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Republic of Korea: 2006 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Korea

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with the Republic of Korea, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 8, 2006, with the officials of the Republic of Korea on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 8, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of September 29, 2006 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 29, 2006 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the Republic of Korea.

The document listed below has been or will be separately released.

Selected Issues Paper

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INTERNATIONAL MONETARY FUND

REPUBLIC OF KOREA

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation
with the Republic of Korea

Approved by Wanda Tseng and Michael T. Hadjimichael

September 8, 2006

- **Dates: May 25–June 8, 2006**.
- **Team**: Mr. Felman (Head), Messrs. Feyzioğlu, Semblat, Chensavasdijai, and Miniane (all APD), Mr. Frydl (MFD), and Mr. Kang (Resident Representative). Messrs. Schiff (APD) and Oh (OED) also participated in the discussions.
- **Korea representatives**: Included then-Deputy Prime Minister and Minister of Finance and Economy Han Duck-Soo; his successor, Kwon Okyu; Bank of Korea Governor Lee Seong-Tae; and Financial Supervisory Commission Chairman Yoon Jeung-Hyun.
- **Previous Article IV Consultation**: Directors emphasized that Korea needed to address underlying structural difficulties, notably by reviving the small- and medium-sized enterprises, modernizing the labor market, and developing the financial sector.
- **Context of Past Surveillance**: The Fund and authorities have generally agreed on broad policy priorities. But the authorities have faced political difficulties in advancing needed pension and labor market reforms.
- **Statistical base**: Adequate to conduct effective surveillance, but fiscal reporting should be improved. Subscriber to Special Data Dissemination Standard.
- **Exchange rate**: Market-determined.
- **Exchange system**: Article VIII, Sections 2, 3, and 4. Exchange system is free of restrictions on payments and transfers for current international transactions.
- **The authorities have not yet indicated their intention to publish the staff report, and have not yet decided to consent to the Fund's publication of the PIN**.

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EXECUTIVE SUMMARY

- **From 2005 until early 2006, Korea enjoyed strong growth** on the back of rapidly increasing exports and consumption. This favorable situation has led to large capital inflows, a stronger won, and low inflation. In the past few months, however, the economy has slowed while inflation has picked up.

- **The staff team anticipates a soft landing,** with GDP growth easing from 5 percent in 2006 to 4¼ percent in 2007, while inflation remains low. However, the risks to growth are mostly on the downside, arising from the possibility of a sharper slowdown in the U.S. economy, high and volatile oil prices, and tighter global financial market conditions.

- **What short-term policies should the authorities pursue?** Until now, they have been withdrawing macroeconomic stimulus as the recovery has progressed. But with downside risks mounting, a neutral stance is more appropriate, with monetary policy guarding against a slowing economy. On the financial policy side, action is needed to improve the flow of debtor information and curb excessive lending by smaller non-bank financial institutions.

- **Beyond these immediate challenges, longer-term problems loom.** Potential output growth has started to decline and would slow much further if current trends—an ageing population, decelerating capital accumulation, and falling productivity growth—continue. Reversing this trend will require a fundamental reform: just as Korea once industrialized by thrusting the manufacturing sector into the global economy, it now needs to do the same for the financial sector, the service sector, and the labor market. Specifically, the authorities should:

    - Implement their plans to build an advanced financial system by deregulating capital markets and the foreign exchange system, while complementing these reforms with measures to contain the attendant risks;

    - Improve service productivity by opening the sector up to more competition and enhancing small firms' access to finance;

    - Increase labor market flexibility by reducing the costs of dismissals while expanding the social safety net;

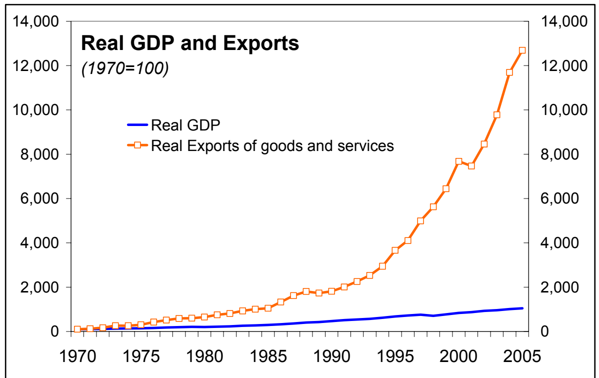
    - Address the prospective long-term deterioration of the fiscal position owing to population aging by tackling the health care and pension problems.

A GLOBALIZATION STORY

"The development plan [aims] to prepare Korea to maintain an acceptable standard of living when external aid ends…Industry is not highly developed."

–First Article IV Staff Report, 1956.

1. **Fifty years ago, Korea held its first Article IV consultation with the Fund**. At that time, the country was a poor agricultural nation, the poorest member of the IMF, in fact. However, it soon embarked on a strategy to transform a nation of farmers into an industrial power. At the heart of this plan was a radical strategy of developing the country through exports. In other words, Korea—for so long known as the "Hermit Kingdom"—decided to join the world.



Source: CEIC Data Company Ltd.

2. **This development path proved the road to prosperity**. By 1982, the country had entered the ranks of the world's top 15 exporters. By the mid-1990s it had joined the OECD. And though the country suffered a setback during the 1997 crisis, this gave further impetus to the strategy of economic opening. Thus, the banking system was opened to foreign capital, while restrictions on foreign portfolio investment were abandoned. And in very short order the economy began growing again, rapidly. Five years after the crisis, the economy was one-quarter larger than it had been before.

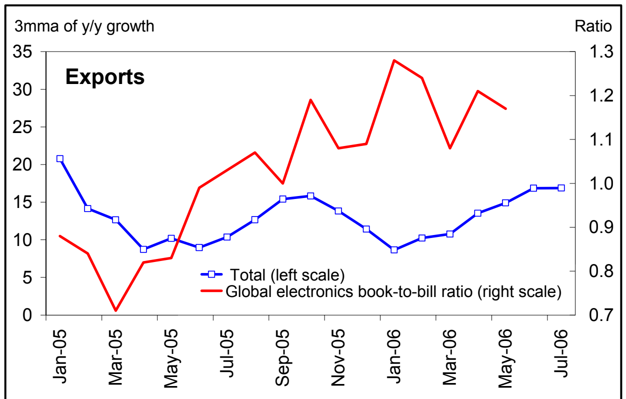
3. **Now, Korea is an industrialized country, specializing in the production of advanced technology products**. But looking ahead to the next 50 years, new challenges loom on the horizon. On current trends, potential growth will slow considerably, in large part because the population is aging rapidly. Moreover, the benefits of economic growth are no longer flowing through to the entire population, since a growing portion of the labor force can only find nonregular jobs, at lower pay and with greater job insecurity.

4. **How can Korea deal with these challenges?** This question formed the crux of this year's Article IV consultation discussions. But first, there are near-term issues that need to be dealt with, since the economy is slowing.

I. HOW CAN KOREA NAVIGATE THE SHORT-TERM?

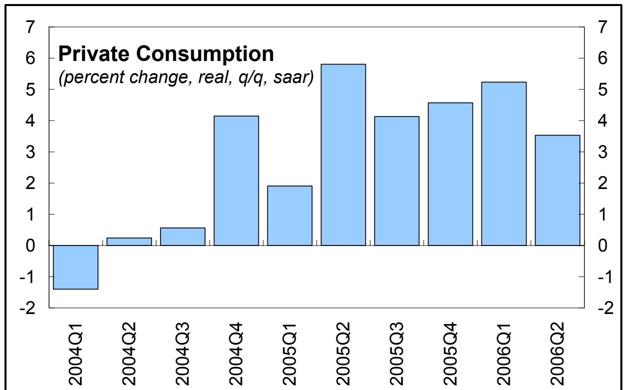
5. **For most of the period since the previous consultation, Korea has enjoyed a "Goldilocks" economy, with growth strong and inflation low** (Table 1). From the second quarter of 2005 through the first quarter of 2006, growth had been running at a 6 percent annualized rate, on the back of rapid export growth. One reason why exports have been doing so well is that nearly 40 percent consists of electronics, and the global electronics sector

has experienced a renewed upswing (Box 1). Another reason is that Korea has been benefiting from the boom in neighboring China, as the two countries have been rapidly restoring their historically close economic ties (Box 2).



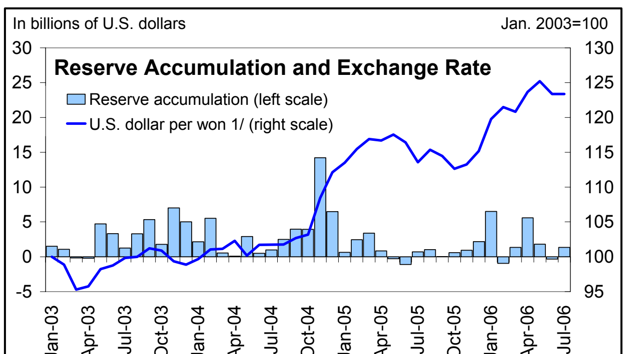
Sources: CEIC Data Company Ltd; and VLSI Research Inc.

6. **At the same time, Korea has been doing well on the domestic front**. During 2003-04, consumption had stagnated as households struggled to repair their balance sheets following a credit card boom that left them heavily overindebted. But by early 2005, the process of adjustment was sufficiently advanced for banks to expand household lending again (Table 2). Since then, consumption has risen rapidly, helped along by increasing employment, a recovery in the local stock market (up around 50 percent since end-2004) and a pick-up in housing prices. Investment, however, has remained sluggish, especially in construction, the result of strict measures introduced to control housing speculation, including levying heavy capital gains taxes of up to 55 percent on sales of secondary homes.



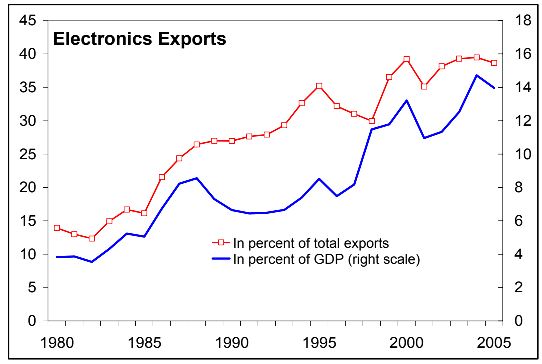
Source: CEIC Data Company Ltd.

7. **The favorable situation has attracted large capital inflows** (Table 3). The impact of these flows on the exchange rate has been partially tempered by a shrinking external current account surplus, which halved to 2 percent of GDP last year and essentially vanished this year, as the oil bill increased and domestic demand improved. Even so, the won has strengthened considerably, rising against the U.S. dollar by around 15 percent between October 2004 and August 2006. During this period, the authorities have pursued a policy of

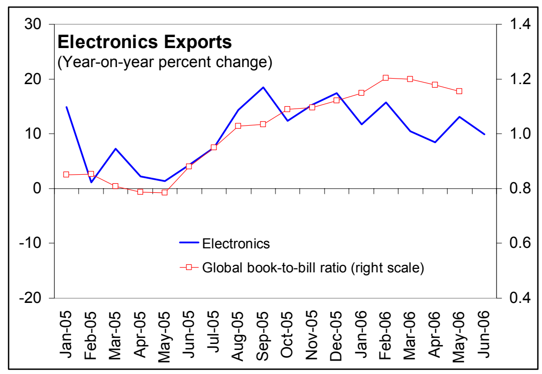


Source: CEIC Data Company Ltd.
[1] An increase indicates appreciation.

Box 1. Korea's Electronics Sector



The spectacular growth of Korea's electronics exports exemplifies the country's successful integration into world markets. Over two decades starting in the mid-1970s, Korea rose from the ranks of the smaller international players to become a global leader in many key electronic product lines. This success did not come about by chance. Businesses made a massive capital investment and the education system produced large numbers of well-qualified engineers. The sector has now become a key part of the Korean economy, accounting for 40 percent of total exports last year.



Electronics exports have performed very well in recent quarters, but some slowdown is expected. Global demand for all lines of electronics products surged in the summer of 2005, initially spurred by advances in consumer electronics and later complemented by higher corporate investment, particularly in the United States. While export performance has so far remained resilient, analysts see a moderation in U.S. demand going forward, which could be partly compensated by higher-than-expected growth in Europe.

In the medium-term, Korea is very well placed to take advantage of global shifts in the electronics sector, particularly in memory products. Korea holds a commanding 60 percent share of global sales of flash memory products, which might prove decisive as flash memory progressively replaces DRAM and hard drives on many lines of electronics hardware.[1] Korean electronic manufacturers are investing heavily to take advantage of these opportunities, both in Korea and abroad. Samsung Electronics, LG Electronics and Hynix plan a combined capex spending of some $15 billion in 2006, comparable to 2005. Early indications show that, while most of capex spending will be done in Korea, capex spending abroad will rise as Korean firms try to cut costs and position themselves closer to final demand. For instance, in the case of Hynix the share of total capex done abroad will rise from 10 percent in 2005 to a planned 35 percent in 2006.

Profits are high—although the stronger won has chipped away some—and market participants are upbeat about future profitability trends. In the wake of the ascending won, net profits fell by 30 percent in 2005 at Samsung Electronics and by 55 percent at LG Electronics, while they increased by a modest 7 percent at Hynix. However, profits are still high: 2005 net profits at Samsung Electronics fell just short of $8 billion. Looking at forward-looking indicators of sectoral profitability, the IT sub-index of the KOSPI has fallen some 15 percent since April together with the overall market, but it remains 25 percent above July 2004 levels.

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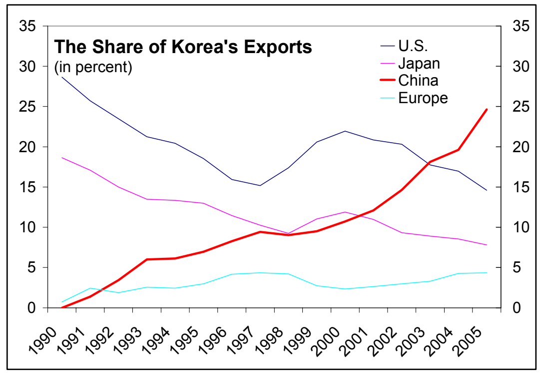
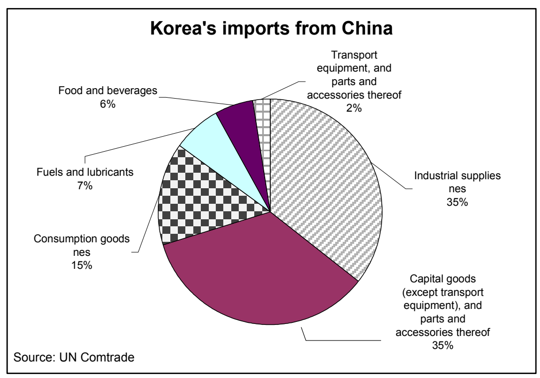
[1] DRAM and flash are two types of memory chips. While DRAM has the advantage of fast memory retrieval, DRAM chips are volatile, meaning that any information stored is lost when the power is turned off. Flash is gaining market share because it is nonvolatile, a very convenient feature for fast-growing items such as handsets and MP3 players. Flash is quickly closing the gap with DRAM in terms of capacity, speed, and cost.

