

**The Political Economy of
Government, Financial System, and
the *Chaebols* before and after the
1997 Financial Crisis in Korea***

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1. Introduction

The purpose of this paper is to examine the role that financial system has played in economic development in Korea and the changes thereof especially since the financial crisis of 1997-98. From the 1960s when rapid industrialization began in Korea until the late 1980s, Korea's financial system was far from being the kind typically associated with the Anglo-American economies. It was, in fact, directly under government with the banks, the main component of Korea's financial system then, allocating credit among the large family-owned conglomerates called the *chaebols* at the behest of government. In other words, this was a period during which the so-called financial repression was in force in Korea.

In the early 1980s, Korea began reforming its financial system in an attempt to introduce a freer financial system. The reforms were, however, ill-conceived and were heavily influenced by interest politics and led indirectly to the financial crisis of 1997. The post-crisis reforms have been more thorough, bringing the Korean financial system, at least in its formal structure, closer to that found in the Anglo-American economies.

This varied history of Korea's financial system raises a number of interesting questions on the relationship between financial system and economic development and on the difficulties in making the transition from one type of financial system to another. How did Korea manage to achieve rapid industrial development, export expansion, and economic growth in the 1960-70s when its financial system was apparently an archetype of financial repression? What were the forces behind the reform that began in the early 1980s and how was the reform implemented? What was its outcome? What's the relationship between the reform and the crisis of 1997? Was it, as alluded to by Coe and Kim (2002, p.2), an inevitable consequence of the fundamental structural problems built up during the thirty years of rapid economic growth?

Korea's experience in financial development is, however, more than the story of a financial system, as it cannot be separated from the role that the government and the *chaebols* have played in economic development and financial reform. That is, it is a story of how the government, financial system and *chaebols* have interacted in the course of economic development and how the nature of this relationship has changed over time. Certainly, Korea's experience is to a certain extent unique, but given its remarkable success in achieving rapid economic development in a relatively short period of time a study of its experience offers valuable lessons for countries that are still mired in an early stage of economic development.

The rest of the paper is organized as follows. In section 2 we provide a brief discussion of developments in Korea that subsequently laid a foundation for rapid industrialization that began in the 1960s. In section 3 we discuss various features of

Korea's financial system of the 1960-70s, and in section 4 we discuss how this system was used to promote industrialization and export expansion and provide reasons how it could be used effectively to promote industrial development in Korea. In section 5 we discuss the change in economic policy and attempts at financial liberalization that began in the early 1980s, and in section 6 we discuss the influence of interest politics, especially the *chaebols*, on their outcome. In section 7 we discuss the consequences of the reform, which led to the crisis of 1997-98. In section 8 we discuss the post-crisis reform in the financial sector and its effect, and in section 9 we discuss the post-crisis reform in financial supervision and its effect. In section 10 we offer some concluding remarks.

2. Prelude to Rapid Industrialization

What accounts for Korea's rapid economic growth that began in the early 1960s? It is, according to a World Bank publication, *The East Asian Miracle: Economic Growth and Public Policy* (1993), the correct policy "fundamentals" such as "macroeconomic stability, high investments in human capital, stable and secure financial systems, limited price distortions and openness to foreign technology" (pp.10-11). The report admits that the Korean government used selective interventions such as directed credit, promotion of specific industries, and export push to change sectoral shares of value added. But, these interventions were, the report claims, ineffective as the outcome of the interventions was "roughly in accord with neoclassical expectations" (p.334). We argue here that although these fundamentals contributed to Korea's economic growth there is more to the story than that mentioned in the report. That is, there were other factors, besides these fundamentals, that have contributed to Korea's economic growth and have profoundly affected the way the economy has developed in the past forty-some years.

According to Kuznets (1977), Korea was able to begin rapid economic growth in the early 1960s only because, by then, certain institutional or historical constraints on the Korean economy were loosened. Some of these constraints were a part of Korea's colonial legacy. For instance, when the Korean peninsula was liberated from Japanese colonial rule in 1945, the country was left with widespread illiteracy and an ill-trained labor force. It also became separated from the Japanese economy that had served as its market for rice and raw materials and its supplier of manufactured goods. Making the situation worse was the partitioning of the peninsula that deprived South Korea of most of the heavy and chemical industries established in the northern half of the peninsula during the colonial period. Much of the infrastructure and manufacturing capital that South Korea had inherited from the Japanese colonial period was then destroyed during the Korean War of 1950-53. All these made it necessary to rebuild as well as restructure the economy before any fundamentals mentioned in the World Bank report could take effect.

When an economy exports traditional, agricultural products and imports manufactured nondurable consumer goods, as Korea did during its colonial period, the commercial institutions that are engaged in expanding commerce and exporting agricultural products serve the economy well. As the economy makes the transition from exporting agricultural products to producing manufacturing nondurable consumer goods these commercial institutions will be replaced with manufacturing institutions. Whether or not the country makes this transition successfully or not will thus depend on how

successful the manufacturing institutions are in replacing the commercial institutions and growing in strength.

In the early 1960s, when the process of rapid industrialization began in Korea, the private enterprises that possessed entrepreneurial talents, organizational structure, personnel, facilities, and capital resources were, by and large, the large enterprises that had grown during the 1950s. These large enterprises, the *chaebols*, became a powerful instrument in the strategy of rapid industrial development as they provided the necessary organizational base as well as entrepreneurial skills. Given that *chaebols* were used effectively by the Korean government in achieving its developmental objectives in subsequent years, how they happened to come into existence in the early 1960s when the financial system was very much underdeveloped and thus external financing was difficult to obtain is an important story to be told in understanding economic development in Korea. The way that many of them began and have expanded is quite different from the experiences of the industrialized nations of Europe and Japan, where the banking system played an important in developing industrial firms (Cameron 1967).

The origin of some of today's successful *chaebols* goes back to as far as the Japanese colonial period, but a majority of the top 30 *chaebols* (as of 1988) trace their origin only in 1945-60. Sixteen out of the 30 were established during the Rhee government (1948-60) and eight during the Park government (1961-79), and only six traced their origin to the Japanese colonial period (1910-45). Thus by the early 1960s twenty-two *chaebols* were already in place ready to play a key role in industrialization.

The years from 1953 to 1960 were a period during which Korea had a low rate of saving equal to only 0.3 percent of GNP and an underdeveloped financial system. In such a situation, several of the policies that the government undertook had an important effect on the birth and growth of *chaebols* by giving them access to the sources of capital. The first and the most important source of capital was their acquisition of vested properties at favorable prices (Kang 1993). At the time of liberation from the Japanese colonial rule in 1945, there were 166,301 properties that had formerly belonged to the Japanese. These vested properties—which included 3,551 operating plants and firms, land, infrastructure, and inventories, and which accounted for approximately 30 percent of Korea's entire total wealth then—were first entrusted to the American Office of the Property Custodian (AOPC). Some of the properties were distributed by the APOC itself, but the rest were transferred to the Rhee government in August 1948, when it was formally established, and their distribution was completed in 1957.

In distributing vested properties, the transfer prices were set at the pre-1945 book values, which were substantially lower than market prices, and many of the properties were distributed at prices even less than the book values. Furthermore, the properties were sold for a cash payment equal to only ten percent of the sale price, the rest to be paid in installment stretched over 15 years. A high rate of inflation that followed the sales of vested properties further reduced the real burden of the purchase, and in many cases, loan repayment were not even enforced. In fact, as of 1958 when the sales of vested properties were completed, 37.7 percent of the outstanding loans had not been repaid. Significant windfall gains were thus realized by those who had acquired the vested properties (many of these assets were destroyed, however, during the Korean War), and these gains became an important source of capital for a number of enterprises that subsequently grew into large *chaebols* such as Samsung, Lucky, and Hyundai (Cho 1990).

The second source of capital for *chaebols* in 1953-60 was the preferential allocation of import licenses and foreign exchange at an overvalued exchange rate. Overvaluation of the local currency and import restrictions obviously meant that the acquisition of foreign exchange at the official rate made import trading highly profitable and an important source of capital for many of the *chaebols*.

The third source of capital was the allocation of aid funds and materials. Acquisition of foreign aid, whether in the form of aid dollars or raw materials, was an important factor in building an industrial base and becoming a *chaebol*. Furthermore, as recipients of foreign aid the *chaebols* could obtain government-arranged, long-term, low-interest rate bank loans similar to those associated with the sale of the vested properties. In fact, with foreign aid and preferential credit, the *chaebols* could build a plant with its own equity amounting to only 15 to 25 percent of total required capital. This process of capital accumulation was further abetted by government policies that gave them a monopoly position in various domestic markets.

The *chaebols'* preferential access to bank loans was the fourth source of capital especially because of the high rate of inflation that prevailed during this period, which often turned real interest rates negative. It should, however, be noted that access to bank loans was interconnected with other factors such as the acquisition of the vested properties and the allocation of aid funds and materials.

What the allocation of the vested properties and preferential treatments accomplished is subject to dispute. It may only have created what Woo (1991) calls "political capitalists" in a country where "politics, and not innovative drive, has always been umbilical cord nurturing big business." It is likely that many rent-seeking activities were involved in the allocation of scarce resources and opportunities and that some of the rents went toward achieving political ends. But, it is also clear that rents were not all squandered on political payoffs, luxury consumption, or capital flight, as evidenced in the actual growth of the *chaebols*. To give a few examples, Yi Pyong-chol of Samsung turned one or two vested properties into a huge *chaebol*; Chong Chu-yong of Hyundai built up his business by procuring noncompetitive contracts from the government and the U.S. military; and Cho Chung-hun of Hanjin, who headed the Korean Air Group, began his transportation business with one used truck (Woo 1991).

One might argue that if the vested properties and other valuable opportunities had been allocated in a nonpolitical way, Korea would have produced more innovative entrepreneurs. But it is hard to question the innovative entrepreneurship of those who established *chaebols* on the basis of a couple of vested properties, some noncompetitive contracts, or one used truck. These were the people who could have spent their wealth on luxury consumption or taken it abroad, but obviously they did not and, instead, saw to it that their enterprises grew and expanded. In other words, rent-seeking unquestionably led to some waste of scarce resources, but evidence suggests that the rents were mostly used for capital accumulation.

Thus, by the early 1960s there were in Korea several large private enterprises established largely with non-banking sources of capital but with proven entrepreneurship, a ready organizational structure, and capital that could be used as instruments of economic development by a new government committed to developmental objectives. With them in place and with an abundant supply of cheap but well-educated labor, which U.S. aid helped bring about, "sensible macroeconomic policies" or the right

“fundamentals” might have been all that Korea needed to bring about rapid industrialization. What actually happened is, however, quite a different story especially as it relates to a financial system far different from the one that is supposedly conducive to economic growth.

3. State-Controlled Financial System

Until 1961, when a military coup took place, the Korean financial system consisted of state-owned and -controlled banks—the Korea Development Bank and the Agriculture Bank—and several private commercial banks, the former accounting for 71 percent of total bank lending and the latter 29 percent in 1960 (Cole and Park 1983, Table 11). The policy stance of the government then was to privatize government-owned commercial banks and reduce its control over them. An about-face change in this policy stance was brought about with the military coup of 1961, which led to the nationalization of the commercial banks.

The new government nationalized (re-nationalized, to be more precise) the commercial banks by forcing the large stockholders to return their shares to it on the grounds that they had been acquired illicitly during the previous regime. Subsequently, the annual budgets of the commercial banks and appointments to top management positions became a matter subject to the approval of the Minister of Finance. Special banks such as the Small and Medium Industry Bank were established, fully owned and controlled by the government, and the charter of the Korea Development Bank, a state-owned bank, was revised to increase its capital and to authorize it to borrow funds from abroad. Thus the banks—both nationalized commercial and state-owned specialized banks—became an instrument of credit allocation by the government as it became to be tightly controlled by the Ministry of Finance. In 1962, the Bank of Korea law was revised, making it unequivocally subject to the control of the Ministry of Finance. As pointed out by Cole and Park (1983, p. 58), these reforms were a “manifestation of the orientation of the new government towards a centrally managed and powerful set of institutions and instruments for carrying out the government’s policies.” This marked a clear departure from the policy stance of the previous regime, which adopted, albeit in principle only, a policy of central bank autonomy and the private ownership of commercial banks.

The economic system that had emerged from these post-coup institutional changes became to be known as a state-led economy or developmentalism. Although it basically was a capitalistic market economy it differed from its Anglo-American version in that the state held a commanding position in resource allocation through its control of the financial system. This was the system of political economy that the Park regime introduced and used effectively in its pursuit for rapid industrialization and economic growth.¹

This state-led system of political economy resembled, as remarked by a number of observers of the Korean economy (e.g., Amsden 1994, Cho 1994, Pyung Joo Kim 1994),² the system that was used in Japan in the post-World War II era to achieve rapid economic growth and catch up with the advanced economies of the West.³ This resemblance is no pure coincidence, however, as President Park, trained at a Japanese military academy during Japan’s colonial occupation of Korea and thoroughly familiar with Japanese history, allegedly had little regard for academic economists trained in the West, and as many of the economic experts he relied on had been educated in Japanese

schools, worked in Japanese banks, and looked at Japan as a model for rapid economic development (Woo 1991).

