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The Korean Financial Stabilization Programs

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The Korean Financial Stabilization Programs

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Introduction

From the end of the Second World War to mid-1957, Korea had a sharp rise in prices each year. Excluding the hyper-inflationary years of 1950-51, the average annual rise in Seoul wholesale prices was about 54 per cent.^{1/} In the last half of 1957, a bumper rice crop and large aid-financed wheat imports brought grain prices down sharply and the wholesale price index declined 11 per cent. Since the end of 1957, the overall index has been relatively stable, though grain prices have risen seasonally at mid-year.

Inflationary pressures have been generated by heavy expansion of credit to both the governmental and private sectors. Most of the credit to the Government has been used to finance the budget deficits engendered by the maintenance of a very large military establishment. Credit to the private sector has been used in part to finance speculation in various imported and domestic commodities.

With credit and monetary expansion far in excess of increases in real output, prices have risen markedly. From the end of 1953 to the end of 1956, the increase in credit to the government and private sectors was 188 and 56 billion hwan, respectively.^{2/} In the same period, money supply increased three-fold or by 103 billion hwan, and Seoul wholesale prices rose 216 per cent. In 1957, money supply rose 20 per cent but wholesale prices declined 0.6 per cent. In 1958, money supply increased 33 per cent and wholesale prices fell 2.5 per cent. The reasons for this apparent paradox in 1957 and 1958 will be examined in greater detail later.

By late 1956, it was evident that much of the U.S. aid program would be wasted unless inflation in Korea was brought under control. In addition, a fair degree of price stability was deemed essential in order to assure a sound basis for long-term economic development. Accordingly, the first financial stabilization program was formulated in early 1957.

Since the spring of 1957, economic developments in Korea have run their course against the background of three financial stabilization programs. The 1957 program took effect in April of that year; agreement

^{1/} Of the two series of data on wholesale prices, Seoul and national, the latter is available only back to January 1955. For periods prior to 1955 the Seoul index is used, but unless otherwise indicated, the national index is used in this paper for later periods.

^{2/} The official exchange rate for the hwan is 500 to the U.S. dollar but a large share of foreign exchange operations are transacted under a complex system of fluctuating multiple rates determined in foreign exchange auctions. The average exchange rate in the Government's June 1959 foreign exchange auction was 1,060 hwan to the dollar.

was reached in the following December on a program for 1958 and the present program for 1959 was announced last February. These programs provide a convenient frame of reference for examining current economic developments in Korea. The purpose of this paper is to examine the aims of these programs and to assess their relative effectiveness in the light of subsequent economic developments. Most attention will be given to the 1958 program and its results.

The 1957 program

The 1957 Program approved by the Combined Economic Board 1/ on April 20, 1957, had as its key aim the prevention of any increase in net money supply^{2/} during the year. While seasonal fluctuations would be permitted, money supply at the end of the year was to be the same as on December 31, 1956, or 120,9 billion hwan. The overall government deficit before U.S. aid contributions was to be reduced to 47.5 billion hwan, this deficit to be offset by a surplus in the counterpart fund. There was to be no increase in Korean Reconstruction Bank loans or in the amount of rehabilitation bonds outstanding. Similarly, commercial bank loans were to be held to current levels.

The main goal of preventing any increase in the net money supply was not achieved in 1957 as indicated in Table 1 below. Money supply rose by 24.3 billion hwan, a 20 per cent increase. On the other hand, price stability was achieved, wholesale prices declining 0.6 per cent. The overall government deficit was about 10 billion hwan over the goal of a deficit of only 47.5 billion hwan. While expenditures were cut 5 per cent across the board, many obligations were merely carried over into the following fiscal year. Commercial bank operations were effectively held in check. Most expansionary in relation to the aims of the program were the operations of the K.R.B. and K.A.B. which increased money supply by 45 billion hwan. Fortunately, large net counterpart collections of 93 billion hwan offset all but about 10 billion hwan of the expansion resulting from K.R.B., K.A.B., and the Government fiscal operations. The large counterpart collections were in part the result of a substantial increase in aid arrivals in 1957. This increase probably accounted for about half the rise in counterpart deposits and was a major factor contributing to price stability.

1/ The Board is composed of high Korean governmental and U.S. aid officials.

2/ Net money supply consists of notes in circulation, private checking and passbook deposits, and checking and passbook deposits of local governments and their public institutions less checks and bills in process of collection.

