

Korea's Economic Adjustments under the IMF-supported Program

By *Kunio Saito*

(Director, IMF Regional Office for Asia and the Pacific)

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Key Points

Introduction

Like others in the region, Korea took off from a state of the Asian poverty and stagnation and achieved the Asian Miracle. But this process of rapid growth came to a halt, temporarily, by the Asian Financial Crisis.

Problems - How did the crisis occur?

During the boom years, Korean economy undertook large investments financed by large external short-term borrowing. When the economy--especially exports--slowed, these large investments and borrowings caused;

For enterprises- unutilized capacity, low profits, cash flow difficulties and bankruptcies.

For banks - large non-performing assets, loss of confidence by foreign banks, inability to raise new money abroad and roll over maturing debt, liquidity problems, and for some, insolvency.

Traditional policy responses (to save individual firms and banks) were ineffective in an environment of globally integrated markets, where confidence factors play a crucial role.

As confidence weakened, Korea's financial crisis deepened in late 1997.

IMF-supported Programs—How does it work?

The program aims at, first, stabilizing the exchange market, and, then, preparing the ground for resuming rapid growth, by maintaining appropriately tight financial policies and implementing comprehensive structural reforms.

- The exchange market stabilization depends crucially on the restoration of confidence--through on appropriate external financing strategy (debt rollovers, IMF borrowing, etc.) and by maintaining the market determined exchange rate combined with high interest rates. Strong commitments to reform and other program policies are also crucial.
- Financial policies will have to be appropriately tight to maintain macroeconomic stability. But the automatic fiscal stabilizers will be permitted to work, and interest rates can be lowered once stabilization objectives are achieved.
- Reforms include financial sector restructuring, improvements of corporate governance, greater flexibility in labor relations, and accelerated liberalization of capital controls and some remaining trade restrictions.

Conclusion

The IMF-supported program is the best--and perhaps the only available--means to deal with the present crisis. It will work--the economy will stabilize and, although after a period of difficult adjustments, resume rapid growth.

Structural measures--entailing financial sector and other corporate restructuring as well as labor redeployment--are painful in the short-run but are in the nation's best interest in the longer-run. These measures strengthen enterprises' competitiveness, enhance the efficiency of the economy as a whole, and thereby pave the way for rapid growth.

Under the program, liberalization of the capital account and some remaining trade restrictions has been accelerated. Also, improvements are being made regarding the traditional government corporate relationship, inter-enterprise arrangements, and even the management style of each corporation. These improvements will lead to the strengthening of the Korean--and the east Asian--approach to rapid economic growth.

Table 1 Korea: Key Events
(December 1996-November 1997)¹

General
Dec 1996: Korea joins the OECD.
Oct 18: National Assembly turns down 9 financial sector related bills.
Nov 19: Mr. Lim Chang Yuel replaced Mr. Kang Kyong Shik as Finance Minister.
Dec 18: Mr. Kim Dae-jung is elected as the next President of Korea.
Dec 30: Government and the IMF release figures on the total external liabilities of Korea.

Korea and the IMF
Nov 21: Korea asks for the IMF assistance.
Dec 4: IMF approves \$21bn stand-by credit to Korea, \$5.5bn disbursed.
Dec 18: IMF completes its first review. \$3.5bn made available under the new Supplemental Reserve Facility (SRF).
Dec 30: Korea strengthens economic program, additional \$2bn is disbursed.
Jan 8, 1998: IMF approves \$2bn disbursement to Korea after the second review.

Thailand and Indonesia
July 2, 1997: Thai Baht allowed to float.
Aug 14: Indonesian Rupiah allowed to float.
Aug 20: Thailand agrees with the IMF for \$3.9bn Stand-by credit.
Nov 1: Indonesia closed 16 troubled banks.
Nov 5: IMF approves \$10.14bn Stand-by credit to Indonesia.
Dec 8: Thailand announces 56 of 58 suspended finance companies will be shut.

