Report No. 6211-KO

Korea
Country Economic Memorandum

July 31, 1986

Country Programs Department
East Asia and Pacific Regional Office

FOR OFFICIAL USE ONLY

Document of the World Bank

CURRENCY EQUIVALENTS

Currency unit	=	Won
US$1	=	W 880
W 100	=	US$0.11
W 1,000,000	=	US$1,136

GLOSSARY OF ABBREVIATONS

CDs	-	Certificates of Deposit
DFI	-	Direct Foreign Investment
EEC	-	European Economic Community
FRCD	-	Floating Rate Certificate of Deposit
FRNs	-	Floating Rate Note
NBFI	-	Non-bank Financial Institution
NIC	-	Newly-Industrializing Country
OECD	-	Organization for Economic Cooperation and Development
WPI	-	Wholesale Price Index

KOREA

COUNTRY ECONOMIC MEMORANDUM

Preface

This Country Economic Memorandum (CEM) provides a brief assessment of recent economic developments in Korea, and of their implications for the near term, based on a visit to Korea in December 1985. The CEM was prepared by F. Iqbal, in conjunction with the Macroeconomic-Industrial Policy Report (6138-KO) which addresses the broader issues of macroeconomic management and outlook for the medium-term, and provides an in-depth assessment of industrial sector trends and policies. D.M. Leipziger directed the overall program of macroeconomic and industrial work. Research assistance was provided by S.Y. Song.

COUNTRY DATA - KOREA

AREA	POPULATION	DENSITY
98,500 sq km	40.6 million (1984)	387.9 per sq km

POPULATION CHARACTERISTICS (1981-83)

Crude birth rate (per 1,000)	22.8
Crude death rate (per 1,000)	6.2

HEALTH (1981-83)

Population per physician	1,440
Population per hospital bed	960

INCOME DISTRIBUTION (1976)

% of private income received by:	
highest 5% of households	16.1
lowest 20% of households	5.7

DISTRIBUTION OF LAND OWNERSHIP

% owned by top 10% of owners	n.a.
% owned by smallest 10% of owners	n.a.

ACCESS TO PIPED WATER (1980)

% occupied dwellings without piped water	22.0

ACCESS TO ELECTRICITY

% of population - total (1970)	49.9
% of population - rural (1977)	64.9

NUTRITION (1981-83)

Calorie intake as % of requirements	126.0
Per capita daily protein intake (grams/day)	83.0

EDUCATION

Adult literacy rate (1978) (%)	93.0
Primary school enrollment (1981-83) (%)	100.0

GNP PER CAPITA IN 1985: US$2,032

GROSS DOMESTIC PRODUCT IN 1985

ANNUAL RATE OF GROWTH (%, constant Won)

	US$ mln	%	1976-80	1980-84	1985
GNP at market prices	86,179.5	100.0	6.2	8.2	5.2
Gross domestic investment	25,907.5	30.1	11.9	10.4	1.6
Gross national savings	22,240.0	25.8	-15.3/a	18.7	4.6
Current account balance	-882.0	-1.0	-	-	-
Export of goods, NFS	31,365.8	36.4	11.6	11.7	2.3
Import of goods, NFS	30,905.5	35.9	12.5	6.7	-1.5

OUTPUT, EMPLOYMENT AND PRODUCTIVITY IN 1985

	Value added		Labor force		Value added per worker	
	US$ mln	%	Mln	%	US$	%
Agriculture	11,900.2	16.4	3.7	24.9	3,197	66.3
Industry	30,558.4	42.0	4.6	30.5	6,7047	139.1
Services	30,297.8	41.6	6.7	44.6	4,555	94.5
Total/Average	72,756.4	100.0	15.0	100.0	4,819	100.0

GOVERNMENT FINANCE

	General government			Central government		
	W bln	% of GDP		W bln	% of GNP	
	1984	1979	1984	1984	1979	1984
Current receipts	18,503	17.1	22.5	15,010	17.2	22.6
Current expenditure	13,514	27.6	29.8	12,671	14.3	19.1
Current surplus	4,989	-17.1	-7.3	2,339	2.9	3.5
Capital expenditure	3,999	5.5	4.4	1,930	2.4	2.0

MONEY, CREDIT AND PRICES	1980	1981	1982	1983	1984	1985
			(W bln)			
Money supply (M2)	12,534.5	15,671.1	19,909.2	22,938.7	24,705.6	28,562.2
Bank credit to public sector	731.2	1,742.3	2,138.4	2,013.1	1,972.7	2,013.6
Bank credit to private sector	16,046.5	20,273.4	25,370.6	29,833.6	34,086.3	40,548.0
			Percentage or index numbers			
Money as % of GDP	33.1	33.3	37.6	37.6	35.8	38.1
Consumer price index (1980=100)	100.0	121.3	130.1	134.5	137.6	141.0
Annual percentage changes in:						
Consumer price index	-	21.3	7.3	3.4	2.3	2.5
Bank credit to public sector	-	138.3	22.7	-5.9	-2.0	2.0
Bank credit to private sector	-	26.3	25.1	17.6	14.3	19.0

BALANCE OF PAYMENTS (US$ mln)	1981	1982	1983	1984	1985
Exports of Goods, NFS	25,531.7	26,411.1	28,702.7	32,027.8	31,345.8
Imports of Goods, NFS	29,331.4	28,185.0	29,565.3	32,297.9	30,905.5
Resource Gap (Deficit = -)	-3,799.7	-1,783.9	-862.6	-270.1	460.3
Interest payments, MLT (net)	1,995.8	2,397.1	2,257.1	2,550.0	n.a.
Factor services (net)	-2,786.2	-2,992.9	-2,600.2	-2,735.8	-3,058.4
Net transfers	-1,991.4	2,167.9	1,979.5	1,947.4	
Balance on current account	-4,646.0	-2,649.7	-1,606.0	-1,372.9	-739.8
Direct private foreign investment	105.4	100.6	101.4	170.7	250.3
Net MLT borrowing					
Disbursements	5,816.2	4,448.1	5,974.0	6,589.5	n.a.
Amortization	1,927.2	2,038.9	2,432.4	2,783.6	n.a.
Subtotal	3,889.0	2,409.1	3,541.5	3,805.9	n.a.
Other capital (net) and capital n.e.i.	1,007.7	2,162.6	1,417.5	-870.9	n.a.
Increase in reserves (+)	-319.6	-92.7	74.1	-739.9	-100.2
Gross reserves (end-year)/c	6,870.2	6,965.9	6,888.8	7,629.2	7,729.4

EXCHANGE RATE					
US$1 = W	681.03	731.08	775.75	805.98	870.02
W'000 = US$	1.47	1.37	1.29	1.24	1.15

MERCHANDISE EXPORTS (AVERAGE 1982-84)	US$ mln	%
Manufactures	22,966	91.2
Textile & clothing	6,411	25.4
Footwear	1,247	5.0
Electronics	3,042	12.1
Steel	1,931	7.7
Ships	3,750	14.9
Total	25,178	100.0

EXTERNAL DEBT, DEC 31, 1984	US$ Mln
Public debt, including guaranteed	29,067
Nonguaranteed private debt	5,348
Total outstanding and disbursed /b	43,057

NET DEBT SERVICE RATIO FOR 1984 /d	%
Public debt, including guaranteed	13.5
Nonguaranteed private debt	2.3
Total outstanding and disbursed	15.8

IBRD LENDING (DEC 31, 1985)	US$ mln
Outstanding and disbursed	235.2
Undisbursed	0.0
Outstanding Incl. Undisbursed	235.2

/a 1978-80.

/b Includes short-term debt.

/c May not agree with "increase in reserves" because of differences in valuation.

/d Interest and amortization payments as a percent of exports of goods and services.

KOREA

COUNTRY ECONOMIC MEMORANDUM

Table of Contents

Table of Contents (cont'd)

KOREA

COUNTRY ECONOMIC MEMORANDUM

A. Introduction and Overview

1.01 The most noteworthy aspect of Korea's economic development in recent years has been achievement of a respectable rate of growth of GNP together with a reduced rate of inflation and a lower current account deficit. While GNP grew at an average rate of 8% during 1982-84, inflation was reduced from 25.6% in 1980 to about 4% in 1984, and the current account deficit fell from 8.7% of GNP to about 1.7%. By the end of 1984 Korea could be said to have recovered from the shocks experienced at the turn of the decade and to be in the process of consolidating a development trajectory characterized by sustainable high growth and both internal and external balance.[1/] During 1985 the pace of development faltered but the manner in which the economy was managed and subsequent international economic developments in early 1986 indicate that the policy and performance trends established during 1982-84 were not reversed. These trends can thus be expected to continue to characterize Korean economic development in the foreseeable future.

