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Big Banks vs. Little Banks

Reed J. Irvine

Japan is a land where, although branch banking flourishes, the number of commercial banks is fairly large, some eighty-five all told. However, banking is heavily dominated by a handful of large banks with their headquarters in the metropolitan centers. As of November 1957, eleven banks known as the city banks, accounted for 64.4 per cent of the assets of the entire banking system.

This concentration is in part an outgrowth of the war and the desire of the Government to exercise greater control over the use of the nation's financial resources as part of the war effort. The proportion of bank assets accounted for by the city banks rose from a mere 26.3 per cent at the end of 1940 to a full 50 per cent five years later. The process of concentration continued in the inflationary period following the war, as the city banks were less cautious than their smaller competitors and made much freer use of central bank credit to expand their loans. During most of this period, these banks were in the position of having loans in excess of their deposits.

The increasing concentration in banking has aroused little concern in Japan where bigness is regarded as almost synonymous with efficiency and good management. However, contrary to opinion in even official circles, the smaller (prefectural) banks appear to be both more profitable, (perhaps reflecting better management,) and more responsive to the wishes of the monetary authorities than do the large city banks.

In the six months ending September 30, 1957, the yield on funds employed by prefectural banks averaged 9.017 per cent compared with 8.079 per cent for city banks. Prefectural bank profits rose 20.3 per cent compared with the previous period while city bank profits dropped 3.3 per cent, despite the fact that average outstanding loans of the big banks went up 16.8 per cent while those of prefectural banks rose by only 11.7 per cent during this period of monetary restraint. This reflects the fact that the big banks had a smaller increase in the average return on loans, a larger increase in dependence on expensive borrowed funds compared with a decline for the prefectural banks, and a larger increase in the cost of deposits. The city banks borrowed heavily not only from the Bank of Japan, but from the prefectural banks, which were able to employ their excess funds very profitably in the call market.

The contrast between the city banks and the prefectural banks with respect to earnings on capital is even more striking. In the half year ending September 30, 1957, the city banks earned 40.2 per cent on capital while the prefectural banks earned 88.8 per cent. Only a very small part of the difference is attributable to the slightly lower ratio of capital to deposits prevailing among the prefectural banks. If the prefectural banks had the same ratio of capital to deposits as the city banks their return on capital would still be over 80 per cent.

Despite this great difference in profits, no bank is permitted by the Government to pay dividends equal to more than 10 per cent of capital. The purpose of the policy has been to force the accumulation of reserves, and the results have been such that in the case of one small bank the reserves on September 30, 1956 amounted to 18 times the bank's capital. The ratio of profits to capital would drop to more normal levels if a reasonable portion of these reserves were capitalized, but this has not been permitted. The reasoning is that this would result in a larger distribution of profits to the shareholders and would curtail capital accumulation in the form of reserves.

While the aim of increasing equity interest in the banks is a good one, this particular technique has some undesirable effects. It tends to deemphasize the role of profits in banking, since the dividend limitation has been set at a level low enough to enable all banks to pay with no difficulty the maximum permitted. The incentive for bank management to increase profits is slight under these conditions. Indeed, the very large undistributed profits of some banks are a source of embarrassment to management since they invite pressure or criticism from all sides -- the shareholders who want larger dividends, the employees, who want better pay, and the borrowers who see no reason for high interest rates when bank profits are so high. This policy also has the effect of forcing the most profitable banks (which generally have the largest reserves) to add the most to those reserves, which would seem to be just the reverse of what is wanted.

There is some indication that the deemphasis of the profit motive in banking is to blame for what has been criticized as irresponsible behavior on the part of the big city banks. It is now clear that the policy of expanding loans at any cost pursued during the summer of 1957 lowered rather than increased the profits of these banks. Some observers have explained this seemingly irrational behavior as stemming from the desire of bank management to gain added power and prestige. A more logical explanation appears to lie in the fact that the principal stockholders of the city banks have more reason to be interested in these institutions as a source of loans than as a source of profit.

