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SECTION 5: ARMING THE HOMELAND RESERVE

There are fundamentally two different approaches which may be taken to control infiltrators once they penetrate to the interior: employ a highly mobile elite force, with excellent communications and reconnaissance capability to rush to the scene wherever a band of infiltrators shows itself; use a large militia to blanket the country with forces which, while not so well-trained or well-equipped as the infiltrators, are able to defeat the latter by simple weight of numbers. Both approaches have been tried in Korea: the counter-infiltration battalions and combat police represent, to some extent, the former approach and the Homeland Reserve represents the latter. The former approach tends to be capital intensive and the latter approach tends to be manpower intensive.

In the Korean context, the Homeland Reserve concept seems to be working out rather well. The Homeland Reserve distinguished itself against the Ulchin raiders and in the more recent incident at Chumunjin. When the Homeland Reserve was organized, the ROKG had as a goal the provision of one M-1 or carbine for every two reservists, but this objective has now been increased to one gun for every reservist. The guns are stored in armories, and only issued to reservists when they are training or going into action. In November, 1968, the Reserve only had 200,000 serviceable weapons available to it. The USC gave them 434,000 unserviceable weapons in October of that year, and they have been reconditioned at the rate of about 70,000 per month. Together with 37,000 additional weapons purchased by the ROKG, this means that 671,000 weapons should be available to the Homeland Reserve by the beginning of summer.

The ROKG would like to have two million M-1s and carbines for the Homeland Reserve Force by the end of 1969. This means 1,329,000 additional weapons. The US has 400,000 M-1 carbines in storage which could be provided the ROK (with spares and BILLI) at a cost of \$3,068,000. If the other 929,000 weapons could be provided at such a low cost, the total cost of the program would be \$10,193,430. If the other 929,000 weapons were brand new M-2 carbines (which cost \$42 delivered in Korea), then the total cost would be \$42,086,000. If we assume the availability of used weapons is such that the total cost is midway between these two extremes, we get a total estimated program cost of around \$26.14 million. Or, alternatively, if only 250,000 additional weapons are obtained, by replacing rifles currently in ROKA support units with M-16s, at a cost of approximately \$100 per weapon, the cost would still be about \$25 million (see Section 6, Chapter II). The advantages of providing these weapons are as follows:

(1) Unlike expenditures on barrier systems, expenditures on the Homeland Reserve will counter infiltration efforts regardless of what avenue of approach the enemy chooses to use.

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(2) Unlike "elite" counter-infiltration forces, a strong Homeland Reserve tends to involve the whole mass of the population in psychological resistance to infiltration.

(3) The Homeland Reserve has performed well even when most training used arm-bands instead of uniforms and wooden rifles instead of real ones. Real uniforms (now being provided) and real weapons will raise morale and performance standards to still higher levels.

(4) A strong Homeland Reserve will tend to deter not only infiltration but also conventional attack because of the guerrilla warfare threat which it will pose against any enemy who conquers an extensive part of South Korea.

The arguments against providing more arms for the Homeland Reserve are the following:

(1) Many members of the Homeland Reserve begrudge the several hours per week they are required to spend in training. These grudges are not apt to become serious so long as the infiltration threat is real and visible, but if it should die away then undue emphasis on this compulsory program might produce domestic difficulties for the ROKG.

(2) Distributing large number of small arms to storage sites all over the nation may make it very easy for some future indigenous guerrilla activity to acquire arms.

(3) Emphasis on mass military organizations like the Homeland Reserve may tend to engender a militaristic national psychology which may retard the development of civilian democratic institutions. Indeed, it might be used by the Government as a political instrument and become a force for repression.

(4) The money spent on the Homeland Reserve might be more effectively spent on regular military forces.

It should be noted, however, that the ROKG has decided that the arguments in favor of further arming of the Homeland Reserve outweigh the arguments against it.

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SECTION 6: RETALIATION

Defense against infiltration, like defense against smuggling, can never be completely successful. In fact, this could be an argument for doing almost nothing about the overall infiltration problem, beyond the present program. If the coastal radar screen on the east and west coasts is made essentially impervious to infiltration, then the enemy may shift his attention to the south coast; if the radar screen is extended to the south coast, then the enemy may re-emphasize infiltration across the DMZ, or go to airdrops. Always he will strive to work against the weakest point in the system, and will usually be able to achieve some measure of success. If his successes are more spectacular than his failures (as they have not been, so far), then the people of South Korea may begin to lose confidence in the ability of their government to provide security, and one of the prime purposes of the infiltration effort may be achieved.

Since the aggressor has such an advantage in infiltration and raiding, the question arises whether it is really wise to attempt to rely primarily on defense efforts to defeat him. Might not retaliation in kind be a more effective way of countering outrageous actions than merely defensive responses? There are four benefits which could be claimed from mounting retaliatory raids against North Korea:

- (1) They might deter North Korea from continuing their objectionable activities by raising the price of aggression.
- (2) They might strengthen support of the ROK people for their own government by demonstrating that the government is capable of taking effective action against the aggressor.
- (3) They might, if directed against such targets as headquarters, training camps, or boat support facilities, objectively lower North Korean capability to continue infiltrations.
- (4) So long as the US attempts to extend aid packages in lieu of satisfying the ROK's thirst for retaliation, the dollar cost will continue to grow with possibly rather little to show for it; for as long as the North Koreans feel they are immune from retaliation they may continue to exploit whatever weak spots they discover to needle the ROK.