The system did not, however, go unchallenged during the Park regime. In fact, at the behest of U.S. economic advisers attempts were made to “liberalize” Korea’s financial system and make it like a free-market financial system of the West. But, as it turned out, the reforms did not have much of a lasting effect on the basic *modus operandi* of the system—the one employed by the Park regime, as attested in the following observation on the outcome of the reform (Kim 1994, p.278):

During this period a host of U.S. advisors (E.S. Shaw, John Gurley, Hugh Patrick, and others) visited Korea frequently under the auspices of USAID and international organizations. Their recommendations were put into practice with much fanfare and had an apparently dramatic effect for a while. These experiments, imbued with American ideas and implemented by officials more susceptible to U.S. influence, made ripples on the surface of Korea’s financial structure. *In most cases, these experiments were short-lived, distorted, ignored, and eventually overwhelmed by the main currents flowing steadily under the surface.* [Italics added]

What this failed attempt at financial liberalization demonstrates is that President Park was able to fend off challenges from external sources to his own strategy of economic development. As a matter of fact, in spite of objections from the World Bank on the grounds that Korea did not have a comparative advantage he started a program of heavy and chemical industry development in the mid-1970s (Kim 1994). As long as his strategy was successful in bringing about rapid economic growth there were few challenges to the regime to alter its policies and institutions.

The Korean economy grew rapidly between the mid-60s and the late 70s. It happened while the financial system was basically used as an instrument by the government for allocating credit to *chaebol* firms. A financial system such as the one that existed in Korea during this period has been a subject of much research ever since the contribution by McKinnon (1973) and Shaw (1973) to the literature on finance and economic development. It was widely accepted in the literature that in such a system, where the government maintained artificially low interest rates and controlled credit allocation, savings would be less and credit misallocated with a detrimental effect on economic growth.

How then did Korea manage to achieve rapid economic growth with such a financial system? Obviously, the fact that the Korean economy has developed rapidly in the presence of active government intervention has led to economic development. Thus, if we are to find an explanation for Korea’s success we need to first examine the nature of the financial system that existed in the 1960s-70s and provide a theoretical rationale of why and how such a system has contributed to Korea’s economic development. Before we do so, however, we discuss below in greater detail financial and developmental policies, in addition to the nationalization of commercial banks, which were carried out by the government **during the 1960-70s.**

3.1. Facilitating the Inflow of Foreign Capital

Korea of the early 60s was a poor country with meager domestic savings. To supplement these meager savings the government decided to induce the inflow of foreign savings by passing in 1962 a law that guaranteed foreign loans—the Act for Payment Guarantee for Foreign Loans. With the law in place, many Korean firms could now easily obtain foreign loans, which they used to acquire capital goods abroad.

The loan guarantee was not, however, for any and every one since it required the approval of the government, which used as part of its industrial policy. The guarantee was approved by the Economic Planning Board (EPB), which determined the total amount of loans in accordance with investment priorities specified in its five-year economic development plans. The Ministry of Finance then monitored all the approved foreign borrowings and their repayment.

In 1966, the government revised the Foreign Capital Inducement Act to allow the banks to provide guarantees without approval from the National Assembly. But, given that the government was the majority holder of shares in all the banks that guaranteed the foreign loans, it was the government that in effect guaranteed the repayment.

Another important step that the government undertook to facilitate the inflow of foreign capital was the 1965 normalization of diplomatic relations between Korea and Japan in spite of strong anti-Japan sentiments and violent political protests. It opened the door for a large inflow of capital and technology from Japan, which led to the establishment of the Pohang Steel, the third largest steel company in the world.

3.2. Export Credit Programs

One of the measures that the military government initiated in 1961 to promote exports was the export credit program, which lasted until the mid-1980s when Korea ran a current account surplus for the first time in its modern history. The essence of the program was the Bank of Korea's (BOK) automatic rediscounting that, via commercial banks, supplied subsidized credits to export firms upon presentation of export letters of credit (L/C). The rediscounting was extended to pre-shipment exports as well as the imports of raw materials and intermediate products for use in export manufacturing and the purchases of the same from local suppliers.

With the creation of general trading companies a new system of linking financing to export performance was introduced. They became eligible for financing if their exports exceeded those of the preceding year by a certain level. Another measure that the government used to promote exports was to make the annual renewal of their license as general trading company conditional upon their exports exceeding a certain specified amount.

Beginning in 1973 the BOK extended its discount policy to the financing of equipment investment in heavy and chemical industries (HCI), which the government had chosen as the country's next stage of industrial development. To promote exports from these industries the government established in 1976 the Korean Export-Import Bank, which was given the charge of making mid- and long-term post shipment export financing. These export loans, however, decreased significantly, with the large corporations becoming no longer eligible for the BOK rediscount, in the mid-1980s when Korea experienced a current account surplus.

3.3. Interest Rate Reform of 1965

In 1965 the government made a significant change in interest rate policies, raising the nominal interest rate on one-year time deposits from 15 to 30 percent and the general loan rate from 16 to 26 percent. These changes created negative margins between deposit and loan rates, which were intended to provide an incentive for financial saving while not overburdening business with the cost of loans. To protect the profitability of banks, which obviously suffered from the negative margins, the central bank paid an annual interest rate 3.5 percent on the required minimum reserves held by the deposit money banks at the central bank.

The reform brought the official interest rates closer to the market rates except those on loans for export, agriculture, and many other categories of investment. These subsidized loans were all discounted by the central bank at lower rates to ensure the profitability of the deposit banks. Interest rates on loans to exporters, for example, remained at 6.5 percent when the general loan rate was raised to 26 percent.

The raising of interest rates on bank deposits had the effect of diverting private savings from informal curb markets to the deposit banks. In the first three months of the reform their time and savings deposits increased by 50 percent, and in the subsequent four years they grew at a compound annual rate of nearly 100 percent. The M2/GNP ratio shot up from 8.9 percent in 1964 to 31.8 percent in 1971. Total bank loans increased as well to an equivalent extent: the annual growth rate of bank loans rose from 10.9 percent in 1963-64 to 61.5 percent in 1965-69. Thus a paradoxical consequence of the 1965 interest rate reform, which was meant to be a step toward financial liberalization, was to shift funds from the unregulated informal sector to the banking sector and thus increase the financial resources subject to government control.

3.4. Strengthening Selective Credit Policy for HCI Drive

In 1972, with the promulgation of the Presidential Emergency Decree the government reverted to a lower interest rate policy while intensifying at the same time its control over credit allocation. The decree led to an immediate moratorium on all loans in the informal credit markets and reduced the annual bank loan rate from 23 to 15.5 percent. It also led to the conversion of approximately 30 percent of the short-term high-interest commercial bank loans to businesses into long-term loans at concessional terms (to be repaid on an installment basis over five years at an eight percent annual interest rate with a three-year grace period). This lapse into more “repressive” financial policies was motivated by the adoption of a strategy promoting HCI and led to a significant departure from the export-oriented, sector-neutral strategy of the previous decade.

The government adopted two additional measures in support of HCI, which required large amounts of long-term financing. In December 1973, it established the National Investment Fund (NIF) to finance investments in HCI plants and equipment.⁴ The NIF was created with funds from both the private financial intermediaries and the government but predominantly from the former. It did not comprise a large share of total bank loans but it nevertheless provided more than 60 percent of term finance for HCI investments in 1975-80.

The other measure that the government undertook to promote HCI was the expansion of BOK rediscount facilities. Its list of qualified bills for rediscounting now included the bills acquired by the qualified firms in HCI as well as those associated with

raw material imports for HCI. In light of the long gestation period of investments in HCI, BOK increased the maximum loan period for equipment investments from eight to ten years. In addition, it adopted "Guide to Bank Loans," putting HCI on the list of high-priority industries for financing, to induce more lending by banks to HCI and restricting, if not prohibiting in some cases, the banks from financing certain service industries.

3.5. Size and Structure of Policy Loans

Policy loans have indeed been substantial in Korea, constituting about a half of the total credit by domestic financial institutions during the 1970s (Table 1).⁵ Their size fell gradually to about 31 percent of total loans during the late 1980s, in part, due to the expansion of NBFIs, which were not required to make policy loans. The share of policy loans in total loans from DMBs was 63.0 percent in 1973-81, 59.4 percent in 1982-86 when policy loans to large firms were curtailed, and 59.5 percent in 1987-91 when policy loans for SMEs, housing, and agricultural sectors increased and those for exports declined. For the entire period of 1973-91 it averaged 61.2 percent per year.

<Table 1>

During 1973-81, export loans constituted the largest share of total policy loans from DMBs at 21.3 percent, but their share fell significantly after the mid-1980s when Korea realized a large current account surplus. During 1987-91, the share of export loans fell to 5.2 percent.

The NIF captured about five percent of total bank loans during the 1970s and the early 1980s but was gradually phased out after the mid-1980s. The share of discounted commercial bills in total policy loans continued to increase after 1982, reaching 16.5 percent during 1987-91. These bill discounts were primarily for loans to SMEs. Housing loans also increased sharply in the 1980s.

3.6. Sources of Funds

In Korea the sources of policy loans were mainly central bank credits and the deposits mobilized by DMBs and much less the fiscal funds or government-mobilized funds such as postal savings. In 1973-91, the share of government funds in total policy loans accounted for only 7.6 percent (Table 1). During the same period the BOK played a much more important role as a source of funds, discounting 35.1 percent of total policy loans by DMBs (Table 2). Its support for export credit reached 51.1 percent of total central bank lending in 1973-81 but falling to 26.1 percent in 1982-86 and to 7.4 percent in 1987-91. Conversely, the share of BOK rediscounts on commercial bills increased substantially after the mid-1980s, reaching 26.5 percent in 1987-91, as it encouraged SME lending by DMBs. The share of general loans by the central bank increased sharply after the mid-1980s when the BOK discounted numerous loans for the restructuring of the ailing firms in shipping, overseas construction, and electronics. It, in effect, lent 1.7 trillion won during 1985-87 at the low interest rate of 3 percent per year.

In 1973-91 the BOK provided a large amount of support for DMB's key policy loans (Table 3). The ratio of central bank support for export credits to those by DMBs and the ratio of central bank rediscounts on commercial bills to those by DMBs were, respectively, 70.8 and 49.2 percent while the ratio for agriculture-fisheries-livestock

(AFL) loans was 18.5 percent. These ratios are certainly a sign that the BOK discount policy was a major instrument for directing commercial bank loans to strategic sectors and that directed credit relied heavily on high powered money creation.

<Table 2>

<Table 3>

3.7. Government in Risk Sharing

Industrial investment in Korea was financed largely with debt, especially, during the first three decades of its economic growth. Although fiscal incentives and low interest rates made it possible for some firms to accumulate retained earnings for further investment it was, in the absence of a well-functioning domestic equity market, the bank loans and foreign debt that largely financed the investment for industrial expansion. In fact, during 1963-71 the debt ratio of the Korea's manufacturing sector rose by more than fourfold from 92 to 394 percent. It declined somewhat when the stock market expanded in the second half of the 1980s but went up again in the 1990s.

With such a high debt ratio many of the Korean firms were vulnerable to internal and external shocks, but theirs was a risk shared by the government that came to the rescue of troubled firms. In fact, the government made a number of major corporate bailouts in 1969-70, 1972, 1979-81, and 1984-88 in order to ride out recessions and avoid major financial crises. In a state-controlled, credit-based economy such as the one in Korea the government could easily bail out the troubled firms by intervening in the credit market.

The most dramatic example of this kind of bailout was the August 1972 Emergency Measures, which put a moratorium on the payments of corporate debt to curb-market lenders. The decree firmly established a precedent that the government would take measures to relieve financial distress when necessary. Although highly leveraged, large industrial groups could thus undertake risky ventures while maintaining a long-term perspective on their investment decisions.

This government risk-sharing has had certain adverse effects on the economy. It encouraged private firms, especially the *chaebols*, to pay insufficient attention to investment projects, make excessive investments, and become dependent on government for bailout in case of financial difficulty. It also hampered the technical and managerial growth of the banks as they knew that the government would step in whenever indebted firms got into financial difficulty.

4. Functioning of a State-Controlled Financial System

According to the conventional view on finance and development, a country with a financial system described above should have suffered economic stagnation. Korea's experience is obviously to the contrary and thus begs the question of how it has succeeded in achieving rapid economic growth with such a financial system. In this section we offer an answer to the question.

In Korea, state control over financing was the most powerful tool for inducing cooperation and compliance among businesses in promoting exports and industrialization. One distinct advantage of credit support over other policy measures such as fiscal

subsidies is that it gives the government greater control over the borrowers as it confers it with explicit governance rights over the management for the entire duration of the loan (Cho and Hellmann 1993). Credit policies allow the government to allocate subsidies flexibly in accordance with the performance of supported firms or industries. Refinancing decisions—whether or not the existing debt would be rolled over or a new debt extended, and, if so, in what terms—can also be used towards the same end. Well-measured refinancing decisions provide incentives as good performance can be rewarded with continued or expanded support while an inappropriate use of funds is punished with a reduction in or even termination of support, a threat that may make the survival of firms untenable. This carrot and stick policy underlying credit programs makes them an effective tool of government industrial policy—more effective than fiscal incentives, which stem from legislative initiation and are subject to the rigidity of the implementation process.

Credit policies, however, carry their own risk—the risk of government failure. In Korea, the government's continuous communication with business leaders and close monitoring of firms through various channels (such as monthly export promotion meetings) helped reduce this risk. Moreover, by controlling the banks the government created incentives for firms to maximize their assets and growth rather than strive for immediate profitability. As far as they satisfied the government by expanding exports and successfully completing plants, firms were assured of their continual credit support and survival. As such, the government mitigated the risk of failure by adopting a sounder, more stable investment environment.

