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Korea Letter of Intent and Memorandum of Economic Policies, February 7, 1998

Kyung-shik Lee

Chang-Yuel Lim

International Monetary Fund

For more information, see Republic of Korea and the IMF

Seoul, Korea
February 7, 1998

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Camdessus:

1. The government's steadfast implementation of its strengthened economic program supported by the Fund has begun to yield encouraging results: the official international financial community is accelerating financial support; agreement was reached with international creditor banks on the voluntary extension of maturities of Korea's short-term debt; and the external current account is improving rapidly. Moreover, the Tripartite Accord agreed by labor, business, and government on February 6, 1998 marks a milestone in the achievement of social consensus in Korea. Enhanced labor market flexibility ensured by the Tripartite Accord will not only increase the efficiency of the economy by facilitating the corporate restructuring, but also help attract foreign capital. These positive developments have set the stage for Korea to decisively overcome its external financing crisis. The government will build on this solid beginning, and resolutely continue to further advance its far-reaching structural reform program.

2. The attached Memorandum on the Economic Program sets out the policies the government intends to pursue as well as a revised macroeconomic framework for 1998; it also establishes quantitative and structural performance criteria through June 1998. Macroeconomic policies will aim to maintain stability in the foreign exchange market, sustain the restoration of confidence, and support economic recovery. The government will also push ahead to achieve further progress with structural reforms in the areas of financial sector restructuring, and capital account and trade liberalization. In addition, the attached Memorandum details the government's policies to reform labor markets, restructure the corporate sector, and improve corporate governance. The policies in the Memorandum have the full support of the incoming government.

3. In the transitional phase of adjustment, those segments of society most adversely

affected will be protected. Toward that objective, fiscal expenditure on the social safety net, including unemployment insurance, will be increased within a framework of continued fiscal discipline.

4. The government is strongly committed to continue to maintain an open dialogue and the social compact as that would be essential to the successful implementation of reforms, regain investor confidence, and return the economy to a path of sustained growth that will benefit all the Korean people.

Yours sincerely,

/s/	/s/
Kyung-Shik Lee Governor Bank of Korea	Chang-Yuel Lim Deputy Prime Minister and Minister of Finance and Economy

Attachment

Korea: Memorandum on Economic Program, 1998[1]	
Macroeconomic Policies	
Objectives	Macroeconomic policies aim to: --sustain the restoration of confidence and contribute to resolving the external financing crisis; --minimize disruptions to the real economy and support economic recovery in the latter half of the year.
	Macroeconomic projections for 1998 are: --real GDP growth at 1 percent, although zero or negative growth remains a possibility; --inflation to accelerate during the first half of 1998 and to decline thereafter, with average inflation for the year slightly below double digits; --current account to shift into a surplus of US$8 billion (about 2½ percent of GDP) or possibly more.
Monetary policy	--Monetary policy will be conducted flexibly with the aim of maintaining stability in the foreign exchange market. --With the mitigation of the immediate foreign exchange crisis, call rates will be cautiously allowed to ease, in line with continued exchange rate stabilization. --A further lowering of interest rates is only envisaged after the foreign exchange market has durably stabilized. --Interest rates will be determined by demand and supply conditions in the market.
Exchange rate policy	--Exchange rate policy will remain flexible; Bank of Korea (BOK) intervention will be limited to smoothing operations. --The foreign exchange window of BOK, opened during the crisis, will be closed as soon as the short-term debt restructuring has been finalized and usable reserves have reached a more comfortable level.
Reserve management policy	Usable reserves is targeted to increase to US$20 billion by end-March and US$30 billion by end-June 1998.
	As long as the foreign exchange window is open, BOK will continue to strictly limit its use to the repayment of short-term debt. In exceptional circumstances, BOK would provide support for other purposes, such as reductions in foreign exchange deposits, but will shorten the repayment period to two weeks from a maximum of one month.