Business Failures
Jan 1997: Hanbo Steel fails with \$6bn debts.
March: Sammi Steel collapses.
April: Jinro Group became bankrupt.
May: Dainong and New Core Group collapse.
July: Kia asks for emergency loans.
Oct: Korea nationalizes Kia after banks refuse more loans.

Labor Relations
Dec 26, 1996: National Assembly passes new labor laws legalizing lay-offs and maintaining a ban on free union association.
Dec 27-31, 1996: Nationwide strikes against new law.
Jan 1997: Strikes against new laws continue, affecting auto-industry, shipyards and transport.
Jan 1997: President Kim Young-sam agrees further debate regarding the law. Strikes end.

Capital Controls
March 1997: Ceiling on foreigners' equity investment was raised by 3 percent to be 23 percent.
Dec 11: Increased ceiling on aggregate and individual ownership of listed shares to 50 percent from 26 percent and 7 percent, respectively.

Assistance to Business/Banks
March 1997: Bankers association announced extension of loan repayment periods by two months.
Mar 17: MOFE announces it will support merchant banks with BOK loans and with the public money.
Mar 24: BOK announces its readiness for \$1bn loan to seven banks including Korea First Bank.
July: The coverage of enterprises eligible for loan repayment has been expanded.
Nov 19: Government announced a financial stabilization package to restore overseas confidence.

Bank Restructuring
Dec 2: Government suspends nine merchant banks.
Dec 9: Government buys stocks of the Seoul Bank and Korea First Bank.
Dec 10: Government suspends five additional merchant banks.
Dec 10: Government decides to allow the Deposit Insurance Fund and the Non-Performing Asset Management Fund to issue government guaranteed bond totalling 24 trillion won.

Exchange Rate
Oct 17-19: Exchange market virtually closed.
Oct 20: Exchange rate band widened to 10%.
Nov 17: Won drops below 1000 to the dollar.
Dec 16: Abolished daily exchange rate band.
Dec 23: Won falls near 2000 to the dollar.
Jan 14, 1998: Won drifts around 1600-1700 to the dollar.

1. With a few exceptions, this listing is preliminary and is not exhaustive.

Table 2 Korea: Policies Incorporated in IMF-Supported Program

Exchange Rate and Monetary Policy

- Raised official interest rates to stabilize the foreign exchange market.
- Abolished daily exchange rate band on Dec. 16, 1997, with limiting foreign exchange intervention to smoothing operations.
- Eliminated interest rate ceiling on resident foreign exchange accounts below 3 months.
- Call rate was raised to 30 percent to stabilize the exchange rate.
- Legislated to remove any cap on interest rates.
- Sterilization operations are being undertaken to keep overall liquidity sufficiently tight to maintain interest rates at adequate levels.

External Financing

- Raised interest rate on Bank of Korea (BOK) foreign exchange loans to commercial banks as high as needs to conserve reserves.
- Monitoring strictly need for BOK foreign exchange loans to banks unable to rollover foreign currency debt and monitor BOK foreign exchange loans to ensure use of funds limited to debt repayment.
- Established a task force chaired by the MOFE to coordinate developments and implementation of a strategy to address the crisis, and established a MOFE-led team to negotiate with foreign commercial bank creditors to facilitate extensions of outstanding short-term debt and prepare access to mid-term borrowing.

Fiscal Policy

- Strengthen underlying budget balance by adoption of measures yielding 1.5 percent GDP.
- Permit automatic budget stabilizer to operate which could result in a deficit.
- Reassess priority of expenditure to enable an increase in social safety spending.

Financial Sector Reform

- Identified and suspended 14 insolvent merchant banks.
- All merchant banks submitted rehabilitation plans, and assessment of the plans to be completed by March 1998.