1.02 Korea's GNP is estimated to have grown at 5% in real terms in 1985. This is below both the Fifth Plan target rate of 7.5% for the year as well as the rates achieved in 1983 (11.9%) and 1984 (8.4%) (see Table 1.1). The chief cause of the relatively lower GNP growth rate was a sharp decline in the growth of exports, which was caused in turn by the generally sluggish GNP performance of the OECD countries, and in particular of the US. As the GNP growth rate in the industrialized countries dropped from 4.9% in 1984 to 2.8% in 1985 (and in the US from 6.8% to 2.6%), their volume of imports declined from 11.7% to 6.1%. This falloff in OECD import demand had severe consequences for Korean exports which grew at barely 2.3%. This was disappointing in comparison with the nearly 10% growth recorded in 1984 and initially expected for 1985.[2/]

1.03 Still the situation could have been far worse and credit for preventing a more precipitous decline must be given to the flexibility

---

1/ A series of adverse events affected the Korean economy during 1979-80. These were the second oil shock, the onset of a world recession, the surge in international interest rates, poor harvests and political instability generated by the assassination of President Park Chung Hee.

2/ The national accounts data used in this memorandum are based on a new methodology adopted by Korea in 1985. As a result, some of the historical data presented here may appear unfamiliar.

demonstrated in macroeconomic policies during the year.[3/] As developments in the first half confirmed that a sharp deceleration was in the offing the authorities responded with a number of remedial measures. A policy package was devised which contained essentially four elements: (i) a decision to depreciate the won so as to recover competitiveness by reversing the appreciation that had occurred in late 1984 ; (ii) additional credit for investment in facilities producing for export, a measure which contributed to the increase in net domestic assets of the domestic banking system at 24% rather than the 14% targeted in the Economic Management Plan for 1985; (iii) the provision of special tax and depreciation incentives to promote investment in selected areas; and (iv) the passage of a supplementary budget (of about 5% the size of the original budget) to inject selective fiscal stimulus. As these policies were brought into play in the second half, aggregate demand began to recover and the economy finished out the year with a respectable, if below expectations, GNP growth rate of 5.1%. Depreciation of the won prevented a sharper drop in exports and domestic demand expansion has offset some of the slack produced by the unexpected deceleration of export growth. At the same time, the current account deficit was further reduced to $882 million (1% of GNP) and inflation was kept below 4%.

1.04 The alignment of macroeconomic policy instruments and targets in 1985 has sharpened some abiding concerns of the Government and highlighted some new ones. Among the former concerns is the matter of Korea's external debt. Progress in decreasing the rate of growth of the outstanding external debt was slowed in 1985 as Government sanctioned above-target borrowing to meet unanticipated payments on debts associated with the overseas construction business. Part of the rise in debt was also due to the need to finance a larger proportion of exports on a deferred payment basis in order to boost exports in a sagging market. Another concern has been that inflation might be reignited by the substantial depreciation undertaken in 1985. While no signs of an inflationary surge were detected in 1985, there was some concern that this could happen in 1986. Among emerging concerns is the matter of white collar unemployment. The slowdown in growth has coincided with an increase in the supply of college-graduating job-seekers. This increase is the logical consequence of a policy to increase enrolment rates in 1981, a step undertaken in part to deal with the unemployment problem then developing.

1.05 From most present indications it appears that 1986 will allow Korea to return to the high-export/high-growth trajectory envisioned in the Fifth Plan, and to gear up for similar performance over the course of the Sixth Plan. An extremely favorable sequence of developments in the last few months has made it likely that the shortfalls experienced in 1985 will be adequately made up in 1986. Three principal developments are expected to boost Korea back to its planned growth path: (i) the recent steep decline in the price of oil; (ii) the decline in international interest rates; and (iii) the recent sharp appreciation of the Japanese yen. All of these developments should make

---

3/ That the situation could have been worse is illustrated by Korea's better performance in comparison with that of its peers among the newly-industrialized countries (NICs).

it easier for Korea to achieve balance of payments equilibrium and high GNP growth rates without exceeding its self-imposed constraint on additional external debt and without experiencing higher rates of inflation. The decline in the price of oil should help Korea directly by reducing its import bill and indirectly by sparking a higher rate of world economic growth and trade. The appreciation of the yen should stoke Korea's export engine and enable it to increase its export market share.

B. Output and Demand Developments

1.06 Consumption. In terms of the components of aggregate demand, the slow down in 1985 is reflected largely in a sharp reduction in export growth and in fixed investment growth (see Table 1.1). Consumption has played a rather passive role in that it did not grow strongly in the high growth years of 1983 and 1984, nor did it drop sharply in the low growth year of 1985. Its rate of growth has decelerated steadily from 7.2% in 1983 to 5.2% in 1984 to 4.8% in 1985. Within this rather steady trend, however, are concealed rather dramatic changes in the rates of growth of private and government consumption. While private consumption grew at 6.0% in 1984, government consumption decelerated sharply to 0.5% (from 5.3% in 1983). Then, as private consumption growth fell to around 4.6% in 1985 government consumption accelerated to 6.1% to offset the slack.

Table 1.1: GNP BY EXPENDITURE, 1980 CONSTANT PRICES
(Rate of change)

	1981	1982	1983	1984	1985 /a
Consumption	3.6	4.2	7.2	5.2	4.8
Private consumption	3.2	4.8	7.5	6.0	4.6
Public consumption	6.2	0.8	5.3	0.5	6.1
Gross domestic investment	6.3	0.1	17.5	18.6	1.6
Fixed investment	-4.0	12.9	17.1	10.7	2.8
Changes in stocks	2,613.7	-122.7	-1.9	421.7	-21.8
Exports of goods and services	15.0	6.5	15.5	10.0	2.3
Imports of goods and services	4.5	2.0	10.9	10.1	-1.5
GDP	7.4	5.7	10.9	8.6	5.2
GNP	6.6	5.4	11.9	8.4	5.1
Change in stocks/GNP (%)	3.0	-0.6	-0.6	1.7	1.3

/a Preliminary.

Source: Bank of Korea, New System of National Accounts of Korea.

1.07 Investment. There was a slump in the rate of growth of gross domestic investment in 1985. After having grown at an average of about 18% during 1983 and 1984, gross domestic investment grew at a paltry 1.6% in 1985. Plant and equipment investment was stopped in its tracks as export orders sagged in the first half of 1985. It recovered modestly toward the end of the year in response to specific credit incentives. Residential construction investment played a role in propping up aggregate demand also as Government accelerated a public housing program begun in late 1984.

1.08 Despite the overall slump in plant and equipment investment in 1985, there was considerable activity in some manufacturing subsectors such as autos, food processing, machinery and transportation. The rate of growth of investment in the automobile subsector, for example, was 120% and that in food processing was 65%. The spurt in the automobile subsector was linked to the tremendous success of Korean automobile exports during 1985, primarily of Hyundai cars in Canada, and to the prospects of entering the lucrative US market in 1986. Hyundai's success encouraged other large corporations, such as Daewoo and Kia, to expand capacity in automobile production. Investment in this sector is expected to grow significantly in 1986 also. Among sectors experiencing a decrease in the rate of investment in 1985 were textiles (-34%), shipbuilding (-39%) and petrochemicals (-17%). Textiles have been in a state of structural decline for several years partly because of increasing protectionism in OECD countries. Shipping and shipbuilding are in a protracted slump characterized by worldwide excess capacity and cutthroat pricing.

1.09 As a proportion of GNP, gross domestic investment dropped slightly from 31.9% in 1984 to 31.2% in 1985. Gross domestic savings, however, continued to rise and reached a level of 28.6% in 1985. The improvement in savings since 1983 has come about largely because of an increase in the household savings rate which has jumped from 7.1% in 1983 to 10.0% in 1985. Corporate and government savings have risen at slower rates. Savings behavior in 1985 may well reflect the strong economic performance of 1983 and 1984 (with a lag) as well as continuing high real deposit interest rates.

C. Employment, Wages and Prices

1.10 Employment Trends. The employment picture (see Table 1.2) contains aspects which are difficult to reconcile. On the one hand, total employment rose in 1985 (by 3.6%) after having declined in 1984 (by 0.7%) and having stagnated in 1983 (at 0.6% growth). Official statistics indicate that the unemployment rate remained virtually unchanged (at 4%) between 1984 and 1985. On the other hand, there is a pervasive belief in policy making circles that a structural unemployment problem has been gathering speed for several years and has worsened in 1985.