On the other hand, there are arguments against spectacular retaliation which thus far have out-weighed the arguments in favor of it in the minds of both Korean and US officials:

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(1) Retaliation may well strengthen the enemy government more than it weakens it. We have seen that thus far the North Korean raids seem to have increased patriotism, unity, and governmental authority in the ROK. Retaliatory raids might have the same effect in the North. One of the purposes of the infiltration effort is to build a feeling among the people of North Korea that they are threatened by outsiders. Retaliatory raids might essentially concede this point to the Red propaganda machine, especially if the raids were of such a character that they caused numerous civilian casualties. However, the question of how retaliation might affect Kim's position is not susceptible to proof by evidence. Some sophisticated observers feel that retaliation would stand a good chance of intensifying the dissatisfaction with him which is believed to exist behind the scenes, and seriously doubt that it would rally the country and the factionalists in the Party and the Army behind the policy of adventurism in South Korea.

(2) Retaliation commonly leads to counter-retaliation and more and more extended conflict. The US would be put in a political dilemma by a large ROK retaliation: if we condemned it, we would be creating a ROK/US split, thereby conceding a point to the North Korean tacticians; if we condoned it, then we would be in a weak position in other parts of the world (such as the Middle East) to urge restraint on nations facing problems similar to South Korea's.

(3) Retaliation would muddy the international image of who is to blame for the tension in Korea. The ROK has certainly benefitted in the UN and elsewhere from the Blue House and Ulchin raids; to launch a similar raid on their own might throw these benefits away.

So long as the present situation persists, with the enemy winning no spectacular victories and suffering some spectacular defeats, the arguments against retaliation continue to outweigh the arguments in favor of it. However, one major enemy success could cause a ground-swell of popular feeling in favor of retaliation which the ROKG might not be able to resist. Some ROK commandos are trained and ready to go on a "high impact" mission when the President gives the word. If the mission is properly designed, it can emphasize the advantages and ameliorate the disadvantages of a retaliatory policy. In particular, the retaliatory raid should have the following features:

(1) It should be clearly related to the enemy raid which prompted it, if possible. This kind of retaliation has a better chance of "closing" an incident, and is more acceptable to world opinion, than a more open-ended kind of general retaliation.

(2) Civilian casualties are to be avoided if at all possible. By observing this principle you avoid unnecessarily strengthening domestic and international support for the enemy government.

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(3) If possible, direct the raid at the enemy's raiding capability. This will insure that principle "(1)" is satisfied, to some extent, and may contribute to reducing enemy raids by reducing his objective capabilities.

(4) By far the most important principle is that the raid should be successful. A raid which fails will not re-assure the population of South Korea about the competence of their government. Indeed, it will have the opposite effect. Yet the effects of an unsuccessful raid on the North Korean population and on world opinion will be just as serious as if the raid had succeeded. Thus a raid with a high probability of success against a less valuable target is to be preferred to a raid with a low probability of success against a more valuable target.

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CHAPTER SIX

THE ROK ECONOMY

Contents: Introduction and Conclusions, p. 344; Background, p. 347; GNP, Major Determinants, p. 349; Foreign Exchange, p. 352; Government Revenue, p. 357; Financing Korean Defense Needs, p. 359; Political-Economic Considerations, p. 363.

SECTION 1: INTRODUCTION AND CONCLUSIONS

1.1 Introduction

During the past several years, the Korean economy has begun to move from extreme dependence on US aid toward economic self-sufficiency. Recent economic performance has been quite impressive. The economy has grown at an average annual rate of 10% for the past five years. Exports have increased five-fold and tax revenues have almost tripled during the same period. In short, Korean economic growth is becoming less dependent upon US economic aid.

Over-all economic relations with the US, however, are now and will continue to be very important determinants of Korean economic development through the mid-1970's. Despite declining aid levels, about one-half of Korea's foreign exchange resources come from the US, either from Korean exports of goods and services to the US or from the remaining military and economic assistance programs. The Korean balance of payments will continue to be quite sensitive to the whole complex of US political, military, foreign aid, and foreign trade policies.

The Korean economy is clearly not nearly as dependent as it once was on what the US gives to Korea in the way of aid, but at the same time it is still very much influenced by what the US does on a number of policy fronts.

1.2 Economic Aspects of US-Korean Relationships

Currently the most important economic aspects of the US-Korean relationship are:

(1) Military Assistance. The US currently bears the entire foreign exchange cost (approximately \$160 million per year) of the support of Korea's armed forces, one of the largest in the less-developed world.

(2) US Troops. The two divisions of US troops in Korea provide roughly \$100 million annually in foreign exchange earnings through official and personal purchases on the Korean economy.

(3) Earnings from Vietnam. Transfer payments related to the 50,000 ROK troops in Vietnam and war-related Korean exports to Vietnam account for a little over \$100 million annually. This makes the Vietnam war an important element in the current Korean economic variable for Korea.