- Placed Korea First Bank and Seoul Bank under supervision by Bank Supervision Office.
- Issue guidelines for foreign investment in domestic financial institutions.
- Require submission of plans for capital restoration from all commercial banks not meeting Basle capital standards.
- Submitted legislation to grant the relevant authorities the right to issue necessary quantities of bonds to meet the 100 percent deposit guarantee.
- Enacted financial reform bill to amend BOK Act, strengthen bank supervision, and require corporations to prepare consolidated balance sheet.
- Submit legislation to give the supervisory authority clear authority to close insolvent institutions and to review bankruptcy law.

Corporate Governance

- The commercial orientation of bank lending will be fully respected, and the government will not intervene in bank management and lending decisions.
- Improve the transparency of corporate balance sheets, including profit and loss accounts by enforcing accounting standards in line with generally accepted practices.
- Implement measures to change the system of mutual guarantees within conglomerates to reduce the risk it involves.

Capital Account Liberalization

- Liberalized foreign investment in the Korean equity market by increasing the ceiling on aggregate foreign ownership of listed Korean shares from 26 percent to 50 percent on December 11, 1997; and to increase the aggregate ceiling on foreign investment in Korean equities to 55 percent.
- Allow foreign investors to buy equity in the stock market for the purpose of friendly mergers and acquisitions, without limits.
- Allowed foreign investment in the guaranteed corporate bond markets with limits at 10 and 30 percent for individuals and in aggregate respectively; eliminated all limits on foreign investment in non-guaranteed bonds issued by small-and medium-sized companies; raised aggregate limits on foreign investment in non-guaranteed corporate bonds from 30 to 50 percent; eliminated all individual limits for foreign investment in corporate bonds; allowed foreigners to invest in government and special bonds, up to the aggregate ceiling of 30 percent; eliminated all foreign investment ceilings for the government, special and corporate bond markets, including for maturities of less than 3 years.
- Set timetable for January 1998 to permit unlimited foreign investment in domestic money market instrument and an approval to reactivate treasury bill issues to be obtained from

National Assembly.

- Lifted the restriction on foreign borrowing of over 3 years maturity; raised the maximum term of deferred payment credit for imports to 180 days; and the lifting of remaining maturity restrictions on foreign borrowing by corporations is to be consulted with the IMF.
- Allow foreign banks and brokerage houses to establish subsidiaries in March 1998; and place prudential controls on short-term external borrowing of financial institutions in March 1998.

Trade Liberalization

- Eliminate trade-related subsidies in compliance with the WTO commitments.
- Import liberalization, by eliminating the import diversification program, by liberalizing 113 items by the end of 1998, and by reducing the number of items subject to adjustment tariffs.
- Financial services liberalization measures to be announced January 1998 as agreed with OECD as part of commitments to WTO.

Labor Market Policies

- Improve labor market flexibility, the government will announce in January 1998 views on labor market and wage issues, and on a fair sharing of the burden between employers and workers in case of labor redundancies.
- Plan to support the unemployed, intensify training and restructure labor market in order to strengthen government employment insurance system to be announced in February 1998.
- Submit the temporary employment agencies bill to the National Assembly to ease burden of layoffs and expedite redeployment in February 1998.

Source: Korea's letters of intent released by the Korean government.