1.11 Among the trends thought to affect employment is a shift, beginning in the mid 1970s, in the pattern of manufacturing output growth away from light industries to heavy and high technology industries. Since the latter are characterized by higher capital intensity, this intersectoral shift has reduced the employment elasticity of the manufacturing sector during the past 10 years. It is thought that a 1% growth in output now creates jobs for about 40,000 people, whereas in the early 1970s it would have accommodated about

60,000 people. Since about 400,000 job seekers are estimated to enter the market every year, it would seem that, if all the jobs had to be created in the manufacturing sector, a 10% growth in manufacturing output would be required. This did not happen in 1985 and hence the concern about rising urban unemployment.

Table 1.2: KOREA: EMPLOYMENT INDICATORS ('000)

	1981	1982	1983	1984	1985	% change (1984/85)
Economically active population	14,710	15,080	15,128	14,984	15,554	3.8
Employment	14,048	14,404	14,515	14,417	14,935	3.6
Agriculture, forestry and fishing	4,806	4,623	43,314	3,909	3,722	-4.8
Mining & manufacturing	2,996	3,157	3,383	3,493	3,650	4.5
Social overhead capital and other services	6,247	6,644	6,818	7,015	7,559	7.8
Unemployment	661	656	613	567	619	9.2
Unemployment rate (%)	4.5	4.4	4.1	3.8	4.0	-

Source: Bank of Korea, Monthly Statistical Bulletin.

1.12 Together with the decreasing employment elasticity on the demand side, some developments on the supply side are also thought to have been important. In particular, there has been an increase in the supply of college graduates and in the number of workers returning from overseas construction jobs. It is reported that the number of college graduates doubled from 62,000 in 1982 to 118,000 in 1985, while their employment rate has shrunk from 89% in 1982 to 69% in 1985. The increase in supply is due to a sharp increase in enrollment rates permitted in 1981, partly to defuse an open unemployment problem that had developed at that time and partly to respond to an increasing demand for college seats (inspired by the large wage differential between high school and college graduates). The number of Korean workers in overseas construction jobs has declined from 172,000 in 1982 to around 86,000 in 1985, with 45,000 workers returning in 1985 alone. This is clearly linked to the declining construction activity in the Middle East.

1.13 Wage Developments. Nominal wages in manufacturing rose by 9% in 1985 signaling an upturn in the rate of growth of nominal wages from 8.1% in 1984. Nonetheless, these rates of growth are far below those experienced in the 1970s and early 1980s and do not necessarily imply that the wage austerity program underway since 1981 is unravelling. Real wages in manufacturing have

also risen (by 5%) in 1985, as compared to a 4% rise in 1984. The pattern of wage increases has not been uniform. The food and beverage industry experienced a 10% growth in nominal wages while textiles, clothing and leather experienced a 6% growth. This reflects the fact that the former sector has a relatively captive domestic market which has been expanding while the latter sector has to cope with an increasingly competitive export market. The relative strengths of the home and export markets in 1984 and 1985 were reflected in the changes in the rates of growth of nominal wages in these and other manufacturing subsectors.

1.14 Wage guidance is provided to some extent by the nature of wage settlements in the public sector. Public sector wage rate growth has been decelerating since 1981 and was effectively frozen in 1984. A 4% growth has been permitted in 1985. While the general pattern of deceleration of both public and private sector wage growth in recent years indicates that wage guidance does have an influence on private sector wage settlements, other evidence indicates that many other factors are important. In particular, the variation in wage rate growth across manufacturing subsectors indicates that wages respond to variations in subsector performance.

1.15 Price Behavior. The most prominent aspect of price developments in recent years has been the reduction of the rate of inflation in 1980-83 and its stability since (see Table 1.3). In 1985 price stability was maintained despite a significant depreciation of the won. Wholesale prices have risen by barely 1%, consumer prices have risen by about 3% and the GNP deflator rose at about 4%. Such low rates of inflation are due primarily to continuing declines in the prices of oil and other commodities as well as to low inflation in Korea's major industrialized trading partners. Mineral products, principally oil, have a 33% weight in Korea's import price index and agricultural products, principally sugar, cotton and food grains, have a 21% weight. Both of these categories have experienced price weakness in recent years and especially in 1985. The agricultural product price index for Korea's imports declined almost 12% in 1985, contributing powerfully to the overall decline in the import price index. The low rate of inflation in the OECD countries from which Korea purchases manufactured products has also helped maintain price stability in Korea. Manufactured imports, which account for almost half of the import price index, experienced a 3.4% decline in prices in 1985, and this has helped offset the inflationary impact of the depreciation of the won. Finally, while the behavior of oil prices has contributed to price stability in recent years, its contribution is expected to be even greater in the near future because Korea is now purchasing a larger proportion of its oil imports on the spot market where prices have fallen sharply in recent months.

Table 1.3: CHANGES IN PRICE INDICES
(1980 = 100)

	Weights	1981	1982	1983	1984	1985
		(Annual)				
Wholesale prices	100	20.4	4.7	0.2	0.7	0.6
Consumer prices	100	21.3	7.3	3.4	2.3	2.6
Import prices ($)	100	4.0	-5.1	-4.4	0.0	-4.1
Agricultural products	(21)	-2.2	-16.3	0.4	4.7	-11.9
Mineral products	(33)	12.3	-3.3	-11.5	-4.2	-0.9
Manufactured products	(46)	0.8	-1.7	-0.7	1.2	-3.4
Export prices ($)	100	3.0	-3.7	-2.8	1.8	-3.5
GNP deflator	100	15.9	7.1	3.0	3.9	4.0

Source: Bank of Korea, Economic Statistics Yearbook.

D. Fiscal and Monetary Developments

1.16 Fiscal Developments. The hallmark of fiscal policy in recent years has been a shrinking public sector deficit in relation to the GNP. This ratio declined from 4.6% of GNP in 1981 to 1.4% in 1984, and stayed at approximately this level in 1985 despite supplementary expenditures on infrastructure projects and rural assistance programs amounting to about 5% of the original budget. Resources for these additional expenditures were created through a rearrangement of existing expenditures, mainly through a postponement of a one-time transfer to local governments and through savings in operating expenses. Overall expenditures did not rise above original targets for the year and the ratio of expenditures to GNP remained at about 21.5%, the same as in 1984.

1.17 The ratio of total revenues to GNP has been around 19-20% in recent years. The composition of revenues has remained roughly stable despite variations in tax and tariff rates because of offsetting movements in tax and tariff bases. A tax reform enacted in 1982 lowered effective corporation tax rates from 27.8% to 26.7% in 1984. A similar trend is seen in personal income tax rates which fell from 17.9% to 15.1%. Fiscal policy in 1985 also featured tax incentives for business investment and a shortening of the depreciation period for machines and equipment, but these did not affect tax collections appreciably during the year.

Table 1.4: FISCAL DEVELOPMENTS, 1980-85

	1980	1981	1982	1983	1984	1985
Consolidated Public Sector (in billion won)						
Revenue	7,281	9,247	10,074	11,595	13,040	13,881
Expenditure	8,455	11,358	12,296	12,546	13,963	15,169
Deficit	-1,174	-2,111	-2,222	-951	-923	-1,288
Consolidated Public Sector (in % of GNP)						
Revenue	19.6	20.2	19.4	19.9	20.0	19.9
Expenditure	22.6	24.8	23.7	21.5	21.4	21.4
Deficit	-3.2	-4.6	-4.3	-1.6	-1.4	-1.5
Consolidated Public Sector (annual percentage change)						
Revenue		27.0	8.9	15.1	12.5	6.6
Expenditure		34.3	8.3	2.0	11.3	7.3

Source: Bank of Korea, Economic Statistics Yearbook.

1.18 Tax revenues rose 9% from 10.9 trillion won in 1984 to 11.8 trillion won in 1985 largely on account of increased collections from corporate and income taxes made possible by the high growth in nominal incomes and profits in 1984. Since 1985 was a comparatively poor year for business, tax collection in 1986 might suffer. Revenues were also affected by a tariff reform begun in 1983 which reduced the average tariff rate from 21% to 22% in 1984. During 1985 tariff revenue totalled 1.6 trillion won. This was lower than expected from the effects of the large depreciation, partly because the collection from oil imports was considerably lower and partly because of continued reductions in the average tariff rate.[4/]

4/ The budget for fiscal 1986 is in keeping with the restrained spirit of recent budgets. Expenditures and revenues are set to rise by 10.1% in nominal terms thereby keeping pace with the expected rise in nominal GNP. On the expenditure side, social development expenditures are set to increase by 28.2% and education by 11.1% while economic service expenditures are due to rise at a much below average rate of 1.6%. This is also in keeping with the shift in recent years, in the composition of expenditures towards social services a significant reduction in the subsidy given to the grain fund (-54%) is also programmed. The distribution of the revenue burden across different sources will remain roughly the same as in 1985 with the exception of revenue from monopoly proceeds (+18.7%) and nontax income (-15.4%). The overall tax to GNP ratio is to remain at about 19.3%.

