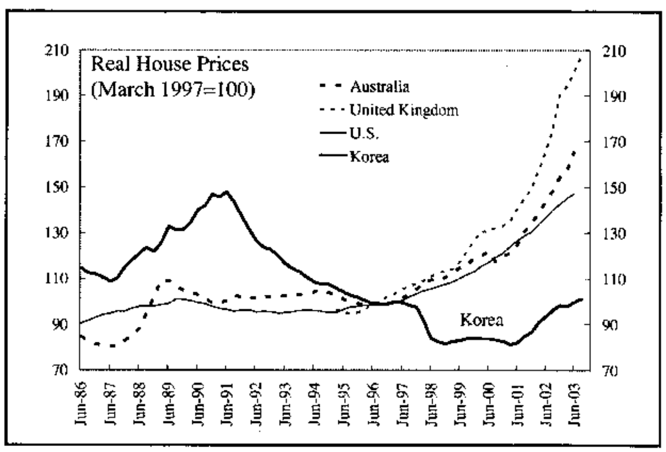
21. **The staff team shared the government's view of fiscal policy**. Both sides agreed on the importance of maintaining Korea's long tradition of fiscal prudence to deal with the demands that will be placed on the budget from the rapidly aging population and uncertainties related to North Korea. Accordingly, the fiscal deficit (excluding social security funds) would eventually need to be eliminated and the budget brought back into balance or surplus.

22. **The only issue was how quickly this should be done**. The original budget plan submitted to the National Assembly aimed to limit the 2004 deficit to 0.4 percent of GDP, which on the staff team's estimates would have imparted a contractionary fiscal impulse estimated at about 1 percent of GDP. In the team's view such a rapid adjustment risked undermining the incipient and still-fragile recovery. Accordingly, the team proposed adopting a neutral fiscal stance for 2004, implying a budget deficit of around 1½ percent of GDP. Subsequently, as the recovery takes hold, the budget could be tightened gradually, so as to bring it into balance by 2005.

23. **The authorities were somewhat more optimistic about 2004, expecting 6 percent growth, but agreed that there were risks to tightening prematurely**. Consequently, after the mission's departure, the budget was eased somewhat, bringing the 2004 target deficit to 0.6 percent of GDP. The authorities further noted that they would front-load spending into the first half of the year, and were prepared to introduce a supplementary budget, should the recovery fall short of expectations.

24. **As for monetary policy, the team judged that the current supportive stance remained appropriate**. Under the staff's baseline scenario, 2004 core inflation is projected to remain close to 3 percent, the midpoint of the central bank's medium-term target range, partly because the output gap would not be closed until next year.[10] It should thus be possible to maintain the current stance for some time, even if the economy recovers as projected.

25. **Some have urged that monetary policy be tightened to counter a potential bubble in housing prices**. They point out that since the end of 2000, apartment prices in the southern Seoul area of Kangnam have risen by over 90 percent, greatly outpacing the increase in apartment rents. The team noted, however, that at the national level, the increase has been much more muted, merely bringing real prices back

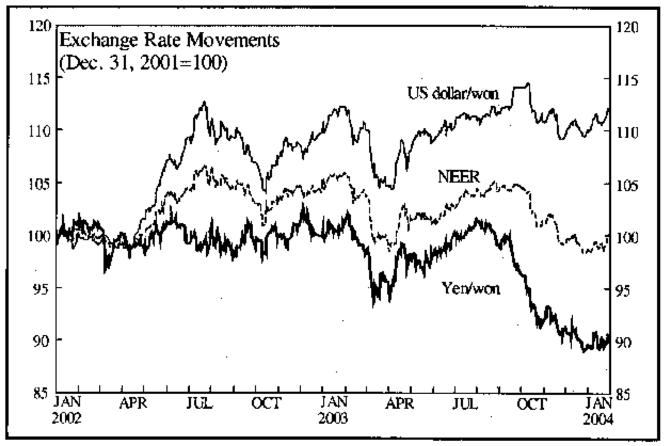


[10] Estimates of the Korean Phillips curve are presented in Chapter II of the forthcoming *Selected Issues* paper.

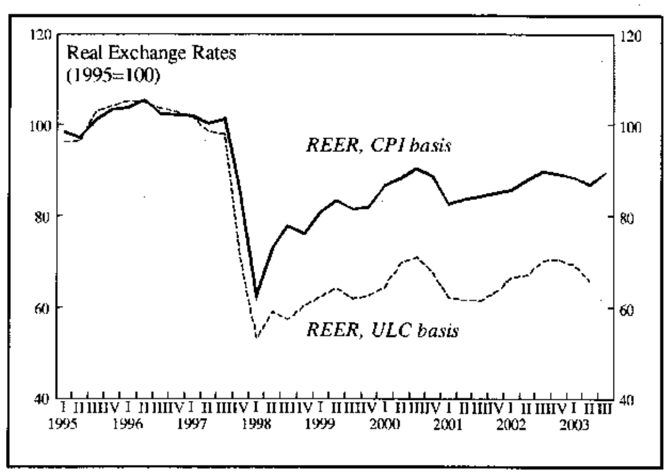
to pre-crisis levels, which in any case were not high by historical standards. Moreover, the pace of national housing price increases has already slowed markedly, falling below 6 percent (y/y) in December 2003.

26. **Accordingly, the team concluded that monetary policy was too blunt an instrument to address the housing price problem.** Instead, it endorsed the authorities' strategy of taking targeted measures, including higher capital gains taxes for owners of multiple apartments. At the same time, the central bank should continue to monitor the situation closely; even though average loan-to-value ratios were only about 60 percent, a property market correction might nonetheless put further strain on household and bank balance sheets.

27. **On exchange rate policy, the team asked why intervention had increased considerably in 2003.** The authorities responded that the exchange rate had actually moved in a wide range last year, with much of the intervention occurring only when market conditions had become disorderly, such as in September 2003. In any case, with others in the region resisting appreciation against the dollar, Korea would have lost considerable competitiveness if they had failed to do likewise, which would have intensified the economic slowdown. Nevertheless, they remained committed to a flexible exchange rate policy, under which intervention would take place only to smooth fluctuations rather than to target the level or trend.



28. **The team urged the authorities' to maintain their flexible exchange rate policy, noting that it had served the country well.** The policy, adopted after the Asian crisis, had stimulated a rapid development of the foreign exchange market and encouraged firms to hedge; an official survey showed that nearly two-thirds of firms were covering their external exposure as of June 2003. It had also preserved Korea's competitiveness, with the real effective exchange rate remaining remarkably stable in recent years, facilitating strong export growth and continued current account surpluses.



B. Strengthening the Financial Sector

29. **Beyond calibrating the macroeconomic settings, restoring sustained growth requires advancing the country's structural reform agenda**. A key task would be to further strengthen the financial sector, not only to address the weaknesses that came to light during 2003, but also to promote the development of Korea's financial sector.

30. **The first step would be to restore the CCCs to financial health.** The team noted that KDB's takeover of LG Card had burdened the development bank, once again, with a difficult restructuring task and a significant potential financial obligation, should the credit losses continue.[11] Moreover, this operation had complicated the efforts to resolve the other CCCs, as the companies may now be reluctant to take painful restructuring measures, while consumers may feel less pressure to pay their debts, if they thought they would be bailed out.

31. **Accordingly, the government needed to make its policy clear**. It should emphasize that LG Card was an exceptional case, due to its size, and demonstrate this point by enforcing prudential regulations strictly. Pressure should be maintained on the other CCCs to recapitalize quickly, with injections sufficient to cover realistic estimates of expected losses. Should existing owners prove reluctant to do this, prompt corrective action should be taken. As for LG Card itself, the company should be sold off swiftly to a suitable buyer, or else be put into court receivership.

32. **Measures should also be put in place to ensure these problems do not recur**. In particular, the authorities need to ensure that the CCCs shift to a more sophisticated risk management systems, which will require developing the credit information bureaus so that they can provide comprehensive information on cardholders' obligations and payment histories. There may also need to be a need to strengthen the supervisory framework itself, especially by shifting away from a regulatory approach, which focuses on compliance with rules, toward a more risk-based approach, as recommended in the FSAP (IMF Country Report No. 03/81).

33. **Meanwhile, steps should be taken to ensure that problems in the CCCs do not spread to the banking sector**.[12] So far, bank nonperforming loans have remained low, but

[11] The KDB has been used in the past as a vehicle for intervention in the financial markets, most notably to underwrite corporate bonds issued by troubled conglomerates during 2001 in the wake of the Daewoo crisis.

[12] Despite write-offs from SK Global and other cases during 2003, CARs of the major commercial banks remained a robust 11.3 percent as of September 2003. The subsequent losses from LG Card are estimated by Standard and Poor's to reduce the CAR of the nine creditor banks involved by about 0.4 percentage points on average.

the very large increase in household and SME debt suggests that it would be prudent to take precautionary measures. The team therefore urged the authorities to intensify supervision and tighten consumer credit standards pre-emptively, most notably by requiring that financial institutions start to take income as well as assets into account when granting loans.

34. **As a further step, the team proposed reversing the recent decision reducing the minimum CAR needed to qualify as a "first class" bank from 10 percent to 9 percent.**[13] This measure was designed as a temporary expedient to promote additional bank lending, after the SK Global crisis impaired the bond market. The reduction, however, had sent an unintended signal that the health of the banks was being subordinated to the credit needs of the corporate sector. With the economy improving, it should be possible to allow this measure to expire earlier than the planned date of end-2004.

35. **The next step would be to reform the ITC sector.** For Korea to exploit its comparative advantage of a large domestic bond market, a strong asset management sector would be crucial. For this reason, the team welcomed the government's plans to recapitalize and privatize the major ITCs. Now that Hyundai ITC has been sold, the government has announced a market-driven strategy for selling the other two ITCs by the end of 2004, under which the precise nature of the transaction would be determined by the demand from potential investors.

36. **As a further spur to the asset management sector, the government is planning to establish a Korean Investment Corporation (KIC).** Initially, \$20 billion will be transferred from the Bank of Korea and outsourced to reputable international asset management firms for investment in marketable securities. In the authorities' view, this move could help jump start the plans for a regional financial hub, by attracting asset management firms to the country. The authorities stressed that the KIC would be independent, and it would not be used as a vehicle for intervention in financial markets, or as a substitute for exchange rate flexibility.

37. **The team nonetheless expressed concerns about this proposal, noting in particular the risk that outside pressures may be brought to bear on investment decisions.** To contain this risk, strong safeguards will need to be put in place. The agency's operational independence, investment guidelines, and rules for any future transfer of reserves should be inscribed in law, while its accounts should be regularly and fully disclosed to the public. Moreover, until the new agency's credibility is firmly established, its funds should not be invested in domestic assets.

38. **Beyond strengthening the asset management sector, measures need to be taken to improve the efficiency of the bond market itself.** One of the by-products of the LG Card rescue was that holders of the company's bonds were bailed out, potentially signaling to investors a return to the pre-crisis approach of "too big to fail." Certainly, the persistent

[13] A first class bank is subject to standard supervision procedures while other banks have more intensive supervision.

rating of LG Card bonds as investment grade, even as the company teetered, as well as the narrow corporate spreads on domestic bonds (compared with spreads in other countries), suggest that markets perceive little default risk in large-company bonds.

39. **The team emphasized that perceptions of implicit guarantees are costly**. They distort the allocation of capital away from smaller firms. They encourage short-term finance, since investors will assume that such guarantees will eventually need to be abandoned. Moreover, by reducing the rewards to careful corporate analysis, they discourage the entry of world-class investment managers, undermining the objective of creating a financial hub. In short, guarantees do not stimulate bond market development—they stifle it.

40. **Consequently, the team recommended that the government make clear it is not providing implicit guarantees, and encourage investors to sharpen their risk assessments**. For this reason, the team welcomed recent government measures to improve the accuracy of bond ratings, including a requirement for ratings agencies to publish the information underlying their assessments. To complement these steps, the team suggested spurring competition by encouraging foreign firms to enter the industry without joint venture partners. At the same time, to ensure orderly work-outs in cases where firms do fail, the team supported the plans to rationalize the bankruptcy system by clearing up the welter of partly contradictory laws. The government submitted a bill to this effect in early 2003, but it has been languishing in the National Assembly.

41. **The authorities responded that they broadly agreed with the team's recommendations**. In particular, LG Card would be sold off as soon as possible, in a sale (like that of the ITCs and other financial firms) open to all qualified investors, foreign or domestic.[14] The KIC's independence would be enshrined in law, and no government officials would be allowed to work for the new agency.

42. **As for the bond market, the government remained firmly committed to the principle that bondholders must bear the risk of investing.** LG Card, however, was a special case, because it posed systemic risks. If LG Card had failed, this would have set off a wave of downgradings, triggering repayment clauses and possibly liquidity crises at the other CCCs, and causing the bond market to freeze. All this could have jeopardized the still fragile recovery. Still, moral hazard was a concern; to minimize it, the authorities had ensured that shareholders were written down, bank creditors have converted much of their debt into equity, and the management has been replaced.

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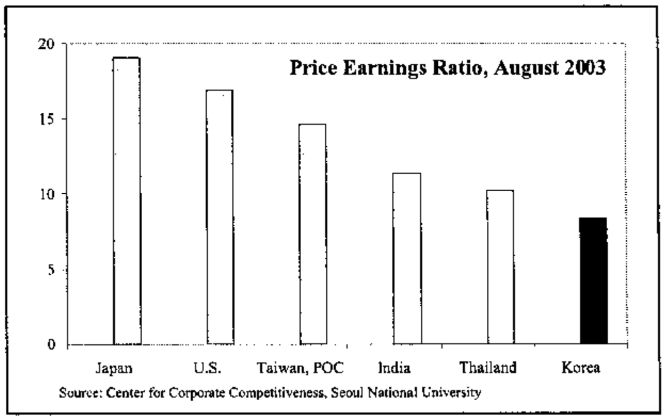
[14] In December, a central bank research paper proposed developing domestic-based alternatives to foreign investment. The authorities have explained, however, that the proposal aims at developing domestic markets, and has no implications for their asset sales policy.

C. Ending the Korea Discount



43. **Another key task is to improve corporate governance.** Despite the considerable progress achieved since the Asian crisis, the market has a lingering distrust of local companies, made manifest in the "Korea discount," which reduces the price/earnings ratio of local firms below that of their regional competitors. If this distrust could be dispelled, Korean firms could enjoy lower-cost equity capital, relaxing the financing constraints on the economy's longer-term growth rate. Moreover, the economy would be less subject to credit events that can lead to financial market break-downs, interrupting growth.

44. **But how can the Korea discount be eliminated?** A growing body of research finds that Korea's corporate governance problems are rooted in the wide divergence between the effective control that key shareholders wield over the *chaebol* and their actual ownership stakes, which are often quite small (Box 2). This divergence is facilitated by the practice of cross-shareholdings, in which members of a *chaebol* hold stakes in the other members of the group, thereby grossing-up capital and creating voting rights that the key shareholders can control.

45. **This is why the authorities' three-year Roadmap for Market Reform aims squarely at reducing the gap between ownership and control**. Under the Roadmap, the gap would be narrowed in one of two main ways. The *chaebol* could improve internal checks and balances, for example by adopting cumulative voting for the selection of independent directors and creating committees of independent directors to monitor related-party transactions.[15] Or they could adopt vertical holding company structures, so that all the group's equity investments are held by one company, as is common in other OECD countries. Such a move would eliminate cross-shareholdings, improve transparency, and perhaps also strengthen the *chaebol's* profit orientation, since holding companies rely for their income on dividends from subsidiaries.

46. **The team strongly endorsed these reforms, but noted that the *chaebol* may not have enough incentive to adopt them**. Under the Roadmap, the main incentive offered is a relaxation in existing regulations: firms which reform would be exempted from the limits on

[15] Cumulative voting means that investors could vote all of their shares for one director, rather than be required to split their votes among all the chairs up for election.

Box 2. Control versus Ownership in the Corporate Sector

- **Korean corporate governance has improved.** Since the Asian crisis, Korea's standing in international measures of corporate governance has risen, reflecting measures to strengthen creditor and minority shareholder rights, improve accounting standards, and tighten regulations.