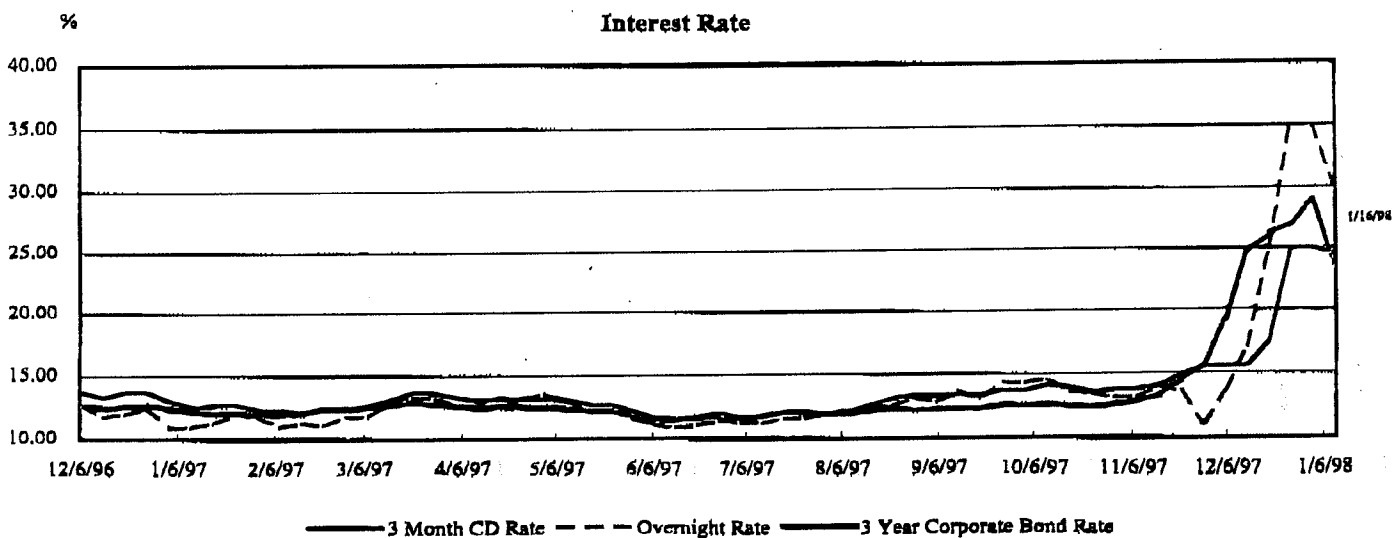
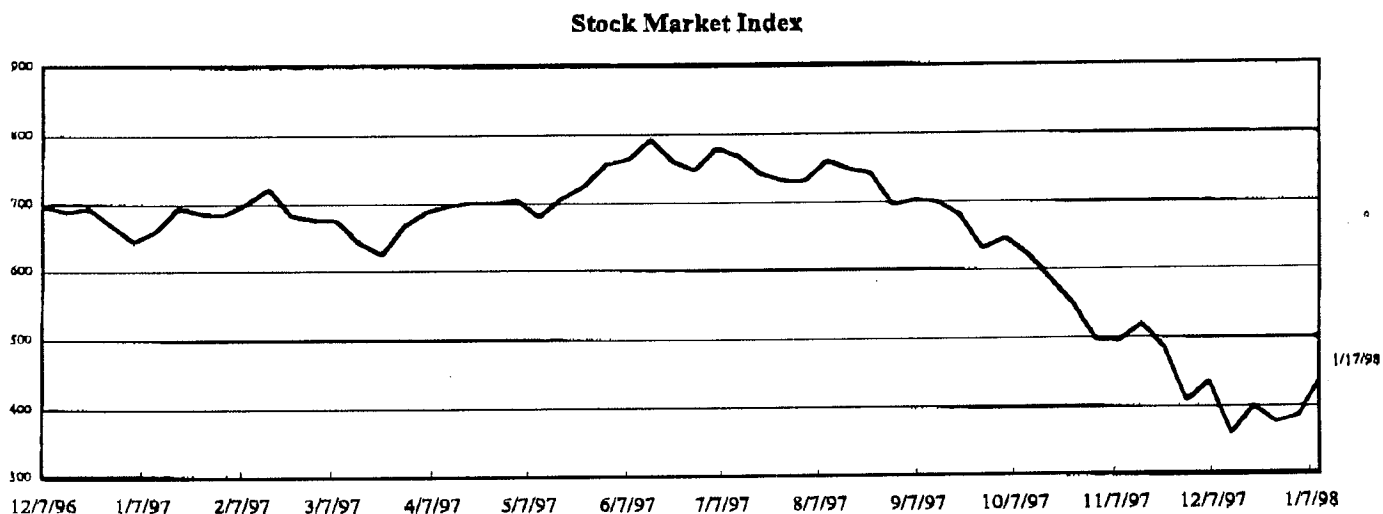
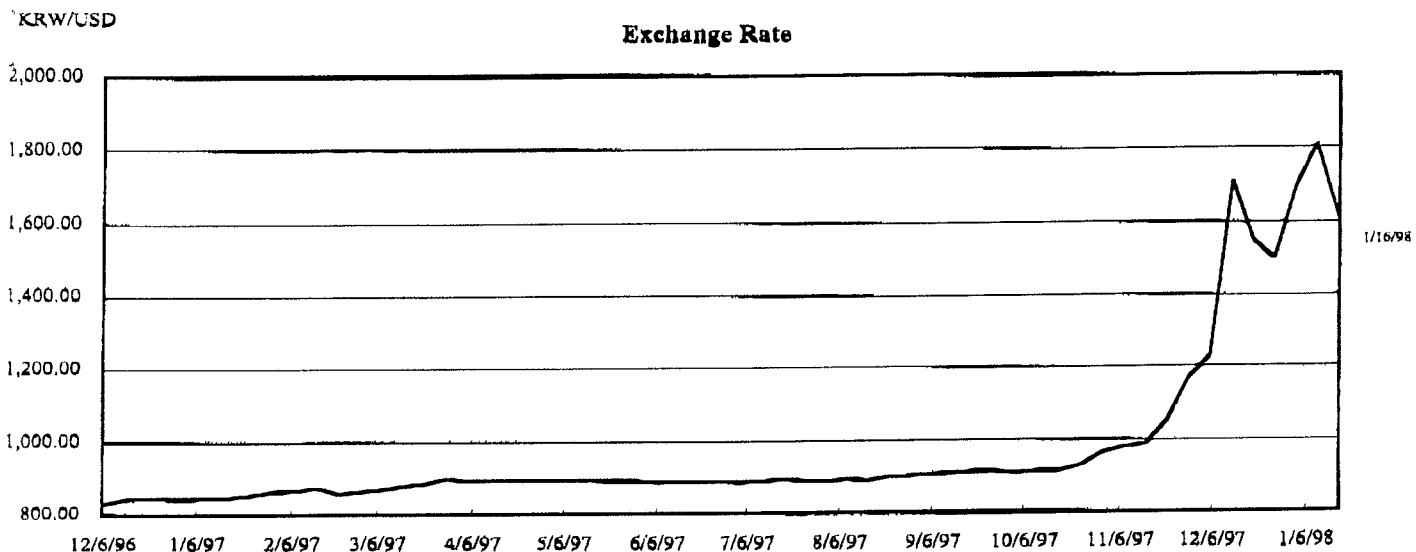
1. Republic of Korea, IMF Stand-by Arrangement, Summary of the Economic Program, December 5, 1997. Internet Address: <http://kiep.go.kr/IMF/hot-1.html>
2. The IMF Program, Comprehensive Implementation Actions and Plans (Summary), December 16, 1997. Internet Address: <http://kiep.go.kr/IMF/hot-2.html>
3. Special Announcement by the Deputy Prime Minister Lim, Chang-Yuel, December 24, 1997. Internet Address: <http://kiep.go.kr/IMF/hot-4-2.html>