Box 2. Economic Integration Between Korea and China

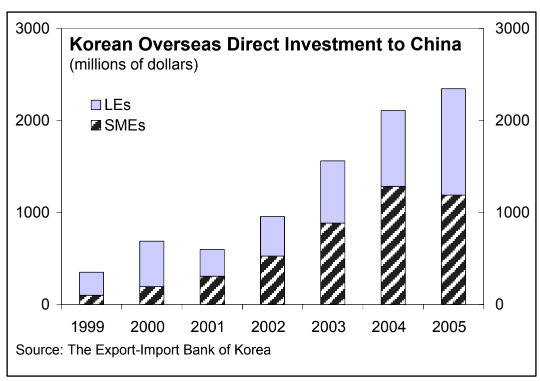
In recent years, Korea's trade with China has been expanding rapidly. Korea's exports to China have grown on average 18 percent per annum during the last five years, to the point where Korea is now the second largest exporter to China after Japan and China is the most important export destination for Korea. These exports are mostly capital goods and industrial supplies, mainly for Korean companies operating in China. About half of these exports are estimated to be re-exported to the G-3 countries, reflecting the successful integration of the economies into the regional production chain. Nevertheless, the share of Korean exports locally consumed in China is also reportedly rising (from very low levels) as Korean brands, particularly in electronics, are gaining popularity. Imports from China to Korea have also increased significantly, reaching 14 percent of the total in 2005, with capital goods and industrial supplies forming the bulk (around 70 percent) and the remainder consisting of agricultural and consumer products.



Korea has also emerged as China's largest foreign direct investor, as Korean companies have shifted basic production to China. While large Korean companies used to dominate the FDI to China in the early 1990s, more recently Korean SMEs have caught up, and their share in total FDI to China has increased to over 50 percent by 2005. China's overseas FDI to Korea has also increased, reaching $1.2 billion in 2004, concentrated in larger strategic mergers and acquisitions.



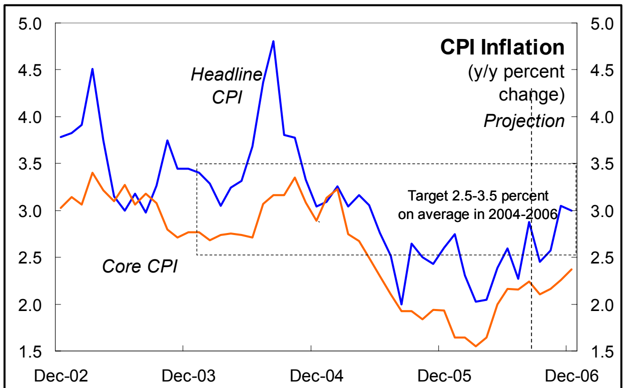
Although for the most part China's integration has helped to boost Korea's exports and growth prospects, China's rapid emergence has also raised concerns in some sectors. Korea's steel industry, for one, is experiencing adjustment pressures in the wake of China's rapid emergence as a net steel exporter, as it has been forced to accept deep price cuts. Traditional export manufacturers such as in textiles and leather and import competing domestic firms are also losing market share due to both the appreciating won and competition from China. Hollowing out pressures from China are one contributing factor behind the sluggish pace of corporate investment and widening gap between large and small companies.



Looking forward, the government expects its plans to transform Korea into a regional hub to further help its economic integration with China. To better serve the needs of the region, the government aims to transform Korea into a logistics, business, and financial hub. In financial services, the government plans include fully liberalizing the capital account, deregulating the capital markets, and overhauling the legal and regulatory system.

generally allowing the external value of the currency to be determined in the market, while intervening to slow the pace of appreciation when inflows became particularly intense. Accordingly, foreign exchange reserves have increased 7 percent over the year to July, reaching $226 billion, exceeding total external debt.

8. **As the won has appreciated, inflation has fallen**. The won's appreciation has contained the impact of international oil price increases, while amplifying the benefits of low imported inflation (especially from China) and declining regional food prices. As a result, from late 2004 to early 2006 both core and headline inflation fell steadily, reaching a low of 1½–2 percent, below the 2½–3½ percent target range.



Sources: CEIC Data Company Ltd; and Fund staff estimates and projections.

9. **In the past few months, however, signs have emerged suggesting that this "Goldilocks" period might be coming to an end**. Headline inflation has been creeping up, and in August surged to nearly 3 percent, the center of the target band. Meanwhile, the economy has been slowing, as the export and consumption booms have begun to mature, while higher global oil prices have also begun to take a toll on the world's fourth largest oil importer. In recent months, production, leading indicators, and sentiment have all turned down.

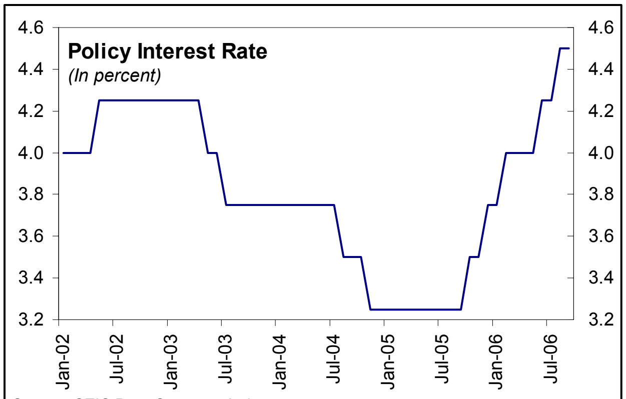
10. **Looking ahead, the staff team anticipates a soft landing**. Under the central scenario, export growth will slow somewhat as the electronics cycle progresses, while private consumption—which has been racing ahead of household income—will slow to a more sustainable pace. Accordingly, GDP growth would decline from 5 percent in 2006 to 4¼ percent in 2007, marginally below the team's estimate of potential growth (Table 4). However, the risks are to the downside, arising from:

- **Slower growth in the United States**. A serious slowdown would have a major impact, since exports are 40 percent of GDP and the United States is Korea's second-largest market after China.

- **High and volatile oil prices**. A sustained 10 percent increase from the $75/barrel forecast could reduce growth by 0.2 percentage point according to the Bank of Korea, an estimate with which the staff agrees.

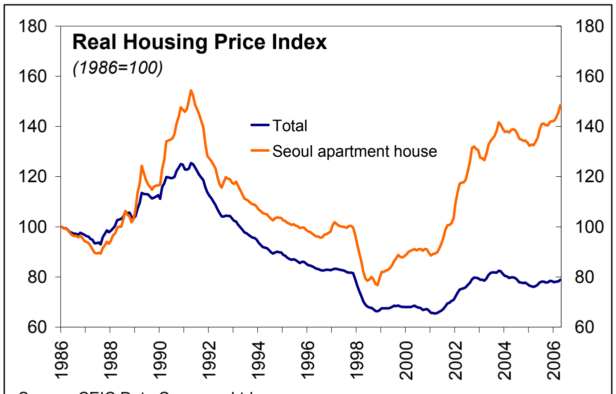
- **Tighter global financial market conditions**. The impact of a rise in global risk aversion should be manageable because Korea's fundamentals are strong: reserves are large, public debt low (36 percent of GDP), and financial and corporate balance sheets are healthy (Appendix I; Tables 5 and 6).[1] Even so, the effect on growth could still be significant, because U.S. interest rates are highly correlated with longer-term Korean rates, and higher domestic rates would put renewed pressure on the highly-indebted household and SME sectors.

11. **Faced with this situation, what short-term policies should the authorities pursue?** Until recently, the central bank had gradually been scaling back its stimulus as the recovery has progressed. Since late 2005, it has raised its policy rate from a historically low level of 3.25 percent to 4.50 percent, closer to its longer-term average. Bank officials explained that this approach was based on two main motivations. To begin with, they have been trying to raise interest rates to what they regard as a more neutral level, as a pre-emptive move against inflationary pressures. Also, they have been concerned about the emergence of real estate speculation, as apartment prices in Seoul have increased by 9 percent in the year to July, fueled by an 11 percent (y/y) rise in bank loans to households.



Source: CEIC Data Company Ltd.

12. **As the economy has slowed, however, the Bank has indicated that monetary policy considerations are now finely balanced**. The team asked whether recovery might now be the greater risk. It noted that inflation seems firmly under control: the August surge was due to temporary factors (flooding led to a sharp rise in food prices), while core inflation is a modest 2¼ percent, unit labor cost growth is similarly subdued. Consequently, inflation would remain low, even under the team's central growth projection, since even in that case, the output gap would not close before 2007. As for housing prices, while they had risen briskly earlier this year in Seoul, nationwide they have remained stable; moreover, the price rises in the capital may have been spurred partly by the increase in capital gains taxes, which has dried up the supply of apartments on the market. In such circumstances, it might be better to address the problem



Source: CEIC Data Company Ltd.

[1] The debt sustainability analysis of the previous consultation remains valid: public debt would remain low even under extreme shocks, while external debt would reach high levels only under unlikely exchange rate scenarios.

through supply-side measures to alleviate the shortage of modern apartments in Seoul, rather than monetary policy.

13. **The Bank responded that their inflation projections were somewhat more pessimistic**. But they agreed that the economy was slowing, and that future rate adjustments would need to be data-dependent.

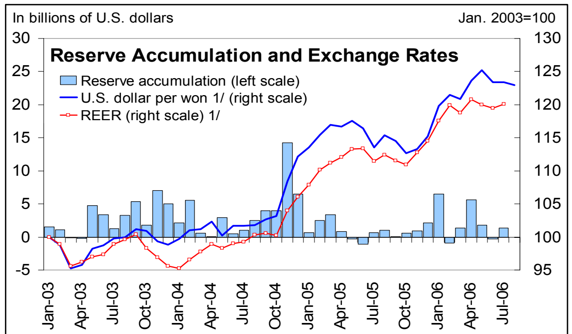
14. **The team and the Bank agreed that in such circumstances, where monetary policy was at a cross-roads, clear communication of the central bank's intentions will be essential**. Partly for this reason, the central bank announced that from 2007 it would be shifting its target from core to headline inflation, a measure that is more widely understood and has a greater impact on expectations. The team supported this shift, which brings Korea into line with most advanced inflation-targeting countries, but noted that it runs a risk, since a renewed surge in oil prices could render a headline target impossible or inappropriate to achieve. In these circumstances, the best solution, the team and authorities agreed, would be to explain the situation clearly to the public.

15. **At the same time, the team recommended three additional refinements to the inflation targeting framework**. First, quantitative surveys of the expected inflation rate could be introduced, so that the central bank could check to see if expectations are in line with the target. Second, the three-year assessment period (under which performance is only evaluated at the end of three years) could be eliminated, so that if the target were to be breached an explanation would be provided relatively quickly. Third, the central bank could provide periodic detailed explanations of what it is doing to achieve the inflation target in the interval between inflation reports, which are published only every six months.

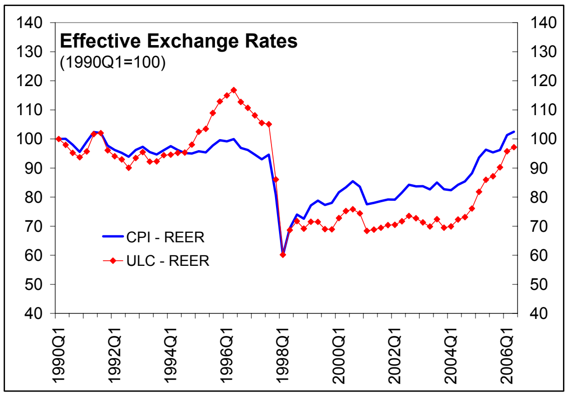
16. **The team commended the authorities for adhering to their flexible exchange rate policy**. Some public commentators have expressed concern that the won's significant appreciation has had a serious effect on competitiveness, pointing to the fall-off in exports by small- and medium-sized enterprises (SMEs) and the recent declines in the profitability of larger firms. But in the authorities' view, shared by the team, overall competitiveness remains appropriate (Box 3). For one, export growth remains rapid and Korea's share of world trade has actually been increasing over the past several years, to record levels. And while corporate profitability has declined, profit levels still remain near historically high levels, as do stock prices, suggesting that the market believes that the strong performance will continue into the future. A key reason for market optimism is that productivity has been advancing rapidly in the export sector, so that the real effective exchange rate based on unit labor costs is not particularly high when viewed in a longer-term context. Finally, the difficulties of small-

Box 3. The Effects of the Won Appreciation

Since 2004 the Korean won has appreciated significantly, more than any other currency in Asia. The cumulative appreciation against the U.S. dollar from October 2004 through August 2006 amounts to more than 15 percent, and the real effective appreciation has been of similar magnitude. Strong capital inflows were met with large and sustained interventions during 2003, but more recent interventions have been shorter-lived and aimed at smoothing the speed of appreciation rather than preventing appreciation altogether.



[1] An increase indicates appreciation. Data for August 2006 is as of August 18.



Despite recent appreciation, the exchange rate remains broadly in line with fundamentals. Econometric analysis by the Consultative Group on Exchange Rates—with which the staff team agrees—suggests that the won appreciation is consistent with Korea's strong productivity growth relative to its trading partners, implying large Balassa-Samuelson effects.

Overall, exports are holding up well. Exports of capital-intensive goods such as machinery and electronics have performed very well in recent months, reflecting Korea's competitiveness in these sectors and the strength of global demand. Exports of small and medium enterprises (SMEs)—often labor-intensive goods—have lagged behind those of large corporates despite some recent improvements. While this reflects long-standing structural problems in the sector rather than pure exchange rate pressures, currency appreciation may exacerbate the polarization between SMEs and large corporates.

Corporate profits are falling due to the stronger currency; nonetheless they remain high, and markets are pricing good future profitability. Overall, the non-financial sector's net savings fell from 9.5 percent of GDP in 2004 to 8.5 percent in 2005, still a historically high level and substantially higher than the 5 percent level in Taiwan Province of China. Moreover, forward-looking indicators such as stock prices have performed well over the period of the won appreciation, with the KOSPI gaining around 50 percent from end-2004 to August 2006.