- **Nonetheless, there are still signs of continuing problems.** The financial accounts of *chaebol* have been found to be suspect, and not only because of recurring scandals such as SK Global. Research has shown that earnings and book value have less explanatory power for stock price variations in *chaebol*-affiliated firms, with this power declining as cross-equity ownership rises.[1] Moreover, controlling families have been found to expropriate minority shareholders in various ways including: transferring profits to affiliates in which they have higher stakes; shifting their ownership from less to more profitable companies at favorable prices; and transferring wealth via mergers.[2] Consequently, *chaebol* stocks trade at a "Korea discount", a relatively low P/E ratio compared to similar enterprises in other Asian countries.

- **The root of these governance failures seems to lie in the high degree of control exercised by the family "owners" relative to their actual ownership.** Research indicates that Korean companies that have high disparities between the ownership and control have lower profitability, higher leverage, and lower P/E ratios.[3]

- **The key means of amplifying control relative to ownership are cross-shareholdings among *chaebol* affiliates.** If company A invests in B, which in turn invests in C (under family control), which then invests back in A, the family has increased its control over A without actually providing any new equity. In this way, families—relatives and management—have been able to maintain their control of the top-10 *chaebol* even as their direct ownership shares fell from 9½ percent to less than 4 percent. Expanding cross-shareholdings has also created "phantom" capital, which has flattered firms' debt/equity ratios without creating a real cushion against losses.

Control of Top 10 *Chaebol*
(In percent)

	Shareholdings			
	Family	Affiliates	Own Stock	Family Control
1997	9.5	29.3	0.7	39.6
1998	7.8	35.4	1.0	44.2
1999	5.8	41.0	1.3	48.1
2000	4.3	38.8	1.6	44.7
2001	4.3	38.9	4.4	47.6
2002	3.7	39.1	4.0	46.9

Source: Fair Trade Commission.

[1] Bae Kee-Hong and Jeong Seok-Woo, 2003, "The Value Relevance of Accounting Information, Ownership Structure, and Business Group Affiliation: Evidence from Korean Business Groups," Asian Institute of Corporate Governance, Working Paper 2003-6.
[2] Chang Sea-Jin, 2001, "Ownership Structure, Expropriation, and Performance of Group-Affiliated Companies in Korea", Korea University, December.
[3] Black, Jang, and Kim, 2002, "Does Corporate Governance Affect Firm Value? Evidence from Korea," Stanford law School Working Paper No. 237. Sung Wook-Joh, 2001, "Korean Economic Crisis and the Corporate Governance System," Korea Development Institute, October.

their equity investments.[16] But these benefits may not be enough to compensate controlling shareholders for the potential reduction in their control or for the cost of equity injections that moving to a holding company structure would entail. Accordingly, the team recommended introducing reinforcing measures.

47. **In particular, the team recommended strengthening market-based mechanisms for exerting discipline on the corporate sector**. Currently, Korea is forced to rely on direct controls (such as equity investment limits and firewalls between the corporate and financial sector) because financial markets still do not have adequate tools to influence companies' behavior. In particular, despite considerable improvements in recent years, investors remain concerned about the quality of information provided, while minority shareholders have found it difficult to enforce their rights.

48. **For these reasons, the team welcomed the recent laws to improve accounting and auditing practices**. These laws, which are similar to those in the American Sarbanes-Oxley Act, will do much to improve the accuracy and timeliness of the information provided to the market.[17] As a next step, the team recommended adopting a "comply or explain" system for the existing Code of Best Practices in Corporate Governance, as other OECD countries have done. If firms were required either to comply with the code or explain on an article-by-article basis why they are not complying, then investors would be better able to identify and reward the companies that have been making strides in improving their governance.

49. **The team also welcomed progress in re-enforcing the legal rights of minority shareholders**. In particular, the team considered the new law allowing class action lawsuits in cases of securities violations in large companies as a major step forward, since it will substantially reduce the cost of legal actions for minority shareholders. As experience with these suits develops, the team noted, the law's coverage could be expanded to all listed companies, as well as other types of violations, such as breaches of duty by directors, managers, and auditors. In addition, the use of derivative lawsuits, which are suits by shareholders on behalf of the company whose shares they own, could also be expanded. For example, it would be helpful to allow "multiple derivative" lawsuits, so that shareholders can sue affiliated companies that have harmed the financial interests of the company in which they hold shares.

50. **The authorities broadly shared the team's views, stating that they would examine its recommendations carefully**. They stressed, in particular, that the scope for intensifying direct controls on the *chaebol* was nearly exhausted; a more effective and

[16] The regulation limits investment in affiliated companies to no more than 25 percent of net assets of the acquiring company, and applies to 17 large business groups.

[17] The reforms require: the CEO and CFO to certify the accuracy of financial statements; the board to approve and publicly disclose loans to major shareholders and executives; and firewalls between consultancy and auditing services within accounting firms. A six-year limit on auditing relationships was added after the SK Global scandal.

sustainable approach was needed. Consequently, the government would be moving toward market-based mechanisms, which is why, for example, passing the class action lawsuit and accounting/auditing bills had been a priority.

D. Modernizing the Labor Market

51. **In addition to financial markets and corporate governance, the third key item on the structural agenda is labor market reform.** Labor reform has become an increasingly important issue, not just because there was an increase in strikes during 2003, but because some fundamental trends are at work. The Korean economy has been changing, shifting from an economy based on manufacturing standard goods to one based on producing advanced products.[18] At the same time, there has been a significant expansion of the service sector. Both trends require a more flexible labor force, so that employers can shift their output as demand and technology change.

52. **The core segment of Korea's labor market, however, is relatively inflexible** (Box 3). Regular workers benefit from strict employment protection, with dismissals being more difficult than in Japan or Germany according to OECD indicators. Employers must show there was "just cause" or "urgent managerial reasons" to justify dismissals or redundancies, which is difficult in practice. In addition, employers found not to have followed the complex dismissal rules properly are potentially subject to criminal charges.

53. **The high cost of firing workers has encouraged employers to turn increasingly to nonregular workers.** In recent years, the bulk of new hires have been nonregular workers, such as those hired on one-year contracts, to the point where they now account for around one-third of total employees, one of the highest ratios in the OECD. As this has occurred, overall job insecurity has increased, fanning labor tensions and leading regular workers to insist on employment protection.

54. **One reason why protection is demanded, the team noted, is that the social safety net is relatively limited.** While employment insurance benefits are similar to other countries, less than one-fifth of the unemployed actually receive benefits, as most nonregular workers are not covered. Those without employment insurance must rely on the social assistance program, but the strict eligibility criteria mean that only half of the poor receive these benefits.

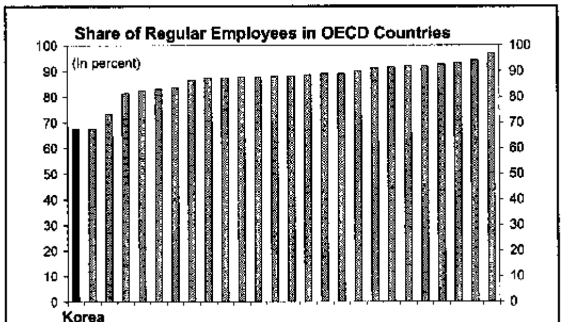
55. **Recognizing the need for change, the government has released a "Reform Proposal for Industrial Relations."** The aim of this plan is to create a new framework for industrial relations that would allow the government to step back from individual labor disputes, narrow the divide between regular and other workers, and make labor relations less confrontational. In particular, flexibility would be improved by shortening the notification period for dismissal from the current 60 days and easing conditions of dismissal for

[18] Two facts illustrate the point: Korea has the highest rate of broadband penetration in the world; and Samsung Electronics is now Asia's largest electronics company measured by market capitalization.

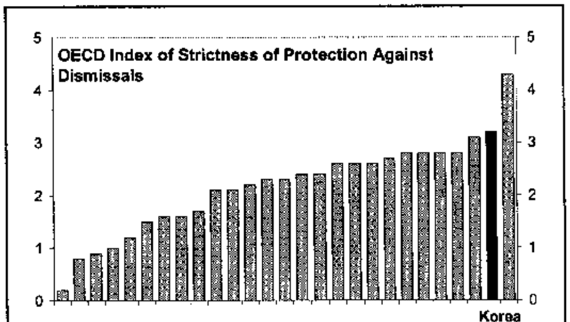
Box 3. Korea's Dual Labor Market

- **Korea's rapid recovery from the Asian crisis was facilitated by labor market reforms**. Emergency legislation allowed dismissal of workers for "urgent managerial reasons" as well as the use of temporary workers; and the social safety net was strengthened by expanding coverage of unemployment insurance and the "productive welfare" system through the National Basic Livelihood Security Law (NBLS). These steps facilitated economic restructuring, and supported the quick return to low unemployment rates, at 3½ percent recently.

- **The Korean labor market has a high degree of duality**. About two-third of employees are "regular" workers, while the remainder are "temporary" or "daily" workers, whose numbers can be more easily adjusted in line with changing economic conditions. Moreover, the proportion of nonregular workers has been increasing, with 70 percent of new hires in 2002 being nonregular workers, because they are paid 20 percent less on average and also have much lower firing costs, both administratively and in monetary terms.



Sources: Ministry of Labor, and OECD (2000), *Pushing Ahead with Reform in Korea.*



Source: OECD Employment Outlook 1999.

- **Regular workers benefit from one of the strongest employment protection in the OECD**. Lay-offs, including for "managerial reasons" in case of business transfer or mergers and acquisitions, are difficult as they have to meet criteria including: (1) the employer must make every effort to avoid dismissals; (2) the selection of employees to be dismissed must be based on fair and reasonable criteria; (3) the employer must consult sincerely with trade unions as to the measures to avoid dismissals and selection of dismissed workers; and (4) employee representatives or unions must be notified at least 60 days in advance of lay-offs. In addition, the definition of unfair dismissals is vague, allowing collective bargaining and precedent to set a high standard for what constitutes a "just cause." High minimum severance payments, and criminal sanctions in case of unfair dismissals, also raise firing costs significantly.

- **The still-limited social safety net in Korea underpins demand for strong employment protection**. Only one-fifth of the unemployed receive unemployment benefits as some nonregular employees do not meet eligibility requirements and some employers, especially in SMEs, do not comply with social contributions. In addition, benefit entitlement under the NBLS is subject to unusually strict income criteria, based on the income capacity (and not actual income) of the extended family. These problems leave many Koreans little means of making ends meet once they are out of a job.

- **This labor market structure undermined the Korean economy in 2003, and may limit future growth**. First, the wide gap in employment protection between regular and nonregular workers tends to make industrial relations confrontational. Second, this rigidity in the formal labor market reduces Korea's attractiveness for FDI and may also promote greater FDI outflows. Third, job precariousness among nonregular workers discourages vocational training, undermining innovation and productivity growth. Fourth, youth unemployment is high at over 8 percent because nonregular jobs are viewed as traps.

companies undertaking bankruptcy proceedings. Meanwhile, the social safety net would be strengthened, by expanding the coverage of the employment insurance system and the industrial accident compensation system.

56. **The team welcomed the Reform Proposal, noting that it constitutes a significant first step toward overhauling the current labor market framework**. Nevertheless, it considered that more reforms would be needed to increase flexibility in the core segment of the labor market, while simultaneously expanding this core by creating incentives for employers to hire regular workers. In considering how this might be done, the team suggested that the experiences of other OECD countries might offer useful lessons. In particular, Spain's experiment in introducing a new type of regular employment contract, with lower layoff costs, might be worth examining, although the authorities would need to tailor any measures to be consistent with Korea's own traditions and legal framework.[19]

57. **The authorities emphasized that they were committed to modernizing the labor market.** But they noted that achieving social consensus on this issue would be difficult, pointing out that even the steps in the Roadmap were politically very contentious, and had still not been fully agreed by the employers and trade unions. As for Spain's experiment, they agreed that it might be worth considering, but pointed out that introducing a such a contract would be very difficult, since the Labor Standards Act would need to be modified, and there might be constitutional challenges to the creation of two different types of treatment for regular workers.

E. Other Issues

58. **The authorities stressed that they were committed to the success of the Doha round of trade negotiations**. In particular, they are paving the way for a gradual opening up of its agricultural sector by offering to provide income support to those farmers who will be most affected by the liberalization. Even so, steps toward liberalization have encountered stiff domestic resistance: Korea's first Free Trade Agreement, with Chile, agreed in 2002, has still not been ratified by the National Assembly, even though a number of agricultural safeguards have been included. Moreover, trade in rice will continue to be restricted; the government will be negotiating an extension of its quantitative restrictions beyond the end-2004 terminal date agreed under the WTO.

59. **Korea has continued to upgrade its statistical system, but improved fiscal transparency is needed** (Annex II). In particular, monthly data on the consolidated central government should provide a more comprehensive breakdown of revenues and expenditures, and data on the general government should also be published.

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[19] Chapter III of the *Selected Issues* paper provides background information on labor market institutions in Korea and analyzes options of reforms.

V. STAFF APPRAISAL

60. **Korea has made a spectacular recovery from the Asian crisis.** Economic growth has been rapid, raising GDP far above its pre-crisis level. Economic resiliency has also improved, as international reserves have been built up to ample levels, while debt ratios have been maintained in a comfortable range. Korea today is a prosperous economy, with strong medium-term prospects, based on its well-educated workforce and expertise in advanced technology.

61. **This remarkable achievement is tribute to the deep structural reforms of the past six years.** By opening up and deregulating the economy, the financial sector has been transformed, freed to allocate capital to its highest returns. This change, in turn, has put pressure on the *chaebol,* forcing them to become more transparent and focus more on earning profits. In short, the reforms have created a more competitive system, guided much more by market signals and far less by government directives.

62. **Despite this considerable progress, structural problems remain, which in 2003 helped derail the economic expansion.** In particular, weaknesses in the credit card and investment trust companies made them vulnerable to liquidity pressures following an accounting scandal in one of the *chaebol*. One effect was to intensify a household credit squeeze already underway, further constraining consumption. Another was to impair the market for corporate bonds, which coupled with rising labor strife and political uncertainties, reduced investment. As a result, for two quarters, the economy actually contracted.

63. **Economic recovery is now underway, but the rebound is highly uneven.** Exports are booming and the global upswing—including vigorous growth in China, Korea's largest trading partner—implies that they will remain strong for some time. But domestic demand will continue to be held back by high levels of household debt and loan delinquency, along with the risk of continuing labor strife and political uncertainties. A broad-based recovery may therefore not occur until 2005, when the process of household balance sheet adjustment should be more complete.

64. **Accordingly, macroeconomic policies in 2004 will need to remain supportive of the recovery.** In particular, the staff recommends maintaining a broadly neutral fiscal stance this year. It therefore welcomes the authorities' steps to amend the original budget proposal to bring it closer in line with this objective, as well as their plans to front-load spending and introduce a supplementary budget, if necessary. Subsequently, as the recovery develops, the staff agrees that it would be prudent to restore fiscal balance gradually, to prepare for the budgetary challenges of an aging population and for uncertainties related to North Korea.

65. **Similarly, there is scope to maintain the current monetary stance for some time.** Forward-looking indicators such as the output gap suggest that inflation should remain subdued this year. And while housing prices have risen in certain areas of the country, this should not constrain policy, unless a nation-wide problem emerges.

66. **At the same time, the staff urges the authorities to scale back their foreign exchange purchases and allow the exchange rate to be determined essentially in the market.** Korea's flexible exchange rate policy, adopted in the wake of the Asian crisis, has served the country well, encouraging financial market development, while maintaining external competitiveness. Moreover, with exports surging and the economy recovering, there would seem to be scope for greater exchange rate flexibility, which would also contribute to an orderly adjustment of global current account imbalances.

67. **Meanwhile, the key remaining structural problems will need to be addressed.** The authorities have set the appropriately ambitious objective of doubling Korean per capita incomes over the longer-term. To help realize this goal, they have developed reform roadmaps for the corporate sector and the labor market, while accelerating ongoing reforms of the financial sector.

