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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED LOAN

TO THE

UNION OF LAND IMPROVEMENT

ASSOCIATIONS

FOR AN

IRRIGATION PROJECT

WITH THE GUARANTEE OF THE

REPUBLIC OF KOREA

April 17, 1969

REPORT AND RECOMMENDATION OF THE PRESIDENT TO THE EXECUTIVE DIRECTORS
ON A PROPOSED LOAN TO THE UNION OF LAND IMPROVEMENT
ASSOCIATIONS (ULIA) WITH THE GUARANTEE OF
THE REPUBLIC OF KOREA

1. I submit the following report and recommendation on a proposed loan in an amount in various currencies equivalent to \$45 million to the Union of Land Improvement Associations (ULIA), to be guaranteed by the Republic of Korea.

PART I - HISTORICAL

2. One of the main objectives of Korea's Second Five Year Plan (1967-71) is to achieve self-sufficiency in foodgrains. Grain imports constitute a heavy drain on the country's foreign exchange which it can ill afford. There is practically no new land which can be put under paddy cultivation so increased production can be achieved only through more intensive use of scarce arable land.

3. Following a request from the Minister of Agriculture and Forestry for assistance in preparing an irrigation project, intensive studies were undertaken by preliminary IERD/FAO missions. The project was appraised in September/October 1968. The Pyongtaek and Kungang irrigation schemes are part of the Government's All Weather Farming Program for the expansion and rehabilitation of irrigation facilities which aims at increasing fully irrigated paddy land from the present 60 percent to 85 percent of the total cultivable area of the country by 1976.

4. Negotiations for the proposed loan were held in Washington from February 14 to 19, 1969. The Borrower, the ULIA, was represented by Mr. E.J. Lim. Mr. B.S. Hann from the Ministry of Agriculture and Forestry and Mr. S.Y. Wei from the Economic Planning Board represented the Government.

5. The proposed Bank loan would be the second to Korea. In the next few months I expect to submit an IDA credit for vocational and technical education and a second loan to the Korea Development Finance Corporation (KDFC).

6. The following is a summary statement of Bank loans and IDA credits to Korea as of March 31, 1969:

<u>Loan or Credit No.</u>	<u>Year</u>	<u>Borrower</u>	<u>Purpose</u>	<u>Amount (U.S. \$ million)</u>		
				<u>Bank</u>	<u>IDA</u>	<u>Undisbursed</u>
25	1962	Republic of Korea	Railway		13.9	Nil
110	1967	Republic of Korea	2nd Railway		11.0	1.2
529	1968	KDFC	Industry	5.0		4.7
S-4	1968	Republic of Korea	Highway Studies		3.5	3.0
Total (less cancellations) now outstanding and held by Bank and IDA				<u>5.0</u>	<u>28.4</u>	
Total undisbursed				<u>4.7</u>	<u>4.2</u>	<u>8.9</u>

7. The projects are progressing satisfactorily. IFC has invested \$700,000 in KDFC and is considering \$6 million in equity and loans to two projects in Korea, a paper plant and a silk manufacturing plant.

PART II - DESCRIPTION OF THE PROPOSED LOAN

8. Borrower: Union of Land Improvement Associations (ULIA).
- Guarantor: Republic of Korea.
- Amount: Various currencies equivalent to \$45 million.
- Purpose: To provide irrigation to, and enable the effective utilization of, approximately 37,000 hectares of land near the western coast of Korea.
- Amortization: In thirty years including a seven year period of grace, through semi-annual installments beginning June 15, 1976 and ending June 15, 1999.
- Interest Rate: 6-1/2 percent per annum.
- Commitment Charge: Three-fourths of one percent per annum.
- Estimated Economic Return on the Project: 14 percent.

PART III - THE PROJECT

9. An appraisal report entitled "Korea - Pyongtaek-Kumgang Irrigation Project (PA-6a)" is attached.

10. While other sectors of the economy have been growing at considerable speed, the agricultural sector has maintained a relatively slow growth rate of five percent per annum over the past several years, with a sharp drop last year due to a severe drought. Recognizing the lag of the agricultural sector and the widening gap between urban and rural incomes, the Government is determined to step up development in this area. Extending irrigation to more areas of the country is part of this effort, and the project under consideration is a major element in what the Government calls the All Weather Farming Program.

