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October 23, 1951

KOREAN INFLATION

Reed J. Irvine

Even before the outbreak of the present conflict, inflation was one of the most serious problems confronting the Government of Korea. After it had run virtually unchecked for over four years, the Government early in 1950 adopted a stabilization program to bring the inflationary spiral under control. This program consisted of stricter control over Government expenditures, increased revenues from Government owned facilities and sales of vested properties, a higher counterpart deposit rate, and a balanced budget for ordinary government expenditures. On the eve of the invasion there were firm indications that this program was meeting with some initial success. The total of bank notes in circulation outside banks declined from 70.7 billion won 1/ in December 1949 to 62.3 billion won by the following June. In addition, deposit currency contracted slightly, from 23.1 to 22.8 billion won during the same period, with the result that the total money supply dropped by 9.4 per cent. The Korean note issue normally undergoes a seasonal contraction in the spring as government receipts from rice sales rise but this decline in the total money supply was unprecedented in the four and a half years since the liberation. The following table shows the semi-annual changes in the pre-invasion money supply.

Pre-Invasion
Korean Money Supply - 1946-1950

Date	Notes in circulation outside banks		Total Checking Deposits		Total Money Supply	
	(Billion won)	(June 1947 = 100)	(Billion won)	(June 1947 = 100)	(Billion won)	(June 1947 = 100)
Dec. 1946	16.5	97	3.6	72	20.1	91
June 1947	17.0	100	5.0	100	22.0	100
Dec. 1947	31.2	183	7.6	152	38.8	176
June 1948	28.3	167	10.9	218	39.2	178
Dec. 1948	30.6	239	12.5	250	53.1	241
June 1949	38.6	227	15.1	301	53.7	244
Dec. 1949	70.7	416	23.1	462	93.9	426
June 1950	62.3	366	22.8	456	85.1	387

1/ The most frequently used rate of exchange for the won at present is the counterpart rate of 6000 won to one U. S. dollar.

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Prices began to reflect the tightened money supply in May, with the retail price index (Pusan) falling 8 per cent by June. Wholesale prices, however, took an unfavorable turn in rising sharply in June after having registered a small decline in the previous month. Nevertheless, the dampening of the inflationary process in the spring of 1950 was far more pronounced than in any previous postwar year and may be safely assumed to have represented more than a mere seasonal trend.

Pre-invasion Price Trend
(1947 = 100)

	Retail		Wholesale	
Date	Index (Pusan)	Per cent increase over same month 1949	Index (Seoul)	Per cent increase over same month 1949
1946	59.2		55.0	
1947	100.0		100.0	
1948	168.4		162.9	
1949	206.8		289.9	
1950 Jan.	301.7	73	319.3	77
Feb.	307.2	69	327.8	88
Mar.	340.7	70	332.3	87
Apr.	348.1	73	339.8	82
May	331.8	59	334.5	70
June	319.3	53	348.0	72

This trend gave rise to hopes that inflation might finally be curbed, but the stabilization program was one of the first casualities of the June invasion and these hopes were buried with it. In the ensuing chaos, the Korean Government could do nothing but borrow from the central bank to meet its soaring expenses. As a consequence, the total money supply expanded by 450 per cent over the next twelve months. The increasing money supply, coupled with a drastic curtailment in the supply of goods and services, resulted in a runaway price inflation. The index of retail prices rose by 540 per cent and that of wholesale prices by 382 per cent in the year following June 1950. The following table shows the course of this inflation.

Money Supply and Prices
June 1950 - June 1951

Date	Money Supply						Prices	
	Notes in circulation outside banks		Total Checking Deposits		Total money supply		Retail (Pusan)	Wholesale (Pusan)
	(Billion won)	(1947 = 100)	(Billion won)	(1947 =100)	(Billion won)	(1947 =100)		
June 1950	62.3	366	22.8	456	85.1	387	319.3	348.0
Sept. 1950	87.2	510	22.5	450	109.7	499	659.4	n.a.
Dec. 1950	224.9	1320	29.3	586	254.2	1155	953.2	831.1
Mar. 1951	328.1	1925	47.6	952	375.7	1708	1934.0	n.a.
June 1951	408.4	2400	58.7	1174	467.1	2123	2062.0	1670.8

Analysis of Increase in Money Supply

The money supply amounted to 467 billion won in June 1951, an increase of 382 billion won since the invasion. No less than 90 per cent of this increase may be credited to the expansion of the note issue of the Bank of Korea, which is summarized in the following table.