68. **With respect to financial markets, the staff agrees that the main priority should be to strengthen the non-bank institutions**. The first task will be to resolve the credit card companies. The government should make it clear that the rescue of LG Card was an exceptional case, and that other card companies will be required to recapitalize quickly, with injections sufficient to cover realistic estimates of expected losses. Should existing owners prove reluctant to do this, prompt corrective action should be taken, including possible court receivership. As for LG Card itself, the company should be sold swiftly to investors with the needed financial strength and management skills. Meanwhile, to prevent similar problems in the banking system, supervisory authorities should encourage lenders to assess the adequacy of borrowers' incomes, as well as their assets. There may also need to be a need to strengthen the supervisory framework itself, especially by shifting away toward a more risk-based approach, as recommended in the FSAP.

69. **The next task will be to strengthen the asset management sector**. Accordingly, the staff welcomes plans to sell the remaining two government-controlled investment trust companies to financially strong and capable buyers, foreign or domestic. With respect to establishing a Korean Investment Corporation, the staff recognizes that the aim is to spur the development of the asset management sector, rather than to provide a a mechanism to intervene in the market or a substitute for exchange rate flexibility. However, it believes that strong safeguards are necessary to guard against the risks involved. The agency's law should guarantee its operational independence, investment guidelines, and rules for any future transfer of reserves. Moreover, the KIC's accounts should be regularly and fully disclosed to the public, and it should refrain from investing domestically, at least until its credibility is established.

70. **To develop the bond market further, the government will need to dispel notions that large companies are "too big to fail."** It should make clear that it is not providing implicit guarantees, and instead encourage investors to sharpen their risk assessments. Accordingly, the staff welcomes the plans to improve the accuracy of bond ratings by requiring agencies to publish information underlying their assessments and recommends that foreign firms be encouraged to enter the credit rating industry, thereby spurring competition.

Moreover, once bondholders have used this information to take risks, they should bear the consequences of their decisions. The unified bankruptcy bill currently before the National Assembly could facilitate this, by promoting orderly workouts in problem cases.

71. **The staff welcomes the three-year roadmap for corporate reform, which eases regulations on *chaebol* that improve their governance.** The staff agrees that direct controls (including strict firewalls between corporations and financial institutions) need to be maintained or even enhanced for the time being. But they should be wound back as market discipline on *chaebol* improves. Particularly important in this endeavor is providing accurate and timely information to investors. Accordingly, the staff welcomes the National Assembly's approval of the long-awaited accounting and auditing reforms, and recommends the adoption of a "comply or explain" system for the Code of Best Practices in Corporate Governance. Since investors must also be able to act on information that suggests their rights have been violated, the staff welcomes the new law allowing class action lawsuits for securities violations, and suggests that this be followed by permitting other kinds of legal action, including multiple derivative lawsuits.

72. **The final item on the structural reform agenda is labor market reform.** As the economy has advanced into the rapidly changing IT sector, and as the importance of services have grown, the need for employment flexibility has increased. The government has proposed a balanced approach of easing employment protection while at the same time expanding the coverage of the social safety net. Nonetheless, employment adjustment costs for regular workers would remain relatively high, so the share of nonregular workers may continue to rise. Other OECD countries have faced similar challenges, and Korea may be able to draw useful lessons for its own reform efforts.

73. **Implementing this ambitious reform agenda will be challenging.** Nonetheless, there is widespread recognition that the key structural problems will need to be addressed for Korea to achieve its target of doubling per capita incomes. Moreover, Korea has already demonstrated a substantial capacity to implement difficult reforms after the Asian crisis. Given Korea's strong drive to advance its economy, staff expects the authorities will find the way forward.

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

Table 1. Korea: Selected Indicators, 1999–2004
(In units indicated)

	1999	2000	2001	2002	2003 Est.	2004 Proj.
Real GDP (percent change)	**10.9**	**9.3**	**3.1**	**6.3**	**2.9**	**5.5**
Total domestic demand	14.7	8.1	2.2	5.7	-0.4	2.7
Final domestic demand	7.6	8.2	2.3	5.8	0.2	2.8
Consumption	9.4	6.7	4.2	6.2	-0.7	2.7
Gross fixed investment	3.7	11.4	-1.8	4.8	2.5	3.0
Stock building [1]	5.4	-0.2	-0.1	-0.2	-0.6	-0.1
Net foreign balance [1]	-1.0	3.1	1.4	2.0	3.8	3.6
Nominal GDP (in trillions of won)	**482.7**	**522.0**	**551.6**	**596.4**	**617.5**	**659.4**
Saving and investment (percent of GDP)						
Gross national saving	32.7	30.8	28.8	27.2	27.4	26.4
Gross domestic investment	26.7	28.2	26.9	26.0	25.1	24.8
Current account balance	6.0	2.7	1.9	1.1	2.3	1.7
Prices (percent change)						
CPI inflation (end of period)	1.4	2.8	3.2	3.7	3.4	3.1
Core inflation (average)	0.3	1.9	3.6	3.0	3.1	3.0
GDP deflator	-2.0	-1.1	2.5	1.7	0.6	1.3
Real effective exchange rate	13.5	8.1	-5.0	3.9	-1.3	-4.0
Trade (percent change)						
Export volume	12.6	20.8	-1.0	12.9	17.2	21.4
Import volume	29.5	18.3	-4.7	12.0	15.1	24.8
Terms of trade	-2.1	-12.8	-4.5	-0.5	1.3	-0.6
Consolidated central government (percent of GDP)						
Revenues [2]	22.4	26.0	26.1	26.6	27.9	28.2
Expenditure [2,3]	25.7	24.8	25.5	23.9	25.2	25.3
Overall balance [2,3]	-3.3	1.3	0.6	2.7	2.7	2.9
Excluding Social Security Funds [2]	-4.9	-1.1	-2.2	-0.3	-0.6	-0.6
Fiscal impulse [2,4]	1.2	-3.1	1.4	-0.5	-0.2	-1.0
Money and credit (end of period)						
Overnight call rate [5]	4.7	5.3	4.0	4.3	3.8	...
Three-year corporate bond yield [5]	9.9	8.1	7.1	5.9	5.5	...
M3 growth	8.0	7.1	11.6	13.6	5.5	9.0
Balance of payments (in billions of U.S. dollars)						
Exports, f.o.b.	145.2	176.2	151.5	163.4	200.6	247.1
Imports, c.i.f.	116.8	159.3	138.0	148.6	176.9	225.3
Current account balance	24.5	12.3	8.0	5.4	12.1	9.4
Usable reserves (end of period)	74.1	96.2	102.8	121.4	155.4	165.9
In percent of short-term debt	132.2	153.2	193.3	185.8	196.6	...
External debt (in billions of U.S. dollars)						
Total external debt (end of period)	152.9	148.5	130.8	144.6	154.8	167.4
Of which: short-term, eop	42.5	49.4	41.9	53.2	55.5	61.8
Total external debt (percent of GDP)	37.7	32.2	30.6	30.3	29.8	30.1
Debt service ratio [6]	23.7	12.6	13.7	9.9	8.0	10.6

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

[1] Contribution to GDP growth.

[2] Refer to budget plan for 2004.

[3] Excluding privatization receipts and rollover of KDIC/KAMCO bonds.

[4] Change in the cyclically adjusted overall balance (excluding net lending). A negative impulse implyies a contractionary stance.

[5] Data for 2003 are as of December 31, 2003.

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

Table 2. Korea: Monetary and Financial Indicators, 2001–03

	2001	2002				2003			
		March	June	Sept.	Dec.	March	June	Sept.	Dec.
				(In trillions of won)					
Bank of Korea									
Reserve money	**32.8**	**33.8**	**33.1**	**36.3**	**38.0**	**38.1**	**37.3**	**38.9**	**40.7**
Net foreign assets	136.7	141.6	135.4	141.0	146.0	148.2	157.3	168.0	...
Foreign assets	145.6	164.2	156.5	160.9	158.1	162.1	159.9	170.8	...
Foreign liabilities	-8.9	-22.5	-21.1	-19.9	-12.1	-14.0	-2.5	-2.8	...
Net domestic assets	-103.9	-107.8	-102.3	-104.7	-108.0	-110.0	-120.0	-129.1	...
Public sector	-2.2	-2.7	-8.3	-9.9	-6.2	1.7	-1.0	-1.0	...
Private financial sector	29.3	28.7	26.2	30.1	28.3	29.3	31.4	34.8	...
Monetary stabilization bond	-79.1	-82.5	-84.8	-84.7	-84.3	-95.7	-97.4	-101.2	...
Other items net	-51.8	-51.4	-35.3	-40.3	-45.8	-45.3	-53.1	-61.7	...
Depository Corporations Survey									
M2	**765.0**	**805.1**	**826.5**	**840.3**	**872.1**	**887.8**	**882.0**	**881.0**	...
Net foreign assets	129.9	131.2	119.6	120.3	118.2	111.5	118.3	132.2	...
Foreign assets	208.4	224.1	212.9	215.9	210.3	214.8	215.3	226.3	...
Foreign liabilities	-78.4	-92.9	-93.3	-95.6	-92.1	-103.4	-97.0	-94.1	...
Net domestic assets	635.0	674.0	706.9	720.0	753.9	776.3	763.7	748.8	...
Public sector	-12.3	-17.3	-21.3	-25.9	-19.5	-23.7	-21.4	-20.9	...
Nonfinancial private sector	734.6	779.4	807.0	843.6	887.1	911.3	918.0	925.3	...
Corporations	456.2	481.8	484.8	500.2	525.8	545.8	540.0	531.2	...
Households	278.4	297.6	322.2	343.5	361.3	365.5	378.0	394.1	...
Other items net	-87.2	-88.1	-78.8	-97.7	-113.6	-111.3	-132.9	-155.6	...
Financial survey									
M3	**1,017.7**	**1,069.1**	**1,092.6**	**1,118.2**	**1,155.7**	**1,171.2**	**1,179.1**	**1,194.4**	...
Net foreign assets	140.5	141.0	129.5	128.4	130.1	125.3	132.5	143.2	...
Foreign assets	201.1	216.1	207.1	211.3	211.7	214.9	213.8	224.5	...
Foreign liabilities	-60.6	-75.1	-77.6	-82.9	-81.6	-89.6	-81.3	-81.2	...
Net domestic assets	877.2	928.1	963.1	989.8	1,025.7	1,045.9	1,046.6	1,051.2	...
Public sector	143.9	141.3	132.7	129.9	139.4	137.7	135.5	131.8	...
Private sector	786.1	827.0	863.5	901.5	935.2	962.5	972.6	992.4	...
Of which: Foreign currency	22.6	23.0	22.7	25.9	40.0	44.8	42.1	40.8	...
Other items net	-52.8	-40.2	-33.0	-41.6	-48.9	-54.3	-61.5	-73.0	...
Household credit [1]	341.7	368.1	397.5	424.3	439.1	439.3	439.1	439.9	...
Memorandum items:				(Percent change, year-on-year)					
Reserve money	16.3	10.0	19.8	9.6	15.7	12.8	12.6	7.3	7.3
M2	8.1	11.8	12.1	9.3	14.0	10.3	6.7	4.8	...
M3	11.6	14.7	13.6	11.3	13.6	9.6	7.9	6.8	...
Private sector credit	11.1	15.5	16.5	17.1	19.0	16.4	12.6	10.1	...
Household credit [1]	28.0	33.3	34.3	34.1	28.5	19.3	10.5	3.7	...
				(In percent)					
Interest rates, end period									
Call rate target	4.00	4.00	4.25	4.25	4.25	4.25	4.00	3.75	3.75
Treasury bond, three-year	5.91	6.39	5.66	5.30	5.11	4.62	4.10	4.46	4.88
Corporate bond, three-year	7.11	7.05	6.76	6.06	5.88	5.44	5.26	5.87	5.53
Deposit rate	3.98	4.70	4.80	4.74	4.69	4.30	4.22	3.94	3.94
Household loan rate	7.26	6.69	6.98	6.82	7.12	6.96	6.64	6.15	6.21
Exterprise loan rate	6.75	6.57	6.47	6.46	6.41	6.37	6.18	5.99	6.11

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

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

Table 3. Korea: Consolidated Central Government Operations, 2001–04

	2001		2002		2003		2004
	Budget	Actual	Budget	Est.	Budget [1]	Proj.	Budget
			(In trillions of won)				
Revenue	**142.7**	**144.0**	**156.3**	**158.7**	**172.0**	**172.3**	**185.7**
Tax revenue	95.9	95.8	103.6	104.0	113.8	113.1	122.3
Social security contributions	16.0	17.5	18.2	19.7	20.9	23.0	24.8
Nontax and capital revenue	30.8	30.7	34.5	35.0	37.3	36.2	38.6
Expenditure and net lending	**150.2**	**140.5**	**157.5**	**142.7**	**155.6**	**155.8**	**166.9**
Current expenditure [2]	107.0	107.8	122.7	113.2	127.5	126.6	134.4
Interest [3]	7.6	13.3	15.2	13.8	9.7	8.4	9.2
Of which: Bank restructuring	...	6.1	7.0	6.9	3.6	3.6	2.5
Non-interest	99.4	94.5	107.5	99.4	117.8	118.2	125.3
Capital expenditure	25.7	24.9	26.4	29.4	27.8	29.2	26.5
Net lending [4]	17.5	7.7	8.4	0.2	0.3	0.0	5.9
Balance	**-7.6**	**3.6**	**-1.3**	**16.0**	**16.4**	**16.5**	**18.8**
Financing	**7.6**	**-3.6**	**1.3**	**-16.0**	**-16.4**	**-16.5**	**-18.8**
Domestic financing	7.9	-3.2	-0.1	-15.5	-10.5	-10.6	-15.7
Of which: Privatization	3.0	3.7	6.7	6.7	1.6	1.3	0.0
External financing	-0.3	-0.4	-0.5	-0.5	-5.9	-5.9	-3.2
			(In percent of GDP)				
Revenue	**25.9**	**26.1**	**26.2**	**26.6**	**27.9**	**27.9**	**28.2**
Tax revenue	17.4	17.4	17.4	17.4	18.4	18.3	18.6
Social security contributions	2.9	3.2	3.0	3.3	3.4	3.7	3.8
Nontax and capital revenue	5.6	5.6	5.8	5.9	6.0	5.9	5.8
Expenditure and net lending	**27.2**	**25.5**	**26.4**	**23.9**	**25.2**	**25.2**	**25.3**
Current expenditure [2]	19.4	19.6	20.6	19.0	20.6	20.5	20.4
Interest [3]	1.4	2.4	2.5	2.3	1.6	1.4	1.4
Non-interest	18.0	17.1	18.0	16.7	19.1	19.1	19.0
Capital expenditure	4.7	4.5	4.4	4.9	4.5	4.7	4.0
Net lending [4]	3.2	1.4	1.4	0.0	0.0	0.0	0.9
Balance	**-1.4**	**0.6**	**-0.2**	**2.7**	**2.7**	**2.7**	**2.9**
Excluding social security funds	-3.7	-2.2	-2.7	-0.3	-0.6	-0.6	-0.6
Excluding social security funds and net lending	-0.5	-0.8	-1.3	-0.2	-0.5	-0.6	0.3
Primary balance	**0.0**	**3.1**	**2.3**	**5.0**	**4.2**	**4.0**	**4.2**
Memorandum items:							
Privatization receipts	0.5	0.7	1.1	1.1	0.3	0.2	0.0
Conversion of KDIC/KAMCO bonds	0.0	0.0	0.0	0.0	-2.1	-2.1	-1.8
Fiscal impulse [5]	1.6	1.4	1.1	-0.5	-0.2	-0.2	-1.0
Nominal GDP (in trillions of won)	551.6	551.6	596.4	596.4	617.5	617.5	659.4

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 W 13 trillion in 2003 amd W 12 trillion in 2004.

[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 (excluding net lending).