1.19 Monetary Developments. Monetary policy has also been characterized by restraint in recent years. The rate of growth of the net domestic assets (NDA) of the banking system decelerated from 39% in 1981 to 14% in 1984 (see Table 1.5). There was a reversal in 1985, however, as net domestic assets were permitted to expand at about 21%. This was probably the most significant monetary development of 1985 and it was caused by three factors. One factor was the need to provide about $500 million dollars of credit to repay the foreign debt obligations of some Korean construction companies, an unanticipated consequence of the government-sponsored restructuring in this sector. A second factor was the unexpected slowdown in investment and export growth which prodded the authorities into expanding credit to resuscitate aggregate demand and prevent too sharp a fall in GNP growth. The third factor was the unexpectedly large increase in deposits in the banking system that occurred in response to the introduction of new savings instruments bearing higher rates of interest. Thus while some of the credit expansion had to be financed through additional foreign borrowing and a reduction of net foreign assets, a substantial part was financed through increased domestic resources of the banking system.

1.20 The behavior of alternative measures of monetary aggregates indicates that the monetary relaxation of 1985 was selective in its effects and did not signify a major reversal of the liquidity situation of the economy. For example, while domestic credit extended through the banking system did jump in 1985 the rate of growth of overall liquidity in the financial system, including credit extended by nonbank financial institution (NBFIs), did not increase significantly; it accelerated modestly from 22% in 1984 to 22.5% in 1985. This indicates that banks gained incremental deposits and credit shares in the system at the expense largely of NBFIs. This development reverses the trend begun a few years ago when the greater flexibility allowed to NBFI's in setting deposit and lending rates led to an increasing shift of financial assets from banks to NBFI's. Concern about the deteriorating asset base and profitability of banks led to a reduction of regulatory discrimination against banks in 1984 and 1985; banks have been allowed to offer higher deposit and lending interest rates and a variety of flexible savings instruments since mid-1984.

1.21 The fact that the change in the rate of growth of overall liquidity in 1985 was in fact rather modest may also explain why the impact of monetary policy on investment has been modest. A sizable NBFI segment in the financial system has consequences for the conduct of monetary policy, since it constrains the ability to reach monetary targets when liquidity expansion in the banking system is offset by contractionary movements in the NBFI segment.

1.22 Monetary policy in 1985 also featured the initiation and the reversal of controls on credit to large conglomerates. In an effort to prevent excessive corporate reliance on commercial bank loans and to foster increased recourse to internally generated finance and equity finance, the authorities placed limits on the borrowings of 705 large companies. If a business group had more than W 100 billion in outstanding debt, it was not permitted to increase its debt without the sanction of its prime bank. In addition, the credit of the 30 largest conglomerates was frozen at end-1983 levels. These controls proved extremely unpopular and, in the event, deteriorating exports and investment necessitated their relaxation in the latter part of the year.

Table 1.5: RATES OF CHANGE OF MONETARY AGGREGATES
(%)

	1981	1982	1983	1984	1985
M1 /a	13.4	24.2	25.9	9.9	10.8
M2 /b	27.4	28.1	19.5	10.7	15.6
M3 /c	30.8	33.2	21.6	20.0	21.3
Net domestic assets	39.1	33.5	18.3	13.5	20.9
Domestic credit A /d	31.2	25.0	15.7	13.2	18.0
Private sector credit	26.3	25.1	17.6	14.3	19.0
Domestic credit B /e	33.9	29.8	11.9	22.0	22.5

/a M1 = currency plus demand deposits.
/b M2 = M1 plus time and savings deposits.
/c M3 = M2 plus other financial institution deposits and debenture issues plus commercial bills and CDs.
/d Domestic credit A = Domestic credit extended by banking system.
/e Domestic credit B = As above plus domestic credit extended by nonbank financial institutions.

Source: Bank of Korea, Economic Statistics Yearbook.

1.23 In 1985 the nonperforming loan problems involving Korean overseas construction firms and shipping companies worsened. The amounts involved were apparently large enough to threaten the position of several banks. Government implemented a special loan program in December 1985 to help affected banks. Under this program a total of 300 billion won was lent at 3% (rather than the standard 5%) to ailing commercial banks to help them cover losses from the nonpayment of interest and principal on nonperforming loans. The loans are repayable in one year but may be extended by the Bank of Korea's authority.5/

1.24 Interest Rate Movements. The last two years have seen gradual upward adjustments of nominal interest rates in the regulated banking systems. Both deposit and lending rates have been raised. Greater spreads have been allowed to commercial banks so as to enable them to cover some risk premium on their loans and to improve their profitability. Higher deposit rates and a variety of new savings instruments (such as CDs) have been permitted with a view to enhancing financial savings. Deposit interest rates now

5/ Similar measures were taken in 1972 to enable banks to recover from bad loans. The "emergency" measures enacted then remained in effect until 1982.

vary from 10% to 13% depending on maturity while lending rates are allowed to move in a band from 10% to 13.5% depending on the lenders' assessment of risk. On average, nominal interest rates have moved up by about two points during 1984 and 1985. The rise in interest rates and the proliferation of savings instruments has resulted in large increases in the amount of financial savings in the form of bank deposits and also in the amount of overall savings. Total bank deposits increased by 8% in 1984 and 16.5% in 1985 while the gross national savings rate rose from 24.8% in 1983 to 27.4% in 1984 to 28.6% in 1985. Thus the increase in financial savings was not entirely due to substitution among assets.6/

E. Trade Account Performance

1.25 The Current Account. The most significant development in the current account in recent years has been the reduction of the deficit from $5.3 billion in 1980 (8.7% of GNP) to $9 billion in 1985 (1% of GNP). In 1985, export growth was a paltry 2.3% and the improvement in the current account deficit occurred largely because of a reduction in import value. The value of merchandise imports fell by almost 3.5% in 1985, from about $27.4 billion to $26.4 billion. Since the import price index fell by about 4% this suggests that volume actually increased slightly, a fact consistent with the slight growth of exports which are, in Korea's case, highly reliant on imported inputs. The recent sharp drop in the price of oil, an item which, in 1985, accounted for about 21% of the value of imports, is expected to have extremely beneficial effects for the balance of payments in 1986.7/ The invisible account has also contributed to the improvement in the current account deficit. As the trade deficit narrowed from $4.4 billion in 1980 to $1.1 billion in 1984, the invisible deficit was reduced from $1.4 billion to $400 million in 1983. In 1984 and 1985, however, the invisibles deficit widened again, to $800 million and $1.4 billion respectively, largely on account of reduced earnings from overseas construction and increased interest payments on the external debt. In 1985, overseas construction receipts amounted to just under $1 billion, down 43% from the $1.7 billion registered

---

6/ In March 1986, Government cut lending rates by 0.5-2.0%, citing as a rationale the need to keep real rates from becoming a burden on Korean corporations and reducing their competitiveness on world markets. Deposit rates were left unchanged, presumably to maintain the incentive for saving.

7/ A $1 drop in the price of oil reduces Korea's import bill directly by about $200 million. The effect on the balance of payments would depend, in addition, on the effects of an oil price drop on Korea's exports, on the additional imports generated by the income effect of this price change, and also on the degree of substitution away from non-oil sources of energy imports.

Table 1.6: BALANCE OF PAYMENTS SUMMARY, 1981-85
(US$ million)

	1981	1982	1983	1984	1985
Current account	-4,646	-2,650	-1,606	-1,371	-882
Trade Balance	-3,628	-2,594	-1,764	-1,036	-30
Exports	20,671	20,879	23,204	26,335	26,405
Imports	24,299	23,474	24,967	27,371	26,436
Service Balance	-1,518	-554	-435	-876	-1,432
Receipts	6,598	7,476	7,179	7,316	6,641
Payments	8,117	8,031	7,613	8,192	8,073
Transfers (net)	501	499	592	541	580
Long-Term Capital (Net)	2,842	1,230	1,270	2,000	1,084
Loans and investments	3,052	2,896	2,569	2,454	2,238
Amortization	-1,315	-1,430	-1,672	-1,768	-1,832
Exports on credit	57	-350	-677	181	-974
Others	1,048	114	1,050	1,185	1,652
Basic balance	-1,804	-1,419	-356	629	201
Short-term capital (net)	-82	4	894	-758	-538
Errors and omissions	-411	-1,296	-942	-889	-878
Overall balance	-2,297	-2,711	-384	-1,018	-1,215

Source: Bank of Korea.