Table 1

Factors affecting money supply 1/
(In millions of hwan)

	<u>1957</u>	<u>1958</u>
1. <u>Government financing</u>		
a. General account, National Defense Bonds	62,187	34,022
b. Grains	-15,573	196
c. Property	2,371	597
d. Other	8,632	-3,303 <u>2/</u>
	<u>57,617</u>	<u>31,512</u>
2. <u>Counterpart fund</u>	-93,035	-9,160
3. <u>Banking</u>		
a. Bank of Korea	- 198	- 52
b. Korean Reconstruction Bank	17,554	10,533
c. Korean Agriculture Bank	27,984	-1,882
d. Commercial banks	757	13,108
	<u>46,097</u>	<u>-21,707</u>
4. <u>Foreign exchange</u>	12,074	13,175
5. <u>Other 3/</u>	<u>1,508</u>	<u>-9,867</u>
Net increase in money supply	24,261	47,367

1/ Minus denotes contraction.

2/ Contraction mainly caused by "Economic Coordination," "transportation and communication" accounts.

3/ Includes "Foreigners Deposits Excluding 402 and 480 for ROK Portion" and "Others and/or Errors."

The 1958 program

Program objectives--On December 26, 1957, the Combined Economic Board agreed on a 1958 financial stabilization program though it was specified that changes would be made in the spring after the Government's fiscal 1958 budget (calendar year) was finalized. In essence, the December agreement was that total money supply during the first three quarters of 1958 should not exceed 135 billion hwan or the level on January 1, 1958,

whichever was lower.^{1/} Provision was made for a 6 per cent increase in the fourth quarter if approved prior to September 1, 1958. During the first three quarters, "every effort" would be made to reduce the total money supply below the agreed ceiling and there would be no net monetary expansion from the Bank of Korea, the Korean Reconstruction Bank, and the commercial banks.

On March 12, 1958, agreement was reached on a more detailed program. This program, which included three "general policies" and seven "courses of action," is described briefly below. General policies were: (1) Increase government revenue (a) by promoting competitive bidding in order to maximize the proceeds from sale of aid goods, (b) adopting a minimum foreign exchange tax, and (c) by intensifying tax collections; (2) undertake a rigorous program to sell government properties, and (3) continue to manage the counterpart account in a non-inflationary fashion. Courses of action were: (1) achieve a balance in the Government's cash budget by executing expenditures within realized cash revenues; (2) limit K.R.B. loans to those funded from bond issues previously authorized, and funds from counterpart, Land Reform Administration, Vested Property Account and Grain Management Account; (3) limit K.A.B. loans to resources arising from repayment of rice, fertilizer and other loans outstanding; (4) limit commercial bank loans to the level at the beginning of the year plus subsequent increases in time deposits and special short-term working capital loans up to a maximum of 5 billion hwan; (5) dollars purchased from the U.N. Command during the course of the year will be sold; (6) the \$7.2 million paid by the U.N. Command to the Government for utility services will be sold, the hwan proceeds being used to repay loans from the Bank of Korea, unless the dollars are sold to the public; and (7) monthly schedules of the program will be assessed in advance and administered so as to achieve the aims of the program. While no mention was made of limits on money supply, the objectives presumably remained the same as in the program agreed on December 26, 1957. Data in Table 1 give some indication of how successful the authorities were in achieving the aims of the 1958 program.

Effectiveness of the program--In general, the 1958 Program was only a partial success. Net money supply expanded 33 per cent or by 47.4 billion hwan, but the national wholesale price index fell 2.5 per cent. Some objectives were not achieved at all and others only partially.

Turning first to the "general policies," no progress was made in 1958 in expanding the competitive bidding system for aid goods. However, there are formal plans for introducing more competitive bidding sometime in 1959 for certain aid goods by abolishing the specified end-user system.

^{1/} Since the December 31, 1957, level was 145.2 billion hwan, the 135 billion hwan figure remained the accepted goal.

A new tax on sales of foreign exchange was passed in August and the first collections were made in September. A minimum tax of 150 hwan for each U.S. dollar sold was established so that purchasers of foreign exchange had to pay a minimum of 650 hwan per dollar (500 H./\$ plus the 150 H./\$ tax). In the competitive bidding almost all offers have been at a rate in excess of 650 H./\$ (which includes the minimum tax), this excess also accruing to the Government as revenue. For example, if an importer pays 800 H./\$, his total tax is 300 hwan. To date the tax has been successful and has generally met collection expectations.

Tax collections in 1958 rose about 36 per cent compared to 1957, or from 105 to 141 billion hwan. This would appear to indicate that the Government's aim of intensified tax collections is achieving some success.

The program to sell government properties has so far been unsuccessful, chiefly because of the poor financial and operative conditions of these properties. A recent offer to sell the Korean Shipping Corporation, for example, brought no bids.

