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INTERNATIONAL DEVELOPMENT ASSOCIATION

REPORT AND RECOMMENDATION
OF THE
PRESIDENT
TO THE
EXECUTIVE DIRECTORS
ON A
PROPOSED CREDIT
TO THE
REPUBLIC OF KOREA
FOR AN
INTEGRATED DAIRY BEEF PROJECT

January 13, 1971

INTERNATIONAL DEVELOPMENT ASSOCIATION

REPORT AND RECOMMENDATION OF THE PRESIDENT
TO THE EXECUTIVE DIRECTORS ON A PROPOSED
CREDIT TO THE REPUBLIC OF KOREA

1. I submit the following report and recommendation on a proposed development credit in an amount in various currencies equivalent to \$7 million to the Republic of Korea for a dairy and beef development project.

PART I - HISTORICAL

2. Agricultural output in Korea has grown reasonably rapidly at an annual average of 4.4% during the past decade. But it has not kept pace with the dynamic expansion of other sectors, notably manufacturing. This discrepancy has resulted in a widening gap in income and standards of living between the urban and rural populations, a trend which was further accelerated by recent severe droughts which particularly affected rice production, the major source of agricultural income. To reduce the dependence of agricultural production on adequate rainfall and to expedite agricultural growth, in recent years the Government has substantially increased investments in irrigation facilities. The Bank in 1969 supported these efforts through a \$45 million loan for the Pyongtaek-Kumgang Irrigation Project (600 KO). Furthermore, the Government actively pursues a policy of diversifying agricultural production. The development of the country's livestock industry is an essential element of this policy and will help meet the rising domestic demand for dairy products and meat.

3. The proposed project was prepared in part by Japanese consultants engaged by the Overseas Technical Cooperation Agency of Japan under a program of technical and financial cooperation between the two countries, and was appraised in April/May of last year. The proposed project, to be implemented by the Korea Dairy Beef Company (KDBC), is the first Bank Group project for livestock in Korea.

4. Negotiations were held in Washington between November 27 and December 2. The Government was represented by Mr. Sung Yong Wei of the Economic Planning Board and Mr. Yong Joo Ha of the Ministry of Agriculture and Forestry. Mr. Yong Koo Hwang represented the KDBC and its parent organization, the Agricultural and Fisheries Development Corporation (AFDC).

5. The following is a summary statement of Bank loans and IDA credits as of November 30, 1970:

Loan or Credit No.	Year	Borrower	Purpose	Amount (U.S.\$ million)		
				Bank	IDA	Undisbursed
25	1962	Republic of Korea	Railway		14.0	-
110	1967	Republic of Korea	Railway		11.0	0.3
529	1968	KDFC	Dev.Fin.Co.	5.0		0.9
S-4	1968	Republic of Korea	Highway Studies		3.5	1.6
600	1969	ADC	Irrigation	45.0		44.3
151	1969	Republic of Korea	Education		14.8	14.7
622	1969	KDFC	Dev.Fin.Co.	20.0		16.5
669	1970	Republic of Korea	Railway	40.0		40.0
183	1970	Republic of Korea	Railway		15.0	15.0
Total (less cancellations)				110.0	58.0	133.3
of which has been repaid to Bank and others				*		
Total now outstanding				110.0		
Amount sold			0.8			
of which has been repaid			0.0	0.8		
Total now held by Bank and IDA				109.2	58.3	
Total undisbursed				101.7	31.6	133.3

* Less than \$50,000

6. Disbursements of the irrigation loan and the education credit are behind schedule. Their effectiveness was delayed for several months because it took longer than expected for the borrowers to employ consultants, and in the case of the irrigation loan the original borrower was succeeded by a new organization about whose competence the Bank had to satisfy itself. The design of school buildings under the education project is now well under way and disbursements for construction and equipment should start in the near future and proceed without any further delay. With regard to the irrigation project, now that the consultant problems have been solved it is expected that disbursements to cover civil works and equipment will proceed satisfactorily. Disbursements under the railway, highway studies and development bank projects are progressing satisfactorily.