Imports of goods and services have surged, but this is only partly due to the higher won. Higher oil prices account for one-third of total import growth since 2004, while the domestic demand recovery accounts for another third, according to staff estimates. The final third can be attributed to the higher won, which has undoubtedly stimulated some imports. For example, travel abroad by Koreans rose by more than 35 percent between the first half of 2004 and the first half of 2006.

Finally, it is worth considering whether the won might actually be undervalued. The case, however, is difficult to make, since the current account balance is not far from estimates of longer-term equilibrium, while corporate profits are not exceptionally high by advanced country standards.

and medium-sized exporters pre-date the appreciation, are deep-rooted, and are best handled through structural measures (spelled out in the 2004 Article IV consultation).

17. **On the budget side, there was broad agreement that a neutral fiscal stance would be appropriate for this stage of the economic cycle**. The government has budgeted a deficit (excluding social security funds, and including the supplementary budget) of 1¾ percent of GDP for 2006, compared with last year's actual outcome of ¾ percent of GDP (Table 7). But the authorities stressed that the actual deficit could be closer to last year's outcome, because expenditures will likely remain below budgeted levels. A similarly neutral fiscal stance was planned for next year, as well.

18. **On the financial policy side, the key task, the team noted, would be to guard against the dangers arising from a renewed rise in global risk aversion**. For such sentiment could quickly spread to Korea, prompting local lenders to raise their lending rates. And this would put renewed pressure on two major groups of borrowers. First, consumers, whose debt amounts to around 140 percent of disposable income (higher than in the United States), the bulk of which is at variable interest rates. Second, SMEs, which have an average debt/equity ratio of 141 percent, well above the 86 percent ratio for Korea's large corporates. Should the creditworthiness of some of these borrowers deteriorate, banks might respond by clamping down on credit, which could have a serious effect on growth.[2]

19. **One way to mitigate these risks, the team noted, was by improving the flow of information**. Specifically, greater provision of positive credit information (on how well borrowers are servicing their debts) would allow lenders to respond in a more precise and graduated fashion. Currently, such information remains scarce, partly because it can only be transmitted to credit bureaus with the permission of credit card customers, which is complex and costly to secure. To eliminate this constraint, the team proposed two measures. One would be to require customers to provide permission before they can get their cards renewed. Another would be to shift to an "opt out" system, as in the United States, where customers are deemed to have agreed unless they specifically object to the new credit terms. The authorities welcomed this suggestion, noting that they have been trying to encourage the development of credit bureaus. But they noted that such measures could run up against the public's strong demand for privacy.

20. **The team also proposed measures to control risks at the mutual savings banks**. These institutions, though currently small (holding only 3 percent of financial system assets), have been taking advantage of their relatively light regulation to expand their loan portfolios

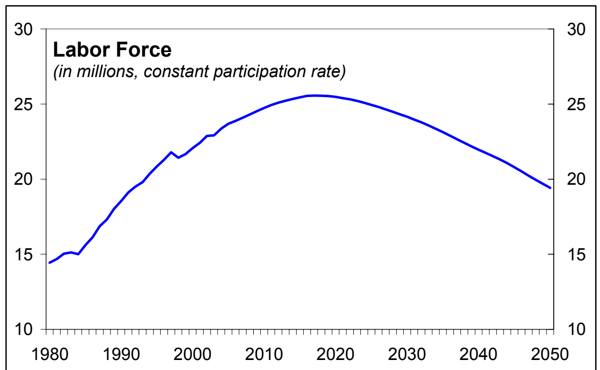
[2] A rise in defaults would affect banks' profitability, but would not threaten their stability since they are well capitalized (average capital-adequacy ratio of 13 percent), loans are short-term and variable-rate, and loan-to-value ratios for mortgages average just 52 percent. These buffers worked well during the credit card crisis: while profits fell temporarily, they soon rebounded, and in the interim banks' credit standing was maintained.

rapidly, especially for mortgages and to SMEs. To contain the risks, the team recommended subjecting these institutions to the same prudential regulations as those imposed on banks, including loan-to-value limits on mortgages and the use of forward-looking criteria (i.e., assessments of firms' future cashflows) when provisioning on loans. In response, the authorities indicated that they were also concerned, and would take steps to rein in their credit growth.

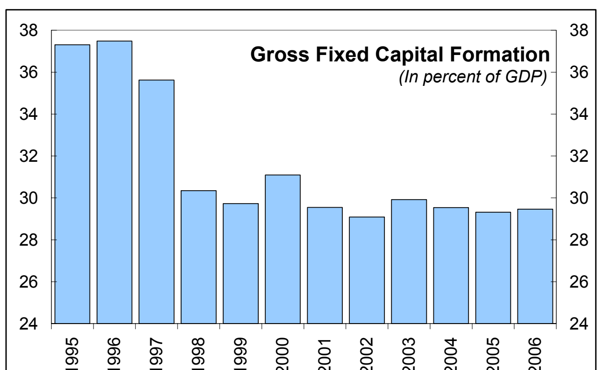
21. **Another issue relates to foreign exchange lending by domestic banks, which increased by $8½ billion in the first half of 2006.**[3] Although the amounts remain relatively modest, they are still of concern to the authorities because these loans are largely unhedged, with many of the borrowers banking on a won appreciation. The authorities consequently plan to monitor this trend closely—a strategy the team endorsed.

II. How Can Korea Spur Long-Term Growth?

22. **Beyond these immediate challenges, longer-term problems loom**. One problem is relates to the labor force. The population aging rapidly, while birthrates are exceptionally low. As a result, labor supply growth is slowing, and if participation rates remain stable, the absolute size of the labor force would decline starting in 2018. At the same time, capital accumulation has also been decelerating, with investment as a share of GDP declining by 2 percentage points since 2000 (and by 6 percentage points since the financial crisis). Meanwhile, overall productivity growth has been falling, since the strong performance in manufacturing has been offset by a poor performance in services.



Sources: CEIC Data Company Ltd; and National Statistical Office.



Source: CEIC Data Company Ltd; and Fund staff projections.

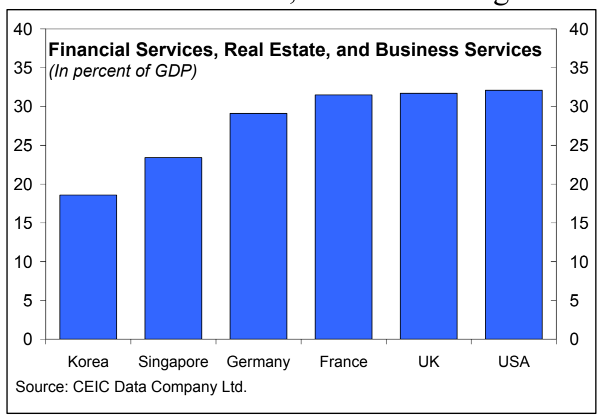
23. **Assuming these trends continue, potential output growth would slow sharply**. The team estimates that potential growth has fallen to around 4½ percent from an average of 8 percent before the

[3] Short-term external debt has been rising by an even larger amount, but this is mainly due to banks closing their long-dollar positions, created by a surge in forward sales of dollars by exporters, which fear further won appreciation.

crisis; by mid-century, it could fall to just 2 percent, an estimate that is broadly in line with the authorities' own projections.[4] And this matters because Korea's per capita income, for all of its tremendous progress over the past 50 years, is still only about 70 percent of the OECD average (in purchasing power parity terms). So, a key longer-term question—perhaps the key question—is how can current trends be reversed, so that Korea can catch up quickly to the most advanced countries. In the government's view, the answer lies in advancing the process started half a century ago: further integrating Korea into the world economy, by deregulating and opening up the financial sector, the service sector, and the labor market. But how should this be done?

A. How Can Korea Build an Advanced Financial Sector?

24. **Consider first the financial sector**. While the sector is sound, and the banking sector has advanced, capital markets remain underdeveloped, with most firms small and inefficient, providing only a narrow range of services.[5] The domestic foreign exchange market is unusually small, less than one-quarter the size that would be expected, considering the size of the country's trade transactions. And the yield curve is limited, both in the short-term money market and in the longer-term bond market (beyond three years). Related to this, secondary bond market turnover is low.



25. **This underdevelopment is costly because an advanced financial sector could help solve a number of Korea's long-term problems**. It could invigorate Korea's investment by providing mechanisms for corporations to transfer risk to the wider investing public. It could foster start-ups and advanced technology companies, which will become increasingly important as Korea becomes more knowledge and technology intensive. In addition, the more developed the financial sector, the better it will be at allocating capital to its most productive uses, thereby stimulating productivity.

26. **But how can such an advanced financial sector be built?** The government's vision is to integrate Korea's financial system into the global economy, eventually building a financial hub for Northeast Asia. In the current stage, the plan is resting on two main pillars, the first of which is the deregulation of the capital market. Under the planned Financial Investment Services and Capital Market Act, the government will remove the restrictions that currently

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[4] The team's projections assume that participation rates are unchanged (the recent trend), the capital stock grows at the rate of the past five years, productivity growth in services does not improve, and manufacturing productivity growth gradually slows to advanced economy levels. See Chapter I of the Selected Issues.

[5] See Chapter II of the Selected Issues.

separate the companies involved in capital market activities, thereby redividing the financial system into three subsectors: banks, insurance companies, and investment banks. At the same time, the sector would be shifted from a positive system of regulation to a negative one, in which all activities not expressedly forbidden would be allowed. The team supported this reform, noting that it will bring Korea into line with international trends, and promote competition and innovation. But it will also give rise to risks.

27. **Prominent among these will be the risk of conflict of interest**. And dealing with these potential conflicts of interest will be critically important, for if there is misconduct following the deregulation, this could damage confidence in the capital market, thereby setting back its development and defeating the purpose of the reform. To discourage misconduct, the team suggested increasing legal penalties for those who violate the law, allowing class action lawsuits for conflict-of-interest violations, and in cases of severe violations, banning the offenders from the industry for life. All of these measures could deter fraud, and bring Korea's system closer to the standards in financially advanced countries. The authorities agreed, and said they were already planning similar measures.

28. **The team asked how the authorities were planning to deal with the potential conflict between underwriters, who will be trying to sell newly-issued bonds and equity, and asset managers, who will be buying them**. The authorities explained that they planned to erect "Chinese walls", so as to block the flow of information and staff between these two entities**.** The team cautioned, however, that such walls have proved porous even in the most financially advanced countries. Consequently, it might be useful to adopt reinforcing measures, such as maintaining a legal separation between underwriters and asset managers (e.g., separate subsidiaries), as practiced in all the top global investment banks.

29. **The team also stressed that it would be important to refrain from allowing industrial groups to take controlling stakes in banks**. The team noted that such a measure is superficially attractive in that it could allow cash-rich corporates to develop the banking system. But it could actually amplify risks because it would open the door for the most damaging conflict of interest of all: connected lending between banks and their owners. The authorities noted that Korea has changed radically since the 1990s: the *chaebol* were now borrowing little from banks, and in any case supervision has improved. The team agreed, but noted that the *chaebols'* financing needs could change, while even the countries with the most advanced supervision are wary of allowing industrial firms to own banks.[6] For this reason, it would be advisable to maintain the current wall.

30. **The second pillar of the financial hub strategy is the complete liberalization of the foreign exchange system**. Recently, a major step in this direction was taken when the government swept away many of the lingering restrictions on capital account transactions, and

[6] See Chapter III of the Selected Issues.

accelerated the timetable for complete liberalization to 2009.[7] The team welcomed these actions, noting that they have helped the market grow deeper and more liquid: foreign exchange transactions grew by 15 percent (q/q) in the second quarter. Consequently, it proposed building on these steps by taking measures to improve the domestic money and bond markets.

31. **Specifically, the team recommended three measures**. First, to develop the money market, participation in the overnight call market could be restricted to banks, forcing others to use longer-term "repo" transactions. Second, incentives could be given to primary dealers to provide liquidity in the bond market. Third, to improve transparency, primary dealers could be required to report publicly all transactions to the dealers' association within 15 minutes, without exception. The authorities broadly agreed.

B. How Can Service Sector Productivity be Improved?

32. **Now, consider the nonfinancial service sector**. The sector is large and growing, accounting for about half of GDP and almost two-thirds of employment. But it is not very productive. Labor productivity is only about half that in manufacturing, the largest gap in the OECD, essentially because the sector has been sheltered from competition, both domestically and globally. For example, only nonprofit institutions can establish schools or hospitals. Small establishments find it difficult to grow, since regulations limit the type of collateral they can use when applying for loans. Meanwhile, the retail sector is dominated by inefficient "mom-and-pop" shops because land use restrictions prevent the proliferation of larger outlets, while labor market rigidities make it difficult for workers to find regular jobs. (See Section C.)

33. **What can be done to address this problem?** The team and authorities agreed that the best way to do this is by further integrating the sector into the world economy. That is why the government is considering opening up and deregulating services, notably in the medical, educational, and business services areas. Amongst these, deregulating education is perhaps the most critical, since high levels of human capital are essential for a knowledge-based economy. In some ways, Korean human capital is exceptionally high: the proportion of high school graduates is the highest in the OECD. Still, problems exist: surveys of academics and employers give low marks to Korean universities. Accordingly, the OECD has recommended deregulating universities and promoting competition amongst them, not least by opening the market to foreign providers. Such measures, however, face considerable domestic political opposition.

34. **As one strategy for advancing service sector deregulation, the government is negotiating free trade agreements with the United States and other countries**. The team noted, however, that it would be important to ensure that the sectoral openings under these bilateral agreements be as nondiscriminatory as possible, so as to simplify implementation and

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[7] Technical assistance for this step was provided by MFD; a further mission is planned on debt management.

minimize the risks of trade diversion. It also stressed that the greatest stimulus from trade liberalization would come from a multilateral liberalization under the Doha development round. The authorities agreed, but noted that a successful conclusion to Doha would require a greater consensus amongst the largest trading blocs. In the meantime, they reached an agreement with trading partners in the most difficult area, rice imports. In-quota imports will be doubled to 8 percent of consumption by 2014, in line with the overall strategy of shifting from import protection to direct support to farmers—although, for the moment, agricultural tariffs still average 52 percent.

35. **In addition to educational and trade initiatives, creating a knowledge-based economy will require ways of encouraging the growth of small but promising service firms**.[8] For it is striking that while Korea is very successful compared to other countries in creating new firms, these firms find it unusually difficult to grow. One reason is the current financing system. To secure bank loans, small firms usually need to pledge land as collateral (or obtain government guarantees). But many small firms, especially knowledge-based ones, do not really have any land; what they possess is intellectual property and contracts with other firms to supply their services. Thus, the civil code needs to be amended to allow them to use these assets as collateral, and commercial credit insurance developed so that this collateral will be accepted by banks. The authorities concurred, explaining that they planned to deregulate commercial credit insurance, allowing banks and insurance companies to enter the field to compete with government agencies.