Table 1.7: COMPOSITION OF EXPORTS BY MAJOR ITEM
(%)

	1975	1980	1984
Primary	18.4	10.1	8.7
Manufacturing	81.6	89.9	91.3
Light	57.1	49.1	39.6
Textiles and garments	35.4	29.5	24.3
Footwear	3.8	5.0	4.6
Heavy and chemical	24.5	40.8	51.7
Iron and steel	4.6	9.5	7.0
Metals	2.3	4.3	4.8
Chemicals	1.5	4.5	3.1
Electrical and electronics	8.7	11.0	13.5
Transport equipment	3.6	6.6	18.9

Source: World Bank Trade System.

Table 1.8: COMPOSITION OF IMPORTS BY MAJOR ITEM
(%)

	1975	1980	1984
Primary	49.3	56.8	44.4
Food	14.2	12.5	6.8
Fuels	19.1	29.9	23.8
(Petroleum)	(18.4)	(27.7)	(21.0)
Other	16.0	14.4	13.8
Manufacturing	50.7	43.2	55.6
Chemicals	10.9	8.3	9.1
Capital Goods	26.2	22.3	32.0
(Nonelectrical machinery)	(11.7)	(10.4)	(10.7)
(Electrical and electronics)	(7.0)	(7.2)	(10.6)
(Transport equipment)	(7.5)	(4.7)	(10.7)
Other	13.6	12.6	14.5

Source: World Bank Trade System.

in 1984. Interest payments on the external debt amounted to $3.5 billion annually in 1984 and 1985.[8/]

1.26 Trade Composition. Table 1.8 shows how significantly the composition of Korea's exports has changed in the last ten years. Two trends are evident. Primary exports have declined in relative importance and manufactured exports have increased their share from roughly 82% in 1975 to 92% in 1984. Within manufactured exports, light industry exports have declined in relative terms as heavy industry products have more than doubled their share from about 25% in 1975 to around 52% of total exports (and 57% of manufactured exports) in 1984.

1.27 While the two broad trends noted above continued to hold in 1985, a number of interesting variations could be observed at a more disaggregated level. For example, the export of ships fared badly in 1985 due to the glut in world markets. The exports of automobiles, however, rose by 25% largely as a result of success in the Canadian market. Automobiles are expected to do even better in 1986 when the large US market will be tested. Another bright spot in the 1985 export picture is presented by machinery which grew at almost 30%. Textiles, steel and electronic exports fared poorly in 1985. While all three were affected by import restrictions, electronics exports were additionally affected by a glut in the world semiconductor market.

1.28 The pattern of imports has also been changing in recent years (since 1980) because of the shift in export composition and because of declining oil prices. The former development has led to an increase in the proportion of capital goods imports from 23% in 1980 to 33% at present. The latter development has led to a reduction in the share of oil and oil-related items in total imports, a reduction helped also by strong energy conservation measures adopted since 1980. The sharp rise in the import of coal, for example, reflects the continuing effect to substitute coal for oil for power generation. Given the sharp drop in the price of oil in early 1986, one would expect imports of coal to be sharply lower in 1986 as the policy of substitution among energy sources is re-examined and reoriented. Machinery imports reflect, of course, Korea's continuing dependence on capital goods imports for both domestic and export uses. Thus even though the volume of overall imports declined in 1985 this category showed an increase.

1.29 Market Diversification. Korea has achieved a fair degree of diversification in its export products and markets since the early 1970s when protectionism first began to constrain its export performance. Among the industrial countries, the US and Japan are Korea's principal trade partners, accounting for over 52% of its exports and 47% of its imports in 1984. In 1984-85 the shares of industrial countries as a whole and the US and Japan in particular have gone up, indicating a retreat from increasing diversification.

8/ A 1% drop in international interest rates leads to a saving of about $300 million in debt service. This is based on the current amortization schedule of total debt of $45.6 billion of which 65% is contracted on a floating rate basis.

Table 1.9: DESTINATION OF EXPORTS
(%)

	1975	1980	1984
United States	30.2	26.3	35.8
Japan	25.5	17.4	15.7
EEC	14.9	14.5	10.2
Other	29.4	41.8	38.3

Source: BOK, Economic Statistics Yearbook.

Table 1.10: ORIGIN OF IMPORTS
(%)

	1975	1980	1984
United States	25.9	21.9	22.2
Japan	33.5	26.3	24.9
EEC	7.4	6.9	8.3
Other	33.2	44.9	44.6

Source: BOK, Economic Statistics Yearbook.

To some extent this is unavoidable since these two countries have been the main source of global incremental demand recently. The decline of the Middle East as a destination for Korean exports has followed the decline in the price of oil; furthermore, most developing countries have been in a state of stagnation since the early 1980s.

1.30 Diversification among sources of imports has been determined by Korea's need to import capital goods for which Japan and the US are important suppliers. Also, as the price of oil has dropped, the share of the oil producing countries in Korea's imports has also dropped while that of non-oil developing countries has risen. An examination of Korea's bilateral trade balances with its most important trade partners shows an interesting overall picture: Korea has been running increasing surpluses with the US since 1981 (only $280 million in 1982 but an average of $3.6 billion in 1984-85) and trade deficits with Japan every year for the last five years ranging from $1.9 billion in 1982 to $3.0 billion in 1984). With the rest of the world, Korea has also run systematic but fluctuating deficits. The pattern of bilateral balances in recent years, like the pattern of market diversification, has been determined largely by the rise in the value of the dollar (from 1982 to end-1985) which has drawn a flood of imports, not just from Korea, into the US market. The exchange rate realignment begun in 1986 may change the pattern of bilateral balances considerably. In the short run (during 1986), the deficit with Japan and the surplus with the US are expected to grow. Over the longer run, however, the deficit with Japan is expected to decrease as a consequence of the appreciation of the yen.

1.31 Trade Diplomacy. During 1984 and 1985 Korea's trade has come under pressure on two fronts. Exports of textiles, steel, footwear and selected electronics products have faced increasing trade restrictions, especially in Korea's biggest market, the US.[9/] On the import front, Korea has faced increasing pressure, especially in 1985 and mostly from the US, to open its markets in general and to open the insurance and financial services market in particular. There also have been demands to provide more effective protection for foreign intellectual property rights, especially in the fields of computer software and pharmaceuticals. These pressures have made trading a more

---

9/ During 1985, 207 Korean export items were covered by some form of restriction (by OECD countries). This accounted for about 36% of Korea's total export items. During this period, 43% of Korea's exports to the US were under import restrictions. The corresponding percentages for exports to Canada, Japan and the EEC were 31%, 43% and 30% respectively. Of the items most affected by restrictions in 1985 the ratio of restricted to total exports was 61% for textiles, 53% for footwear and a high 88% for steel products. Foreign manufacturers filed 19 complaints or antidumping petitions against Korean goods ranging from photo albums and television sets to industrial equipment such as oil rigs. The US Congress has also taken steps to abolish the granting of GSP tariff reductions or exemptions to Korea and other newly industrialized countries, a measure that would lead to an additional 5% tariff on average on Korean exports to the US.

difficult business than it used to be. Under the trade liberalization program in effect since 1981, a series of items has been removed from the restricted list and placed on an automatic approval (but subject to tariff) list. Despite poor exports in 1985, and despite a somewhat hostile trading atmosphere created by US moves to manage trade flows, Korea has stuck by its preannounced import liberalization schedule for 1985 and reconfirmed its schedule for the next three years. The financial services business is also being opened up. During 1985, restrictions on foreign branches of commercial banks were eased and they were permitted to rediscount their loans through the Bank of Korea just as local banks do. The number of such banks has been increased. Foreign securities firms have also been permitted to purchase up to 10% of the shares of Korean securities firms and thereby enter the securities business in the country. The insurance industry has also been placed on notice that opening up to foreign competition is imminent.

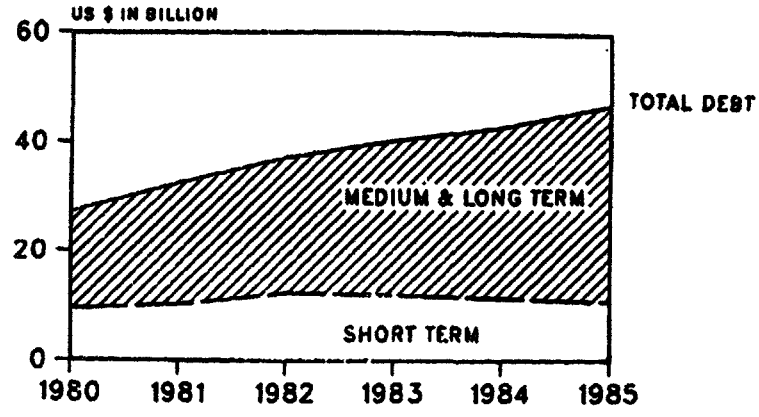
F. Capital Account Performance

1.32 External Debt Developments. While external debt has risen substantially from $27 billion in 1980 to $45.6 billion in 1985, making Korea the fourth most indebted among developing countries, Korea's debt situation is not a cause of anxiety in international capital markets. This is because there have been significant improvements in recent years in the sustainability of Korea's debt. First, the rate of growth of debt has decelerated sharply from about 36% in 1980 to less than 10% in the past three years. Second, the maturity structure has improved. Short-term debt has declined from a third of total debt in 1980-82 to a quarter at present. Third, the debt-service ratio has remained around 20-22% in recent years and is judged by most to be a manageable level in Korea's context. What is most important is that there is a consensus that Korea's domestic economic management continues to be sound and variation in the debt situation reflect transitory and external influences and are not caused by any unsustainable domestic policy configuration. This consensus is reflected in the fact that Korea currently has good access to the international syndicated loan (and bonds) market and can borrow at low spreads.