As indicated in Table 1 net counterpart operations in 1958 were contractionary. Receipts of 118.7 billion hwan exceeded outpayments by 9.2 billion hwan. However, this contractionary influence was far below that in 1957.

With regard to the seven "courses of action," there was a deficit of 31.5 billion hwan in the Government's cash budget in 1958. Approximately half of this deficit was accounted for by the financing of increased grain inventories. Other factors contributing to the deficit were the increase in wages for the military and government employees and a shortfall in revenues from the sale of vested properties.

K.R.B. expansion of 10.5 billion hwan, most of which occurred in the first half of 1958, was approximately equal to the permissible expansion under the March 12, 1958, supplement. Table 1 indicates that operations of the K.A.B. in 1958 had a net contractionary influence on money supply of 1.9 billion hwan.

Commercial bank lending in 1958 expanded money supply by 13.1 billion hwan, 6.2 billion of which occurred in December. Since the 1958 program permitted an expansion of 8 billion hwan (3 billion hwan increase in time deposits plus 5 billion hwan for working capital funds), commercial banks exceeded the permissible expansion by 5.1 billion or 64 per cent.

Foreign exchange operations contributed to 28 per cent of the monetary expansion in 1958 by adding 13.2 billion hwan to the money supply. The March 1958 agreement specified that the Government would sell all dollars purchased from the U.N. Command. However, during the year direct

purchases of dollars from U.N. forces totaled \$25.7 million and sales of dollars were only \$19.2 million hwan, a shortfall of \$6.5 million. With relative price stability having been achieved during 1958, Korean authorities were reluctant to sell foreign exchange in spite of their commitment under the March 1958 agreement. With the rapid increase in money supply near the end of the year, a somewhat belated attempt to slow this rise was made in December when \$8 million was auctioned, but money supply rose from 178.3 to 192.6 billion hwan in December.

With regard to the sixth "course of action" listed earlier, it is not clear whether the Government used the hwan proceeds from the \$7.2 million utility settlement to repay loans from the Bank of Korea. It is known, however, that the settlement contributed to the \$31 million rise in foreign exchange reserves in 1958.

From the monthly assessments of the program, it became clear in October that the limitation on money supply, even taking into account the permissible 6 per cent increase in the fourth quarter, would not be achieved. On November 5, 1958, the limit for the end of the year was set at 171.3 billion hwan, but this was soon exceeded, money supply reaching 178.3 billion hwan at the end of November.

In retrospect, the 1958 Program's failure to restrain monetary expansion did not lead to subsequent price rises, but this was due largely to fortuitous circumstances. Future conditions are not likely to be as favorable.

The main sources of expansion were the Government's deficit, bank credit expansion and foreign exchange operations. The budget deficit was increased as a result of heavy purchases of grain and a doubling of government salaries in the fall. The relatively small contractionary impact from counterpart operations did little to offset this. On the other hand, the grain held off the market under the Government's grain purchasing program now constitutes a potential price depressant. In addition, eventual marketing of this grain will increase the Government's financial resources though some losses may occur.

Bank credit was expanded mainly by the Korean Reconstruction Bank in the first half of 1958 and the commercial banks in the last quarter. Commercial bank credit, which was chiefly for providing working capital and financing aid-goods imports, exceeded substantially the credit ceilings under the 1958 Program.

The expansionary effect of foreign exchange operations could have been avoided by auctioning more exchange. In the absence of a larger volume of auctions, foreign exchange reserves rose from \$112.6 to \$143.2 million during the year. So far foreign exchange auctions in 1959 have

been at a substantially higher level than in 1958.

The paradox of monetary expansion and relative price stability--
In 1957, net money supply rose 20 per cent but wholesale prices at year end were approximately at the same level as at the end of 1956. In 1958, net money supply rose 33 per cent but wholesale prices fell 2.5 per cent. Several factors account for this paradox. First, Korea had one of its largest rice crops in years in 1957, production rising 23 per cent. Production of all grains was up 11.2 per cent and output of grains, pulses and potatoes was also up 11.2 per cent. Second, industrial production rose 30.8 per cent, one of the highest gains in years. Third, foreign aid arrivals hit peak levels in 1957. The deficit in the trade balance in 1957 was \$410 million compared to \$345 million in 1956. With the expansion of available goods, price stability was aided by a decline in the velocity of circulation.