This is suggested by the relatively unattractive yield on city bank shares and the large proportion of shares owned by corporations. City bank shares have been priced 20 to 25 per cent above prefectural bank shares despite their poorer earnings records and the relatively poorer prospects of future capital gains in the event of removal of restrictions on dividends and capitalization of reserves. The reason for this probably lies in the high degree of corporate interest in city bank stocks. In September 1956, 67 per cent of the stock of the thirteen largest banks was owned by corporations, 56 per cent of it by non-financial corporations. This is just the reverse of ownership pattern of the prefectural banks. Averaging the stock ownership of 32 prefectural banks as of the same date, 71 per cent was in the hands of individuals and only 29 per cent was held by corporations.

From the standpoint of the yield on the funds the large Japanese industrial firms that are big holders on city bank shares could more profitably invest this capital in their own businesses. The yield on these shares ranges from 6.5 to 7.5 per cent, which is considerably less than the interest which these firms pay on their bank loans. The motivation for holding bank shares must be related to their relations with the banks as customers. The relationships become very complex, since in many cases the banks own large blocs of stock of the industrial corporations which are their own largest shareholders. In addition, these firms often have such large loans from individual banks that the failure of a single borrower might result in the failure of the bank. Banks have been known to pour good money after bad for this reason. The interests of the city banks are thus very closely intertwined with the interests of the big industrial firms that are partially owned by them and at the same time their owners and their largest clients.

Under these conditions, it is probably futile to expect this major sector of the banking system to behave as it would if a simple lender-borrower relationship prevailed.

Bank profits, as has been seen, may be sacrificed in the interests of the subsidiary-shareholder-borrower. This probably explains why the city banks have been less profitable and less responsive to policies of monetary restraint than the smaller banks during the past year.

It is now suggested that the "irresponsibility" of the city banks indicates the need for more direct controls over the banking system. A better solution would appear to lie in measures that would undo the complex relationships that have been built up between the city banks and their major clients. This would involve (1) imposing some limitations on the size of loans to single borrowers and possibly upon bank investment in corporate securities and (2) alteration of the existing limitations on the payment of dividends by banks and the capitalization of their reserves. Such a reform would be essential in any move to restore the profit incentive to its proper place in banking. This incentive is essential if monetary policy is to operate successfully.

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The High Price of Cheap Rice

Reed J. Irvine

One of the most discouraging aspects of the Korean economic situation in the postwar period has been the difficulty of narrowing the tremendous trade deficit. Korean exports have been pitifully small. In 1953, when the U. S. was buying tungsten in substantial quantities at a premium price, exports amounted to $40 million, while imports totaled $428 million. Since then exports have fallen sharply; in 1956 Korea exported only $25 million worth of goods. Imports also dropped in value, but they were still high, amounting to $369 million in 1956. In the first 9 months of 1957, exports fell to an annual rate of $22 million and imports through August rose to an annual rate of $489 million. Despite large American aid expenditures no progress toward the goal of economic self-support is evident in South Korea. Indeed, the trend appears to be in the opposite direction.

In the period 1936-38, about 80 per cent of all Korea's imports were covered by export earnings. In recent years, exports have covered less than 7 per cent of total imports of South Korea. This is an even poorer performance than in 1949 when nearly 11 per cent of imports were covered by exports. The record of the past eleven years appears to indicate that South Korea cannot exist as an economic entity without very great outside support. What are the basic weaknesses that have reduced this country to such a state of helplessness?

The division of the country not a major factor

In the division of Korea, the bulk of the heavy industry, minerals, and electric power went to the North. South Korea, however, was not left stripped of means of support. Indeed since South Korea had produced nearly three-quarters of the country's rice and had nearly all of the light industry it would appear to have obtained more of the resources that would contribute to early attainment of viability than did the North.

Although nearly all of Korea's heavy industry was located in the north, heavy industrial products were not an important element in the prewar Korean balance of payments. Korea's heavy industry consisted of iron and steel, cement and chemicals, mainly fertilizer. The combined export value of iron ore, pig iron and steel ingots was only 3.24 per cent of total exports in 1935-36, the last prewar years for which figures are available.[1] Cement exports in 1936-38 averaged 0.7 per cent of all exports, and chemical fertilizer was not exported. Minerals were somewhat more important in northern Korea. A very large part of the coal deposits were in the north and about 68 per cent of the gold was produced there.

1/ The Far East Yearbook, 1941, p. 518.