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(4) Foreign Trade. The US is Korea's most important export market, and the proportion of exports going to the US has increased steadily, accounting for about \$200 million or nearly one-half of total Korean exports in 1968. This obviously makes growth of Korea's exports dependent upon a relatively liberal US trade policy and particularly vulnerable to further US import restrictions on textiles (which accounted for 30% of US imports from Korea in 1968).

(5) Economic Aid. US economic aid (AID and PL 480) is still an important though declining source of foreign resources for Korea -- about \$110 million in FY 1970.

### 1.3 General Conclusions

In the course of the next decade, Korea is likely to make sufficient economic progress to reach the stage of self-sustaining economic growth. Under an optimistic set of assumptions, Korea could generate enough savings by 1973 to support a 7% growth rate. Of course, as a small country, the more Korea becomes industrialized, the more will she be dependent on trade with other countries. She will need foreign exchange to import the required raw materials and capital goods, and she will need export markets to obtain the bulk of the foreign exchange. As Korea loses the artificial export market created by the war in Vietnam and the presence of US servicemen, her continued ability to expand commercial export will become particularly critical. The imposition of textile import quotas by the US, for instance, could significantly extend the period of Korea's dependence on concessional foreign assistance.

Uninterrupted growth of exports and an increasing flow of private capital would continue to make the Korean economy less vulnerable to reductions of foreign exchange from non-commercial sources. Under these conditions the US could follow a number of policies which would reduce the foreign exchange resources made available to Korea. Such policies would tend to slow her economic growth but would be unlikely to cripple the economic development program.

The policy options considered in this study, i. e., the withdrawal of US forces, the phase-down of US economic assistance, and the introduction of a military sales program are feasible in the sense that they would not disrupt Korea's economic development. On the basis of a model developed for this study, it can be shown that the proposed policy measures would not reduce the growth rate below 7% under a fairly broad set of conditions, including loss of all US forces from Korea in 1972 and an end to the Vietnam war. This finding, of course, depends on the assumption that other aspects of US policy do not change.

### 1.4 Specific Policy Options

The following US policy options are feasible on economic grounds:

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(1) Military Assistance

The CINCPAC "MAP Transfer Program" suspended in 1965 can be resumed and a modest military credit import program can be initiated. The foreign exchange costs of such a program would be as follows:

	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>
Military Import Program	10	24	46	67	87
MAP Transfer Program	10	16	24	33	38
TOTAL					

(2) US Troops

US troops can be withdrawn by 1972.

(3) Economic aid

The phase-down of US economic assistance does not need to be interrupted. The phase-down schedule, as presented in the FY 1970 Program Memorandum, and an alternative program, are as follows:

TABLE 6-1

AID PROGRAMS

<u>Aid Category</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>
<u>Program Memorandum</u>					
Supporting Assistance	15	--	--	--	--
Development Loans	30	25	20	--	--
PL 480 - Title I	53	52	48	35	25
PL 480 - Title II	11	6	5	3	2
TC	4	4	3	3	2
<u>Accelerated Program</u>					
Supporting Assistance	15	-	-	-	-
Development Loans	30	25	20	-	-
PL 480 - Title I & II	66	38	33	-	-
TC	5	4	3	1	1

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SECTION 2: BACKGROUND

2.1 Postwar Development

For several years after the Korean War, the economy was disorganized and totally dependent on foreign capital. In the immediate postwar years the rate of inflation was around 50% per year; a degree of price stability was achieved by the late 1950's only through an extremely tight credit policy which hampered the growth of industry. Until 1961 foreign savings were greater than total investment, a reflection of the fact that domestic resources were not even sufficient to sustain the consumption level. As a consequence, through 1962 growth of real income was slow and irregular - averaging less than 4% per year, while the population, already swollen by refugees from the north, was expanding at a very rapid pace - 3% or more per year.

During this period the groundwork for future growth was laid through extensive investments in social overhead facilities and, to a lesser degree, in mining and manufacturing. Income in mining, transportation, and electric power grew at a 13% rate through 1962. Exports, although insignificant in the mid-1950's, were expanding, led first by agricultural and marine products and then after 1961 by manufactured products. AID funds were used mainly to import grains for relief and for investment in social overhead and selected industries. Through most of the 1950's, more than half of each year's government budget came from counterpart funds derived from local sales of AID imports.

The results of this extensive foreign support, coupled with strong Korean initiatives, have been significant. From 1963 through 1968 real GNP has increased about 10% per year with growth of the manufacturing sector averaging about 17% per annum. Manufacturing now accounts for about 20% of GNP, double the share of 1955/57, and 75% of commodity exports, almost five times the 1957/58 percentage.

The dollar value of commodity exports increased at a compound annual rate of 40% per year in the decade 1958-68. Exports of goods and services increased from less than 3% of GNP in 1957 to 14% of GNP in 1967. As a result, the economy now is more vulnerable to shifts in world market conditions.

Since 1964, price increases have been limited to about 10% a year. This relative price stability, along with an interest rate reform late in 1965, helped to sustain the growth of savings and to channel more of it into the industrial sector. The reliance on foreign capital thus has declined. Foreign savings dropped from more than 100% of investment to about one-half of investment, and domestic savings have increased from a negative figure to about 14% of GNP.

