



REPORT TO THE CONGRESS

Economic Assistance Provided To Korea By The Agency For International Development

B-164264

Department of State

*BY THE COMPTROLLER GENERAL
OF THE UNITED STATES*

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JULY 16, 1968



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D C 20548

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To the President of the Senate and
The Speaker of the House of Representatives

This report presents the results of our review of selected aspects of the economic assistance program for Korea as administered by the Agency for International Development.

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Copies of this report are being sent to the Director, Bureau of the Budget, the Secretary of State, and the Administrator, Agency for International Development.

A handwritten signature in cursive script that reads "James B. Stacks".

Comptroller General
of the United States

D I G E S T

WHY THE REVIEW WAS MADE

During fiscal years 1966 and 1967, Korea received \$266.8 million and \$185.3 million, respectively, in U S economic assistance. Korea was the fourth largest recipient of Agency for International Development (AID) support in those years.

GAO reviewed selected aspects of the program in Korea because of the program's significance and of continuing congressional interest in AID's administration of foreign assistance.

The review was directed primarily to development loan projects, now the largest single segment of economic assistance to Korea.

FINDINGS AND CONCLUSIONS

Korea has made significant economic progress in recent years and hopes to achieve a self-sustaining economy by 1971. It has been increasing its foreign exchange reserves and is more and more able to obtain economic assistance from sources other than the United States.

Consequently, sizable reductions were planned in U S assistance to Korea, beginning with fiscal year 1968.

Korea has made significant economic improvement in recent years, to which U S assistance has contributed substantially. GAO believes that the U S assistance provided to certain sectors of the Korean economy was not as effective as it could have been, in that

- Delays occurred in completing electric power projects. Had these projects been completed on schedule, power shortages would have been reduced.
- Delays occurred in procuring diesel engines and railroad shop equipment. As a result, possible savings in operating costs were not fully realized.
- AID has not urged the Republic of Korea Government (ROK) to institute an adequate program to improve and expand coal production. ROK has neglected developing this domestic resource and has turned to importing oil as a basic fuel.

- AID has continued to provide loans for small and medium industry development in Korea even though (a) prior AID loans had not been used, (b) the ROKG has been increasing its foreign exchange reserves more rapidly than anticipated, and (c) external financing was available from sources other than AID

RECOMMENDATIONS OR SUGGESTIONS

GAO proposed that AID

- Take adequate measures to facilitate the implementation of loans so that lengthy delays will be prevented
- Reevaluate the necessity of future development loans for small and medium industry development.
- Make every effort to demonstrate to the ROKG the benefits of an adequate coal development policy and take measures to assist the ROKG in developing this industry

AGENCY ACTIONS

AID has initiated a number of actions to reduce serious and lengthy delays in the implementation of large capital projects. A proposed increase of \$12 million in an existing loan for small and medium industry development is being delayed so as to coordinate the time of its availability to the time of depletion of the existing loan.

ISSUES FOR FURTHER CONSIDERATION

AID has concluded that power, transportation, and large capital projects are of such priority to the ROKG that financing can and will be obtained from sources other than AID and that AID should use a large percent of its limited funds for development of medium and small industries.

GAO believes that AID should also encourage the ROKG to use its own foreign exchange and to look to sources other than AID for small and medium industrial loans. AID should be a source of last resort.

As a means to help in answering the coal versus oil issues, the Korean Institute of Science and Technology has been commissioned to carry out a study of overall energy demands and investment possibilities. AID believes that, as a result of this study, it will be in a better position to advise the ROKG.

LEGISLATIVE PROPOSALS

None.

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- Delays occurred in completing electric power projects. Had these projects been completed on schedule, power shortages would have been reduced.
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LEGISLATIVE PROPOSALS

None

INTRODUCTION

The General Accounting Office has reviewed selected aspects of the economic assistance program for Korea as administered by AID. Our review was directed primarily to development loan projects, which are becoming the largest single segment of economic assistance to Korea.

This review was made as part of our continuing review of foreign assistance programs, pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67). Our review was made at the Washington office of AID and at the Agency's overseas mission in Korea, known as the United States Operations Mission (USOM). The scope of our review is described on page 33.

The principal officials responsible for the administration of activities discussed in this report are shown as appendix I.

On November 2, 1967, we submitted our findings and proposals to AID for comment. AID's comments, which are set forth in a letter dated January 23, 1968, are presented as appendix II and, where appropriate, are discussed in the body of the report.

OBJECTIVES AND ASSISTANCE

UNITED STATES OBJECTIVES AND GOALS

The general nature of AID's objectives in Korea in the past few years has been:

*** to develop its economic strength under conditions of political stability to help Korea increasingly meet its own needs and fulfill its aspirations. A strong ally, Korea is heavily dependent on substantial foreign assistance. It is important that the U.S. demonstrate in Korea the value and dependability of the U.S. alliance and support, and the effectiveness of the non-Communist approach to nation-building. The ultimate goal of the U.S. in Korea is to enable it to become economically

self-reliant, and to terminate concessional aid, first by shifting the content of the program from grants to loans and subsequently by hardening the terms of U S lending until such times as Korea can afford commercial financing terms."

The basic problems that cause the need for external assistance have been summed up by AID as follows.

"(a) a limited resource base and a large and growing population, with a growth rate of 2.9%, Korea is one of the most crowded countries in the world, the mountainous terrain provides relatively little cultivable area and few mineral deposits, in consequence, Korea's foreign trade position has always been adverse, and her domestic economy plagued by inflation,

"(b) a small and inexperienced managerial class, while education is relatively widespread, and literacy high, the Koreans did not have the opportunity to manage their own government and business enterprise until after withdrawal of the Japanese; traditional education has been ill-suited to the technical and operational problems which the country now faces,

"(c) the need to maintain one of the largest standing armies in the world, in addition to major MAP assistance, approximately 31% of Korea's national budget is utilized for defense expenditure."

Since 1963 AID has evolved a framework of economic goals in which its programs are directed. These goals were established to support the ROKG plans as set forth in the First Five-Year Plan (1962-66). AID efforts for 1967 were planned to support the Korean Second Five-Year Plan (1967-71) with five basic goals to

1. Improve resource mobilization and allocation.
2. Accelerate growth and efficiency of domestic and export industries.

3. Develop the rural economy.
4. Improve social planning and policies.
5. Improve government organization and administrative capability.

UNITED STATES ECONOMIC ASSISTANCE

United States economic assistance to Korea from inception through June 30, 1967, is summarized in the following schedule:

	<u>Obligations and Loan Authorizations</u>								
	<u>Fiscal years</u>								
	<u>Before 1962</u>	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1962-67</u>	<u>Total</u>
	(millions)								
AID and predecessor agencies									
Grants	\$2 027 1	\$ 94 6	\$ 81 8	\$ 77 3	\$ 70 7	\$ 64 9	\$ 52 6	\$ 441 9	\$2,469 0
Loans	25 3	25 2	25 8	27 6	47 9	79 0	60 3	265 8	291 1
Total loans and grants	<u>2,052 4</u>	<u>119 8</u>	<u>107 6</u>	<u>104 9</u>	<u>118 6</u>	<u>143 9</u>	<u>112 9</u>	<u>707 7</u>	<u>2,760 1</u>
Food for Freedom (Public Law 480)									
Title I		60 6	62 7	79 6	34 3	41 4	38 5	317 1	
Country use	176 5	-	-	-	-	-	1 5	1 5	493 6
Loans	-	-	-	-	-	-	-	-	1 5
Title II									
Emergency relief	22 1	-	1 2	23 2	20 3	69 8	24 7	139 2	161 3
Voluntary "	115 5	10 2	10 1	10 2	8 6	11 2	2 5	52 8	168 3
Total food for peace	<u>314 1</u>	<u>10 8</u>	<u>74 0</u>	<u>113 0</u>	<u>63 2</u>	<u>122 4</u>	<u>67 2</u>	<u>510 6</u>	<u>824 7</u>
Export-Import Bank loans	-	-	-	-	-	-	3 8	3 8	3 8
Peace Corps	-	-	-	-	-	5	1 4	1 9	1 9
Other U S economic programs	859 3	-	-	-	-	-	-	-	859 3
Total economic assistance	<u>\$3,225 8</u>	<u>\$190 6</u>	<u>\$181 6</u>	<u>\$217 9</u>	<u>\$181 8</u>	<u>\$266 8</u>	<u>\$185 3</u>	<u>\$1,224 0</u>	<u>\$4,449 8</u>

As shown by the foregoing schedule, AID grants have gradually decreased since 1962 but AID loans have gradually increased. During fiscal year 1967 development loans represented the largest single segment of economic assistance to Korea.