A unique and important institutional arrangement that Korea had in the 1960s and 1970s was a close and continuous cooperative relationship between the government and some of the *chaebols*. The government, for instance, conducted two separate monthly meetings, led by President Park and attended by business leaders, representatives from industry associations, and bankers, to assess economic trends and promote exports. One of these meetings was the Monthly Economic Trends Report Meeting prepared by the EPB, and the other the Monthly Export Promotion Meeting prepared by the Ministry of Commerce and Industry (MCI). A total of 298 meetings (146 Economic Trends Report Meetings and 152 Export Promotion Meetings) were conducted between 1965 and October 1979, when President Park was assassinated (Y.H Rhee 2006, p.11 and p.70). Analyses of domestic economic problems and information on international market trends were shared at these meetings, which also provided an opportunity for the government and the private sector to discuss policies and for bureaucrats, businessmen, and bankers to exchange information and build a consensus. Key leaders from financial institutions included the governor of the central bank and the governors and presidents of other major banks, and other representatives of the banks. Decisions were usually made in a consultative manner and were close monitored by the government. For example, when the government found out that the plant construction for a chemical industry complex was behind schedule because the lending banks were providing insufficient support, it summoned the bank presidents and asked them for greater cooperation in supporting the project. When some exporters reported in a monthly export promotion meeting that the international market was slow and they were forced to hold an excessively large inventory, the government urged the bank to extend them greater working capital credit.

In the Monthly Export Promotion Meetings, export performance was monitored item by item and region by region (C.Y. Kim 1990, Y.H Rhee 2006). This not only allowed the top exporting performers to be recognized and rewarded but also led to vision sharing among the government and private sectors that resulted in better policy coordination.

4. 1. The State, Finance, the *Chaebols* in Industrial Development⁶

To better understand the role that the Korean government played in promoting economic development Lee (1992) proposes that the government and the *chaebols* be regarded as constituting an internal organization. This entity is a hierarchical organization and, as such, it handles transactions that may otherwise be carried out on market as internal administrative processes (Williamson 1975, 1985). Organizations such as firms and the *chaebols* are all internal organizations.

The relationship between government and the *chaebols* especially during the period we are referring to was hierarchical as well and was a nexus for a set of implicit contracts.⁷ The allocation of preferential credit to business firms that had succeeded in achieving government-assigned export targets is an example of such contract. The boundary of this internal organization was not, however, legal and was not clearly delineated as its constituent firms might change from time to time. For these reasons and to differentiate it from the private internal organization, the internal organization consisting of the government and the *chaebols* in Korea is called a *quasi-internal organization*. We can then see that in an economy where this organization exists, the government is not merely an outsider to the market system providing macroeconomic stability, public goods, a neutral incentive structure, and so on—the role of government commonly depicted in standard neoclassical economics.

One of the salient features of Korea's manufacturing sector in the 1960s-70s, which still is true, was its dual characteristics: a relatively small number of *chaebols* and a relatively large number of small and medium-sized firms. In 1975-78, for instance, the largest 50 and 100 firms listed in the stock market accounted for 52.9 percent and 73.9 percent of the total sales of all listed manufacturing firms, respectively (Chong 1990). Many of these firms were not independent entities as they belonged to the *chaebols* such as Daewoo, Hyundai, Samsung, and Lucky-Gold Star. At the end of 1977, there were 40 such *chaebols* in mining, manufacturing, and services (excluding financial, insurance, and trading industries). The top 30 *chaebols* controlled 126 enterprises in 1970, 429 in 1979, and 402 in 1982. In 1971-79, these *chaebols* made a net addition of 303 enterprises, 202 by establishing new ones and 135 through acquisition. Even during the 1980-82 recession, when the *chaebols* as a whole shed 27 firms, they established 30 new units and added 2 through acquisition.

What makes this feature of Korea's manufacturing sector different from that of some of the industrialized countries in the West was the relationship of the government with these enterprises, which was more direct and intimate than that with numerous small and medium-sized firms. Even in Korea, the latter was at an arm's length with control over market parameters as a key instrument while the former was like a relationship within an internal organization. In fact, this relationship was described as a partnership where the government was a senior partner and private enterprises junior partners (Jones and Sakong 1980). Such a relationship between government and business was maintained

through channels like the two monthly meetings discussed above, examples of what are referred to in the literature as “deliberation councils” and “discussion groups,” and facilitated a more direct exchange of information than was possible through markets.

These relationships between the government and the *chaebols* constituted, however, more than meetings of deliberation councils and discussion groups, as the government used various measures such as auditing the balance sheets of targeted enterprises. Its most important instrument, however, was its control of the banking system and the access to subsidized credit by these enterprises or, as Roh (1990) described it, “preference and selectivity” in the allocation of financial resources. By controlling their access to bank credit especially in the absence or underdevelopment state of other financial instruments the government controlled their decisions on investment and thus the pattern of industrial development.

According to a widely held view in the literature on finance and economic growth, an economy with such a “repressed” financial system would not function efficiently and thus could not achieve rapid economic growth (e.g., Fry 1988, Levine 2004). The fact that Korea has done well with such a financial system is thus a puzzle that needs to be resolved.⁸ As remarked by Johnson (1985), neither the doctrine of the Leninist command economy nor that of the “Anglo-American ‘free-enterprise’” economy can accommodate the role that government has played in Korea’s economic development.

The theoretical consequences of a financial system such as the one that existed in Korea during its early stage of rapid industrial development are all well documented. They are reduced savings resulting from low or even negative real interest rates on deposits and an inefficient allocation of credit as it is allocated not by markets but bureaucrats who are influenced by rent-seeking activities. Many of the studies attempting to provide empirical evidence on the negative effect on saving were not successful, showing at best that although low or negative real interest rates have a significant effect on bank deposits their effect on national and household savings are marginal (e.g., Dowling, Jr. 1984, Giovannini 1983, van Wijnbergen 1982).

One of the allocative inefficiencies resulting from financial repression is supposed to be the adoption of overly capital-intensive and large-scale production techniques in relatively capital-poor developing countries as credit is allocated by the government at artificially low real interest rates (Fry 1988, pp.410-417). Whether this actually takes place will depend on whether credit allocated is used for the targeted projects. To the extent that credit is diverted to other uses such as the informal credit market this allocative inefficiency will be attenuated as credit is diverted from government-designated projects to presumably more profitable projects through the informal credit market. Since government control of the financial system is likely to lead to higher interest rates in the informal credit market than otherwise, credit rationing by the government and subsequent credit diversion will lead to the adoption of overly labor-intensive production techniques by the ultimate recipients of credit in the informal credit market.

According to Cole and Park (1983) and Hong and Park (1986), there probably was a high degree of credit diversion as the initial recipients of credit could make large rents by diverting it from government-designated projects to other more profitable projects. Such credit diversion would have meant that government policy of credit allocation was not effective and Korea’s rapid industrialization in the 60s and 70s was

more a result of the private sector subverting the government policy and less a result of its decisions on credit allocation.

Empirical evidence on credit diversion was provided by Hong and Park, who examined the association between subsidies provided to a sector through credit allocation and the growth of that sector's output and exports. They took the ratio of loans to value added (L/VA) in a given sector as a proxy for the amount of subsidy provided to that sector. The results of their investigation are that in spite of relative low L/VA ratios labor-intensive sectors realized very high "gross" rates of return throughout the 70s and the early 80s and achieved either significant factor substitution or significant expansion of output or both. Further, many of these sectors became major exporting industries in Korea. In contrast, capital-intensive industries earned, according to Hong and Park, low gross rates of return in 1971-73 in spite of their relatively high L/VA ratios, and a majority of them failed to become exporters (but we should note that later on some have become successful exporters).

Hong and Park regard the high rates of return of the labor-intensive industries as evidence that they would have done well even without the subsidies and conclude that the subsidies were a pure rent for the labor-intensive industries with little or no effect on output and export expansion. This is an odd interpretation based on the assumption that beyond a certain level of profit it has no incentive effect on a firm's decision on output and export.

The effect of a subsidy on output depends, other things being equal, on the elasticity of supply, the effect being greater the larger the elasticity. In a labor-abundant developing country such as Korea of the 60s and 70s we would expect that the price elasticity of supply is larger for labor-intensive manufactured goods than for the products of technologically more sophisticated, capital-intensive industries, which may still be in an "infant-industry" stage. Furthermore, since the demand for the former in both domestic and world markets is more price elastic than that for the latter, the same amount of subsidy would also have a larger effect on the output of the former.

In Korea, during the 60s and 70s credit diversion might have been very limited because of, among others, a widely held ideology of export drive, close monitoring of the use of government-allocated credit, and severe penalties imposed on infraction.⁹ Credit diversion presents a classic example of monitoring problem in the principal-agent relationship in which ideology can play a positive role in reducing the monitoring cost. In the quasi-internal organization that existed in Korea during the 60s and 70s the government was in fact a principal and the firms receiving subsidized credit the agents who were to carry out investment projects designated by the government. By imbuing the mindsets of the firms with the importance of exports for the survival of the nation, the government legitimized the societal goal of export expansion, aligning the individualistic self interest more closely with it than otherwise.

If credit diversion did not circumvent the control of government over credit allocation, then how did government-led credit allocation bring about rapid economic development in Korea? Did it mimic a free-market allocation of credit? Or was it more efficient than free-market allocation in the case of Korea, a country in the early stage of economic development?

4.2. Capital Market Imperfections in Developing Countries

Capital markets in developing countries are underdeveloped for various reasons. For one, the institutional infrastructure necessary for the efficient functioning of capital markets are in many cases absent (Lee 2003). Even in developed countries capital markets do not operate as depicted in “textbook models” of perfect competition as the problems of adverse selection, moral hazard, and contract enforcement are inherent in these markets. Consequently, “credit rationing” and “equity rationing” are inherent characteristics of capital markets (Stiglitz and Weiss 1987, Stiglitz 1989).

Banks engage in credit rationing, making loans to relatively safe projects at below-the-market clearing interest rates because of the asymmetry of information and risk aversion. That is, they do not make loans to the borrowers who are willing to pay the highest interest rates as the banks lack information about their credit worthiness: they instead lend at lower interest rates to those who they deem to be less risky. Credit rationing by banks will lead to the exclusion of risky but potentially highly profitable projects from bank loan portfolios. Such projects are more likely to be funded if there exists a well-functioning equity market and investors can share in both gains and losses from such projects (Cho 1986). Even then, risky projects may not be funded because of equity rationing practiced by firms considering such investment projects. This takes place because the firms are reluctant to issue new equities to fund projects since doing so may result in large decreases in their share prices and become potential takeover targets. Thus, unwilling to see their net worth decrease, the firms will be disinclined to issue new shares and rely more on internal financing for new projects to a less than an optimal scale. That is, because of credit- and equity-rationing inherent in any capital market a free-market financial system does not have the properties normally ascribed to “textbook models” of a competitive market.

There are reasons to believe that the problems of capital market imperfections are more serious for developing countries: capital markets are underdeveloped and the economies are subject to greater changes and uncertainties (Diaz-Alejandro 1985). Furthermore, these countries are not likely to have developed private as well as public institutions necessary for well-functioning capital markets (Lee 2003). Thus the effect of credit and equity rationing is more serious, as noted by Stiglitz, for developing than developed countries:

In more developed economies, large firms have developed internal capital markets that lead to reallocation of funds among units that are the size of many firms in LDCs. The LDCs are thus a double disadvantage: not only are there informational imperfections, leading to credit and equity rationing; not only are these informational imperfections likely to be more important within LDCs, because the process of change itself leads to greater informational problems; but more importantly, the institutional framework for dealing with these capital market imperfections are probably less effective, because of the small scale of firms within LDCs and because the institutions for collecting, evaluating, and disseminating information are likely to be less well developed (Stiglitz 1989, pp.200-1).

For a developing country the message is clear: a free-market financial regime even combined with a well-developed equity market will not necessarily bring about an efficient allocation of funds. We argue here that what Korea did with government-

directed credit allocation was an institutional innovation for overcoming those capital market imperfections: it created an internal capital market with the government as the allocating principal. That is, it created an internal organization with its own internal capital market as an alternative to imperfect capital markets. As noted above, this quasi-internal organization (QIO) consisted of the government and a number of *chaebols* with financial institutions functioning only as an instrument of credit allocation. In principle, it could mimic the internal capital market of a large multi-unit corporation in a developed country and thus could be as efficient as the latter in overcoming capital market imperfections. In other words, QIO was Korea's substitute for a financial system which, because of its underdevelopment, could not adequately perform the usual functions of well developed financial markets such as producing information *ex ante* about possible investments, allocating capital, monitoring investments, and exerting corporate governance (Levine 1997, 2004).

4.3. Quasi-Internal Organization as an Internal Capital Market

There are a number of reasons why QIO could overcome the capital market problems faced by developing countries. First, QIO is an internal capital market in which the government allocates credit among a number of *chaebols*. Those *chaebols* selected for preferential credit were given, especially during the 70s, large sums of preferential credit to develop certain product lines targeted by the government. Although such practice is commonly referred to in the literature as financial repression, it differs little from the way an internal capital market works within a large multi-unit corporation. QIO did certainly have objectives different from those of the multi-unit corporation but its basic structure was the same as that of the latter.

The structural similarity between QIO and the modern multi-unit corporation is clear. The activities of their component units and transactions among them are internalized, and these units are monitored and coordinated by salaried employees (i.e., bureaucrats) instead of market mechanism. Given this similarity and given that the multi-unit corporation is an efficient organization (Chandler, Jr. 1977), it follows that QIO *can* be as efficient in achieving its objectives as General Electric, for example, is in making profits.¹⁰

In analyzing the efficiency of internal transactions relative to that of market transactions, Williamson (1975) points out two characteristics of the internal organization that make it better handle informational imperfections. First, because of its hierarchical structure that allows the specialization of decision making and economizes on communication costs, the internal organization is able to extend the boundaries of rationality. Second, the internal organization is able to reduce uncertainty by coordinating the decisions of interdependent units to adapt to the unforeseen contingencies.

QIO in Korea had the advantages of these features of internal organization. Because of the direct contact maintained through channels such as deliberation councils and discussion groups the government and the *chaebols* were able to share the information that would otherwise had had to be conveyed indirectly through market signals. Thus, the decisions over the allocation of credit could be made before price changes could signal changes in profitability and private market agents could respond to these signals. In addition, by coordinating these enterprises QIO could adapt to unforeseen contingencies. For example, the government established the Korea Traders

Association that collected economic and trade information from virtually all over the world, evaluated and disseminated it to the members of QIO.

