Appendix A

IMF AGREEMENTS WITH KOREA, 1997-99

(LETTER OF INTENT)

IMF Stand-By Arrangement Summary of the Economic Program Agreed by the Government of the Republic of Korea and the International Monetary Fund, 5 December 1997.

MACROECONOMIC POLICIES

Objectives

The program should narrow the external current account deficit to below 1 per cent of GDP in 1998 and 1999, contain inflation at or below 5 per cent, and if confidence is restored quickly, limit the deceleration in real GDP growth to about 3 per cent in 1998, so recovery can occur in 1999.

Monetary policyand exchange rate policy

To demonstrate to markets the authorities' resolve to confront the present crisis, tighter monetary policy should 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 has been reversed, and the call rate was raised from 12.5 per cent on 1 December 1997 to 21 per cent, and will be raised further.

Money growth during 1998 will be limited to a rate consistent with containing inflation at or below 5 per cent.

A flexible exchange rate policy will be maintained, with intervention only limited to smoothing operations.

Fiscal policy

A tight fiscal policy in 1998 should alleviate the burden on monetary policy and 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 per cent of GDP. The present estimates of the interest costs of financial sector restructuring is 0.8 per cent of GDP. Offsetting measures amounting to about 1.5 per cent of GDP will be taken to achieve a balanced budget and, preferably, a small surplus. This should be achieved by both revenue and expenditure measures including:

- 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 transport tax
- reducing current expenditures particularly support to the corporate sector
- reducing low priority capital expenditures.

FINANCIAL SECTOR RESTRUCTURING

Financial sector reform bill

The following financial sector reform bills submitted to the National Assembly will be passed before the end of 1997:

- 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.

Restructuring and reform measures

Troubled financial institutions will be closed, or if they are deemed viable, restructured and/or recapitalised. The government already suspended nine insolvent merchant banks on 2 December 1997. These banks are have been placed under the control of MOFE and must 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 includes closures as well as mergers and acquisitions by domestic and foreign institutions, providing new groupings are viable. Clear principles will be established on how losses will be shared among equity holders and creditors.

- The disposal of non-performing loans will be accelerated.
- 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 strictly conditional.
- All support to financial institutions, other than Bank of Korea 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.

- Staffing in the unit supervising merchant banks will be sufficiently increased to make supervision effective and 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.

The Bank of Korea's international reserve management will be reviewed 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

Trade liberalization

Timetables complying with the WTO commitments, will be set at the first review to:

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

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 per cent to 50 per cent by the end of 1997 and to 55 per cent by the end of 1998. The ceiling on individual foreign ownership will be increased from 7 per cent to 50 per cent by the end of 1997
- effective immediately, the supervisory authority will allow foreign banks to purchase equity in domestic banks in excess of the 4 per cent limit requiring supervisory authority approval, providing such purchases contribute to the efficiency and soundness of the banking sector; legislation will be submitted to the first special session of the National Assembly to harmonise 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 unrestricted foreign investment in the domestic corporate bond market
- further reduce restrictions on foreign direct investment through simplifying procedures
- eliminate restrictions on foreign borrowings by corporations.

Corporate governance and corporate structure

By the first review, the timetable will be set 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
- 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 (such as to agriculture and small business) will continue, the interest subsidy will be borne by the budget.

Government subsidised support or tax privileges will not be provided to bail out individual corporations.

The 'real name' system in financial transactions will be maintained, although possibly revised.

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, thereby reducing the risk involved.

Labour market reform

The capacity of the new employment insurance system will be strengthened to facilitate the redeployment of labour, in parallel with further steps to improve labour market flexibility.

Information provision

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

Source, IMF, 1997, 'Republic of Korea - Standby Arrangement, Letter of Intent'.