Through June 30, 1967, development loans totaling \$291.1 million had been authorized by AID and the predecessor Development Loan Fund (DLF). The loans are for power, transportation, communications, public works, lending, and commodity imports. Loan applications are received from the

ROKG and are subject to feasibility studies to determine the national and economic benefits to be derived, the technical feasibility, and the reasonableness of repayment. The loans are for long-terms (40 years), bear low-interest (up to 2-1/2 percent) and are, except for the DLF loans, repayable in dollars. They are generally made to the ROKG, which in turn relends the funds to the user or subborrower. The relending is for a shorter term (about 12-20 years) and is repayable to the ROKG in local currency (won). Repayments are placed into a special account and become available for relending or use as agreed upon by AID and the ROKG.

The loans generally are used to purchase investment-type items from United States sources. In agreeing to the loans, AID often requires investments by the subborrower, improvements in the conduct of his business, and the use of United States consulting engineers to assist in determining and procuring equipment. AID also retains the right to approve the various steps of project implementation.

NON-UNITED STATES ASSISTANCE

Korea has been one of the largest recipients of external financial assistance. This assistance has averaged some \$275 million annually in recent years. The main contributors have been the United States and other free-world countries. The United States has been by far the major contributor.

International lending agencies have provided the following financial assistance to Korea as of fiscal year 1967:

	<u>Fiscal year</u>					
	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1946-67</u>
International Development Association	\$14 0	-	-	-	-	\$14 0
United Nations Special Fund	1 6	\$1 7	\$1.0	\$2.1	\$1 4	11 0
Other United Nations funds (note a)	<u>4</u>	<u>4</u>	<u>4</u>	<u>7</u>	<u>7</u>	<u>4 7</u>
	<u>\$16.0</u>	<u>\$2.1</u>	<u>\$1.4</u>	<u>\$2.8</u>	<u>\$2 1</u>	<u>\$29.7</u>

^aCalendar year

Additionally, free world countries other than the United States have provided the following financial assistance to Korea as of the end of calendar year 1966:

	<u>Calendar years</u>			
	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1960-66</u>
Japan	\$ 2	\$50 4	\$35.7	\$ 91.9
Germany	11.0	5 0	6 6	26 4
Other	<u>.7</u>	<u>3 0</u>	<u>7 3</u>	<u>16 5</u>
	<u>\$11.9</u>	<u>\$58.4</u>	<u>\$49 6</u>	<u>\$134 8</u>

ADMINISTRATION OF UNITED STATES ASSISTANCE PROGRAMS

The three major United States agencies in Korea, which are the Department of State, AID, and the Department of Defense operate under a country-team concept. Under this

concept, it is the responsibility of the U.S. Ambassador to direct, within the framework of policies and goals established by the Department of State, the efforts of all parties. Generally, this country-team concept requires contact between team members to discuss current problems and resolve any questions.

We discussed the workings of the country team in Korea with each member of the team and were informed by all members that they believed the team to be one of the best they had experienced. We were informed that meetings of the team were held whenever necessary and that consultations between two members are frequent. We were informed also that this cooperative effort extended into the operating levels where day-to-day contacts were maintained so that each agency was aware of the efforts of the others in common areas.

In addition, we were informed that contact with United Nations agencies working in Korea is maintained to prevent duplication of effort and that the United States Information Service and Peace Corps programs are subject to American Embassy review and discussion to ensure that they are conducted within established Department of State policy.

The economic and technical assistance program for Korea is conducted under authority of a comprehensive aid agreement dated February 8, 1961.

The AID Mission in Korea is known as the United States Operations Mission to Korea. The ROKG counterpart to USOM is the Economic Planning Board with which USOM works directly and which acts as a liaison between USOM and other ROKG agencies.

In July 1967, USOM employed 134 Americans and 363 Koreans. In addition, there were 57 Americans and 20 Koreans connected with the United States economic assistance program under contract to AID.

FINDINGS AND CONCLUSIONS

ECONOMIC PROGRESS AND PLANNED REDUCTION OF UNITED STATES ASSISTANCE

Korea has made very significant economic progress in recent years, and it hopes to achieve a self-sustaining economy by 1971. Sizable reductions are planned in United States economic assistance to Korea, beginning with fiscal year 1968.

Some indicators of the very significant economic progress that Korea has made are presented below:

1. Gross National Product (GNP) increased by an average of 8.5 percent a year over the 6-year period from 1961 to 1967. Per capita GNP increased by a total of 29 percent--from \$108 in 1963 to \$139 by 1967.
2. Industrial production nearly doubled from 1961 to 1966. It rose 18 percent in 1966 and was expected to increase about 21 percent in 1967.
3. Exports have jumped from \$33 million in 1960 to \$250 million in 1966 and are expected to exceed \$350 million in 1967.
4. Domestic government revenue more than doubled, increasing from \$251 million in 1965 to \$550 million in 1967, and is expected to reach \$778 million in 1968.
5. From December 31, 1965, to December 31, 1967, gold and foreign exchange reserves increased from \$146 million to an estimated \$356 million. The ROKG had set a goal of \$190 million, to be reached by December 1967.

We believe that the following factors have contributed to this economic progress:

1. The substantial amounts of United States assistance have provided needed commodities and technicians.

During fiscal years 1966 and 1967, Korea was the fourth largest recipient of United States economic assistance. Assistance provided under AID and Food for Peace programs was equal to about 60 percent of Korea's total domestic revenues for fiscal year 1966.

2. The increase in foreign exchange reserves was caused partly by earnings from Korean activities in Vietnam. Foreign exchange earnings from these activities were estimated to be about \$150 million during 1967. A portion of these earnings can be attributed to agreements entered into by the United States for special economic assistance to countries that have contributed military forces in South Vietnam.
3. Improvements have been made in the organization and administration of the Government, and a more stable Government has been established through improvements in training, position classifications, salaries, and tenure.
4. Outside experts have given qualified approval to Korea's current 5-year development plan as a solid guide for economic development.
5. A major reform in the interest rates is said to be a major factor in the improvement of domestic savings.
6. The Government has reorganized and improved its taxation agencies, established training programs, and changed the tax structure.

Korea is becoming increasingly able to obtain economic assistance from non-United States sources. During calendar year 1967 Japanese assistance totaled \$104.1 million and assistance from free-world sources other than the United States and Japan totaled \$104.9 million.

Sizable reductions are planned in AID economic assistance to Korea, beginning with fiscal year 1968. During fiscal year 1967, AID provided \$112.9 million in economic assistance to Korea. As a result of the significant

economic progress made by Korea, of Korea's ability to obtain assistance from other sources, and of reductions in U S foreign assistance appropriations for fiscal year 1968, AID plans to provide only \$66 million in economic assistance to Korea during fiscal year 1968.

DEVELOPMENT OF INDUSTRY

During the period covered by our review (1962-67), AID's primary assistance has been in the sector of industrial expansion. Assistance included development loans, supporting assistance (commodity import program), Public Law 480 imports, technical cooperation projects, and utilization of local currency. The extent of assistance by each program for the period July 1, 1961, through June 30, 1967, is shown in the following schedule.

<u>Type of assistance</u>	<u>Amount (millions)</u>
Development loans	\$213.0
Direct to manufacturers	\$ 14.5
For relending to industry	42.0
Direct to service industries	136.5
Supporting assistance commodities (note a)	252.9
Production materials	249.3
Capital goods	3.6
Technical cooperation projects	14.3
Local currency loans (Public Law 480 funds)	1.0

^aThe commodities imported are paid for by the importers in local currency (counterpart) which is owned by the ROKG. USOM and the ROKG agree on the uses of these funds--most of which have gone to support the ROKG budget.