It should, however, be pointed out that QIO being able to function as an internal capital market does not necessarily mean that funds would be allocated efficiently. Even the reduction of informational imperfections does not mean that QIO would utilize the improved information for developmental goals. Efficiency in allocation is judged in terms of the objectives for allocation, and they do not necessarily have to be the nation's developmental objectives. They can be obviously the maximization of QIO, which could be the regime and a few selected *chaebols*. Efficiency as an instrument for achieving certain goals is not sufficient for achieving developmental goals. (As a matter of fact, certain previous political regimes and a number of *chaebols* have subsequently been accused of having enriched themselves at the expense of the nation.)

Will QIO allocate resources efficiently if it is committed to developmental goals? In the case of a private firm with its own internal capital market, the choice of a wrong product /technology may lead to its bankruptcy since market competition will ensure the survival of only those firms that on average choose right products/ technologies.

QIO does not face the competition that private firms face in the market place as it is the only organization in the economy. Is there then any mechanism that would correct an inefficient allocation that QIO might make? In the case of Korea, it was provided in the form of externally determined export prices, a consequence of an outward development strategy. The government's commitment to that strategy meant that export prices were determined in world markets and beyond the government's control to arbitrarily change to cover the consequences of its mistakes in allocating credit. Because of this constraint an inefficient internal allocation of credit which supported wrong investment projects would have resulted in financial losses for the *chaebols* undertaking those projects. They would have survived with subsidies from the government but their losses would have been internal to QIO. Thus, whether there were subsidies or not QIO would have suffered financial losses, and it would eventually have been forced to correct the mistakes in credit allocation.

In contrast, a small developing country with an inward-oriented development strategy could have altered prices to cover the consequences of an inefficient credit allocation. Potential losses of certain *chaebols* could have been made to disappear by changing prices with little noticeable effect on the government treasury. QIO could have avoided making losses resulting from poor allocative decisions, and there would have been at least in the short run little or no incentive or compulsion to correct the existing pattern of credit allocation.

As market competition is necessary to ensure the survival of efficient internal organizations, so is competition necessary to ensure that QIO committed to achieving developmental objectives make efficient allocation of credit. For QIO, such competition exists only if it is exposed to competitive forces in world markets. Fortuitous or not, both the QIO and an outward-oriented development strategy were the policies that the Korean government adopted in the 60s with far-reaching consequences on the development of the Korean economy.

4.4. Quasi-Internal Organization for Effective Policy Implementation

Another reason why QIO could contribute to rapid industrialization in Korea was that it could effectively implement government policies. In a market economy of the neoclassical mold, government intervention is indirect as it is implemented through taxes and subsidies and through arm's-length regulations. Here the cost of policy implementation is the cost of collecting taxes on appropriate activities, making certain that subsidies are used for designated activities, and also making certain that regulations are abided by. This method of policy implementation works essentially by controlling market parameters.

In Korea, during the 60s and 70s, an alternative mode of policy implementation was used as policies were implemented within QIO. As such, policy implementation was an internal transaction and did not rely solely on market parameters. Since it paralleled transactions within a private internal organization, they would have also been efficient for the reasons that private internal organizations are said to be efficient relative to markets. These are extended bounded rationality, reduced opportunism and uncertainty, reduced small-number indeterminacies, better information, and a group-oriented atmosphere, which all reduce transaction costs of an internal organization.

Direct and continuous contact between government and *chaebols* permitted sharing information that would have been done indirectly through the market.¹¹ The government possessed both non-price and price incentives and control techniques to be brought to bear upon the *chaebols* in a selective manner. It could coordinate a number of *chaebols* to adapt to unforeseen contingencies, and it could resolve by fiat small-number indeterminacies among *chaebols* to promote the public good. Thus with better information and with various incentives and control techniques the government could see to it that its policies were effectively carried out by the *chaebols*.

Korea's response to the oil crises of 1973 and 1980, the development of the heavy and chemical industries, and the promotion of construction service exports, to name a few, are some of the cases that clearly illustrate the way the government implemented its policies (Cho and Kim 1991). In all of these cases, the government used both discretionary and parametric manipulation to achieve its policy objectives. It made decisions quickly, often in consultation with *chaebols* but changed policies when they were shown to be inappropriate. Even if one might argue that some policies were wrong, one would be hard pressed not to admit that they were effectively carried out.

It was noted above that credit diversion could have subverted the effective implementation of government-directed credit allocation. It is now clear that QIO would have made credit diversion difficult. Since preferential loans went by and large to the *chaebols* constituting QIO, they would have been subject to internal scrutiny and would have found it difficult to engage in opportunistic behavior of credit diversion. In other words, because the relationship between government and the recipients of subsidized credit was that inside an internal organization and not an arm's-length relationship it would have been difficult for credit diversion to take place.

Williamson (1985) notes that the efficiency of the internal organization relative to markets is related to environmental and human factors as it is dependent on social context within which transactions take place. For similar reasons it may also be argued that the effective policy implementation within QIO was dependent on social and cultural factors. In the case of Korea the widely held Confucian hierarchical patrimonialism (Biggart 1997) may have been one of these factors. This ethos performed the role of an ideology

which, according to North (1981), reduces the cost of monitoring the principal-agent relationship. Thus QIO might have been well suited for Korea with such a strong Confucian patrimonialism.¹²

5. Paradigmatic Shift, Demise of QIO, and Attempts at Financial Liberalization¹³

The special relationship between government and business described above began to weaken somewhat in the late 1970s due to structural and macroeconomic reasons. In the 1960s and early 1970s government monitoring and information sharing—one of two pillars of the modus operandi of QIO—was based on export performance, perhaps the most effective single indicator of competitiveness. The scope for efficiency gains from linking preferential financing to export performance began diminishing since the mid-1970s when the developmental objective was shifted to the promotion of HCIs in part driven by national security concerns of President Park.

Although export orientation was maintained in industrial targeting in the hope that, once built on a sufficient scale, HCIs would become Korea's new export industries, the export performance test could not serve as an effective instrument for credit allocation. That was because given the long gestation lag of HCIs there was no practical benchmark against which the future export potential or competitiveness could be assessed. In short, industrial targeting in the mid and late 1970s aimed at promoting HCIs substantially reduced the benefit of export performance test.

Interestingly enough, the frequency of the two sets of monthly meetings between government and business began to decrease in 1975. There was a noticeable decline in the Monthly Economic Trend Report meetings largely because more of the administrative capacity was now being spent on overseeing the development of HCIs. The frequency of the Monthly Export Promotion Meeting, which was less anyway than the other monthly meeting, also decreased as there was less need for monitoring exports when the country's export-base had become firmly established (Rhee 2006).

Another structural development that may have undermined the effectiveness of QIO was that policy coordination and information sharing within QIO had become increasingly more difficult and less efficient with the increase in size and number of *chaebols*. It was not uncommon during the period of HCI promotion for *chaebols* to triple the number of their affiliates through acquisitions (Table 4). In terms of size or economic power, the *chaebols* had already emerged as a dominant economic power by the time the HCI drive was completed: the top five and thirty *chaebols* accounted for 23 and 41 percent of manufacturing sales, respectively, in 1981 (K.U. Lee, 1986).

<Table 4>

What eventually brought down QIO was the assassination of President Park in 1979 in the midst of an economic crisis brought about by a number of adverse macroeconomic factors—a terms-of-trade deterioration resulting from the second oil crisis and a high rate of inflation and excess capacity and low profitability in some of the heavy and chemical industries (OECD 2000). A subsequent military coup engineered by General Chun Doo Hwan led to the establishment of a new government, which took the course of restoring the country's economic health as a way of gaining the legitimacy of the regime. Continuing with the state-led development strategy of President Park was not, however, a

viable option for the new regime since the public held it responsible for the crisis. In need of new ideas and new policies to bring back the economic health the government brought in a number of economists who had been trained in neoclassical economics at major American universities (Moon 1994).

One such individual, brought in as the chief economic advisor to President Chun Doo Hwan, was a Stanford University trained economist named Kim Jae Ik. He and his like-minded colleagues prepared a major reform agenda—mostly macroeconomic—for the new government, basing it on the lessons they had learned in their graduate schools. That is, the agenda consisted of government deficit reduction, a tight monetary policy, a restraint on the growth of wages, trade-account liberalization, relaxing control over foreign investment, privatization of major commercial banks, and phasing out the subsidies to heavy and chemical industries (Kim 1991). These are exactly the core set of policies that subsequently became to be known as the Washington consensus—fiscal discipline, appropriate public expenditure priorities, tax reform, financial liberalization, appropriate exchange rate policy, trade liberalization, abolishment of barriers to foreign direct investment, privatization, deregulation, and property rights (Williamson 1994).¹⁴

This congruence between the reform agenda of the new government and the Washington consensus is not surprising, given that Kim and most, if not all, of his colleagues were trained in economics at major American universities where neoclassical economics had dominated and given that they were cognizant of the changes in the intellectual climate toward neoliberalism in the West and the policy reforms influenced by it in other parts of the world (Williamson and Haggard 1994). With the support of the president of an authoritarian government who admittedly was a *tabula rasa* in economics and, consequently, had no vision or ideas of his own for guiding the development of the economy, the newly empowered liberal economists met few challenges to translating the policy prescriptions of neoclassical economics into concrete reform agenda to be adopted by the new government (Woo 1991).

5.1. Financial Liberalization of the 1980s

With strong endorsement of President Chun, the newly empowered liberal technocrats and economists proceeded to translate their liberal ideology into concrete structural reforms, albeit confronted initially with some resistance from conservative technocrats, particularly those from the MOF (Woo 1991). Such reforms included the privatization of banks, entry deregulation, and decreasing importance of policy loans.

5.1.1. Bank Privatization

The first to be privatized were the five nationwide commercial banks, of which the government equity ownership ranged from 20 to 30 percent. The primary objective of the privatization was to create banks that would be staffed with responsible owner-managers.¹⁵ Drawing lessons from the negative consequences of bank privatization in the 1950s, the government took precautionary measures to prevent industrial capital, or more specifically *chaebols*, from taking over banks and thus control financial resources. When the divestiture of government shares of Hanil Bank—the first one chosen for privatization—was completed in June 1981, it turned out that two major *chaebols* including Samsung

acquired the controlling shares of the bank. This outcome of the first privatization triggered policy debates on the need for imposing a ceiling on the equity share that a single company or individual was allowed to hold. Not much progress, however, came out of these debates as the banks to be privatized were confronted with mounting non-performing loans, a result of an increasing number of corporate bankruptcies—particularly those of debt-ridden firms—in the midst of domestic economic stabilization and a global recession following the second oil crisis.

In May 1982, a high-profile financial scandal involving a close relative of President Chun broke out, leading to the resignation of both the prime and finance ministers. This created an unexpected opportunity for the advocates of bold and fast financial reforms when the president appointed a liberal technocrat from the EPB as the finance minister. Under his leadership the pace of bank privatization sped up with two more banks, Korea First and Seoul, being privatized in 1982 and another, Cho Hung, in 1983.

Again, however, the tentacles of large *chaebols* could not be stopped from reaching out to the privatized banks, which they now controlled indirectly through the bank shares held by the NBFIs under their control. Finally, concerned with the growing influence of *chaebols* on financial resources, the government imposed in December 1982 a ceiling of eight percent on the individual ownership of nationwide commercial banks by amending the General Banking Act. This ceiling was an outcome of a compromise between a five percent ceiling advocated by the ruling party (Democratic Justice Party) and a ten percent ceiling proposed by the MOF, which regarded it as a minimum level that would allow a reasonable basis for a few large shareholders to jointly exercise responsible managerial control¹⁶ (Choi, 1993).

Despite this restriction on bank ownership, however, the ownership structure of Korean banks was no less concentrated than in advanced countries such as the United States. As of the end of 1996, the combined shares of those who own more than one percent of the total voting stocks of nationwide banks accounted, on average, for 39.3 percent (Table 5). For local banks whose ownership structure is much more concentrated than nationwide banks due to a higher ceiling, the combined shares of large shareholders who own more than one percent was 49.7 percent. In particular, the most predominant in this group of large shareholders was the top 30 *chaebols* (Table 6).

<Table 5>

<Table 6>

Bank privatization did not necessarily bring about the managerial autonomy of the banks. Although their ownership structure was comparable to that of the advanced countries, the large shareholders of many of the banks remained passive in exercising their voting rights and were even negligent in monitoring the management. Even worse, the government continued to appoint the management personnel of the banks, which made it impossible for the board of directors to act independently and effectively monitor the management. A certain number of non-executive directors served on the board of the large nationwide banks, but they were neither given a clearly defined role nor had access to information necessary for monitoring. In short, the privatization of commercial banks was nothing but a superficial change in legal ownership with no effect on the way that the banks are governed and managed.

There were three major reasons why the government continued to intervene in credit allocation. First, to carry out the massive restructuring of industrial firms the government had to have control over credit allocation. Those firms, especially, in overseas construction, shipping, textile, machinery, and lumber industries had expanded on debt financing and had had high debt ratios. During the first half of the 1980s when the world economy went into a recession they accumulated large amounts of NPLs and became vulnerable to bankruptcy. To prevent massive unemployment and financial instability the government bailed out the insolvent firms by directing the creditor banks to provide credit at preferential terms.¹⁷

Second, SMEs became a preferred sector of the new government, which had made the balanced growth of the economy one of its political and economic objectives. The third reason, somewhat related to the second, was to limit the concentration of *chaebols*' economic power by increasing SMEs' access to bank credits and thus promote their growth. To achieve this objective the government introduced in 1987 a credit ceiling on the share of bank loans going to the 30 largest *chaebols*. Furthermore, the Bank Supervisory Board intensified supervision over those *chaebols* to encourage them to finance a certain proportion of their new investments with funds obtained by disposing of their shareholdings in affiliates or real estate holdings. Specifically, the Board enjoined the conglomerates to repay their debts by raising new capital in the stock market.

