

# GENERAL AGREEMENT ON

RESTRICTED

BOP/R/183/Add.1

27 October 1989

## TARIFFS AND TRADE

Limited Distribution

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Committee on Balance-of-Payments Restrictions

CONSULTATION WITH THE REPUBLIC OF KOREA

Addendum

1. The Committee resumed its consultation with Korea on 23 October 1989. It had before it new documentation supplied by the Korean authorities (BOP/289/Add.2/Rev.1) and by the International Monetary Fund ("Recent Economic Developments" dated 15 September 1989 and supplementary material dated 26 September 1989).
2. The statements made at the meetings held in June and October 1989 by the representative of Korea and, at the invitation of the Committee, by the representative of the IMF, are annexed.
3. The representative of the IMF said that, in confirming the preliminary assessment reached in June 1989, she was aware that the precise wording used was giving a few members of the Committee pause, as being perhaps too close to the language in which the Committee formulated its decisions. The Fund did not wish to trespass on the work of the Committee. It was something of a surprise that the formulation used in conveying the Fund's assessment to the Committee - which was not new by any means - could give rise to difficulties for some members. The word "warranted" could be used interchangeably with "justified" and would convey the Fund's view just as well. From her point of view, thus, the Fund's finding could be read to say that the balance-of-payments position of Korea did not warrant maintenance of restrictions on imports. It was obviously for the Committee to decide how this finding related to the Committee's legal framework.
4. In reply to a question concerning the data supplied, the IMF representative said that the addition of preliminary statistics for January-September 1989, which were not available at the time of the IMF Board's discussion of the Korean situation, confirmed the earlier projection for a current account surplus of some US\$6 billion, or 3 per cent of GNP, for the year.
5. One member said that the information now available from the data presented by Korea, the Fund, and independent observations confirmed what had been obvious in June, that the invocation of Article XVIII:B was completely inconsistent with Korea's balance-of-payments situation. Korea's smaller surplus this year was the consequence of policies which had been undertaken to correct the unsustainable surpluses of 1987 and 1988. These policies should be continued. With real GNP growth projected at 5 to 6 per cent, growth in real domestic demand of 13.3 per cent in the first half of 1989, a large current account surplus, falling debt servicing, and increasing reserves, Korea's economy was one of the healthiest in the

world. Removal of import restrictions would assist the adjustment process. In the view of his delegation, Korea was no longer in a position to employ trade restrictions under Article XVIII:B and should disinvoke the Article now. The Committee's rôle was confined to determining whether or not Korea fulfilled the criteria for invoking Article XVIII:B. While his delegation was prepared to discuss the question of a timetable for phasing out of Korea's restrictions, this should not be a condition for disinvocation.

6. Several Committee members noted that the IMF's assessment of Korea's balance-of-payments situation confirmed the view expressed by the Fund at the previous meeting. Despite some turbulences, Korea's external position remained sound and prospects were good. In these circumstances, they said that trade-restrictive measures could not be justified under Article XVIII:B. A number of members recognized that the question of phase-out procedures could go beyond the competence of the Committee. It was recalled, however, that the Committee's reports were adopted by the Council and it was hoped that a practical solution could be found in this framework.

7. Members of the Committee welcomed Korea's commitment to disinvoke Article XVIII:B. Some members stressed the need for Korea to do so without delay. Korea was encouraged, in the light of established precedents, to develop, in consultation with other contracting parties, an orderly programme of liberalization which would phase out remaining restrictions in a reasonably short time. Liberalization should be undertaken in a practical way which took account of the need to avoid domestic political problems as far as possible. A realistic programme should be drawn up which would take care of Korea's requirements while being acceptable to the Committee.

8. In this connection, Korea's commitment to a steady, progressive liberalization programme was welcomed. Such a programme should give all due consideration to the interests of other contracting parties. Some members said that a phase-out period should be no longer than five years; a ten-year period was longer than was justified by the success of the Korean economy. However, the need for a flexible attitude was recognized, bearing in mind the social and political constraints which could be associated with liberalization. Consultation provisions would be an important element of the procedures. Understandings would also have to be reached concerning the rights of contracting parties under the General Agreement.

### Conclusions

9. The Committee took note of the evolution of the balance of payments of Korea since the last consultation. It noted the statement made by Korea concerning its present economic situation and future prospects, and the statement by the IMF on the strength of the reserves position and the positive results of Korea's economic policies.

10. The Committee welcomed the decision by Korea to disinvoke Article XVIII:B by 1 January 1990.

11. The Committee welcomed the substantial progress made by Korea in trade liberalization since the last consultation in 1987, and the current liberalization programme up to 1991 presented by Korea in document BOP/289/Add.1. The Committee recognized that appropriate flexibility was necessary for Korea to phase out, or bring into conformity with other GATT provisions, its remaining restrictions. It noted that these restrictions were largely concentrated in the agricultural sector.