Need for additional power and transportation facilities

Shortage of electric power

The United States has provided about \$157.4 million in grants and loans for electric power production and distribution facilities and technical assistance in Korea since 1954. Despite this massive assistance, power availability in Korea has not increased in proportion to demand. The Korea Electric Company (KECO) estimates that power will be in short supply through April 1968 and will then be ample until the fall of 1968. The primary cause of the current power shortage is attributed by the power industry and USOM officials to the increase of power needs that is due to rapid industrial expansion and has outstripped the capability of the power industry.

During our prior review in 1961, we noted that a shortage of electrical power was a contributing factor to low utilization of various production and other facilities. We recommended in our report (B-125060, September 21, 1962) that a concerted effort be made to implement planned power producing projects and that a power development plan be devised. Subsequently, power production projects were completed, and in 1964 power rationing was eliminated. Also, a power expansion plan was devised by a team of AID-financed consultants for KECO. Until the spring of 1967, power production was considered sufficient to supply the needs of the economy. At that time, a power shortage resulted because of (1) expansion of the industrial sector at a rate proportionally faster than expansion of the power production capability, (2) delays in power projects financed by AID development loans, and (3) a drought.

The power development plan made by KECO was soon revised because forecasts of power needs projected a much higher rate of increase than had been used in the preparation of the plan. By June 1966 KECO became aware that power demand would outstrip production in June 1967. Measures were proposed by KECO, including installation of small turbine generators, which would decrease but not eliminate the projected shortage. The increased projected demand was

attributed to additional industrial users. According to ROKG officials, a relatively sluggish export performance in the first half of 1967 was partly attributable to the electric power shortage.

AID informed us in January 1968 that USOM had been aware of the problem, because USOM, KECO, and the ROKG have participated in a joint committee to keep power needs and the construction program under review. However, they have stated that, although emergency measures to provide additional temporary power units have been taken, there still will be a shortage until a thermal plant is placed in service in April 1968. Power will then be ample until the fall of 1968. Moreover, KECO is negotiating for additional gas turbine capacity, which could be available by the fall of 1968.

Need to improve railroad capabilities

Although AID has provided substantial funds to improve the railway transportation system in Korea, this basic industry is still considered to be a problem area in the Korean economy. A lack of sufficient freight cars and of necessary improvements to railroad facilities is hindering effective operation and, as a result, other sectors of the economy have suffered adverse effects.

AID and its predecessor agencies have provided about \$228.3 million in grants and loans to the Korean National Railroad (KNR) since 1954. Another \$27.4 million has been provided to KNR through loans from Japan, Great Britain, and the International Development Association (IDA) of the International Bank for Reconstruction and Development (IBRD).

KNR and USOM have been aware of a continuing shortage of freight cars since at least 1961, when KNR obtained a loan from IDA for the purchase of some needed freight and passenger cars. At that time, KNR estimated that 1,000 freight cars would be required to meet the short-term needs of the economy and over 3,600 additional freight cars would be required by 1966. KNR requested \$20 million from IDA but obtained only \$14 million, with which they purchased 930 freight cars as well as 115 passenger cars.

According to a study of KNR performed by a team from IBRD, KNR obtained only 1,123 of the required freight cars by 1966, which left a shortage of about 2,500 cars. Current estimates by the IBRD team are that KNR must obtain over 4,600 freight cars by 1971 in order to meet anticipated need. In addition, this team states 1,000 cars should be rebuilt.

Korea experienced a coal shortage in the 1966-67 winter season, which was attributed to a transportation shortage rather than a shortage of coal. During this shortage the ROKG encouraged the use of oil in lieu of coal in electric thermal plants and heavy industry, which thus necessitated using Korean-owned foreign exchange (KFX) for purchasing the oil. USOM estimated that the additional cost of using oil rather than coal was over 261 million won (almost \$1 million).

The agricultural industry also was affected by the 1966 transportation shortage. Although the ROKG planned to move by rail 750,000 metric tons of limestone to be used to neutralize acidic soil during the 1966 growing season, KNR could only haul 144,000 metric tons because of the shortage of freight cars. Agricultural experts estimate that, had the planned amount of limestone been applied, a net increase of over \$32 million in crop yield would have resulted. In addition, we noted that in 1966 the ROKG had to import over 18,000 metric tons of rice costing over \$3 million in KFX. Furthermore, AID agricultural experts have estimated that the spring 1967 crop of barley will be reduced by 53,000 metric tons because of a lack of limestone during 1966. It appears likely that, had KNR obtained their estimated freight car requirements, the recent shortage of freight hauling capability would not have occurred, or at least would have been less severe.

At the time of our review, KNR had applied for an additional loan from IDA to purchase 1,100 freight cars and also had some other foreign loans pending for additional procurement of 1,331 freight cars and for material with which to manufacture an additional 1,378 freight cars.

The IBRD transportation survey showed other needs for railroad improvements that are required to effect operational

improvements in the system. These areas include improvements in station facilities, marshalling of yards, double tracking in many areas, central traffic control automatic block signals, and communications, all of which would facilitate a faster and smoother flow of traffic and allow for more effective rolling stock utilization.

AID informed us in January 1968 that IDA had just signed an \$11 million credit for 1,050 additional freight cars and that IDA is also providing experienced technicians to assist KNR in several areas. It is believed that these efforts will provide for the betterment of KNR operations.

- - - -

In commenting on our findings, AID informed us in January 1968 that

"Because of A.I.D.'s planned phase-down in Korea, we have already discussed with the ROKG the need for them to look to other sources for financing, particularly for power, transportation, and large capital projects. The President of the KECO recently told A.I.D. that KECO had just completed plans for the foreign exchange financing for all their power plant construction through 1975 ***. This includes financial assistance from Germany, Italy, Japan, U.S. private sources and possibly U.S. Export-Import Bank "

AID has concluded that power, transportation, and large capital projects are of such priority to the ROKG that financing can and will be obtained from sources other than AID. AID believes that it should be the source of last resort but that financing for the above-type projects will be available on a timely basis from sources other than AID.

Delays in completing power and transportation facilities

Electric power

From 1962 through 1966 AID authorized about \$62.4 million in loans to the ROKG for purchasing necessary equipment

to construct four power plants and improve and expand the transmission and distribution (T&D) system. Completion of three of these projects has been delayed for periods ranging from 1 to 2 years for various reasons--some delays are due to ROKG's and KECO's untimely actions and some are due to delays within AID. Had these projects been implemented on schedule, the current power shortage would not have been so serious.

Completion of the Kunsan Thermal Power Plant has been delayed almost 2 years from its originally planned completion date. One delay of 9 months--from date of loan authorization to date of loan agreement--was due to the time taken to change the wording relating to debt limitations in the loan agreement. Another 9-month delay occurred because of KECO's and ROKG's failure to meet conditions precedent to loan disbursement. Other delays occurred because KECO changed the coal source and because KECO failed to assign a project manager. The Kunsan Power Plant was originally scheduled to start operations in 1966 but was not placed in service until April 1, 1968. If the Kunsan plant had been completed as planned, total installed capacity of KECO power plants would have increased by 66 megawatts (MW), which would have been almost sufficient to cover the largest anticipated monthly power deficit in 1967.

The Seoul Thermal Power Plant (137.5 MW) was originally scheduled to commence operation in 1968, but the present forecast is that it will be completed in 1969. The delays on this plant were due to a change of the rated capacity of the plant, the change being recommended by AID consultants in June 1966 and not approved by AID/Washington (AID/W) until September 1966, and to KECO's inability to finally meet conditions precedent relating to rate increases and obtain legislation permitting a revaluation of KECO's plant.

The first T&D project was supposed to bring T&D facilities in line with the generation construction program that was in progress and was programmed to make available abundant power to the system. According to USOM's justification for recommending the loan, inadequate T&D would become a limiting factor to the utilization of the generating facilities and to unrestricted delivery of electricity. This

project was to be completed in 24 months from the date the loan agreement was signed (December 1964). The project is now expected to be delayed for a total of about 2 years. KECO failed to meet conditions precedent to financing, which delayed financing of procurement until January 1966--over 1 year from the date of the loan agreement. Numerous changes have been made in the subprojects in this loan, which have also delayed completion for varying periods of time.