5.1.2. Entry Deregulation

Along with bank privatization, the government implemented entry deregulation with the aim of promoting competition in the financial industry and facilitating external financing. Soon following the deregulation, two joint venture commercial banks were established—Shinhan Bank capitalized by Korean residents in Japan in July 1982 and the KorAm Bank subscribed by the Bank of America and some major companies in Korea in March 1983. The Citizen's Bank was privatized in 1990, and in 1991 two commercial banks, Hana and Boram, were established through a merger and conversion of several investment and finance companies. The number of foreign bank branches also increased sharply in 1981 and 1982. By 1987, there were 57 foreign bank branches, accounting for over ten percent of total assets and 63 percent of foreign exchange loans of all deposit banks (Chung, Keunyung, pp113-14 and Choi, 1993).

The 1982 financial scandal, mentioned earlier, was basically a financial scam in the informal curb market and prompted the government to formalize it, making its transactions more transparent. Entry barriers to the non-bank financial sector were also lowered in 1982. Its effect was immediate with the number of NBFIs increasing within a year by 12 short-term finance companies and 57 mutual savings companies.

5.1.3. Efforts to Discontinue Policy Loans

Discontinuation of subsidized policy loans—one of the key instruments for the government in the 1960s and 1970s—was a logical step toward financial liberalization. The new finance minister, appointed after the 1982 financial scandal, took the first move by eliminating the subsidy elements in the interest rates on policy loans including those for export financing. He also reduced the number of large firms eligible for policy loans.

As can be clearly seen in Table 7, subsidies on policy loans for exports decreased significantly, nearly disappearing after 1982. The emergence of a current account surplus

for the first time in Korea's modern history in the mid-1980s and pressure from the United States in trade dispute with Korea led to the elimination of preferential interest rates on export financing. Political democratization also spurred popular demands for equity and pressured the government to expand its assistance to SMEs and housing and abolish policy loans to large corporations.

<Table 7>

To implement the new policy the government raised, in 1980, the required ratio of loans to SMEs to total bank loans from 30 to 35 percent for nationwide banks and from 40 to 55 percent for local banks. In 1985 the foreign bank branches and certain NBFIs also became subject to a similar ratio requirement (Table 8). In 1981 it set up the National Housing Fund to finance investments in housing for low-income households.

<Table 8>

The BOK also introduced a number of measures to support SMEs. It offered different amounts of subsidized discount loans to the banks, the amount depending on whether or not they had met the required ratio of loans to SMEs. In addition, it set up rediscount ceilings for export and commercial bills associated with SMEs. Starting in 1983, it also allowed SMEs to receive discount loans for R&D activities, environmental protection investment, and bills associated with financing the purchase of SME products.

These supportive measures for SMEs, together with tighter credit control on loans to large firms, led to an increase in the share of bank loans to SMEs and a gradual decrease to *chaebols*. The share of domestic bank loans to SMEs out of total bank loans increased from 48.1 percent in 1988 to 56.8 percent in 1991 while the share to the 30 largest *chaebols* decreased from 23.7 to 20.4 percent during the same period (Table 9).

<Table 9>

<Table 10>

The effect of all these policy changes was to reduce the difference in access to credit. To demonstrate this point we measure access to credit by dividing total bank and foreign loans by the total assets for various groupings—export and non-export, HCIs and light industry firms, and large and SMEs—in 1973-81, 1982-86 and 1987-90 (Table 10). We see clearly that over time the exporting firms lost their favored access to credit. This loss is especially more pronounced in the case of large firms that now had less access than SMEs in 1987-90. The difference in credit access between HCIs and light industry firms, however, remained more or less the same over the period.

5.2. Effects of Financial Reform

As discussed above, starting in the early 1980s the Korean government undertook a series of reforms in the financial system as part of its overall structural adjustment program (Corbo and Suh 1992). It sold off government-held shares in commercial banks while imposing an eight percent limit on the number of shares of a bank that an individual

person or a *chaebol* could own. It also removed a number of entry restrictions, thus making possible the establishment of foreign joint-venture banks, regional banks and non-bank financial institutions (NBFIs) such as insurance and security companies. The commercial banks were also given the freedom to set interest rates on regular deposits and loans and on corporate bonds, commercial papers, and transferable certificates of deposit. NBFIs were also given more freedom in setting interest rates.

In the end, however, these reforms were more about interest rate deregulation and less about credit allocation. Although the share of policy loans in total domestic credit was reduced due to the growth of NBFIs, it was still about 60 percent of total commercial bank loans throughout the 1980s. Such a large share of policy loans is a clear sign that even though the government no longer owned the commercial banks it did influence their credit allocation through various administrative measures (Dalla and Khatkhate 1995, Nam 1994).

One outcome of the financial reforms in the 1980s was the growth of NBFIs and stock and bond markets, which had the effect of bringing curb market funds into formal financial institutions, mobilizing savings, and reducing corporate indebtedness. In fact, NBFIs' share in total deposits increased from less than 30 percent up to 1980 to more than 60 percent by the early 1990s and beginning in 1988 their share of deposits surpassed that of banks (Table 11). The same can be said about their share of loans, which increased while the share of banks decreased and which exceeded that of banks by 1990. This rapid growth of NBFIs, which was due to their being subject to fewer regulations with respect to interest rates and policy loans than the commercial banks, was what the government intended to promote. What it did not, however, foresee was that NBFIs would displace the commercial banks as a major source of funds for *chaebols* (Leipziger and Petri 1993).

<Table 11: growth of commercial banks and NBFIs>

The Korean stock and bond markets also grew rapidly in the second half of the 1980s (Table 12). The ratio of the market capitalization of the listed companies to GNP (market value/GNP), which was less than ten percent in the early 1980s, skyrocketed to 67.7 percent in 1989. Although it declined somewhat in the 1990s it has remained in the range of 30 to 40 percent since then. A similar pattern was also observed in the bond market, showing a big jump in growth in the late 1980s. Such a rapid growth of stock and bonds markets was, in part, due to a huge surplus in the balance of payments in the mid-1980s. It was, however, also due to the government policies of promoting these markets to lower the corporate debt-equity ratio and opening the *chaebols* to public ownership. Those policies included measures such as tax incentives, the upgrading of stock market institutions, and better monitoring and scrutiny over irregular or illegal speculative investment (Amsden and Euh 1993, Cho and Kim 1997).

<Table 12: growth of capital markets>

Concomitant with the growth of NBFIs and the stock and bond markets was a change in corporate financing, which has had the effect of replacing banks as a major source of funds. The share of NBFI loans and direct financing increased from 38.1

percent in 1980 to 67.5 percent in 1988 and 69.3 percent in 1990 while bank loans decreased from the peak of 35.4 percent in 1985 to 19.4 percent in 1989 and 16.8 percent in 1990 (Table 13). Moreover, foreign bank loans to large firms decreased significantly in the 1980s when *chaebols* started raising funds directly in foreign bond markets.¹⁸

<Table 13: corporate financing>

One of the consequences of the changes in corporate financing was the increasing autonomy of *chaebols* from the state, as they became less dependent on the government-controlled commercial banks. Their ownership of NBFIs, which provided them with an alternative source of financing, further bolstered this autonomy. As of 1988, the top 30 *chaebols* owned 12 security companies (out of a total of 25), 18 insurance companies (out of a total of 35), and 18 investment trust companies (out of a total of 38). Although there was a ceiling on the number of shares that could be held by a single *chaebol*, the top 30 *chaebols*, as a whole and directly and indirectly, owned about 30 percent of the total outstanding shares of the banking sector in 1988. These changes clearly indicate that by the late 1980s the government lost much of its power to influence *chaebols'* investment decisions. In other words, the late 1980s saw the demise of the quasi-internal organization that had effectively been used to promote economic growth in Korea during the preceding two decades. This is not to say that the Korean government did not try to control *chaebols*. As a matter of fact, several measures were introduced since the mid-1980s for that purpose but to no avail (Lee 1997, Nam 1996).

In the mid-1980s the government, for instance, introduced a system that imposed an upper limit on the total amount of credit (including bank loans and loan guarantees) that a *chaebol* could obtain. But, given that *chaebols* were becoming less dependent on bank financing, this measure was not much of a constraint on their ability to raise funds.

The government also tried to impose strict restrictions on the ownership of land and its use in order to control real estate speculation. It tried to require the use of the “real name” in all bank accounts so as to keep track of the true identities of depositors and their transactions. In spite of a popular support for these measures, the government failed to implement them in the face of opposition from *chaebols* that argued such measures would bring about a serious economic recession.¹⁹

In the early 1990s the Korean government tried to adopt three policy measures in order to rein in the power of *chaebols*. The first was to make *chaebols* sell the land that they owned but was not being used for active business (the so-called May 8 Decree of 1990). The second measure was to reduce the scope of *chaebols'* activities by designating for each *chaebol* a maximum of three companies to specialize in the areas in which it supposedly had the strongest comparative advantage and growth potential. The third measure was to reduce ownership concentration by requiring the owner families to dispose of some of their shares. The penalty for not following the first measure was higher interest payments for bank debts and an eventual credit moratorium. To implement the other two measures the government offered incentives such as the lifting of upper limits on credit for the three affiliate companies selected by each *chaebol* for specialization and for whatever number of other companies in which the owner-family share was less than 10 percent of the outstanding shares.

In spite of such penalties and incentives the government was not successful in inducing *chaebols* to adopt those measures. One month after the official deadline of March 1991 the *chaebols* as a whole disposed of only 60.1 percent of the non-business related land.²⁰ Some of them were reported to have opted to pay the interest penalty as they expected the land price appreciation to exceed whatever the penalty they might have to pay. The incentives for specialization were also ineffective as *chaebols* could receive the same kind of credit benefit by designating any of their companies for a specialized line of products and then change the designation after three years. Thus, the net effect of the incentives was, as argued by some, only to free *chaebols* from credit control without changing either their ownership or the extent of their specialization.

All these events—attempts by the government to control *chaebols* and its failure to do so—is a testament to the fact that by the early 1990s the demise of the quasi-internal organization was complete and Korea needed a new system of economic management. There was, however, no serious debate on designing a system that could manage an economy increasingly dominated by powerful and ever-expanding *chaebols*. Instead, the prevailing paradigm in both academia and officialdom was a neoliberal, hands-off stance that regarded macroeconomic stability and deregulation sufficient for sustaining economic growth (Lee 2003).

6. *Chaebols*' Influence on Financial liberalization in the 1990s

The 1990s saw an increasing demand from *chaebols* for deregulation such as lifting the ceiling on their ownership of bank shares, financial opening for greater freedom in foreign borrowing, raising the aggregate credit ceiling, and so on. *Chaebols* were successful in getting these measures adopted as they were consistent with the prevailing paradigm on economic management, as by then the government had no effective stick over *chaebols*, and as the bureaucracy had been increasingly co-opted by *chaebols*. In the event, in the 1990s *chaebols* launched a strong investment drive, exemplified in the rush into the petrochemical industry by several *chaebols* and Samsung's entry into automobile assembly.

6.1. Domestic Liberalization: Entry and Interest Rate Deregulation

In the early 1990s, the government deregulated the entry and business scope of financial institutions in the belief that greater competition would result in increased economic efficiency in financial markets. One consequence of deregulation was a mushrooming of merchant banks. Many of the newly established merchant banks were formerly small-scale investment finance companies called *dan-ja-hoi-sa*, which used to specialize in short-term commercial paper discounting and call-market loans. With deregulation they simply changed their names and became merchant banks. In 1994, nine such merchant banks were established and, in 1996, additional 16 were established. Many of these merchant banks were owned and controlled by *chaebols* since they had been the investment finance companies owned by the same *chaebols* and nothing else had changed but the name.

Another important deregulation in domestic financial business was a significant loosening of restriction on *chaebol* ownership of other NBFIs such as life insurance companies and investment trust companies. Before the deregulation, the top 15 *chaebols* were not allowed to own and control life insurance companies while the next top 15

chaebols were allowed to have only up to a 50 percent ownership of life insurance companies. But, in May 1996 all *chaebols* but the top five were allowed to own and control life insurance companies. Also, before the deregulation only the commercial banks could own investment trust companies, but in 1996 that restriction was abolished, resulting in *chaebols*' control of many of the investment trust companies.

The lifting of entry restrictions did not result in the hoped-for improvement in efficiency in financial markets but rather in an increased control of NBFIs by *chaebols*. As a matter of fact, as of 1995 the top 10 *chaebols* together owned 25 NBFIs with each owning on average 2.5 NBFIs (Table 14).

<Table 14: ownership of NBFIs>

In the 1990s, important progress was made in the deregulation of interest rates. This contrasts with the difficulty that the government had in the 1980s in deregulating interest rates (Choi 1993). Then, *chaebols* were opposed to interest-rate deregulation because they feared a heavier interest burden that higher market-determined interest rates would impose on them. In the 1990s, in contrast, interest-rate deregulation went rather smoothly because *chaebols* saw an advantage in having free NBFIs and thus freer access to credit, albeit at higher interest rates than charged by the still regulated commercial banks. Thus, in 1993 the new government of President Kim Young Sam was able to declare the deregulation of all lending interest rates (except for policy loans) and many deposit interest rates, including long-term savings, corporate bonds, certificate of deposits, and checking account. The actual implementation of this deregulation policy took, however, a bizarre course.