2.2 Korea Relative to Other AID Recipients

A review of Korea's position relative to other less-developed countries may provide some perspective. In population, Korea is somewhat larger than

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the typical developing country. After the giants, India and China, the large countries are, with population in millions, Pakistan (120), Indonesia (110), and Brazil (82). The next tier of countries includes Nigeria (44), Mexico (41), Philippines (35), Thailand (34), Turkey (33), UAR (31), Korea (30), Ethiopia (24), and Argentina (22). Important less-developed countries which are considerably smaller than Korea include Colombia (17), Venezuela (9), Chile (9), Algeria (12), Ghana (8), Taiwan (14), Malaysia (10), and Vietnam (17).

In per capita income (\$135 in 1968), Korea ranks below the mean. Most Latin American countries have higher per capita incomes, and the larger ones have incomes two to five times the Korean level. In Asia, Thailand and Ceylon have a comparable per capita income, and Taiwan, Malaysia, Turkey, Iran, Jordan, the Philippines and others have higher incomes. The major countries ranking below Korea are India, Pakistan, and Indonesia. A number of African countries rank higher than Korea in per capita incomes, notably Ghana, Liberia, Algeria, Tunisia, Zambia, Morocco and the UAR.

By world-wide standards, Korea is relatively resource-poor. Primary products do not bulk large in Korea's exports (raw silk, fish, seaweed, and some minerals are the major primary exports). Thus manufacturing plays an unusually important role for a country of that income level, and entrepot trade is significant. The literacy rate is quite high by the standards of the less-developed world.

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SECTION 3: GNP: MAJOR DETERMINANTS

3.1 Introduction

GNP growth in the three years, 1969-71, should be about 11% per annum. For the longer term, the outlook is for somewhat lower growth rates -- around 7% to 8% per year -- which still constitutes good performance by worldwide standards. These high growth rates will permit rapid increases in consumption, even though the share of GNP devoted to investment will be large.

3.2 Foreign Exchange Availabilities

The limiting factor to growth will continue to be the availability of foreign exchange, while trade will be a much more important source of foreign exchange than it has been.

Manufacturing now accounts for about 20% of GNP and 75% of commodity exports. This industry is highly dependent on imported raw materials, since Korea itself does not have an ample supply of natural resources. Moreover, further growth of the manufacturing sector will call for large imports of capital goods. The availability of foreign exchange is thus critical for both full employment and growth in the industrial sector.

While agriculture continues to be an important sector of the economy, manufacturing has been and will continue to be the most important source of growth. Since Korea's own market is rather small, however, she can obtain the economies of scale of modern mass production techniques only by exporting a large part of her industrial output. Continued Korean success in securing export markets, including US markets, is thus vital to a reduction in US economic and military assistance to Korea. Currently, nearly 40% of Korean commercial exports go to the US, and unless sales to the US continue to expand, a commodity export growth rate in the range of 10% to 20% cannot be maintained.

The effects of changes in export earnings and capital inflows on GNP growth are shown in Table 3-1:

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TABLE 3-1

EFFECTS OF DIFFERENT LEVELS OF CAPITAL INFLOWS  
AND EXPORTS ON GROWTH OF GNP (1969-1974)\*

<u>Capital Inflow Average Annual Rate</u>	<u>High Exports (\$1340M)</u>	<u>Medium Exports (\$1300M)</u>	<u>Low Exports (\$1270M)</u>
High Capital Inflow (\$220M)	9.5	8.7	8.3
Medium Capital Inflow (\$180M)	8.7	8.3	7.9
Low Capital Inflow (\$110M)	8.3	7.9	7.7

\*These growth rates are average rates for the period from 1969-1974 inclusive. They are merely illustrative in the sense that they are based on a number of assumptions about the behavior of consumers and the government during the period. Where a number of assumptions seemed reasonable, the more conservative assumption was usually chosen.

The figures in parentheses under the alternative levels of exports and capital flow are average values for the years 1969-74 inclusive. The full series is shown below:

<u>EXPORTS:</u>	<u>69</u>	<u>70</u>	<u>71</u>	<u>72</u>	<u>73</u>	<u>74</u>	<u>TOTAL</u>	<u>AVERAGE</u>
High	942	1108	1238	1345	1574	1829	8036	<u>1340</u>
Medium	942	1108	1236	1354	1503	1650	7793	<u>1300</u>
Low	942	1108	1238	1295	1443	1586	7612	<u>1270</u>
<u>CAPITAL:</u>								
High	224	261	238	200	200	200	1323	<u>220</u>
Medium	200	200	200	174	174	150	1098	<u>180</u>
Low	224	200	150	100	0	0	674	<u>110</u>

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3.3 Savings

Domestic savings have grown remarkably during the last decade, from a negative saving rate in 1958 to a savings rate\* of 12.5% in 1968. Over the last five years, the marginal savings has averaged around 25% - see Table 3-2:

TABLE 3-2

THE PATTERN OF SAVINGS  
(billion 1965 won)

	<u>1960</u>	<u>1961</u>	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>
Domestic Savings	-5	15	-4	31	59	61	112	124	140
Government Savings	28	29	37	38	40	50	58	78	104
Private Savings	-33	-13	-42	-7	18	11	55	47	37
Net Foreign Savings	68	58	82	106	56	58	95	111	170
GNP	589	614	635	693	750	806	914	995	1125
Domestic Savings as Percent of GNP	.01	.03	-.01	.05	.08	.08	.12	.13	.13
Foreign Savings as Percent of GNP	.12	.09	.13	.13	.07	.07	.12	.10	.10

Over the next five years, the marginal saving rate is expected to stay around 25%. The average savings rate will thus continue to rise. If the economy continues to grow at a 10% rate, domestic savings could be sufficient to finance the investment required to support a 7% growth rate by 1973. This projection assumes a capital output ratio of 2.5. Should the capital output ratio rise, or the interim growth rate drop, Korea's ability to support a 7% growth rate on her own would not come until later. At a capital-output ratio of 2.9 and an interim growth rate of 7%, this would not happen until 1982.