12. The Committee welcomed the undertaking by Korea to eliminate its remaining restrictions or otherwise bring them into conformity with GATT provisions by 1 July 1997. It also welcomed the undertaking given by Korea to continue to phase out its remaining restrictions in a generally even manner, on a most-favoured-nation basis, over two three-year programmes beginning on the expiry of the current liberalization programme. It recognized the undertakings given by Korea to report the progress of liberalization annually to the Council, to notify to the Council its three-year programmes for liberalization by March of the year before their introduction, and to give all due consideration, in drawing up its programmes, to the interests of other contracting parties in a balanced manner. Such interests would be communicated to the GATT secretariat.

13. The Committee understood that, on the basis of the implementation of these undertakings by Korea, other contracting parties will exercise due restraint in the application of their rights under the General Agreement in relation to products included in the programmes of liberalization.

14. The Committee recommends to the Council that it adopt the report and agree to the points set out above, as emerging from the Committee's discussions.

ANNEX I

1. Statement by Korea, 27 June 1989

This is the thirteenth time that Korea is consulting with its fellow contracting parties under Article XVIII:B since its accession to GATT in 1967, and the seventh full consultation.

The present session of balance-of-payments consultation with Korea is taking place at a time of particular importance in terms of the Korean economy as well as the future of the GATT system itself.

For Korea, the timing of this consultation coincides with serious downturn in its economy, after years of virtually uninterrupted growth.

For GATT, this is a crucial time when assessment of the existing world trading system and charting new direction for the system's future are being conducted in the context of the Uruguay Round negotiations. At this consultation we are handling a case, the impact of which may reach far beyond the question of one country's balance-of-payments restrictions. To our knowledge, it is the first time that in this Committee the validity of the invocation of Article XVIII:B by a developing country is being questioned. As we understand, there are no specific criteria or precedents in this regard, on the basis of which the Committee can draw conclusions. Therefore, the decision to be made by the Committee on the case in hand will set a very important precedent for other developing countries in the years to come.

Against this background, I should like first to describe Korea's current economic situation, including particular difficulties faced by Korea in recent months. Next, I will move on to the trade liberalization measures Korea has been taking and will take in the future.

Then I would like to share with the Committee the impact on Korea of the future liberalization programme, and the BOP issues related to it.

Recent Economic Developments

Since the basic document, BOP/289, on the current economic situation of Korea submitted by my delegation, has been already made available to the Committee, I will concentrate on the developments and difficulties we are recently experiencing.

In 1988, the Korean economy recorded a GDP growth of 11.3 per cent, somewhat lower than that in the previous two years. In the same year, the current account balance recorded a surplus of US\$14.2 billion. Of this, the trade surplus was US\$11.4 billion while the invisible account surplus was US\$1.3 billion. The latter surplus was largely due to an increase in tourist revenues during the Seoul Olympics.

The overall favourable economic performance last year was attributable to a number of both external and internal factors. Among other things, the world economy was relatively good and the oil price remained stable throughout the year. Noticeable expansion of domestic consumption also contributed to the high growth rate of the economy.

If we look deeper into the Korean economy, however, the scene becomes less bright. Since the last balance-of-payments consultation in November 1987, various worrisome developments have taken place, casting serious doubts on the future of our economy. Manufacturing and export, the two sectors which had played a major rôle in our economic growth in the past, began in mid-1988 to show clear signs of decline, raising concern over whether our economy has not lost its momentum of growth. Entering 1989, most relevant economic indicators developed in a way that could justifiably create a strong apprehension that the Korean economy may embark upon a speedy downward trend, as the effects of those developments materialize in the coming years.

Let me briefly elaborate on some of the new difficulties the Korean economy is now faced with.

Firstly, labour disputes pose a serious threat to the Korean economy and society. Until the mid-1980s, labour disputes have been limited to only a handful of labour-intensive manufacturing industries. However, in recent years, they have spilled over to the whole manufacturing sector including the basic industries and to the service sector.

As a result to the continuing disputes, wages were driven up sharply, whereas the increase in labour productivity substantially slowed down. In the 1980s, up to the middle of 1987, the average annual wage increase remained at the level of 10 per cent. However, in 1988 coinciding with the democratization process in Korea, the wage increased by 19.6 per cent, and by May 1989, the wage increase surpassed the level of 20 per cent and continues to rise.

