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REPORT ON THE 1987 CONSULTATION WITH THE REPUBLIC OF KOREA

Annex II

Statement by the Representative of the International Monetary Fund

The Korean economy experienced serious internal and external imbalances in the early 1980s; growth faltered, inflation accelerated, and the balance of payments deteriorated. Korea borrowed heavily externally and became a major debtor in the developing world. In response to these developments the Government implemented a comprehensive adjustment program aimed at securing external adjustment and price stability in a context of steady economic growth. The policies were far-reaching and included restrained fiscal and financial policies, considerable depreciation in the real effective value of the won, as well as measures to improve efficiency, including realistic pricing policies and the liberalization of finance, investment, and trade. These policies were supported by four stand-by arrangements from the International Monetary Fund (March 1980-February 1981, February 1981-February 1982, July 1983-March 1985, and July 1985-March 1987).

The success of Korea's adjustment is now well known. Output growth averaged 8 percent annually between 1981-86, inflation was virtually eliminated, the balance of payments strengthened remarkably, and the debt burden was substantially reduced. Not only has domestic savings risen strongly, but domestic investment has also increased rapidly and laid the foundation for sustained growth. While favorable external conditions played a role, it was the timely and sustained

implementation of adjustment policies that poised Korea to fully exploit these developments.

Prudent financial policies produced a stable macroeconomic environment in support of structural adjustment. The consolidated central government budget declined from a deficit of about 5 percent of GNP in 1981 to near balance in 1986; domestic bank financing for the deficit was limited. The growth in domestic credit fell from over 30 percent in 1981 to less than 15 percent in 1986. The real effective value of the won depreciated by 22 percent between early 1985 and mid-1986.

Structural policies have emphasized improving efficiency through greater competition. Administrative price controls were reduced or removed completely. Industrial policy was reoriented to providing general support in manpower training, information, and technical guidance and promoting small and medium industries; a new fair trade and antimonopoly law was enacted to prevent unfair business practices and collusion among firms. Measures were taken to improve the efficiency of the financial system including the relaxation of controls on interest rates and privatization of major commercial banks.

Restrictions on foreign investment were liberalized. In 1984, the Government adopted a negative list system for foreign investment approval. As a result, the range of projects eligible for foreign investment was substantially widened and the authorization procedures simplified. Currently about 21 percent of the industries in the three-digit level of the Korean Standard Industry Classification are excluded from foreign investment compared with 39 percent prior to the negative list system.

Perhaps the most important aspect of structural adjustment has been trade liberalization. In 1984, the Government announced five-year programs of tariff reduction and import liberalization. The tariff reduction program aimed at reducing the average unweighted tariff rate from 24 percent in 1983 to 18 percent in 1988, and at narrowing the dispersion in rates from a range of 0-100 percent to a modal rate of 20 percent. By 1988, only 8 percent of all tariff lines will have tariff rates exceeding 20 percent. The protection afforded by tariffs is highest in agriculture where the program envisaged a reduction in the average tariff rate from 31 percent in 1983 to 25 percent in 1988. For industrial products, the envisaged reduction is from 23 percent in 1983 to 17 percent in 1988.

The import liberalization program aimed to reduce the share of import items subject to quantitative restrictions from about 20 percent of the items in the eight-digit classification of the Customs Cooperation Council Nomenclature (CCCN) at the end of 1983 to about 5 percent by the end of 1988--the level presently prevailing in some industrial countries. At the end of the liberalization program, most manufactured goods--except a few pharmaceuticals and silk products--will be freely importable. The share of agricultural goods subject to quantitative restrictions will fall to below 20 percent in 1988, down from about 27 percent in 1983.

Consistent with the Government's desire to promote effective liberalization, uses of temporary procedures to prevent import surges of

newly liberalized items have been limited. ^{1/} The number of items on the surveillance list was reduced from 165 (2.7 percent of all liberalized items) in 1983 to 106 (1.5 percent of all liberalized items) in the first half of 1987. The number of items subject to adjustment or emergency tariffs have also been reduced, from 104 items in 1983 to 10 items in the first half of 1987, at rates 5-20 percentage points above the basic rates.

The legacy of strong adjustment measures and favorable external conditions has resulted in a remarkable strengthening of the current account and sharply higher growth since early 1986. The current account position shifted from chronic deficits to a surplus of US\$4.6 billion (5 percent of GNP) in 1986 and rose to US\$7 billion in the first nine months of 1987. As indicated in the supplementary material provided for the consultation, the surplus for 1987 is now expected to exceed the original forecast of US\$7 billion. Real GNP growth, led by exports and export-related investment, soared to 12 1/2 per cent in 1986 and to 15 per cent in the first half of 1987. Unemployment fell and there was virtually no inflation. The emergence of a current account surplus permitted a reduction in external debt, which is a major external objective of the Government during the the Sixth Plan period (1987-91). The authorities intend to use current account surpluses to reduce outstanding external debt from US\$45 billion (47 percent of GNP) at end-1986 to US\$30 billion (20 percent of GNP) by 1991.