C. How Can Korea's Labor Market be Fixed?

36. **As Korea shifts toward a knowledge-based economy, labor market flexibility will become increasingly important.** Already, Korean firms have been trying to overcome the inflexibility of the regular labor market by replacing permanent employees with fixed-term staff. Consequently, over the past four years alone, the share of nonregular (i.e., fixed-term) employment has grown by 10 percentage points to 37 percent of salaried employment, more than double the OECD average. At the same time, involuntary self-employment has increased, notably in the "mom-and-pop" retail sector.[9]

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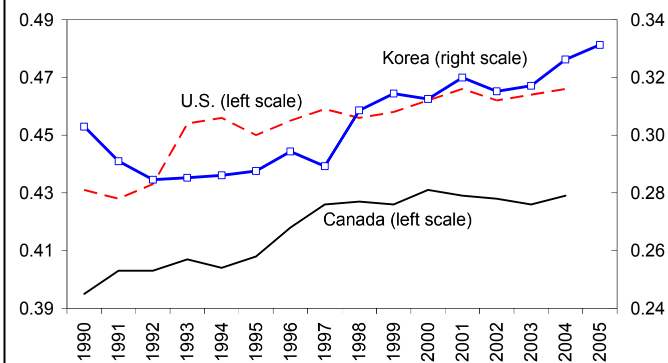
[8] See Chapter IV of the Selected Issues.

[9] See Chapter V of the Selected Issues.

37. **These shifts in employment have been accompanied by a significant increase in income inequality**. To be sure, much of this increase in inequality has been caused by other factors, including global trends to which Korea has not been immune. But the changes in Korea have been more dramatic than elsewhere. Since 1997, for example, the Gini coefficient has risen by more than four percentage points, compared to less than one percentage point in countries such as the United States and Canada. And the problem goes beyond income: the rising number of nonregular workers means that job insecurity has increased and many workers are slipping through the social safety net. Consequently, income inequality and the wider concept of "social polarization" have become major political issues.

Gini Coefficients in Korea and Comparators



Sources: U.S. Bureau of Labor Statistics, Statistics Canada, and Prof. Kyungsoo Choi, Korea Development Institute.

38. **What can be done to address this problem?** The key ingredients of a solution are two: less costly dismissal conditions and better social safety nets. Currently, firms are reluctant to hire regular workers because the cost of laying them off, should market conditions change, is very high: conditions for mass dismissals are strict, while consultation periods with trade unions are mandatory and long. These requirements need to be relaxed, either by changing the current system or perhaps by introducing a new contract, while "grandfathering" those already employed under the existing one. Such changes, the team argued, could trigger an increase in new regular jobs and thereby reduce polarization. The authorities indicated that they have been trying to reduce dismissal costs, but this has proved an intractable problem because it requires social consensus, which was very difficult to obtain.

39. **The authorities agreed that improving the social safety net was a priority**. They planned to introduce an Earned Income Tax Credit in 2008, to ensure that all wage earners would have a minimum standard of living. In addition, they had expanded the proportion of workers eligible for unemployment benefits to 85 percent from 66 percent in 2003, though because of compliance problems actual coverage remained much lower.

D. How Can the Long-Term Fiscal Issues be Addressed?

40. **Finally, even if the longer-term growth and polarization issues are addressed, one major long-term challenge will remain: the prospective deterioration of the fiscal position**. Under current parameters, the aging of the population could raise the cost of health and long-term care by 8½ percent of GDP by 2050, and deplete the assets of the pension

system, requiring annual budgetary transfers of close to 7 percent of GDP (according to OECD projections).[10]

41. **Given these looming fiscal burdens, the team noted, it will be helpful to preserve as much "fiscal space" as possible to deal with them**. The authorities agreed, explaining that they were framing medium-term fiscal policy so as to ensure that the debt/GDP ratio remained around its current ratio (30 percent of GDP under their definitions), thereby ensuring that future taxpayers will not need to bear a large interest burden, on top of the heavy health and pension costs. To achieve this target, they would carefully examine the scope for offsetting the costs of new expenditure programs by reducing other expenditure.

42. **The team asked about the specific measures being taken to tackle the health care and pension problems**. The authorities stated that they were introducing new mechanisms to contain health care cost pressures, including by revamping the pricing mechanisms for health services and pharmaceuticals. They had also recently proposed reducing the replacement ratio (the ratio of benefits to wages) of the National Pension Fund to 40 percent from the current 60 percent, while raising contribution rates to 12–13 percent from the current 9 percent, a step that should go a long way in restoring the system to financial health. But this proposal, they noted, had encountered considerable resistance in the National Assembly, where the government lacks a majority.

43. **Even with such determined efforts to control spending, the authorities noted, expenditure was still likely to rise over the medium-term**. Apart from the pressures from population aging, the growing social polarization is fueling demands for additional social spending, which remains much lower than in most OECD countries. Consequently, they are now considering how to increase revenues, preferably without raising tax rates. The team noted that the greatest scope for this would seem to come from the personal income tax, which at 3 percent of GDP is well below the OECD average of 10 percent, largely because deductions are extensive and audits infrequent. The authorities responded that efforts were currently being made to step up enforcement, particularly against those with scope to understate their income, such as professionals and the self-employed. For example, penalties for tax fraud are being increased, and high-income self-employed will be required to use business bank accounts for all business transactions.

44. **Finally, the team flagged the risks arising from off-budget spending, notably from the increasing use of Build-Transfer-Lease (BTL) projects**. The mission noted that such projects are appealing in an environment of fiscal restraint, since they avoid the need for immediate outlays, which are funded by the private sector. Yet the cash costs are not eliminated: they are merely postponed until the time when the lease obligations begin to fall due. Consequently, fiscal transparency would require a clear accounting of the value of these future obligations. The authorities stated that the capital value of the projects would be made

[10] See Chapter VI of the Selected Issues.

public, but noted that a full solution would need to await the move to accrual budget accounting, which would take place over the medium term.

III. Staff Appraisal

45. **It is now been half a century since Korea joined the International Monetary Fund**. During this period, the country has developed from a poor agrarian society into a modern industrial power, a transformation that has been so rapid, thoroughgoing, and unusual that it has been termed the "Miracle on the Han River". This transformation was achieved by integrating the manufacturing sector into the global economy. But other sectors—the financial and service sectors, and the labor market—have remained regulated and sheltered from foreign competition, stymieing their development and keeping Korea's per capita income below that of the richest nations.

46. **Moreover, looking ahead to the next half century, major challenges loom**. Potential growth is slowing as the population ages, while social polarization—that is to say, the gap in incomes and job security between those who have good jobs and those who do not—is growing.

47. **How can Korea deal with these challenges?** The government firmly believes that the solution lies in furthering Korea's integration into the world economy. Just as the government thrust the manufacturing sector into the global arena a few decades ago, now it plans to apply the same remedy to the other sectors. The staff strongly supports this strategy. Consequently, its recommendations have focused mainly on tactics, on specific measures to achieve these broad objectives.

48. **But before addressing the medium-term issues, there is a question of how to navigate the short-term difficulties**. For after a comfortable period when growth was rapid and inflation low, the economy is now slowing while inflation has been creeping upwards. Moreover, further complications arise because growth in the United States has softened, oil prices are high and volatile, while global financial conditions are tightening. In these circumstances, what policy stance should the authorities take?

49. **On macroeconomic policy, the authorities have been scaling back their policy stimulus as the recovery progresses**. But the monetary policy rate may now be close to neutral levels, while the greater risk seems to be to the recovery, rather than to inflation, which is likely to remain at low levels. Consequently, policy will need to be data-dependent, with the rationale communicated clearly. In this endeavor, the recent shift to targeting headline inflation should help, by making it clear that Bank of Korea is aiming at the same cost of living measure used by the general public. Beyond this, some other steps could be taken to improve the efficiency of monetary policy, notably introducing surveys of quantitative inflation expectations, providing periodic explanations of the central bank's strategy between inflation reports, and (to improve accountability) eliminating the three-year period for assessing monetary policy.

50. **The staff commends the authorities' policy of allowing the won's external value to be determined in the foreign exchange market, limiting intervention to smoothing operations**. Despite the won's rise and the sharp fall in the current account balance, productivity increases have ensured that overall competitiveness remains appropriate, as shown by the rise in Korea's share of world trade to record levels. While SME exports have fallen, this reflects long-standing problems, which should be dealt with through structural measures.

51. **On the financial policy side, the key task would be to guard against the dangers arising from a renewed rise in risk aversion**. For such sentiment could prompt lenders to raise their lending rates and curb their credit, which could have a serious impact on growth. One way to mitigate this risk would be by improving the flow of information to credit bureaus, so that lenders can monitor and respond in a more precise fashion. At the same time, mutual savings banks, which have been expanding loans rapidly, should be monitored carefully and subjected to the same prudential regulations as those imposed on banks. And since banks have been expanding foreign currency loans rapidly, supervisors should ensure that these institutions are monitoring borrowers' cashflow carefully.

52. **On the structural side, the staff warmly welcomes the plans to develop an advanced financial sector**. The plan to deregulate the capital markets, in particular, should prove a major spur to competition and innovation. But its needs to be accompanied by strong measures to contain risks. Specifically, the staff recommends maintaining a legal separation between investment banks and asset managers, while increasing legal penalties and allowing class action lawsuits for conflict-of-interest violations. It will also be important to maintain the policy of preventing industrial groups for owning banks, because such ownership could lead to connected lending, the most damaging conflict of interest of all. At the same time, the plan to fully liberalize the foreign exchange system should be complemented by measures to improve the domestic money and bond markets, specifically to boost repo transactions, encourage primary dealers to provide liquidity to the market, and improve transparency in transactions.

53. **The staff supports the government's strategy trying to spur productivity in nonfinancial services by opening up and deregulating the sector**. In particular, it supports the strategy of opening sectors through trade liberalization. But it notes that bilateral trade deals need to be as nondiscriminatory as possible, and urges Korea—with its large stake in the future of the global trading system—to take a leadership role in advancing multilateral liberalization under the Doha Development Round. Beyond this step, measures are also needed to improve the financing of small but promising service firms, notably by allowing intellectual property and supply contracts with other firms to be used as collateral.

54. **As Korea shifts toward a knowledge-based economy, labor market flexibility will become increasingly important**. Already, since the regular labor market is inflexible, firms have been replacing permanent employees with fixed term staff—a trend that has exacerbated income inequality and social polarization. The staff strongly recommends, therefore, that the government revive its efforts to ease conditions of regular employment, while continuing to expand and strengthen the social safety net.

55. **Finally, even if the growth issues are addressed, a long-term fiscal issue would remain**. This is because the aging of population will raise health care costs and, under current parameters, deplete the assets of the pension system. To deal with this problem, it will be important to preserving as much fiscal space as possible by adhering to the plans of maintaining the government debt/GDP ratio at its current, low, level over the medium term. At the same time, the long-standing plans to restore the national pension system to viability by raising contributions and reducing replacement rates need to be implemented swiftly, because the longer the adjustments are delayed, the larger and more painful they will need to be. On the tax side, the staff endorses the authorities' plans to also broaden the personal income tax base, to bring it closer into line with that in other OECD countries.

56. **To sum up, Korea has come a long way over the past 50 years**. How will it fare over the next fifty? There are challenges, to be sure, and many seem daunting. But Korea has faced even more daunting challenges in its past, and has overcome each one. The staff is confident that the same will occur this time, because Korea is heading in the right direction, towards greater deregulation and greater integration with the world economy. This strategy, applied to manufacturing, produced the "Miracle on the Han" in the 20th century. And by applying this strategy now to the other sectors, Korea should be able to create another "miracle": a knowledge-based, advanced technology, economy for the 21st century.

57. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Table 1. Korea: Selected Economic Indicators, 2002–07

Nominal GDP (2005): US$787.6 billion
Main exports (percent of total, 2005): Electronics (39)
GDP per capita (2005): US$16,308
Unemployment rate (2005): 3.7 percent
FDI (2005): $4.3 billion
Public debt (2005): 36.4 percent of GDP
Foreign public debt (2005): 4.0 percent of total public debt

	2002	2003	2004	2005	2006 Proj.	2007 Proj.
Real GDP (percent change)	7.0	3.1	4.7	4.0	5.0	4.3
Total domestic demand	7.0	0.5	1.8	2.8	4.1	3.6
Final domestic demand	7.3	1.0	1.0	3.1	3.7	3.8
Consumption	7.6	-0.3	0.4	3.4	4.5	3.8
Gross fixed investment	6.6	4.0	2.1	2.3	1.8	4.0
Stock building 1/	-0.2	-0.5	0.8	-0.3	0.4	-0.2
Net foreign balance 1/	-0.2	2.5	3.3	1.4	1.4	1.0
Nominal GDP (in trillions of won)	684.3	724.7	779.4	806.6	833.3	883.3
Saving and investment (in percent of GDP)						
Gross national saving	30.1	31.9	34.5	32.2	29.9	29.7
Gross domestic investment	29.1	30.0	30.4	30.1	29.6	29.4
Current account balance	1.0	2.0	4.1	2.1	0.4	0.3
Prices (percent change)						
CPI inflation (end of period)	3.7	3.4	3.0	2.6	3.0	2.7
Core inflation (average)	3.0	3.1	2.9	2.3	2.0	2.7
GDP deflator	2.8	2.7	2.7	-0.4	-1.6	1.7
Real effective exchange rate 2/	4.9	1.7	1.8	12.1	7.3	…
Trade (percent change)						
Export volume	13.2	16.7	22.5	9.7	13.5	10.8
Import volume	12.3	7.3	11.8	6.1	13.6	11.6
Terms of trade	-0.5	-6.1	-4.3	-7.4	-6.5	-0.2
Consolidated central government (in percent of GDP) 3/						
Revenues	23.2	23.7	22.9	23.7	25.3	25.7
Expenditure 4/	20.9	21.0	20.7	21.6	22.9	23.2
Overall balance 4/	2.3	2.7	2.3	2.1	2.4	2.5
excl. Social Security Funds	-0.2	0.0	-0.5	-0.8	-0.7	-0.7
Money and credit (end of period)						
Overnight call rate 5/	4.3	3.8	3.3	3.7	4.5	…
Three-year corporate bond yield 5/	5.9	5.6	3.7	5.5	5.1	…
M3 growth 6/	13.6	4.7	7.1	7.4	7.7	…
Balance of payments (in billion U.S. dollars)						
Exports, f.o.b.	163.4	197.3	257.7	289.0	328.8	370.1
Imports, c.i.f.	148.6	175.3	220.1	255.5	310.9	353.2
Oil imports	19.2	23.1	29.9	42.6	57.5	65.0
Current account balance	5.4	11.9	28.2	16.6	3.3	2.9
Gross international reserves (end of period)	121.3	155.3	199.0	210.3	228.7	237.0
in percent of short-term debt	161.4	194.9	254.3	239.8	181.6	167.4
External debt (in billion U.S. dollars)						
Total external debt (end of period)	141.5	157.6	172.3	190.0	232.0	253.7
Of which : short-term (end of period)	48.2	50.8	56.3	65.8	101.2	117.0
Total external debt (in percent of GDP)	25.9	25.9	25.3	24.1	26.5	27.3
Debt service ratio 7/	12.5	13.1	10.6	8.5	8.4	8.7

Sources: Korean authorities; and Fund staff estimates and projections.