An example of delays due to changes is that KECO proposed that certain subprojects be changed in order to reflect the then current needs. These changes involved no significant overall cost increase. The changes were requested in September 1965, after USOM informed KECO that these changes were minor and could be approved by USOM without referral to AID/W. An AID official stated that, prior to receiving this information from USOM, KECO had no intention of requesting any changes because it feared excessive delays in the project. Subsequently, USOM determined that these changes must be referred to AID/W for approval. The requested changes were submitted to AID/W in February 1966 and were eventually approved upon revision of the loan agreement in June 1966. Overall, a delay of 8-1/2 months resulted in this one instance.

Diesel engines

Since 1962 AID has provided three development loans, totaling more than \$36 million, for the procurement of diesel engines to replace the steam locomotives used on the majority of KNR's operating lines. The diesels were justified on the basis of operating cost and foreign exchange savings and the ability of diesels to haul more weight and cover more mileage than steam locomotives. Our review showed that the possible savings in operating costs were not fully realized because of delays in implementation of one of the loans.

The second diesel loan in the amount of \$11 million was delayed about 1 year--between the time of authorization of the loan (March 5, 1964), and the signing of the loan agreement (March 12, 1965)--because of discussions relating

to a stipulation in the loan agreement that KNR should be a separate entity under the Ministry of Transportation and because of a discussion on possible changes in the number and sizes of the diesels to be procured. Shop equipment to be purchased under the third loan will apparently be delayed about 9 months because of a KNR delay in meeting conditions precedent relating to contracting for audit services. These delays cause less effective operations, since diesel locomotives cost less and operate more efficiently and the shop equipment is needed to effectively maintain rolling stock.

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In our draft report we proposed that AID take adequate measures to facilitate the implementation of loans so that lengthy delays will be prevented.

In commenting on the delays in completing power and transportation facilities, AID stated that the use of the word "delay" is "unmeritorious" since it is difficult to establish a norm for the desirable amount of time for each step because of the great differences between projects. In its opinion, when there is a delay it is due to normal project complications or to care taken to avoid mistakes or waste of funds. AID feels that several of the delays related to serious problems in implementing self-help measures and believes that the institution-building aspects were as important as the meeting of physical schedules.

We concur that care must be taken to avoid any significant deficiencies, however, we believe that the time expended to resolve some of the problems was excessive--for example, a 9-month delay to change to the wording relating to debt limitations in one loan and an 8-1/2 month delay to approve a minor change so insignificant that it was not going to be requested because KECO feared an excessive delay. AID also informed us that

"Neither USOM nor AID have been satisfied with the length of time that it takes to complete loan projects, even apart from delays which result from self-help negotiations. However, a number of proposals have been made and initiated to shorten this time period without impinging on the

soundness of project planning and execution or on any of our statutory requirements, for example, telescoping certain steps in the procedures and reducing the number of items that have to go back and forth for approval.

"In addition, the Assistant Administrator for the East Asia Bureau has recently inaugurated a system of review and approval actions which is expected to reduce the chance of some types of serious and lengthy delays which has been experienced with some of our large capital projects in the past "

Questionable need for loans for small
and medium industry expansion

In 1966 AID granted two loans totaling \$17 million to be used to provide foreign exchange for subloans to small and medium industries. By April 1967 the ROKG requested that these two loans be increased by a total of \$15 million. In June 1967 AID increased one loan by \$3 million even though no part of the two 1966 loans had been utilized. On completion of our review, an increase of \$12 million in the other loan was being reviewed by USOM and AID/W. We believe that the requests for these increases were premature and that AID should not have granted the increase of \$3 million, because the 1966 loans had not been utilized and because the ROKG appeared to have access to sufficient foreign exchange to satisfy current demands for small and medium industrial loans.

Since 1960 AID has granted three loans aggregating \$25 million for small and medium industry expansion. Of these loans, two totaling \$17 million were to the Korean Reconstruction Bank (KRB). The third loan, to the Medium Industry Bank (MIB), was initially for \$5 million but was increased in June 1967 to \$8 million. KRB and MIB were to make subloans to eligible industrial firms for the importation of machinery and equipment.

The first of the two loans to KRB was for \$5 million and was granted in April 1960. In September 1962, however, AID froze disbursements under this loan because the selection of subborrowers was not in accord with AID's understanding of loan criteria. AID then undertook a program to improve the management of KRB. A management consulting firm and a public accounting firm were engaged to perform reviews of KRB operations and assist in implementing improvements. In the meantime, the loan was reopened under a revised agreement.

In 1966 AID granted a second loan to KRB for \$12 million and a loan to MIB for \$5 million. By April 1967 the ROKG had requested increases, totaling \$15 million, in these two loans--\$3 million in the loan to MIB and \$12 million in the loan to KRB. These increases were justified on the basis that the available foreign exchange did not satisfy

the investment requirements. However, as of June 1967, the banks had not utilized any of the \$17 million provided in 1966.

In June 1967 AID increased the loan to MIB by \$3 million. On completion of our review, the increase of \$12 million in the loan to KRB was being reviewed by USOM and AID/W.

In our draft report we proposed that AID reevaluate the necessity of future development loans for this purpose, including the proposed increase of \$12 million in the loan to KRB. In commenting on our findings, AID informed us in January 1968 that the proposed increase was being delayed so as to coordinate the time of its availability to the time of depletion of the funds provided in 1966. Also, AID pointed out that any delays in the utilization of AID loans did not reflect the lack of need or demand for subloans. The demand for subloans had far exceeded the availability of funds, which made it necessary for KRB to establish and apply priorities to subloan applications.

As previously pointed out AID has concluded that power, transportation, and large capital projects are of such priority to the ROKG that financing can and will be obtained from sources other than AID. Therefore, AID firmly believes it should use a large percent of its limited funds for development of medium and small industries. Also, AID informed us in January 1968 that

"In the past few years, demand for foreign exchange has risen sharply among small and medium industries reflecting the rapidly expanding nature of the Korean economy and the need for modernization of plant and equipment. Since 1965, approximately \$40,750,000 in foreign exchange loans has been made available to small and medium industry through the MIB and KRB. Demand for these funds, as measured by the total amount of applications received, exceeds \$200 million leaving a gap of some \$160 million. While as much as 25-35 percent of this gap may not be bankable, it is nevertheless obvious that the shortage of foreign exchange credit has been and

still is critical and well in excess of \$100 million. Of this unfulfilled need for FX financing for small and medium industry, only about \$60 million is currently under consideration by financing institutions including A.I.D., IBRD, Federal Republic of Germany, and the Japanese Government. The ROKG is also exploring the possibility of utilizing its own foreign exchange to assist in financing such credit."

* * * * *

"Taking into account the present availability of foreign exchange for small and medium industries, there is still a large requirement not yet financed or in immediate prospect. ***"

In making the foregoing comments, AID seems to have overlooked the fact that the ROKG had publicly announced plans to utilize \$60 million of its own foreign exchange for capital investment loans to small and medium industries. Moreover, it seems that the \$60 million to be released by the ROKG plus the \$60 million currently under consideration by the institutions mentioned by AID will be more than sufficient to satisfy current demands for small and medium industrial loans.

Concerning future demands for small and medium industrial loans, we believe that AID should encourage the ROKG to utilize its own foreign exchange and to look to sources other than AID for financing. As previously pointed out, the ROKG has been increasing its foreign exchange reserves and is becoming increasingly able to obtain financing from sources other than AID. Consequently, we believe that AID should be the source of last resort.

Concerning the proposed increase of \$12 million in the loan to KRB, we believe that AID should also encourage the ROKG to obtain these funds from another source.

DEVELOPMENT OF NATURAL RESOURCES

AID's efforts in this area have been primarily toward assisting in the development of mineral and water resources.

The extent of progress in these areas has varied, advancements being noted in mineral exploitation except for the coal industry. A relatively new program on water resources development is advancing satisfactorily. Since 1961, AID has obligated about \$12.9 million in loans and grants to assist this sector, allocated as follows

<u>Type of assistance</u>	<u>Amount (millions)</u>
Technical cooperation projects	\$ 3.39
Development loans	<u>9.50</u>
Total	<u>\$12.89</u>

Need for development of coal resources

Since 1956 AID and its predecessors have invested about \$16.9 million in developing and studying coal resources in Korea. Resultant recommendations by experts are that it is feasible and necessary that a large-scale investment be made to rationally develop and utilize this fuel source. Regardless, AID has not followed through on these recommendations, the result being that, instead of developing and utilizing this significant natural resource, the ROKG is turning to importing oil as a major fuel source. We believe that this causes prevention of necessary expansion of the coal industry, which, along with a shortage of railroad facilities, is requiring the ROKG to unnecessarily expend large amounts of its foreign currency to import oil.

