KOREA: MEMORANDUM ON ECONOMIC POLICIES

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<tr><th colspan="2">Macroeconomic Policies</th></tr>
<tr><td rowspan="2">Objectives</td><td>Economic policies aim to :
• boost confidence and consolidate the progress made in resolving the external financing crisis;
• support a recovery of domestic demand and strengthen the social safety net so as to mitigate the hardship of the unemployed;
• press ahead with financial sector and corporate restructuring so as to lay the foundation for the resumption of sustained growth.</td></tr>
<tr><td>Macroeconomic projections for 1999 are:
• positive growth resuming during the year; the timing and strength of recovery will depend critically on improvements in domestic confidence and the external environment;
• inflation being contained to 5 percent;
• a current account surplus of about US$20 billion (7 percent of GDP).</td></tr>
<tr><td>Monetary and exchange rate policy</td><td>• Monetary policy has been eased substantially with call rates now well below their pre-crisis levels. This easy monetary stance will be maintained consistent with achievement of the inflation target and subject to the broad stability of the won in nominal effective terms;
• Interest rate policy will continue to be conducted in a flexible manner with upward and downward adjustments as necessary;
• Exchange rate policy will remain flexible and BOK intervention will be limited to smoothing operations.
• Usable reserves, which are targeted to reach US$41 billion at end-1998, have already reached US$45 billion at end-October and are expected to rise moderately in 1999.</td></tr>
<tr><td>BOK foreign exchange window</td><td>• The BOK foreign exchange window was closed effective May 15, 1998 and schedules to repay emergency support by end-June 1999 have been agreed with banks; penalty interest rates have been reduced to 400–600 basis points above LIBOR. Any amounts overdue in terms of the repayment schedules will be subject to a penalty interest rate of LIBOR plus 800 basis points.</td></tr>
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<tr><td>Fiscal policy</td><td>In order to support economic activity and further strengthen the social safety net, the second Supplementary Budget passed in September increased the deficit target for 1998 to 5 percent of GDP.
The government will make every effort to accelerate budgetary spending in order to meet the deficit target for 1998.
Starting with the 1999 fiscal program, the timeliness of the reporting of fiscal data will be significantly improved through the introduction of a computerized reporting system. Data on revenue, expenditure and financing of the consolidated central government will be made available publicly on a monthly basis with no more than a four week lag as early as possible, but no later than mid-1999.</td></tr>
<tr><td>The 1999 Budget</td><td>Fiscal policy in 1999 will provide prudent stimulus to the real economy. The Government has submitted a budget to the National Assembly targeting a budget deficit of 5 percent of GDP in 1999.
Revenues are projected to increase by 1¼ percentage point of GDP to reach 24¼ percent of GDP, due in large part to higher nontax revenue. The VAT base will be broadened further and the tax rate on real estate capital gains will be reduced.
The expenditure program will need to accommodate an increase in interest payments (including the carrying costs for financial sector restructuring) of 1¾ percent of GDP. As a result, several expenditure categories will experience modest cuts relative to 1998, including wages and salaries, purchase of goods and services, capital spending, and net lending. However, budgetary outlays on the social safety net will increase substantially.
Expenditures will be front-loaded during the year to counter the traditional budgetary pattern of running surpluses in the first half of the year.</td></tr>
<tr><td>Social Safety Net</td><td>The social safety net has been strengthened during 1998. In response to the crisis, the unemployment benefit system has been expanded with eligibility widened and the minimum benefit level and duration of benefits raised. Budgetary allocations for social welfare programs, including cash and in-kind benefits and special loan programs, have also been increased.</td></tr>
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<tr><td>Social safety net (continued)</td><td>The social safety net will continue to be strengthened in 1999 through an expansion of existing programs.
• Direct social safety net outlays are projected to increase from W 5.7 trillion in 1998 to W 8.2 trillion (about 2 percent of GDP) in 1999.