^{1/} The temporary procedures are the import surveillance list and adjustment and emergency tariffs. Items on the import surveillance list require prior approval before an import license can be opened. Adjustment tariffs may be applied at rates of up to 100 percent beyond the basic or general tariff; adjustment tariffs are subject to review every six months, up to a maximum cumulative period of three years. Emergency tariffs may be applied at rates up to a maximum rate of 40 percentage points beyond the regular tariff rate.

The Government is promptly reorienting its economic policies to managing external surpluses instead of deficits. Market opening measures have included an acceleration in the scheduled import liberalization and tariff reduction programs, removing indirect restrictions on imports, easing controls on services transactions, and adjustments in trade financing. The real effective exchange rate of the won, after a small depreciation between mid-1986 and early-1987, appreciated by 6 1/2 percent between April and August. Between August and October, the won appreciated by 0.8 percent against the dollar; however, as the dollar weakened against other major currencies, the won depreciated by about 1 1/2 percent in nominal effective terms. Recent labor unrest has resulted in large increase in wages, estimated at some 25 percent. Information is not yet available on movements in the real effective exchange rate during August to October.

On July 1, 1987, the share of restricted imports was reduced from 8.5 percent to 6.4 percent, as originally scheduled. The composition of items to be liberalized, however, was changed in order to advance the liberalization of certain items which are particularly sensitive for bilateral trade relations. Tariff reductions on 157 items were advanced from January 1988 to July 1, 1987, many of which involved larger cuts than originally scheduled. As a result, the tariff rates on these 157 items were lowered by 7 1/4 percentage points to 25 percent, bringing the overall unweighted tariff rate to below 19 percent.

The Foreign Trade Act was enacted on July 1, 1987 which, among other things, introduced a system of safeguards against import surges that is more transparent and less restrictive than the present system of import surveillance list and adjustment tariffs. Under the Foreign

Trade Act, protection will be granted only after the Korean Trade Commission considers a formal petition by affected producers. With the implementation of the Foreign Trade Act, the import surveillance list was halved to 58 items and will be eliminated altogether in 1988; all adjustment tariffs were also abolished. 1/

Another market opening initiative in mid-1987 was the implementation of a program for liberalizing invisibles with the aim of bringing the Korean regulations in conformity with OECD guidelines within three years; controls on payments for travel, construction, professional services, repairing, assembly and processing activities, and royalties were relaxed. During the second and third years of the program, further liberalization in the areas of business and industry, transportation, insurance, and films is expected.

Additional market opening measures were implemented on September 25, 1987, including the following: (i) advancing import liberalization of computer peripherals; (ii) reducing tariffs on 132 items, many of which involved items not originally scheduled for tariff cuts or larger cuts than originally scheduled; (iii) increasing import financing; and (iv) easing import restrictions imposed on the basis of special laws. These laws serve various public interest objectives. After reviewing these laws for their import restrictive aspects, the Government reduced the coverage of special laws and relaxed provisions for safety and quality inspections, labeling, and documentation for various products including food, cosmetics, pharmaceuticals, and industrial goods.

1/ However, for two of the products previously subject to adjustment tariffs of 10 percentage points above the basic rates, emergency tariffs of 5 percentage points above the basic rates were imposed instead.

While Korea has been liberalizing its trade and exchange system at home, its exports have been increasingly subject to protectionist measures. Restrictive measures have included import quotas, voluntary export restraints and administrative/procedural measures. Unilateral voluntary export restraints were intensified and additional restraints were placed on ten items in mid-1987. The application of countervailing and antidumping duties against Korean products has increased from 13 cases in 1982 to 32 cases in 1986. Of Korean exports to OECD countries in 1986, 31 percent were subject to restrictions or countervailing and antidumping duties compared with 25 percent in the late 1970s.

Recent political and social developments pose new challenges for economic management. In August 1987, the intensification of labor unrest disrupted production in major export industries. While the majority of strikes have been settled, the large increase in labor costs, estimated at some 25 percent, have reduced competitiveness and put some pressure on prices.

Economic management in Korea during the 1980s has been successful in achieving adjustment and has responded promptly to the turnaround in the external position. The authorities' surplus management program focuses appropriately on broadly based market-opening and exchange rate policy. The Fund hopes that the authorities will continue to take advantage of the strengthened external position to accelerate liberalization of the exchange and trade system, and that progress in this regard will be facilitated by Korea's unimpeded access to its export markets.