PRESS RELEASE NO. 97/55

Press Release: IMF Approves SDR 15.5 Billion Stand-by Credit for Korea

December 4, 1997

The International Monetary Fund today approved Korea's request for a three-year stand-by credit equivalent to SDR 15.5 billion (about US$21 billion) in support of the government's economic and financial program (/external/np/oth/korea.htm). Of the total, SDR 4.1 billion (about US$5.56 billion) is available immediately. SDR 2.6 billion (about US$3.58 billion) will be available December 18, following the first review under the program, and a further SDR 1.5 billion (about US$2 billion) on January 8, 1998 following the second review. Subsequent disbursements will be made available subject to the attainment of performance targets and, in some cases, program reviews. The stand-by credit is equivalent to 1,939 percent of Korea's quota [1] (#I2) of SDR 799.6 million (about US$1.09 billion) in the IMF.

In approving Korea's request for the stand-by credit, the IMF made use of the accelerated procedures established under the emergency financing mechanism (EFM), which was adopted in September 1995. The EFM strengthens the IMF's ability to respond swiftly in support of a member country facing an external financial crisis and seeking financial assistance from the IMF in support of a strong economic adjustment program.

Background

For the past several decades, the Korean economy has grown rapidly. With per capita GDP rising at an annual rate of nearly 7 percent, a once poor agrarian economy has been transformed into an advanced industrial economy. At the same time, in the process of development, the limitations of Korea's system of detailed government intervention at the micro level have become increasingly apparent. In particular, the legacy of intervention has left an inefficient financial sector which has led to a highly leveraged corporate sector that lacks effective market discipline.

Until the present financial crisis, Korea's macroeconomic performance in 1997 was broadly favorable. Notwithstanding a sharp slowing of domestic demand, real GDP grew by 6 percent during the first three quarters and inflation declined slightly to 4 percent. Subdued import demand and rapid growth of exports caused the external current account deficit to narrow in the second quarter, and a current account deficit of 3 percent of GDP is expected in 1997. Fiscal policy remained prudent, and despite a large tax shortfall, expenditure cuts were made so as to ensure that the consolidated central government accounts record only a small deficit for 1997.

However, since the beginning of the year, an unprecedented number of highly leveraged conglomerates (chaebols) have moved into bankruptcy. This reflected a number of factors, including excessive investment in certain sectors such as steel and autos, and a weakening in the profitability associated with the cyclical downturn. The bankruptcies severely weakened the financial system and nonperforming loans rose sharply to the equivalent of 7-1/2 percent of GDP. At the same time, the steep decline in stock prices has cut the value of banks' equity and further reduced their net worth. These developments exacerbated the existing weaknesses in the banking system caused by a lack of commercial orientation and limited experience in pricing and managing risk, combined with lax prudential supervision. The weak state of the banking sector has led to successive downgrades by international credit rating agencies and a sharp tightening in the availability of external finance.

Program Objectives

The macroeconomic objectives of the program include: building the conditions for an early return of confidence so as to limit the unavoidable slowdown of GDP growth in 1998, followed by a recovery towards potential in 1999; containing inflation at or below 5 percent; and building international reserves to more than 2 months of imports by end- 1998.

The government's program is built around (1) a strong macroeconomic framework designed to continue the orderly reduction in the external current account deficit; build up international reserves; and contain inflationary pressures through a tighter monetary stance and significant fiscal adjustment; (2) a comprehensive strategy to restructure and recapitalize the financial sector and make it more transparent, market-oriented, and better supervised; (3) measures to reduce the high degree of reliance of corporations and financial institutions on short-term debt and allow a better diversification of risk in the economy.

To demonstrate to markets the government's resolve to confront the present crisis, monetary policy is being tightened immediately to restore and sustain calm in the markets and contain the inflationary impact of the recent won depreciation. In line with this policy, the large liquidity injection in recent weeks is being reversed and money market rates have been raised sharply and will be maintained at a high level as needed to stabilize markets. The day-to-day conduct of monetary policy will be guided by movements in the exchange rate and short-term interest rates which will be used as indicators of the tightness of monetary conditions. A flexible exchange rate policy will be maintained, with intervention limited to smoothing operations.

For 1998, fiscal policy will remain tight. Because of lower growth, a weaker exchange rate, and the cost of servicing public funds raised to recapitalize the banks, the budget would have shifted into a deficit. To offset this, and to alleviate the burden on monetary policy, additional fiscal measures of about 1-1/2 percent of GDP will be put in place to achieve at least balance, or a small surplus through both revenue and expenditure measures. These measures include: increases in mineral oil taxes that have already gone into effect; a broadening of the VAT base and selective increases in income and corporate taxes; cuts in current expenditures, and, to a limited extent, in infrastructure and other capital expenditures.

Financial Sector Restructuring

The centerpiece of the government's program is a comprehensive restructuring and strengthening of the financial system to make it sound, transparent, and more efficient. The strategy comprises three broad elements: a clear and firm exit policy; strong market and supervisory discipline; and increased competition.