    • The budgetary allocation for public works programs will be doubled to reach W 2 trillion, so as to provide employment for 450,000 people.
    • Outlays for a temporary livelihood protection program and a cost of living subsidy will also be doubled; these programs are expected to reach about 570,000 individuals.
    • The coverage of the unemployment insurance system will be widened so that unemployment benefits become available to workers in firms with less than five employees, part-time workers and temporary workers, effective April 1, 1999. As a result, unemployment insurance eligibility will rise to 70 percent of wage workers compared to 35 percent before the crisis. It is expected that 600,000 individuals (about one-third of the unemployed) will receive benefits in 1999.
    • Outlays for job training will amount to W 0.8 trillion in 1999, which covers training for 320,000 individuals.
• The government will also continue to play an important role in promoting indirect social safety net measures, for which W 6 trillion was provided in 1998, including job creation through social overhead capital (infrastructure) projects.</td></tr>
<tr><td>Temporary assistance to credit-constrained enterprises</td><td>• Up to $3.3 billion in trade financing will be provided on commercial terms to small- and medium-sized enterprises, and larger enterprises not affiliated with the top five chaebol, for periods of up to one year, comprising;
    • US$3 billion for import financing, of which: US$1 billion has been financed through the World Bank’s SAL, and a further US$2 billion will be provided if necessary from reserves in excess of program targets. Of the latter, at least US$1 billion will be reserved for small- and medium-sized enterprises;
    • US$0.3 billion in BOK rediscount of export bills for small- and medium-sized enterprises.
• The guarantee ceiling of Credit Guarantee Funds for small- and medium-sized enterprises has been raised by a further W 26 trillion through an injection of W 1.3 trillion.</td></tr>
<tr><td rowspan="2">Privatization</td><td>The government is moving forward with the privatization program of 11 state-owned enterprises and their subsidiaries. Preparations are underway to privatize the first five state-owned enterprises (including POSCO and Korea Heavy Industries) by end-1998 or soon thereafter. One subsidiary, Namhae Chemical Corporation (the largest fertilizer producer in Korea), has already been sold.</td></tr>
<tr><td>Full privatization of four other state-owned enterprises (Korea Ginseng and Tobacco, Korea Gas, Daehan Oil Pipeline, Korea District Heating) will be phased over the next four years. In addition, the government will reduce its share of KEPCO by 5 percent to 60 percent by end-1998 or soon thereafter and its share of Korea Telecom to one-third by 2000.</td></tr>
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Financial Sector Restructuring 1/		
Type of measure	**Measure**	**Timing**
Undercapitalized Commercial banks	The FSC will monitor all banks that were identified to be undercapitalized under the BSA capital adequacy review and CAMEL analysis to ensure: • a sufficient initial increase in capital to make the attainment of minimum capital requirements feasible and credible; • adherence to a clear timetable for achieving specific performance including: (i) improvements in capital ratios to 6 percent by March 1999, 8 percent by March 2000; banks will be encouraged to increase their capital ratios further to 10 percent by December 2000; (ii) improvements in operating performance that would lead to improved profitability and risk management, and (iii) continuing identification and resolution of nonperforming loans; • for regional banks that do not engage in international business and commercial banks that do not lend in amounts above W 5 billion to an individual corporate and that do not engage in international business, the timetable for improvements in capital ratios will be 4 percent by March 1999, 6 percent by March 2000, and 8 percent by December 2000; • submission and adherence to a clear timetable for progressive cost reductions; • further capital increases on account of: (i) supervisory examinations (including diagnostic reviews as necessary) leading to a reclassification of assets; (ii) any further deterioration in asset quality; (iii) the strengthening of supervisory rules and procedures; • an objective assessment is made of progress in meeting the terms of the implementation plans, using outside expertise as necessary.	Ongoing