Analysis of Factors
Affecting Currency Issue of the Bank of Korea
July 1, 1950 to June 30, 1951
(Billion won)

	7-1-50/ 12-31-50	1-1-51/ 3-31-51	4-1-51/ 6-30-51
Change in accounts of the Bank of Korea:			
Currency issue	+165.7	+108.8	+ 79.4
Change in accounts with National Government			
Advances			
For Korean Government	+152.8	+ 52.9	+ 7.5
For U. N. Forces	+ 60.8	+ 52.7	+ 97.9
Nat'l. Gov't. Bonds	.0	+ .1	+ 2.8
Less Gov't. Deposits in Bank of Korea	- 48.6	+ .8	- 12.7
Less U. N. Deposits in Bank of Korea	- 6.1	- 6.2	- .9
Net change in Nat'l. Gov't. obligations to Bank of Korea	+158.9	+100.1	+ 94.6
Change in accounts with banking system and public			
Loans	+ 9.6	- 6.6	+ 15.9
Foreign exchange account	+ 28.4	- 5.2	- 4.6
Less other deposits	- 15.1	- 9.0	- 1.3
"Other assets" less "other liabilities, capital and reserve" 1/	- 16.1	+ 29.3	- 25.2
Change in currency issue	+165.7	+108.8	+ 79.4

1/ Includes Special Deposit for Counterpart Fund and Aid Supply Funding.

In the last half of 1950 the change in the net obligations of the Government to the Bank of Korea, including the item of advances for the U. N. forces, amounted to 96 per cent of the net increase in the currency issue, and in the first half of 1951 it has exceeded 100 per cent of the net increase. Net advances to the Government of Korea to finance its own operations averaged 17.4 billion won a month for the second and third quarters of FY 1950, 1/ and 17.9 billion in the fourth quarter. This was converted into an average monthly net surplus of 1.7 billion won a month in the first quarter of FY 1951. Deduction of bond sales to the public and financial institutions other than the Bank of Korea reduces this to a net deficit of 1.1 billion won.

Won Advances to U. N. Forces

The demands of the U. N. forces in Korea for local currency have been met by additional advances to the Government by the Bank of Korea, and these have been superimposed upon the ordinary budget. The first advance was made in September 1950, and since that time the average monthly deficit incurred for this reason has grown rapidly from 16.5 billion won in the third quarter of FY 1950 to 32.3 billion in the first quarter of the current fiscal year. These advances for the U. N. forces alone exceeded the new currency issue in this latter period, and in view of the fact that the accounts of the Korean Government would have only a very small deficit had it not been for this factor, it has been possible for the Koreans to picture the demands of the U. N. forces as providing almost all the fuel for the continuing inflation. The Korean Government has refused to treat this expense as a contribution to the U. N. effort for which it must budget, and is pressing the U. N. nations involved for a repayment in foreign exchange of the won advances made up to date.

The agreement concluded between the U. S. and Korean Governments announced on October 10, 1951 for the immediate payment of $12,155,714 as a settlement of ₩63 billion of the Korean claim is in part a response to this pressure. However, this represents only that portion of the won sold to the U. S. troops for their personal expenditures and does not include the sums expended for official procurement of goods and services or the personal expenditures of other U. N. troops. This settlement implied no acceptance on the part of the U. S. of these elements of the Korean claims.

1/ All FY references are to the Korean fiscal year, which begins April 1.

The manner in which the dollar exchange acquired through the recent settlements and any future settlements will be employed to curb inflation is as yet unknown. As shipping and port facilities are a limiting factor affecting imports and are beyond the control of the Korean Government, it is not likely that the new dollar exchange can be employed to effect a rapid augmentation of the supply of goods available for sale to the public. As an alternative to an immediate large scale increase in imports, it has been suggested that the dollars be used as backing for bonds to be sold to the public, thus absorbing won now in circulation and holding it until such time as increased supplies of goods become available. This, however, would probably force the Government into a revision of the exchange rate of the won, which at ₩6000 to $1.00, the current counterpart deposit rate and "special" rate of exchange for military pay certificates, is considerably overvalued. In selling bonds backed by dollars a realistic exchange value of the won would have to be used if the device were to be effective in mopping up excess currency to any appreciable degree. This, however, would have to be balanced against the Korean Government's desire to maintain the present favorable rate of exchange, since an upward revision would reduce the exchange acquired in any future settlements with the U. N. forces.

Outlook for the Current Fiscal Year

It would be overly optimistic to assume that the problem of the U. N. advances is the only remaining obstacle to the stabilization of the Korean economy. As long as the present emergency continues, the prospects of effecting a substantial reduction in government expenditures are not bright and the past record of tax collection in Korea does not encourage hope that sufficient revenue can be raised to achieve a balanced budget. A comparison of the FY 1950 revised budget and the original FY 1951 budget indicates how great this problem is.