Labour disputes and work stoppages are becoming increasingly frequent, longer and more violent. The wage increase outpacing productivity has caused a sharp drop in the competitiveness in the Korean industries, thus adversely affecting Korean exports and moreover its overall economy.

According to my Government's estimation, labour disputes caused production and export losses, amounting to US\$4.5 billion and US\$1 billion respectively during the first five months of this year. What is more serious is that it has also dampened the investment climate in the private sector, which may prove to be seriously detrimental to the economic growth in longer term. For example, in the first quarter of 1989, the increase in the private equipment investment remained as low as 2 per cent compared to 16.7 per cent the same period last year.

Secondly, the appreciation of the won. Since September 1985, Korean won has significantly appreciated against major foreign currencies; for

example, by 34 per cent against US dollar. In 1988 alone, it appreciated by 15.8 per cent against US dollar. In particular, light industries such as textiles, toys and footwear manufacturing were severely hit. In 1988, hundreds of companies went bankrupt.

Thirdly, the price stability, which had contributed much to the smooth growth of the Korean economy during past five years, began to break off and gave way to further inflationary pressures. In 1988, these pressures pushed the consumer price up by 7.2 per cent, the highest level since 1982. Such trends are expected to continue for some time.

Before moving on to the balance-of-payments situation, I would like to give the Committee a brief account on the built-in weakness and unique character of Korea's economic structure.

In a piece of land which is even smaller than the State of Virginia in the United States, and 70 per cent of which is mountains, 42 million people live. Korea is poorly endowed with natural resources, without even a single drop of crude oil produced. The ratio of foreign trade vis-à-vis Korea's GNP is as high as 75 per cent as of 1988, showing an extremely high sensitivity of the Korean economy to the change of international market situations. Furthermore, Korean people have engaged mainly in agriculture over several thousand years. It is only from the early 1960s that Korea embarked upon the industrialization process. It is for this reason that the Korean economy even after achieving a high rate of growth within a time span of three decades, still suffers from built-in structural weakness.

Korea's development policy and strategy which concentrated on industrialization and export-orientated growth during the past 30 years resulted in a wide development gap between agricultural and non-agricultural sectors, and in imbalance of income level between urban and rural areas. In 1988, the agricultural sector accounted for only 10.9 per cent of the GNP while it employed 17.2 per cent of the population or 7.3 million people.

#### Balance-of-Payments Situation

Korea has suffered from chronic current account deficit as well as trade deficit for nearly 40 years since its independence. Even in the first half of the 1980s, the average annual current account deficit amounted to US\$3 billion.

It was only in 1986 when Korea for the first time experienced a current account surplus, which continued through the ensuing two years. Such current account surplus was realized mainly owing to the coincidental trade surplus. The trade surplus which occurred during the said period was by and large due to favourable international circumstances including low oil price and low interest rate.

Unfortunately, in the earlier part of 1989, an undesirable change began to show its shape on Korea's economic scene.

The real GNP growth rate fell down to 5.7 per cent in the first quarter of 1989, while the current account surplus shrank to US\$1.3 billion from US\$2.9 billion for the same period of last year.

In March 1989, on the basis of customs clearance statistics, Korea's trade balance reversed into deficit of US\$5 million for the first time after 35 months of continued surplus. In April and in May, a trade deficit of US\$34 million and US\$66 million was recorded respectively, with the accumulated trade deficit reaching US\$10 million for the first five months period. This is in stark contrast to the US\$2.3 billion surplus recorded during the same period last year.

Korea's external debt stands at the level of US\$31.2 billion as of the end of 1988. Korea was able to reduce the size of external debt from the peak of US\$46.8 billion in 1985 to the current level. During the three-year period coinciding with the period for registering current account surplus, Korea's foreign debt was reduced by US\$15.6 billion. There is always correlation between smooth continued repayment of foreign debt and the size of current account surplus.

Korea's foreign exchange reserve at the end of 1988 was US\$12.3 billion, which is equivalent to the cost of merely 2.5 months' imports of goods and services. It is also important to note that Korea's oil import in 1988 took up 30 per cent of its foreign reserve. This shows the insufficiency of Korea's foreign exchange reserve which may be quickly depleted if oil price goes up.

#### Trade liberalization

Since the early 1980s Korea has consistently pursued policies to liberalize its market and reduce tariffs, and it will continue to do so in the future.

Since the last balance-of-payments consultation held in November 1987, Korea added 333 items in 1988 to the liberalization list covering both industrial and agricultural products. This brought the import liberalization ratio up to 94.7 per cent and also represented a remarkable improvement over a liberalization ratio of only 68.6 per cent in 1980.