7. IFC made an equity investment in KDFC of \$0.7 million at the time of the 1968 Bank loan. In June 1969, IFC made an equity investment of \$0.3 million in, and a loan of \$1.4 million to, a silk company; and in May 1970 the Atlas Paper Company received a loan of \$4.5 million and an equity investment of \$0.5 million from the IFC. Prospects for further IFC investments in Korea are being investigated.

8. Before the end of this fiscal year I expect to recommend Bank financing for a third loan to the Korea Development Finance Corporation and for highway construction.

PART II - DESCRIPTION OF THE PROPOSED CREDIT

9. Borrower: Republic of Korea

Beneficiary: Korea Dairy Beef Company (KDBC)

Amount: In various currencies equivalent to \$7 million

Purpose: To help finance loans for dairy farm development, the construction of two dairy products processing facilities, and related management and technical services.

Amortization: In 50 years including a ten-year period of grace, through semi-annual installments of $\frac{1}{2}$ of 1% from May 15, 1981 through November 15, 1990 and of $1\frac{1}{2}$ % from May 15, 1991 through November 15, 2020.

Service Charge: $\frac{3}{4}$ of 1% per annum

Re-lending Terms: The proceeds of the IDA credit would be re-lent by the Government to the KDBC (i) at 9% for 15 years for investment in two dairy processing facilities, and (ii) at 3% for 15 years for re-lending by the KDBC to participating farmers at 9%. KDBC would carry the exchange risk.

Estimated Economic Return: 12%

PART III - THE PROJECT

10. An appraisal report entitled "Integrated Dairy Beef Development Project - Korea" (PA-63a) on the proposed project is attached.

11. Agricultural development is a matter of high priority to the Korean Government. Within the framework of a ten-year rural modernization program, the Government is supporting land consolidation, farm mechanization, slopeland development and diversification of agricultural production. The development of the country's livestock industry on a systematic basis is a crucial element of this strategy, and is being undertaken under the Four-Year Livestock Industry Development Program, which encourages commercial production of the major animal species, with emphasis on beef and dairy cattle.

12. The demand for dairy products and meat has grown rapidly in recent years, reflecting the rising standard of living. As the economy is expected to continue to grow at a fast pace, dietary patterns should continue to change, causing further demand for milk products and beef. At the present time beef and dairy production are in their infancy. The cattle population consists of slightly more than one million head, mostly native Korean cattle, and beef production is about 40,000 tons per year, based mostly on the slaughter of draft animals. Dairy cattle have increased considerably in the past few years, but still number only about 15,000. Milk processing started only within the past decade, and considerable amounts are imported to meet the demand. The proposed project would establish a pattern for the development of a beef and dairy industry using the presently existing farm structure, and therefore could be applied to other parts of the country.

13. There are essentially two parts to the project: the development of about 700 small and medium dairy farms; and the construction and operation of two dairy products processing plants. There will also be management and technical services related to these activities. The project would be carried out by the Korea Dairy Beef Company, a wholly-owned subsidiary of the Agriculture and Fishery Development Corporation. The latter was established in 1967 by the Government to foster agro-industry through equity investments and loans subscribed by the Government. The AFDC presently has twenty-two subsidiaries and has a majority interest in eighteen of them. Some of the subsidiaries are in the process of being consolidated to streamline the operations of the AFDC. The AFDC tries to sell its holdings in a subsidiary to private interests once the subsidiary is well established. The management of the AFDC is sound, and it provides managerial and limited technical services for its subsidiary companies.

14. KDBC was founded by AFDC in February 1969 to engage in dairy production, milk processing, and marketing. The Company, which has no earning power at the moment, is expected to begin making a profit three years after the start of the project. Its issued share capital, entirely held by AFDC, amounts to 150 million won (\$500,000). Under the terms of the proposed credit, AFDC is to increase its equity subscription to the KDBC to \$1 million as a condition of effectiveness, and by the end of 1973 to increase its equity contribution to \$2 million.