Table 4. Korea: Balance of Payments, 2000–04
(In billions of U.S. dollars, unless otherwise indicated)

	2000	2001	2002	2003 Est.	2004 Proj.
1. Current account balance	**12.3**	**8.0**	**5.4**	**12.1**	**9.4**
Trade balance	17.0	13.5	14.8	23.7	21.8
Exports	176.2	151.5	163.4	200.6	247.1
(growth rate, in percent)	(21.2)	(-14.0)	(7.9)	(22.8)	(23.2)
Imports	159.3	138.0	148.6	176.9	225.3
(growth rate, in percent)	(36.2)	(-13.4)	(7.7)	(19.0)	(27.4)
Services	-2.8	-3.9	-8.2	-8.5	-9.2
Income	-2.4	-1.2	0.4	-0.2	-0.3
Current transfers	0.6	-0.4	-1.6	-2.9	-2.9
2. Financial and capital account balance	**12.1**	**2.3**	**5.9**	**15.2**	**2.3**
Financial account	12.7	3.0	7.0	16.5	3.7
Portfolio equity investment, net	12.6	9.8	-1.1	12.4	1.9
Portfolio debt flows, net [1]	-0.6	-3.2	1.4	6.7	0.3
Direct investment, net	4.3	1.1	-0.2	0.3	0.3
Inflows	9.3	3.5	2.4	3.5	3.0
Outflows	-5.0	-2.4	-2.6	-3.2	-2.7
Trade credits, net	3.6	-3.9	2.8	4.0	-0.3
Loans, net	-7.1	-4.4	6.7	-3.8	2.8
Short term	-4.7	-1.8	9.4	-3.4	2.5
Medium and long term	-2.4	-2.6	-2.7	-0.4	0.3
Currency and deposits	0.5	1.4	-0.3	-1.6	-1.1
Others	-0.6	2.3	-2.3	-1.3	-0.2
Capital account	-0.6	-0.7	-1.1	-1.4	-1.4
3. Net errors and omissions	-2.2	2.0	7.3	7.3	0.0
4. Overall balance (1+2+3)	**22.1**	**12.3**	**18.6**	**34.5**	**11.8**
5. Financing	**-22.1**	**-12.3**	**-18.6**	**-34.5**	**-11.8**
Change in usable reserves (increase -)	-22.1	-6.6	-18.6	-33.9	-10.5
Net IMF purchases	0.0	-5.7	0.0	0.0	0.0
World Bank/AsDB [2]	0.0	0.0	0.0	-0.6	-1.2
Memorandum items:					
Current account balance (as percent of GDP)	2.7	1.9	1.1	2.3	1.7
Balance of trade (as percent of GDP)	3.7	3.2	3.1	4.6	3.9
Gross reserves	96.2	102.8	121.4	155.4	165.9
(in months of imports of goods and services)	6.0	7.2	7.9	8.6	7.4
External debt	148.5	130.8	144.6	154.8	167.4
(in percent of GDP)	32.2	30.6	30.3	29.8	30.1
Short-term external debt (inc. trade credits)	49.4	41.9	53.2	55.5	61.8
Nominal GDP	461.5	427.1	476.7	518.9	556.9

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

[1] Bonds and notes, money market instruments, and financial derivatives.

[2] These World Bank and ASDB loans were extended as exceptional financing in the 1997–98 crisis.

Table 5. Korea: Medium-Term Projections, 2001–08
(In units indicated)

	2001	2002	2003	2004	2005	2006	2007	2008
			Est.	Staff Projections				
Real GDP (percent change)	3.1	6.3	2.9	5.5	5.3	5.1	5.2	5.2
Total domestic demand	2.2	5.7	-0.4	2.7	5.1	5.0	5.0	5.0
Final domestic demand	2.3	5.8	0.2	2.8	5.0	4.8	4.8	4.8
Consumption	4.2	6.2	-0.7	2.7	4.9	4.7	4.7	4.8
Gross fixed investment	-1.8	4.8	2.5	3.0	5.1	5.0	5.0	5.0
Stock building [1]	-0.1	-0.2	-0.6	-0.1	0.0	0.0	0.0	0.0
Net foreign balance [1]	1.4	2.0	3.8	3.6	1.3	1.2	1.3	1.3
Prices, period average (percent change)								
Consumer price	4.1	2.8	3.5	3.4	3.2	3.0	3.0	3.0
GDP deflator	2.5	1.7	0.6	1.3	1.7	1.8	1.8	1.7
Savings and investment (in percent of GDP)								
Gross national savings	28.8	27.2	27.4	26.4	25.8	25.5	25.0	24.5
Gross domestic investment	26.9	26.0	25.1	24.8	24.6	24.5	24.5	24.5
Current account balance	1.9	1.1	2.3	1.7	1.2	1.0	0.5	0.0
Consolidated central government (in percent of GDP)								
Revenues	26.1	26.6	27.9	28.2	28.4	28.7	28.9	29.0
Expenditure	25.5	23.9	25.2	25.3	24.9	25.1	25.3	25.4
Balance [2]	0.6	2.7	2.7	2.9	3.5	3.6	3.6	3.6
Excluding Social Security Funds	-2.2	-0.3	-0.6	-0.6	0.0	0.0	0.0	0.0
Debt, domestic plus external [3]	20.5	21.2	23.4	24.1	24.5	24.5	22.9	21.4
Government guaranteed restructuring bonds [3]	17.7	16.0	12.3	9.5	6.7	4.3	3.7	3.1
Trade (percent change)								
Merchandise exports	-13.9	7.9	22.8	23.2	12.3	10.3	11.0	11.0
Volumes [4]	-1.0	12.9	17.2	21.4	12.3	10.2	10.1	10.0
Merchandise imports	-13.3	7.7	19.0	27.4	14.2	11.1	12.3	12.5
Volumes [4]	-4.7	12.0	15.1	24.8	16.1	12.6	12.3	12.1
Terms of trade	-4.5	-0.5	1.3	-0.6	1.7	1.4	0.8	0.5
Balance of payments (in billions of U.S. dollars)								
Current account	8.0	5.4	12.1	9.4	7.0	6.2	3.6	-0.2
Trade balance	13.5	14.8	23.7	21.8	20.3	20.3	18.6	15.9
Merchandise exports	151.5	163.4	200.6	247.1	277.6	306.1	339.6	377.1
Merchandise imports	138.0	148.6	176.9	225.3	257.3	285.8	321.0	361.2
External debt								
In billion U.S. dollars [5]	130.8	144.6	154.8	167.4	180.1	193.1	207.6	223.5
(as percent of GDP)	30.6	30.3	29.8	30.1	30.0	29.9	29.9	29.9
Debt service ratio [6]	13.7	9.9	8.0	10.6	8.6	6.8	5.0	6.8
Memorandum items:								
Nominal GDP (in trillions of won)	551.6	596.4	617.5	659.4	706.3	756.3	809.8	866.8
Per capita GDP (in U.S. dollars)	9,022	9,918	10,714	11,416	12,175	12,982	13,843	14,755
Output gap (percent of potential GDP)	-1.3	0.1	-0.6	-0.3	0.0	0.0	0.0	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, W 49 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: Indicators of External Vulnerability, 2000–03
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2003 Date
Financial indicators					
Total general government debt [1]	34.4	39.8	38.4	...	...
Consolidated central government debt [1]	32.4	38.2	37.2	34.9	Proj.
Broad money (M3, percent change, 12-month basis)	7.1	11.6	13.3	5.3	Nov-03
Private sector credit (Fin. survey, percent change, 12 month basis)	-2.7	11.1	18.1	8.3	Oct-03
One month call borrowing rate	5.3	4.0	4.3	3.8	Dec-03
One month call borrowing rate (real)	3.1	0.8	1.5	0.3	Dec-03
External indicators					
Exports (percent change, 12-month basis in U.S. dollars) [2]	21.2	-14.0	7.9	32.5	Dec-03
Imports (percent change, 12-month basis in U.S. dollars) [2]	36.2	-13.4	7.7	22.1	Dec-03
Terms of trade (percent change, 12 month basis)	-12.8	-4.5	-0.5	0.4	Sep-03
Current account balance (projection for full year)	2.7	1.9	1.1	2.3	Proj.
Capital and financial account balance (projection for full year)	2.6	-0.8	1.2	2.8	Proj.
Of which : Inward portfolio investment (debt securities etc.)	2.6	2.8	0.9	4.3	Proj.
Other investment (loans, trade credits etc.)	-0.3	-4.1	0.9	0.4	Proj.
Inward foreign direct investment in the form of debt or loans	0.2	0.1	0.1	0.1	Proj.
Gross official reserves (in billions of U.S. dollars)	96.2	102.8	121.4	155.4	Dec-03
Central Bank short-term foreign liabilities (in billions of U.S. dollars) [3]	2.6	0.4	0.4	0.3	Nov-03
Short-term foreign liabilities of the financial sector (in billions of U.S. dollars)	37.7	32.4	41.8	48.0	Sep-03
Official reserves in months of imports GS (projection for full year)	6.0	7.2	7.9	8.6	Proj.
Broad money(M3) to reserves	7.5	7.4	7.8	6.8	Nov-03
Reserves to total short term external debt (in percent) [4]	153.2	193.3	185.8	196.6	Proj.
Total external debt	32.2	30.6	30.3	29.8	Proj.
Of which : Public sector debt	6.6	5.4	4.7	...	
Short-term debt	10.7	9.8	11.2	...	
Total external debt to exports GS (in percent)	71.8	72.5	75.4	67.0	Proj.
External interest payments to exports GS (in percent)	4.7	4.2	2.9	2.1	Proj.
External amortization payments to exports GS (in percent)	8.0	9.6	6.5	5.2	Proj.
Exchange rate (per U.S. dollar, period average)	1,131	1,291	1,251	1,186	Jan 15, 04
REER appreciation (+) (12-month basis)	8.1	-5.2	3.9	0.5	Nov-03
Financial market indicators					
Stock market index (KOSPI)	505	694	657	846	Jan 15, 04
Stock market index (KOSPI, percent change, 12-month basis)	-50.9	37.4	-5.3	30.4	Jan 15, 04
Foreign currency debt rating (Moody's/S&P)	Baa2/BBB	Baa2/BBB+	A3/A-	A3/A-	Jan 15, 04
Dollar sovereign bond spread (EMBI Global in bps, end of period)	264	167	97	78	Jan 14, 04

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

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

[2] The latest estimates are from customs clearance data.

[3] Excluding IMF repurchase obligations. Reported in the reserves template, which was initiated in May, 2000, as "Predetermined short-term net drains on foreign currency assets."

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

Table 7. Korea: Financial Soundness Indicators, 1997–2003

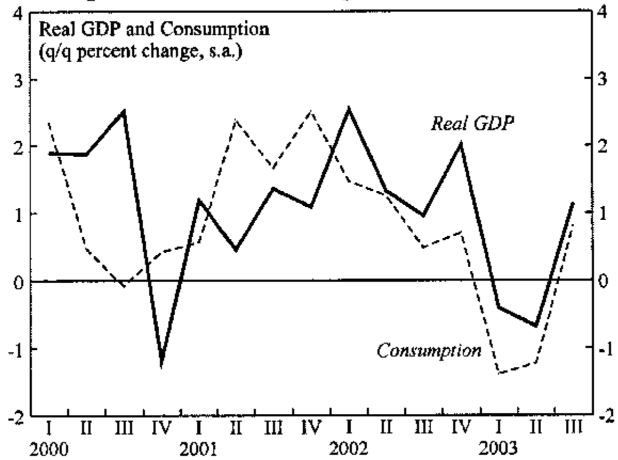
	1997	1998	1999	2000	2001	2002	Latest Available	Date
Financial Sector				(In percent)				
Total loans/GDP	...	...	122.4	119.1	116.8	137.1	150.8	Jun-03
Commercial banks	...	...	68.0	69.2	68.7	77.9	80.2	Sep-03
Other financial institutions	...	...	54.4	49.8	48.1	59.2	72.9	Jun-03
Commercial banks								
Capital adequacy ratio	6.7	8.2	10.8	10.5	10.8	10.5	10.7	Sep-03
Tier 1 capital ratio	4.7	...	...	6.3	6.7	5.7	6.3	Jun-03
Precautionary or below loans, share	...	...	21.2	14.0	7.9	5.7	6.9	Sep-03
Substandard or below loans, share	...	...	13.6	8.9	3.3	2.4	3.4	Sep-03
Return on assets	-1.0	-3.0	-1.4	-0.5	0.8	0.6	...	
Net interest margin	...	...	2.9	2.7	3.0	2.9	2.7	Sep-03
Corporate Sector								
Corporate debt/GDP	152.3	158.0	135.8	131.6	128.3	121.9	126.6	Sep-03
Enterprise delinquency ratio to banks	...	8.9	4.4	3.4	2.1	2.0	2.5	Oct-03
Debt ratio to:								
Equity	396.3	303.0	214.7	210.6	182.2	135.4	101.6	2003H1
Total assets	54.2	50.8	42.8	41.2	39.8	31.7	...	
Sales	66.4	62.7	52.8	42.7	40.1	29.8	...	
Interest coverage ratio [1]	129.1	68.3	96.1	157.2	132.6	260.3	335.4	2003H1
Percent of companies < 100	41.4	45.8	32.6	26.3	28.6	23.6	28.8	2003H1
Current assets/current liabilities	91.8	89.8	92.0	83.2	97.9	106.1	...	
Operating income/sales	8.3	6.1	6.6	7.4	5.5	6.7	8.6	2003H1
Financial expenses/sales	-6.4	-9.0	-6.9	-4.7	-4.2	-2.6	...	
Ordinary income/sales	-0.3	-1.9	1.7	1.3	0.4	4.7	7.3	2003H1
Household Sector				(In percent of GDP)				
Household credit	34.3	29.8	34.6	43.3	55.5	71.3	71.4	Sep-03
Of which: Commercial bank	9.0	8.6	12.4	17.4	25.4	36.1	39.9	Sep-03
Delinquency ratio				(In percent)				
Bank loan	...	...	2.4	2.5	1.3	1.5	2.1	Oct-03
Credit card debt	...	...	...	...	...	6.0	13.5	Nov-03
Including re-aged loans	...	...	...	...	...	12.8	42.1	Nov-03
				(Million persons)				
Deliquent individuals	...	...	...	2.08	2.45	2.63	3.60	Oct-03
Of which: Credit card related	...	...	...	0.80	1.04	1.51	2.28	Oct-03
Housing prices, percent change	2.0	-12.4	3.4	0.4	9.9	16.4	5.7	Dec-03
Of which: Seoul	2.0	-13.2	5.6	3.1	12.9	22.5	6.9	Dec-03
Ratio of housing price to rent	100	107	95	86	81	86	92	Dec-03
Of which: Seoul apartment	100	110	93	87	84	99	112	Dec-03

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

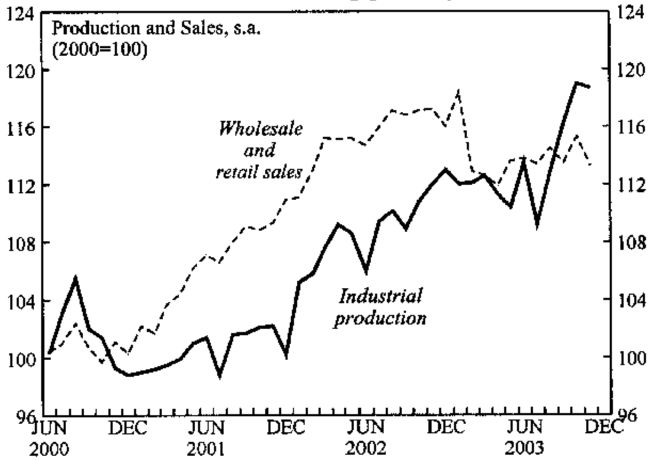
[1] Operating income to gross interest payments. Operating income treats depreciation as a expense, so this ratio is lower than calculations using earnings before interest, taxes, and depreciation allowance (EBITDA).