With regard to tariffs, Korea reduced tariff rates in a five-year schedule starting in 1984. As a result, the average tariff rate was lowered from 23.7 per cent in 1983 to 18.1 per cent in 1988. According to yet another five-year tariff reduction schedule starting in 1989, the average tariff rate will be lowered to 7.9 per cent in 1993, which is comparable to levels in OECD countries.

In addition to these import liberalization and tariff reductions, Korea has improved import access to its market by taking necessary measures including the abolition of the import surveillance system designed to prevent import surges of newly liberalized items. These measures also included the reduction of the number of restricted items under special laws.

Further measures have been taken to liberalize invisible transactions, foreign investment in Korea and overseas investment by Koreans. By 1993, overall report system will be introduced in place of approval system for foreign investment in Korea.

In April 1989, my Government announced a new three-year programme for liberalization covering 273 products, including 237 agricultural items which will cover the period from 1989 to 1991.

The liberalization programme did not come without pain. The Korean Government last January faced furious opposition from the agricultural producers, including violent demonstrations by tens of thousands of farmers in front of the National Assembly. In February, the so-called "red-pepper riot" boiled up to the brink of creating serious social chaos. These examples are indications of the gravity of the market opening for Korean farmers.

#### Future liberalization programmes

After implementation of the said three-year liberalization programme, certain items, mostly agricultural products, will remain restricted subject to Article XVIII:B. They are 274 items as classified under the 10-digit HS, 2.7 per cent of total 10,241 items on the tariff line, as the list in document BOP/289/Add.1 shows. Additional liberalization programme will be drafted in due course so that it can be announced by March 1991. The process is difficult and lengthy because the remaining items are mostly agricultural products.

Liberalization of agricultural trade is a highly sensitive issue that cannot be dealt with only on the basis of economic considerations, because it inevitably entails social and political implications. GATT has experienced the difficulty of handling agricultural trade throughout its forty-year history.

#### Conclusion

Korea's current economic situation and the outlook for its balance of payments are bleak. They are likely to worsen because, among other things, the difficulties facing the economy are essentially structural and caused by the fundamental changes in socio-political factors.

Even under worsening economic conditions, Korea will pursue the process of liberalization without interruption. I hope that the Committee will duly acknowledge and appreciate the trade-liberalization measures which Korea has taken in the past, the liberalization steps it is currently taking, and those which it is to take in the future.

In view of instability and uncertainty of its current economic and balance-of-payments situation, Korea believes that a continued invocation of Article XVIII:B for some time would be most desirable.

However, I do not foreclose the possibility of discussing disinvocation of Article XVIII:B, provided that the Balance-of-Payments Committee:

- (1) recognizes Korea's need for and agrees to a grace period sufficiently long enough for further liberalization and phase-out of the restrictions presently under BOP cover after its disinvocation, and
- (2) reaches an understanding that Korea will not be subject to any unilateral actions or to multilateral legal challenges in terms of GATT provisions during the agreed grace period.

2. Statement by Korea, 23 October 1989

At the outset, I would like to state that it was by and large owing to its external trade that Korea could develop itself from the rubbles of war several decades ago to one of the important trading nations of the world today, and that, for this reason, Korea remains firmly committed to the free-trade system under the GATT.

At the previous consultation which was held in June, I made a statement providing the Committee, among others, the difficulties the Korean economy was facing.

Notwithstanding those difficulties, I did not foreclose the possibility of discussing the disinvocation of Article XVIII:B, provided that certain flexibilities including a grace period could be allowed to Korea in phasing out the existing restrictions long justified under the said Article.

During the course of discussions last June, the members of the Committee, appreciating Korea's difficulties, particularly those in the agricultural sector, recognized the need for such flexibilities, and the Chairman of the Committee took the trouble to draft a formula whereby Korea was to phase out the balance-of-payments restrictions, upon its disinvocation of Article XVIII:B.

During the intervening four months' period, we have carefully examined the Chairman's draft formula, weighed the possible impacts of the disinvocation, and studied the ways to minimize such impacts.

Today I would like to put forward a proposal for consideration by the Committee.

Before doing this, let me first give you an account of the latest economic developments in Korea since the June meeting which unfortunately sustain the concern I expressed four months ago over the gloomy prospect of our economy.

The aggravation of the trade balance that was already evident four months ago has continued even after the last consultation, and has thus deteriorated Korea's overall balance-of-payments situation.

As of the end of the first half of this year the real GDP posted a meagre 5.8 per cent growth showing virtually no improvement since the end of the first quarter but sharply down from the 11.1 per cent growth in the same period last year.

The current account surplus during the first eight months of this year stood at only US\$2.7 billion which is a decrease of 65 per cent from US\$7.9 billion a year ago.

What is alarming is that in August this year, Korea's monthly current account turned into a deficit of US\$136 million for the first time in 42 months.