The value of the gold produced in north Korea in 1936-38 is estimated to be equal to about 9 per cent of the value of total exports in those years.[1] Coal exports in these years amounted to 1.18 per cent of total export earnings. Earnings from the export of other minerals were relatively small, and a substantial part of the production of the most important ones, tungsten and graphite, came from south Korea. The only other important exports that were produced mainly in north Korea were soybeans, timber, paper and rayon cloth, which combined accounted for 5.7 per cent of total exports in 1936-38. Organic fertilizer was an important export, accounting for another 5.6 per cent of the total in these same years, but how much was produced in the north and how much in the south is not known. All of these products originating in north Korea probably did not account for more than 20 per cent of prewar Korea's exports.

On the import side, it appears that only a small percentage of south Korea's large imports at the present time consist of commodities formerly obtained from the north. The main commodity that fits in this category is chemical fertilizer. If it is assumed that three-quarters of the amount produced in the north would normally be used in south Korea, it can be said that the loss of this supply has necessitated import from abroad of about 300,000 tons of fertilizer a year, adding some $20 million to foreign exchange payments. South Korea's coal imports are about half as large as coal imports for all Korea prewar, and it is therefore doubtful that their present volume can be attributed to the division of the country. The loss of electric power supplied from the north was a heavy blow to South Korea originally, but it has been made up by increases in generating capacity in the South. The new thermal plants use domestic anthracite mixed with fuel oil and so there is no large recurring foreign exchange expenditure as a result of this substitution. The other items that may have been partially supplied by the north prewar include cement, soybeans, some chemicals, and rayon yarn. Total imports of these items have not accounted for more than $20 million of Korea's imports in recent years, and it is doubtful that very much of this represented goods that could actually have been supplied by north Korea.

It is likely that about 10 per cent of south Korea's imports are substitutes for goods formerly supplied from the north. The south, of course, supplied goods and services to the north in return. If there were any net loss to the south as a result of the elimination of this trade it could not have been very large and would certainly not account for a very significant portion of the present trade deficit.

The most important single commodity in the prewar trade of Korea was rice, which was produced chiefly in the south. The south, with about 64 per cent of the total population, produced 72 per cent of the rice. Rice consumption on a per capita basis may have been somewhat higher in the south than in the north, but there is no question but that most of the rice exported by Korea before the war was produced south of the 38th parallel. In addition, the south had other valuable agricultural, aquatic and mineral resources as well as the bulk of the cotton textile mills, which supplied the most

1/ Bank of Korea, Sangop Chongnan, 1954, p. 276 and Far East Yearbook, 1941, p. 525.

important industrial export in 1937-38. The loss of the area north of the 38th parallel therefore does very little to explain the failure of South Korea to make a better export showing in the postwar period.

Rice is the key

Although rice was far and away the leading export of the country before the war, South Korea has not exported any rice in the postwar period except for about 100,000 tons shipped to Japan in 1950. This is a major factor in Korea's failure to make any progress toward self-support in the postwar period. This once large rice exporting country has become a deficit area that has had net rice imports nearly every year since the end of the war.

According to official figures rice production in South Korea from 1936 to 1941 averaged 2.54 million metric tons of brown rice a year, excluding the very bad year of 1939. From 1948 to 1956, omitting the two worst years, 1951 and 1952, the average production was reported to be 2.2 million tons. Crop reporting in Korea is notoriously bad, with a strong bias toward under-reporting. The Japanese estimated that beginning in 1936, when a stringent compulsory collection system was enforced, the actual crop for each year was about 20 per cent greater than the reported figures. This appears to have held true in the postwar period as well. In a number of years, American experts have made independent estimates of the Korean rice crop, and they generally found production to be about 17 per cent above the official figures. In 1956, a Bank of Korea study, based on a sampling of yields, indicated that the crop for that year was about 16 per cent greater than was officially reported.[1] It appears safe to assume that the errors in production in the prewar and postwar periods are of roughly the same magnitude and that a realistic estimate of average prewar rice production in South Korea would be in the vicinity of 3 million tons as compared with 2.64 million tons postwar, excluding in both cases the abnormally low years. In the very best years, prewar production probably went above 3.4 million tons, while the best postwar crop has probably not exceeded 2.75 million tons.

