

Monetary Trends



Homer Jones' Views on the Korean Crisis

In 1968, Homer Jones, the director of research of the Federal Reserve Bank of St. Louis, prepared a report for the Agency for International Development on financial problems in South Korea. In light of recent developments in South Korea, it is interesting to see that certain recommendations he made 30 years ago are timely in today's environment. The Jones report focused on financial policies that would assist the development of a sound and growing private enterprise economy. Jones argued that a low and stable inflation rate would promote saving, investment, foreign trade and foreign investment, which are crucial for growth. I highlight three conclusions emerging from Jones' analysis.

First, Jones concluded that the South Korean interest rate structure was highly distorted by controls and ceilings for specific interest rates. As such, he recommended that market forces be allowed to determine interest rates and allocate capital. Second, Jones stressed that the monetary authority be both a powerful as well as independent part of government. Third, Jones was concerned Koreans, especially government officials, did not clearly distinguish between government planning of its own economic activities and projections of the performance of the entire economy, which depended on the decisions of numerous private individuals and firms. While government should plan its activities, the blurring of these two concepts led to bureaucratic interference in the private sector. This interference, Jones argued, reduced economic freedom and caused the economy to perform at less than its potential.

The basic thrust of Jones' recommendations is present today in the conditions required of Korea in exchange for funding from the International Monetary Fund (IMF). Regardless of one's position on the

appropriate role of the IMF, it is clear that the conditions reflect an IMF advocacy of the style of capitalism recommended by Jones that is centered on free, competitive markets with government providing an environment in which private decision makers gain or lose depending on the results of their decisions. Specifically, the IMF is requiring radical reform of the tight relationship between the South Korean government and business conglomerates. This relationship, though perhaps contributing to South Korea's substantial growth over many years, was nevertheless flawed and eventually has proved a hindrance to growth and financial stability. For example, most analysts have characterized this relationship as producing, among other things, politically-controlled bank lending that ignored proper risk-assessment and highly-leveraged conglomerates with excess capacity.

Numerous reforms are underway to increase the role of private decision makers while reducing the role of government. For example, foreign ownership of Korean banks will be permitted; banks in Korea will make loans according to commercial considerations rather than government fiat; insolvent Korean merchant banks will be closed; insolvent commercial banks will be merged with healthy banks or closed; and tariffs will be lowered. In addition, consistent with IMF recommendations, legislation has been passed granting the central bank independence. This institutional change places the bank in a better position to pursue and maintain low and stable inflation. In addition, legislation creating a unified financial supervisory agency has been passed that is intended to result in much closer adherence to safe and sound banking practices.

Even though it is far too early to render an assessment of the consequences of following the recommendations consistent with those made by Homer Jones 30 years earlier, his insights remain useful for the construction of public policies not only in Korea, but elsewhere throughout the world.

—Cletus C. Coughlin