Poor trade figures were the main factor behind such a decline. It was mentioned in my opening statement of the June meeting that for the period of March-May this year Korea's trade balance on the customs clearance basis has reversed into a deficit after nearly three years' continued surplus. The ensuing months were no exception, for, by the end of August this year, the aggregate trade deficit on the customs clearance basis reached US\$342 million showing significant aggravation from a US\$10 million deficit during the first five months of this year.

Furthermore, exports of automobiles, footwear, textiles and iron and steel products are being substantially decreased since the turn of the year due to loss of competitiveness in foreign markets. This has a worrisome implication on overall performance of Korean economy since these industries have been the driving force behind Korea's export-oriented growth.

These trends are not likely to be reversed in the near future, since such poor record both in export performance and balance of payments is largely attributable to the structural factors embedded in the nation's economy, such as excessive appreciation of the won, drastic wage increase, stagnant labor productivity and decline of international competitiveness. Furthermore, the deterioration of market access situation in Korea's traditional export markets coupled with our own market opening efforts would not warrant any substantial improvement in our trade balance.

It is highly probable that our current account balance would become even worse next year. In fact, some leading economic research organizations in Korea have been predicting a substantial downward trend.

The trend also vindicates our argument four months ago that it was premature to conclude that Korea had now obtained a sound and stable current account surplus on the basis of the surplus experienced only for the last three years after 40 years of chronic deficit.

What makes Korea more worried about simply disinvoking the Article XVIII:B without obtaining due grace period is the fact that the items subject to liberalization after the disinvocation are mostly agricultural products. If the balance-of-payments cover were to be removed abruptly, the Korean farmers would receive a severe and irrevocable damage, thus creating a most sensitive social and political problem.

On agricultural trade, it is generally recognized that the abrupt opening of the market may create immense difficulty for any country because of its special characteristics. For this reason, even many developed countries still maintain various mechanisms for protection of their agricultural market.

Agricultural trade was one of the most difficult issues in the past GATT/MTN negotiations, and remains to be so in the ongoing Uruguay Round negotiations. I will come back to this point later in my presentation.

Korea's development policy in the past three decades concentrating on the industrial sector has left a wide gap of income level between the urban and the rural areas. As of now, therefore, the agricultural sector is far behind.

To cite 1988 statistics, Korean farmers account for 17.3 per cent of the total population of 42 million, but their income occupies only 10.9 per cent of the GNP of the nation.

Although farming population has been continuously declining from 15.8 million in the early 1960s to 7.3 million today, more than 60 per cent of total farm households still have less than one hectare of cultivable land on an average. Only 40 per cent of Korean farmers' total income comes from non-farming activities, and more than 80 per cent of Korean farmers are presently in debt.

Under such a grave circumstance, we believe that the question of agricultural market liberalization cannot be dealt with in the context of simple comparative advantage. It is an issue having direct bearing on the very existence of the farming population, with far-reaching social and political implications.

Now, returning to the Uruguay Round, I would like to point out that the TNC meeting last April also recognized the difficulty for any country to achieve the full liberalization of agricultural trade. The April text says "the long-term objective is to provide for substantial progressive reductions in agricultural support and protection sustained over an agreed period of time."

From this text, it is quite clear that what the Uruguay Round negotiators are seeking to achieve is a progressive and gradual reduction of agricultural support and protection over a long period.

Therefore, the argument we came across last June that Korea should remove all restrictions on agricultural trade within a short period of time

runs counter to the spirit and element of the April agreement on agriculture.

As I have mentioned earlier, a number of developed countries still maintain various mechanisms for protection of their agricultural market in one way or another.

If, in spite of all these, Korea, a developing country experiencing balance-of-payments surplus only for three years in its entire history, were to be completely undressed of all protection of its agriculture and thrown out into the cold with only a nominal grace period, we cannot but express our serious doubt as to the justice and fairness of the GATT system itself.

By saying this, however, I do not mean that Korea will shy off the global initiatives in terms of agricultural trade liberalization. Korea has already embarked upon implementing the three-year agricultural market opening plan, running up to 1991. We are committed to eventual import liberalization for agriculture. What we are calling upon the Committee now is to provide Korea with flexibility in carrying out such liberalization in connection with the disinvocation of Article XVIII:B.

Now, noting the feeling of the Committee embodied in the Chairman's draft formula, and taking into consideration the difficulties faced by Korea, I would like to propose the following:

We will agree to disinvoke Article XVIII:B provided that the CONTRACTING PARTIES:

- (i) agree to a grace period of ten years from the date of disinvocation;
- (ii) allow Korea to phase out during the grace period the existing balance-of-payments restrictions in a progressive manner, but having due regard to the interests of other contracting parties; and
- (iii) reach an understanding not to take any unilateral or multilateral legal actions against Korea's remaining restrictions during the given grace period.