1/ Contribution to GDP growth.
2/ Data for 2006 are for June.
3/ Refer to budget plan for 2006, with staff adjustments.
4/ Excluding privatization receipts and rollover of KDIC/KAMCO bonds.
5/ Data for 2006 are as of September 8.
6/ Data for 2006 are as of June.
7/ Debt service on medium- and long-term debt in percent of exports of goods and services.

Table 2. Korea: Monetary and Financial Indicators, 2002–06

	2002	2003	2004	2005				2006	
				March	June	Sept.	Dec.	March	June
				(In trillions of won)					
Bank of Korea									
Reserve money	38.0	40.7	38.8	42.4	40.7	39.3	43.2	45.3	43.1
Net foreign assets	146.0	186.3	208.0	217.8	210.4	212.9	213.5	219.1	215.9
Foreign assets	158.1	196.6	230.7	242.2	226.0	233.7	232.1	237.8	234.8
Foreign liabilities	-12.1	10.3	22.6	24.4	15.6	20.8	18.5	18.7	18.9
Net domestic assets	-108.0	-145.5	-169.3	-175.4	-169.7	-173.6	-170.3	-173.7	-172.8
Public sector	-6.2	0.5	2.4	12.2	10.7	9.4	4.6	8.3	3.7
Private financial sector	28.3	43.1	47.8	48.5	50.3	55.2	60.3	62.1	64.9
Monetary stabilization bond	-84.3	-105.5	-142.8	-161.6	-159.0	-160.8	-155.2	-159.1	-157.5
Other items net	-45.8	-83.6	-76.7	-74.6	-71.7	-77.5	-80.0	-85.0	-84.0
Depository Corporations Survey									
M2	872.1	898.1	954.7	970.6	999.8	1,004.1	1,021.4	1,040.1	1,082.2
Net foreign assets	118.2	151.8	180.5	182.7	174.6	177.3	181.5	186.8	172.6
Foreign assets	210.3	255.8	298.0	305.4	285.4	298.3	293.8	305.4	310.4
Foreign liabilities	-92.1	104.0	117.5	122.7	110.7	121.0	112.3	118.6	137.8
Net domestic assets	753.9	746.2	774.2	788.0	825.2	826.8	839.9	853.3	909.7
Public sector	-19.5	-19.0	-13.6	-11.6	-6.6	-17.8	-24.1	-26.2	-29.3
Nonfinancial private sector	887.1	930.1	961.8	969.5	995.6	1,020.1	1,054.8	1,083.2	1,135.7
Corporations	525.8	523.4	520.2	527.3	537.7	552.0	575.4	600.7	639.1
Households	361.3	406.7	441.6	442.2	457.9	468.2	479.4	482.4	496.6
Other items net	-113.6	-164.9	-174.0	-169.9	-163.9	-175.5	-190.7	-203.7	-196.8
M3 1/	1,155.7	1,209.8	1,295.8	1,309.5	1,350.7	1,367.2	1,391.6	1,406.3	1,436.1
L 2/	1,353.0	1,415.8	1,518.9	1,542.7	1,584.8	1,615.1	1,653.2	1,670.7	1,729.6
				(Percent change, year-on-year)					
Memorandum items:									
Reserve money	15.7	7.3	-4.8	9.1	-3.8	-6.0	11.5	7.0	5.8
M2	14.0	3.0	6.3	6.2	7.6	6.2	7.0	7.2	8.2
M3 1/	13.6	4.7	7.1	6.1	7.4	6.6	7.4	7.5	7.7
L 2/	13.6	4.6	7.3	6.5	7.8	7.6	8.8	8.3	9.1
Household credit 3/	28.5	1.9	6.1	6.1	7.9	8.8	9.9	10.7	...
				(In percent)					
Interest rates, end period									
Call rate target	4.25	3.75	3.25	3.25	3.25	3.25	3.75	4.00	4.25
Treasury bond, 1 year	4.98	4.65	3.31	3.78	3.81	4.39	4.70	4.56	4.82
Treasury bond, 3 year	5.11	4.82	3.28	3.91	4.02	4.60	5.08	4.93	4.92
Corporate bond, 3 year	5.88	5.61	3.73	4.48	4.18	4.92	5.49	5.30	5.17
Deposit rate	4.69	4.12	3.41	3.49	3.44	3.80	4.14	4.26	4.38
Household loan rate	7.12	6.31	5.48	5.60	5.28	5.50	5.63	5.68	5.72
Enterprise loan rate	6.41	6.18	5.54	5.65	5.60	5.67	5.80	5.99	6.09

Source: Bank of Korea.

1/ M2 plus other deposits/financial instruments issued by financial institutions.

2/ M3 plus financial instruments issued by non-financial institutions.

3/ Covers credit from banks, savings institutions, and insurance, credit card, finance, and merchandise companies.

Table 3. Korea: Balance of Payments, 2002–06

(In billions of U.S. dollars, unless otherwise indicated)

	2002	2003	2004	2005	2006 Proj.
1. Current account balance	5.4	11.9	28.2	16.6	3.3
Trade balance	14.8	22.0	37.6	33.5	17.9
Exports	163.4	197.3	257.7	289.0	328.8
(growth rate, in percent)	7.9	20.7	30.6	12.1	13.8
Imports	148.6	175.3	220.1	255.5	310.9
(growth rate, in percent)	7.7	18.0	25.6	16.1	21.7
Services	-8.2	-7.4	-8.0	-13.1	-12.9
Income	0.4	0.3	1.1	-1.3	1.1
Current transfers	-1.6	-2.9	-2.4	-2.5	-2.7
2. Financial and capital account balance	6.3	18.1	9.1	2.6	15.4
Financial account	7.3	19.5	10.9	4.9	17.9
Portfolio investment, net	0.7	17.9	8.6	-1.3	-16.5
Direct investment, net	-0.2	0.1	4.6	0.0	0.0
Inflows	2.4	3.5	9.2	4.3	5.0
Outflows	-2.6	-3.4	-4.7	-4.3	-5.0
Other investment, assets	1.4	-5.1	-8.1	-4.0	-4.5
Other investment, liabilities	5.4	6.6	5.8	10.2	38.9
of which short-term loans	5.1	0.1	3.3	3.7	32.0
of which medium and long-term loans	-3.1	-9.3	-5.8	-5.2	-2.4
Capital account	-1.1	-1.4	-1.8	-2.3	-2.5
3. Net errors and omissions	0.2	0.0	2.9	2.8	0.0
4. Overall balance (1+2+3)	11.8	30.0	40.2	21.9	18.8
5. Financing	-11.8	-30.0	-40.2	-21.9	-18.8
Change in usable reserves (increase -)	-11.8	-25.8	-38.7	-19.8	-18.4
Net IMF purchases	0.0	0.0	0.0	0.0	0.0
World Bank/AsDB 1/	0.0	-4.2	-1.5	-2.1	-0.4
Memorandum items:					
Current account balance (in percent of GDP)	1.0	2.0	4.1	2.1	0.4
Trade balance (in percent of GDP)	2.7	3.6	5.5	4.3	2.0
Gross reserves	121.3	155.3	199.0	210.3	228.7
(in months of imports of goods and services)	7.9	8.6	8.8	8.0	7.3
External debt	141.5	157.6	172.3	190.0	232.0
(in percent of GDP)	25.9	25.9	25.3	24.1	26.5
Short-term external debt (inc. trade credits)	48.2	50.8	56.3	65.8	101.2
Nominal GDP	546.7	608.2	680.0	787.6	877.2

Sources: Korean authorities; and Fund staff estimates and projections.

1/ These World Bank and Asian Development Bank loans were extended as exceptional financing in the 1997-98 crisis.

Table 4. Korea: Medium-Term Projections, 2004–11
(In units indicated)

	2004	2005	2006	2007	2008	2009	2010	2011
			Staff Projections					
Real GDP (percent change)	4.7	4.0	5.0	4.3	4.6	4.6	4.5	4.5
Total domestic demand	1.8	2.8	4.1	3.6	4.3	4.3	4.4	4.5
Final domestic demand	1.0	3.1	3.7	3.8	4.3	4.3	4.4	4.5
Consumption	0.4	3.4	4.5	3.8	3.9	3.8	3.8	3.8
Gross fixed investment	2.1	2.3	1.8	4.0	5.1	5.4	5.7	6.0
Stock building 1/	0.8	-0.3	0.4	-0.2	0.0	0.0	0.0	0.0
Net foreign balance 1/	3.3	1.4	1.4	1.0	0.8	0.7	0.6	0.5
Prices, period average (percent change)								
Consumer price	3.6	2.7	2.5	2.7	2.7	2.7	2.7	2.7
GDP deflator	2.7	-0.4	-1.6	1.7	1.7	1.9	2.1	2.4
Savings and investment (percent of GDP)								
Gross national savings	34.5	32.2	29.9	29.7	29.4	29.3	29.3	29.5
Gross domestic investment	30.4	30.1	29.6	29.4	29.4	29.6	29.8	30.0
Current account balance	4.1	2.1	0.4	0.3	0.0	-0.2	-0.5	-0.5
Consolidated central government (in percent of GDP)								
Revenues	22.9	23.7	25.3	25.7	25.7	25.5	25.4	25.2
Expenditure	20.7	21.6	22.9	23.2	23.1	23.0	22.9	22.7
Balance 2/	2.3	2.1	2.4	2.5	2.5	2.6	2.5	2.5
excl. Social Security Funds	-0.5	-0.8	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Debt, domestic plus external 3/	25.2	29.6	32.3	31.5	31.1	30.8	30.5	30.5
Government guaranteed restructuring bonds 3/	8.4	6.8	4.9	4.4	3.9	3.4	3.0	2.5
Trade (percent change)								
Merchandise exports	30.6	12.1	13.8	12.6	9.8	10.0	10.1	10.1
Volumes 4/	22.5	9.7	13.5	10.8	9.8	9.7	9.5	9.3
Merchandise imports	25.6	16.1	21.7	13.6	10.7	10.8	10.8	10.5
Volumes 4/	11.8	6.1	13.6	11.6	10.7	10.8	10.8	10.7
Terms of trade	-4.3	-7.4	-6.5	-0.2	0.0	0.3	0.5	1.0
Balance of payments (billion U.S. dollars)								
Current account	28.2	16.6	3.3	2.9	0.1	-2.6	-5.1	-6.2
Trade balance	37.6	33.5	17.9	16.9	15.2	13.6	12.0	11.6
Merchandise exports	257.7	289.0	328.8	370.1	406.4	446.9	492.0	541.8
Merchandise imports	220.1	255.5	310.9	353.2	391.2	433.3	479.9	530.1
External debt								
In billion of U.S. dollars 5/	172.3	190.0	232.0	253.7	274.5	297.4	321.5	347.1
(as percent of GDP)	25.3	24.1	26.5	27.3	27.9	28.4	28.9	29.2
Debt service ratio 6/	10.6	8.5	8.4	8.7	8.1	7.9	7.6	7.4
Memorandum items:								
Nominal GDP (trillion won)	779.4	806.6	833.3	883.3	936.1	994.2	1,057.5	1,127.4
Per capita GDP (U.S. dollars)	14,142	16,308	18,015	18,939	19,907	20,971	22,124	23,393
Output gap (percent of potential GDP)	-0.1	-0.9	-0.4	-0.1	0.0	0.0	0.0	0.0

Sources: Korean authorities; and Fund staff estimates and projections.

1/ Contribution to GDP.
2/ Excluding privatization receipts and conversion of KDIC/KAMCO bonds into treasury bonds.
3/ During 2003-06, W49 trillion in government guaranteed KDIC/KAMCO bonds have been converted into treasury bonds.
4/ Customs clearance basis.
5/ Includes IMF and offshore borrowing of domestic financial institutions and debt contracted by their overseas branches.
6/ Debt service on medium- and long-term debt in percent of exports of goods and services.

Table 5. Korea: Financial Soundness Indicators, 1999–2005

	1999	2000	2001	2002	2003	2004	2005
Financial Sector				(In percent)			
Total loans/GDP	111.6	107.4	103.6	119.5	97.8	94.2	98.6
Commercial banks	62.0	62.5	60.9	67.9	68.9	65.7	67.9
Other financial institutions	49.6	44.9	42.6	51.6	28.9	28.5	30.7
Banks 1/							
Capital adequacy ratio	11.9	10.6	11.7	11.3	11.2	12.1	13.0
Tier 1 capital ratio	7.7	6.7	7.7	7.2	7.0	8.0	9.3
Substandard or below loans, share	12.9	8.0	3.4	2.3	2.6	1.9	1.2
Return on assets	-0.8	-0.6	0.7	0.6	0.2	0.9	1.3
Net interest margin	2.5	2.4	2.6	2.7	2.6	2.6	2.8
Corporate Sector							
Corporate debt/GDP	123.9	118.0	114.2	107.2	105.8	101.2	102.2
Delinquency ratio (domestic commercial bank loans)	4.4	3.4	2.1	2.0	2.1	2.1	1.5
Debt ratio to:							
equity	214.7	210.6	182.2	135.4	123.4	104.2	100.9
total assets	42.8	41.2	39.8	31.7	28.3	24.0	22.9
sales	52.8	42.7	40.1	29.8	26.6	20.7	19.9
Interest coverage ratio 2/	96.1	157.2	132.6	260.3	367.1	575.8	525.4
Percent of companies < 100	32.6	26.3	28.6	23.5	26.2	...	...
Current assets/current liabilities	92.0	83.2	97.9	106.1	109.8	117.0	121.4
Operating income/sales	6.6	7.4	5.5	6.7	6.9	7.6	6.1
Financial expenses/sales	-6.9	-4.7	-4.2	-2.6	-1.9	-1.3	-1.2
Ordinary income/sales	1.7	1.3	0.4	4.7	4.7	7.8	1.2
Household Sector							
				(In percent of GDP)			
Household credit	38.4	45.4	54.5	62.6	59.8	60.1	63.0
Of which : Commercial Bank	13.7	18.2	25.0	31.6	33.9	35.0	36.9
Delinquency ratio (all bank loans)				(In percent)			
Households	3.7	2.5	1.3	1.5	1.8	1.7	1.1
Credit card	7.8	7.5	7.3	11.8	10.5	5.5	3.2
				(In million persons)			
Delinquent individuals	…	2.08	2.45	2.63	3.72	3.62	2.97
Of which : Credit card related	…	0.80	1.04	1.49	2.40	2.43	...
Housing prices, percent change	3.4	0.4	9.9	16.4	5.7	-2.1	4.1
Of which : Seoul	5.5	3.0	13.0	22.5	6.8	-1.4	6.4
Ratio of housing price to rent	95	86	81	86	92	95	96
Of which : Seoul apartment	93	87	84	99	112	116	120

Sources: BOK, FSS, Korean Federation of Banks, and Kookmin Bank.