It is difficult to predict what the capital-output ratio will be. During the last three years it has averaged around 2.0. The changing sectoral composition of output will increase the ratio somewhat. More industry relative to agriculture, more heavy industry relative to light industry, and more housing and modern structures in the service sector will contribute to this trend.

A significant shift in savings could, of course, affect the rate at which GNP can grow, assuming a given level of foreign capital inflows. At a capital output ratio of 2.5, the GNP growth rate would fall (rise) by one percentage point for every five percentage point fall (rise) of the average savings rate.

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\* Savings rate computed as percent of GNP.

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SECTION 4: FOREIGN EXCHANGE

4.1 Foreign Exchange: Sources and Uses

Imports are being financed less by grant aid and more by export earnings and long-term capital -- of which an increasing proportion is private capital. The dollar value of government grants in 1968 was less than one-third of the 1957 figure, and private remittances have increased to about the level of government grants in 1967-68. Total exports earnings, which were about one-fifth of private plus government grants and one-seventh of imports in 1957, now finance 60% of all imports and in dollar value are more than twice the grants. Net foreign capital inflows rose from about zero in 1957-60 to about \$250 million per year in 1966-67, and the inflows should be larger yet in 1968-69 (see Table 4-1).

TABLE 4-1

MAJOR COMPONENTS OF THE BALANCE OF PAYMENTS  
(Million \$US at Current Prices)

	<u>1957</u>	<u>1960</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968<sup>F</sup></u>
<b>Exports:</b>							
Commercial Commodities	22	33	119	175	250	320	480
Services	<u>57</u>	<u>84</u>	<u>92</u>	<u>115</u>	<u>204</u>	<u>323</u>	<u>344</u>
Total Goods & Services	79	117	211	290	454	643	824
Percent on Government Account	(72.3%)	(71.8%)	(37.4%)	(32.7%)	(37.3%)	(43.5%)	(36.0%)
<b>Imports:</b>							
Total Goods & Services	446	379	432	488	778	1,064	1,350
<hr/>							
Balance of Trade:	-387	-262	-221	-198	-324	-421	-526
Net Foreign Capital Inflow:	21	-4	26	5	202	307	284
<b>Net Transfer Payments:</b>							
US Government	106	105	137	137	92	95	114
Japanese Government	-	-	-	-	29	37	30
Private	29	20	54	69	98	91	74
Other	<u>154</u>	<u>151</u>	<u>4</u>	<u>-3</u>	<u>1</u>	<u>2</u>	<u>2</u>
Total Net Transfer Payments	349	276	195	203	220	225	220
Net Foreign Exchange Accumulation	-17	10	0	10	98	111	-22

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4.2 Exports of Goods and Services

The Korean economy is becoming less sensitive to variations in aid flows and private capital flows, but it is becoming more vulnerable to fluctuations in world market demands for exportables. Exports of goods and services to the UN forces stationed in Korea have been important to the Korean economy throughout the postwar period. More recently, exports related to the Vietnam war have added to foreign exchange earnings. Commercial exports have been increasing much more rapidly, however, and now play a larger role than the "non-commercial" exports. In 1957-59, the value of total non-commercial exports was nearly four times the value of commercial exports, while in 1967 the two categories of exports were about the same. By 1970-71, commercial exports should be more than three times the other exports.

4.3 Capital Inflows

The role of grants has been decreasing and the role of foreign loans increasing. During 1957 through 1961, net foreign capital inflows were slightly negative: Foreign savings thus consisted primarily of grants and transfer payments. In 1967, for the first time, net capital inflows exceeded transfer payments. In the 1970's, foreign capital receipts will probably continue to exceed transfer payments receipts by a large margin.

Projections of net capital inflows are shown in Table 4-2 below.

TABLE 4-2

	<u>PROJECTED NET ARRIVALS OF FOREIGN CAPITAL</u> <sup>1/</sup>				
	(million dollars)				
	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>
USAID <sup>2/</sup>	284	225	261	238	167

1/ Excluding transfer payments and short-term credits.

2/ FY 70 Program Memorandum, p. 119.