I would like to elaborate on these points.

First, we request ten years of grace period to start from the date of the disinvocation.

Given the fact that even some developed countries are not prepared to commit themselves to total elimination of trade restrictions or supports in agricultural trade at the Uruguay Round negotiations, the ten-year time Korea asks for a grace period is by no means too long.

Korea needs at least ten years to carry out its structural adjustment or reform in agricultural sector.

According to the long-term projection of the Ministry of Agriculture, Forestry and Fisheries, by the turn of the century, the farming population is to be brought down to 11 per cent of the total population, landholding per farming household to be increased to 1.5 hectare, non-farming income to constitute 50 per cent of the total farming household income, income gap between urban and rural areas will be considerably narrowed down, and Korean farmers will enjoy relatively high level of farming mechanization.

Second, Korea suggests that, during those ten years, the restrictions be phased out through implementation of successive three-year liberalization schemes in continuation of the first three-year liberalization scheme announced last April. Korea will announce subsequent three-year schemes by March of the year preceding the start of each scheme.

We want to establish our schedules and implement them by the three-year time unit, because we find it the most manageable mechanism under the circumstances.

In formulating and implementing the liberalization schemes we will take into consideration the particular interests of any contracting party, if requested through the GATT secretariat.

We also undertake to report the progress of liberalization to the GATT Council.

Lastly, Korea requests that the CONTRACTING PARTIES reach an understanding to the effect that Korea will not be made subject to any unilateral or multilateral legal actions with regard to the remaining restrictions during the grace period.

At this consultation, we are handling a case, the impact of which may reach far beyond the question of any one country's balance-of-payments restrictions. The phase-out formula that the Committee is going to lay down at the end of the current consultations with regard to Korea's import restrictions under the balance-of-payments cover will certainly set a precedent for the disinvocation of article XVIII:B by many other developing countries.

With this in mind, the Korean delegation is prepared to participate in the Committee discussions with all its sincerity with a view to seeking a practical solution acceptable to all the members of the Committee.

ANNEX II1. Statement by the Representative of the International Monetary Fund,  
27 June 1989

During the 1980s, economic management in Korea has been dominated by structural adjustment measures aimed at bringing the domestic economy and the external balance into lasting equilibrium. In the first half of the 1980s, adjustment policies focused primarily on improving the current account balance and reducing the growth of external debt. The focus changed in 1987 when, in response to the dramatic improvement in economic performance, policies were shifted toward reducing the underlying external surplus to about 2-3 per cent of GNP while sustaining high non-inflationary growth.

The reorientation of policies since 1987 was supported by the Fund at the conclusion of the 1988 Article IV consultation on 18 May 1988. The Fund commended the authorities for the broad-based adjustment measures already taken, and recognized that these measures and other developments, notably large increases in wages, were working to reduce the external surplus. They agreed that demand management policies could support, but not lead, the needed structural measures that would both reduce the external surplus and increase the domestic standard of living.

Developments in 1988 clearly show the effects of the policy line adopted in 1987. Although growth was maintained at about the same high rate - 12 per cent in real terms - as achieved in 1987, its structure was markedly different. The contribution of the external sector declined, while that of domestic demand picked up. This shift reflected, in part, large increases in disposable income from wages, which were only partly offset by a rising inflation rate.

Despite the shift in the underlying trend toward higher domestic absorption, the current account surplus widened from \$10 billion in 1987 (8 per cent of GNP) to \$14 billion in 1988 (8½ per cent of GNP). This widening resulted primarily from higher US dollar prices of traded goods and a small gain in the terms of trade. A sharp fall in export volume growth was to some extent matched by imports, reflecting the high import content of exports, and imports and exports grew at roughly the same rate in real terms.

The adjustment process in 1988 was supported by a continued appreciation of the won. By the first quarter of 1989, the nominal effective appreciation of the exchange rate, together with the relative acceleration of consumer prices and unit labour costs, had fully eroded the gains in external competitiveness that had been registered between mid-1985 and mid-1986. In fact, measured against major competitors rather than trading partners, there may have been some net loss in competitiveness as exchange rate changes were about similar, but Korean unit labour costs rose faster than elsewhere.

The Korean authorities continued their market-opening and economic restructuring efforts during 1988 and early 1989. The central elements in these policies have been measures to liberalize and improve access to domestic markets. In May 1988, the Fund commented that, while substantial progress had been made in market opening, there remained ample room for action in this area. Indeed, the authorities intensified their market-opening efforts during 1988 and 1989, and further measures are planned as part of an overall strategy of phased liberalization.