Budget Comparisons

	Budget items (Million won)		Percentage increase or decrease in FY 1951 as compared with FY 1950	
	FY 1950	FY 1951	In terms of current won	In terms of won of constant value 1/
Revenue				
General Account	79,978	363,652	230	55
Special Account	321,244	402,225	25	-41
Total	401,222	665,877	66	-18
Expenditure				
General Account	291,527	227,303	-22	-63
Special Account	310,942	438,574	40	-25
Total	602,468	665,877	11	-48

1/ Calculated on basis of retail prices in Pusan in the last three quarters of FY 1950. Wholesale prices would show a somewhat less severe depreciation, but complete figures are not available.

As the current value of the won in real terms is only 47 per cent of its average value during the last three quarters of FY 1950, this year's budget actually projected a cut in total expenditures of 48 per cent. The large increase of 230 per cent in tax and other General Account revenue when similarly deflated shrinks to an increase of only 55 per cent. This is actually a modest increase in view of the fact that tax collection in FY 1950 came to only 20 per cent of budget estimates. At the beginning of the current fiscal year the Government introduced new regulations designed to keep expenditures down to the budgeted levels and also took steps to strengthen the tax laws and tax collection machinery. Possibly as a result of this there was a budgetary surplus of W7.3 billion in the first quarter, excluding advances for the U. N. forces. Tax collections amounted to only 43 per cent of assessments, but this was compensated for by higher collections of other revenue and the fact that expenditures were kept below the estimates. While the inflation has been sharply decelerated in the three months ending June 1950, it would be premature to consider this a permanent change. The decrease in tempo indicated in the following table does not appear to vary significantly from the seasonal trend.

Average Monthly Rate of Increase of Inflation Indices

(Per cent)

	January-March 1951	April-June 1951
Bank notes in circulation outside banks	13.6	7.3
Money supply	13.9	7.5
Retail prices	27.4	2.2

Retail Price Index (Pusan)

January-June 1951

Month	Index 1947 = 100	Per cent increase over same month 1949
January	1,118.1	470
February	1,398.8	600
March	1,934.0	862
April	2,014.6	866
May	1,745.7	735
June	2,062.0	882

Figures for the second quarter are not yet available, but it is known that the budget had to be revised upward in July. The data available on this revision is conflicting, but it appears that the increase in expenditures was of the order of 60 per cent. It is unlikely that the increase in budgeted expenditures will actually be balanced by higher revenue collections. It would appear, therefore, that barring a drastic change in the scale of outside economic aid for Korea or the unlikely possibility of outside intervention in the formulation and execution of Korean fiscal policy, a continuation and possible acceleration of the present inflation may be expected in the last half of 1951.

In face of this alarming prospect of continuing inflation, it should be stressed that an underestimation of the importance of the Korean economic front and the pursuit of policies which either feed or fail to curb hyper-inflation weakens the economic fabric and also the political and social stability of the country, creating unrest and resentment at a time when we are attempting to win support for the free world.

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BOARDS OF DIRECTORS IN LATIN AMERICAN CENTRAL BANKS

Harry A. Gillis, Jr.

Of the twenty Latin American republics, Panama is the only one not having a central or quasi-central bank. Among these banks, there is considerable diversity of central banking structure as well as of responsibilities and powers, of freedom to formulate proper monetary policy, and also of many other criteria of comparison. Since central banks should be organized and administered to fit the needs of their respective countries, this diversity is to be expected. The following discussion of the composition, duties and responsibilities of the boards of directors of the Latin American central banks may highlight their principal differences without, however, explaining their origins. A brief appraisal is also made of the effect of the central bank directorate's composition upon their policy decisions.

Structure of the Boards of Directors

Most of the Latin American central banks have one board of directors which is responsible for determining the central bank's monetary policies as well as guiding its daily administration. Exceptions to this rule occur among those central banks which are also engaged in commercial banking activity and have separate boards governing each type of activity, that is, one policy-determining board to consider issues usually associated with central banking and another board to administer the bank itself and its commercial banking operations. Apart from the delineation of authority contained in the banking legislation or charter, coordination between the two boards is achieved in various ways. For example, in Bolivia, the president of the central bank presides over a joint session of the monetary policy and commercial banking boards acting on matters affecting both phases of the bank's activities. In Paraguay, the central bank's monetary board, by law, is independent of and separate from the bank's administrative board. In practice, however, this situation has deteriorated and the membership of the two boards has become almost identical. 1/