The United States through AID and its predecessor agencies has invested a total of \$5.6 million in defense support grants, \$1.8 million for technical cooperation (including consultant contracts), and \$9.5 million in development loans to the Korean coal industry. In addition, excess equipment having an acquisition value of \$7 million was made available through the Korean Office of Mineral Exploration Program for use by the entire mining industry.

The consultants hired by AID have been rendering general and technical services to the Korean coal industry since 1959. A major part of these services was the conducting of an industrywide survey of the coal supply situation in the Republic of Korea (ROK). The survey report was presented to USOM in August 1966, and a supplementary report was submitted in March 1967. A preliminary report, which was consistent with the data presented in these reports, was submitted in December 1965. These reports pointed out that it is possible for Korea to develop a steadily increasing rate of production to reach 20 million tons in 1973 and to sustain that annual rate beyond 1990 on the basis of the known reserves of 500 million tons as of January 1, 1967. The reports stated that there are many promising areas in Korea where coal-bearing formations are either known or believed to exist that have not been explored and that, with continuing geological survey, additional reserves could be delineated.

The consultants believe that, by investing \$62 million (of which no more than \$39 million would be foreign exchange) in the coal industry, to meet KECO requirements, the ROK would benefit from

- 1 Lower electric power production costs.
- 2 Savings in foreign exchange
3. Development of a local industry and supporting community development.
- 4 Employment for 10,000 persons.
5. Development of housing and community service buildings.
6. Increase in corporate taxes.
7. Earnings in foreign exchange from exports.

The consultants recommended that

- 1 Large capacity, long life (base-load) coal mines in ROK be developed at a more rapid rate and to a greater extent than presently planned in order that future supplies of fuel may be provided most economically
2. Geological exploration programs be continued in order to determine future coal reserves
3. To ensure that production of coal will keep pace with the growing demand, the ROK Government discontinue its adverse policies, such as holding down coal prices, and implement policies which will support an increased rate of coal mine development, such as allowing coal prices to reach a realistic level and providing tax incentives to encourage investment in coal
4. A positive program be implemented immediately for development of base-load mines for an ultimate capacity of 10 million tons annually in order to

replace productive capacity, which will be lost as older mines are depleted, and to provide for increased coal production

5. Increased total rail haulage capacity Mechanized coal-handling facilities for loading and unloading would reduce car-turn-around time.
- 6 A program of road improvement, since a large portion of production is truck hauled from mines to rail loading points.

The ROKG second 5-year plan (1967-71) proposed total financing--\$10 7 million in foreign exchange and \$22.6 million in local currency--for all coal mine development The consultants estimate that this is less than one third of the total required to develop and equip base-load mines in order to produce 10 million metric tons a year.

During the 1966-67 winter season, Korea experienced a coal shortage, which was attributed to a shortage of railroad facilities rather than a shortage of coal. (The shortage of railroad facilities is discussed on pages 13 to 15 During this shortage, the ROKG encouraged the use of oil in lieu of coal in electric thermal plants and heavy industry Large amounts of KFX had to be expended for the oil The consultants estimated that, had the same amount of KFX as was used for oil been used for coal mine development, it would have provided mine capacity to produce coal every year for 20 years, the tonnage of coal thus produced would have been approximately 18 times the tonnage of coal replaced by oil

The ROK policy for substituting fuel oil for coal in power plants, general industrial plants, and commercial buildings has continued Three thermal plants plan to convert from coal-burning to oil-firing. The basis for this plan to substitute fuel oil for coal is that the coal reserves, which are limited to some 500 million tons, are best suited for household heating and therefore should be conserved for that purpose.

It should be noted that the consultants pointed out that, in addition to the 500 million tons existing in

known reserves, additional reserves could be delineated by means of continuing geological survey. Moreover, though there be a steadily increasing rate of coal production to reach 20 million tons in 1973, the known reserves of 500 million tons alone would sustain that annual rate beyond 1990

Moreover, the conversion of power plant fuel to oil does not appear to be necessary. The coal consultants investigated the use of coal as a power plant fuel and found that beneficiation processes (oil treatment) can be applied to coals from some of the fields to produce fuel of uniform lower ash content and hence of considerably improved combustion characteristics for thermal plant usage. Related studies indicate that, by using beneficiated coal, the power industry could save about 331 million won (\$1.2 million) annually in fuel costs. Thus, the demand of the power industry for run-of-mine production actually would be decreased. The studies showed that the use of oil as a fuel would result in higher fuel costs and in the use of valuable foreign exchange for oil imports.

In commenting on the foregoing matters, AID pointed out that

1. An October 1965 report stated that coal-fired thermal power plants are about 10 percent cheaper to operate than equivalent plants fired by oil only. However, the report stated also that in the future this margin will decrease and may be completely eliminated.
2. KECO had decided that all future thermal plants will be totally oil-fired. This decision was in accord with a feasibility study showing that, when compared to the costs of a coal/oil plant, the costs of an oil-fired unit are \$8 million less in the original capital investment and about \$750,000 less yearly in the cost of producing power, including both overhead and operating costs. These savings were based on coal and oil prices as of June 1966.

3. On October 1, 1967, the coal price was increased by 30 percent, therefore, the savings from using oil will increase. Moreover, oil prices include a 10-percent Government tax and coal prices do not include transportation costs

We recognize that the original capital investment is much less for an oil-fired plant than for a coal-fired plant and we are not questioning KECO's decision to construct only oil-fired plants in the future. However, for those plants that were initially constructed to use coal or those that could use either fuel, we believe that AID should encourage the ROKG to use coal, even if the price of coal is somewhat higher than that of oil. The efficient use of coal resources presents considerable potential for alleviating many of the basic problems of Korea's economic structure--utilization of natural resources, reduction of unnecessary imports, increasing employment--all of which are necessary elements in achieving a self-sufficient economy. The potential savings in foreign exchange from the use of coal is particularly important. For example, an August 1966 study showed that the development of adequate coal mine capacity to meet KECO's annual requirement for 20 years would require a one-time expenditure of \$62 million, of which \$39 million would be foreign exchange. On the other hand, oil imports would cost about \$37 million in foreign exchange annually, or \$735 million during the same 20-year period.

In our draft report, we proposed that AID make every effort to demonstrate to the ROKG the benefits of an adequate coal-development policy and take measures to assist the ROKG in developing this industry for the benefit of the ROK economy and in achieving AID's goals of helping the ROK to achieve self-sufficiency.

AID informed us that, to help answer the coal/oil issues, the Korean Institute of Science and Technology has been commissioned to carry out a study of overall energy demands and investment possibilities. AID believes that, with the results of this study, it will be in a better position to advise the ROKG on its entire fuel energy situation

DEVELOPMENT OF AGRICULTURE
FORESTRY AND FISHERIES

This primary sector of the Korean economy has been assisted through technical cooperation, commodities, and just recently by two large development loans for fertilizer plants that will supply fertilizer previously provided under the commodity import program.

Overall, since 1961, United States input to this area totals \$708 million, as follows

<u>Type of assistance</u>	<u>Amount</u> <u>(millions)</u>
Technical cooperation projects	\$ 2.3
Public Law 480 commodities (wheat and other food products)	506.9
Supporting assistance commodities (fertilizer)	150.0
Development loans	<u>48.8</u>
Total	<u>\$708.0</u>

AID has recently completed an evaluation of USOM's rural development program, which will be followed by preparation of an overall Rural Development Strategy Statement for 1967-71. Briefly, AID's evaluation concluded that, although agriculture has progressed in the past, as indicated by increased production and yield per land unit, certain important elements of agricultural needs have not been developed. These include a multipurpose approach to land and water development and utilization, an adequate financing system, development of forestry for conservation and fuel needs, and adaptive research, especially on wheat. AID's current evaluation of agriculture also encompassed the Public Law 480 program.