4.4 Imports

There has been substantial investment in import-replacing industries. Since the growth of demand for imports has been strong, however, the net effect has been a slight increase in dependency on imports. Demand for food grains

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TABLE 4-3

KOREAN DEBT REPAYMENT PROJECTIONS

(million dollars; principal and interest)

	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>
<u>I. USAID Program Memorandum FY 1970</u>								
A. Total	<u>297.0</u>	<u>149.0</u>	<u>210.0</u>	<u>282.0</u>	<u>223.0</u>	<u>236.0</u>	<u>291.0</u>	
B. Govt.	5.0	9.0	12.0	16.0	20.0	24.0	31.0	
C. Commercial								
4-yr. & over	48.0	79.0	131.0	162.0	201.0	212.0	260.0	
D. Short-term								
1-3 years	36.0	39.0	67.0	104.0	2.0			
E. Very short								
less than 1-yr.	208.0	22.0						
<u>II. IBRD Survey 3/69<sup>1/</sup></u>								
A. Total	<u>54.8</u>	<u>153.2</u>	<u>158.8</u>	<u>194.6</u>	<u>169.2</u>	<u>139.1</u>	<u>117.8</u>	<u>102.1</u>
<u>III. National Advisory Council Staff Report 2/26/69<sup>2/</sup></u>								
A. Total 3-yrs and longer	<u>52.5</u>	<u>71.5</u>	<u>114.0</u>	<u>113.9</u>	<u>114.8</u>	<u>94.8</u>	<u>84.7</u>	
<u>IV. State Airgram, Seoul 1488, 3/26/69</u>								
A. Total		<u>235.0</u>	<u>252.0</u>	<u>262.0</u>				
B. Med. & long-term 3 yrs		94.0	149.0	164.0	170.0	136.0	123.0	109.0
<u>V. Exports of Goods and Services<sup>3/</sup></u>								
	824.0	942.0	1108.0	1238.0	1345.0	1538.0	1718.0	1885.0
<u>VI. (I.A) ÷ (V)</u>		.158	.190	.228	.166	.153	.169	

1/ IBRD reports a total outstanding debt of 1,421 as of June 1968.

2/ NAC reports a total outstanding debt of 1,347 as of April 1968.

3/ Assuming a medium level of exports. (See Annex V, Appendix A.)

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TABLE 4-3  
KOREAN DEBT REPAYMENT PROJECTIONS

(million dollars; principal and interest)

	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>
<u>I. USAID Program Memorandum FY 1970</u>								
A. Total	<u>297.0</u>	<u>149.0</u>	<u>210.0</u>	<u>282.0</u>	<u>223.0</u>	<u>236.0</u>	<u>291.0</u>	
B. Govt.	5.0	9.0	12.0	16.0	20.0	24.0	31.0	
C. Commercial								
4-yr. & over	48.0	79.0	131.0	162.0	201.0	212.0	250.0	
D. Short-term								
1-3 years	36.0	39.0	67.0	104.0	2.0			
E. Very short								
less than 1-yr.	208.0	22.0						
<u>II. IBRD Survey 3/69<sup>1/</sup></u>								
A. Total	<u>54.8</u>	<u>153.2</u>	<u>158.8</u>	<u>194.6</u>	<u>169.2</u>	<u>139.1</u>	<u>117.8</u>	<u>102.1</u>
<u>III. National Advisory Council Staff Report. 2/26/69<sup>2/</sup></u>								
A. Total 3-yrs and longer	<u>52.5</u>	<u>71.5</u>	<u>114.0</u>	<u>113.9</u>	<u>114.8</u>	<u>94.8</u>	<u>84.7</u>	
<u>IV. State Airgram, Seoul 1488, 3/26/69</u>								
A. Total	<u>235.0</u>	<u>252.0</u>	<u>262.0</u>					
B. Med. & long-term 3 yrs. & more		94.0	149.0	164.0	170.0	136.0	123.0	109.0
<u>V. Exports of Goods and Services<sup>3/</sup></u>								
	824.0	942.0	1108.0	1238.0	1345.0	1538.0	1718.0	1885.0
<u>VI. (I.A.) + (V)</u>	.158	.190	.228	.166	.153	.169		

<sup>1/</sup> IBRD reports a total outstanding debt of 1,421 as of June, 1968.

<sup>2/</sup> NAC reports a total outstanding debt of 1,347 as of April, 1968.

<sup>3/</sup> Assuming a medium level of exports. (See Annex V, Appendix A.)

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has continued to grow faster than production; the ratio of imported raw materials to industrial production has remained approximately constant; the ratio of imported capital goods to industrial investment has increased. Total imports of goods and services constituted about 21% of GNP in 1957/58 and 25% of GNP in 1966/67.

#### 4.5 Payments on External Debt

As foreign loans have become more significant than foreign grants, Korea's foreign indebtedness has increased accordingly. Moreover, as private loans have grown relative to concessional public loans, interest payments have likewise risen. The servicing of Korea's external debt is thus creating an increasing claim on export earnings. While the servicing of this debt does not seem to be creating an unmanageable situation over the foreseeable future, a sudden increase in short-term borrowing could lead to a real foreign exchange financing problem a few years hence.

Various forecasts of the Korean debt repayment schedule are presented in Table 4-3 on page 355. Problems of data availability have resulted in a wide range of forecast figures; clearly, there is no agreement on the repayment terms of the outstanding debt. The best projections for 1971-74 are probably those presented in the FY 70 Program Memorandum. The forecasts in the National Advisory Council Staff Committee Report of February 1969 are unaccountably low.