Rice production appears to have fallen by over 10 per cent in the postwar period. Acreage in 1956, which was the highest in several years, was 8 per cent below the prewar high of 2.94 million acres planted in 1938. The yield per acre in the best postwar year, 1954, was 12 per cent below the best prewar year. It would appear that an important part of the answer to Korea's economic problem might be found by studying the question of why both rice acreage and yields have failed not only to surpass but even to equal prewar levels.

The drop in yields contrasts with the performance of Japan, where in the years 1951-55 the per acre yield of paddy was 4 per cent above the

1/ Bank of Korea Monthly Review, February, 1956, pp. 3-9.

1935-39 period. The Japanese credit increased use of improved seeds, well-balanced fertilizers and improved insecticides for the progress they have made.

Chemical fertilizer has been abundant in South Korea in recent years. Indeed some think that it has been too plentiful and that the excessive use of nitrogenous fertilizers has damaged the soil and hurt yields. Reliance on chemical fertilizer is still not as great as in Japan, but apparently insufficient attention has been given the problem of educating the Korean farmer to take measures to counteract the growing acidity of the soil.

Korea has probably fallen behind in improving seed strains, and it may be that less than full advantage has been taken of modern insecticides. Irrigation projects have been encouraged, but production figures do not reflect the gains that should have resulted from an expansion of the irrigated area. These are technical problems that might be explored to advantage. On the economic side, there is a question of whether price and collection policies have been factors in blunting the incentive of the farmers to produce. Still another question is whether the drafting of large numbers of farm boys for military service has had an adverse effect on the quality of the agricultural labor force.

Whatever the explanation for the lag in rice production in South Korea, it seems safe to say that had the problem of rice since the war been given emphasis at least comparable to that shown in the prewar period the picture would be quite different today. Even the achievement of the average prewar yield and acreage would give Korea an extra 300,000 to 400,000 tons of marketable rice.

Rice consumption

The other side of the coin is consumption. We don't know how much of the rice exported from undivided Korea prewar was produced north of the 38th parallel and how much in the south. South Korea in 1938 had 64 per cent of the population and produced on the average about 72 per cent of the rice, indicating that the bulk of the surplus was produced in the south. Per capita consumption of rice was probably somewhat greater in the south than in the north, but it is impossible to say how much. From 1912 to 1929, the amount of rice available for consumption in all Korea ranged from about 1.4 to 1.8 million metric tons. There was no upward trend in the rice supplied the domestic market during this period despite the growth of population.

The steady rise in exports from 76,000 tons in 1912 to 1.07 million tons in 1928 was achieved through expanding production and decreasing per capita consumption. Rice available for consumption dropped from 120 kilograms per capita in 1912 to about 78 kilograms in 1926-28 while production per capita fell from 126 kilograms to 110 kilograms due to the population increase.

In the early 'thirties, the decline in consumption accelerated, falling to about 60 kilograms per capita, half of what it had been in 1912.[1] Exports were increased sharply, and in 1934 and 1935 more than half the rice supply was exported.

The modernization of Korea was clearly made possible not only by intensive efforts to increase the production of rice but also by inducing a radical change in the pattern of consumption. This pressure was eased in the years immediately preceding the outbreak of war in the Pacific when record crops and smaller exports boosted the amount of rice available for consumption to well over 100 kilograms per capita.

The population of South Korea has grown from 14.5 million in 1938 to an estimated 22.3 million in 1957, a 53 per cent increase. This has a great deal to do with South Korea's failure to export rice on the same scale as before the war but it is not the only explanation nor does it mean that the export of rice has become impossible. Per capita consumption of rice has also risen sharply, probably exceeding 110 kilograms per capita in the better years. The relative importance of rice in the diet has risen strikingly. Probably about two-thirds of the calories consumed in the form of grains are now provided by rice compared with only a little over a third in 1936. This places Korea on a par with such countries as Japan, Philippines and Pakistan. Such an improvement in living standards would be desirable if there were any hope that Korea could afford it. Unfortunately to achieve a self-supporting economy in South Korea, it appears a lower level of rice consumption and export surplus rice will be required. If rice consumption were cut to the level that prevailed in the first half of the 'thirties, only 1.34 million tons would be required to feed the present population of South Korea. On this basis with the 1957 rice crop unofficially estimated at 2.79 million tons of brown rice, allowing for seed and reserves, Korea might make as much as 1.3 million tons of this available for export. If production could be increased by 300,000 tons, South Korea would have a potential export capacity of 1.6 million tons. This is just a little under the record export total of undivided Korea in 1938.