11. The proposed Borrower is the Union of Land Improvement Associations (ULIA), a semi-autonomous public organization within the Ministry of Agriculture and Forestry. ULIA was founded in 1940, and through its member associations now controls about 43 percent of Korea's total irrigated area. Its annual budget is almost totally dependent on Government appropriations, either as grants or loans. Under ULIA's guidance and supervision, a considerable number of small scale reservoir and pump-lift irrigation projects have been completed. In addition, several thousand hectares of tidal flats were successfully reclaimed and a large number of small fragmented areas were irrigated. Although ULIA has a large and technically competent staff, the proposed Bank project is larger and more complex than the other irrigation schemes undertaken by ULIA, and therefore ULIA will appoint supervising consultants, acceptable to the Bank, for the construction of the project.

12. The project which the Bank is financing is the irrigation of two separate land units, Pyongtaek and Kumgang. It also includes the preparation by consultants of an improved seeds multiplication project. The project under consideration would involve pumping water from river estuaries into canals to irrigate land in adjacent valleys and on lower slopes. Construction in the Kumgang area would take about three years and that in the Pyongtaek area about five.

13. The total cost of the project is estimated at approximately \$90 million. The proposed Bank loan is half that amount. Water rates will be set at levels to recover all operating and maintenance costs and at least 40 percent of capital costs over a period of thirty-five years. This approximates the established pattern in Korea. The rates will equal about one-third of the incremental family income generated by the project and will provide ULIA with funds to cover approximately half the annual debt service on the proposed Bank loan. The balance would come from the Government.

14. The additional output resulting from the project would be 81,000 tons of rice, 38,000 tons of barley, 136,000 tons of vegetables and lesser amounts of fodder, fruit and other minor crops. At full development, the annual gross value of production from the project area

is expected to exceed \$30 million, more than triple the present level. The net farm income for the average farm family after all charges is expected to double to about \$600 at full production, an increase of \$300 over what the family would have earned without the project. The rate of return to the economy for the project as a whole is calculated at 14 percent.

15. All equipment and major civil works contracts would be let after international competitive bidding. As Korea has a large and highly competitive construction industry and competes favorably in certain kinds of equipment, it is expected that at least \$3.0 million and possibly as much as \$20 million would be disbursed against contracts won by local suppliers. Because of the high priority the Government accords to land improvement, equipment imported for that purpose is exempted from import duties. Accordingly, no preference will be given to local bidders.

16. Korea has made remarkable development efforts and its savings performance has increased considerably, being presently about 14 percent of GNP. But there is nevertheless a resource gap which can not be met entirely by financing only the foreign exchange costs of projects suitable for Bank consideration. Many of the projects having a high foreign exchange component, particularly in the industrial sector, are financed with funds from private and bilateral government sources. In these circumstances, financing of some local expenditures on high priority projects is justified.

17. The proposed project is of high priority and fits into the Bank's strategy of upgrading the agricultural sector. The Borrower, with the help of supervising consultants, will be capable of carrying it out efficiently.

PART IV - LEGAL INSTRUMENTS AND AUTHORITY

18. The draft Loan Agreement between the Bank and the Union of Land Improvement Associations, the draft Guarantee Agreement between the Republic of Korea and the Bank, the Report of the Committee provided for in Article III, Section 4 (iii) of the Articles of Agreement and the text of a Resolution approving the proposed Loan are being distributed to the Executive Directors separately.

19. The draft Loan And Guarantee Agreement conform substantially to the pattern of agreements used for irrigation projects. Under the Guarantee Agreement Korea will take several steps essential for the successful execution of the project, but which are outside the competence of the ULIA. In particular, Korea will take appropriate steps to ensure

that river waters required for the project are not diverted or utilized in a manner prejudicial to the efficient execution of the Project. (See Section 3.06.)

PART V - THE ECONOMY

20. An economic report entitled "Current Economic Position and Prospects of the Republic of Korea" (in three volumes) No. EAP-4a was circulated to the Executive Directors on March 14, 1969.

21. The performance of the Korean economy continues to be impressive. GNP in real terms grew by 9 percent in 1967 and 13 percent in 1968 in spite of successive droughts in these years. This is appreciably higher than the 7 percent growth rate originally planned, largely because of very high growth rates of industrial output of 22 percent and 26 percent in 1967 and 1968 respectively. The rate of population growth has slowed down from 3 percent to 2.3 percent in the last decade and per capita GNP has grown at rates approaching 10 percent, to about \$170 equivalent in 1968.