Our review of this sector of the Korean economy was limited to followup on findings in our prior report (B-125060, September 21, 1962).

Fertilizer program

Among the various commodities imported into Korea under the supporting assistance program is fertilizer. Since 1961 about \$150 million has been obligated for fertilizer imports under this program. Our prior report, which covered the period 1957-61, commented on the following problems relating to the handling of fertilizer under this program

1. Lack of technical guidance by USOM.
2. International Cooperation Administration (AID's predecessor) was being excluded from basic fertilizer decisions.
3. Fertilizer procurement costs were higher than necessary because lower off-season prices were not being obtained and commercial importers were not able to obtain prices as low as those obtained by Korean Government agencies.
4. Fertilizer produced by an ICA-financed fertilizer plant was not being utilized.

We recommended that consideration be given to increasing USOM's advisory staff, to further improve administration of this program.

During our current review, we found that because of changes in procurement planning and procedures and the establishment of a closer working relationship between USOM advisors and cognizant ROKG agencies, these problems had been eliminated. Also, we were informed that fertilizer imports under the commodity import programs will cease after the 1967 program and that future imports will be financed by Korean-owned foreign exchange. This reduction of import needs has been made possible by increased local production capability of the Korean economy, including an anticipated large increase which was due to the construction of two mixed-fertilizer plants that were financed partially by AID development loans.

DEVELOPMENT OF GOVERNMENT
ORGANIZATION AND ADMINISTRATION

AID is now operating a group of technical cooperation projects that deal with and assist the ROKG in stabilizing and improving the operation of the Government and other closely related operations, such as banking and credit. Obligations under these various projects have totaled over \$3.7 million since fiscal year 1961. Major current projects include economic planning, improvement in administration of banking, and improvement in credit and revenue administration. On the basis of the improvements throughout this sector in administration and in growth of savings, revenues, exports and other economic indicators, it appears that these projects have been worthwhile.

The purposes of the economic planning project are for gaining an understanding of conditions of and prospects for Korea's economy, providing guidance and assistance on formulation of economic policies and investment plans, and analyzing important social projects relating to modernization. Consultants under this project assisted in the development of Korea's current 5-year plan and in a major interest-rate reform. Outside experts have given qualified approval to the 5-year plan as a solid guide for economic development, and the interest-rate reform is said to be a major factor in the improvement in domestic savings, which has taken place in the past 2 years.

The revenue improvement project, carried out by borrowed Internal Revenue Service employees, was not too successful until 1965, when USOM convinced ROKG officials that a decline in AID assistance made self-generation of operating funds a necessity. Since that time, AID's tax advisors have assisted in helping the ROKG to reorganize and improve its taxation agencies, establish training programs, and assist in tax structure changes. A measure of the improvement can be seen by a comparison of tax revenues of 1965 with those of 1966. These revenues rose from 41.8 billion won in 1965 to 70.5 billion won in 1966, an increase of about 69 percent. Also, revenue collections for the first 6 months of 1967 were exceeding the increased estimated rate of tax collections for 1967.

The project for improvement of administration of banking and credit has primarily been directed toward ROKG banking institutions and has utilized contract consultants to a large degree. The project is related closely to the financial loans made by AID to these banks. The consultants have made a number of recommendations for banking improvements, which have been accepted and implemented by the banking institutions.

Other institutional progress which USOM states reflects its influence through the above-mentioned and other projects includes

1. Strengthening of capabilities and program of ROKG's Administrative Improvement Research Commission.
2. Shifting ROKG in-service training to a more job-related basis.
3. Development of a modernized Korean position classification system.
4. A start toward improving the ROKG salary structure.
5. A very significant growth of interministerial consultative and joint working groups in a large number of fields of economic development in which coordination was previously lacking.

SCOPE OF REVIEW

The basic purpose of our review of the economic assistance program for Korea was to examine into and make observations as to the general effectiveness of this program in accomplishing United States objectives in Korea. Our review was directed primarily to development loan projects, which are becoming the largest single segment of economic assistance to Korea.

We reviewed program documents, reports, correspondence, and other pertinent records available at AID offices in Washington, D.C , and in Korea. We discussed appropriate matters with responsible United States officials and with representatives of certain agencies of the ROKG. In addition, we visited selected locations in the country, where development loan projects were being carried out. In preparing this report, we considered the comments submitted to us by AID/W in January 1968.

APPENDIXES

PRINCIPAL OFFICIALS
 HAVING MANAGEMENT RESPONSIBILITIES
 ASSOCIATED WITH THE MATTERS
 DISCUSSED IN THIS REPORT

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
SECRETARY OF STATE Dean Rusk	Jan. 1961	Present
ADMINISTRATOR, AGENCY FOR INTERNATIONAL DEVELOPMENT David E Bell William S. Gaud	Dec 1962 Aug. 1966	July 1966 Present
UNITED STATES AMBASSADOR TO THE REPUBLIC OF KOREA Samuel D Berger Winthrop G Brown William Porter	June 1961 Aug 1964 Aug. 1967	Aug. 1964 June 1967 Present
DIRECTOR, UNITED STATES OPERATIONS MISSION TO KOREA James S Killen Joel Bernstein	Sept 1961 July 1964	July 1964 Present

DEPARTMENT OF STATE
AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON D C 20523

ASSISTANT
ADMINISTRATOR

JAN 23 1968

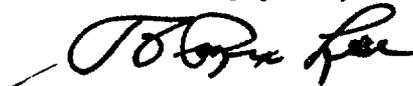
Mr. Oye V Stovall
Director, International Division
U S General Accounting Office
Washington, D. C 20548

Dear Mr. Stovall:

We appreciate the opportunity afforded this Agency to review the General Accounting Office draft report entitled "Review of Economic and Technical Assistance Program for Korea " Agency comments, which are included as an attachment to this letter, list some of the actions taken by our Mission in Korea to improve our operations there. In addition, we have suggested various word changes which should more clearly explain the material presented in the report.

We will be pleased to confer with you or members of your staff to discuss the Agency's comments, if you consider it necessary.

Sincerely yours,



H Rex Lee

Attachment: a/s

GAO note The page numbers cited by the Assistant Administrator for Administration in these comments refer to pages in the draft report submitted for review, the page numbers shown in brackets refer to the corresponding pages of this report.

AGENCY FOR INTERNATIONAL DEVELOPMENT
COMMENTS ON THE
GENERAL ACCOUNTING OFFICE (GAO) DRAFT REPORT ENTITLED
"REVIEW OF ECONOMIC AND TECHNICAL ASSISTANCE PROGRAM FOR KOREA"

Set forth are comments and suggestions which are keyed to the draft report by topic headings and page numbers. Requests for deletions of security classifications are also keyed to page numbers as applicable.

[See GAO note on p. 47.]

Pages 25 to 30 [12 to 19] - Power The Power Survey Team's (PST) forward projections were made in 1964 and early in 1965. The work of the Team was completed in April of 1965. Since that time the Gross National Product (GNP) has moved considerably higher than had originally been anticipated and in fact economic development across the board had increased at a rate much faster than anyone expected. Further, Korea has been very successful in attracting foreign capital investment into the country and this has contributed to additional requirements for electric power which could not have been foreseen. The category of small and medium industries has grown at a very rapid rate and the demand for power for this category of user has increased at the present time to a 29.6 percent per annum growth figure. The ROKG and the Korea Electric Company (KECO) have gone all out in securing from various foreign governments, loans for additional generating capacity to keep up with the growth rate.

In this general situation of rapid growth in the economy requiring frequent upward revisions of estimates of various economic variables, KECO, the ROKG, and the USOM have participated in a joint committee established to keep power needs and implementation of the construction program under continual review. This review has resulted in a series of upward revisions of future power demands. In response to these estimates, KECO and the ROKG have made provisions for some relatively rapid increases in total generating capacity and have also increased the longer term construction program.