1/ This includes nationwide commercial banks, regional banks and specialized banks.
2/ Operating income to gross interest payments. Operating income treats depreciation as a expense, so this ratio is lower than calculations using earnings before interest, taxes, and depreciation allowance (EBITDA).

Table 6. Korea: Indicators of External Vulnerability, 2000–06
(in percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	Date
Financial indicators								
Consolidated central government debt 1/	31.8	35.3	33.4	32.6	33.5	36.4	35.4	Proj.
Broad money (M3, percent change, 12-month basis)	7.1	11.6	13.6	4.7	7.1	7.4	7.7	Jun-06
Private sector credit (Fin. survey, percent change, 12 month basis)	-2.7	11.1	19.0	6.4	4.1	10.1	10.6	Feb-06
One month call borrowing rate	5.3	4.0	4.3	3.9	3.3	3.8	4.2	Jul-06
One month call borrowing rate (real)	2.5	0.8	0.5	0.5	0.2	1.2	1.9	Jul-06
External indicators								
Exports (percent change, 12-month basis in US$)	21.2	-14.0	7.9	20.7	30.6	12.1	11.9	Jul-06
Imports (percent change, 12-month basis in US$)	36.2	-13.4	7.7	18.0	25.6	16.1	18.7	Jul-06
Terms of trade (percent change, 12 month basis)	-12.8	-4.5	-0.5	-6.1	-4.3	-7.4	-6.0	Jun-06
Current account balance (projection for full year)	2.4	1.7	1.0	2.0	4.1	2.1	0.4	Proj.
Capital and financial account balance (projection for full year)	2.4	0.5	1.1	3.0	1.3	0.3	1.8	Proj.
Of which: Inward portfolio investment (debt securities etc.)	2.3	2.4	0.8	3.5	2.4	1.1	0.4	Proj.
Other investment (loans, trade credits etc.)	-0.2	-3.6	1.0	0.4	0.6	1.0	4.4	Proj.
Inward foreign direct investment in the form of debt or loans	-0.2	-0.1	-0.1	-0.1	-0.2	-0.1	...	...
Gross official reserves (in US$ billion)	96.1	102.8	121.3	155.3	199.0	210.3	225.7	Jul-06
Central Bank short-term foreign liabilities (in US$ billion)	1.7	1.9	2.0	2.1	2.0	2.2	...	...
Short term foreign liabilities of the financial sector (in US$ billion)	24.1	21.1	20.3	27.0	30.0	32.6	...	...
Official reserves in months of imports GS (projection for full year)	6.0	7.2	7.9	8.6	8.8	8.0	7.3	Proj.
Broad money(M3) to reserves	7.5	7.5	8.0	6.5	6.3	6.5	6.8	Jun-06
Reserves to total short term external debt (in percent) 2/	134.1	170.4	161.4	194.9	254.3	239.8	181.6	Proj.
Total external debt	28.9	26.7	25.9	25.9	25.3	24.1	26.5	Proj.
Of which: Public sector debt	3.8	3.8	3.2	1.9	1.5	1.1	...	...
Of which: Short-term debt	9.7	8.4	8.8	8.4	8.3	8.4	11.5	Proj.
Total external debt to exports GS (in percent)	71.6	71.3	73.8	68.4	57.5	56.8	60.6	Proj.
External interest payments to exports GS (in percent)	3.3	3.1	2.1	1.4	1.0	1.9	2.7	Proj.
External amortization payments to exports GS (in percent)	11.6	12.2	10.4	11.7	9.6	6.6	5.7	Proj.
Exchange rate (per US$, period average)	1,130	1,291	1,252	1,192	1,146	1,024	957	Aug 21, 06
REER appreciation (+) (12-month basis)	7.3	-6.2	4.9	1.7	1.8	12.1	5.7	Jun-06
Financial market indicators								
Stock market index (KOSPI)	505	694	628	811	894	1379	1322	Aug 21, 06
Stock market index (KOSPI, percent change, 12-month basis)	-51.7	37.4	-9.5	29.2	10.2	54.3	18.4	Aug 21, 06
Foreign currency debt rating (Moody's/S&P)	Baa2/BBB	Baa2/BBB+	A3/A-	A3/A-	A3/A-	A3/A	A3/A	Aug 21, 06

Sources: Korean authorities, private market sources; and Fund staff estimates.

1/ Including government guaranteed restructuring bonds issued by KDIC and KAMCO.
2/ Short-term debt measured on a residual maturity basis.

Table 7. Korea: Consolidated Central Government Operations, 2002–06

	2002	2003	2004	2005	2006	
					Budget	Proj.
			(In trillions of won)			
Revenue	158.7	171.7	178.8	191.5	208.1	210.8
Tax revenue	104.0	114.7	117.8	127.5	135.3	138.0
Social security contributions	19.7	20.7	22.8	24.9	28.9	28.9
Nontax and capital revenue	35.0	36.4	38.1	39.1	43.9	43.9
Expenditure and net lending	142.7	152.4	161.2	174.4	197.0	190.6
Current expenditure 1/	113.2	124.4	132.8	146.7	165.8	159.4
Interest	13.8	7.8	8.3	10.1	10.4	10.4
Of which: bank restructuring	6.9	3.2	3.1	1.6	0.8	0.8
Non-interest	99.4	116.6	124.5	136.6	155.4	149.0
Capital expenditure	29.4	30.6	27.0	24.6	25.4	25.4
Net lending 2/	0.2	-2.6	1.4	3.0	5.8	5.8
Overall balance	16.0	19.3	17.6	17.1	11.1	20.2
o/w: SSF balance	17.6	19.6	21.2	23.6	26.0	26.0
Excluding SSF	-1.6	-0.3	-3.6	-6.5	-14.9	-5.8
Financing	-16.0	-19.3	-17.6	-17.1	-11.1	-20.2
Domestic financing	-15.5	-13.4	-15.0	-13.8	-10.0	-19.1
Of which : Privatization	6.7	1.3	0.0	0.0	0.0	0.0
External Financing	-0.5	-5.9	-2.6	-3.3	-1.1	-1.1
			(In percent of GDP)			
Revenue	23.2	23.7	22.9	23.7	25.0	25.3
Tax revenue	15.2	15.8	15.1	15.8	16.2	16.6
Social security contributions	2.9	2.9	2.9	3.1	3.5	3.5
Nontax and capital revenue	5.1	5.0	4.9	4.9	5.3	5.3
Expenditure and net lending	20.9	21.0	20.7	21.6	23.6	22.9
Current expenditure	16.5	17.2	17.0	18.2	19.9	19.1
Interest	2.0	1.1	1.1	1.3	1.2	1.2
Non-interest	14.5	16.1	16.0	16.9	18.6	17.9
Capital expenditure	4.3	4.2	3.5	3.1	3.1	3.1
Net lending	0.0	-0.4	0.2	0.4	0.7	0.7
Overall balance	2.3	2.7	2.3	2.1	1.6	2.4
o/w: SSF balance	2.6	2.7	2.7	2.9	3.1	3.1
Excluding Social Security Funds	-0.2	0.0	-0.5	-0.8	-1.8	-0.7
Primary balance	4.3	3.7	3.3	3.4	2.6	3.7
Memorandum items :						
Privatization receipts	1.0	0.2	0.0	0.0	0.0	0.0
Conversion of KDIC/KAMCO bonds	-1.8	-1.7	-1.5	-1.5	-1.4	-1.4
Nominal GDP (trillion won)	684.3	724.7	779.4	806.6	833.3	833.3

Sources: Ministry of Planning and Budget; and Fund staff estimates.

1/ The conversion of KDIC and KAMCO bonds is excluded, amounting to W13 trillion in 2003, and W12 trillion annually thereafter.
2/ Excludes privatization receipts.

APPENDIX I: KOREA—SOUNDNESS OF THE KOREAN FINANCIAL SYSTEM

Korea's banks are doing well. They have improved their profits significantly over the past five years, and pushed their returns to equity above 18 percent by 2005 (see tabulation next page), high by most standards. Their balance sheets and capital have strengthened also: nonperforming loans have declined, provisions have remained above 100 percent, and the average capital adequacy ratio stood at 13 percent at end-2005, significantly higher than the minimum 8 percent required by Basle core principles. While some temporary factors, including reversal of overprovisioning, have played a role, the key underlying factor for this strong performance has been the significant transformation of the banking system since the Asian crisis. In particular, prudential regulations were revamped, most of the banks were reprivatized, and the banks' orientation was switched away from the industrial conglomerates. These steps in turn have led banks to seek and benefit from more profitable and sound lending opportunities.

These favorable results also reflect the recovery from the recent credit card crisis. Korea's credit card industry had expanded rapidly from 1999 to 2002, but that boom had come to an abrupt end as household delinquency rates rose sharply to unprecedented levels. Since then, a number of programs created for resolving household debts and tighter credit standards on credit cards have helped reduce the delinquency rate (including restructured loans) for credit card companies from its peak of around 28 percent in late 2003 to 9 percent by end 2005. In addition, for the stand-alone credit card companies that were the hardest hit by the consumer credit card problems, shareholders injected new funds, increasing the average capital ratio of these companies to 19 percent at end-2005, from -5½ percent at the end of 2003. As a result, by 2005 credit card companies became profitable once again.

Nevertheless, the size and composition of household indebtedness remain a concern. While those households that were affected by the credit card crisis have been repairing their balance sheets, others have increased their borrowing, in particular mortgages. In aggregate, households' financial debts have increased faster than their financial assets, and now their debts compared to their assets are significantly higher than those observed in advanced economies such as the United States, United Kingdom and Japan. Moreover, their ability to pay their debt has weakened somewhat, because their disposable income has not grown as fast as their debt. At the same time, their loans have become more sensitive to interest rate fluctuations as they have increased their holding of loans with variable rates. Therefore, a sharp increase in interest rates could push debt payments beyond some households' ability to pay, and thus increase delinquencies.

Another area of concern is mutual savings banks. In 2005, mutual savings banks have sharply increased their loans, especially for construction and housing purposes. However, they have been doing this by often exceeding the loan-to-value ratios that are imposed on commercial banks, in many cases providing second mortgages. These savings banks' profit structure is already in a precarious state, reflected by more than half of them registering a deficit last year, with a significant number of them for at least two more years before that. Moreover, their capital base is not as strong as the commercial banks, their nonperforming loans are large, and provisions are insufficient. Therefore, a substantial increase in delinquencies will likely hit the mutual savings banks first and further weaken their already fragile position.

Appendix I

Table I.1. Korea: Financial Soundness Indicators, Total Banks
(percent, unless otherwise indicated)

	2001	2002	2003	2004	2005
Capital adequacy					
BIS capital adequacy ratio	11.67	11.33	11.16	12.08	13.00
Core capital (Tier I)/risk-weighted assets	7.69	7.16	6.95	7.96	9.32
Shareholders' equity/total assets	4.83	4.73	4.63	5.59	6.85
Loan quality					
SBL ratio (substandard and lower loans)	3.41	2.33	2.63	1.90	1.22
Loan loss provisions/SBL loans	76.07	89.59	84.04	104.46	125.20
Profitability					
ROA	0.66	0.60	0.17	0.85	1.26
ROE	12.76	10.91	3.41	15.16	18.41
Nominal interest margin (percentage points)	2.64	2.70	2.56	2.59	2.81
Net interest revenue/assets	1.34	1.67	1.85	2.08	2.24
Operating income/assets	0.68	0.80	0.28	0.96	1.11
Liquidity					
Current assets/current liabilities (in Won)	99.33	106.17	104.91	111.17	109.68
Current assets/current liabilities (in FX)	107.00	99.38	98.43	105.75	106.16
Current assets/total assets	31.69	28.21	28.87	36.11	36.27
Loans by class (percentage of total loans)					
Manufacturing		36.82	35.04	34.67	34.29
Real estate		44.38	45.53	45.13	46.57
Wholesale/retail		10.53	10.18	9.69	9.13
Corporate		51.54	51.86	49.90	48.82
Household		46.09	46.16	48.02	48.96
Bank loans to business (KW trillions)					
SMEs	165.4	202.8	237.8	245.1	257.8
Sole proprietor	47.7	67.5	85.8	89.8	91.6
Other SME	117.7	135.3	152.0	155.3	166.2
Large companies	47.9	45.3	42.5	40.1	45.0
Total	213.3	248.1	280.3	285.2	302.8

Source: FSS

APPENDIX II: KOREA—FUND RELATIONS
(As of July 31, 2006)

I. **Membership Status**: Joined August 26, 1955; Article VIII

II. **General Resources Account**:

	SDR Million	% Quota
Quota	1,633.6	100.0
Fund Holdings of Currency	1,444.6	88.4
Reserve Position in Fund	189.1	11.6

III. **SDR Department**:

	SDR Million	% Allocation
Net cumulative allocation	72.9	100.0
Holdings	33.3	45.7

IV. **Outstanding Purchases and Loans**: None

V. **Latest Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	12/04/1997	12/03/2000	15,500.00	14,412.50
of which: SRF	12/18/1997	12/17/1998	9,950.00	9,950.00
Stand-by	07/12/1985	03/10/1987	280.00	160.00

VI. **Projected Obligations to the Fund**
(SDR million; based on existing use of resources and present holdings of SDR's):

	2006	2007	2008	2009	2010
Principal					
Charges/Interest	0.75	1.52	1.52	1.52	1.52
Total	0.75	1.52	1.52	1.52	1.52

VII. **Exchange Rate Arrangement**:

Korea's exchange rate system is classified as "independently floating." Previously, the exchange rate against the U.S. dollar was allowed to float only within specified margins around the previous day's weighted average exchange rate in the interbank market. The margins were widened five times between March 1990 and November 1997 (most recently to +/-10 percent), and on December 16, 1997 were eliminated altogether. On September 8, 2006, the exchange rate was W 956.3=US$1. Korea maintains restrictions on transactions by certain individuals, groups and organizations in accordance with UN Security Council resolutions against the financing of terrorism. A 144 notification of these measures will be issued shortly.