22. Merchandise exports increased from an average level of less than \$90 million in 1962-64 to \$320 million in 1967 and to almost \$490 million in 1968, but imports also expanded rapidly, especially in the last two years, as a result of the economic expansion, the need for foodgrains imports and trade liberalization. The deficit on goods and services account increased therefore to almost \$620 million in 1968 from \$415 million in 1967 and \$220 million in 1964.

23. Agricultural performance in the last two years has been disappointing; the 1968 output remained at the low level of 1967 which was 6 percent below 1966. While poor weather undoubtedly was the major reason, a slowdown in land development and the use of agricultural inputs has been noticeable. The irrigation project for which the proposed loan would be made will help to rectify this situation and alleviate the impact of possible future droughts on agricultural production. Therefore, it has high priority among proposed Bank Group operations in Korea.

24. Private savings, which had slowed down somewhat in 1967 due to the low level of agricultural income and increased private consumption, regained some strength in 1968. Public savings rose substantially owing to a sharp increase in tax revenue, following a tax reform and further improvement of the tax administration. Total gross domestic savings stayed at a level of 13.5 percent of GNP in 1968, but are expected to go up to about 15 percent of GNP in 1969 on the assumption that private savings would further recover to about 10.5 percent of GNP and public savings remain at the present level of about 4.5 percent of GNP.

25. Gross capital formation amounted to 24 percent of GNP in 1968. As investment increased more rapidly than domestic savings, the resource gap, which has been widening since 1966, reached close to 11 percent of GNP in 1968. Capital inflow from abroad filled this gap; however, the share of official grants declined and that of loans, especially of short-term commercial loans, increased sharply. Gross investment at current prices is expected to reach a level of close to Won 500 billion (US\$ 1.8 billion) in 1969 or almost 26 percent of GNP. This would result in a

resource gap of between 10 percent and 11 percent of GNP or roughly Won 200 billion (US\$ 720 million) to be financed by the inflow of capital from abroad. Investment as a proportion of GNP is forecast to remain at the level of roughly 26 percent in 1970 and 1971, while domestic savings may go up to 16 percent of GNP in 1971 but hardly very much farther. This would still leave a resource gap of between 9 and 10 percent of GNP in 1971 to be filled by external borrowing.

26. Korea has incurred during the last two years a rather large amount of short-term debt. As a result the debt service ratio increased from 2.6 percent in 1966 to 7.4 percent in 1968. If items now on order are delivered on schedule service on public and private debt will reach 20 percent or more in 1970, not counting any provision for the service of new debt. In these circumstances the projected rate of investments at present appears to be unreasonably high. Korea cannot realistically expect to fill the estimated resource gap with borrowings on long and concessionary terms, so that the ambitious level of investments would add further to the already heavy external debt burden. A slower growth of exports in the future and a possible decline of receipts from Vietnam will accentuate the problem of debt service in the coming years, and this will have to be taken into account in reviewing the future investment targets.

27. In present circumstances it is imperative that the Government control the accumulation of short- and medium-term debt. The Government currently exercises reasonable control over the level of Government-guaranteed loans; however, the degree of control over commercial bank-guaranteed loans is inadequate and should be extended. Measures to control the inflow of further short- and medium-term capital include an agreement with the International Monetary Fund which would limit new commitments of short- and medium-term loans to more prudent proportions.

28. The Government has been informed of our doubts regarding the size of the proposed investment program, which includes a number of projects which could be postponed or scaled down without seriously affecting future growth rates. Similarly, private borrowing abroad and private investment could be restrained by applying cost benefit analysis more strictly in the selection of projects using foreign exchange and budgetary funds. Given the generally sensible economic policies followed by the Korean Government in recent years, it is reasonable to expect that the Government will take the necessary action to control the growth of the country's external debt burden while keeping future investments at the level necessary to maintain further rapid economic growth.

29. Considering the good export and savings performance of the Korean economy, Korea can be regarded as creditworthy for this loan.

PART VI - COMPLIANCE WITH ARTICLES OF AGREEMENT

30. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Bank.

PART VII - RECOMMENDATION

31. I recommend that the Executive Directors approve the proposed loan.

Robert S. McNamara
President

Attachment

Washington, D.C.
April 17, 1969