Table 3. Korea: Selected Indicators (Annual Percent Changes unless otherwise indicated)

	1994	1995	1996	1997
Market (end of period)				
EX rate (KRW/USD)	788.70	774.70	844.20	1,695.00
Stock Price Index	1,027.37	882.94	651.22	376.31
Real GDP Growth (%)	8.6	8.9	7.1	5.9
Investment (%)	12.0	11.7	7.1	-4.0
CPI Inflation at end year (%)	5.6	4.7	4.9	6.6
Fiscal Balance (% of GDP)				
Central Government	0.5	0.4	0.3	-0.5
Public Sector		
Money Growth (%)				
M3	17.6	13.7	16.7	15.6
Reserve Money	9.2	16.3	-12.2	-12.5
Export Growth (%)	16.8	30.3	3.7	5.4
Import Growth (%)	22.1	32.0	11.3	-3.7
Current Account Deficit (in percent of GDP)	-1.2	-2.0	-4.9	-2.0
Balance of Payment and Debt (billions of USD)				
Current Account	-4.5	-8.9	-23.7	-8.9
Direct Investment	0.4	-1.9	-2.0	-1.4
Other ¹⁾	3.2	17.9	25.7	-12.7
Official Reserves	25.6	32.7	33.2	20.4

¹⁾ includes: portfolio investment, trade credits, deposit money banks, other, errors and omissions.