In order to get quick relief, KECO purchased 10 fifteen-megawatt (MW) gas turbines from Japan. Four of these are in operation and the other six will be operating in another 2 months. The ROKG and KECO are taking other emergency measures to provide additional temporary power units this year. However, there will still be some deficiencies for a short period until the Kunsan Thermal

APPENDIX II

Page 3

plant is placed in service in April 1968. The Kunsan contribution (75 MW) will be ample until the fall of 1968. To increase capacity for that period, KECO is negotiating for 90 MW of additional gas turbine capacity which could be available by the fall of 1968. Pusan 3 and 4 (200 MW) are due to be in service by January 1969.

We believe the emphasis on "delay" here and elsewhere in the report is unmeritorious. At best, each phase of a capital project requires much complicated work, and agreement and coordination between USOM, AID/W, and ROKG, KECO, and any American contractor involved. It is difficult to establish a norm in the capital project agreement for the desirable time for each step because the circumstances differ so greatly from project to project. Moreover, and most important we think in getting a project moving and avoiding delay, the dates we use in project agreements for implementation action by the Koreans must be used to some degree to push them to more expeditious action than might otherwise be the case. When there is "delay," it is due to normal project complications or to A I D 's insistence to take whatever care is needed to avoid mistakes or waste of funds.

We recognize, however, that in institution-building efforts, self-help negotiations and agreements are critical. These frequently require difficult, time-consuming Korean decisions. However, the result is often worth the delay. Several of the delays in the projects mentioned in the GAO report (Kunsan Thermal, Seoul Thermal, T&D #1, KNR 2nd & 3rd Diesel loans) related to serious problems on the Korean side in implementing the agreed upon self-help measures in the loan agreements. We believe the institution-building aspects were required in any project to be as important as the physical aspects and should not be subordinated to meeting physical schedules.

[See GAO note on p. 47.]

Pages 30 - 37 [12 to 19] - Railroad Transportation A I D takes the same exception to the use of the term "delay" on page 34 instead of "time elapsed," as we did above. The second Diesel loan was authorized March 5, 1964, and the loan agreement was signed March 12, 1965. While we agree that the length of time between the loan authorization and signing was undesirable, there were important issues concerning the financial structure of the Korean National Railroad (KNR) that had to be resolved before the loan agreement could properly have been signed. Despite very strong A I D efforts to get these issues resolved as quickly as possible, it was not able to do so before the March 1965 signing date.

A key issue was the implementation of the "separate entity" concept. The International Development Association (IDA) loan of August 1962 required that KNR be established as a "separate entity" and this requirement was repeated in A I D 's first loan to KNR (signed October 29, 1962). The ROKG issued a

Cabinet Decree on December 17, 1963, providing for reorganization of KNR in accordance with this concept, but key elements of the shift to a business-type management were not introduced until early 1965--particularly the establishment of business-type accounting and budget management which was dependent on the results of a technical assistance effort with KNR, carried out in 1964 by Booz-Allen-Hamilton and financed by proceeds from the IDA loan. A I D felt that this shift, which was required in the first loan to KNR, should be effected before it signed a second loan, and also that the ROKG should agree in writing to some other points involved in implementing the concept of a "separate entity" and in making the railroad more of a self-financing entity, viz.

a That the KNR's commercial accounting system include the necessary accounts and procedures to record appropriate asset reserves for depreciation modernization, and expansion

b Acceptance by the ROKG and the KNR of the principle that the KNR should make available from its revenues funds adequate to finance an increasing proportion of new capital investment

Some other particulars were also involved, and the whole package was agreed to by mid-January 1965

It should be noted that the time taken up to December 1964, to resolve the foregoing issues, was not time lost in any case, because it was A I D s policy from the spring of 1964 to December not to sign any pending loan agreements until the ROKG had taken adequate action on a number of basic policy measures to stabilize the economy. The latter action was necessary to create a healthy overall economic climate in which the expenditure of A I D loan funds could be expected to be more effective. By late November, much progress had been made

The further time required in the first quarter of 1965 was to iron out differences of view over a new proposal by KNR to change the equipment to be financed. A new General Manager of KNR proposed larger and more expensive locomotives than those recommended by the American consulting engineering firm (Coverdale and Colpitts). The consultants had made an extensive study of the needs of KNR and their recommendations had been accepted by the preceding General Manager, ROKG, USOM, and AID/W. (There was some feeling that the new General Manager was influenced by an equipment supplier on this point). The Ministry of Transportation then replaced the General Manager and his successor agreed with the consultant's recommendations.

A I D views the shortages of freight cars as being only one of several needs of the KNR. In addition to rolling stock, the KNR requires improvements in station facilities, marshalling yards, double tracking and central traffic control in many areas, automatic block signals, communications and several refinements in other areas that are mutually interdependent with

rolling stock for railroad operations. It also requires continuing increases in the modern managerial skills essential to running a railroad. To meet many of these needs the KNR and the IDA have just signed an \$11.0 million credit for 600 coal hopper cars and 450 oil tank cars. To assist the KNR in some of its other needs, IDA is also providing experienced technicians to assist in (1) Train Scheduling, (2) Rolling Stock Operations, (3) Supply Management, (4) Shop Management, and (5) Marshalling Yard Operations. It is believed that these top level technicians will provide much needed skills for the betterment of KNR operations.

The main thrust of A I D advice to the KNR, the ROKG, and those agencies providing assistance to them, has been to accelerate their efforts to build transport capabilities so as to catch up with and get a bit ahead of the rapidly expanding demands for transport. To assist these efforts, A I D has been attempting to speed up the implementation of our diesel loans and has consulted extensively with the Japanese Government and the International Bank for Reconstruction and Development (IBRD) on their assistance in this field, urging maximum speed. Under the third diesel loan signed June 29, 1966, all locomotives were developed by August 1967, 4 months ahead of schedule. The USOM/K continues to work with the ROKG in a joint committee to keep the transport situation under review and plan ways and means of improving it.

Pages 37 to 40 [20 to 22] - Small & Medium Loans

[See GAO note on p. 47.]

It should be accented that any delays in the utilization of A I D loans through Korean intermediate credit institutions do not reflect a lack of need or demand for such funds by Korean private firms. It does reflect the fact that the handling of A I D dollar loans is a new activity to such banks, that the prescribed practices and procedures by both the ROKG and A I D as well as the general difficulty of obtaining credit in Korea involve a considerable time span for completion of the administration of an A I D sub-loan. However, under the best circumstances, the authorization of an A I D loan to finance sub-loans by an intermediate credit institution is only the initial step of a long involved process of making and implementing such sub-loans. This is particularly true of the initial A I D loans such as the \$5 million loan to the KRB and \$8 million to the Medium Industry Bank (MIB). It should be kept in mind that A I D is not only lending funds, but is assisting in the development of new financial institutions.

The \$12 million loan to KRB represented the second A I D loan of this nature. During the interval, A I D had supplied considerable technical assistance under contracts with the A T Kearney Co and the Arthur Young Co. In view of its difficulties under the initial \$5 million loan, KRB has made special effort to assure that there would not be a repetition of the previous experience.

Further, the demand for loans has far exceeded the availability of funds which made it necessary for KRB to establish and apply priorities to sub-loan applications and to evaluate the loan applications at one time, instead of processing one loan at a time. As of December 1, 1967, the KRB had submitted 14 such loans to USOM for approval. Five of these loans totaling \$3,289,117 have been approved by USOM and letters of credit are in the process. Two of the loans totaling \$670,000 have been rejected and the remaining seven amounting to \$3,654,753 are under review by the Loan Committee. The total approved or under USOM review is over 50 percent of the \$12 million loan, although the first letter of commitment thereunder was only opened in June 1967.

With further reference to the Japanese loans, they are restricted to purchases from Japan and do not meet the requirements and desires of Korean businessmen for U S machinery and equipment. Also, A I D dollar loans not only directly finance U S exports but promote a demand for further U S goods in the form of spare parts, raw materials, and replace elements. A I D feels it is important to have a steady availability of U S sub-loan money through the KRB for this purpose. At the present rate, the second KRB loan will be exhausted in a few months. The third loan application is being delayed so as to coordinate its availability to the depletion of the second loan.

[See GAO note on p 47]

Pages 46-47 - Recommendation Regarding Development Loans

1 [Pages 20 to 22] Evaluation of current availabilities as well as future projections for foreign exchange is a continuing process within the USAID Mission to Korea. A I D through their participation in the International Economic Consultative Organization for Korea (IECOK), sponsored by the IBRD, has access to the reports of investment and loan activity of the 12 member nations. As a result, A I D has a fairly accurate assessment of the availability of foreign exchange for Korea.