Increased real output was one of the main factors countering monetary expansion again in 1958. Output in the agricultural, forestry and fishing sector rose from 414 billion hwan in 1957 to 445.7 billion hwan in 1958, or by 7.6 per cent in terms of constant 1955 prices. Production of grains, pulses and potatoes in 1958 rose 9.1 per cent compared to 1957. Grains alone were up 11 per cent. In addition, while there was a drop in aid-financed imports, the relative volume contributed substantially to price stability. The deficit in the trade balance was \$357 million in 1958 compared to \$410 million in 1957. The bumper grain crop plus heavy arrivals of imported grains held the mid-year rise in grain prices to relatively low levels in comparison with earlier levels. The new national wholesale grain price index reached 195 (1955 = 100) and 212 in the third and second quarters of 1956 and 1957, respectively; but in 1958 the second quarter peak was 162. The subsequent decline in grain prices, which are given a weight of one-fourth in the total index, offset the mild rise in the fourth quarter in non-grain prices. General consumption demand was also held down by the lowered returns to the farm population as a result of the low grain prices, though this was mitigated to some extent by increased output. Industrial production also rose 5.4 per cent in 1958.

The relative price stability achieved in 1957 after many years of inflation also has encouraged saving, judging from the increase in time deposits in 1958. From 9.4 billion hwan at the end of 1957, these deposits rose to 13.5 billion hwan at the end of 1958 or by 43 per cent. A decline in the velocity of circulation was also reflected in a decline in the turnover rate of demand deposits from 7.6 in 1957 to 6.5 in 1958.

A third factor contributing to price stability was an 8 per cent drop in import prices in 1958. This decline was general for most categories.

Except in 1956, when rice output fell 18 per cent compared to 1955, monetary expansion exceeded changes in prices during 1954-58 as indicated in Table 2 below.

Table 2

Comparison of change in money supply and wholesale prices

	<u>Per cent change in money supply ^{1/}</u>	<u>Per cent change in national wholesale price index ^{2/}</u>
1954	92	51 ^{3/}
1955	61	37
1956	29	38
1957	20	--
1958	33	- 2

^{1/} Change in money supply computed from end of year data.

^{2/} Change in index computed from December to December.

^{3/} Seoul wholesale price index.

Source: Monthly Statistical Review, Bank of Korea

The 1959 program

On February 21, agreement was reached on a financial stabilization program for 1959. In the introduction to the program, it was agreed that "money supply expansion in 1959 would be restricted to a moderate amount." It was recognized, however, that money supply in the first two months had already increased about 16 per cent and that unless corrective measures were taken soon, the pre-1957 inflationary conditions would recur.

Eight measures were listed as being essential for maintaining financial stability: (1) cut General Account expenditures by 18 billion hwan or about 6 per cent; (2) raise the minimum foreign exchange tax from 150 to 200 hwan to the U.S. dollar; (3) program foreign exchange sales by quarters, selling the amount necessary in the quarter so as to offset in full the monetary impact of the Bank of Korea's net foreign exchange purchases in the preceding quarter; (4) eliminate the specified end-user system, instituting competitive bids without restrictions as to end-user for aid-financed imports of cotton, wheat, industrial coal, all paper products and fishery supplies; (5) program all future aid-financed fertilizer imports on

a competitive basis; (6) obtain authorization from the National Assembly to adjust upward utility rates and establish a permanent, independent, professionally staffed public utility rate-regulating company; (7) intensify efforts to increase tax collections and dispose of government-owned properties, and (8) utilize repayments under the rice lien program for future rice liens.

So far there has been more inflation under the 1959 Stabilization Program than under the 1958 Program. Wholesale prices and net money supply both rose 7 per cent in the first half of 1959 but only 3 per cent during the same period in 1958. However, wholesale prices in June were at about the same level as a year earlier. Non-grain prices have been rising since the third quarter of 1958, but a sharp concurrent drop in grain prices contributed to the decline in the overall price index through the first quarter of 1959. A seasonal rise in grain prices in the second quarter reinforced the upturn in the overall index in that quarter.

On the basis of data for the first five months of 1959, there has been a slowing down in the rate of increase of industrial production. Output in the first quarter of 1959 was 3.5 per cent above a year earlier but in April-May it was off 1.2 per cent compared to the same period in 1958. The decline occurred in the manufacturing sector, production continuing to rise in the mining and electrical power sectors.

During the first four months of 1959, imports dropped to \$89.9 million compared to \$137.4 million in the same period in 1958. Exports rose by \$1.3 million and the trade deficit fell from \$132.9 million to \$84.1 million.

The government deficit was the main expansionary force in the first half of the year. This was engendered largely by purchases made under the Grain Management Account. Contractionary forces consisted of counterpart collections and commercial bank operations since the rate of increase in time deposits was higher than that of loans advanced. However, these contractionary forces only offset about half of the total expansion. Since April, money supply has declined slightly, aided by sales of foreign exchange.