	BOK will reach agreement by June 30, 1998 with domestic banks on a schedule of repayment of the emergency support extended since November 1, 1997.
External debt	--Continue developing external debt reporting system to enhance debt management and monitoring. --Continue to publish detailed data on the outstanding stock and maturity structure of debt on a monthly basis, within 30 days from the end of the month.
Fiscal policy	--At the time the program was adopted in December 1997, a package of tax and expenditure measures, designed to yield 1½ percent of GDP, had been taken to achieve a small surplus in 1998 (including the interest cost of bank restructuring of 0.8 percent of GDP). --However, with a weaker growth outlook for 1998 and the impact of the exchange rate depreciation, the fiscal balance would have weakened to a deficit of 1½ percent of GDP.
	In addition, the government, as part of its contribution to the social compact with labor and businesses, will provide higher expenditures on the social safety net, including unemployment insurance (amounting to about ½ percent of GDP).
	Additional fiscal measures (yielding 1.2 percent of GDP) were taken, including: --cuts in all ministries' budgets, except for budgets related to unemployment, social affairs, and small- and medium-sized enterprises; --cuts in low-priority public investment projects; --cuts in defense expenditure; --cuts in general administrative expenditure; --freeze in government salaries; --increase in the tax rate on interest income.
	As a result, a fiscal deficit of about 0.8 percent of GDP is projected. Additional social safety net expenditure will be provided in the context of the Tripartite Accord. The fiscal deficit target will be reviewed in the event that growth is lower and unemployment is higher than expected, with the aim of allowing the automatic stabilizers to work.
Assistance to small- and medium-sized enterprises	--Guarantee ceiling of Credit Guarantee Funds for exports and domestic operations of small- and medium-sized enterprises has been raised from W21 trillion to W57 trillion through an injection of AsDB capital and an easing of the funds' capitalization requirement. Approval procedures have been streamlined and simplified. --Bank of Korea rediscount facility for small- and medium-sized enterprises would be raised by W1 trillion.

[1]It is the government's intention to seek the approval of the National Assembly for the measures that require the enactment or amendment of laws.

Korea: Memorandum on Economic Program, 1998

Financial Sector Restructuring

Type of Measure	Measure	Timing
Merchant banks	All merchant banks submitted preliminary rehabilitation plans	Done. December 30,1997
	Evaluation Committee completed assessment of rehabilitation plans based on ability of banks to achieve minimum BIS capital adequacy ratios of 4 percent by March 31 and 6 percent by June 30, 1998.	Done. January 26, 1998
	Evaluation Committee recommended revocation of licenses of 10 suspended merchant banks. Government ordered closure of these banks.	Done. January 30, 1998

	Bridge Merchant Bank established to pay out depositors of suspended merchant banks and to take over, manage, collect, or liquidate their assets.	Done. December 30, 1997
	Remaining 20 merchant banks to submit revised rehabilitation plans for second-round evaluation by the Evaluation Committee.	February 7, 1998
	--Second-round evaluation to be completed. The evaluation will involve due diligence analysis and assessment of rehabilitation plans based on criteria regarding liquidity, asset quality, and management capability. -- Merchant banks failing to pass the second evaluation will have their operations suspended immediately, and will have their licenses revoked by April 30, 1998.	March 7, 1998
	--If the rehabilitation plan is approved, the bank will enter into a managerial contract with the supervisory authority that will include a timetable to achieve capital adequacy ratio of 4 percent by March 31, 6 percent by June 30, 1998, and 8 percent by June 30, 1999. --The managerial contract will also include a schedule for achieving specified performance indicators. --In the event that a plan is not implemented to the satisfaction of the supervisory authority, the bank will have its license revoked.	March 21, 1998
Commercial banks	Government recapitalized Korea First Bank (KFB) and Seoul Bank (SB) and took effective control; equity of existing shareholders written down; government and KDIC stake is now equivalent to 94 percent of capital.	Done. January 31, 1998
	Appoint outside experts to assist Privatization Committee to develop privatization strategy for KFB and SB and select lead manager for privatizing the banks.	March 31, 1998
	Obtain bids for KFB and SB.	November 15, 1998
	--Endow the Special Task Force at the Ministry of Finance and Economy (MOFE) with adequate powers to coordinate and monitor bank restructuring and provision of public funds. --Ensure that the Task Force has adequate resources to oversee the bank restructuring process until these functions are transferred to the Financial Supervisory Board in April. --Make appropriate arrangements for the smooth transfer of these functions, including, as necessary, transfers of staff and other resources.	March 7, 1998
	Establish a unit for bank restructuring under the Financial Supervisory Board with adequate powers and resources to coordinate and monitor bank restructuring and the provision of public funds.	April 30, 1998
	Commercial banks to report capital adequacy ratios as of end 1997 (authorities advanced date from March 31, 1998) based on full provisioning.	February 5, 1998
	--Supervisory authorities to order submission of recapitalization plans from commercial banks whose capital adequacy ratios (as of end 1997), based on full provisioning, falls below 8 percent. The plans will need to: --specify a clear schedule to meet capital adequacy standards and provisioning requirements within a frame of six months to two years, the sources and amounts of new capital, and confirmation from suppliers of funds (three months in advance of each capital injection); --indicate any intended changes in management and ownership; --present a business plan; --set out measures to improve risk assessment and pricing, and loan recovery;	February 28, 1998