15. Being only a little more than a year old, KDBC does not have sufficiently experienced staff to carry out the project on its own. It has undertaken to expand its organizational structure and employ management and technical experts during the implementation period of the project. A key element in the project is preparing the selected farms to receive and care for the heifers, and as a condition of effectiveness, KDBC will employ a Dairy Husbandry Specialist who will advise the management of the Company on major policy matters concerning dairy farm development, supervise its implementation, scrutinize and be responsible for approving the farm development plans, and in general have overall control over this part of the project. The KDBC is also to employ a Dairy Processing Specialist, an Agronomy Specialist and an Animal Nutrition Specialist. The Dairy Processing Specialist will have overall supervisory control of the milk processing plants including their design, tendering and construction. The Agronomy and Nutrition Specialists would provide specialized guidance to participating farmers, and would assist the Government in developing a coordinated program of applied research in cattle production to provide the basis for the long-range development of Korea's potential cattle resources. With the assistance of these four experts the KDBC is expected to carry out the project effectively. The KDBC is presently looking for these specialists, with IDA assistance, and it is expected that suitable candidates will be found without undue difficulty.

16. The total estimated cost of the project is the equivalent of \$12.6 million. The proposed development credit of \$7 million would cover 55% of total costs; the equivalent of \$2 million would be provided by participating farmers in cash or kind; \$2.1 million would come from KDBC's increased equity and its own resources; and \$1.5 million would come from the Government as its contribution to the costs of dairy farm development.

17. Of the proposed \$7 million IDA credit, \$4.4 million would be for dairy farm development and \$2.0 million for the two dairy processing plants. The balance of the funds would go for managerial and technical specialists, research equipment, training fellowships and a few vehicles. The amount of \$4.4 million from the proposed credit for farm development would be re-lent by the Government to KDBC at 3% for 15 years, for on-lending to participating farmers at 9%. These rates are similar to those currently applicable to dairy farm development in Korea. KDBC would thus be getting a spread of six percentage points on these funds, which would cover the administrative expenses of handling the sub-loans and provide a cushion for KDBC to bear the foreign exchange risk. These sub-loans to farmers would have a repayment period of eight to ten years, which is reasonable considering the projected cash flows. At full development, after about the seventh year, the annual net cash balance after debt service of the average small (10 cow) farm would be the equivalent of about \$2,600, and about \$10,000 for the larger (30 cow) farms.

18. KDDBC would itself own and operate the two milk processing plants to be financed by \$2.0 million from the proposed credit. These funds would be re-lent by the Government to KDDBC at 9% for 15 years. It is expected that KDDBC will be able to earn a financial rate of return of about 35% on milk plants, which would strengthen its ability to bear the foreign exchange risk on the IDA funds.

19. Procurement of equipment for the milk plants will be on the basis of international competitive bidding, and procurement of cattle and semen will be based on quotations from at least three countries qualified to provide the required stock and meeting Korean health standards. Items to be procured by farmers for the development of their dairy farms will be through local commercial channels, as the cost of the goods to be purchased is too small to warrant international bidding. Contracts for civil works for the milk plants, and for the few jeeps and motorcycles to be used by the management and technical specialists, will be awarded after local competitive bidding. Disbursements from the credit will cover 56% of farm development loans, 44% of the construction cost of the milk plants, and 100% of the other items.

20. The foreign exchange component of the project is estimated at \$6 million, or 48% of the total project cost, on the assumption that in addition to the cattle and semen all equipment required for the milk processing plants would be imported. Local manufacturers are expected to participate in the bidding for stainless steel tanks, small electric motors and other minor items for the milk plants, valued at about \$200,000. They would be given a preference of 15% or the level of existing customs duties, whichever is less. On this basis, Korean manufacturers are likely to win some contracts. The proposed credit would cover the foreign exchange cost of the project and between \$1 million and \$1.2 million in local currency expenditures, depending on the outcome of bidding for the items mentioned above.