1/ These measures have been formulated in close collaboration with both the IMF and the World Bank.

Financial Sector Restructuring		
Type of measure	**Measure**	**Timing**
	When approved implementation plans are not achieved, banks will be subjected to corrective actions by the FSC, including Prompt Corrective Action (PCA) procedures.	Ongoing
Provision of Information	The FSC will provide to the Fund all the relevant information, including the results of diagnostic reviews and information on MOUs, as necessary for monitoring the restructuring of the financial system.	Ongoing
Government-owned commercial banks	The government undertakes to reprivatize government-owned commercial banks as soon as market conditions permit.	Ongoing
	In the interim, banks will be operated on a fully commercial basis and the government will not be involved in the day-to-day management of the banks. The chief executive officer will be a well-qualified professional. The nonexecutive directors of the banks shall not be public servants, or members of any branch of government.	Within 60 days of the government becoming a major shareholder
	Obtain binding bids for privatization of Korea First Bank and Seoul Bank from strategic investors with sufficient capital and expertise to manage those banks.	January 31, 1999
All Commercial Banks	The FSC will continue to monitor the capital ratios, CAMELS, and CAEL ratings of all commercial banks in order to provide an early indication of problems. If the capital adequacy ratio of a bank which had been above 8 percent falls below that level subsequently, the FSC will invoke the PCA procedures. Similarly, if the CAMELS or CAEL ratings of a bank become 3 or worse, the FSC will adopt appropriate supervisory actions, including the PCA procedures. For the banks shown to be undercapitalized in light of the diagnostic reviews, the FSC will strengthen supervision and provide administrative guidance to encourage mergers or recapitalization from private sources.	Ongoing

Financial Sector Restructuring		
Type of measure	**Measure**	**Timing**
	Banks will be required to increase capital on account of: (i) supervisory examinations (including diagnostic reviews as necessary) leading to a reclassification of assets; (ii) any further deterioration in asset quality; and (iii) the strengthening of supervisory rules and procedures.	Ongoing
	Every effort will be made for banks to hire well-qualified bank managers, in particular those with international experience.	Ongoing
Use of public funds for bank restructuring	Public funds should only be used to the extent that is necessary to facilitate the liquidation of failed institutions and the restructuring of weak but viable banks. Determination of viability by the FSC (using outside expertise as necessary) will be a precondition for the use of public funds. In addition, restructuring which involves the use of public funds should be limited to: • private sector recapitalization and mergers approved by the FSC, where there is adequate burden sharing, which would be expected to involve contributions of capital from existing or new shareholders, and/or other stakeholders; or • Purchase and assumption (P&A) transactions; or • direct recapitalization by the government with full write down of shareholder capital and replacement of management, in exceptional cases and where a bank is of systemic importance.	Ongoing

Financial Sector Restructuring		
Type of measure	**Measure**	**Timing**
	Government and KDIC funds can only be used, either to inject capital directly (including contributions to cover the deficiency in net worth in P&A transactions) or to purchase impaired assets through KAMCO.	Ongoing
	In order to enhance the incentives for banks to participate fully in the corporate restructuring process, no public funds, whether by way of KAMCO purchases or capital injections or other means, shall be made available to banks which are not certified by the FSC to be performing their role in the corporate sector restructuring process. In addition, no public funds will be made available to any bank that is not in compliance with the timetable on the reduction of large exposure limits set out below. Exceptions will be made, in consultation with the Fund, only in emergency cases or when public support is required to complete a merger or P&A transaction.	

Financial Sector Restructuring		
Type of measure	**Measure**	**Timing**
Use of public funds for bank restructuring (concluded)	• The bulk of asset purchases by KAMCO should be from commercial banks and other financial institutions where there is a deposit guarantee. In exceptional cases, asset purchase may be made from other institutions if failure of these institutions poses a systemic risk. Any such purchases would be made in the context of a comprehensive restructuring plan for the relevant sector. In order to minimize its borrowing requirement, KAMCO will accelerate the sale of its assets. • Purchases should be at prices that reflect actual and expected recovery rates as well as the opportunity cost of the funds employed for collateralized loans, and nominal prices for unsecured loans. • KAMCO's performance, in particular as regards asset acquisition and recovery, will be subject to a half- yearly audit to international standards by a firm with international experience in auditing this type of agency and in the valuation of impaired assets. The results of the reviews and any qualifications will be published. Any losses identified will be reflected in KAMCO's audited financial statement.	Ongoing Ongoing January 1, 1999
	Capital subscriptions by the government, KDIC or any other government agency involved in financial sector restructuring should be on terms that provide the authorities with a share in any improvement in profitability and give the authorities powers, e.g., by the exercise of conversion rights, to take control in the event of a deterioration.	Ongoing
Specialized and development banks	• Provide for recapitalization of the IBK (W 1.5 trillion). • Provide additional W 1.15 trillion in capital to KDB, KEXIM and IBK in the context of the September Supplementary Budget.	December 31, 1998