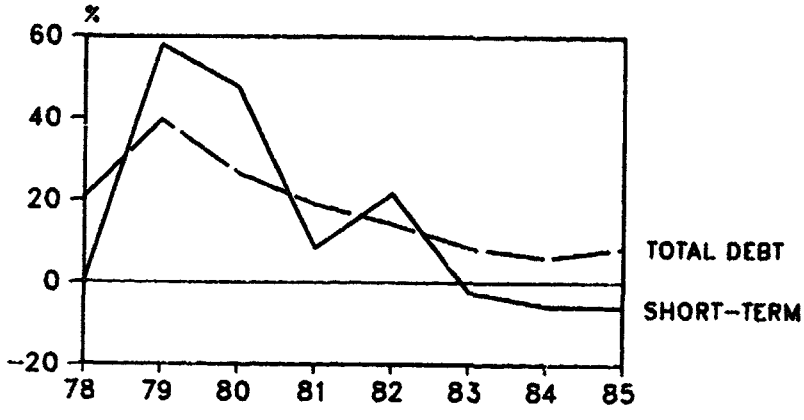
1.33 Deceleration in the rate of growth of debt since 1980 has been brought about principally by the decrease in the current account deficit. However, total external debt rose from $42.6 billion to $45.6 billion during 1985, due in part to an unanticipated need to finance the repayment of about $900 million of debt owed by some Korean construction companies operating abroad. In accordance with standard practice, the external obligations of Korean firms registered abroad are not included in conventional external debt statistics. The total amount of such offshore debt is thought to be about $6 billion and of this amount about $3.5 billion is thought to be owed by construction companies. The increase in external finance requirement was also due in part to the need to provide an unusually large sum for export credit, reflecting efforts to boost exports in a slow market.

EXTERNAL DEBT DEVELOPMENTS

(a) OUTSTANDING EXTERNAL DEBT BY MATURITY



(b) RATE OF GROWTH OF EXTERNAL DEBT



(c) DEBT SERVICE PAYMENTS

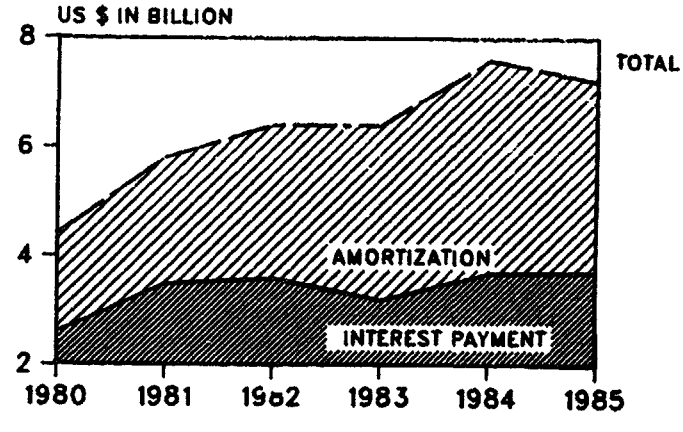


Figure 1.1

Table 1.11: EXTERNAL DEBT DEVELOPMENTS

	1981	1982	1983	1984	1985
Total external debt ($ billion)	32.5	37.1	40.2	43.1	46.7
Medium- and long-term debt (%)	68.5	66.5	69.9	73.2	77.0
Short-term debt (%)	31.5	33.5	30.1	26.8	23.0
Debt service payments ($ billion)	5.8	6.4	6.4	7.6	7.2
Principal repayments (%)	39.8	43.4	49.8	50.6	48.6
Interest payment (%)	60.2	56.6	50.2	49.4	51.4
Debt service ratio	21.2	22.6	20.9	22.6	21.8
Debt/GNP ratio	48.3	52.4	53.4	52.5	56.2
Growth rate of external debt	18.9	14.3	8.3	6.6	8.5

Source: Ministry of Finance.

1.34 Short-term debt has been reduced in recent years, partly because Korea's improving external position has allowed it greater access to the longer maturity segment of the market but mostly because Korea has taken direct steps to control the amount of short-term debt being contracted. Among these steps have been a tightening of eligibility for trade credit (selected imports rather than all imports have now been deemed eligible), shortening of the maturity period allowed for trade credit (to 90 days from 180 days), a reduction in the volume of outstanding short-term swaps with foreign banks, and a tightening of the availability of foreign currency loans to fund equipment imports. Despite unfavorable export developments in 1985 and an increased need for foreign financing, the amount of short-term debt was reduced from $11.4 billion to $11.1 billion. Furthermore, the level of gross international reserves were raised from $8.2 billion to $8.4 billion. The slower-than-expected growth of exports in 1985 increased the debt service ratio from 21.5% in 1984 to about 23% in 1985. This is not viewed with great concern, however, because the sharp drop in exports earnings growth is temporary. The decline in oil prices and the recovery of growth in the OECD economies is expected to provide enough of a boost to Korea's export earnings to enable a steady reduction in the debt-service ratio over the next five years.

1.35 Uses of Funds. There has been a change in the composition of the uses to which externally borrowed funds have been applied over the last four years. As the current account deficit has declined, reducing the need for such funds, other uses such as repayment of loans, exports on credit and increase in reserves have acquired greater prominence. The surge in borrowing

that occurred in 1977-81 is now being reflected in rising amortizations. The share of amortizations in the gross annual financing requirement has risen from 29% in 1982 to 42% in 1984. It is expected to rise further to about 80% by 1990 before declining. The strategy of relying upon export growth to pull the current account out of a deficit position has also had consequences for the external financing requirement. As exports have grown since 1981 so has the amount of foreign exchange required to finance advance credit for exports, from $583 million in 1982 to an average of about $1 billion in the succeeding years.

Table 1.12: COMPOSITION OF ANNUAL GROSS FINANCING REQUIREMENT BY USE (%)

	1982	1983	1984
Current account deficit	34.9	24.0	18.7
Repayment of loans	29.0	37.8	41.3
Exports on credit	7.7	21.0	14.2
Other items (including reserve increase)	11.3	3.2	13.4
Errors and omissions	17.1	14.0	12.4
Total ($ billion)	7.6	6.7	7.3

1.36 Sources of Funds. Changes of a more significant nature have been occurring in the sources of external financing. Bonds have become an important source of finance and direct and portfolio foreign investments (DFI and PFI), while still minor sources, have risen in an encouraging fashion in recent years in response to facilitating legislation. Korea's gross annual financing requirements have averaged about $7 billion during the last three years. Of this over 95% has been funded through debt instruments.

1.37 The syndicated loan market has not expanded appreciably for Korea during the last three years. In fact, the exposures of the large US banks have been reduced in relative, and in some cases, absolute terms as their global portfolio allocation strategy has responded to changes in banking regulations and to equity market perceptions regarding loans to developing countries as a whole. Net lending to Korea by US bankers declined from $2.3 billion in 1981 to $700 million in 1983. In 1984 and 1985, the flow was actually reversed as net lending averaged about -$1.5 billion. The slack thus created has been largely taken up by Japanese banks and by alternative financing arrangements. In particular, much greater use has been made of bond-type instruments such as promissory notes of various types and floating rate notes and certificates of deposit (FRNs, FRCDs).

Table 1.13: COMPOSITION OF ANNUAL GROSS BORROWING (MLT) BY TYPE
(%)

	1977-81	1982	1983	1984
Public loans	27.1	37.3	21.8	18.3
Commercial loans	34.7	18.3	14.2	11.0
Bank loans	20.9	28.9	27.9	22.1
Bonds	1.6	5.5	13.2	23.3
IMF credit	6.1	2.4	3.0	7.6
Other	9.6	7.6	19.9	17.7
Total ($ billion)		5.0	6.9	7.8

Source: Ministry of Finance.