As originally planned, long-term interest rates were to be deregulated before short-term interest rates. In the event, however, short-term interest rates such as the rates on the certificates of deposits and commercial papers of NBFIs were deregulated first in a speedy manner while time deposit rates of commercial banks were still under *de facto* government control until 1966. In loans as well, the commercial bank lending rates and corporate bond interest rates remained subject to administrative guidance when all restrictions were removed from interest rates on NBFIs' commercial papers and from the amount that they could issue.

A consequence of this "short term commodities first, long term commodities later" deregulation was a rapid increase of the share of commercial papers in firms' external financing from 7.6 percent in 1992 to 16.1 percent in 1995 (Cho 1999). High-yield commercial papers and other short-term instruments became an important part of financial transactions with NBFIs being a major player in that business. As a result, the Korean financial market came to be dominated by short-term financial activities with a concomitant rise in overall financial risk. It also became a dual structure consisting of tightly controlled commercial banks still lending at low controlled interest rates and rapidly growing and relatively free NBFIs headed by merchant banks, lending at higher market-determined interest rates.

6.2. External Liberalization

Given that the top 30 *chaebols* were subject to an aggregate ceiling in the amount of bank credit they could obtain, they naturally turned to NBFIs for financing. They also sought

financing from offshore banking and began demanding the liberalization of international financial transactions. This demand coincided with the pressure from international financial capital for access to the Korean market. The Korean government itself also had good reason for accommodating this demand since it was keenly interested in joining the OECD, which required Korea's capital-account opening as a condition for its membership. This conjunction of forces made the post-1993 financial opening of Korea one of the most rapid and comprehensive ones in the developing world

Capital-market opening measures included removing regulations on the issuance of foreign-currency denominated bonds by domestic firms and financial institutions, export-related foreign borrowing and general commercial borrowing, and abolishing the annual ceiling on foreign-currency loans by financial institutions. These measures did not, however, apply equally to both long-term and short-term transactions: short-term transactions were fully deregulated while long-term transactions were either partially deregulated or not at all.

Why did the government carry out such unbalanced financial opening? The idea of financial liberalization was not something to which the Korean government was then fully committed. It still regarded it necessary to use the commercial banks as a vehicle for achieving policy objectives such as promoting small and medium-sized enterprises and establishing strategic industries.²¹ The pressure for financial liberalization was increasing, however, from both *chaebols* that saw the advantage of having easy access to the global capital market through their NBFIs and foreign financial interests that saw profitable opportunities in investing in the booming Korean economy. Under such unyielding pressures the government undertook financial liberalization, giving in where pressure was strong and holding back where it was not (Cho 2003). Given that NBFIs' activities were mainly in short-term transactions whereas those of the commercial banks were in longer-term maturity, the unbalanced financial opening—full deregulation on short-term transactions but not on long-term transactions—was an inevitable outcome of the influence of interest politics on financial liberalization.

While financial liberalization—both external and internal—gave more freedom to *chaebols* in their search for financing, the government's ability to control them was substantially reduced since 1993. Although control over *chaebols* was deemed necessary to curb their highly concentrated economic power, government policies toward them were basically grounded on the so-called "free market principle", which gave them more freedom than ever. For instance, in 1993 the credit-ceiling scheme—the last stick that the government had over *chaebols*—was modified, exempting from the ceiling the affiliated companies that were in *chaebols*' chosen areas of specialization. Furthermore, the number of *chaebols* to which the ceiling applied was reduced from the top 50 to the top 30 in 1993 and was further reduced to the top 10 in 1996. Restrictions on the holdings of non-business related land and the debt structure were also abolished. The ceiling on the ownership of bank shares was also raised in 1994, allowing more shares to be purchased by *chaebols*, and in 1996 they were given more freedom with respect to the ownership of NBFIs. Along with these measures of deregulation the government made effort to introduce stricter rules regarding cross debt guarantees, cross shareholdings, insider trading, the role of the board of directors, and the rights of minority shareholders. These efforts, however, failed to materialize into laws.

One consequence of the haphazard financial deregulation and lack of control over *chaebols* was a rapid debt-financed growth of investment accompanied with low profitability of investment in the 1990s. In fact, compared with Japan and Taiwan, Korea had the highest growth rates of investment and asset but the lowest profitability (Table 15). Especially noteworthy is a sudden increase in investment in the mid-1990s, namely 56.2 percent in 1994 and 43.6 percent in 1995.

<Table 15: comparison of profitability in Korea, Taiwan and Japan>

Another important aspect of this expansion by *chaebols*, apart from their low profitability, is that it was done at the expense of profitability of the banks and other financial institutions affiliated with them. In 1997, for instance, the debt-asset ratio for *chaebols* that did not have affiliate finance companies was 45.9 percent whereas that for *chaebols* that had affiliate finance companies was 56.6 percent. And the rate of return on the assets of *chaebol*-affiliate finance companies was 0.27 percent whereas the rate of return for independent finance companies was 1.0 percent (J. Kim 1999). In other words, the *chaebol*-affiliated finance companies helped finance *chaebols'* expansion in the 1990s at the expense of their own profitability. As a result, when a *chaebol* went into bankruptcy it triggered the failure of the affiliate finance companies and, given the web of credit linkage among financial institutions, it also led to the failure of unrelated financial institutions.

7. Consequences of Liberalization without Adequate Supervision

7.1. Growth of Merchant Banks

The bank supervisory system that existed in Korea in the mid-1990s was a collection of supervisory responsibilities dispersed among several competing authorities. Supervisory responsibility over the foreign currency denominated businesses of commercial banks was divided between the Ministry of Finance and Economy (MFE, a super-ministry created by merging the Economic Planning Board and the Ministry of Finance) and the Bank of Korea. The former supervised long-term foreign capital transactions and outward foreign direct investment while the latter had jurisdiction over short-term foreign capital inflows and their impact on the money supply. Further, while the MFE was in charge of designing economic policies related to foreign exchange, the Bank of Korea was responsible for implementing them.

Another fact about financial supervision in Korea then was that merchant banks were less well supervised than commercial banks. The commercial banks were subject to regular and relatively solid prudential supervision by the bank supervisory authorities under the Bank of Korea. The MFE was formally responsible for merchant banks but had neither the necessary supervisory manpower nor the know-how of supervision. Consequently, only a few randomly selected merchant banks were examined each year. Even then, it is doubtful whether proper examination was in effect carried out since many of the retired MFE officials held positions in merchant banks and were actively involved in lobbying on their behalf.

The merchant banks were inclined toward short-term borrowing at higher interest rates since they had neither good international credentials nor experience in international business. Consequently, their portfolios tended to be skewed toward high yield risky

assets and were prone to term- and currency- mismatches with high vulnerability to market and liquidity risks. Furthermore, *chaebol*-affiliated merchant banks tended to concentrate their loans to *chaebol*-affiliated firms. These merchant banks could make such related lending because they were not subject to the more strict restrictions on related lending imposed on commercial banks. For instance, a merchant bank could lend as much as 150 percent of its equity capital to any single borrower, whether an individual or a *chaebol*, whereas the limit for a commercial bank was 45 percent. Not surprisingly, as of March 1997 the top 30 *chaebols* accounted for as much as 51 percent of the merchant banks' total outstanding loans. In early 1997, when Kia, an automobile assembler, was declared bankrupt, the non-performing loans of about 30 merchant banks amounted to 4,000 billion Won, which exceeded their total equity of 3,900 billion Won. The size of nonperforming loans increased to 10,000 billion Won later in the year when several conglomerates (Jinro, Daenong, Sammi, and Wooseoung) joined Kia in bankruptcy.²²

A similar situation existed in the case of a number of the offshore funds established by Korean security or investment companies. Their number grew rapidly after 1994, reaching 166 in 1997. The total value of the 98 offshore funds set up by 28 security companies was as large as US\$2.6 billion, and in 1997 their loss was estimated to be about 11,000 billion Won.²³

7.2. Short-Term “Borrowing Spree”

Starting in the mid-1980s Koreans were allowed to borrow abroad without government approval and guarantee. It was, however, the post-1993 financial liberalization that made it decisively easier for Korean firms and financial institutions to borrow abroad, leading to a big surge in borrowing especially by the rapidly growing merchant banks. In 1992 and 1993, total short-term foreign borrowing by financial institutions was \$1.2 billion and \$1.1 billion, respectively, but it then jumped to more than \$7 billion in 1994, \$11.8 billion in 1995 and \$12.6 billion in 1996.

In 1994, out of the total short-term borrowing of \$7 billion by financial institutions, \$5.3 billion were by commercial banks and only \$0.87 billion by merchant banks. In contrast, two years later the amount borrowed by merchant banks reached \$3.19 billion (a 267 percent increase) while that by commercial banks reached \$7.19 billion (a 34 percent increase), although the latter still accounted for more than twice the amount borrowed by the former. Non-financial institutions, notably *chaebols*, also increased their foreign borrowing—from minus \$2.66 billion in 1993 to \$4.65 billion in 1994, \$8.05 billion in 1995, \$10.42 billion in 1996, and \$18.07 billion in 1997 (Table 16).

<Table 16: foreign borrowing>

What prompted this surge in foreign borrowing, especially the short-term borrowing, was that there was neither a limit on the amount that a merchant bank could borrow abroad nor effective monitoring over potential borrowers. This can be seen in the rapid increase in the number of foreign branches or subsidiaries of Korean banks—from 175 in 1993 to 273 in 1997. Many of these branches/subsidiaries were not knowledgeable about advanced financial techniques and risk management and dealt mainly with foreign

subsidiaries of *chaebols* and among themselves. Furthermore, they received little supervision from either the head offices in Korea or government authorities.

7.3. Capital Exit by Stopping Rollover: The Crisis

While short-term foreign borrowing by *chaebols* increased rapidly they were not earning revenues large enough to service their debts. Various measures of profitability all show that the top *chaebols*—the top 30 as well as the top 10—earned less in 1996 than in the preceding two years (Table 17).

<Table 17: *chaebols*' profitability>

Beginning in January 1997 a number of *chaebols* went bankrupt, starting with the Hanbo Steel. The Hanbo case is most typical of a reckless expansion financed with bank loans obtained through political connections. Following Hanbo, eight of the top 30 *chaebols* went bankrupt in 1997. Many of these bankrupt groups had a debt-equity ratio that exceeded 500 percent, and some in excess of 1,000 percent!

Another important feature of *chaebol* bankruptcies is that because of the cross-guarantees of debts among the affiliated firms of a *chaebol*, an affiliated firm's bankruptcy led to the bankruptcy of other affiliated firms. This chain of bankruptcies eventually brought down the entire group, destroying the myth that *chaebols* are "too-big-to-fail". The bankruptcy of several *chaebols* thus caused international investors to re-evaluate the creditworthiness of Korean borrowers, especially in the wake of the July 1997 financial crisis in Thailand and Malaysia.

The financial crisis in Southeast Asia turned many of the loans and investments by Korean banks and firms in the region into nonperforming loans, which in turn caused the plummeting of their institutional credit rating (IMF 1998). In response, the Korean government undertook several corrective measures in August 1997, but some of them were either too late or too ineffective while others turned out to be outright wrong measures. Too late or too ineffective was the government effort to guarantee foreign debts of the Korean banks and to provide them, especially the merchant banks, with more foreign exchange loans. Wrong was the government intervention in the foreign exchange market to defend the Korean Won against the dollar, which quickly led to the depletion of the country's foreign exchange reserves. In the end, even the government lost credibility when the official disclosure of the foreign exchange reserves became questionable.

The fall in the creditworthiness of Korean firms and banks and the loss of credibility in the government finally resulted in a massive capital outflow when international creditors stopped rolling over the Korean debt (Table 18). Until then the rollover had been more or less automatic, the rollover rate being more than 100 percent up to June 1997; but in July it dropped to 89 percent and then to 59 percent in November. For the merchant banks the fall in the rollover rate began earlier in February, well before for the commercial banks, when it fell to 79 percent. This is a clear sign that many of the Korean financial institutions were losing their creditworthiness in international capital markets well before the financial crisis in Southeast Asia had any adverse effect on their balance sheets.

<Table 18: rollover rates>

On December 1, 1997, with less than \$3 billion left in its foreign exchange reserves the Korean government was forced to go to the IMF for an emergency loan. On December 4, 1997 the IMF announced a bailout package of \$57 billion, but that did not stop the panic in the currency market. It was not until December 24, 1997, when the United States and other industrialized countries formally joined the IMF in rescuing Korea from the crisis that the panic stopped with some degree of stability returning in the currency market.

8. Institutional Reforms in the Post-Crisis Era

In the wake of the 1997 financial crisis the Korean government carried out a number of reforms in the financial sector. These reforms include the restructuring of financial institutions, liberalization of financial intermediation industries, reform in governance and regulation, and structural changes in the financial sector.

8.1. Restructuring of Financial Institutions

In Korea, even before the crisis, under-capitalization was the normal state of operation for many of the banks. It was, however, made worse by the crisis as several of the banks lost much of their capital base. Fraught with many nonperforming loans (NPLs) and a weakened capital base and unable to raise new capital, the troubled financial institutions were forced to curtail lending to improve their BIS ratios. This further intensified a severe credit crunch that the crisis had impacted on the economy and led to massive corporate bankruptcies.

Under these circumstances the government took upon itself the task of disposing of NPLs and recapitalizing the troubled banks. As a first step toward this end, it identified insolvent financial institutions and resolved their problems through P&A (purchase and assumption) or liquidation. By October 2006 it succeeded in having 893 financial institutions either suspend their operation or closed for good: in particular, 16 banks, 29 merchant banking corporations, 15 securities companies, 12 investment trust companies, and 20 insurance companies were closed through either exits or mergers (Table 19).

