IMPLICATIONS OF JULY'S IMF POLICY REVIEW

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What Was Agreed Upon

An important agenda in the IMF policy review which was completed in July was to revise the 1999 forecast of the Korean economy. The IMF and the Korean Ministry of Finance and Economy (MOFE) revised their original growth rate forecast from 2% to 6-7%. This revision is mostly based on the better-than-expected economic performance during the first half of this year. What is more encouraging is that they extended this optimism to next year's forecast: in the year 2000, the Korean economy will grow 5-6%. According to the IMF-MOFE forecast, other macroeconomic indicators will show stability as well. Consumer prices are to rise only by 2% this year, while the current account continues to post a surplus of at least $20 billion.

In addition to revising the macroeconomic indicators, the IMF and the MOFE agreed that the current monetary policy direction should be sustained. The IMF appreciated the effect of single-digit interest rates on the course of economic recovery. On such ground, the two parties decided to keep the interest rates low and adopt a flexible money supply policy. Also, unless inflationary pressures become apparent soon, the growth target of M3 will continue to be 13-14%.

Regarding the BOK's intervention in the foreign exchange market, the IMF kept a lenient position, allowing limited[1] intervention on condition that at the usable foreign exchange reserves reach at least $60 billion. As the economy recuperates, however, the IMF should have adjusted the target of fiscal budget deficit from higher than 5% of GDP to 4%. In sum, as far as the macroeconomic picture is concerned, July's policy review was a procedure in which the two parties confirmed the solid recovery of the Korean economy in

Table 1. Change of Macroeconomic Forecasts and Targets

	year	growth rate	consumer price	current account	budget deficit
July 1999 Review	1999	6~7%	lower than 2%	$20 billion	4% of GDP
	2000	5~6%	lower than 3%	surplus, but less than 1999's	3.5% of GDP
January 1999 Review	1999	2%	around 3%	substantial amount of surplus	5% of GDP

Source: MOFE Press Release, Republic of Korea

1) Officially, the BOK's intervention can be justified when it aims for a "smoothing operation" in the FX market.

1999 and 2000.

Mere appraisal of improved macroeconomic performance is not the most salient feature of this review. The agreement of early repayment of the supplemental reserve facility (SRF), conditionally provided by the IMF upon the financial crisis in 1997, has a far-reaching implication. Up until mid-July this year, the Korean government has paid back $9.5 billion of the SRF[2] and is supposed to return the rest by June 2000. But according to the new agreement, Korea will repay the remaining $4 billion by the coming September.

This agreement carries a special meaning in several aspects. First, the IMF fully acknowledges Korea's capability to repay its external debts without jeopardizing the foreign exchange reserves position. Second, upon the early repayment of SRF, the Korean economy can reinforce its unofficial position as a "success" example of the IMF's bailout program.

Last but not the least, the Korean government has come to face an important policy issue: repayment of foreign liabilities. No expert can deny that the Korean economy is on a recovering path, paved with solid restructuring in both public and private sectors. Moreover, the probability of another foreign currency crisis hitting Korea in the near future is very low. Naturally enough, therefore, the next phase of economic policy-making for the Korean government should focus on resolving the foreign debt problem, in other words, assessing how good (or bad) the current foreign debt situation is and deciding when to repay its foreign debts. Above all, this issue could be directly linked to the issue of official "graduation" from the IMF bailout program.

Assessing the Foreign Debt Situation

According to the government statistics, Korea's foreign liabilities amount to $142.8 billion as of May 31. Out of this amount, only $31 billion is the short-term debts which are due within a year. During the past several months, the Korean government, businesses and financial institutions strived to pay back their foreign debts as

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Table 2. Assessing Korea's Foreign Debt Structure

	1997	1998	March 1999	April 1999
foreign debt (billion dollars)*	158.1	149.4	145.5	142.7
foreign debt/GDP**	33.2%	46.5%	40.0%	39%
foreign debt/total export**	116.1%	112.1%	109.4%	107.3%
debt-service ratio***	-	-	16% ~ 22%	

*) End of period

**) Hyundai Research Institute forecasts that GDP and total export in 1999 will be $366 billion and $133.3 billion, respectively.

***) Interest rates on foreign debts are assumed to be 8.0%~10.0%, whereas the principals (of long-term debts) in 1999 range between $10 billion and $15 billion.

2) Out of $19.5 billion Korea borrowed from the IMF since November 1997, $13.5 billion is from the SRF.

scheduled. More importantly, the share of short-term debts has been reduced and maintained below the 25% level. That is to say, Korea's foreign debts are continuously diminishing and its term structure has been stabilized. Experts agree that sovereign debts are a "light burden" when the ratio of foreign debts to GDP is below 50%.

Applying this standard, Korea's foreign debts can be classified as a "light burden", as they are less than 40% of its GDP. Another standard is the debt-service ratio which estimates the expected cash flow of hard currencies to cover the repayment of interests and principals (of long-term debts). In 1999, the debt-service ratio of Korea's foreign debts is going to be around 20%. This means that the amount of interests and principals due in this year reaches only 20% of total export. Therefore, the likelihood of another foreign currency crisis seems to be extremely low.

Decreasing the foreign debts implies better credibility in the international community. Most OECD member countries have foreign debts as small as 30% or lower of their GDP. The Korean economy should aim at this "30% of GDP" level in the long run; this means the size of foreign debts should be around $100 billion.

With such a stable debt structure and abundant usable foreign exchange reserves, does Korea have to hasten the repayment schedule? The answer is positive for the following reasons. First, solely from a financial perspective, the next several months may be the best time for repaying (and thus reducing or re-scheduling) foreign debts.

Currently, the international financial markets continue to post low interest rates but the general situation is quite vulnerable to a sudden change by the end of this year, namely the looming possibility of a U.S. interest rate rise. Repayment of foreign debts, especially the part of flexible interest rates, would substantially reduce financial costs from next year. Moreover, with reduced sovereign debts, Korean businesses and financial institutions will have better positions in terms of market accessibility.

Second, with respect to the domestic policy, it is necessary to pay back early. Current account in 2000 is expected to record a surplus, but of a substantially smaller amount when compared to those of 1998 and 1999. There is no guarantee that next year's foreign currency liquidity condition, therefore, will be better than that of the second half of this year. Furthermore, inducing Korean firms and banks to aggressively repay their foreign liabilities could push the won/dollar exchange rate up and maintain above the 1,200 won level, benefitting Korea's exporters.

Third, decreasing the foreign debts implies better credibility in the international community. Most OECD member countries have foreign debts as small as 30% or lower of their GDP. The Korean economy should aim at this "30% of GDP" level in the long run; this means the size of foreign debts should be around $100 billion. Last, lowered foreign debts are the most important prerequisite for "graduating" from the IMF program. The official "graduation" is usually announced by the IMF when a country is out of the woods, when it is substantially and continuously repaying its foreign debts, and when the IMF feels there is no need for an additional policy review with its government.

Korea is definitely out of the danger of facing another foreign exchange crisis; the restoration of economic stability is heightening the possibility that the policy review in the first half of next year may be the last review. In light of this situation, the Korean economy's foremost policy agenda should deal with the repayment of its foreign debts as much and soon as possible in the near future. VIP