21. The Korean economy has shown a remarkable capacity to grow rapidly. In spite of a satisfactory growth of domestic savings and a relatively high savings rate, the resource gap to be covered from external sources continues to be substantial, so much so that the Government is now trying to slow down the rate of investment and economic growth. Even though requirements for external financing will remain large, the number of high priority projects in the public sector having a substantial foreign exchange element is relatively limited. Many projects with a large foreign exchange component are in the private industrial sector and are financed from private sources and export credit agencies. Infrastructure, education and agriculture projects, with often low foreign exchange components but still of very high priority, are increasingly dependent for their financing on the Bank, IDA and the Asian Development Bank. In these circumstances, and in view of the importance of the proposed project as the first of its kind in Korea, I consider that the financing by the Association of some local expenditures is appropriate.

22. The economic return on the project as a whole is 12%, with direct benefits accruing not only to KDBC and the farmers participating in the project, but also to a large segment of the population through an increased supply of milk, milk products and beef.

PART IV - LEGAL INSTRUMENTS AND AUTHORITY

23. The Draft Credit Agreement between the Republic of Korea and the Association, the Draft Project Agreement between the Association and Korea Dairy Beef Company Limited and Agriculture and Fishery Development Corporation, the Recommendations of the Committee provided for in Article V, Section 1(d) of the Articles of Agreement, and the text of a Resolution approving the proposed Credit are being distributed to the Executive Directors separately.

24. The Draft Agreements contain covenants normally included in agreements for agricultural credit projects. The relending of the proceeds of the Development Credit will be governed by the terms of a First Subsidiary Loan Agreement satisfactory to the Association to be concluded between the Republic of Korea and KDBC. Funds to be provided by the Government will be lent to KDBC pursuant to a Second Subsidiary Loan Agreement satisfactory to the Association to be concluded between AFDC and KDBC.

PART V - THE ECONOMY

25. A report entitled "Economic Position and Prospects of the Republic of Korea" (EAP-12a, dated March 16, 1970) was circulated to the Executive Directors on March 27, 1970. An economic mission visited Korea in September/October, 1970, and is now finishing its report. An updated data sheet is attached.

26. Korea's economic progress in recent years has been outstanding, and continued so during the past year. Since 1965, GNP in real terms has grown at an average rate of 11.7% a year; a record rate of 15.9% was achieved in 1969, due in part to a bumper rice crop following a poor harvest in the previous year. In the first nine months of 1970, real GNP increased by about 11% over the corresponding period of 1969. With the assistance of an active family planning program, the population growth rate was reduced substantially in the last decade. The latest census taken on October 1, 1970, shows that the population growth was reduced from 2.6% a year during 1960-65 to 1.9% a year during 1966-70. Per capita real GNP has increased by over 9% annually during 1965-69, reaching \$195 equivalent in 1969.

27. The major aspect of the rapid economic growth has been the sharp increase in capital formation from about 15% of GDP in 1965 to 30% of GDP in 1969. With rising incomes, domestic savings have also increased substantially, from 8% of GDP to 19% of GDP in 1969. The increase of public savings is particularly impressive, reaching 6% of GDP in 1969, as a result of new taxes, generally higher tax rates, and intensified tax collection. However, domestic savings are still obviously not enough to meet the large rise in investment.

28. Industrialization has played a leading role in Korea's economic growth, supported by the development of the economic infrastructure. During 1965-69, the manufacturing sector grew at 22.5% a year in terms of value added. At the same time, agricultural output grew at an average rate of about 4-5% a year. Parallel with the rapid expansion of manufacturing and its associated service sectors, there has been a shift of employment and population from rural to urban areas. To some extent, the economic transformation through rapid industrialization has left the rural population behind. In recent years there seems to have been hardly any improvement in the real income level of the average rural household, because prices paid by the farmer have risen as fast as his money income. On the other hand, the real income of the average urban labor household, which was in 1963 at more or less the same level as that of the average rural household, increased by about 60% by 1969. The Government is now making great efforts to increase rural income by supporting prices of food crops and raising agricultural production. More important in the long run will be the increase of agricultural productivity and diversification of agricultural activities into areas with high value products and rapidly rising demand, such as meat, dairy products, fruits and vegetables.