<Table 19: Financial Institutions Closed or Merged>

As an additional step, the government created or expanded two state-owned corporations—the Korea Asset Management Corporation (KAMCO) and expanded the Korea Deposit Insurance Corporation (KDIC)—to clean up the NPLs and shore up the capital base of the banks. As of November 2006 these corporations spent 168.4 trillion Won (25 percent of Korea’s GDP in 2002) in public funds to that end (Table 20). By the end of 2006, KAMCO alone spent 38.8 trillion Won to purchase nonperforming assets worth 111 trillion Won in face value but managed to recover 40.8 trillion by disposing of some of the assets—105.2 percent of the injected public funds. By yearend of 2006 KAMCO and KDIC together recovered 50.2 percent of the public funds they had spent since the crisis (Figure 1).

<Table 20: Fiscal Support for Financial Restructuring, 11/1997 ~ 11/2006>

<Figure 1: Recovery Ratio of Public Funds>

Financial sector restructuring also led to a drastic downsizing in employment in financial institutions. Employment in commercial banks that reached 128,503 at the end of 1997, the year of the crisis, fell to slightly over 90,000 at yearend of 1999, a decline of about 30 percent. Since then, employment in the financial sector recovered somewhat but reached about 100,000 only in 2006 (Table 21).

<Table 21: Number of Employee by Financial Sector, 1997-2006>

Another consequence of the restructuring is an increase in the banking sector's market share: its share of total assets of the financial sector increased from 67.4 percent in 1996 to 71.8 percent in 2006 while the share of NBFIs such as mutual savings banks and credit cooperatives decreased. These changes confirm Lim and Hahm's observation (2004) that the Korean financial system, which became more market-based immediately following the crisis, has reverted back to a bank-based financial system.

<Figure 2: Share of Assets by Sector>

The restructuring also has had the effect of increasing market concentration in the banking sector. To determine the degree of concentration we calculated two indices of concentration. One is the so-called k -th bank concentration ratio (CR_k), which measures the market share of the top k -th banks in the market. The other is the Herfindhal-Hirschman Index (HHI), which is calculated by summing the squares of the individual percent market shares of all the participants in a market. In calculating these indices we use total assets as a measure of bank size.

Figure 3 shows that there has been a large increase in market concentration since the crisis although there is a slight downward trend in more recent years. This increase was mainly due to consolidation in the banking industry that brought about the mergers of Korea's two large banks—the Kookmin Bank and the Korea Housing & Commercial Bank in April 2001. In terms of CR_3 , we see a substantial rise in the ratio from 28.4 percent in 1997 to 54.4 percent in 2002 but then a gradual decrease to 46.2 percent in 2006. We find a similar pattern in the HHI—a sharp increase from 664 in 1997 to 1,481 in 2002 and then at about the same level in 2006, which is typically considered as “moderately concentrated.”²⁴

<Figure 3: Concentration Ratio of the Banking Sector in terms of Assets>

Another consequence of the post-crisis restructuring is the burgeoning of financial conglomerates.²⁵ As can be seen in Table 22, the formation of financial holding companies has led to an increase both in the number of institutions affiliated with financial conglomerates and in their total assets.

<Table 22: Financial Conglomeration by Types in Banking, Insurance, Securities, and ITCs>

Hahm and Kim (2006) examine the performance of the Korean financial conglomerates in terms of profitability and risk taking. These large firms appear to have been able to take advantage of new business opportunities arising from consolidation and

diversification with noticeable consequences on their profitability, capital adequacy, and the risk profile of their portfolios.²⁶ According to Hahm and Kim, during 2001-03 these financial institutions obtained a significantly higher profitability while maintaining a lower variability in ROA. This may be a sign that they were operating at a superior efficient frontier due to their size, and this size effect may in turn reflect the economies of scale and diversified portfolios of the financial conglomerates that were made possible through financial consolidation.

Hahm and Kim find, controlling for the size effect, no evidence that conglomerates take higher risks compared with non-conglomerate, independent institutions in the post-crisis Korea. This finding suggests that the post-crisis regulation on the business scope for financial institutions is based on a “compartmentalism,” not a “universal banking,” approach, and on a positive-list system that limits the business scope to those on the approved list and prohibits them from offering those not on the list.

Profitability in the banking sector has improved considerably after several years of poor performance. In particular, bank profitability turned around significantly in 2001 after the second injection of large amounts of public funds. Although the injection of public funds must have played an important role in improving the bank profitability we conjecture that it was helped by a major downsizing in employment and a reduction in the number of branches. Furthermore, the introduction of automated teller machines and the internet-banking seems to have contributed to the increased cost efficiency of banks.²⁷

The profitability of credit card companies was down significantly in 2003 when there was a burst of a credit card bubble that had been building up in 1999-2002. It has somewhat improved since 2005 (Figure 4).

<Figure 4: Profitability: Profits/Losses for Financial Industries>

By the standard metrics of bank soundness the Korean banks have become healthier since the crisis: the BIS ratio rose from seven percent in 1997 to 13.1 percent in 2006 and the NPL ratio decreased from 9.2 percent in 1999 to 1.9 percent in 2006 (Figures 5 and 6). These changes put the Korean banking sector on a level close to those in the advanced countries. We should, however, note that the standards of risk management, particularly the evaluation of firm’s creditworthiness and human resources, are not on a par with the international standard.

<Figure 5: Bank’s BIS Ratio>

<Figure 6: NPL Ratio for the Whole Financial Industry>

With the liberalization of the financial intermediation industry the share of foreign ownership in Korea’s banking sector has increased significantly. In fact, all but one Korean bank have a good portion of foreign ownership, the one exception being the Woori Financial Group which is largely owned by the government (Figure 7). Corresponding to this increase in foreign ownership is a marked increase in the market share of foreign-owned banks and NBFIs over the past several years (Figures 8 and 9).

<Figure 7: Share of Foreign Ownership in Korean Banking Sector>

<Figure 8: Market Share of Foreign Owned Banks in Korean Banking Sector>

<Figure 9: Market Share of Foreign Owned NBFIs>

Another consequence of liberalization is an increase in the share of foreign ownership in the equity market, a consequence of the lifting of the ceiling on foreign ownership in 1998. In fact, foreign investors' share of equities rose from 13 percent in 1996 to 42 percent in 2004, but it then fell to about 38 percent as of October 2006 (Figure 10).

<Figure 10: Foreign Investor's Share of Equities and Bond Market>

Finally, Korean financial institutions have experienced structural changes in their portfolios as a debt reduction for large firms has paralleled a rise in consumer loans (Figure 11). Before the crisis the total outstanding consumer loans were far less than business loans, but since the crisis they have increased rapidly, narrowing the gap between the two and finally surpassing the total outstanding business loans in 2005.

Financial institutions have focused on expanding in home financing market and, as to be expected, this has fueled a boom in the housing market. In fact, there is a high correlation between the growth of both household home financing credits and housing prices (Figure 12). A collateral effect of the boom in home financing credit is an increased burden of household debts: the ratio of consumer credits to personal disposable income rose dramatically from 61.3 percent in 1996 to 112.6 percent in 2004 (Figure 13).

<Figure 11: Outstanding Loans by Financial Institutions by Sector>

<Figure 12: Growth of Household Credits and Housing Prices>

<Figure 13: Ratio of Consumer Credits to Personal Disposable Income>

8.2. Liberalization of Financial Intermediation Industries

One of the financial reform measures undertaken by the government was the deregulation of interest rates and the expansion of the scope of business that financial institutions may engage in. In February 2004, interest rates on demand deposits were deregulated, a measure that culminated the 4th and final phase of the interest rate deregulation that began in 1991. Embracing the system of "universal banking," the government allowed financial institutions to expand the range of services and products they may offer, such as beneficiary certificates and Bancassurance. Furthermore, in 2003 the definition of securities issued by securities companies was broadened, and in 2000 the outsourcing of non-core business through alliance with other financial institutions was also allowed. In particular, the financial holding company (FHC) was introduced in October 2000 for the purpose of creating synergies such as the cross selling of financial products, lowering funding costs, and streamlining IT investment.²⁸

Various measures were introduced to open the financial intermediation industry to foreign investment. These include the elimination of restrictions on foreign equity ownership, enactment in August 1998 of the Foreign Investment Promotion Act to attract foreign direct investment, and full liberalization of hostile M&As by foreigners as well as

foreign investment in the stock and short-term money markets. Following these measures, FDI in the financial industry has steadily increased with especially large increases taking place in 2004 and 2005, when Citi Bank and Standard Chartered Bank, respectively, acquired Koram Bank and the Korea First Bank. In 2005, the total accumulated amount of FDI in the financial intermediary industry stood at \$18.2 billion.

<Figure 14: Inward FDI in Financial Industries (\$billion)>

8.3. Financial Sector Governance and Regulatory Reform

The government also undertook a number of measures to strengthen prudential regulations and improve the internal and external governance structure of financial institutions. As for the governance reform, the most dramatic and effective measure was undoubtedly the closure of insolvent institutions. This certainly has opened a new chapter in Korea's financial history—no single commercial bank had ever been closed in the four decades prior to the 1997 crisis.

Further reforms were introduced to improve regulatory standards and enforcement. For instance, under the Act Concerning the Structural Improvement of the Financial Industry, the supervisory authority is now able to order equity write-offs against shareholders deemed responsible for bank insolvency. In order to encourage shareholders and internal auditors to better monitor the management, the government has eased the conditions required of minority shareholders to exercise their shareholder rights and require financial institutions to fill one half of the board of directors with outside members. Banks, securities and insurance companies are now required to make quarterly instead of semi-annual reports for more transparent financial disclosure. Shareholders may now bring class action suits against the management if they suspect stock price manipulation, insider trading, and false financial disclosure. An efficient system of sanction is in place so that, if necessary, civil and criminal liabilities can be imposed on the directors. A similar sanction may also be applied on external auditors and examiners of supervisory authorities for negligence of their duties.

The supervisory authority has introduced a number of measures for stricter standards in prudential regulation and supervision. First, banks are now required to engage in prompt corrective actions (PCAs) if the Financial Supervisory Commission (FSC) deems it necessary on the basis of capital adequacy ratios, the composite grade of CAMELS (Capital, Asset quality, Management, Earnings, Liquidity, Sensitivity of market risk), and the individual grade of capital adequacy or of asset quality of a bank. PCA consists of three sets of progressively more stringent corrective procedures (Table 23). Initially, PCAs were applied to banks, merchant bank corporations, and securities companies (April 1998) and then were extended to insurance companies and mutual savings banks (June 1998) and finally to credit unions (December 1999). Second, to strengthen banks' disclosure system the FSC has expanded the scope of regular disclosure items to the level dictated by the International Accounting Standards (IAS).

<Table 23: Prompt Corrective Actions in Korea (Revised in March 1999)>

Third, loan classification standards as well as provisioning requirements were strengthened in accordance with international practices (Table 24). Also, forward-looking

asset quality classification standards were introduced to commercial banks in 1999. Such criteria are based on the ability of debtors to generate sufficient future cash flows rather than on their past payment history. Similar standards were introduced for merchant bank corporations (June 2000) and insurance companies (September 2000).

Fourth, the asset category subject to loan loss provisions was widened to include commercial papers, guaranteed bills and privately placed bonds in trust accounts. In addition, the evaluation standard for marketable and investment securities held by banks changed from the “lower-of-cost-or-market” method to the “mark-to-market” method

<Table 24: Loan Classification Standard and Required Provisions>

In tandem with these changes in prudential regulations, the FSC has strengthened direct regulations with respect to the exposure limits of banks and merchant banks (Table 25). First, the definition of exposure to a single borrower has expanded to include not only the loans and payment guarantees in the conventional sense but also all direct and indirect transactions that carry credit risks such as corporate bond and CP holdings. Second, since May 1999 the combined exposure to firms affiliated with the same *chaebol* has been reduced to 25 percent of bank capital from 45 percent. Third, the total sum of large exposure of more than ten percent of bank capital to a single borrower or the group of firms affiliated with the same *chaebol* is limited to five times the bank capital. Fourth, the exposure to large shareholders of a bank with ten percent or more of the outstanding shares is limited to the equity shares of the large shareholders in question with maximum of 25 percent of bank capital. Obviously, the main purpose of these regulations is to prevent *chaebol*-affiliated financial institutions from taking too many risks by maintaining unduly large exposures to other subsidiaries of the same *chaebol*.

<Table 25: Ceilings on Credit Exposures of Financial Institutions>

9. Post-Crisis Reform in Financial Supervision²⁹

Soon after the crisis the government created new supervisory institutions—the Financial Supervisory Commission (FSC) in April 1998 and the Financial Supervisory Service (FSS) in January 1999. The first was created to function as an integrated supervisory agency for all types of financial institutions and markets, while the second was established to act as an executive arm of the former. FSC is a state agency whereas FSS is a private corporation in the form of a special legal entity operating in the public domain. Although they are formally separate, the two agencies are supposed and expected to operate as a single supervisory authority.

Under the new system of financial supervision FSC/FSS is the sole supervisory agency for banks and non-banks, formerly the charges of the Bank of Korea (BOK) and the Ministry of Finance and Economy (MOFE), respectively. The monetary and credit policy functions, over which MOFE had a considerable leverage, are now wholly vested in BOK with its autonomy to pursue the goal of monetary stability much strengthened. The Korea Deposit Insurance Corporation (KDIC), which first began its deposit insurance operation for insured banks in January 1997, became an integrated deposit insurance agency in April 1998, taking in as its charge not only insured banks but also

insured NBFIs. With these changes now in place MOFE, FSC/FSS, BOK, and KDIC are the four public agencies that are responsible for keeping Korea's financial system efficient and stable (Kim 2004b).