Turning to the aims of the 1959 Stabilization Program, General Account expenditures (including National Defense) were 134.6 billion hwan in the first half of 1959 compared to 97.4 billion hwan in the same period a year earlier. Therefore instead of reducing expenditures 6 per cent, the Government has expanded them 38 per cent. On the other hand, the budget deficit in the first half was about the same as in the first half of 1957.

The minimum foreign exchange tax has not been raised from 150 to 200 hwan to the U.S. dollar, but this step would not now affect government revenues since current exchange rates have been well above 700 hwan to the U.S. dollar. Under the present arrangement, the Government receives any surplus above the minimum tax and since these surpluses have been substantial, foreign exchange tax revenues have been an important revenue source this year.

The Government's performance in the first half of the year in auctioning foreign exchange at a rate approximating that of its acquisition was good. A total of \$14 million was auctioned in the first half compared to only \$13 million auctioned in all of 1958 and a 1959 programmed total of \$20.5 million.

In August 1959, the specified end-user system was terminated for all P.L. 480 imports but no final action has yet been taken to eliminate the specified end-user system with regard to Section 402 imports, particularly cotton.

All aid-financed fertilizer imports have not yet been placed on a competitive bid basis. However, in March 1959 the Office of the Economic Coordinator presented a paper to various economic ministries calling for the importation of all fertilizer through commercial channels. Currently 30 per cent is procured by the Government.

The National Assembly has not yet authorized an upward adjustment in utility rates or the establishment of a utility rate-regulating body.

While efforts to dispose of government-owned properties have not been successful, Government attempts to increase tax collections have met with some success. In the first quarter, tax collections exceeded the budgeted figure by nearly 10 per cent.

With regard to the rice lien program, the low level of rice prices has discouraged farmers from selling and paying off their loans. At mid-year, only 4 billion hwan had been collected out of the initial 27 billion hwan loaned by the Agricultural Bank on rice collateral. This will, of course, reduce the possibilities of utilizing repayments to finance future rice liens. It now appears that the loans made earlier in the year were at too high a level in relation to subsequent prices for rice.

Government retention of a large share of the grain crop has partly nullified the anti-inflationary effect of the increase in agricultural output. This aspect has undoubtedly been a factor in the 7 per cent increase in wholesale prices during the first half of 1959. On the other hand, these stocks can be utilized in the future to counter further

inflationary pressures.

From the above, it is evident that the 1959 Stabilization Program has only been partly successful in achieving its aims. Tax collections have improved and foreign exchange auctions have been at higher levels than in 1958. But unless governmental expenditures are brought under control, there is a danger that the Korean economy may again become the victim of marked inflation. This danger is now reinforced by the substantial overhang of monetary resources available to the public from their longer-term deposits. In addition, the contractionary effect of the counterpart fund is expected to weaken in the future as U.S. aid declines. But some comfort can be found in the relatively large grain stocks now controlled by the Government which constitute a potentially strong anti-inflationary resource.

Conclusion

The three stabilization programs have been only partially successful. The general aim of price stability has been achieved, but this has been partly fortuitous since there has been a significant increase in agricultural output each year. Some aims of each program have been achieved but these have tended to be in the minority.

Nevertheless, the programs have been useful in that they have highlighted certain worthwhile aims which might have been largely ignored otherwise. In addition, the programs have provided a framework for continuous review and revision of the plans to achieve stability. It is quite likely that less stability would have been achieved in the absence of the programs.

Although Korea has succeeded in obtaining greater price stability, there still exist many serious economic problems. A major one is the attainment of economic self-sufficiency and independence from U.S. aid. This will be difficult to achieve unless the large military force is reduced to moderate size. Another obstacle to self-sufficiency is the difficulty of expanding export markets. There is a strong need for the Koreans to come to terms with the Japanese on many problems, since Japan is the natural market for many Korean products. For economic progress, it will also be important for Korea to provide an attractive climate for domestic and foreign investment, with economic stability maintained through appropriate monetary and fiscal policies.

These goals will not be achieved overnight. As U.S. aid declines--it probably reached its peak in 1957--Korea will be forced to take steps to become increasingly self-sufficient. The recent achievement of

relative price stability has already been helpful in increasing time deposits and creating funds for investment. This in turn should help promote increased investment, leading to higher exports and increased output in general. While the volume of U.S. aid will probably continue to decline, Korea will undoubtedly continue to receive technical assistance from the U.S. as the country continues to work toward economic self-sufficiency and a higher standard of living.