REPUBLIC OF KOREA

IMF Stand-By Arrangement
Summary of the Economic Program
December 5, 1997

Macroeconomic Policies

1. **Objectives**

The program is intended to narrow the external current account deficit to below 1 percent of GDP in 1998 and 1999, contain inflation at or below 5 percent, and--hoping for an early return of confidence--limit the deceleration in real GDP growth to about 3 percent in 1998, followed by a recovery toward potential in 1999.

2. **Monetary policy and exchange rate policy**

- To demonstrate to markets the authorities' resolve to confront the present crisis, monetary policy will be tightened immediately to restore and sustain calm in the markets and contain the impact of the recent won depreciation on inflation.
- In line with this policy, the large liquidity injection in recent days has been reversed, and the call rate has been raised from 12 1/2 percent on December 1, 1997 to 21 percent today, and will be raised further in the next few days.
- Money growth during 1998 will be limited to a rate consistent with containing inflation at 5 percent or less.
- A flexible exchange rate policy will be maintained, with intervention limited to smoothing operations.

3. **Fiscal policy**

- A tight fiscal policy will be maintained in 1998 to alleviate the burden on monetary policy and to provide for the still uncertain costs of restructuring the financial sector.
- The cyclical slowdown is projected to worsen the 1998 budget balance of the consolidated central government by about 0.8 percent of GDP. The present estimates of the interest costs of financial sector restructuring is 0.8 percent of GDP. Offsetting measures amounting to about 1.5 percent of GDP will be taken to achieve at a minimum budget balance and, preferably, a small surplus. This will be achieved by both revenue and expenditure measures to be determined shortly. These may include, among others:
  - increasing VAT coverage and removing exemptions;
  - widening the corporate tax base by reducing exemptions and certain tax incentives;
  - widening the income tax base by reducing exemptions and deductions;
  - increasing excises, luxury taxes, and transportation tax;

- reducing current expenditures particularly support to the corporate sector; and
- reducing low priority capital expenditures.

Financial Sector Restructuring

1. The following financial sector reform bills submitted to the National Assembly will be passed before the end of the year:

- A revised Bank of Korea Act, which provides for central bank independence, with price stability as its main mandate.
- A bill to consolidate supervision of all banks, including specialized banks, merchant banks, securities firms, and insurance companies in an agency with operational and financial autonomy, and with all powers needed to deal effectively with troubled financial institutions.
- A bill requiring that corporate financial statements be prepared on a consolidated basis and be certified by external auditors.

2. **Restructuring and reform measures**

- Troubled financial institutions will be closed or if they are deemed viable, restructured and/or recapitalized. The government has already suspended 9 insolvent merchant banks (on December 2, 1997). These banks have been placed under the control of MOFE and required to submit a rehabilitation plan within 30 days. These plans will be assessed in consultation with Fund staff and, if not approved, the institution will have its license revoked.
- A credible and clearly defined exit strategy will include closures as well as mergers and acquisitions by domestic and foreign institutions, provided the viability of the new groupings is assured. Clear principles on sharing of losses among equity holders and creditors will be established.
- The disposal of nonperforming loans will be accelerated.
- The present blanket guarantees which will end in three years will be replaced by a limited deposit insurance scheme.
- A timetable will be established for all banks to meet or exceed Basle standards.
- Prudential standards will be upgraded to meet Basle core principles.
- Any support to financial institutions will be given on strict conditions.
- All support to financial institutions, other than BOK liquidity credits, will be provided according to pre-established rules, and recorded transparently.
- Accounting standards and disclosure rules will be strengthened to meet international practice. Financial statements of large financial institutions will be audited by internationally recognized firms.
- Manpower in the unit supervising merchant banks will be sufficiently increased to make supervision effective and to allow proper handling of troubled banks.
- The schedule for allowing foreign entry into the domestic financial sector will be accelerated, including allowing foreigners to establish bank subsidiaries and brokerage houses by mid-1998.
- Borrowing and lending activities of overseas' branches of Korean banks will be closely monitored to ensure that they are sound. Nonviable branches will be closed.
- BOK's international reserve management will be reviewed with the intention to bring it closer to international practice. Deposits with overseas branches of domestic banks will not be increased further, but gradually withdrawn as circumstances allow. Financial institutions will be encouraged to improve their risk assessment and pricing procedures, and to strengthen loan recovery; actions in these areas will be reviewed as part of prudential supervision.

Other Structural Measures

1. **Trade liberalization**

Timetables will be set, in compliance with the WTO commitments, at the time of the first review, to:

- eliminate trade-related subsidies;
- eliminate restrictive import licensing;
- eliminate the import diversification program; and
- streamline and improve the transparency of the import certification procedures.

2. **Capital account liberalization**

- The present timetable for capital account liberalization will be accelerated by taking steps to:
  - liberalize foreign investment in the Korean equity market by increasing the ceiling on aggregate ownership from 26 percent to 50 percent by end-1997 and to 55 percent by end-1998. The ceiling on individual foreign ownership will be increased from 7 percent to 50 percent by end-1997.
  - effective immediately, for foreign banks seeking to purchase equity in domestic banks in excess of the 4 percent limit requiring supervisory authority approval, the supervisory authority will allow such purchases provided that the acquisitions contribute to the efficiency and soundness of the banking sector; legislation will be submitted to the first special session of the National Assembly to harmonize the Korean regime on equity purchases with OECD practices (with due safeguards against abuse of dominant positions.)
  - allow foreign investors to purchase, without restriction, domestic money market instruments.
  - allow foreign investment, without restriction, in the domestic corporate bond market.
  - further reduce restrictions on foreign direct investment through simplification of procedures.
  - eliminate restrictions on foreign borrowings by corporations.

3. **Corporate governance and corporate structure**

- Timetable will be set by the time of the first review to improve the transparency of corporate balance sheets, including profit and loss accounts, by enforcing accounting standards in line with generally accepted accounting practices, including through:
  - independent external audits,
  - full disclosure, and
  - provision of consolidated statements for business conglomerates.
- The commercial orientation of bank lending will be fully respected, and the government will not intervene in bank management and lending decisions. Remaining directed lending will be eliminated immediately. While policy lending (agriculture, small business, etc.) will be maintained, the interest subsidy will be borne by the budget.
- No government subsidized support or tax privileges will be provided to bail out individual corporations.
- The "real name" system in financial transactions will be maintained, although with some possible revisions.
- Measures will be worked out and implemented to reduce the high-debt-to-equity ratio of corporations, and capital markets will be developed to reduce the share of bank financing by corporations (these will be reviewed as part of the first program review).

- Measures will be worked out and implemented to change the system of mutual guarantees within conglomerates to reduce the risk it involves.

4. **Labor market reform**

- The capacity of the new Employment Insurance system will be strengthened to facilitate the redeployment of labor, in parallel with further steps to improve labor market flexibility.

5. **Information provision**

- There will be regular publication of data on foreign exchange reserves, including the composition of reserves and net forward position with a two weeks delay initially. Data on financial institutions, including nonperforming loans, capital adequacy, and ownership structures and affiliations will be published twice a year. Data on short-term external debt will be published quarterly.