As indicated in Line VI of the table, the forecast debt service burden remains fairly moderate relative to total export earnings. Substantial variations in long-term borrowings would not make much difference in the repayment schedule through 1975, so it seems safe to say that the 1973-75 repayments will remain below 20% of total export earnings, after rising well above that mark in 1971. There are no hard and fast rules regarding levels of debt accumulation, but a ratio of repayments (principal and interest) to export earnings of 20-21% is generally regarded as near the upper end of the permissible range. Currently foreseen levels of foreign borrowing thus are not likely to affect the future availability of capital to Korea.

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SECTION 5: GOVERNMENT REVENUE

5.1 Domestic Revenue

The Korean revenue collection system has been undergoing extensive reform since 1965, and as a result budget magnitudes have been increasing at a faster rate than GNP (see Table 5-1 below). This process should extend at least through 1970. Beyond 1970 it is difficult to foresee the impact of the elections in 1971 and the subsequent government policy orientation. Nonetheless, it is clear that the Korean revenue system is operating on a much higher plane of efficiency and that it will not return to the pre-1965 conditions. To illustrate, the pre-1965 rate of tax enforcement would yield only half the domestic revenues expected from the 1970 tax base.

TABLE 5-1

GOVERNMENT REVENUES  
HISTORICAL SERIES

	<u>billion 1965 won</u>									
	<u>60</u>	<u>61</u>	<u>62</u>	<u>63</u>	<u>64</u>	<u>65</u>	<u>66</u>	<u>67</u>	<u>68</u>	
Total Domestic Revenues	63	61	68	75	75	90	114	142	186	
of which Internal Taxes	(42)	(41)	(50)	(52)	(49)	(57)	(79)	(101)	(127)	
of which Customs Duties	(11)	(10)	(7)	(9)	(10)	(13)	(15)	(18)	(25)	
of which Non-Tax Revenues	(10)	(11)	(10)	(104)	(17)	(20)	(20)	(24)	(34)	
Foreign Budget Support	36	35	40	37	36	36	29	29	33	
Total Revenues	99	97	108	112	112	126	142	171	233	
Gross National Product	590	614	635	693	750	806	914	995	1125	
Domestic Revenues as Percent of GNP	11	9	11	11	10	11	12	14	17	

Government revenue collections should continue to grow very rapidly in 1969 and 1970 and at a good pace through 1974. (see Table 5-2 on the following page):

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TABLE 5-2

GOVERNMENT REVENUES - PROJECTIONS<sup>1/</sup>

	<u>68</u>	<u>69</u>	<u>70</u>	<u>71</u>	<u>billion 1965 won</u>		
					<u>72</u>	<u>73</u>	<u>74</u>
Total Domestic Revenues	186	224	267	287	311	332	360
of which Internal Taxes	(127)	(153)	(185)	(199)	(220)	(236)	(258)
of which Customs Duties	(25)	(27)	(30)	(32)	(33)	(34)	(36)
of which Non-Tax Revenues	(34)	(43)	(52)	(55)	(58)	(62)	(65)
Foreign Budget Support	33	24	21	20	16	13	11
<hr/>							
Total Revenues							
Gross National Product	1135	1277	1411	1519	1661	1776	1931
Domestic Revenues as Percent of GNP	16	18	19	19	19	19	19

<sup>1/</sup> The assumptions built into these projections are (a) low level of exports; (b) a moderate capital inflow; (c) high tax collection efficiency.

The revenue projections were checked against a cross-country tax model developed by two members of the International Monetary Fund Staff, Jorgen Lotz and Elliott Morss.\* They estimated tax revenues on the basis of GNP per capita and the degree to which the economy engages in international trade.

#### 5.2 Foreign Budget Support

Foreign budget support revenues (counterpart) will become increasingly marginal to the budget. In 1967, total foreign revenues constituted 19% of the total budget; by 1972 that figure will have declined to less than 5%, and by 1974 it should be 3% or less. Long-term foreign capital inflows contribute to the lessening of dependence on counterpart budget revenues through increasing the country's income level and therefore its tax base. A dollar more foreign capital over the four years 1972-75 results in forty cents to fifty-three cents more domestic government budget revenues. The difference between \$200 million and \$800 million in net foreign capital inflows over these four years means a difference of \$258 million in domestic revenues over the same four years.

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\* Jorgen R. Lotz and Elliott R. Morss, "Measuring 'Tax Effort' in Developing Countries," IMF Staff Papers, Vol. 14, 1967, pp. 478.497.

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SECTION 6: FINANCING KOREAN DEFENSE NEEDS

6.1 Introduction

Korea's ability to finance its military establishment is limited both by the government's ability to collect taxes and the ability of the economy to generate foreign exchange. In order to arrive at an estimate of the revenues and foreign exchange which could be available to finance the defense effort, a two-step procedure was adopted: (1) Total revenues and foreign exchange were projected on the basis of fairly conservative assumptions; (2) Competing requirements for budget revenues and foreign exchange were estimated. The residual will be treated here as the financing available for defense purposes. In all likelihood, the Korean allocation process tends to operate the other way around: defense estimates are given first priority, and other interests compete for the residual funds. However, this approach insures that planning for future defense needs will not be conducted on the basis of unrealistically low estimates of non-defense needs.