Financial Sector Restructuring		
Type of measure	**Measure**	**Timing**
Nonbank Financial Institutions	The FSC will evaluate the adequacy and consistency (with regulations for commercial banks) of prudential regulation for the nonbank financial institutions (merchant banks, investment trust companies, securities companies, insurance firms, and leasing companies) and bring these regulations into compliance with international best practice.	Ongoing
Merchant banks	Minimum capital adequacy ratios of 8 percent will be achieved by June 30, 1999. All merchant banks will be encouraged to move progressively beyond the minimum 8 percent capital adequacy ratio after June 1999.	June 30, 1999

Financial Sector Restructuring		
Type of measure	**Measure**	**Timing**
Insurance Companies	The FSC will review the strengthening of the solvency margin standard in consultation with the Fund and announce plans to implement any needed changes in the regulations.	March 31, 1999
	The FSC will announce plans to liberalize the regulations and controls on the terms and pricing and expense ratio of insurance contracts.	March 31, 1999
Securities Companies	The FSC will issue regulations requiring all securities companies to fully segregate clients' funds from proprietary accounts.	June 30, 1999
Investment Trust companies	• The FSC will require investment trust companies to reduce their outstanding bridge loans by 35 percent.	March 31, 1999
	• The FSC will announce guidelines for reducing investment trust companies' outstanding bridge loans according to their financial position, redemption abilities, etc.	March 31, 1999
	• Investment trust companies will be required to:	
	• mark new funds to market;	November 15, 1998
	• mark all funds to market.	July 1, 2000
Public Debt Management	Establish a committee on marketable debt with participating representatives from the MOFE, BOK, KDIC and KAMCO. The committee will meet regularly to exchange information on market conditions, to coordinate public sector debt issues, facilitate monetary management, and act as a liaison between the government and market participants.	December 31, 1998

Prudential regulations and supervision		
Type of measure	**Measure**	**Timing**
Financial Supervisory Commission	Consistent with the Basle Committee's 25 core principles for effective banking supervision, independence of FSC will be enhanced through ensuring operational independence and adequate resources. In this context, the Budget and Planning Commission is conducting a comprehensive management review of government organization and will report its findings by February 1999.	February 1999
Prudential regulations	The FSC is updating its regulations to bring them closer to international best practice as expressed in the Basle Committee's *Core Principles.* Forthcoming changes include:	
	• Deduction from Tier 2 capital of all provisions except those in respect of all assets classified as "normal" and "precautionary".	January 1, 1999
	• Introduction of rules providing disclosure to beneficiaries of the financial position of the trust and precluding any possibility of payment by managing banks to make good or guarantee any loss. All trust accounts with guarantees will be regarded as on balance sheet for all supervisory and accounting purposes. For capital adequacy purposes, assets in such accounts will be weighted at 50 percent from January 1, 1999, and 100 percent from January 1, 2000.	January 1, 1999
	• Introduction of restrictive rules to be applied to all trust accounts ensuring segregation for management as well as accounting purposes.	January 1, 2000
	In addition, future changes will include:	
	• revised definitions of loan classifications so as to fully reflect capacity to repay and not solely past performance.	June 30, 1999
	• Financial Supervisory Service (FSS) examiners will ensure banks classify loans according to the new definitions on a trial basis.	July 1, 1999
	• Audited financial statements will be required to reflect new definitions.	December 31, 1999