Brazil presents a more peculiar exception since monetary policies are determined by an agency--the Superintendency of Money and Credit--which is institutionally separate from the Bank of Brazil. The Bank of Brazil, a

1/ Comments in this paper with regard to Paraguay refer to the existing central bank, not to the bank envisaged in legislation drafted by a recent Federal Reserve Board mission.

commercial bank in which the Government has a controlling interest, holds a dominant position in the Brazilian banking system and for this reason is considered by some as a quasi-central bank. More properly, however, the Superintendency may be considered as Brazil's central bank.1/ This body, composed of representatives from seven separate agencies, determines and has the power to implement the monetary policy for the country.

Size of the Boards of Directors. Considering only the central or quasi-central bank boards responsible for determining monetary policy, but excluding the commercial banking and/or administrative boards, the size of the boards varies from three to fourteen members.

Composition of the Boards of Directors. One of the characteristics of Latin American central banks is that virtually all of them have a president who serves the bank in a full-time capacity. In almost every country, the bank president is the chairman or at least a member of the board of directors. Exceptions to this are the central banks of Brazil, where the central bank is an inter-institutional committee; of Colombia, Ecuador and Mexico, which have only general managers who are not board members; and of Chile and Peru where the central bank president may be, but not necessarily, is appointed from among the directorate's membership.

In the composition of the respective central bank boards of directors, the government is the special interest most commonly found included. In fifteen countries,2/ governmental interests are specifically represented by ministry officials, federal agency representatives, and/or other government appointees. In ten of these countries,3/ the Minister

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1/ When the Superintendency was established in 1945, it was given the general attributes of a central bank and was intended to serve as such until a true central bank is created. The Superintendency's Council is composed of the Minister of Finance, Executive Director of the Superintendency, President of the Bank of Brazil, and directors of the legally independent Exchange Department, Rediscount Department, Banking Mobilization Fund, and Banking Supervision.

2/ In every country but El Salvador, Nicaragua, Uruguay, and Venezuela. Even in the first three of these countries, government appointees representing general interests may be selected on the basis of their willingness to support government policies.

3/ Argentina, Brazil, Colombia, Costa Rica, Dominican Republic, Ecuador, Guatemala, Haiti, Honduras, and Paraguay.

of Finance (in Ecuador, the Minister of Economy) is a member (ex officio). Among these countries, the minister is the president (ex officio) of the board in the Dominican Republic and Paraguay and, in Argentina, the president (ex officio) both of the board and the central bank.

The non-governmental activity most commonly represented in the board membership is that of the commercial banks. In eleven countries, 1/ the commercial banks, in joint meeting, either elect one or more representatives to sit on the governing board or (in the Dominican Republic) nominate candidates one of whom is then appointed by the President of the Republic. In addition to these countries, the central bank directorate includes representatives from four government-owned credit institutions in Argentina, and the governing council of the Superintendency of Money and Credit in Brazil includes the president of the Bank of Brazil and directors of independent departments associated with the Bank of Brazil. In three of the eleven countries (Chile, Colombia, and Cuba), foreign- and domestically-owned commercial banks are differentiated, each group of banks electing their own representatives to the board of directors of the respective central banks.

The other special interests explicitly represented in central banking directorates in many Latin American countries are agriculture, industry or commerce (in eleven countries) and labor (in three countries).

Internal functions and powers of the Boards of Directors. The boards of directors of the Latin American central banks in every case are responsible for establishing monetary policy, within the limits imposed by direct or indirect government intervention. Further duties, particularly in the field of the central bank's administration and operations, vary from one country to another. The extremes are represented on the one hand by boards responsible only for policy determination and for approving annual reports and budgets and on the other hand by boards exercising rather complete administrative and operational supervision as well as policy determination.

The variations in the administrative responsibilities of the boards of directors are inversely related to the duties with which the central bank presidents and/or general managers are charged. All but five of the Latin American central banks 2/ have both a president and a general manager. These

1/ Bolivia, Chile, Colombia, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Peru, and Venezuela.

2/ Brazil, Ecuador, El Salvador, Mexico and Venezuela have only one or the other.

officers, assisted in some countries by vice-presidents and assistant managers, are responsible for the daily functions of the central bank and for carrying out the instructions of the board of directors. Since the boards meet once a week or twice a month,1/ the president, as chief executive officer of the bank, regulates the bank's operations and manages its personnel; the general manager serves as the immediate supervisory officer under the president. The less frequently the board meets and the fewer its administrative responsibilities, the greater the importance attached to these posts.