1.38 Bond-type instruments accounted for only 6% of the gross financing requirement in 1982 but rose to 13% in 1983, 23% in 1984 and 24% in 1985. This substantial and rapidly increasing access to these instruments reflects both developments in international capital markets and Korea's own debt management strategy. The many reschedulings that commercial banks have had to endure since the early 1980's have reduced the attractiveness of conventional syndicated loans and increased the appeal of instruments which are transferable, i.e., have a secondary market. Bonds are convenient in this regard. From Korea's point of view bonds are useful because they allow a potentially wider market to be tapped and the transaction costs are lower. Nonetheless, it should be pointed out that much less diversification among sources of funds has been achieved in practice than would appear to be the case from the changing composition of commercial debt. This is because it is primarily large international banks (and not regional banks, institutional investors or individuals) who have purchased Korean bonds. Furthermore, it is primarily a rather small set of Japanese and US banks who hold the bulk of Korean paper with Japanese banks believed to account for almost 70% of net new lending.

1.39 Direct Foreign Investment (DFI) has surged in the last few years. During the two decades ending in 1982 the cumulative volume of such investment was about $1.2 billion. Since 1982, however, the cumulative volume has doubled as changes in legislation and attitude towards DFI have induced greater flows. DFI approvals exceeded $450 million annually in 1984-85 as the number of industries in which DFI is permitted has been increased to around 700 currently (out of a total of 999 industrial subsectors). The goal is to open up at least 90% of Korea's industries to various forms of DFI by 1988 and to attract such investment at the rate of about $1.2 billion per year by then. At present, the ratio of disbursed DFI to the gross annual financing requirement is around 3%; however, by 1988 Government hopes to raise this ratio to around 16% as part of its strategy to diversify external liabilities. Japanese and US investors account for the largest portion of DFI by far (with equal shares of 47% each). While the investment has been spread fairly

evenly across different industries in the past, in recent years it has gone into hotels and tourism, electrical and electronic products, and the automobile business.[10]

1.40 Portfolio Foreign Investment (PFI) was not permitted before 1981; however, under a capital market liberalization plan announced in 1981 and being implemented in stages since, Korea expects to remove all limits on PFI by the end of the decade. Korea is still in the first stage of this plan in which it has been allowing foreigners to buy Korean securities indirectly through special investment trusts. Six such trusts have been formed since November 1981 and each has performed remarkably well despite the absence of an active secondary market for all but one of the funds. Another source of PFI that is being explored is that provided by convertible debentures and depository receipts. Fourteen companies are to be allowed to issue such instruments over the next 3 years and a total of $300 million has been sanctioned under this arrangement.[11] While the existing volume of PFI (of $200 million) is miniscule compared to Korea's gross external liabilities present indications are that there is a considerable appetite abroad for such investments and that the scope for PFI is limited not as much by the state of Korea's capital market as by Government regulations concerning PFI volume.[12]

Exchange Rate Management

1.41 The principal objective of exchange rate management in recent years has been to maintain the competitiveness of Korean exports. This objective has been pursued vigorously but strategically since freedom of action is constrained both by the sensitivity of trading partners and by the need to import capital goods in order to produce exports. The nominal exchange rate has been depreciated in small steps following a devaluation of 17% (against the dollar) in 1980. Since macroeconomic policy has been generally tight and inflation in Korea generally below that of its major trading partners, the nominal depreciation has also resulted in a real depreciation: the real effective exchange rate index has fallen 20% from 1980 to end-1985. Since the dollar is prominent in the won's currency basket, there was a slight appreciation in late 1984 and early 1985 as the won was pulled up relative to the nondollar OECD currencies by the rise of the dollar. This appreciation compounded the difficulties brought on for Korea's export growth by the simultaneously spreading stagnation in OECD economies. Government decided to

---

10/ The two largest investments in 1984 were a US$100.5 million commitment by General Motors to invest in an auto parts plant and a US$92.5 million venture by the Lotte Group of Japan to build a hotel in Pusan.

11/ The premier issue was launched by Samsung Electronics Co. in November 1985 and was reasonably well received although there have been complaints also that the terms of the issue were too favorable to the issuer. Four other companies are expected to issue convertible debentures in 1986.

12/ A small amount of foreign investment is also being allowed in venture capital trust funds. The first such unit was authorized in December 1985.

depreciate the won sharply so as to restore competitiveness in the EEC market and the real effective exchange rate dropped considerably (see Table 1.14). Since then the dollar has descended sharply and the nondollar hard currencies have appreciated. Korea has, however, maintained rough nominal parity with the dollar at the end-1985 level, thereby capturing a competitive advantage from the dollar's decline vis-a-vis Japan and the European countries.

Table 1.14: EXCHANGE RATE DEVELOPMENTS
(1980 = 100)

		Nominal effective exchange rate	Real effective exchange rate
1982	I	99.6	99.8
	II	99.5	99.7
	III	100.7	100.7
	IV	99.4	99.5
1983	I	95.6	97.1
	II	94.2	94.9
	III	93.2	93.9
	IV	91.6	91.2
1984	I	91.3	91.1
	II	91.2	90.4
	III	92.6	91.9
	IV	92.5	91.5
1985	I	92.8	92.0
	II	88.4	87.0
	III	84.0	82.5
	IV	83.5	82.0

Sources: IMF, International Financial Statistics; staff calculations.

G. The Outlook for 1986

Favorable External Developments

1.42 According to the original Economic Management Plan for 1986 (which was published at the end of 1985), GNP was projected to grow at 7% (in constant 1980 terms) on the basis of nominal growth in exports, investment and consumption of 10%, 10% and 4.5% respectively. These targets were to be achieved simultaneously with inflation kept to 3.5%, unemployment to 4% and the current account in balance. The confluence in the first quarter of 1986, of extremely favorable developments with respect to three key prices for Korea -- those of oil, foreign loans and the Japanese yen -- has made it very likely

that 1986 will be a banner year and that the original macroeconomic targets will be easily met if not exceeded. Thus, while Korea paid about $27 per barrel of imported oil in 1985, the recent sharp decline in the price of oil may bring its average cost per barrel down to about $18 in 1986.[13/] International interest rates such as the LIBOR have dropped by about 100 basis points during October 1985-March 1986 and do not appear to have bottomed out yet. The Yen - Won exchange rate has slipped from 420 won per yen to 520 won to the yen in the last three months, which amounts to a nominal depreciation of about 25% for the won. As a consequence of these developments, Government has recently revised its targets for 1986. Real GNP is now projected to rise by 8%, inflation is projected to stay below 3% and the current account is expected to register a surplus of $300 million at least. Exports are now expected to reach a level of $34 billion. Most analysts of the Korean economy would agree that these are achievable targets. Certainly the economy is off to a very good start in the first quarter.

Balance of Payments Outlook

1.43 The balance of payments position should move into a modest surplus in 1986 largely because of the dramatic reduction in the cost of oil imports but also because of rising exports. Rough calculations suggest that if 1986 oil imports remain at the 1985 level of approximately 200 million barrels, and if the price of oil averages $18 per barrel, Korea stands to save around $1.9 billion in import costs. There will undoubtedly be an expansion of oil and other imports following from the income-effect of the oil price drop and the revised GNP growth target but there should still remain a large net saving in import costs. In the short run, this will be partially offset by the increased cost of imports from Japan arising from the appreciation of the Yen. Korea has not yet been able to adequately substitute away from Japanese sourcing of capital goods imports that it needs to produce exports. Recent data indicate a 31% increase in imports from Japan during January-March 1986. Nevertheless, the positive effects of the yen appreciation for exports are expected to convert this development into a net benefit.[14/] Korea stands to gain handsomely in such important new export lines as automobiles, electronic goods and selected machinery products, especially in markets where it competes actively with Japan. Exports should also be helped by the additional growth induced in OECD economies by the oil price drop. Early indications are promising. Exports have increased by 27% during the first quarter (to a level of $7 billion) as compared to the (admittedly low) figures for the same period in 1985. Exports to Europe, in particular, are growing strongly and have risen by about 85% in the first quarter.

13/ A portion of Korean oil imports in 1986 were covered by long-term contractual arrangements at a price considerably higher than the prices being forecast currently. As a consequence, the Economic Planning Board expects the average cost of imported oil to be around $18 per barrel.

14/ In the long run, of course, the depreciation of the won relative to the yen should lead to efficient import substitution and to decrease Korea's trade deficit with Japan.