Prudential rules for foreign exchange liquidity and exposures	Compliance with existing guidelines that require commercial banks to have: • short term assets (less than 3 months) of at least 70 percent of short term liabilities; • long term borrowing (more than 3 years) in excess of 50 percent of long term assets.	January 1, 1999
	Merchant banks to have short-term assets in excess of 50 percent of short-term liabilities by end- December 1998, 60 percent by end June 1999, and 70 percent by end-December 1999. Long-term borrowing will exceed 40 percent of long-term assets by end-June 1999 and 50 percent by end-December 1999.	December 31, 1999 (full compliance)
	Implement requirements for commercial and merchant banks to: • Maintain internal liquidity control systems based on a maturity ladder approach; • Report maturity mismatches for sight to 7 days; 7 days to 1 month; 1 to 3 months; 3 to 6 months; 6 months to 1 year; and over 1 year. • Maintain positive mismatches for the first period. From sight to 1 month, any negative mismatch should not exceed 10 percent of total foreign currency assets; • Publicly disclose statistics on foreign currency liquidity; The FSC will monitor implementation of internal liquidity controls on a monthly basis	January 1, 1999 (commercial banks) and July 1, 1999 (merchant banks)

	• Introduce amendments to the Foreign Currency Regulations to entrust all responsibility for the setting of foreign exchange exposure limits, as well as the supervision of banks' foreign exchange risk, to the FSC. • The BOK will provide regularly information it collects on foreign exchange positions to the FSC. • Introduce a new measurement system for foreign exchange exposures that includes positions between foreign currencies as well as positions against the won, based on the "shorthand" method recommended by the Basle Committee.	December 31, 1998
Specialized and development banks	Issue regulations to extend, effective January 1, 1999, prudential rules applied to commercial banks to specialized and development banks taking into account the specific characteristics of the institutions.	November 15, 1998
	Establish systems for reporting to the FSC on the same basis as commercial banks.	December 31, 1998
	• Ensure appropriate arrangements are in place for the FSC to conduct examinations of KDB, KEXIM Bank, and IBK. The examination of KDB will be completed at the latest by March 31, 1999. • As a result of these examinations, FSC will make recommendations to the MOFE as to any remedial action required, including increases in capital, and develop plans for rigorous supervisory strategies (including regular monitoring and off-site and on-site reviews).	March 31, 1999

Connected lending	The limit of 25 per cent of equity capital for lending to large shareholders and their affiliates, and other restrictions on connected lending, that apply to commercial banks will be applied to merchant banks. The excess over the 25 percent limit will be progressively reduced by 20 percent by January 1, 1999, an additional 40 percent by January 1, 2000, and eliminated by January 1, 2001.	January 1, 1999
	The FSC will review the provisions on connected lending in the General Banking Law with a view to bringing them into line with international best practice.	December 31, 1999
	All connected lending, and the terms on which it is provided, will be audited and disclosed in the 1998 and subsequent annual financial statements.	January 1, 1999

Large Exposures	For commercial banks, the government will submit legislation to the National Assembly to amend the General Banking Law, to redefine single borrower and group exposure limits. The new definition will include all off-balance sheet exposures. • From January 2000, both limits will be reduced from 45 percent to 25 percent of total capital, using the new definition. The exposure to each borrower or group of borrowers in excess of 45 percent outstanding at end-June 1998 will be reduced by 50 percent by end-June 1999, and eliminated by end-December 1999. • Exposures in excess of 25 percent at end-December 1999 will be subject to progressive reduction over the following three years, that is, one third of the excess over 25 percent will be reduced by end-December 2000, two-thirds of the excess by end-December 2001 and the remaining excess eliminated by end-December 2002. • In addition the authorities will limit the aggregate of exposures (with the new definition) in excess of 10 percent of total capital to 500 percent of capital by end-March 2000. • Banks with aggregate large exposures in excess of this limit as of December 31, 1998 will be set interim benchmarks of 800 percent by end-March 1999, 700 by end-September 1999, and 600 percent by end-December 1999.	November 30, 1998
	For merchant banks, amending legislation will be submitted to the National Assembly to redefine large exposures to include all off-balance sheet exposures. • The current limit of 100 percent will be reduced to 25 percent as of end-June 2000. Exposures to borrowers or groups of borrowers in excess of 45 percent at end-June 1998, will be reduced by 40 percent by end-June 1999, and eliminated by end-June 2000. • Exposures in excess of 25 percent as of end-June 2000 will be subject to progressive reduction over the following three years, that is one third of the excess over 25 percent will be reduced by end-June 2001, and two thirds by end-June 2002, with the excess eliminated by end-June 2003. • The aggregate of exposures in excess of 10 percent of total capital will be limited to 600 percent of total capital by end-June 1999 and to 500 percent of total capital by end-June 2000.	November 30, 1998