TABLE 6-1

RECENT AND PROJECTED ROK GENERAL BUDGET EXPENDITURE MAGNITUDES<sup>1/</sup>  
(billion won, current prices)

	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>
General Account	41.9	59.3	84.6	116.0	154.2
(Share)	(.45)	(.41)	(.47)	(.46)	(.48)
Defense	29.9	40.5	49.2	64.7	82.8
(Share)	(.32)	(.28)	(.27)	(.25)	(.26)
Investment & Other	21.8	43.5	46.3	74.0	84.0
(Share)	(.23)	(.31)	(.26)	(.29)	(.26)
Total	93.6	143.3	180.1	254.7	321.0

<sup>1/</sup> From the FY 70 Program Memorandum, p. 125  
(Price increases, as measured by the wholesale price index, are 10% or less for each of these years. The budget definitions used for these data differ slightly from the definitions used elsewhere in this economic chapter; this table is presented to illustrate recent trends.)

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6.2 Domestic Revenues Available for Defense

Government revenue projections were discussed in Section 5, and shown in Table 5-2. It should be recalled that these projections are based on an assumption of increased Korean efforts to collect taxes. Poor performance in revenue collections could reduce these figures substantially, but that is not likely.

Government savings (investment) have been projected on the basis of the Korean Plan documents, since the plans have had the most force in the area of public works expenditures.\* Government consumption (in the non-defense area) is projected by means of the past relationship between government consumption and gross national product.

TABLE 6-2

PROJECTIONS OF POTENTIAL DEFENSE BUDGET  
(BILLIONS OF 1965 WON)

	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>
Domestic Revenues	224	267	287	311	332	360
Non-Defense Consumption	-72	-79	-84	-92	-98	-106
Non-Defense Investment	-107	-118	-129	-140	-151	-163
<hr/>						
Domestic Revenues Available for Defense						
Expenditures	45	70	74	79	83	91
Projected Foreign Budget Support	24	21	20	16	13	11
Potential Defense Budget	69	91	94	95	96	102
<hr/>						
Potential Defense Budget 2/ (Millions of 1968 dollars)	376	472	487	492	497	528

- 1/ These projections are made on the basis of conservative assumptions about foreign exchange availabilities. We have assumed a low export level and a medium capital inflow level (see Table 3-1 for definition). These levels also take into account foreign exchange losses associated with a withdrawal of all US forces from Korea in 1972. They also allow for a termination of aid as proposed (see Section 1.3) and an end to the Vietnam War by 1972.
- 2/ The conversion factor is 193. The conversion is accomplished by dividing through by the won/dollar exchange rate in 1965 (271) and then multiplying through by the price index for 1968, which is 1.39.

\* Second Five-Year Plan and the annual Overall Resource Budgets.

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The projected budget capabilities to finance defense expenditures are compared with the projected won costs of Korean military forces under different deployments (see Table 6-4 on the next page). The projected force structures were developed in Chapters II-IV. In all cases the projected government revenues available for defense are more than enough to meet the defense needs; thus there appears to be some room for shifting to the ROK budget a number of items currently financed by the US Military Assistance Program. Where such a transfer involves foreign exchange costs, it would have to be within Korean foreign exchange availabilities discussed in Section 6.3 below.

**6.3 Foreign Exchange Available for Defense**

As pointed out in Section 4, large increases in exports and in private capital flows have improved the Korean foreign exchange position significantly in recent years. This larger availability of foreign exchange opens up the possibility of shifting some of the foreign exchange costs of Korean defense from the US MAP program to the ROK budget. The balance of payments effects of such a shift are similar to a reduction of capital inflows. An examination of the economic effects of a lower capital flow should therefore provide an approximate estimate of the effects of larger overseas military procurement. (The impact of lower capital flows on economic growth is shown in Table 3-1.)

Projections show that a military import program building up to \$125 million in 1974 is consistent with growth rates between 7.5% and 8% (see Table 6-3 below).

TABLE 6-3

ESTIMATED ROK FOREIGN EXCHANGE  
AVAILABLE FOR DEFENSE PROGRAM

	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>
Total Foreign Exchange Availability	20	40	70	100	125
CINCPAC MAP Transfer Program	10	16	24	33	38
Military Import Program	10	24	46	67	87

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TABLE 6-4

ROK DEFENSE BUDGET CAPABILITIES AND NEEDS  
(Million 1968\$US)

	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>
<b>I. Capabilities</b>					
Total Defense Budget Capability <sup>1/</sup>	<u>472</u>	<u>487</u>	<u>492</u>	<u>497</u>	<u>528</u>
of which maximum ROK foreign exchange component <sup>2/</sup>	20	40	75	100	125
<b>II. Requirements<sup>3/</sup></b>					
Total Budget Cost of Present Force	<u>367</u>	<u>329</u>	<u>353</u>	<u>395</u>	<u>437</u>
of which local currency of which ROK foreign exchange <sup>4/</sup>	257	303	329	362	399
	10	16	24	33	38

<sup>1/</sup> See Table 6-2.

<sup>2/</sup> See Table 6-3.

<sup>3/</sup> Estimates based on Chapters II-IV.

<sup>4/</sup> Projections taken from CINCPAC MAP Plan, July 1968, assuming that the "MAP Training Program" suspended in 1965 is reinstated.

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