Chart 4. Korea: Financial Market Indicators



Source: Bloomberg

Chart 5 KOREA: Monetary Conditions Indicator

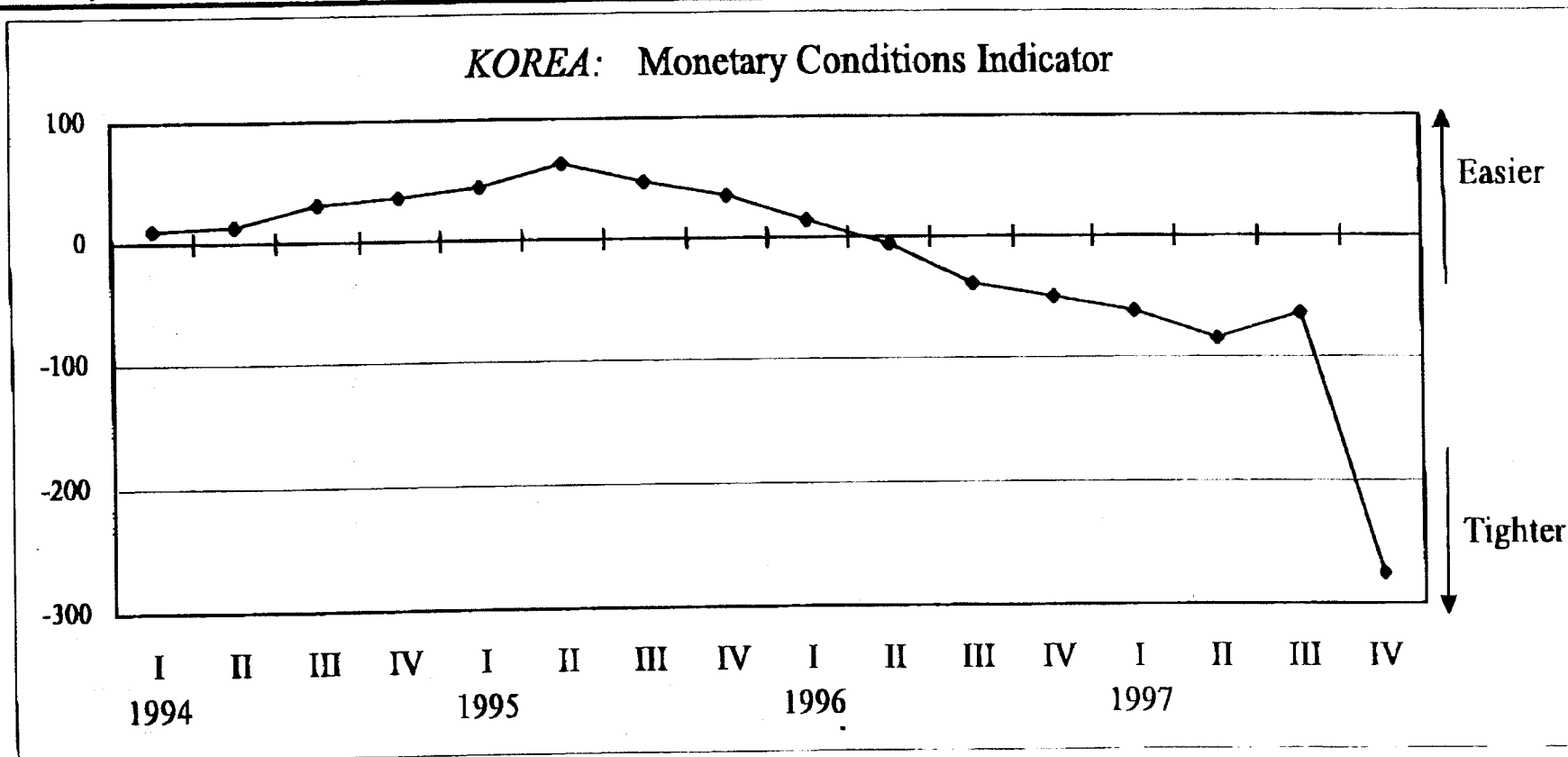
Monetary Conditions Indicator is defined as Change in Real Effective Exchange Rate (A) times Real Interest Rate (B).