	The aggregate excess exposure for each commercial bank and for each merchant bank will be published quarterly, as from end-December 1998.	Early 1999
Cross guarantees	The FSC has established internal interim bench-marks to monitor progress toward the elimination of cross guarantees covered by the provisions in Article 10(2) of the Fair Trade Act by end-March 2000. As a part of the efforts to eliminate cross-guarantees, the top 5 chaebols will be required to eliminate all inter sub-industry group cross-guarantees by the end of 1998. The remaining cross-guarantees within sub-industry groups will be eliminated by March 2000.	Completed by March 31, 2000
Consolidated supervision	Upon completion of the unification of supervisory organizations: • Enhance consolidated supervision to encompass the full range of banking risks, including foreign exchange risk, whether carried on in the principal bank or its foreign branches and domestic affiliates and subsidiaries; and • extend the supervisory arrangements for commercial banks to all nonbank financial institutions, including merchant banks, securities companies, and investment trust companies as appropriate.	 January 1, 1999 January 1, 1999
Disclosure, auditing, and accounting standards	The MOFE, the FSC and KICPA and the relevant regulatory bodies should work to improve disclosure, auditing, and accounting standards. These steps involve: • Upgrading Korean accounting, auditing and disclosure standards to bring them in line with international best practice. • Requiring published financial statements, including off-balance sheet positions, of financial institutions, listed companies, and joint stock companies with assets in excess of W 70 billion as required under the External Audit Act to be audited and prepared in accordance with these upgraded standards, effective 1999 reporting year. • Introducing regulations that will ensure that accounting and disclosure standards for financial institutions fully comply with the minimum requirements of IAS 30; • Reviewing regulation of the auditing profession to ensure that auditing standards reflect international auditing standards issued by the IFAC. • Improving reporting requirements for banks, in order to strengthen the ability of supervisors to be forewarned of potential problems.	 January 1, 1999 January 1, 1999 November 1998 March 1999 Ongoing

Trade and Capital Account Liberalization		
Import Liberalization	Phase out Import Diversification Program (presently covering 48 items) • Liberalization of additional 32 items; and • Liberalization of remaining items.	 December 1998 June 1999
	Review all existing subsidy programs and their economic rationale. Present a proposal for rationalizing existing subsidy programs.	November 15, 1998
Services	Permit foreigners to engage in deep sea foreign freight transport.	January 1, 1999
	Increase foreign ownership ceilings on: • publishing of newspapers (to up to 33 percent); • publishing of periodicals (to up to 50 percent).	 January 1, 1999 January 1, 1999
Six capital account liberalization measures initially envisaged to be completed by December 31, 1998 have been completed ahead of schedule.		
Foreign exchange liberalization	Promulgate Presidential decrees to implement revised foreign exchange law enacted in September 1998 to accelerate liberalization of foreign exchange transactions.	January 1999

Transparency, Monitoring and Data Reporting		
Financial Sector	Details of all public support for financial sector restructuring, including by KAMCO and KDIC, will be published on a regular basis.	Ongoing
	Develop a set of indicators to monitor the soundness of the financial system, including regular reporting of such data to the IMF.	Ongoing
External Debt	Continue developing the external debt reporting system to enhance debt management and monitoring.	Ongoing
	Develop external vulnerability indicators as an “early warning system”.	Ongoing
	Promulgate the necessary regulations to ensure compliance with reporting on external liabilities of the corporate sector.	March 1999
Foreign Reserves	Data on usable reserves of the BOK are being published twice monthly (for 15th and the last day of each month) within five business days. Data on net forward position of the BOK is being published monthly. All of these data have been placed on the BOK Web site.	Ongoing