Effective 1 November 1988, Korea accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Fund's Articles of Agreement. In addition, restrictions on external capital transactions have been eased, and a four-year phased capital market internationalization plan was introduced in December 1988. Under this plan, the domestic equity market will be gradually opened up to foreign investors, and, by 1992, non-resident foreigners will be able to invest directly in portions of the equity market.

By early 1989, the number of restricted import items was lowered to 5 per cent of total items, with most manufactured goods free of quantitative import restrictions. Individual health and safety laws, which mainly affected imports of foodstuffs, cosmetics, and pharmaceuticals have also been simplified. Most remaining import restrictions relate to agricultural products, and a further phased reduction in the ratio of restricted import items to less than 3 per cent is to be completed by 1991. In April 1989, a three-year schedule for the liberalization of 243 of the 643 agricultural, forestry, and fisheries products currently subject to quantitative import restrictions was announced.<sup>1</sup> The schedule will raise the liberalization ratio for these products from 72 per cent in 1988 to 85 per cent in 1991. Liberalization of the agriculture, forestry, and fisheries sector will be accompanied by a fiscal programme designed to support a restructuring of this sector to improve efficiency and foster competition in a freer market environment.

Following the completion of a five-year (1984-88) tariff reduction programme, a second five-year programme was introduced, effective 1 January 1989, which will lower average tariffs from 18 per cent in 1988 to 8 per cent in 1993, comparable to levels in OECD countries. As a result of this programme, the proportion of tariffs imposed at a rate greater than 20 per cent will fall from 8.6 per cent in 1988 to 5.7 per cent in 1993. Over the same period, the modal tariff level will decline from 11-20 per cent (66 per cent of all tariffs) to 6-10 per cent (61 per cent of all tariffs). At the same time that the Korean authorities put in place their trade liberalization programme, Korean exports have continued to be subject to restrictive measures as noted in the RED, dated 4 May 1988, made

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<sup>1</sup>Of the 643 agricultural, forestry, and fisheries products, subject to quantitative import restrictions, restrictions on 501 items are justified by the Korean authorities under Article XVIII:B.

available to the Committee, and as set out in the secretariat's report C/W/590 on Developments in the Trading System, dated 2 June 1989.

Financial policies in 1988 and 1989 have been geared toward preventing excessive demand pressures from emerging that would result in higher inflation. The fiscal balance recorded a small surplus in 1988 as a result of strong revenues that reflected the rapid growth of incomes. Inflationary pressures and the large inflows of liquidity associated with the external surplus have created a policy dilemma for the authorities. While credit policies have been tightened to combat inflation, they have also placed upward pressures on domestic interest rates. This, in turn, has encouraged external capital inflows thereby further complicating the task of monetary management. As part of a policy to move toward market-determined interest rates, most bank and non-bank lending and some deposit rates were deregulated in December 1988.

In the first quarter of 1989, the growth of real GNP slowed down to 5½ per cent. In the period of January-April, the current account surplus fell to \$1.7 billion, less than half that recorded a year earlier, although net foreign assets continued to rise. Based on preliminary data, real exports may have declined by 3 per cent, while real imports were up by about 10 per cent as compared with a year earlier. To some extent these developments reflected transitory factors, notably a disruption of production owing to widespread labour disputes associated with the springtime round of wage negotiations.<sup>2</sup> Letters of credit, which are a leading indicator for export shipments, showed considerable recovery in April and May.

The forthcoming 1989 Article IV consultation mission will analyse in depth the latest developments in Korea's balance of payments. Nevertheless, it is clear that Korea's underlying external position has strengthened considerably over the past several years. The level of international reserves has increased substantially, even though foreign debt has been prepaid. Gross official reserves reached \$12.3 billion by end-1988, equal to 2½ months worth of imports of goods and services, and rose \$2½ billion further in the first four months of 1989. At the same time, gross foreign assets of the rest of the banking system, amounting to \$8½ billion at end-1988, provided a further reserve cushion. With the prepayment of external debt of some \$4 billion, the debt service ratio, excluding debt prepayment, fell to about 9 per cent in 1988, less than one half its 1986 level.

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<sup>2</sup> Among the transitory factors contributing to the decline in the current account surplus in early 1989 was also a retiming of imports to take advantage of tariff cuts that became effective on 1 January 1989; these cuts exceeded those implemented on 1 January 1988, as a portion of the cuts foreseen for that date had been implemented in July 1987.