The exit policy seeks to ensure the rapid resolution of troubled financial institutions in a manner that minimizes systemic distress and avoids moral hazard. The authorities have moved to suspend 9 insolvent merchant banks. Those merchant banks that are unable to submit appropriate restructuring plans will have their licenses revoked. The authorities' policy involves the restructuring and recapitalization of all banks that fail to meet the Basle Committee capital standards. In addition to recapitalization by current owners, this policy will include mergers and acquisitions by domestic or foreign institutions. The supervisory authorities will review such mergers and acquisitions to ensure the new groupings are economically viable. This process will entail losses to shareholders.

The deposit guarantee currently in place is intended to facilitate an orderly restructuring of the financial system in present circumstances. In order to enhance market discipline and minimize moral hazard problems, the government is committed to eliminate the guarantee by the end of 2000 and replace it by a regular deposit insurance system that will only protect small depositors and be financed solely by contributions from the financial sector.

In order to improve transparency in the financial sector and upgrade accounting and disclosure standards toward best international practice, large financial institutions will be required to have their financial statements audited by internationally recognized firms. Disclosure standards will require the publication of key data by financial institutions twice a year, including nonperforming loans, capital adequacy, and ownership structures and affiliations.

To strengthen financial sector supervision, the authorities will urgently request passage of a bill to set up an agency to consolidate the supervisory functions currently distributed among various agencies. The legislation will also allow prompt closure of insolvent financial institutions, the replacement of managements and the dilution of shareholders equity when appropriate. The passage of early legislation will also be sought to make the Bank of Korea independent and with price stability as its overriding mandate.

To promote competition and efficiency in the financial sector, the authorities will allow foreigners to establish bank subsidiaries and brokerage houses by mid-1998.

Structural Policies

Although the government has undertaken substantial trade liberalization since the early 1980s, further liberalization will help enhance domestic competition. Therefore, a timetable will be set in line with WTO commitments to eliminate trade-related subsidies, restrictive import licensing and the import diversification program. Steps will also be taken to streamline and improve the transparency of import certification procedures.

The government plans to substantially accelerate its ongoing capital account liberalization program. The ceiling on aggregate foreign ownership of listed Korean shares will be increased from 26 percent to 50 percent by end-1997 and to 55 percent by end-1998. The ceiling on foreign ownership will be increased from 7 percent to 50 percent by end-1997. By the end of February 1998, steps will be taken to liberalize other capital account transactions, including those restricting foreigners' access to domestic money market instruments and the corporate bond markets, and by further reducing restrictions on foreign direct investment by simplifying approval procedures. A timetable will be set by the end of February 1998 to eliminate restrictions on foreign borrowing by corporations.

To facilitate the ability of the Korean labor market to respond to changing economic conditions, labor market flexibility will be enhanced by easing dismissal restrictions under mergers and acquisitions and corporate restructuring, which continue to rely on time-consuming court rulings. To ease the burden of layoffs and to expedite reemployment, the employment insurance system will be strengthened and private job placement agencies and temporary employment agencies will be allowed to operate.

Financing Needs

In addition to the IMF funding of US$21 billion, the President of the World Bank has indicated the Bank's readiness to provide up to US$10 billion in support of specific structural reform programs, in accordance with bank policy. Similarly, the President of the Asian Development Bank has indicated his readiness to recommend to his Board to provide up to US$4 billion in support of policy and institutional reforms, within the framework of the bank's policy. At the same time, a number of countries (Australia, Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) have informed the IMF that they are prepared, in the event that unanticipated adverse external circumstances create the need for additional resources to supplement Korea's reserves and resources made available by the IMF and other international institutions, to consider--while Korea remains in compliance with the IMF credit arrangement--making available supplemental financing in support of Korea's program with the IMF. This second line of defense is expected to be in excess of US$20 billion.

Korea: Selected Economic Indicators

	1995	1996	1997	1998*
	(Percent change)			
Real GDP growth	8.9	7.1	6.0	2.5
Consumer prices (end of	4.7	4.9	4.2	5.2

period)

	(Percent of GDP)			
Central government balance (deficit -)	0.3	0.3	-0.5	0.2
	(Billions of US$)			
Current account balance deficit -)	-8.9	-23.7	-13.8	-2.3
External debt	78.4	104.7	101.5	126.8

Sources: Korean authorities; and IMF staff estimates.

*Program.

---

[1] A member's quota in the IMF determines, in particular, the amount of its subscription, its voting weight, its access to IMF financing, and its share in allocations of SDRs.

IMF EXTERNAL RELATIONS DEPARTMENT

Public Affairs

E-mail: publicaffairs@imf.org (mailto:publicaffairs@imf.org)

Fax: 202-623-6278

Media Relations

E-mail: media@imf.org (mailto:media@imf.org)

Phone: 202-623-7100