Figure 1. Korea: Activity and Prices

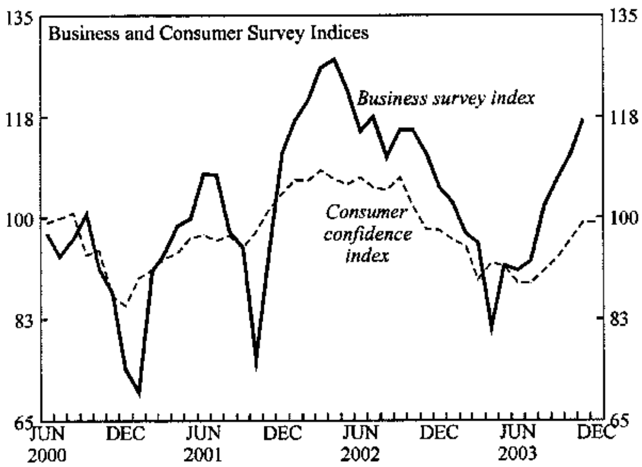
GDP growth was negative in the first half of 2003 but began to recover in the third quarter.



Production is picking up speed and domestic sales are recovering gradually.

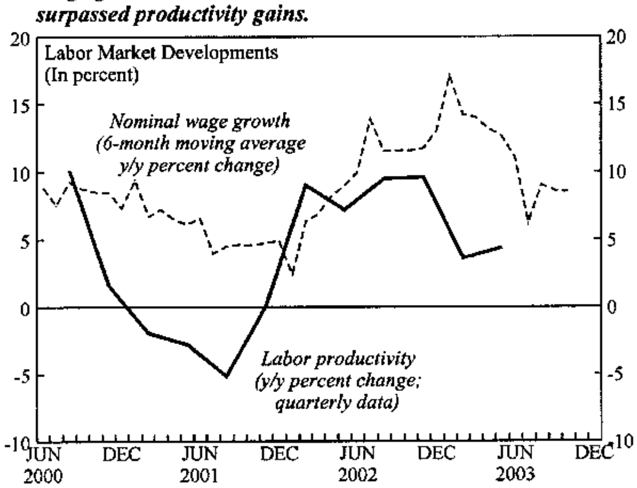


Business and consumer confidence have improved recently...

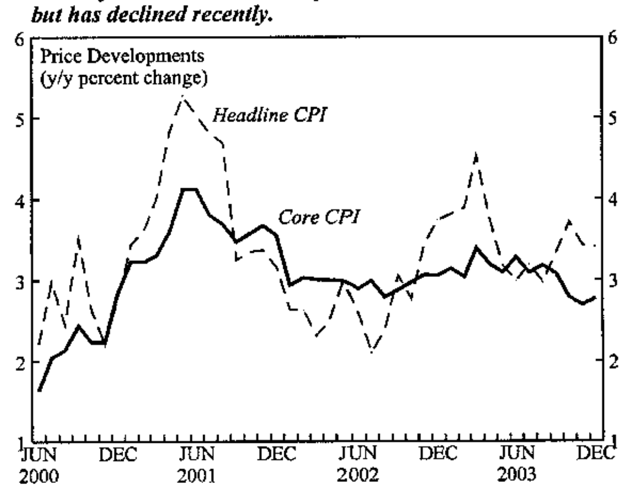


...as capacity utilization has risen, even though unemployment has increased.

Wage growth slowed but still surpassed productivity gains.



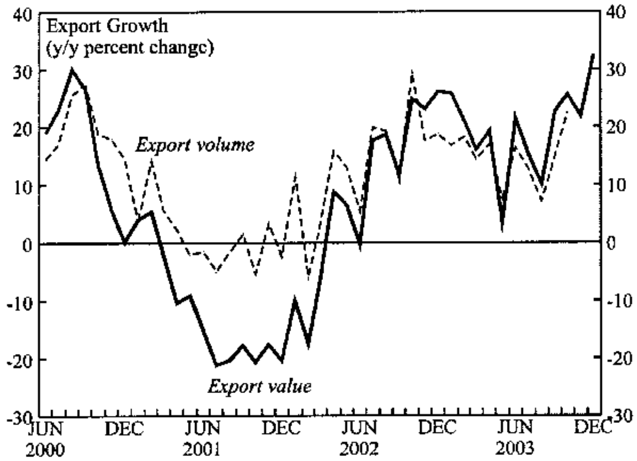
Core inflation was stable at 3 percent, but has declined recently.



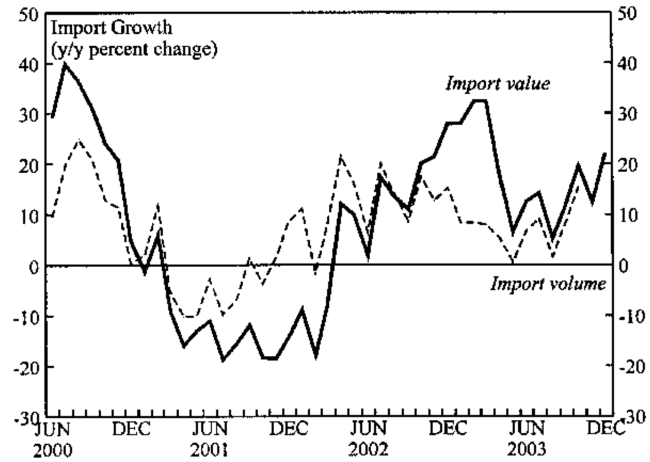
Sources: Korean authorities, CEIC database; and Fund staff calculations

Figure 2. Korea: External Developments

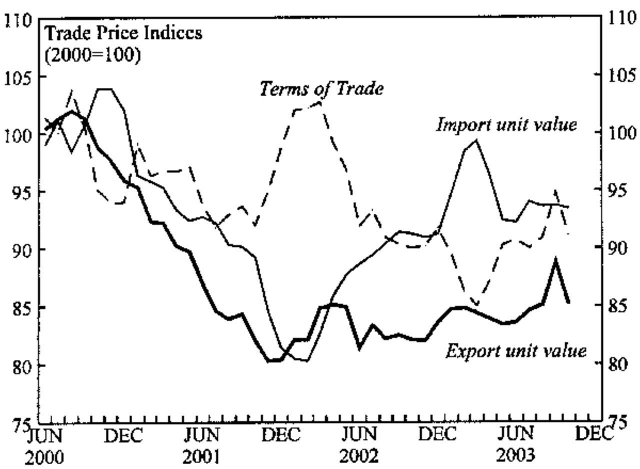
Export growth has been very strong...



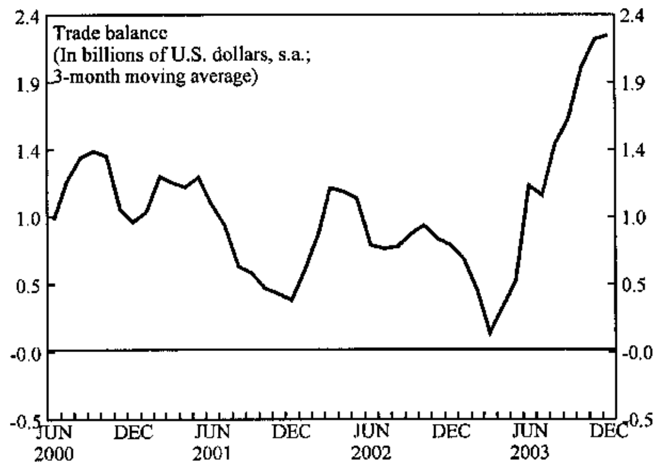
...and import growth is picking up speed.



The terms of trade has improved in recent months...

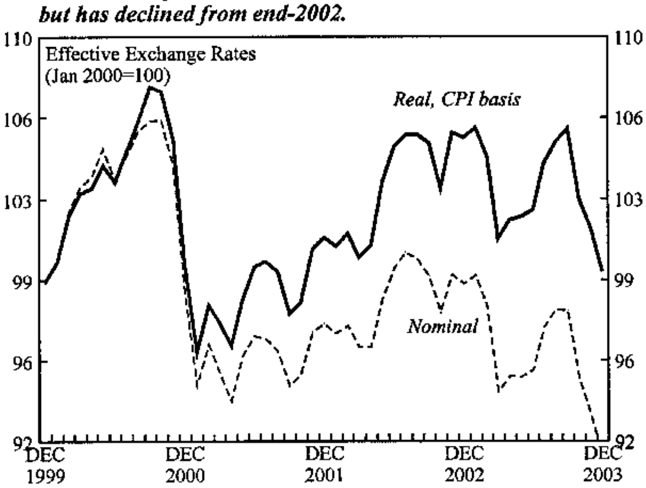


...and the trade surplus has widened.



Foreign reserves have accumulated at a brisk pace, and external debt continued to rise.

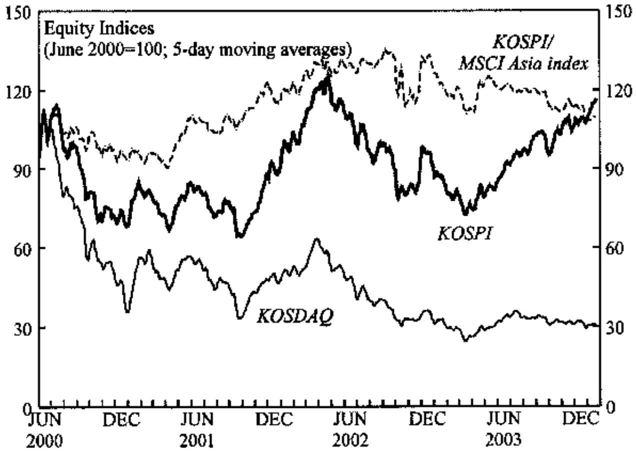
The won has fluctuated in 2003, but has declined from end-2002.



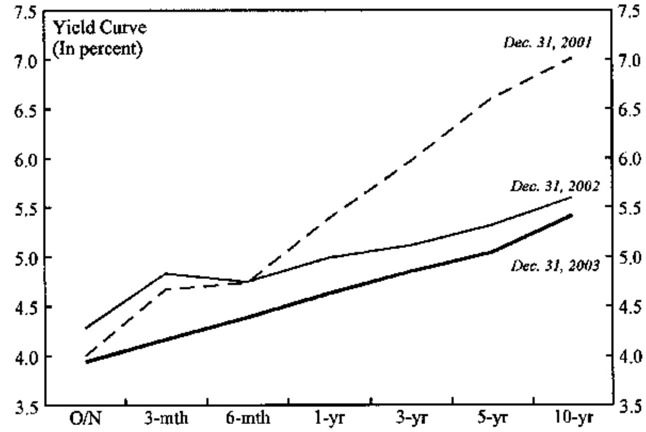
Sources: Korean authorities, CEIC database, Bloomberg; and Fund staff calculations

Figure 3. Korea: Financial Market Indicators

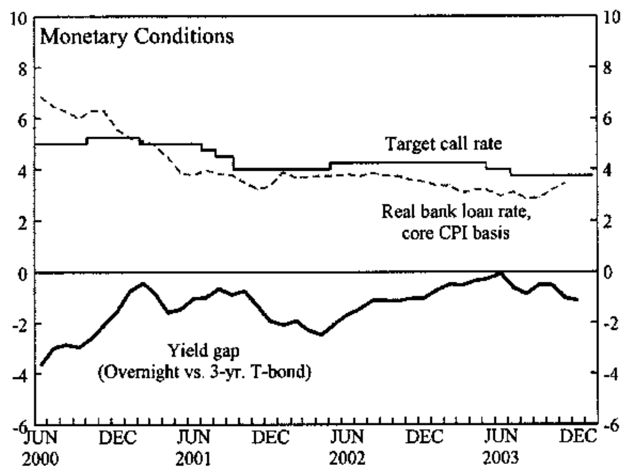
Equity prices have risen, although a little less than in the region...



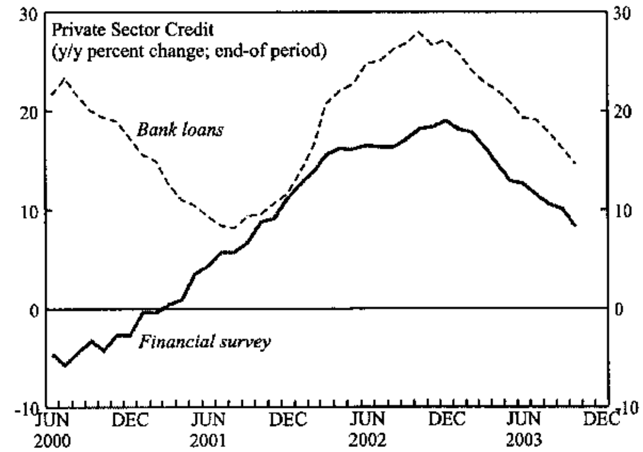
...and yields have declined across the curve.



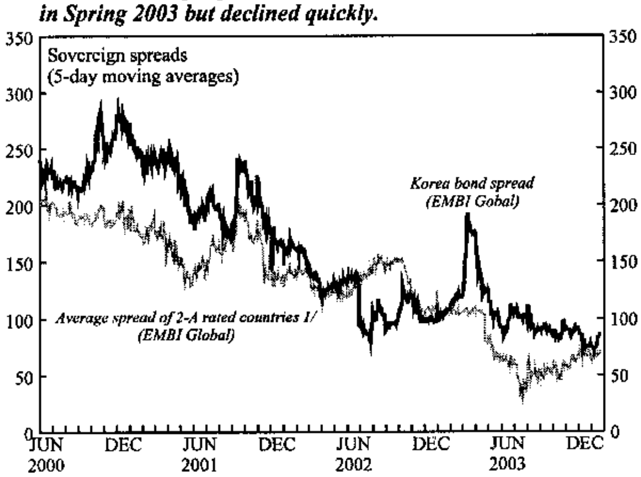
Real interest rates remain historically low...



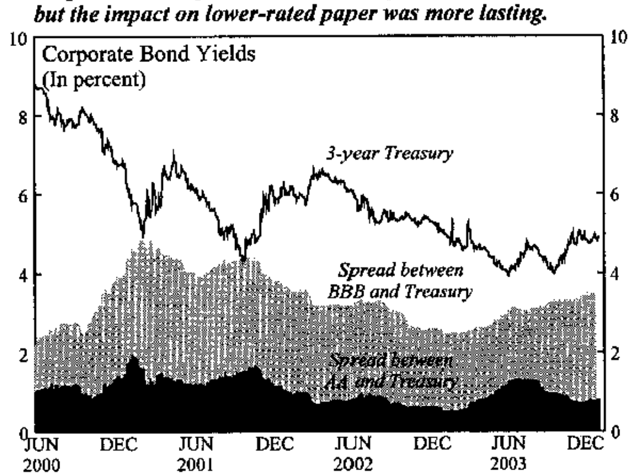
...and private sector credit growth slowed.



Korean sovereign spreads rose sharply in Spring 2003 but declined quickly.