	--set of measures to reduce costs and improve internal governance.	
	Banks to submit recapitalization plans.	April 30, 1998
	The bank restructuring unit will assess recapitalization plans. If the plan is approved, the bank will enter into a managerial contract with the Supervisory Authority to implement the plan; the contract will include a schedule for achieving specified performance indicators. In case a plan is not accepted, or is not implemented as agreed, the Supervisory Authority will adopt appropriate measures to the full extent of its powers.	June 30, 1998
	Further loan purchases by KAMC will be made in the context of recapitalization plans approved by the bank restructuring unit, or as part of the process of liquidation.	February 11, 1998
Prudential supervision and regulations	Initiate consultations with the banking community and outside experts on the strengthening of prudential regulations that involve the following:	April 30, 1998
	Issue regulations phasing out inclusion of specific provisions in Tier-2 capital.	August 15, 1998
	Issue regulations or amend laws phasing in the harmonization of rules on and definitions of large exposure limits and connected lending for all financial institutions.	August 15, 1998
	Review the possibility of accelerating the timetable for reducing large exposure limits and of further reduction in consultation with the Fund staff.	August 15, 1998
	Issue regulations on mark to market accounting for all financial institutions.	August 15, 1998
	Issue regulations phasing in the treatment of guaranteed trusts as on-balance sheet for capital adequacy and provisioning requirements.	August 15, 1998
	Issue regulations phasing in forward-looking loan classification criteria and review provisioning rates for commercial and merchant banks.	August 15, 1998
	Issue regulations setting global limits on combined spot and forward positions.	November 15, 1998
	Issue regulations phasing in the extension of prudential regulations to specialized and development banks.	November 15, 1998
	Complete contracts for external audits of specialized and development banks by internationally recognized accounting firms.	November 15, 1998
Financial legislation	Strengthen legislation on the closure of financial institutions, the allocation of losses, and equity write-downs.	Mostly done in amendments to Financial Industry Restructuring Act in December 1997 (**advanced from February 28, 1998**)
	Introduce legislation to allow full write-down of existing shareholders equity, eliminating the current minimum bank capital floor for this purpose.	June 30, 1998
Information	BOK/MOFE will record all public support for financial sector restructuring on a transparent basis.	Ongoing

Korea: Memorandum on Economic Program, 1998		
Capital Account Liberalization		
Money market	Full liberalization of money market instruments issued by nonfinancial institutions.	February 16, 1998
	Full liberalization of money market instruments issued by financial institutions.	December 31, 1998
	Deepen treasury bill market by issuing treasury bills of more than W1 trillion.	April 30, 1998
Corporate borrowing	--Lift restrictions on borrowing up to US$2 million for venture companies;	February 15, 1998
	--Review the removal of restrictions on corporate borrowing of 1-3 year maturities for large firms and small- and medium-sized firms (defined according to the Small and Medium Company Act).	May 15, 1998
	Comprehensive review and announcement of all remaining restrictions on corporate borrowing.	December 31, 1998
Financial sector	Following the passage of the Banking Act (in December 1997), issue Presidential Decree to provide transparent guidelines governing foreign investment in domestic financial institutions.	February 28, 1998
	Allow foreign banks and brokerage houses to establish subsidiaries.	March 31, 1998
Foreign borrowing	Place prudential controls on short-term external borrowing of financial institutions.	March 31, 1998
Equity market	Eliminate aggregate ceiling on foreign investment in Korean equities.	December 31, 1998