Can Korea offer rice for export?

The idea that Korea might regain her position as one of the world's leading exporters of rice is dismissed by those accustomed to thinking of the country as a hopeless economic invalid. Some say that the idea is fantastic because the average Korean diet is not far above the minimum subsistence level even with net food imports. In 1949, when the grain harvest was about the same as in 1957, studies indicated that the average diet provided about 2900 calories, and it was concluded that some rice could be exported without substituting cheaper grains. Whether this is true today could only be determined by new research. Estimates based on the very inaccurate food production reports are of little value in this connection.

1/ Bank of Korea, Sangop Chongnan, 1954, p. 685

Even if it were decided that the Korean diet could bear no quantitative reduction and there were no possibility of increasing production this would in no way dictate against the export of rice. The export of large quantities of rice could easily be accomplished by importing through the cheaper grains, such as wheat or barley, to replace the rice. The caloric equivalent of one ton of rice could be obtained by substituting 1.108 tons of wheat or 1.246 tons of barley. The cost of these amounts of wheat and barley delivered in Korea would be about $74 and $66 respectively at current prices. This compares with the world market price of rice of about $150 per ton. The real question is, can South Korea afford not to make a change in the consumption pattern that offers the prospect of such large net earnings.

Assuming that foreign aid on the present scale cannot be counted on for all eternity this change will have to be made. It is desirable that it be made before the people become so accustomed to their present high rate of rice consumption that the adjustment to a different diet becomes more difficult. The adjustment at the present time would not necessarily involve great difficulties. The average diet undoubtedly changes considerably at the present time in response to seasonal price fluctuations. The export of large quantities of rice might only reduce rice consumption to the level already prevailing in the summer months when rice supplies are low and prices high.

The Korean Government has followed a policy of prohibiting the export of rice in order to insure an adequate domestic supply and keep the price of rice low. This is reminiscent of policies once popular in Europe but which for at least two centuries have been recognized as economically undesirable. If the prohibition of the export of agricultural products has any effect it taxes the producer for the benefit of the consumer. If domestic food production is inadequate to satisfy effective demand no legal prohibitions are necessary to insure that food will not be exported. If under free market conditions food is exported this demonstrates a consumer preference for the imports that can be purchased with the proceeds of the food sales abroad. When the Government prevents the export of food it forces the price down, depriving the producer of income that he would otherwise receive. At the same time, it reduces the volume of imports that can be purchased and increases the price the consumer must pay for such goods. The result is to discourage the production of food and to encourage the domestic production of articles which could be obtained at less cost through import if agricultural production and trade were not fettered.

This course of development is clearly observable in South Korea. The failure of rice production to expand has been matched by a proliferation of manufacturing enterprises. This is regarded in some quarters as a sign of progress, but it can hardly be so for the Korean who must give up 12.5 kilograms of rice for a crudely made umbrella of domestic manufacture when he could get an imported umbrella of much better quality for a little over half of the same quantity of rice. The only justification for this policy of prohibiting food exports is that it provides a form of relief for the destitute. While it is true that this presents a less complex budgetary problem than direct relief or subsidies it must be recognized that a device that discourages the most profitable types of production and encourages the less efficient enterprises can only lower the standard of living.

The results of this policy would long since have proved to be intolerable in Korea had it not been for U. S. aid. This has made it possible for the Koreans to eat their rice and have imports too and to maintain the exchange rate at levels which have led some to the strange conclusion that Korean rice is too high priced to sell on world markets. In setting a value for the Korean currency, it has apparently been forgotten that the function of an exchange rate is to equalize foreign exchange payments and receipts. Since the only way South Korea's trade can even approach balance is through large scale rice exports, the exchange rate must be set at a level that will make such exports possible. There is no way of computing this precisely, but in August 1957, when rice supplies were depleted the domestic price was such that a rate in the vicinity of 1600 hwan to the dollar would have been required to divert any rice into export channels. With the new crop the rice price has fallen sharply, and there is no doubt that exportation would be attractive at a rate of 1600 to 1. Presumably the effect of exportation at this rate would be to reduce the amount of rice available for domestic consumption to about the level prevailing in August. Whether this would suffice or whether the rate would have to be set even higher to get the desired amount of rice exports is something that could be learned only from experience. Since other exports would be stimulated it might also be possible to get by with a lower rate.