Real Effective Exchange Rate is estimated as market exchange rate times US CPI divided by Korean CPI.

Real Interest Rate (B) is estimated as money market rate minus Korean CPI change.

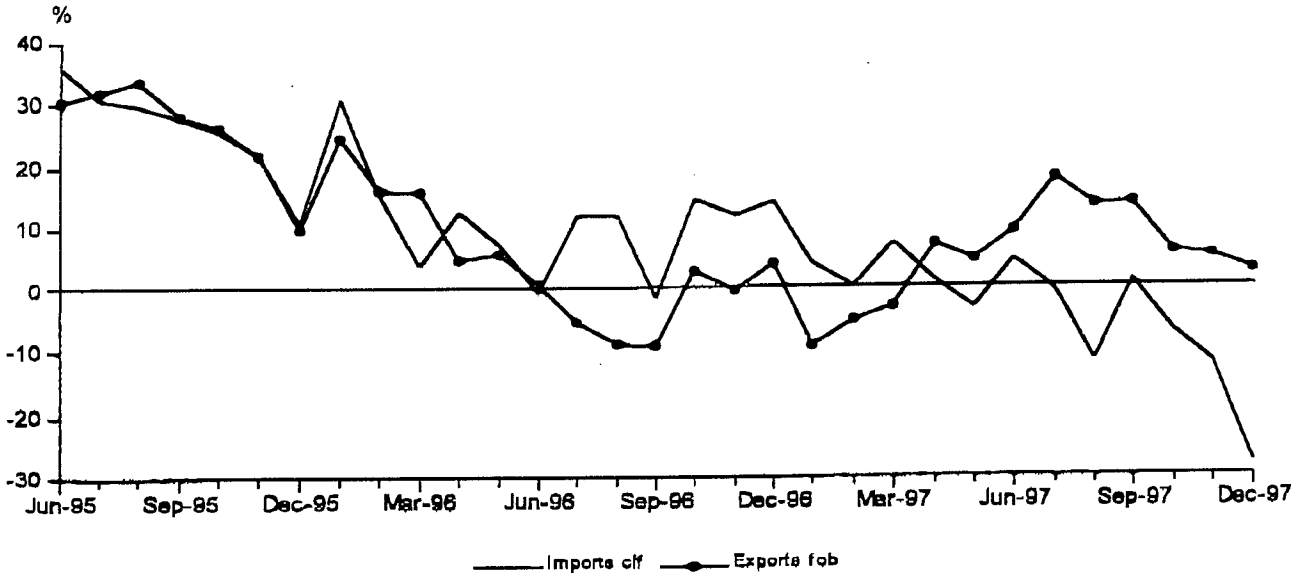
All variables are shown using period-average data.