Korea: Memorandum on Economic Program, 1998		
Trade Liberalization		
Trade-related subsidies	--One subsidy was abolished administratively. --Submit to National Assembly a bill to abolish three additional trade-related subsidies.	January 1, 1998 March 1998
Import liberalization	Phase out Import Diversification Program (presently covering 113 items) (committed to WTO by end-1999). a. Liberalization of 25 items b. Liberalization of additional 40 items c. Liberalization of additional 32 items d. Liberalization of remaining items	 Done. December 30, 1997 July 1998 December 1998 June 1999
	Reduce number of items subject to adjustment tariffs from 62 to 38.	Done. January 1, 1998
	Review existing import certification procedures and present a plan to streamline them and bring them in line with international practice.	August 15, 1998
	Review all existing subsidy programs and their economic rationale. Present proposal for rationalizing existing subsidy programs.	November 15, 1998
Financial services	Binding of Korea's OECD commitments on financial services liberalization in WTO.	Announced in WTO Financial Services Committee on January 30, 1998

Korea: Memorandum on Economic Program, 1998

Labor Market Reform and Social Safety Net

Objectives	Measures
Labor market flexibility[1]	--In the context of the Tripartite Accord, amend legislation to clarify the circumstances and procedures for layoffs. --Relax restrictive legal provisions relating to private job placement and manpower leasing services.
Social safety net	--Budget allocation for the employment insurance fund, including for more training support and employment stabilization, will be tripled from W0.7 trillion to W2 trillion. --Social welfare assistance, including income support to persons without own incomes, was protected and will be increased at least by 13 percent compared with 1997. --Additional social expenditures will be provided in the context of the Tripartite Accord.
Unemployment benefits scheme	The unemployment benefits scheme will be extended as follows: --expand coverage to workers in firms with more than 10 employees from January 1, 1998 (from firms with more than 30 employees); and to workers in firms with more than 5 employees from July 1, 1998; --increase in the minimum benefit level to 70 percent of the minimum wage (from 50 percent) from March 1, 1998; --increase in the minimum duration of benefits to two months (from one month) from March 1, 1998. --Temporarily extend (from April 1, 1998 to June 30, 1999) eligibility by reducing the minimum period of contribution from one year to six months.

[1]The details of these measures will be included in the World Bank Structural Adjustment Loan (SAL). Agreed proposals for amending the Employment Adjustment Laws were announced in the Tripartite Accord on February 6, 1998.

Korea: Memorandum on Economic Program, 1998

Corporate Governance and Restructuring[1]

Objectives	Measures
Transparency	--Require financial statements of listed companies to be prepared and audited in accordance with international standards. --Require publication of combined financial statements for associated companies. --Further reduce the use of mutual guarantees by affiliates/subsidiaries. --To increase the degree of independence of CPAs, an outside auditor selection committee should be mandatory for listed companies and large conglomerates. The committee should be composed of internal auditors, shareholders, if applicable outside directors, and representatives of creditors.
Accountability to shareholders	--Require listed companies on the Korea Stock Exchange to have at least one outside director. --Remove restrictions on voting rights of institutional investors in listed companies (Investment Trust Companies and trust accounts of banks). --Strengthen minority shareholders' rights by lowering substantially the thresholds on exercising these rights (for example, the right to file a representative suit and the right to make a proposal). --Review the possibility of allowing for class action suits against corporate executive and auditors.
Corporate restructuring	--Ensure that all corporate restructuring is voluntary and market-oriented. --Liberalization of the domestic mergers and acquisitions by removing the mandatory tender offer requirement. --Permit takeovers of non-strategic Korean corporations by foreign investors without government approval. --Raise the ceiling on the amount of stock foreigners can acquire in non-strategic companies without approval by the company's Board of Directors to one third from 10 percent.

Bankruptcy procedures	--Amend bankruptcy law to facilitate more rapid resolution of bankruptcy proceedings.
[1]The details of these measures will either be included in the World Bank Structural Adjustment Loan (SAL) for implementation or be announced by the government in the first half of 1998.	

Annex A

Structural Performance Criteria

March 31, 1998

1. Complete second-round evaluation of the remaining 20 merchant banks and suspend operations of those banks which fail to pass the evaluation.