On the basis of the information now available but prior to the Article IV consultation discussions with the Korean authorities that are to be held shortly, the preliminary view of the Fund is that, in light of Korea's balance-of-payments and reserve position, restrictions on imports can no longer be justified on balance-of-payments grounds. The Fund's assessment will be confirmed following the Article IV consultation discussions.

2. Statement by the Representative of the International Monetary Fund,  
23 October 1989

Since the GATT's Balance-of-Payments Committee's consultation with Korea in June 1989, the Fund has concluded its 1989 Article IV consultation with Korea on 6 October. The statement today is intended to provide an update to the Fund's statement delivered in June, based on the information received and discussions held with the Korean authorities during the recent Article IV consultation.

Since the Fund's statement in June, it is yet clearer that the economy is firmly on the path of adjustment. Output growth was nil in the first half of 1989, but it is projected to recover in the second half to an annual rate of about 9 per cent, implying growth of 5-6 per cent for 1989 as a whole compared with annual rates of 12-13 per cent during 1986-88. The present slowdown in growth is primarily due to a sharp swing in the contribution of the external sector from 1 per cent in 1988 to a negative 5 per cent in 1989. Domestic demand, by contrast, remains strong. This shift in the pattern of growth reflects the effects of continued high wage settlements and the lagged adjustments sizable increases in wealth and income, as well as the authorities' policies. Consumer price inflation in 1989 is expected to moderate to 6 per cent compared with 7 per cent in 1988.

Korea's external current account surplus fell to \$2.7 billion in the first eight months of 1989, about one third its level a year earlier. To some extent, this decline reflected transitory factors in the first half of the year. However, letters of credit, a leading indicator of export shipments, weakened in June and July following the recovery recorded in April and May. For the year as a whole, the current account surplus is projected to decline to \$6 billion (3 per cent of GNP) compared with \$14 billion (8½ per cent of GNP) in 1988. This reduction in the surplus is due to a projected decline in export volume of about 4 per cent together with an increase of about 10 per cent in import volume.

The steady appreciation of the won since late 1987 was continued in the second quarter of 1989, with the won exchange rate rising by a further 5 per cent in both nominal and real (CPI) effective terms. Since the second quarter, the exchange rate has remained broadly stable in nominal effective terms. In total, the nominal appreciation of the won and the relative increase in domestic prices since 1987 has fully reversed the increase in external competitiveness registered between late 1984 and mid-1986. Indicators of competitiveness based on export unit values show

similar movements, while measures based on unit labour costs have risen by less.

The authorities are committed to the liberalization and opening of domestic markets, and, during 1989, they have continued to implement measures to achieve this. The main measures undertaken in 1989 were noted in the Fund's statement in June, in particular the three-year agricultural and fisheries import liberalization programme announced in April, and the second five-year tariff reduction programme that commenced on 1 January. A more detailed description of these measures is contained in the report on Recent Economic Developments and its Supplement, dated 15 and 26 September 1989, respectively. Most recently, the authorities have been actively studying the reform of the exchange rate<sup>3</sup> system so as to enhance the influence of market forces on exchange rates. As a first step, the won exchange rate has been allowed, effective 20 September, to fluctuate within a specified band on a daily basis.

In view of the sharp decline in external demand, financial policies in 1989 are designed to provide moderate support to the expansion of domestic demand, while containing domestic price pressures. The fiscal balance is expected to move from a surplus of 1 1/4 per cent in 1988 to a small deficit in 1989, as revenues weaken owing to the deceleration in economic activity. Monetary policy in 1989 has continued to be directed at sterilizing the monetary impact of the balance-of-payments surplus through open-market operations and a tightening of credit policies. This has sustained upward pressures on domestic interest rates in the first half of the year. Monetary growth for the year as a whole is targeted to decline somewhat in line with the slowdown in output growth.

Korea's underlying external position has strengthened considerably over the past few years. International reserves are high, with gross official reserves amounting to \$16½ billion at end-August, equivalent to three months of imports of goods and services, up from \$12½ billion at end-1988. Although the gross foreign assets of the rest of the banking system fell by \$1 1/4 billion during the first seven months of 1989, they amounted to \$7 1/4 billion at end-July. Both the level of external debt and debt service payments are relatively low. Outstanding external debt was \$30½ billion at end-August (about 15 per cent of GNP), and debt service payments, as a ratio to current account receipts, are expected to fall below 10 per cent in 1989. In addition, the external current account, although weakening, remains in surplus.

Korea's balance-of-payments and reserve position is strong. The authorities have also shown their ability in the past to deal with balance-of-payments problems through appropriate adjustment policies. In light of these factors, the Fund confirms its assessment of June 1989 that Korea's restrictions on imports can no longer be justified on balance-of-payments grounds.

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<sup>3</sup> Korea maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.