APPENDIX II

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In the past few years, demand for foreign exchange has risen sharply among small and medium industries, reflecting the rapidly expanding nature of the Korean economy and the need for modernization of plant and equipment. Since 1965, approximately \$40,750,000 in foreign exchange loans has been made available to small and medium industry through the MIB and KRB. Demand for these funds, as measured by the total amount of applications received, exceed \$200 million, leaving a gap of some \$160 million. While as much as 25-35 percent of this gap may not be bankable, it is nevertheless obvious that the shortage of foreign exchange credit has been and still is critical, and well in excess of \$100 million. Of this unfulfilled need for FX financing for small and medium industry only about \$60 million is currently under consideration by financing institutions including A I D , IBRD, Federal Republic of Germany, and the Japanese Government. The ROKG is also exploring the possibility of utilizing its own foreign exchange to assist in financing such credit.

The IBRD is making \$50 million available to medium and small industry, for expansion and development through a loan to the privately-owned Korean Development Finance Corporation (KDFC). A I D is also providing a \$50 million loan to the KDFC.

The Japanese Claim Fund allocation for industrial development recently made by the ROKG is still subject to Japanese Government approval. The policy of the Japanese Government thus far is to adhere closely to the settlement agreement with Korea, which provides for \$20 million of Japanese Government loans per year to the ROKG for all purposes. Small and medium industry loans are only one of several uses (railroad rolling stock, steel for bridge repairs, pumps and irrigation materials, construction materials, shipbuilding materials, etc.) for which these funds are programmed. Thus, it is unlikely that the Japanese Government will release more than \$10 million per year, if that much for loans to small and medium industry. Even the EPB which normally estimates Japanese loans very much on the high side, says it does not expect more than \$45-50 million to be committed to small industry loans by the end of 1971. The ROKG Finance Ministry has announced that, as of June 30, 1967, arrival on Japanese loans for promoting small and medium size industries were \$53,000 or 3 percent of the \$15 million programmed in 1966. Thus the rate of flow of this program is proving to be quite slow.

Taking into account the present availability of foreign exchange for small and medium industries, there is still a large requirement not yet financed or in immediate prospect. Provision of additional loan funds to the KRB and MIB would promote several U S and ROKG policy objectives, viz: (1) Rapid development of small and medium size industries which is one of many critical sectors in overall growth of the Korean economy, (2) Increase employment and income (small and medium industries in Korea tend to be highly labor intensive) (3) Expand and strengthen the private enterprise sector, (4) Strengthen institutional capability to pursue the foregoing objectives.

Provision of U S funds in this form as well as through the machinery and equipment portion of our program loans is a good way to create sales opportunities for a wide variety of U S products in Korea. A I D , therefore,

feels it should continue to provide funds to the KRB and the MIB as planned

[See GAO note on p. 47.]

3 [Pages 12 to 15] Korea has made impressive economic progress since 1964 in growth of GNP, exports, domestic savings, and industrial development. Although Korea still relies on military and economic assistance and has a low per capita income, the Korean Government has established an environment of monetary and fiscal stability conducive to foreign investment and economic development.

This environment and fiscal stability has encouraged other countries and other lending institutions to consider Korea as a satisfactory credit risk. The IBRD and the IFC have initiated investments and loans in Korea. IDA has just signed an \$110 million credit for Korea in the transportation sector and the U S Export-Import Bank has concluded \$83 million in several small loans to Korea and has given positive assurances that it will do more before the end of FY 1968.

Because of A I D 's planned phase-down in Korea, we have already discussed with the ROKG the need for them to look to other sources for financing, particularly for power, transportation, and large capital projects. The President of the KECO recently told A I D that KECO had just completed plans for the foreign exchange financing for all their power plant construction through 1975 (total cost to KECO will be about 200 billion, foreign exchange portion about \$355 million). This includes financial assistance from Germany, Italy, Japan, U S private sources and possibly U S Export-Import Bank.

A I D has concluded that power, transportation and large capital projects are of such priority to the ROKG that financing can and will be obtained elsewhere. A I D is the source of last resort and it is apparent that financing for the above type projects will be available on a timely basis from sources other than A I D. We stand ready, however, to consider such projects if other sources are not available.

Therefore, A I D firmly believes that using a large percentage of our limited funds for development of medium and small industries, a vital sector of the Korean economy but one which involves more risk, contributes not only to development goals of the ROKG but helps to strengthen private enterprise.

[See GAO note on p 47]

4 [Pages 15 to 19] Neither USOM nor AID/W have been satisfied with the length of time that it takes to complete loan projects, even apart from delays which result from self-help negotiations. However, a number of proposals have been made and initiated to shorten this time period without impinging on the soundness of project planning and execution or on any of our statutory requirements. For example, telescoping certain steps in the procedures and reducing the number of items that have to go back and forth for approval.

In addition, the Assistant Administrator for the East Asia Bureau has recently inaugurated a system of review and approval actions which is expected to reduce the chance of some types of serious and lengthy delays which has been experienced with some of our large capital projects in the past

Pages 48 to 54 [22 to 28] - Coal vs Oil The PST report (Thomas report) of October 1965, said that coal-fired^{1/} thermal power plants are about 10 percent cheaper to operate than equivalent plants fired by oil only. However, the report also stated that "in the future this margin will decrease and may be completely eliminated" (Vol I, p 66)

KECO has decided that all future thermal plants will be totally oil-fired, beginning with the Pusan #3 and #4 units and the Yongnam #1 and #2 units. KECO's decision was in accord with the feasibility study for the Yongnam #1 thermal unit, conducted by the Kuljian Corporation. Kuljian's analysis showed that "when compared to a coal/oil plant, an oil-fired unit results in a saving of \$8 million in KECO's original capital investment, and of approximately \$750,000 yearly in the cost of producing power, including both overhead and operating costs "

Kuljian's calculations were based on coal and oil prices as of June 1966. On October 1, 1967, the coal price was increased by about 30 percent, to better cover actual mine operating costs and encourage the greater production the GAO report recommends, so the savings from using oil only will increase.

The trend in oil prices has been relatively stable over the past few years, and the world's known reserves of oil continue to increase. Kuljian's calculations assumed a stable oil price, but the price used included the 10 percent tax in Korea. Deducting the 10 percent tax, to better reflect costs to the economy, results in an even larger saving from using oil only in thermal power plants.

^{1/} "Coal-fired" means using a fuel composed primarily of coal (85 percent) with the remainder oil.

In addition, coal is about $2\frac{1}{2}$ times as expensive as oil to transport, per b t u. Although in Korea the transport costs from the point of origin are not reflected in delivered coal prices (freight being absorbed in the price), the economy must bear the cost burden.

Another factor in the decision to build oil-fired plants has been the growing household demand for coal. In 1965, households consumed 70 percent of the total coal supply of 10.3 million MT. The Second Five-Year Plan provides for sufficient investment to increase annual coal production only to 14 million MT in 1971. The Yongnam #1 plant alone would consume 580,000 MT of coal yearly if it were coal-fired, according to the Kuljian report.

Lastly, even if budgetary constraints permitted the sizable investments in coal recommended by the Pierce Management Corporation, it is doubtful if coal output could be expanded rapidly enough to meet household, industrial, and electric power needs over the next few years if there were no conversions to oil use in the manufacturing and power sectors. A I D and the ROKG feel that fuels policy is not an either-or matter, rather, more of both coal and oil will be needed in the future. The relevant question is how much of each for what uses and, consequently, what types of investments in fuels will be most beneficial. Several of the power plants now under construction will be able to use either fuel, as from time to time the market indicates-- a practice also used in the U S. To help answer the coal/oil issues, the Korean Institute of Science and Technology has been commissioned to carry out a study of overall energy demands and investment possibilities. The work is being conducted under subcontract by the Battelle Memorial Institute. With the results of this study, we will be in a better position to advise the ROKG on their entire fuel energy situation.

[See GAO note below.]

GAO note. Deleted comments relate to classified or other matters discussed in the draft report but omitted from this report. Additional information furnished to us by the Agency with these comments has been considered in the preparation of this report.