	1994				1995				1996				1997			
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
Real Effective Exchange Rate (REER)	100.00	100.86	102.21	102.63	104.56	108.36	108.51	107.86	107.09	107.32	103.83	101.62	97.87	96.19	95.96	76.53
Change in REER (A)	2.2	2.2	4.5	5.1	4.6	7.4	6.2	5.1	2.4	-1.0	-4.3	-5.8	-8.6	-10.4	-7.6	-24.7
Money Market Rate	11.2	11.9	13.7	13.0	14.4	13.2	11.5	11.3	10.5	11.1	14.2	13.8	11.9	12.2	12.4	16.2
Real Interest Rate (B)	4.7	6.1	6.8	7.2	9.7	8.5	7.6	6.9	5.8	6.2	9.1	8.7	7.2	8.2	8.5	11.1
Monetary Conditions Indicator	10.3	13.5	31.0	36.2	44.1	62.9	46.9	35.3	14.1	-5.9	-39.3	-50.5	-62.2	-84.7	-64.3	-275.1

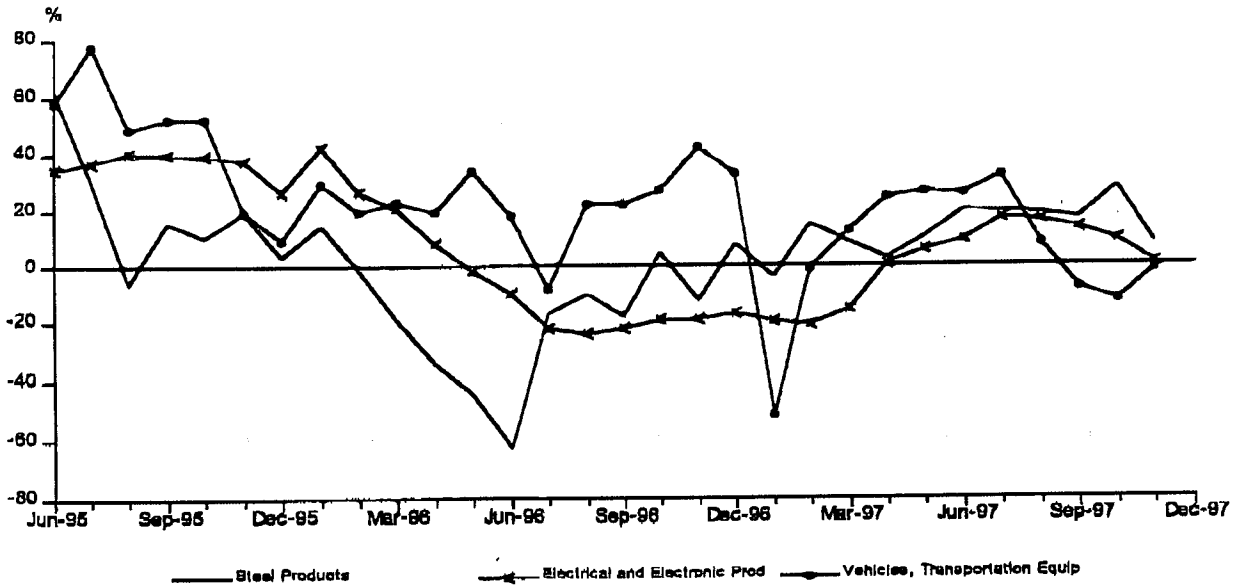


Source: IMF(OAP) staff estimate based on data from IFS/Bloomberg.

**Chart 6. Korea: Growth Rates of Exports and Imports
Year-on-Year**



Korea: Growth Rates of Major Export Products



Source: DRI Asia Database

KUNIO SAITO--BIO DATA

Personal

Born 1940 in Japan
Married (two children)

Education

Graduated Hitotsubashi University (Japan) and Edinburgh University (U.K.)

Current Assignment

Director, Regional Office for Asia and the Pacific, International Monetary Fund

Previous Assignments

1964-68	-	Ministry of Finance, Japan (Officer in the International Finance and Securities Bureaus)
1969-86	-	International Monetary Fund (Economist, Division Chief, and Assistant Director, mostly in the Asian Department)
1987-88	-	Asian Development Bank (Chief, Development Policy Office)
1989-91	-	International Monetary Fund (Deputy Director, Asian Department)
1991-1996	-	International Monetary Fund (Director, Southeast Asia and Pacific Department)
Jan. 1997- present	-	International Monetary Fund (Director, Regional Office for Asia and the Pacific)