2. Allow foreign banks and brokerage houses to establish subsidiaries.

June 30, 1998

1. Complete assessment of the recapitalization plans of commercial banks.

2. Introduce legislation to allow a full write-down of existing shareholder equity, eliminating the current minimum bank capital floor for this purpose.

3. Establish a unit for bank restructuring under the Financial Supervisory Board with adequate powers and resources to coordinate and monitor bank restructuring and the provision of public funds.

Annex B

Monetary Sector

Outstanding Stock as of:	Limit (In billions of won)
Net domestic assets	
End-December 1997	
Adjusted performance criterion	26,571
Actual[1]	25,819
End-March 1998[2]	17,875
End-June 1998[2]	6,745
End-September 1998[3]	3,155
End-December 1998[3]	–2,700
Reserve money	
End-December 1997	
Indicative limit under the program	23,271
Actual	22,519
End-March 1998[3]	23,580

End-June 1998[3]	24,000
End-September 1998[3]	25,430
End-December 1998[3]	25,640

[1]With net foreign assets valued at program exchange rates.
[2]Performance criterion.
[3]Indicative limit.

Net domestic assets (NDA) is defined as the difference between reserve money and the won equivalent (converted at the program exchange rate) of net international reserves (NIR) as defined in the program. The NDA target is defined as the difference between the indicative limit on reserve money and the won equivalent (converted at the program exchange rate) of the adjusted NIR target.

The ceiling on NDA and the indicative limit on reserve money will be increased (decreased) for any increase (decline) in required reserve ratios.

Annex C

Net International Reserves of the Bank of Korea

	Floor (In billions of U.S. dollars)
End-December 1997	
Adjusted performance criterion	–3.0
Actual	–3.0
End-March 1998[1]	3.8
End-June 1998[1]	11.9
End-September 1998[2]	16.5
End-December 1998[2]	21.8

[1]Performance criterion.
[2]Indicative floor.

For monitoring purposes, net international reserves (NIR) of the Bank of Korea (BOK) is defined as the U.S. dollar value of gross foreign assets in foreign currencies minus gross foreign liabilities.

Gross foreign assets will include all foreign currency denominated claims, including monetary gold, holdings of SDRs, and the reserve position in the Fund. Excluded from gross foreign assets will be participation in international financial institutions, as well as holdings of nonconvertible currencies, claims on residents, and deposits of the BOK at overseas branches and subsidiaries of Korean banks. Gross foreign liabilities are all foreign currency denominated liabilities of contracted maturity up to and including one year plus the use of Fund credit but excluding any liabilities to foreign central banks arising from the activation of the second line of defense provided for under the overall financing package. All assets and liabilities will be valued at program exchange rates.

The net forward position is defined as the difference between the face value of foreign currency denominated BOK off-balance sheet (forwards, swaps, options, and any futures market contracts) claims on nonresidents and foreign currency obligations to both residents and nonresidents. However, the amounts of swaps included in the definition will exclude swaps entered into with regard to any support provided as part of the second line of defense.

The floor on NIR:

(i) will be adjusted downward by the amount of any cumulative shortfall in financing activated under the second line of defense compared to the program baseline (and upward by any cumulative excess). Baseline assumptions are $2.5 billion through end-March 1998 and $8 billion through end-June 1998.

(ii) will be adjusted upward for any increase in the net forward position over the end-January 1998 position of US$6.8 billion (including swaps of US$2.1 billion).

Annex D

Fiscal Sector

	Floor (In trillions of won)
Balance for 1997	
Indicative limit under the program	–2.0
Estimated actual	–1.6
Cumulative balance from January 1, 1998 to:	
End-March 1998[1]	–3.0
End-June 1998[1]	–3.3
End-September 1998[1]	–3.5
End-December 1998[1]	–3.6

[1]Indicative limit.

The consolidated central government balance is defined as the consolidated balance of the central government (comprising the general account, the special accounts, and the special budgetary funds) and the public enterprises special accounts.

The consolidated central government balance will be measured through the government treasury accounts. It is defined as the change in the government's deposits and treasury cash with the BOK; plus the change in deposits with commercial banks and nonbank financial institutions; plus the change in government bonds outstanding; plus foreign borrowing by the government.