Inflation Outlook

1.44 There is a significant possibility of zero inflation in 1986. One could have expected inflation to rise because of the substantial depreciation (vis-a-vis the dollar) engineered, as a matter of policy, during 1985 and the even more substantial depreciation, vis-a-vis the yen and other nondollar currencies, brought about by the exogenous appreciation of these currencies in early 1986. So far, however, there is no evidence that the exchange rate realignment has affected domestic inflation. Indeed, figures for the first quarter of 1986 show only a 0.8% increase in the CPI and a 1.1% decline in the WPI. It would appear that the sharp drop in the price of oil has more than offset whatever exchange rate induced inflation there might have been. Government has been active in passing along the oil price cut in the controlled prices of various fuels and oil-based products. The inflation outlook is also affected favorably by the decline in international interest rates. These have already been instrumental in putting downward pressure on domestic interest rates which are an important cost of production in Korea because of the high degree of leverage in the corporate finance structure.

Growth Outlook

1.45 The single most important determinant of Korea's growth performance is probably export performance. Thus the sharply improved external environment should, in and of itself, guarantee a much improved GNP growth performance in 1986. In addition, the reform initiatives Korea has taken during 1982-85 in the areas of trade, domestic finance and industrial policy, should help the economy in benefitting from the improved external environment. A growth rate of 8% should be quite possible. Encouraging signs are already visible. According to a recent survey by the Ministry of Trade and Industry, major Korean manufacturers are planning to raise their investment spending to W 4.2 trillion in 1986, an increase of W 1.3 trillion or 42.5% over 1985 levels. Investment and output growth is expected to be most rapid in the steel, machinery, textile and petrochemical sectors. While the survey estimate of investment growth is clearly on the exuberant side it does indicate the nature of the current business climate. Gross fixed capital formation in the economy as a whole (including the agriculture and service sectors) should rise at about 12%.

1.46 Private and public consumption will also share in the improved performance expected. Private consumption should rise by about 6%, close to the highest rate established in recent years (6.6% in 1983). Private consumption growth will be moderated by the continuing attractions of saving due to high real deposit rates. Public consumption may rise at a much higher rate than set in recent yeras, perhaps even higher than the 6% growth in 1985. This may happen because Government may choose to let public sector wages rise significantly in 1986 so as to compensate for several years of belt-tightening in the recent past. Public expenditure may also be directed at a one-shot industrial restructuring effort whereby some ailing companies and banks may be helped financially by Government. Increased housing and

infrastructure construction, especially in rural regions, will continue to attract public funds. Some deserving projects previously shelved for lack of funds may now be revived. It is possible that planned expenditures connected to the Olympics (in 1988) may be brought forward.

External Finance Outlook

1.47 The external finance situation deteriorated in 1985 but should be very comfortable in 1986. On the demand side, Korea expects to run a current account surplus and reduce its net debt in 1986. The original gross borrowing target for 1986 was $5.7 billion, itself greatly reduced from the $7.4 billion that had to be borrowed in 1985. With the improvement in the outlook for an external surplus, this target seems quite achievable. However, it now appears that Government may favor cutting foreign borrowing even more than originally planned, perhaps to $4.7 billion. Considering that amortization payments on the accumulated external debt will be roughly $4 billion in 1986, such a revision may leave too little of a margin to facilitate the export growth necessary to meet the revised GNP growth target. Nor would such a revision seem to be necessitated by a supply constraint. Foreign banks and investors appear quite willing to finance the original $5.7 billion target. If anything, country risk has been lowered by favorable recent developments. In particular, foreign investors are quite keen to participate in Korea's bright economic future and 1986 may be an opportune time to avail of this eagerness.

Medium Term Outlook

1.48. Korea has set itself ambitious targets for the remainder of the 1980s. Its medium-term goals are expressed in the Sixth Plan (to be implemented during 1987-91) and consist essentially of a high average rate of GNP growth (7%) and a sharply reduced average rate of growth of external debt (under 2%). These goals are to be attained via a high export growth rate (of 10%) and continuing improvements in the national savings rate (targeted at 33% in 1991).

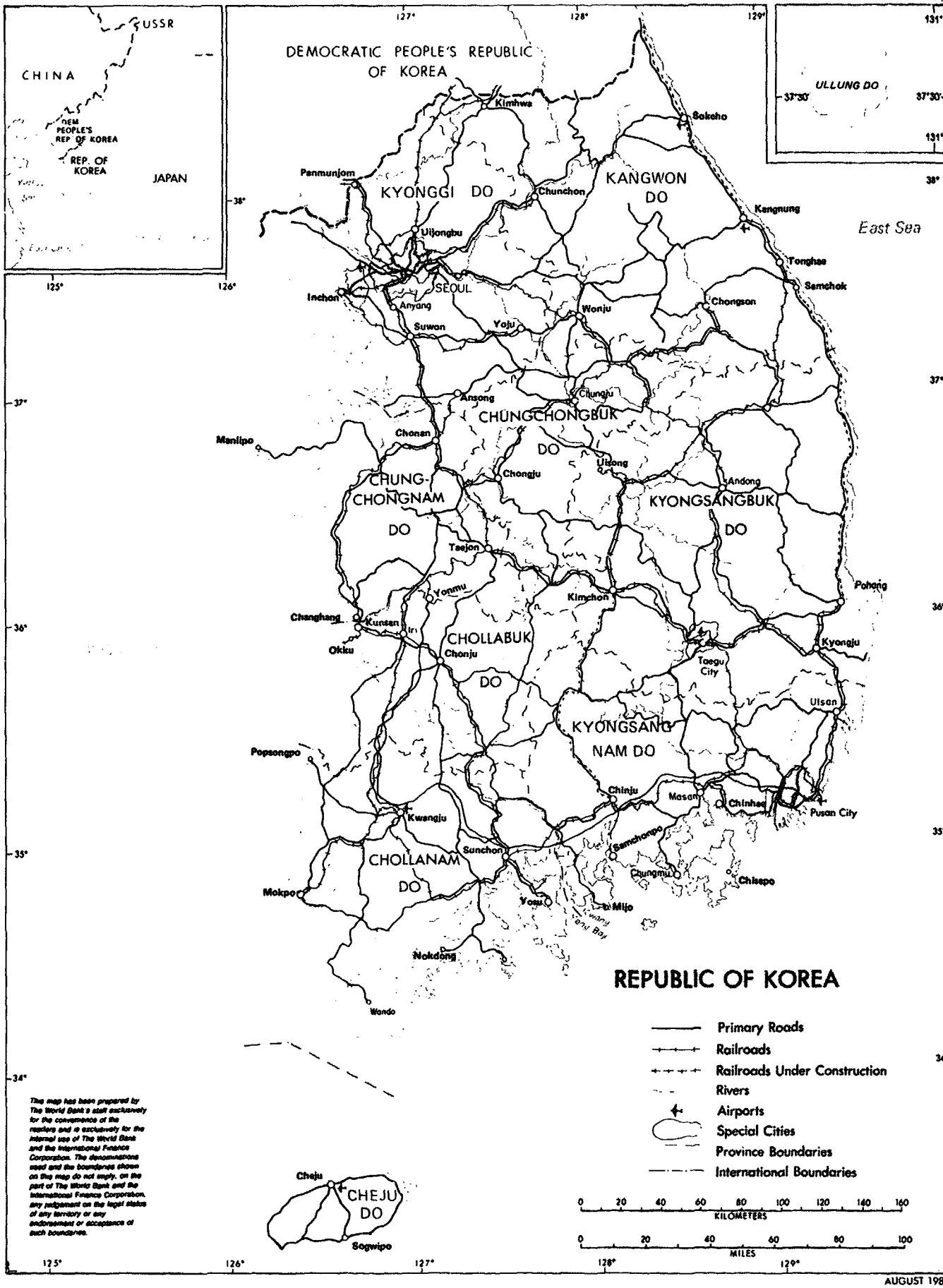
1.49 The path to these medium-term goals remains uncertain and difficult and could be affected by factors beyond the control of domestic policy. The principal risks are external. Difficulties could ensue if, as in 1985, a world recession and increasing protectionism against Korean exports were to be encountered, or if the supply of external finance were to be curtailed.[15/] Such developments would place the export and savings targets in jeopardy and thereby produce a lower rate of income growth as well as continued vulnerability to the international finance market.

1.50 These cautions notwithstanding, the particular combination of domestic policies and external developments that exists as present leads to optimism with respect to Korea's ability to achieve its targets. The external

---

15/ The reader is referred to Chapter 1 of the Macroeconomic-Industrial Policy Report (6138-KO) for a detailed account of the factors determining the medium-term outlook.

environment presently features positive developments (for Korea) in oil prices, interest rates and the exchange rate. Should these continue through the medium run, they will assist Korea in expanding exports and achieving a surplus on the current account, thereby raising the growth rate while simultaneously reducing reliance on external debt. The domestic policy environment features trade, financial and industrial policy initiatives that should reduce distortions and make the economy more productive, efficient and flexible. Should these initiatives be sustained, the prospects for growth and stability will become all the brighter.



AUGUST 1986