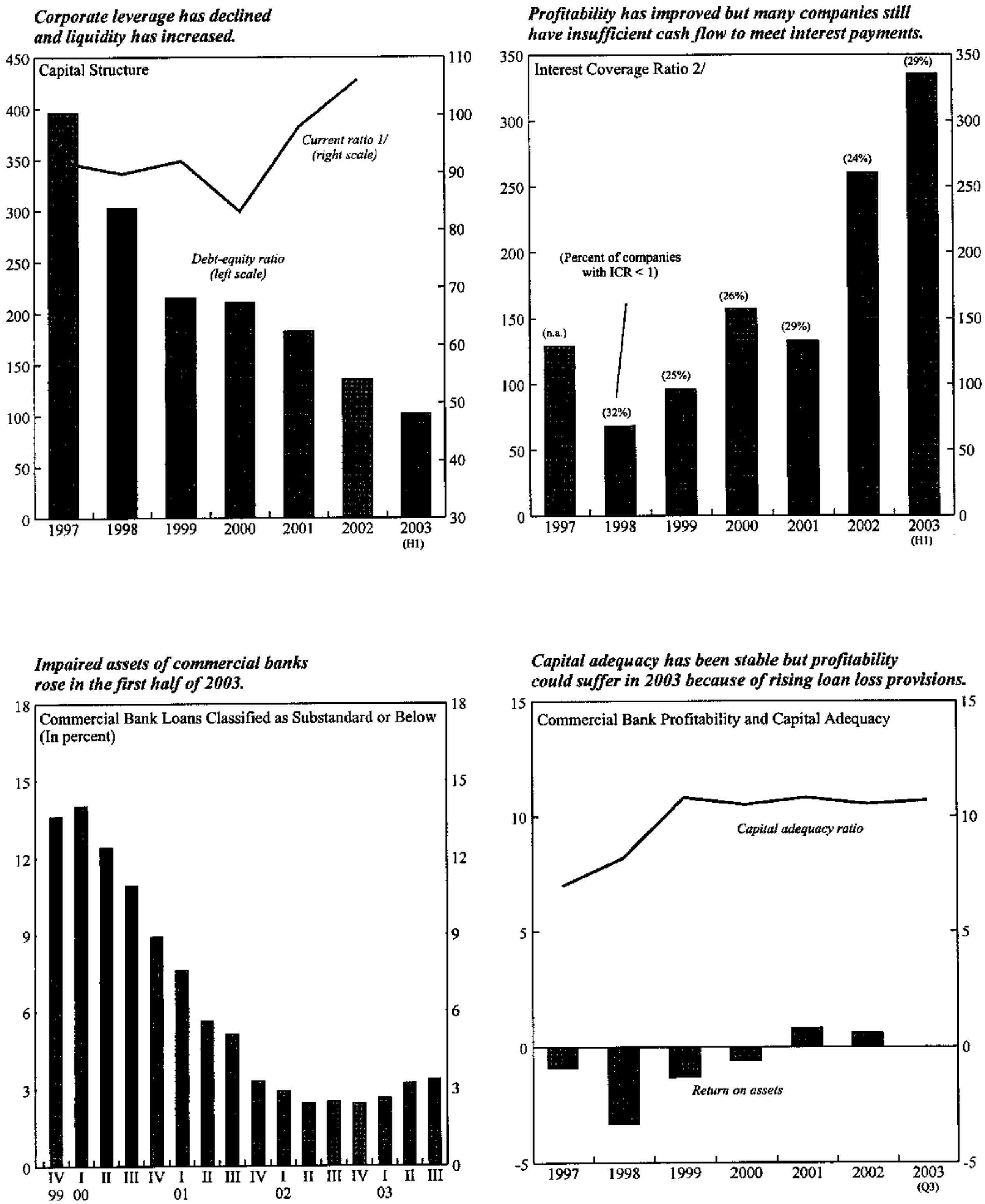
Corporate bond spreads widened temporarily on AA paper but the impact on lower-rated paper was more lasting.



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

1/ Countries include China and Poland.

Figure 4. Korea: Corporate and Financial Sector Soundness



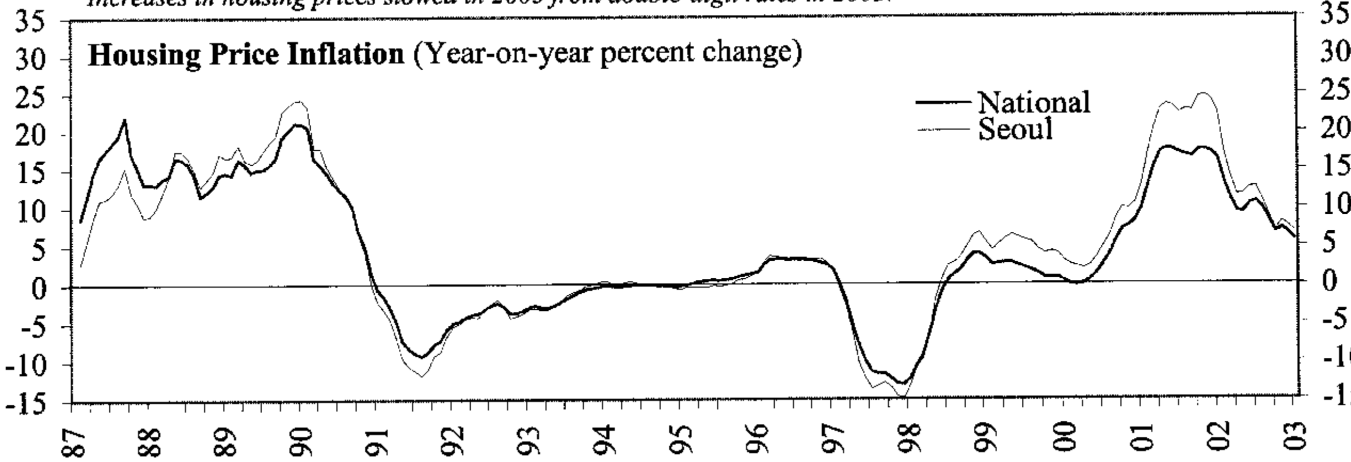
Source: Bank of Korea and Financial Supervisory Service.

1/ Current assets to current liabilities.

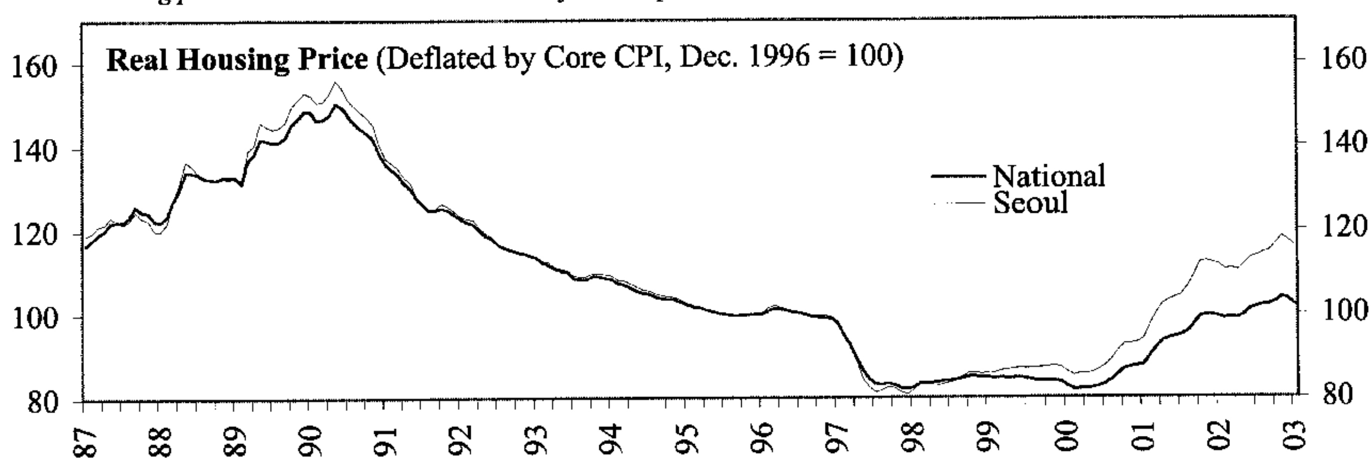
2/ Operating profits to interest payments.

Figure 5. Korea: Housing Price Developments

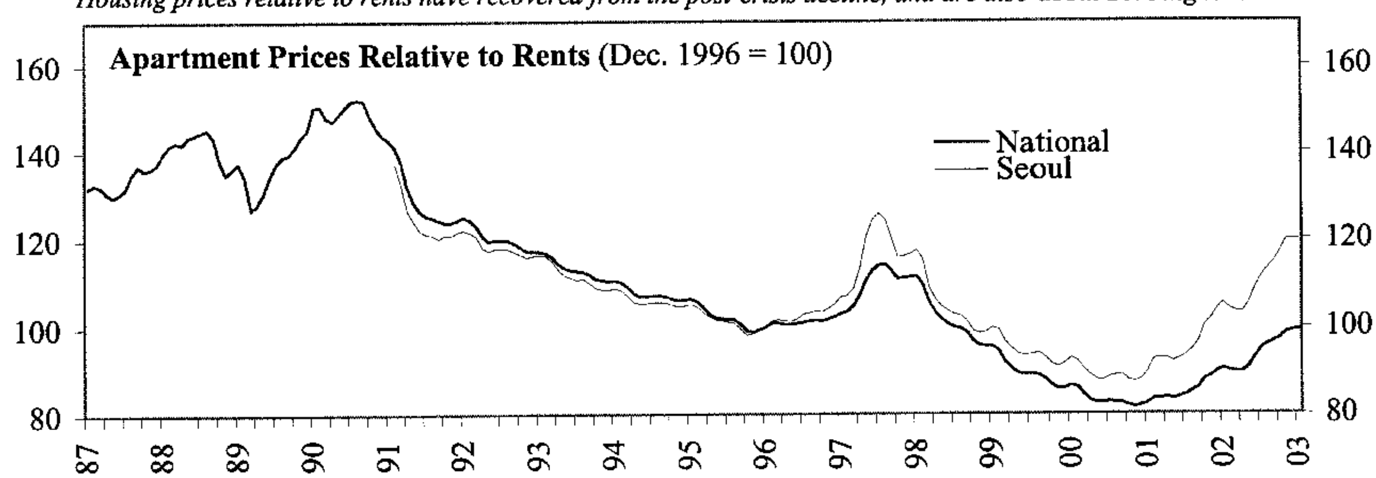
Increases in housing prices slowed in 2003 from double-digit rates in 2002.



Housing prices in real terms have recovered from the post-crisis decline, and have risen almost 20% in Seoul.



Housing prices relative to rents have recovered from the post-crisis decline, and are also about 20% higher in Seoul.



Source: CEIC database and IMF staff calculations.

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 30 percent in 2003 and the public debt/GDP ratio at 23½ 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 corporate and financial sectors expose it to a domestic demand shock. The failure of a major corporation or credit card company could lead to renewed runs on ITCs, a rise in corporate bond spreads and reduction in bond issues, bank losses and falling equity values, which would slow consumption and investment.

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 4.9 percent, so a shock of one standard deviation would imply no growth in real GDP in 2004. 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 60 percent of GDP even in the face of extreme shocks (Annex I, Table 1). In the baseline, public debt remains stable as a ratio to GDP, as the central government budget returns to balance (excluding the accumulation of social security funds) in the medium-term, 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, SM/03/58). The shock to real GDP (B2) has the greatest impact, lifting public debt to 53 percent of GDP by 2008, but the shock is extreme, with GDP falling 18 percent and the primary deficit rising by almost 5 percentage points of GDP. Public debt rises to 40 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 27 percent of GDP.

External debt is most sensitive to exchange rate shocks, but shocks of the assumed magnitude appear very unlikely (Annex I, Table 2). Korean external debt is projected to remain about 30 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 46 percent

- a two standard deviation shock (B3) lifts the external debt ratio to 64 percent—the exchange rate falls by 49 percent given the 13.2 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] The authorities have 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, National Assembly approval of these reforms is uncertain.

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

Table 1. Korea: Public Sector Debt Sustainability Framework, 1998–2008
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	1998	1999	2000	2001	2002			2003	2004	2005	2006	2007	2008	
								I. Baseline Projections						**Debt-stabilizing primary balance 10/**
1 **Public sector debt 1/**	16.1	18.6	19.3	20.8	21.2			**23.4**	**24.1**	**24.5**	**24.6**	**23.0**	**21.5**	**-0.1**
Of which : Foreign-currency denominated	5.4	4.9	4.8	4.7	3.9			3.1	2.2	1.8	1.5	1.3	1.1	
2 Change in public sector debt	4.9	2.5	0.8	1.4	0.5			2.2	0.7	0.4	0.1	-1.6	-1.5	
3 Identified debt-creating flows (4+7+12)	3.4	1.1	-2.1	-1.3	-6.0			-1.3	-2.5	-3.4	-3.6	-5.3	-5.2	
4 Primary deficit	3.5	2.1	-2.6	-2.0	-4.0			-4.0	-4.2	-5.1	-5.2	-5.2	-5.1	
5 Revenue and grants	21.8	22.4	26.0	26.4	26.6			27.9	28.2	28.4	28.9	29.1	29.1	
6 Primary (noninterest) expenditure	25.3	24.5	23.4	24.5	22.6			23.9	23.9	23.4	23.6	23.9	24.1	
7 Automatic debt dynamics 2/	-0.1	-0.4	0.5	0.7	-0.8			0.6	-0.1	0.0	0.1	-0.1	-0.1	
8 Contribution from interest rate/growth differential 3/	1.0	-0.1	-0.1	0.5	-0.4			0.6	-0.1	0.0	0.1	-0.1	-0.1	
9 *Of which:* Contribution from real interest rate	0.2	1.6	1.5	1.1	0.8			1.2	1.1	1.2	1.3	1.1	1.1	
10 Contribution from real GDP growth	0.8	-1.6	-1.6	-0.6	-1.2			-0.6	-1.2	-1.2	-1.2	-1.2	-1.1	
11 Contribution from exchange rate depreciation 4/	-1.1	-0.3	0.5	0.2	-0.4			0.0	0.0	0.0	0.0	0.0	0.0	
12 Other identified debt-creating flows	-0.1	-0.6	0.0	0.0	-1.1			2.1	1.8	1.7	1.6	0.0	0.0	
13 Privatization receipts (negative)	-0.1	-0.6	0.0	0.0	-1.1			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	0.0			2.1	1.8	1.7	1.6	0.0	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)	1.6	1.4	2.9	2.7	6.5			3.5	3.2	3.8	3.6	3.7	3.7	
Public sector debt-to-revenue ratio 1/	73.9	83.1	74.3	78.5	79.8			84.0	85.7	86.1	85.2	79.0	73.7	
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	-6.7	10.9	9.3	3.0	6.4	5.7	4.9	2.9	5.5	5.3	5.1	5.2	5.2	4.9
Average nominal interest rate on public debt (in percent) 6/	6.7	8.2	7.7	7.1	7.1	6.6	1.1	6.6	6.3	6.9	6.9	6.7	6.7	6.7
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.7	10.3	8.8	5.8	4.3	3.1	4.3	5.9	5.1	5.2	5.5	4.9	5.0	5.3
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	40.8	5.8	-10.0	-3.7	9.7	-1.4	22.3	0.8	0.5	0.5	0.5	0.5	0.5	0.6
Inflation rate (GDP deflator, in percent)	5.1	-2.0	-1.1	1.3	2.8	3.5	3.4	0.6	1.3	1.7	1.4	1.8	1.7	1.4
Growth of real primary spending (deflated by GDP deflator, in percent)	8.4	7.4	4.8	7.4	-1.7	8.2	5.0	8.8	5.6	2.9	6.4	6.3	6.0	6.0
Primary deficit	3.5	2.1	-2.6	-2.0	-4.0	-0.5	2.2	-4.0	-4.2	-5.1	-5.2	-5.2	-5.1	-4.8
								II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 10/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2004–08 7/								23.4	27.4	31.7	35.6	37.9	40.0	-1.0
A2. Primary balance under no policy change in 2004–08								23.4	24.0	24.9	25.3	23.7	22.1	-0.1
A3. Country-specific shock in 2004, with reduction in GDP growth (relative to baseline) of one standard deviation 8/								23.4	27.2	28.7	29.4	28.3	27.2	-0.3
B. Bound Tests														
B1. Real interest rate is at historical average plus two standard deviations in 2004 and 2005								23.4	25.6	27.5	27.6	25.9	24.4	-0.1
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005								23.4	29.4	38.6	44.8	48.8	53.1	-0.2
B3. Primary balance is at historical average minus two standard deviations in 2004 and 2005								23.4	32.4	41.8	41.9	40.2	38.7	-0.1
B4. Combination of 2-4 using one standard deviation shocks								23.4	32.0	41.8	42.4	41.1	39.9	-0.1
B5. One time 30 percent real depreciation in 2004 9/								23.4	25.5	25.9	25.9	24.3	22.8	-0.1
B6. 10 percent of GDP increase in other debt-creating flows in 2004								23.4	34.1	34.5	34.6	32.9	31.4	-0.1

1/ Central government debt. Includes projected conversion of publicly guaranteed debt of KDIC and KAMCO into treasury bonds, see Box 3 of SM/03/58.