Central Bank Board of Directors Vis-a-Vis the Government 2/

The central bank's place in the government's organizational structure, and its relationship with the treasury, vary widely from one Latin American country to another. It is reasonable to assume, however, that the membership of the Minister of Finance in ten boards of directors of Latin American central banks and the prestige of his ministerial position certainly give him an influence on monetary decisions far beyond the formal powers with which he may be endowed. Even in such countries as the Dominican Republic, Costa Rica, Guatemala, and Honduras, where legislation explicitly grants the central bank responsibility to make final decisions in the field of monetary policy, the Minister of Finance's participation in discussion and voting probably does much to nullify the legislative grant of seeming independence. The Minister's influence on monetary policy is particularly obvious in Colombia and Mexico where legislation requires that certain specified central bank monetary policies and actions be submitted to him for his approval or prior review.3/

1/ Uruguay's central bank is the only one requiring meetings oftener than once a week. Banking legislation in most other countries, however, provides general rules for calling special sessions whenever necessary.

2/ This section is based upon a memorandum submitted in September 1950 regarding Treasury-Central Bank relations.

3/ In Colombia, any action by the board of directors to change rates of interest and discount, to change reserve requirement ratios, to establish discount ceilings or credit quotas, etc., requires the Minister's favorable vote. The Mexican Secretary of Finance has the right to veto measures proposed by the board of directors of the Bank of Mexico which pertain to (a) operations affecting the volume and composition of monetary circulation; (b) operations of buying and selling gold, foreign exchange, divisen, or foreign currency titles or documents; (c) loans guaranteed by the Bank of Mexico's liquid assets; and (d) the deposits which member banks must maintain as reserves in the Bank of Mexico.

Apart from the influence exerted by government representation in the board of directors, economic and historical factors make it nearly impossible for a Latin American central bank to refuse an insistent treasury request for credit if the treasury has the support of the highest executive authority. Increasing governmental expenditures for developmental investments and for the extension of social services, difficult problems in raising tax revenues correspondingly, and the general unwillingness of the public and commercial banks to hold any sizable portion of their assets in the form of government securities have made the central bank virtually the only source of domestic finance for government deficits. The central bank, or more personally the directors of the board, can attempt to impress upon high government officials and even the public the monetary implications of proposed fiscal policies. After a certain course of fiscal action has been taken, however, the central bank can only minimize any undesirable repercussions of the treasury's operations by regulating the availability and cost of credit to the private sectors of the economy. Even this regulation may be difficult to effect if the representatives of the private sector on the board of directors seek to protect their own particular interests.

In a few countries, the burden on the central bank of resisting treasury requests for credit is relieved by statutory limitations on the central bank's ability to extend credit to the government. These limitations have taken the form of absolute ceilings upon government borrowing from the central bank (Peru), of ratios between central bank holdings of government securities and average fiscal revenues of the government over a number of preceding years (Cuba, Paraguay), or of ratios between the central bank's credit to the government and the bank's capital and reserves (Chile, Colombia). When further credit to the treasury would result in exceeding certain established legal limitations, the potential conflict between the treasury and the central bank is sometimes resolved either by the National Council of Economic Coordination 1/ (Paraguay) or by the legislature (Chile, Colombia).

1/ The Council is charged with integrating and then putting into effect coordinated national economic policies. The Council of seven members is composed of the President of the Republic; the President of the central bank; the Ministers of Finance, of Industry and Commerce, and of Agriculture; and one co-delegate from each of the first two Ministries.

Relation of Directorate's composition to its policy decisions

As described earlier, the directors of Latin American central banks generally represent the government, commercial banks, and certain special private interests. Latin American legislators enacting central banking laws purposefully provided for such a composition. They did so on the rationale that the public welfare would best be served by dividing responsibility for central bank policy determination among those groups most familiar with and most concerned in monetary matters. In practice, however, the representatives of each group have tended to place the interests of their sponsor above that of the general public.

Reference has already been made to the influence of government representation on the board of directors, particularly by the Minister of Finance. Commercial banks are profit-maximizing organizations whose representatives in the central bank are not likely to propose policies restricting unduly the profit opportunities of their sponsors. By the same token, directors representing agricultural and livestock producers, miners, exporters, importers, merchants, and others will be reluctant to adopt policies adversely prejudicial to the represented group.

Given the composition and nature of Latin American central bank directorates, it is not surprising that many of the boards of directors have traditionally had "do-nothing" monetary policies. Since it has been easier to drift with the tide of political and economic circumstances, the tremendous post-depression expansion of bank credit in Latin America has not been unexpected.