29. Industrial output has been an important factor in export expansion, and this in turn has contributed significantly to rapid economic growth. Merchandise exports increased from \$175 million in 1965 to \$658 million in 1969, and are likely to exceed \$900 million in 1970. Exports of goods and services grew at 40% annually during 1965-69. However, imports have grown equally fast, and there was little improvement in the ratio of exports to imports (about 60%) up to 1969.

30. The gains of recent years have somewhat eased Korea's economic difficulties, but they nevertheless remain formidable. Dependence on external resources continues to be heavy. The deficit in the external account, and the corresponding gap between savings and investment, was about 11% of GDP in 1969. In that year, over two-fifths of gross investment was financed with foreign resources, increasingly in the form of commercial loans. As a result, the debt service ratio rose from less than 3% in 1966 to about 11% in 1969 and is estimated to reach a level of 20% in 1970. The ratio is expected to stay at a level of around 25% for the seventies, and could be higher if unfavorable export markets prevail or inflation develops. This ratio, although high, does not give cause for as much concern as it would in a less dynamic economy.

31. Realizing the importance of keeping the external debt burden within manageable limits and of containing inflation, the Government in late 1969 adopted a set of monetary and fiscal stabilization measures. In accordance with its Standby Agreement with the IMF, the Government has observed both the ceilings for domestic credit and short and medium foreign debt commitments. In particular, Government and private investment in building construction in the cities has been curbed. The total amount of foreign commercial debt with maturity of over 3 years contracted during January-August, 1970, was \$163 million compared with \$623 million for the whole of 1969. The outstanding amount of short-term credit with 1-3 year maturity was reduced by \$37 million during the first eight months of 1970.

32. As a result of these stabilization measures, imports in the first nine months of 1970 increased only by 6% over the corresponding period of 1969, as compared with a 26% increase in 1969 over 1968. Merchandise exports, being exempted from the restrictive measures, continued to increase at a rapid rate of 37% in the first nine months of 1970. Thus, in spite of a reduction in receipts from U.N. forces' expenditure in Korea and from Vietnam, the deficit on goods and services account showed a decline for the first time since 1965, from \$593 million in the first nine months of 1969 to \$531 million in the first nine months of 1970. The index of consumer prices rose more slowly in the first nine months of 1970 (7.7%) than in the corresponding period of 1970 (12.5%).

33. The Government is making determined efforts to achieve a more orderly and stable growth of the economy, and has recently agreed that limitations on new external debt and domestic credit expansion be included in the IMF Standby Agreement for 1971 at levels comparable to those for 1970. For 1971 the Government has set a target increase of 10% for real GNP and less than 3% increase in gross investment; but at 27% of GNP, the level of investment will not be unduly depressed. The Central Government's expenditure for 1971 is budgeted to increase modestly by about 18%, with more funds allocated to defense (24% of total expenditure) in view of the partial reduction of U.S. forces, but smaller increases in salaries and wages for Government employees. Receipts from counterpart funds will decline drastically because of the reduction of U.S. aid, but domestic tax revenue is expected to increase by over 24%. No deficit financing is visualized. Because of the uncertainties in the world market and developments in Vietnam, the rate of increase in exports of goods and services is expected to slow down, but imports will also not increase much. The Government envisages further improvement in the current account of the balance of payments in 1971. Considering the dynamic performance of the Korean economy and the willingness of the Government to strive for economic stability, Korea can be regarded as creditworthy for Bank loans.

34. However, Korea will depend on substantial amounts of foreign capital for some time to come even if economic growth is below the levels achieved over the past decade. Some of this assistance should

be on concessional terms considering Korea's low level of per capita income and heavy debt burden.