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 e = 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/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

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

9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

10/ 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 2. Korea: External Debt Sustainability Framework, 1998–2008
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	1998	1999	2000	2001	2002			2003	2004	2005	2006	2007	2008	
								I. Baseline Projections						**Debt-stabilizing non-interest current account 6/**
1 **External debt**	51.2	37.7	32.1	30.6	30.3			**29.8**	**30.0**	**30.0**	**30.0**	**30.0**	**30.0**	**-1.8**
2 Change in external debt	15.4	-13.6	-5.5	-1.5	-0.3			-0.5	0.2	0.0	0.0	0.0	0.0	
3 Identified external debt-creating flows (4+8+9)	2.8	-20.4	-10.5	-2.4	-3.9			-7.0	-4.1	-3.5	-3.4	-3.5	-3.2	
4 Current account deficit, excluding interest payments	-12.6	-6.0	-4.7	-3.7	-2.5			-3.5	-2.8	-2.5	-2.3	-1.9	-1.4	
5 Deficit in balance of goods and services	-13.3	-6.8	-3.0	-2.3	-1.4			-2.9	-2.3	-1.7	-1.5	-1.0	-0.5	
6 Exports	49.3	42.3	44.7	42.2	39.9			44.4	50.5	52.5	53.9	55.4	57.0	
7 Imports	36.0	35.4	41.7	39.9	38.5			41.5	48.2	50.8	52.4	54.3	56.5	
8 Net non-debt creating capital inflows (negative)	-1.6	-4.1	-3.5	-2.5	0.3			-2.4	-0.4	-0.2	-0.5	-0.8	-1.1	
9 Automatic debt dynamics 1/	17.0	-10.3	-2.3	3.8	-1.6			-1.1	-0.9	-0.8	-0.6	-0.8	-0.7	
10 Contribution from nominal interest rate	0.0	0.0	2.1	1.7	1.4			1.2	1.1	1.3	1.4	1.4	1.4	
11 Contribution from real GDP growth	3.6	-4.4	-3.1	-1.1	-1.7			-0.8	-1.5	-1.5	-1.4	-1.4	-1.5	
12 Contribution from price and exchange rate changes 2/	13.3	-5.9	-1.2	3.1	-1.3			-1.5	-0.5	-0.6	-0.5	-0.7	-0.6	
13 Residual, including change in gross foreign assets (2-3)	12.6	6.8	5.0	0.9	3.6			6.5	4.3	3.5	3.4	3.4	3.2	
External debt-to-exports ratio (in percent)	103.9	89.1	71.9	72.6	75.8			67.0	59.4	57.1	55.7	54.2	52.7	
Gross external financing need (in billions of U.S. dollars) 3/	23.4	14.5	46.7	58.5	48.8			53.3	69.6	74.3	77.0	81.3	101.0	
in percent of GDP	7.3	3.6	10.1	13.7	10.2			10.2	12.5	12.4	12.0	11.7	13.6	
Key Macroeconomic Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	-6.7	10.9	9.3	3.1	6.3	5.7	4.9	2.9	5.5	5.3	5.1	5.2	5.2	4.9
GDP deflator in U.S. dollars (change in percent)	-29.6	14.6	4.0	-10.2	4.9	-0.4	13.2	5.8	1.8	2.2	1.9	2.3	2.2	2.7
Nominal external interest rate (in percent)	0.0	0.0	6.3	5.0	5.1	2.1	2.9	4.3	4.0	4.6	4.9	4.9	5.1	4.6
Growth of exports (U.S. dollar terms, in percent)	-4.4	8.9	20.3	-12.7	5.8	8.8	12.5	21.1	22.0	11.9	9.9	10.6	10.7	14.4
Growth of imports (U.S. dollar terms, in percent)	-32.8	25.2	33.7	-11.3	7.8	9.3	21.0	17.3	24.7	13.3	10.5	11.6	11.9	14.9
Current account balance, excluding interest payments	12.6	6.0	4.7	3.7	2.5	2.1	4.9	3.5	2.8	2.5	2.3	1.9	1.4	2.4
Net nondebt creating capital inflows	1.6	4.1	3.5	2.5	-0.3	1.3	1.6	2.4	0.4	0.2	0.5	0.8	1.1	0.9
								II. Stress Tests for External Debt Ratio						**Debt-stabilizing non-interest current account 6/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2004-08 4/								**29.8**	**29.9**	**29.3**	**28.7**	**28.2**	**27.5**	**-1.9**
A2. Country-specific shock in 2004, with reduction in GDP growth (relative to baseline) of one standard deviation 5/								**29.8**	**31.4**	**28.6**	**27.2**	**26.5**	**26.4**	**-2.0**
A3. Selected variables are consistent with market forecast in 2004–08								**29.8**	**32.1**	**34.5**	**37.1**	**39.5**	**42.0**	**-2.2**
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005								**29.8**	**31.1**	**31.9**	**31.9**	**31.8**	**31.8**	**-1.8**
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005								**29.8**	**33.3**	**37.1**	**37.6**	**37.9**	**38.2**	**-2.2**
B3. Change in U.S. dollar GDP deflator is at historical average minus two standard deviations in 2004 and 2005								**29.8**	**41.5**	**58.4**	**60.7**	**62.3**	**63.6**	**-3.6**
B4. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005								**29.8**	**40.6**	**50.5**	**50.1**	**49.6**	**49.2**	**-2.2**
B5. Combination of 2-5 using one standard deviation shocks								**29.8**	**43.6**	**60.3**	**60.1**	**59.7**	**59.4**	**-3.0**
B6. One time 30 percent nominal depreciation in 2004								**29.8**	**42.9**	**43.9**	**45.0**	**45.7**	**46.3**	**-2.6**

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

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

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

6/ 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 nondebt 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 at the time of the next rebasing to take effect during 2003–04. Also, the commodity flow technique could be improved by moving to the Supply and Use Table framework. The BOK intends to produce such a framework in 2004, but there are currently difficulties with obtaining the basic data required.

- The **Consumer Price Index** (CPI) is based on internationally endorsed standards and uses classifications compatible with internationally recommended systems. Concepts and definitions used for the compilation of the CPI are in line with the recommendations of the International Labor Organization (ILO). The scope of the CPI covers urban areas, but excludes single person, farm and fishing households. The CPI is compiled using sound procedures and methods which, however, could be improved by also including single-person households, and by having the prices of missing seasonal items imputed by similar items within their group. The coverage gaps can be a potential problem with the level of the indices, while the absence of good imputation procedures can potentially introduce a bias in short-term price trends and affect inflation monitoring. New weights and a new market basket using the 2000 Household Income and Expenditure Survey were introduced in the CPI for January 2002.

- The **Producer Price Index** (PPI) is also based on internationally endorsed standards and recommendations. Concepts and definitions used for the compilation of the PPI are in line with the *1993 SNA*. The scope of the PPI covers all domestic industrial activities and a large segment of service activity, as well as free trade zones and bonded warehouses. The PPI is compiled using sound procedures and methods but could be improved by imputing missing prices from other similar commodities, rather than being simply carried forward using the last reported price.

Fiscal Sector

- Consolidated statistics on the **general government** aligned with internationally recognized standards are not compiled. Statistics following these standards only cover the central government, which accounts for about 75 percent of total general government. National concepts and definitions differ from those internationally recognized. Therefore, two sets of government finance statistics are compiled for the central government, using national definitions and using internationally recognized standards. Concepts and definitions used in the latter set of central government finance statistics generally follow the recommendations of the *1986 Government Finance Statistics Manual* (*GFSM 1986*). The data cover the budgetary units of the central government (including social security funds owned and/or managed by the government) and the 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 and 2002.

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

Korea: Survey of Reporting of Main Statistical Indicators 1/
(As of January 20, 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	12/31/03	11/30/03	11/03	10/03	10/03	12/31/03	12/03	12/03	10/03	10/03	Q3 2003	6/03
Date Received	12/31/03	11/30/03	12/03	1/14//04	1/14/04	1/14/04	01/04	01/04	11/03	11/03	11/03	9/03
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 November 30, 2003)

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

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	1,633.60	100.0
Fund Holdings of Currency	1,142.47	69.9
Reserve Position in Fund	491.2	30.1

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	72.91	100.00
Holdings	14.18	19.45

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

V. **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
Stand-by	07/08/1983	03/31/1985	575.78	575.78

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

VII. **Exchange Rate Arrangement:**

Korea's exchange rate system is classified as "independently floating." Previously, the exchange rate against the U.S. dollar was allowed to float only within specified margins around the previous day's weighted average exchange rate in the interbank market. The margins were widened five times between March 1990 and November 1997 (most recently to +/-10 percent), and on December 16, 1997 were eliminated altogether. On January 15, 2004, the exchange rate was W 1,180.2=US$1.

VIII. **Last Article IV Consultation**:

Korea is on a 12-month consultation cycle. Staff discussions for the 2002 Article IV consultation were conducted on a mission to Seoul during October 16–29, 2002. The Article IV consultation was concluded by the Executive Board on March 3, 2003. In addition, a Staff Visit took place during April 22–April 30, 2003.

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 (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 (SM/01/22) 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
February 20, 2004

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 reinforces the macroeconomic assessment in the staff report.**

- Surging exports are continuing to drive economic activity. Merchandise exports rose 33 percent (y/y) in January 2003, fueling a rapid growth in industrial production, which increased 10½ percent (y/y) in December.

- However, domestic demand remains sluggish. Wholesale and retail sales declined 2½ percent (q/q, s.a.) in the fourth quarter, similar to the declines in the two preceding quarters.

- Inflation remains subdued. In January, the core CPI rose by 2.8 percent (y/y), while housing prices fell slightly, reducing the year-on-year increase to 5½ percent.

3. **Capital inflows accelerated in early 2004, propelled by a global shift of portfolio investment into Asia**. Foreign investment in Korean equities amounted to $4½ billion in the first six weeks of 2004, helping to increase reserves by around $7 billion to $162.6 billion on February 13, 2004. Despite the reserve increase, the Korean won appreciated over this period by 3 percent against the U.S. dollar and 2½ percent in nominal effective terms.[1]

4. **The National Assembly ratified Korea's first free trade agreement (FTA)**. After intensive government lobbying, the FTA with Chile, which had been signed in October 2002, was ratified on February 17, 2004.

5. **Former Finance Minister Lee Hun-Jai was appointed as Deputy Prime Minister and Minister of Finance and Economy on February 10, 2004**. He replaced Mr. Kim Jin-Pyo, who resigned to run in the April 15 parliamentary elections. No significant change in economic policy direction is expected.

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[1] The authorities have also announced that they will ease their recently introduced restrictions limiting the size of positions that domestic financial institutions can take in the nondeliverable forward (NDF) market.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 04/11
FOR IMMEDIATE RELEASE
February 25, 2004

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

IMF Concludes 2003 Article IV Consultation with Korea

On February, 20, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Korea.[1]

Background

For most of the period after the Asian financial crisis Korea's economy has grown rapidly, the result of favorable cyclical developments and deep structural reforms. But in 2003, this ascent was interrupted. The economy contracted during the first half of the year, after a household credit boom came to an end and some long-standing structural problems re-emerged. Although growth has now resumed, the recovery relies heavily on surging exports, while domestic demand remains subdued.

For 2003 as a whole, economic growth fell to an estimated 2.9 percent from 6.3 percent in 2002. The main factor was a decline in domestic demand. Private consumption fell, as a sharp rise in credit card delinquencies forced financial institutions to rein in household credit. Meanwhile, an increase in labor tensions and a corporate governance scandal (SK Global) took a toll on bond markets and investment, including foreign direct investment intentions, which declined by 29 percent.

As growth slowed, the authorities used macroeconomic policies to support the economy. Monetary policy was eased, with the policy rate being cut to an historic low of 3.75 percent,

[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.

facilitated by a reduction in inflation below the 3 percent mid-point of the authorities' target band. The fiscal stance was also relaxed, by front-loading expenditures and adopting two supplementary budgets, thereby avoiding the traditional underspending of the budget, which would have imparted a significant contractionary impulse.

In addition, the authorities resisted pressures for an exchange rate appreciation. With portfolio inflows exceptionally large, they stepped up their foreign exchange purchases, contributing to a US$34 billion increase in reserves to US$155 billion. These actions limited the won's appreciation against a weakening dollar, keeping the average nominal effective exchange rate for the year essentially unchanged.

At the same time, the authorities were able to advance their structural reform agenda. To spur further improvements in corporate governance, new accounting and auditing bills were passed, which will increase the amount of information provided to investors and help ensure that this information is accurate. At the same time, to ensure that investors can enforce their legal rights in cases where the information does prove misleading, class action lawsuits were legalized in cases of securities violations.

Further progress was also made during 2003 in financial sector privatization. The government sold stakes in three large banks, leaving its 87 percent stake in the Woori Group as its sole sizeable holding remaining—and even in this case, it initiated procedures to sell down its shares. The government also arranged to sell the largest investment trust company, Hyundai ITC, to a foreign securities firm, facilitated by a large injection of public funds.

As for 2004, the IMF is expecting a moderate recovery, with growth of around 5½ percent, propelled by a continued rapid growth in exports. There is even some upside potential to this forecast, as the export performance may flow through rapidly into domestic demand. But there are also downside risks, especially since consumption could continue to be weighed down by heavy household indebtedness, while investment could be dampened if firms continue to take a "wait and see" attitude, pending improvements in the labor situation or April's National Assembly elections.

Executive Board Assessment

Executive Directors commended the authorities for Korea's impressive recovery from the Asian crisis. During most of the past six years economic growth has been rapid, raising output far above its pre-crisis level, while economic resiliency has also improved. Korea today is a prosperous economy, with strong medium-term prospects, based on its well-educated workforce and expertise in advanced technology. This remarkable achievement is a tribute to deep structural reforms, which have created a more competitive and transparent economic system, guided predominantly by market signals.

Notwithstanding this considerable progress, Directors noted that the structural reform agenda remains unfinished. The end of a credit card boom has left households saddled with high levels of debt and loan delinquencies, and the credit card companies themselves in financial difficulties. Other nonbank financial institutions also suffer weaknesses, corporate governance practices should still be further improved, and the labor market remains dualistic. In 2003, these problems combined to derail the economic expansion. While a recovery is now underway, propelled by surging exports, domestic demand remains weak. Directors therefore agreed that decisive action will be needed to strengthen the foundations for broad-based and sustained rapid growth, in line with the authorities' long-term objective of doubling Korea's per capita income. Accordingly, they were encouraged by the authorities' continued readiness to learn from experience, and their plans to address the remaining structural weaknesses.

Against the backdrop of a still uneven recovery, Directors encouraged the authorities to continue to ensure that macroeconomic policies in 2004 remain supportive. They welcomed the steps towards maintaining a broadly neutral fiscal stance, including the plans to front-load spending and adopt a supplementary budget if necessary. As the recovery takes hold, it will, however, be important to restore fiscal balance to prepare for the budgetary challenges of an aging population and uncertainties related to North Korea.

Directors endorsed the continuation of a supportive monetary policy given the subdued level of inflation and the remaining output gap. The rise in housing prices in certain areas of the country will require continued vigilant monitoring, suggesting that the authorities should continue to pursue targeted measures, which are better suited to deal with this issue than monetary policy actions.

Directors observed that Korea's flexible exchange rate policy, adopted in the wake of the Asian crisis, has served the country well, supporting financial market development, while maintaining external competitiveness. To preserve these gains, they urged the authorities to allow the exchange rate to be determined essentially by market forces by scaling back their foreign exchange purchases, which should be limited to smoothing excessive volatility. Going forward, and with surging exports, Directors considered that greater exchange rate flexibility would help achieve more balanced growth domestically, while also contributing to cooperative efforts towards an orderly adjustment of global current account imbalances.

Directors were encouraged by the authorities' plans to address the remaining structural problems in the financial sector, corporate governance, and the labor market. The most pressing priority will be to strengthen the credit card companies. Directors emphasized the importance of making it clear that the rescue of LG Card was an exceptional case, and that other card companies will be required to recapitalize at an early date. It will also be important to sell LG Card quickly to investors with strong financial and managerial credentials. To prevent similar problems in the banking system, Directors recommended that the authorities tighten household lending standards and strengthen the supervisory framework by shifting toward a more risk-based approach, as recommended in the Financial Sector Assessment Program (FSAP).