VIII. **Last Article IV Consultation**:

Korea is on a 12-month consultation cycle. Staff discussions for the 2004 Article IV consultation were conducted on a mission to Seoul during October 13–28, 2004. The Article IV consultation was concluded by the Executive Board on January 21, 2005. In addition, two staff visits took place during May 30-June 7 and November 9–17, 2005.

IX. **FSAP and ROSC Participation**:

MFD: The final FSAP mission was conducted during October 2002. The mission completed the FSAP by assessing the short-term vulnerability of the financial sector to macroeconomic and sectoral shocks and analyzing overall financial sector soundness and developmental challenges, including issues arising from the draft standards assessments. A follow-up technical assistance mission on the supervision of derivatives markets was held in Seoul during January 9–20, 2003. The Financial System Stability Assessment report has been published (IMF Country report No. 03/81) and is available on the web through the following link: http://www.imf.org/external/pubs/ft/scr/2003/cr0381.pdf

FAD: Discussions on fiscal transparency were held in Seoul during June 2000, and a report was drafted and finalized in November 2000, with input from APD staff. The report has been published and is available on the web through the following link: http://www.imf.org/external/np/rosc/kor/fiscal.htm

STA: Discussions on Korea's data dissemination practices against the IMF's Special Data Dissemination Standard (SDDS) were held in Seoul during April 2001, and a report was drafted and finalized on November 28, 2001. The report has been published and is available on the web through the link: http://www.imf.org/external/pubs/ft/scr/2003/cr03127.pdf

X. **Technical Assistance**:

FAD: A technical assistance mission visited Seoul during January 8–19, 2001 to evaluate current practices in budgeting and public expenditure management and to provide advice on setting up a medium-term fiscal framework. A mission visited Seoul during August 31–September 16, 2005 to provide technical assistance on the reform of tax policy and administration.

MFD: A mission conducted a high-level technical seminar during May 16–22, 2000 on the development of the foreign exchange market. The seminar covered issues in supervision, market monitoring, derivatives instruments, and market microstructure. A technical assistance mission visited Seoul to provide advice on macroprudential and derivatives supervision during October 27–November 7, 2005, and on the reform and development of the foreign exchange market during March 30–April 13, 2006.

STA: A technical assistance mission visited Seoul during March 29–April 12, 2000 to provide advice on balance of payments and external debt statistics, with a view toward improving the recording of financial derivatives and developing an international investment position statement.

XI. **Resident Representative**:

The resident representative office in Seoul was opened in March 1998. Mr. Kenneth Kang has been the Resident Representative since September 2003. Meral Karasulu will start as the new Resident Representative in Seoul on September 11, 2006.

APPENDIX III: KOREA—STATISTICAL ISSUES

Korea's macroeconomic statistics and statistical base are adequate to conduct effective surveillance and the country subscribes to the Special Data Dissemination Standard (SDDS).

Real Sector

The overall structure of the **national accounts** mainly follows the *1968 System of National Accounts* (*1968 SNA*). While the delineation of the economy, the valuation rules, and the production and asset boundaries are in line with the *1968 SNA,* classifications are broadly in accordance with the *1993 SNA*. The Bank of Korea (BOK) plans to begin a gradual shift to the *1993 SNA*. The data collection program is not being fully exploited to compile the national accounts and there is scope to improve certain surveys. While the size of the informal sector is not known, informal activities (including some illicit activities) are expected to be reflected in the next revision of the national accounts. The commodity flow technique could be improved by moving to the Supply and Use Table framework, but there have been difficulties in obtaining the basic data required.

The **Consumer Price Index** (CPI) covers 36 urban city areas (about 82 per cent of the urban population) and is defined to exclude single person and farm and fishing households. The CPI could be further improved by also including single-person households and by and extending its coverage to sample from rural areas. The basket is updated every five years. New weights and a new market basket using the 2000 Household Income and Expenditure Survey were introduced in the CPI for January 2002. The geometric mean of price changes would be a suitable alternative to the ratio of arithmetic average prices as the formulas at the elementary level where products aggregated are not homogeneous.

The scope of the **Producer Price Index** (PPI) covers all domestic industrial activities and a large segment of service activity, as well as free trade zones and bonded warehouses. The PPI could be improved by imputing missing prices using those of similar commodities, rather than carrying forward the last reported price, as is sometimes the case.

Fiscal Sector

Two sets of government finance statistics (GFS) are compiled for the **central government**, using national definitions and using internationally recognized standards. Concepts and definitions used in the latter generally follow the recommendations of the *Manual on Government Finance Statistics 1986* (*GFSM 1986*). The data cover the budgetary units of the central government (including social security funds owned and/or managed by the government) and the extra-budgetary funds owned or managed by these units. These statistics are produced from the National Financial Information System (NAFIS), which integrates the preparation of budget data, accounting reports, and the generation of fiscal statistics on a monthly basis. The NAFIS provides for automatic crosschecks at different levels of the compilation process.

Consolidated GFS on the **general government** consistent with international standards are not compiled, with the central government accounting for about 75 percent of general government operations. Korea recently updated its 2002-05 GFS, and these data are expected to be published officially in the 2006 edition of the *GFS Yearbook*.

Monetary Sector

The overall quality of monetary statistics is generally sufficient for policy formulation. Following the recommendations of the 2001 data ROSC mission, revised monetary aggregates have been compiled since early 2002. These aggregates almost fully comply with the Monetary and Financial Statistical Manual (MFSM 2000). The analytical usefulness of data relating to foreign assets and foreign liabilities is affected by the BOK's practices of valuing its financial assets and financial liabilities at book value (rather than at market value) and revaluing its foreign currency denominated assets and liabilities twice yearly (rather than on a monthly basis). Also, some banks are using nationality rather than residency to distinguish between resident and nonresident individual and household accounts, affecting the accurate measurement of net foreign assets of the banking sector. The authorities have begun reporting monetary data to STA using the new Standardized Reporting Forms.

External Sector

The overall quality of **balance of payments** data is good. The BOK implemented the fifth edition of the IMF's *Balance of Payments Manual (BPM5)* in early 1998, but some deviations remain in the classification and sectorization of balance of payments transactions. Following liberalization, the coverage of the balance of payments statistics has become less comprehensive, as residents were permitted to conduct transactions via accounts with banks abroad. There is also incomplete coverage of transactions via intercompany accounts, nonresident won-denominated accounts with domestic banks, and noncash transactions. The BOK has developed an array of statistical techniques and collection systems to improve the coverage, classification, and timeliness of source data, including timing and valuation adjustments to trade statistics compiled from customs documents, grossing of certain services transactions, and recording long-term construction contracts under direct investment.

The quality of **external debt** statistics has greatly improved since the financial crisis. However, until September 2003, the statistics were not compiled on a residency basis, and certain external liabilities are excluded from the disseminated data. Hence, the external debt statistics were not comparable with the balance of payments statistics, or with external debt data disseminated by other countries. In September 2003, the BOK started to release external debt statistics on a residency basis according to the SDDS specifications; a debt service schedule, an encouraged item in the SDDS, is not disseminated. The BOK has released annual data on Korea's **International Investment Position** (IIP) for 2001–04.

Data dissemination on international reserves and foreign currency liquidity generally meets the **SDDS specifications** for periodicity, timeliness, and advance release calendar. In late April 2006, the authorities decided to disseminate foreign reserves on a monthly basis rather than twice a month, as had been done since 1997.

Appendix III
Korea: Table of Common Indicators Required for Surveillance
(As of August 24, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange Rates	08/24/06	08/24/06	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	July. 2006	Aug. 2006	M	M	M		
Reserve/Base Money	Jun. 2006	Aug. 2006	M	M	M	LO, O, LO, LNO	LO, O, O, O
Broad Money	Jun. 2006	Aug. 2006	M	M	M		
Central Bank Balance Sheet	Jun. 2006	Aug. 2006	M	M	M		
Consolidated Balance Sheet of the Banking System	Feb. 2006	Jun. 2006	M	M	M		
Interest Rates[2]	08/24/06	08/24/06	D	D	D		
Consumer Price Index	Jul. 2006	Aug. 2006	M	M	M	O, LO, O, O	O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	NA	NA	NA	NA	NA	O, LNO, LO, O	O, NA, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Jun. 2006	Aug. 2006	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q2 2006	Jun. 2006	Q	Q	Q		
External Current Account Balance	Jun. 2006	Jul. 2006	M	M	M	O, LO, LO, LO	LO, O, O, O
Exports and Imports of Goods and Services	Q2 2006	Jul. 2006	Q	Q	Q		
GDP/GNP	Q2 2006	Jul. 2006	Q	Q	Q	LO, LO, O, LO	O, LNO, O, O
Gross External Debt	Q1 2006	Jun. 2006	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[7] Reflects the assessment provided in the data ROSC or the Substantive Update (published on May 2003, and based on the findings of the mission that took place during April 11-25, 2001) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revision studies.

Statement by the Staff Representative
September 29, 2006

1. This statement provides additional information that has become available since the circulation of the staff report. The information does not change the thrust of the staff appraisal.

2. **Recent data continue to suggest that the economy is headed for a soft landing.** In August, the consumer sentiment index fell to a two-year low, but a rebound in large-store retail sales eased fears of a sharp worsening in consumption. At the same time, external demand remained very strong, with exports increasing by 16 percent (y/y) on average in the last three months.

3. **The Bank of Korea kept its key interest rate unchanged at 4½ percent in September.** The Bank noted that the economy was slowing while inflation remained subdued but warned that pressures could pick up if growth or oil prices rebound.

4. **The government announced the highlights of the draft budget for 2007.** The draft budget envisages a deficit of 1½ percent of GDP, the same as budgeted for 2006, with broadly unchanged levels of spending and taxation (relative to GDP). However, the composition of spending will be shifted toward the social safety net and away from infrastructure and public administration. Meanwhile, revenues from VAT and personal income tax are expected to increase rapidly on the back of measures to widen the tax base, while the share of excise taxes and taxes on transportation and securities in GDP would decline.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 06/111
FOR IMMEDIATE RELEASE
October 11, 2006

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2006 Article IV Consultation with Korea

On September, 29, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Korea.[1]

Background

For most of the period since early 2005, Korea has enjoyed the benefits of strong growth and low inflation. Output growth reached 6 percent, propelled by double digit export growth on the back of an upswing in the global electronics sector. Consumption also rose rapidly as households, which had been heavily overindebted following a credit card boom, advanced in repairing their balance sheets, helped along by a sharp rise in the local stock market and a pick up in housing prices.

These favorable conditions encouraged large capital inflows and the won strengthened considerably. This was only partially tempered by a shrinking current account balance, which has essentially vanished this year as the oil bill increased and domestic demand improved. The substantial won appreciation and falling regional food prices lowered inflation throughout 2005 and much of 2006, bringing inflation to the bottom of the Bank of Korea's 2½–3½ percent target band. Nonetheless, with output growing rapidly, the central bank gradually raised benchmark interest rates by 125 basis points starting in October 2005 to counter inflationary pressures pre-emptively, and to respond to mounting upward pressures on asset prices.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

However, recent signs show that the period of high growth is coming to an end. The economy is slowing as the consumption recovery is maturing, while the export boom—notably in electronics—may abate as the U.S. economy slows.

Staff anticipates a soft landing, with GDP growth easing from 5 percent in 2006 to 4¼ in 2007, while inflation remains low. This baseline scenario has risks however, which are tilted to the downside. In particular, the U.S. economy could experience a sharper than expected slowdown. This would have a major impact on Korea, given that exports account for 40 percent of GDP and the United States is Korea's second largest export market after China. Also, while ample reserves and healthy financial and corporate balance sheets would help cushion Korea, should global risk aversion increase, the associated increase in lending rates would hurt Korean households and small and medium enterprises given their high leverage.

While the performance of the Korean economy over the last year and a half has been encouraging, daunting challenges loom on the horizon. In particular, the population is aging rapidly, capital accumulation is decelerating, and overall productivity growth is falling. If these trends continue, potential output growth will slow substantially by mid-century, and strong fiscal pressures will emerge.

Executive Board Assessment

Executive Directors lauded the remarkable progress Korea has made since its first consultation with the IMF 50 years ago: over this span, the country has developed from a poor, agrarian society into a prosperous advanced economy. By integrating the manufacturing sector into the global economy, while maintaining prudent macroeconomic policies, Korea has been able to enjoy a prolonged period of strong growth and low inflation, which offers lessons for other countries. Looking ahead, Directors were confident that the Korean authorities would succeed in tackling the underlying long-term issues related to an aging population, decelerating capital accumulation, and falling productivity growth.

Directors noted that the Korean authorities have been tightening macroeconomic policies as a pre-emptive action against inflation. In recent months, the economy has begun to decelerate, and while a soft landing is expected, prospects could weaken if the slowdown in the United States proves sharper than expected, oil prices rebound, or global financial conditions tighten further. Meanwhile, inflation should remain subdued. In this environment, Directors considered that it would be appropriate to maintain a neutral fiscal stance. Similarly, they believed that any further monetary policy tightening should be data-dependent, based on signs of inflation. Directors endorsed the Bank of Korea's decision to shift to targeting headline inflation, a step that would improve transparency because this index is the one used and understood by the public.

Directors commended the authorities for adhering to their flexible exchange rate policy and allowing the won's value to be determined in the foreign exchange market, while limiting intervention to smoothing operations. They considered that overall competitiveness remains appropriate, as reflected in the sustained increase of Korea's share in global export markets.

With respect to financial stability, Directors noted the strengthening of Korea's banking system in recent years. However, they cautioned that mutual savings banks have been expanding loans rapidly, a situation that requires careful monitoring and steps to subject them to the same prudential regulations as banks. Directors endorsed the authorities' close monitoring of domestic foreign exchange lending, which has also been expanding rapidly. In addition, they recommended improving the flow of information to credit bureaus to help lenders respond to risks in a more timely and accurate fashion.

Beyond these immediate challenges, Directors emphasized the need to tackle longer-term problems. On current trends, potential growth will slow considerably, largely because the population is aging rapidly, while productivity growth has proved disappointing, especially in the services sector. The authorities' strategy to deal with this challenge is to open the services sector to more domestic and external competition, which Directors strongly supported.

Directors welcomed in particular the plans to develop the financial sector by integrating it further into the global and regional economy. They supported the planned deregulation of capital markets, noting that this measure will spur competition and innovation. Directors stressed, however, that this reform will need to be accompanied by measures to contain the accompanying risks, notably by imposing stronger sanctions against conflict-of-interest violations, and continuing to prevent industrial groups from owning banks. Many Directors favored maintaining a legal separation between investment banks and asset managers.