Marketing the rice

There is no question that South Korea could put large quantities of rice on the world market. The ability of the market to absorb the rice is another problem. Japan is the logical customer. Japan took nearly all the rice exported by Korea before and during the war. Korean rice is suited to Japanese tastes and is preferred to the Southeast Asian rice that Japan has been compelled to rely upon in the postwar period. Korean rice would therefore command a much better price in the Japanese market than it would in the distant markets of southern Asia where a less glutinous rice is preferred.

Before the war, Japan imported from 900,000 to 1,600,000 tons of rice from Korea and 500,000 to 600,000 tons from Taiwan. Average net imports from 1936 to 1938 were nearly 2 million tons. Japanese rice imports have been sharply curtailed in the postwar period in spite of the fact that population has grown much more than domestic production. Per capita consumption of rice in 1953-55 was only a little over 70 per cent of the prewar level. The difference has been made up mainly by larger use of wheat and barley. Japanese rice imports totaled 950,032 tons in the 1955-56 food year, but fell to a low of 380,300 tons in 1956-57. Larger imports are planned in 1957-58, with 540,000 tons to be purchased in the first half of the food year, but this still represents a drastic reduction from prewar levels. Will Japan ever again become a large market for Korean rice?

This won't happen overnight, but there is a good possibility that the market can be regained over a period of time. Japanese rice consumption has been curtailed by government control of the supply and distribution, which has kept the price high and rising despite contrary world market trends. The Japanese consumer is now paying the equivalent of $242 a ton for rationed domestic rice and blackmarket prices are considerably higher. Taiwan rice, which is now being sold to Japan for $147 a ton, is rationed to the consumer at the equivalent of $206 a ton. There is little doubt that Korean rice could be priced at a level that would win it a large market, if the Japanese consumer were free to exercise any choice in the matter. Import restrictions on rice in Japan now provide price support for the Japanese producers, and the Japanese Government will no doubt act slowly in exposing the domestic producers to foreign competition that would lower their incomes. However, Japanese governments are also mindful of the need for markets for industrial products. It would be realistic to expect that eventually arrangements might be worked out providing for the mutual relaxation of restrictions on trade between Japan and Korea. This would open the way for the sale of very large quantities of rice annually to Japan.

This year would be an ideal time for Korea to begin an effort to regain a major share of the Japanese market. Both the Thai and Burmese crops are down sharply from last year, and India and Ceylon have suffered major crop failures that are already being reflected in higher rice prices. Korean entry into the market would help relieve this pressure and would not create any serious problems for other rice producing countries. This is probably true for the long run as well as for the immediate future. The population growth that is taking place in Asia, development programs designed to raise living standards and a neglect of agricultural development in some countries combine to make a picture of a strong long term demand for rice.

It should be possible for Korea to sell 500,000 tons of rice in 1958 for at least $150 per ton, earning $75 million in foreign exchange. It might be necessary to increase import of substitute grains by $30 million or so, but the net gain to Korea would be considerably larger than all other export earnings combined and would mark the first significant progress toward economic self-support. The fact that Korea might not be able to market immediately all the rice she is capable of exporting should not be used as an excuse for postponing the effort. There is nothing to be gained by delay, and there is much to be lost. As the Korean people are becoming accustomed to eating more rice, their potential customers are becoming accustomed to eating less. Moreover, the demand for rice is being met by increased production in other countries, production which in the case of Japan is already receiving protection against foreign rice. The longer this goes on the more difficult will be the task of breaking it down.

"Cheap rice" may be a good political slogan, but the price of cheap rice in Korea is either indefinite dependence on American largesse or extremely dear prices for nearly every other commodity. Both Americans and Koreans might well ask whether the price is not too high.