PART VI - COMPLIANCE WITH ARTICLES OF AGREEMENT

35. I am satisfied that the proposed development credit would comply with the Articles of Agreement of the Association.

PART VII - RECOMMENDATION

36. I recommend that the Executive Directors approve the proposed credit.

Attachment

Robert S. McNamara
President

January 13, 1971

BASIC DATA - REPUBLIC OF KOREA

<u>Area</u>	98,438 sq. km.		
<u>Population</u> (mid year 1969)	31.14 million		
Growth rate (1969)	2.2 percent ^{a/}		
Density (per sq. km.)	315		
<u>Gross National Product</u>			
Total (1969 at current prices)	2,047 billion won		
Annual average real rate of growth (1965-69)	11.7 percent		
Per Capita GNP (1969)	\$195 equivalent		
<u>Industrial Origin of Real GNP (1969)</u>	100 percent		
Agriculture, Forestry and Fisheries	28 percent		
Mining and Manufacturing	26 percent		
Economic Overhead and Construction	13 percent		
Other Services	33 percent		
<u>Gross Domestic Expenditure</u> (current prices; as percentage of GDP)			
	<u>1965</u>	<u>1968</u>	<u>1969</u>
<u>Consumption</u>	<u>94</u>	<u>88</u>	<u>84</u>
Private	84	77	73
Public	10	11	11
<u>Gross Capital Formation</u>	14.8	27.1	30.4
<u>Gross Domestic Saving</u>	8.2	15.2	19.1
Public	(1.8)	(6.5)	(6.4)
Private	(6.4)	(8.7)	(12.7)
<u>Resource Gap</u>	<u>6.6</u>	<u>11.9</u>	<u>11.3</u>
<u>Public Finance</u> (current prices, in billion won)			
Current Revenue	91	285	370
Current Expenditure	81	191	248
Surplus	10	94	122
Capital Expenditure	41	154	231
Receipts from Counterpart Funds	33	24	17

^{a/} This figure has not been adjusted by the result of the 1970 census, which shows an average annual growth rate of 1.9% between 1966 and 1970.

	<u>1965</u>	<u>1968</u>	<u>1969</u>	<u>Jan- Sept. 1970</u>
<u>Money and Credit</u> (annual rate of change in percent)				
Money Supply	33	25	46	26
Time and Saving Deposits	112	99	77	17 ^{1/2}
Total Bank Credit Outstanding	42	63	60	22
<u>Price Indices (percent increase)</u>				
Consumer Prices (Seoul)	13.6	11.1	10.1	7.7
Wholesale Prices	10.0	8.1	6.8	7.3
<u>Balance of Payments (in million US \$)</u>				
Merchandise Exports (f.o.b.)	175	486	658	625
Merchandise Imports (f.o.b.)	-416	-1,322	-1,650	-1,224
Deficit	-241	-836	-992	-599
Receipts from Military Expenditures	74	217	249	174
Other Services, net	- 27	- 48	- 51	-106
Balance on Goods & Service Account	-194	-667	-794	-531
<u>International Liquidity (in million US \$)</u>				
Gross Foreign Exchange Reserves	146	391	553	618
Month's Imports of Goods & Services	4	3	3	3
IMF Quota	18.8	50	50	50
IMF Drawings (outstanding)	-	12.5	12.5	1.8
<u>Net Inflow of Foreign Capital (in million US \$)</u>				
Grants	203	226	244	116
Loans	- 3	421	634	302
Direct Investment	-	20	16	24
Total	<u>200</u>	<u>667</u>	<u>694</u>	<u>442</u>

External Debt

Total outstanding external debt (disbursed) with maturity of over one year at the end of June, 1970: \$1,875 million

Amortization and interest payments on these debts during the first six months of 1970 were estimated at \$114 million, or 18.5 percent of export earnings.

Exchange Rate (end Dec. 1970). Banks' selling rate: 317 won to the dollar

^{1/} After some statistical adjustments

January 13, 1971