Directors also welcomed the plans to open up and deregulate the nonfinancial services sector. They emphasized the importance of multilateral trade liberalization in these efforts, urging the authorities to take a proactive role in advancing the Doha Development Round. Directors stressed that as Korea opens up its services sector, labor market flexibility will become increasingly important. They noted that the lack of flexibility in the regular labor market has led firms to replace permanent employees with fixed-term staff, which has exacerbated income inequality and social polarization. Directors therefore strongly recommended a renewal of efforts to secure a social consensus to ease conditions of regular employment, while continuing to strengthen the social safety net.

As a final longer-term challenge, Directors cautioned that Korea's traditionally strong fiscal position will gradually come under pressure from the aging of its population. Expenditure pressures will grow as health care costs climb, while pension costs will rise and eventually deplete the assets of the pension system under current parameters. Directors strongly endorsed the authorities' plans to keep the debt-to-GDP ratio low by creating fiscal space, putting the pension system back on a sustainable track, and containing health care expenditures. However, they stressed that the key to success was prompt action, especially on pensions, for the longer corrective actions are delayed, the more painful the measures would ultimately need to be.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Korea: Selected Economic Indicators

	2002	2003	2004	2005	2006 IMF Staff Projections	2007 IMF Staff Projections
Real GDP (percent change)	7.0	3.1	4.7	4.0	5.0	4.3
Consumption	7.6	-0.3	0.4	3.4	4.5	3.8
Gross fixed investment	6.6	4.0	2.1	2.3	1.8	4.0
Net foreign balance 1/	-0.2	2.5	3.3	1.4	1.4	1.0
Prices (percent change)						
Consumer prices (end of period)	3.7	3.4	3.0	2.6	3.0	2.7
GDP deflator	2.8	2.7	2.7	-0.4	-1.6	1.7
Labor market (in percent)						
Unemployment rate	3.3	3.6	3.7	3.7	...	...
Wage growth, manufacturing	12.0	8.7	10.0	7.8	...	...
Consolidated central government (In percent of GDP)						
Revenues 2/	23.2	23.7	22.9	23.7	25.3	25.7
Expenditure	20.9	21.0	20.7	21.6	22.9	23.2
Balance 2/	2.3	2.7	2.3	2.1	2.4	2.5
Money and interest rates (In percent)						
Overnight call rate	4.3	3.8	3.3	3.7	4.5	…
M3 growth	13.6	4.7	7.1	7.4	7.7	…
Yield on corporate bonds	5.9	5.6	3.7	5.5	5.1	…
Balance of payments						
Current account balance (In billions of U.S. dollar)	5.4	11.9	28.2	16.6	3.3	2.9
Current account balance (In percent of GDP)	1.0	2.0	4.1	2.1	0.4	0.3
Won per U.S. dollar (Period average)	1,252	1,192	1,146	1,024	…	...

Sources: Data provided by the Korean authorities; and IMF staff estimates and projections.
1/ Contribution to GDP Growth.
2/ Excluding privatization receipts and rollover of KDIC/KAMCO bonds.

Statement by John Nam Oh, Executive Director for the Republic of Korea and Jong-Won Yoon, Senior Advisor to the Executive Director
September 29, 2006

My authorities are most grateful to staff for their productive discussions and the high-quality papers covering impending and structural, longer term issues. There is a broad consensus between the staff and the authorities on most aspects of diagnosis of and policy recommendations for the Korean economy. My authorities highly value the Board's and the staff's views on Korea's reform agenda, which will help pave the way for resilient and sustainable growth into the future.

Given that the report adequately reflects the shared views between the authorities and staff regarding Korea's policy needs, we will focus on providing some background information on the economic outlook and macroeconomic policy responses, structural reform agenda to enhance the growth potential, and longer term issues, including population ageing and related fiscal issues.

Macroeconomic outlook

Growth at its potential level, low inflation, and modest current account surplus have been achieved since the second half of 2005. With the orderly resolution of the household debt bubble and helped by strong global demand, the Korean economy showed a resilient recovery, especially with consumption continuing to grow in tandem with income. Notwithstanding adverse shocks including high oil prices and rapid exchange rate appreciation, this year's growth is expected to reach around 5 percent, with a balance between domestic demand and net exports. While recent data show some signs of slowdown in industrial and service activities, they seem mainly to reflect temporary factors, and the authorities anticipate that the economy will get back on track, once these factors recede, with steady consumption and brisk exports.

Looking ahead, however, the authorities are vigilant of downside risks. Volatile oil prices, a possible deceleration of the US economy, and tightening global financial market conditions could adversely affect the Korean economy. Worsened terms of trade could also limit consumption recovery by impairing the purchasing power of consumers. While growth would moderate due to these uncertainties, my authorities agree with the staff that a soft landing can be expected, with growth rates staying close to their potential.[1]

[1] According to the authorities' projections based on the traditional production function approach, potential growth rates for 2006-2010 were estimated at the high 4 percent, compared to the mid- to low 4 percent by the staff. While growth projections are subject to uncertainties and vary depending on underlying assumptions, the authorities expressed concern that the staff's low growth projections based on somewhat conservative

Short-term policy responses

The authorities are broadly in line with the staff's view on macroeconomic policy directions. While the policy stance was accomodative to support the much- needed recovery until last year, it has gradually moved to a neutral one commensurate with the closing of the output gap. With downside risks looming ahead, the authorities are now closely monitoring market developments, and stand ready to maneuver in the event that such risks materialize.

Fiscal policies have been largely neutral. This year's budget envisaged a slight deficit at 1½ percent of GDP, with no frontloading of expenditures. While a supplementary budget was implemented in August with flood-related spending to the tune of ¼ percent of GDP, the actual outturn is expected to be a deficit at less than 1 percent of GDP.

As agreed between the staff and the Bank of Korea, future adjustment of policy rates would be data-dependent. As the policy rate was gradually raised by 125 basis points to the current 4.5 percent, it now seems to have approached its longer-term average. The Bank of Korea is prepared to respond flexibly to future market developments so as to guard the economy against output risk as well as inflationary pressure. Regarding the staff's recommendation on refining the inflation targeting framework, the Bank of Korea agrees in principle on removing the three-year assessment period. However, under the current situation where the inflation targeting system has not been firmly established, such a refinement could hamper flexibility in maneuvering monetary policy.[2] Therefore, the possibility of further refinement will be reviewed over the longer-term horizon, based on a careful assessment of the status of the inflation regime's stability.

The authorities have continued and are firmly committed to a flexible exchange rate policy. While there was a rapid appreciation of the exchange rate early this year due to expectation of further appreciation and large capital inflows, it has since stabilized, fluctuating at around 950 won vis-à-vis US dollar. In an attempt to alleviate pressures on the exchange rate coming from capital account surpluses and, more importantly, to deepen the foreign exchange market, my authorities have taken bold measures to remove remaining restrictions on capital account transactions and announced a timetable to accelerate complete liberalization by 2009. My authorities are confident that the liberalization measures would expedite the development of the foreign exchange market, a key element of the financial hub strategy.

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assumptions could exacerbate economic sentiment and result in a low-growth equilibrium by affecting expectations.

[2] Under the current situation where inflation regime is not yet very stable, the abolition of the 3-year assessment period could press the Bank of Korea to stick to the target constantly, which could result in its rigid operation.

On financial policy front, my authorities agree with staff that the financial markets should be guarded against potential dangers resulting from a renewed rise in global risk aversion. My authorities have moved forward on a greater provision of positive credit information, and plan to provide financial institutions with positive credit information held by the public sector. In the case of individual credit information, a private credit bureau has already begun to provide positive credit information. Also, my authorities agree with the need for curbing risks at the mutual savings banks (MSBs). Applying the same prudential regulations as banks to MSBs, however, will be carefully reviewed, taking into account the absorptive capacity of the MSBs based on their operational and financial status. Meanwhile, enforcement of the current prudential regulations will be strengthened, with continued efforts to restructure them.

Long-term growth potential and structural reform

My authorities broadly concur with the staff that the growth potential might slow over time with lower factor input, coupled with population ageing and stagnant total factor productivity. Therefore, the priority of government policy is moving more towards enhancing growth potential and addressing structural and longer-term issues, which include greater integration with the world, expediting structural reforms, and raising productivity of small and medium-sized enterprises and service industries, as well as coping with long-term risks including the graying of the Korean society and related fiscal issues.

Inviting competition through greater integration into the world economy will be pursued as a key to enhancing growth potential and strengthening competitiveness. Toward this end, the government is proactively working to achieve multilateral and bilateral cooperation with the world economy. The Korea-EFTA Free Trade Agreement became effective in September 2006**.** FTA negotiations with major countries including ASEAN, Canada, and more recently with the United States are now underway. My authorities anticipate that the ongoing FTAs will contribute not only to the expansion of Korea's overseas markets and but will also enhance the competitiveness of domestic industries by bringing in greater competition and meeting global standards.

My authorities share with the staff that an advanced financial sector plays a pivotal role in promoting efficiency and stimulating productivity. The government has been implementing the financial hub policy, for which a roadmap was drawn up in 2003, as an effective apparatus to advance the financial market. The legal and institutional framework has already been set up, and concrete policy measures are being implemented, including the establishment of the Korea Investment Corporation in 2005, the opening of the accounting market planned for 2007, and the deregulation of the capital markets. These efforts, together with the introduction of a retirement pension scheme and the building of foreign investor-friendly environments, aim to accelerate the globalization of Korea's asset management industry.

To integrate Korea's financial system into the global economy, the authorities are pursuing fundamental reform of the capital markets. A new bill on capital market consolidation, to be submitted to the National Assembly this fall, will bring together the Securities and Exchange Act, Futures Trading Act, and other capital market-related laws under a single Act. The bill, once passed, will serve to promote financial innovation and competition through deregulation and stronger investor protection, thereby streamlining some 300 financial regulations to 190. With regard to this initiative, the staff suggested the maintenance of a legal separation between underwriters and asset managers so as to minimize the potential conflict of interests. While my authorities are well aware of the risk, they are concerned that a strict legal separation would unduly limit the scope of the intended synergy effect. Instead, my authorities believe that financial institutions themselves should decide whether to place both businesses in-house or to run separate subsidiaries based on their cost and benefit of synergy effect, examples of which can easily be found in advanced countries.[3] In order to minimize the potential risk, however, my authorities intend to impose stronger institutional arrangements than in most advanced countries, which include an obligatory setup of internal control systems, restriction of staff and informational exchange, and strong legal penalties for conflict-of-interest violations.

My authorities are fully aware of the importance of greater labor market flexibility and improving social safety nets. The government has been preparing the legal groundwork for advanced labor relations with the participation of management and labor unions, which incorporates both enhancing flexibility and strengthening protection for the working vulnerable in the labor market.[4] With a view to expand social safety nets, the coverage of unemployment benefits was widened, and the Earned Income Tax Credit is planned to be implemented in 2008. Regarding the introduction of a new employment contract proposed by staff, the authorities will carefully review its feasibility.

Recognizing the significance of the service sector in the economy, my authorities are pushing forward with measures to open up and deregulate the non-financial service sector, notably in the business, educational, and medical services areas.[5] As noted by the

[3] Many top global investment banks are legally practicing both businesses as a single legal entity in such advanced countries as the United States, Japan, the United Kingdom, and Australia, which include UBS Global Asset Management Inc., Merrill Lynch Fund Managers Limited, Fidelity Investment Services Limited, HSBC Investment Funds Ltd., and Citibank International Plc.

[4] The law proposes: a single bargaining channel for multiple trade unions at a workplace, no wage payment to full-time union officials, rationalization of arbitration by authority and emergency adjustment processes, diversified relief programs for unfair dismissals, and easing of the layoff requirements for managerial reasons.

[5] A legal framework for foreign lawyers is being set up to ensure their sound activities in Korea. Rules on setting up and operating foreign schools have been eased. The school system has also become more diversified through the introduction of innovative public schools and independent private high schools. External investment in hospitals is being encouraged and steps will be implemented to prevent a sudden rise in medical costs and retain the competitiveness of the medical services sector.

staff, further integration of the sector into the world economy will help improve the sector's productivity, and a successful conclusion of the FTA with the United States will provide an impetus to this endeavor. When it comes to collateral for bank loans, my authorities will assess the possibility of intangible assets such as contracts being used as collateral, while intellectual property is currently allowed under the civil code. Also, my authorities are drawing up blueprints to allow banks and insurance companies to enter the commercial credit insurance market over the medium term.

Long-term risks and fiscal issues

The staff noted that the rapid pace of population ageing and low fertility would not only impair long-term growth potential but also aggravate the fiscal position over time. Being mindful of the grave consequences of delayed reform, my authorities enacted a Basic Law in 2005, and are closely overseeing the socioeconomic strategies on how to prepare for the graying of the Korean society. A comprehensive plan to cope effectively with these long-term risks has been drawn up, with concrete policy measures set into action. The policy package aims to: (i) provide incentives for childbirth; (ii) establish a social foundation for women to carry on both professional and family work so as to promote greater economic participation of females; (iii) cultivate ageing-friendly industries; and (iv) expand the socioeconomic infrastructure for elderly welfare.

My authorities agree with the staff that early and effective reform measures should be implemented in the areas of pension, health and long-term care so as to avoid undesirable fiscal consequences. A proposal to help bring the National Pension Fund back to financial health has been put forward, and the health care system is being revamped to contain its cost pressures. While it takes some time to reach public consensus, the much needed adjustments are expected to be made in the near future.

Korea is well-known for its sound and prudent fiscal position, and my authorities are fully committed to keeping its sustainability over the medium and long term. In order to address increasing expenditure pressures, my authorities have been strengthening efforts to consolidate expenditures and increase revenues. As for revenue measures, my authorities are focusing on broadening the tax base by removing various exemptions and strengthening enforcement rather than raising tax rates, which the staff supports. Off-budget spending will also be properly accounted for in the budget with the adoption of accrual budget accounting in the near future.

Conclusion

Korea is at a crossroads. While Korea has made remarkable success in the last 50 years of development history, the challenges we are now facing are entirely different in their nature from those in the past. We are faced with a rapidly ageing population, the speed of which is unprecedented, widening economic and social disparities; diminishing growth potential, and ever fierce global competition. Deeply mindful of the gravity of these challenges, my authorities have already moved forward in tackling them. Through maintaining sustainable government finances and sound monetary policy, greater integration with the global economy, and building an institutional environment conducive to growth by continued structural reform, we believe, Korea will make another giant leap forward and succeed in transforming itself into a knowledge-based, advanced country in the 21st century.