In the asset management sector, Directors welcomed plans to sell the remaining two government-controlled investment trust companies to financially strong and capable buyers. They also welcomed the authorities' declaration that the planned Korean Investment

Corporation will be independent and will not be used as a vehicle for intervention in financial markets, and their intention to enshrine these principles in the agency's law. To ensure a high level of transparency, the agency's accounts should be disclosed fully and on a regular basis.

In the bond market, Directors urged the authorities to dispel notions that large companies are "too big to fail". To encourage investors to sharpen their risk assessments, they supported the plan to improve the accuracy of bond ratings. They also looked forward to an early approval of the unified bankruptcy bill currently before the National Assembly.

Directors strongly encouraged the authorities to press ahead with measures to further improve corporate governance. They supported the authorities' three-year roadmap for corporate reform, aimed at easing regulations on *chaebol* that improve their governance. Also welcome are the new accounting and auditing reforms, which will contribute to more accurate and timely information to investors. As a further step, Directors encouraged the authorities to explore the scope for further enhancements. They suggested requiring firms to comply with the Code of Best Practices in Corporate Governance, or, at least, explain why they are not doing so. They welcomed the new law allowing class action lawsuits for securities violations, and encouraged further steps to improve investors' legal protection.

Directors underscored the importance of a sustained effort to reform Korea's labor market, especially since greater employment flexibility will be needed to help face the challenges of an economy increasingly specialized in high technology and services. Directors consequently welcomed the plans to ease employment protection, while at the same time expanding the coverage of the social safety net, and encouraged the authorities to continue to build the required consensus to move forward in this area. Since even with these reforms the share of nonregular workers may continue to rise, Directors encouraged the authorities to envisage further efforts to increase flexibility in the regular labor market, noting that Korea could draw useful lessons from the experiences of other OECD countries in this area.

Directors welcomed the recent approval by the Korean parliament of a free trade agreement with Chile, and looked forward to further trade opening steps, including in the agricultural sector.

Directors recognized that implementing this ambitious reform agenda will be challenging. They were, nevertheless, confident that the authorities will find the way forward, building on their demonstrated capacity to implement difficult reforms and the widespread awareness that tackling the remaining challenges will be key to substantially lift per capita incomes.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with Korea is also available.

Korea: Selected Economic Indicators

	2000	2001	2002	2003 Staff Est.	2004 Staff Proj.
Real GDP (percent change)	9.3	3.1	6.3	2.9	5.5
Consumption	6.7	4.2	6.2	-0.7	2.7
Gross fixed investment	11.4	-1.8	4.8	2.5	3.0
Net foreign balance 1/	3.1	1.4	2.0	3.8	3.6
Prices (percent change)					
Consumer prices (end of period)	2.8	3.2	3.7	3.4	3.1
GDP deflator	-1.1	2.5	1.7	0.6	1.3
Labor market (in percent)					
Unemployment rate	4.2	3.8	3.1	3.4	3.3
Wage growth, manufacturing	8.5	6.3	12.0	9.5	...
Consolidated central government (percent of GDP)					
Revenues 2/	26.0	26.1	26.6	27.9	28.2
Expenditure	24.8	25.5	23.9	25.2	25.3
Balance 2/	1.3	0.6	2.7	2.7	2.9
Money and interest rates (in percent)					
Overnight call rate 3/	5.3	4.0	4.3	3.8	...
M3 growth	7.1	11.6	13.6	5.5	9.0
Yield on corporate bonds 3/	8.1	7.1	5.9	5.5	...
Balance of payments					
Current account balance (billion US$)	12.2	8.0	5.4	12.1	9.4
Current account balance (in percent of GDP)	2.7	1.9	1.1	2.3	1.7
Won per U.S. dollar (period average)	1,131	1,291	1,251	1,190	...

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

1/ Contribution to GDP growth.
2/ Excluding privatization receipts.
3/ Latest available data for 2003.

Statement by Michael J. Callaghan, Executive Director for the Republic of Korea and Won-Dong Cho, Advisor to Executive Director
February 20, 2004

Key Points

- Our authorities are very appreciative of the constructive policy dialogue they have had with the Fund and believe the staff have produced a good report, with which they broadly agree.

- They also appreciate the effective contribution the Fund is making towards building domestic public consensus in support of reforms.

- While the impact of the bursting of the credit card boom is still being unwound, economic activity is strengthening and the investment outlook is positive.

- An accommodative macroeconomic policy setting is being maintained which will support the recovery.

- While the authorities are taking direct steps to address the duality in the labor market, there is so far little evidence that the increase in the non-regular labor sector has impacted on labor productivity. On the contrary, it has contributed to the flexibility of the labor market.

- The takeover of LG Card by the Korea Development Bank (KDB) is not a repeat of past episodes of chaebol affiliates restructuring. KDB was the largest creditor to LG Card, and the fact that the LG Group and its owner paid a much higher price for management's failure than the legal procedure would have allowed, should be duly noted.

- The "chaebol" legacy is dying as large conglomerates streamline their ownership structures. There is now a "chaebol discount" in the domestic capital market, as opposed to the "chaebol premium", which existed prior to the crisis.

The Fund's support has been pivotal in building public consensus for continued reform

Our authorities would like to record their deep appreciation to staff for a very productive Article IV consultation process. The team's policy recommendations for the Korean economy, which have been articulated in a well-written report, are very relevant. Importantly, they were formulated through a constructive dialogue between the mission team and the authorities. The manner in which this dialogue was conducted was greatly appreciated by the authorities, the highlight of which was staff's seminar at the conclusion of the mission. The seminar was well attended by officials from various ministries and was instrumental in reaching a common understanding on the policy needs of Korea and the way forward.

Our authorities also appreciate the team's effective communication with the press during their visit. As rightly noted in the report, Korea's policy environment is not currently ideal, with the governing party having only a minority in the National Assembly and a general election is scheduled for April. An example of those difficulties was the recent passage of the ratification of the FTA with Chile. The ratification was only passed after three failed attempts due to strong resistance from congressmen from rural constituencies. Notwithstanding these difficulties, the authorities have managed to advance some important reform bills, as well as strengthen the accommodative stance of the 2004 budget (most of these developments taking place after the team's departure). They are also appreciative of the team's contribution to enhancing public awareness of this process.

Looking ahead, the authorities strongly believe that building public consensus is the best way to push ahead with necessary reforms and, as was the case during the fast recovery after the crisis, the Fund will continue to be a crucial ally in this effort. In this regard, they would like to convey their gratitude to the Managing Director who has agreed to visit Korea shortly after the Article IV Board discussion.

Given that the report reflects the common views of the authorities and staff regarding Korea's policy needs, we will focus on providing some background information on the macroeconomic policy mix, labor market developments, and some comments on "legacy issues" in relation to financial and corporate restructuring.

Policy mix remains accommodative

While the impact of the bursting of the credit card boom still remains, there are signs that economic activity has started to strengthen. The leading composite index has continued to rise since the second half of 2003 and industrial production growth has also gained pace. Although a full recovery in domestic consumption (which accounts for around 60 per cent of GDP) will take some time due to high household indebtedness and the problems associated with credit card debt, investment is expected to rise as production moves closer to full capacity. (The latest average capacity utilization ratio is 81.2 per cent – the highest level since April 1997.) With the pick-up in domestic demand, economic growth is expected to draw closer to its potential by year's-end.

Like staff, the authorities are of the view that the macroeconomic policy mix needs to remain accommodative in order to support the economic recovery. The deficit target for the 2004 budget has already been moderated and the authorities plan to front-load expenditure, as they did last year. The recently-announced budget disbursement plan envisages that 54 per cent of budgeted expenditure will be spent during the first half of the year, surpassing last year's record of 53 per cent. The authorities remain vigilant to ensure that the economic recovery progresses and will monitor the need for a supplementary budget.

Following the adoption of targeted tax measures last November, price rises in one segment of the real estate sector have now been brought under control. Given that core inflation remains comfortably within the target range, the Monetary Policy Commission (MPC) has not adjusted the policy interest rate.

Since the last Board discussion on Korea, there has been a further improvement in the inflation targeting regime, along the lines recommended by staff. The medium-target is now fully incorporated into law and the independence of the MPC has been further strengthened, with the Bank of Korea being represented by more members in the nine-member monetary policy decision-making body.

Reflecting the better-than-expected performance in the external sector, the won appreciated substantially last year, however, pressure is expected to dissipate as imports rise with the recovery in domestic demand. That said, it is clear that much of the recent appreciation in the currency has reflected capital transactions. While the authorities are committed to the maintenance of a flexible exchange rate, they are also very mindful of the damaging consequences of excessive volatility in the exchange rate and the fact that Korea still has a very shallow foreign exchange market. Hence, as noted by the staff, intervention in the foreign exchange rate occurred when market conditions became disorderly.

While the authorities found the staff's description of the foreign exchange rate policy broadly fair, they are concerned about the explicit reference to currency appreciation due to market sensitivities.

Labor sector issues are the key to the continued success of the Korean economy

The labor sector poses a number of inter-related challenges for the Korean economy. The economy is more vulnerable to industrial disputes than implied by the low union participation ratio (currently 11.6 per cent and continuing to decline from 15.6 per cent of ten years ago). Unionization is concentrated in upstream, assembly industries. As a result, the impact from any sustained industrial action in those industries can easily spill over to the downstream, parts industries. Business confidence is often affected by disputes in the labor market and foreign investors tend to single-out labor militancy as one of the major inhibitors to investment.

Another challenge comes from the increasing duality of the labor market (as analyzed in Box 3 of the staff report). So far, there is little evidence that the increase in the non-regular labor sector has impacted on productivity. To the contrary, it has brought remarkable flexibility to the labor market and contributed to a moderation in unit labor costs since the 1997 crisis. As indicated in the divergence between CPI-based REER and ULC-based REER (text figure on page 15 of the staff report), the increase in unit labor costs has been lower than inflation. However, regular sector wages have grown faster than productivity gains in recent years. The authorities are very mindful that the continuation of this trend would undermine productivity gains and are determined to rectify this trend.

Obviously, addressing the duality of the labor market involves narrowing the gap in employment protection between regular and non-regular labor sectors. The Spanish model suggested in the selected issues paper has merit but, as explained in the staff report, it could raise legal issues in Korea. Strengthening the social safety net would certainly be helpful in generating consensus, but the authorities are cognizant of the fact that the generosity of severance payments in the regular sector is well above the OECD average.[1]

The authorities prefer a more direct approach. Their agenda includes reducing the mandatory notification period for lay-offs from 60 days to 30 days and a further relaxation of the lay-off procedures for those firms under insolvency filing, while providing more protection for non-regular workers. But, as noted in the staff report, it is not an easy process and is politically contentious given that regular workers, who are unionized, tend to take their existing employment rights for granted. The process could result in further serious industrial relations strains, at least in the short term.

The authorities are a making concerted effort to achieve social consensus in addressing the adverse impacts of the duality of the labor market. Currently, the reform agenda is being discussed in the context of the Employee-Employer-Government Tripartite Commission. Thus far, progress has been encouraging as evidenced by the recent agreement that the three parties will cooperate in advancing job creation. According to the agreement, the unions will refrain from illegal strikes and will moderate their wage demands, management will make efforts to avoid unnecessary job cuts, and the government will provide better protection for non-regular workers. The authorities expect that consensus will emerge by June, which would allow the new National Assembly to incorporate the agreement into law.

The chaebol "legacy" and financial/corporate restructuring

The staff report tends to present the LG Card case as a government-sponsored bail-out. This is based on the fact that the Korea Development Bank (KDB), which is government-owned, would become the largest shareholder of the company once the proposed restructuring plan is implemented. We would like to note that this is a fair resolution, with more burden-sharing by shareholders in the chaebol affiliate for management's failures, apart from the systemic risk that the company's abrupt resolution would imply. (LG Card is the largest credit card company, accounting for about 25 per cent of assets in the credit card sector and KDB is one of LG Card's largest creditors.)

According to the absolute priority principle under the corporate insolvency scheme, a shareholder's legal responsibility ends once the share value is given-up when a company is in bankruptcy. It then becomes the responsibility of creditors to decide the fate of the company. In the case of LG Card, the LG Group has already agreed to give-up its equity in the company. However, the reality of corporate governance in Korean chaebols is that families exercise far more control than indicated by their ownership in the groups (as shown in Box 2

[1] R. Holzman, K. Iyer and M. Vodopivec, 2003 "Severance Pay Programs around the World: Rational, Status and Reforms" (a paper presented to a workshop organized by the World Bank/International Institute for Applied Analysis/Ludwig Bolzmann Institute for Economic Analysis).

of the staff report). Conversely, creditors insist that families be more accountable for their management's failure in ailing affiliates than is reflected by their shareholding. Creditors also know that this approach can not be achieved through bankruptcy filing. Hence, creditors prefer out-of-court settlements where families are pressed to bear greater losses for management's failure than simply giving-up their equity in the company.

This was the case with LG Card. Creditors, led by the largest creditor (KDB), struck a loss-sharing arrangement with the LG family. In addition to giving-up its and the group's equity in LG Card, the family agreed to surrender another non-bank financial company (LG Investment Securities), whose sale proceeds would be injected into LG Card, in return for a creditors' debt-equity swap plan. The family also agreed to take over 70 per cent of any additional losses should they materialize during the restructuring of LG Card, by offering its equities in other affiliates of the group as collateral.

Obviously, the deal is only enforceable when creditors collectively agree to take-up the remaining 30 per cent of the additional losses. Faced with reluctance from other creditor banks, which are now managed under ever-increasing foreign ownership, the KDB (as the largest creditor) agreed to the risks involved for the resolution of LG Card.[2] Such an outcome between creditors and the shareholder family may go beyond the provisions of the law but, given the persistence of the "legacy" of the Korean chaebols' governance structure, it can be argued that it is much closer to a fair burden-sharing arrangement than would likely emerge under insolvency procedures.[3]

The chaebols' legacy is dying. Previous corporate reform measures have already brought enormous market pressure upon the Korean chaebols' complicated ownership structure. Families' minor ownership positions have been challenged in a number of recent hostile take-over bids. The chaebols now realize that cross-shareholding among affiliates of their group can be at their own peril, rather than insurance, as it can be an easy route for a successful take-over of one affiliate to spread into other affiliates in the group.

The "Korea discount" referred to in the staff report is a painful phenomenon, but it is now well recognized in business circles. In the case of the chaebols, the pain is even more acute because their affiliates are increasingly being treated with a "chaebol discount" in local capital markets, rather than a "chaebol premium", which they enjoyed before the crisis.

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[2] The deal has not yet been implemented as one of the creditor banks (Korea Exchange Bank whose largest shareholder is now New Bridge Capital) refused to accept the debt-equity swap proposal which does not require creditors, except the KDB, to bear any further burden-sharing in association with "additional losses".

[3] This does not mean to downplay the importance of corporate insolvency reform. To the contrary, the existence of strong insolvency laws has facilitated corporate restructuring in Korea. Last year, Hynix (the second largest semi-conductor producer in Korea), underwent a complete restructuring under the Special Law for Corporate Restructuring Promotion, which was legislated on a temporary basis in the light of the protracted progress by the National Assembly in enacting a more comprehensive reform bill on corporate insolvency. However, when it comes to the restructuring of chaebol affiliates, creditors tend to regard legal channels as only the last option. There are even disagreements among creditors since some are also creditors of other affiliates in the group, as evidenced in the recent case of SK Global.

Facing ever-fierce market pressures, big conglomerates have begun to streamline their ownership. A number of chaebols have already broken their groups into smaller operations by adopting the holding company structure. The authorities' plan to relax some stringent qualifications for establishing holding companies is expected to speed-up this process further.

Finally on the Korean Investment Corporation (KIC) issue, we wish to confirm that the authorities do not have any disagreement with the staff's suggestion. In fact, they are now preparing a draft bill which will accommodate the staff's views. We hope that the staff's concern, as recorded in the staff report, will not be interpreted as a negative stance by the Fund on this issue.