All these changes clearly attest to the fact that Korea has successfully undertaken a number of major institutional reforms in financial supervision. In spite of these reforms doubts, however, have been raised as to whether they have led to the establishment of a well-functioning system of financial supervision (Kwon 2004). As will be discussed, the costly financial instability relating to credit-card companies and household debts in Korea in 2003 is a case in point that renders support to these concerns raised about the "success" that Korea has made in reforming its system of financial supervision.

The post-crisis reform in financial supervision has largely been limited to changing formal institutions for financial supervision. Although they were created or reorganized as *independent* agencies in the aftermath of the crisis, FSC/FSS and BOK have not in reality functioned as such due to constraints imposed on them by other extant, formal as well as informal, institutions in Korea. Unable to function independently, the supervisory agencies have failed to properly carry out their statutory responsibilities and prevent the abuses and misconduct by credit-card companies that led to the financial instability of 2003. In fact, this is a point alluded to by the World Bank (2003: 2) when it recommended that "[t]he division of responsibilities between MOFE, FSC, and the FSS should be made more transparent ... [and] ... [s]teps should be taken to reassure markets that the independence of the regulator is important." In other words, the post-crisis financial reform in Korea is far from being complete as it has failed to address the problems relating interdependency among institutions.

As part of the post-crisis reform of the financial system the Korean government undertook a major structural reform in its main economic ministry, MOFE. With the promulgation of the newly amended Government Organization Act early in 1998 MOFE was reorganized with some of its functions transferred to other public agencies. For instance, its non-bank supervisory function was transferred to FSC/FSS while the monetary and credit policy functions were transferred to BOK. In addition, the budgetary functions were taken away from MOFE. This reorganization of MOFE was prompted by the realization that "policy decision-making had become overly concentrated, thereby undermining the checks and balances required for effective government" (MOFE 2002) and the criticism that those weaknesses had contributed much to the outbreak of the 1997-98 financial crisis in Korea.

The reform of MOFE and in financial supervision led to the division of responsibilities and powers that had been concentrated in MOFE among a number of public agencies. MOFE was given the task of preparing and coordinating economic policies, drafting tax and customs legislation, and formulating policies for the financial system; FSC/FSS that of supervising financial institutions; BOK that of maintaining monetary stability and keeping an oversight of the financial system; and KDIC that of protecting depositors. In other words, the defining characteristic of the new regulatory regime is the division of responsibilities among a number of public agencies with each of them given its own policy mandate and responsibilities while they all share the common objective of securing financial stability (Kim *et al.* 2002). The new regime, however, has not been successful in achieving this objective as it failed to bring about interagency

cooperation necessary for policy coordination and to maintain checks and balances among them.

In spite of the apparent division of responsibilities among specialized and separate agencies it was not long before the new regulatory regime in effect turned into a hierarchical system headed by MOFE (Kim *et al.* 2002). With the power to initiate legislation MOFE has become the most powerful agency dominating other agencies although the system is supposed to work on the basis of the division of responsibilities and powers. In fact, FSC/FSS and BOK have come under the direct influence of MOFE, and there has been very little of either functional cooperation or horizontal checks and balances among the public agencies. Appearances to the contrary, the *modus operandi* of the new regulatory regime has remained the same as that of the old one in which all the powers and policy functions were concentrated in the hands of MOFE. In short, the post-crisis reforms in financial supervision have had very little effect on the way that financial supervision is carried out in Korea (Kim 2004a and 2005).

Given the scope and power of the FSC, FSS, and SFC, their independence is a matter of great importance. Although embodied in the law, in practice their operational independence has been called into question. Concerns arise because of the role taken by MOFE in interpreting laws and supervisory regulations, giving the FSC, FSS, and SFC only limited freedom in implementing supervision. In addition, the rapid turnovers of the FSC chairmanship (the chairman also is the governor of the FSS) and the policy whereby FSC staff sometimes move to and from MOFE have the potential to detract from the credibility of supervisory independence.

The recent episode relating to credit-card companies is an exemplary case demonstrating the failure of reform in formal institutions to alter in a significant way the manner in which financial supervision is actually carried out in Korea. This failure is a consequence of limiting the scope of reform to those institutions directly involved in financial supervision and not extending it to other institutions that, although not directly involved in financial supervision, affect nevertheless the functionality of the supervisory agencies. That is, the post-crisis reform in financial supervision shows that the persistence of incompatible—formal as well as informal—institutions has hampered the functionality of the reformed *formal* institutions. Those institutions include the practice of rotating appointments of supervisory government officials, which has hampered FSC from developing a long-term policy horizon and top-notch supervisory expertise; lack of transparency and openness in government decision-making, which might have led to a purposeful cover-up of supervisory problems; and the highly hierarchical structure of government that places MOFE above other public agencies such as FSC/FSS and BOK, which has allowed MOFE to dominate them in policy matters and, specifically, to subordinate their supervisory task to achieving its short-term macroeconomic objectives. The price Korea has paid for the limited reform is the recent large-scale financial instability, which has its root cause in the inadequate supervision of credit card companies by the reformed supervisory agencies.

9.1 Continuing Dominance of MOFE

As part of the post-crisis reform of the financial system, the Korean government carried out a major structural change in MOFE. With the promulgation of the newly amended Government Organization Act early in 1998, MOFE was reorganized with some of its

functions transferred to other public agencies. For instance, its nonbank supervisory function was transferred to FSC/FSS, while the monetary and credit policy functions were transferred to BOK. In addition, the budgetary functions were taken away from MOFE. This reorganization of MOFE was prompted by the realization that “policy decision-making had become overly concentrated, thereby undermining the checks and balances required for effective government”³⁰ and by the criticism that those weaknesses had greatly contributed to the outbreak of the 1997–98 financial crisis in Korea.

The reform of MOFE and reform in financial supervision led to the division among a number of public agencies of responsibilities and powers that had been concentrated in MOFE. MOFE was given the task of preparing and coordinating economic policies, drafting tax and customs legislation, and formulating policies for the financial system; FSC/FSS was charged with supervising financial institutions; BOK was responsible for maintaining monetary stability and keeping an oversight of the financial system; and KDIC was assigned to protect depositors. In other words, the defining characteristic of the new regulatory regime is the division of responsibilities among a number of public agencies, with each of them given its own policy mandate and responsibilities while sharing the common objective of securing financial stability (Kim, Kim, Kim, and Lee 2002). The new regime, however, has not been successful in achieving this objective, as it failed both to bring about the interagency cooperation necessary for policy coordination and to maintain checks and balances among them.

In spite of the apparent division of responsibilities and powers among specialized and separate agencies, it was not long before the new regulatory regime turned into a hierarchical system headed by MOFE. In effect, appearances to the contrary, the modus operandi of the new regulatory regime has remained the same as that of the old one in which all the powers and policy functions were concentrated in the hands of MOFE, with FSC/FSS and BOK subject to its direct influence. In short, the post-crisis reforms in financial supervision have had very little effect on the way that financial supervision was carried out in Korea (Kim 2005).

In this regard, it is worth quoting fully a passage from the World Bank report on Korea’s financial sector reform.³¹

Given the scope and power of the FSC, FSS, and SFC, their independence is a matter of great importance. Although embodied in the law, in practice their operational independence has been called into question. Concerns arise because of the role taken by MOFE in interpreting laws and supervisory regulations, giving the FSC, FSS, and SFC only limited freedom in implementing supervision. In addition, the rapid turnover of the FSC chairmanship (the chairman also is the governor of the FSS) and the policy whereby FSC staff sometimes move to and from MOFE have the potential to detract from the credibility of supervisory independence.

In other words, the institutional reform that was meant to create independent financial supervisory agencies in Korea has failed to do so, because it left intact other institutions and policies that affect the functionality of the reformed institutions. These

obviously include MOFE's presumptive role in interpreting laws and regulations, frequent staff rotation between FSC and MOFE, and the rapid turnover of FSC chairmanship, which are symptomatic of the informal institutions that underlie the bureaucratic system of the Korean government in general and MOFE in particular.³² The post-crisis reform has left these institutional arrangements intact, thus allowing MOFE to influence the operation of the supervisory agencies and thereby limit their operational independence.

In the following section, we discuss the recent supervisory failure relating to credit card companies as a case in point. This failure was a consequence of limiting the scope of reform to those *formal* institutions directly involved in financial supervision and not extending it to other institutions that, although not directly involved in financial supervision, affect the functionality of the supervisory agencies.

9.2. Supervisory Failures Relating to Credit Card Companies

In 2003, the financial markets in Korea suffered instability with serious prudential problems relating to credit card companies and huge household indebtedness. In March of that year, the solvency of those companies began to be widely questioned, and soon the financial markets were shaken with instability. To prevent an impending crisis MOFE, FSC/FSS, and BOK intervened, taking the lead in arranging rescue plans and forcing credit card companies to abide by hastily drawn-up restructuring packages. Soon afterwards the markets returned to a seemingly stable situation.

The basic underlying problem, however, persisted, threatening market stability. For instance, the LG Card, the biggest credit card company in Korea, became illiquid in November 2003; it subsequently became insolvent and had to be bailed out in January 2004. The seriousness of the problem can be seen in the fact that at the end of 2003, there were over 3.7 million credit defaulters (one-sixth of Korea's economically active population)³³ with total credit to households amounting to US \$389.2 billion³⁴ (over three-fifths of Korea's GDP for 2003) (Bank of Korea 2004).

What brought about such huge credit default and household indebtedness? The following quote from FSS (2002) points to a proximate cause for the problem: misconduct by credit card companies:

Granting cards to minors without parental consent, renewal or re-issuance of cards after expiration without the consent of the member even though no transaction took place in the member account . . . attempts to attract new members with offers of high-priced giveaways . . . setting credit limits well beyond the card members' income or ability to pay only after perfunctory or negligent verification process, and using the offer of high credit limit as a marketing tool to attract new members.³⁵

It seems obvious that misconduct on the part of credit card companies such as these contributed to the huge credit default and household indebtedness, but it is also obvious that they could not have been committed if those companies had been properly supervised by the appropriate supervisory agencies. We must thus hold those agencies ultimately accountable for the misconduct of credit card companies and the consequent

credit default and household indebtedness.³⁶ The following discussion, based on a detailed examination of the relevant documents and data published by MOFE, FSC/FSS, and BOK during the period 1999–2003, reports how these public agencies failed in their role as supervisory agencies (Kim 2004).

9.2.1. MOFE

MOFE began undertaking a series of deregulatory measures for credit card companies in 1997–1999. It included expanding the scope of financial activities permitted (e.g., cash advances and card loans), removing the corporate borrowing limit (twenty times the stockholders' equity), and also removing the ceiling ratio (60 percent) of account balances of non-core credit card businesses (i.e., cash advances and card loans) to those of both core (i.e., settlement of credit card payment) and non-core credit card businesses. These were soon followed in 1999–2001 with another series of deregulatory measures, which aimed at popularizing a wide use of credit cards by the general public. It included removing the monthly credit limit (approximately US \$609) on cash advances, offering tax breaks for credit card purchases, awarding lottery money for the receipt of credit card payments, requiring corporate entertainment expenses to be paid with corporate credit cards, and offering further tax breaks for credit card purchases.

These deregulatory measures were undertaken as part of government policies aimed at boosting domestic demand in the post-crisis economy. These and other actions taken by MOFE to stimulate real estate investment in mid-1998 were probably warranted at that time, when the Korean economy was experiencing a credit crunch and a high rate of unemployment as a result of the crisis. MOFE, however, continued with the policy of promoting the use of credit cards well beyond the time when it was appropriate.

Early in 2001, there began to appear signs of excessive competition among credit card companies. Household debts (including credit card debts) were snowballing, and the number of credit defaulters was increasing at a rapid rate. MOFE nevertheless stuck to its credit card promotion policy through the first half of 2002, apparently because it was intent on boosting domestic demand and making a rapid recovery from the crisis of 1997–1998. This action by MOFE suggests that it was interested more in achieving a rapid economic recovery than in securing financial stability.

In February 2002, the Financial Policy Coordination Committee,³⁷ which consisted of the MOFE vice-minister, the FSC vice-chairman, and the BOK vice-governor, agreed to pursue a broad set of policy measures to limit the surge of household debt. As it turned out, however, the public agencies did not regard it as a top priority issue; what concerned them the most then was economic recovery from the crisis. In fact, at a meeting subsequently held in March 2002, the committee expressed its reservations about taking *excessive* measures against household indebtedness, as it feared such measures would suppress consumption and thus delay economic recovery. It thus appears that the task of supervising credit card companies was subordinated to the goal of rapid economic recovery. A consequence of this policy stance was an increase in overdue credits, credit default, and household indebtedness.

In May 2002, the MOFE minister, the FSC chairman, and the Policy Committee chair of the Millennium Democratic Party (then the incumbent party) got together in the Ruling Party–Administration Consultation Meeting³⁸ and agreed to make an aggressive effort to combat the prudential problems relating to credit card companies and household debt. Finally, faced with the signs of the aggravating problems, MOFE decided to give up its policy of boosting domestic demand that it had maintained for four years, from mid-1998. In July 2002, MOFE undertook policy measures to deal with the problems, but its belated action only had the effect of putting a heavier regulatory burden on credit card companies instead of mitigating the severity of the problem. Then, in mid-March 2003, the discovery of accounting frauds by SK Global triggered a very serious, albeit temporary, instability in the financial markets already overburdened with overdue credits, credit default, and household indebtedness.

9.2.2. FSC/FSS

In February 2001, FSC/FSS first recognized signs of excessive competition among credit card companies and subsequently decided to carry out a comprehensive set of measures to deal with the prudential problems relating to credit cards. They wanted to reintroduce, for instance, the ceiling ratio of account balances of non-core credit card businesses to those of both core and non-core credit card businesses. FSC/FSS was, however, unable to put such measures into practice because of MOFE's opposition to revising the relevant laws and regulations.

As noted earlier, the ceiling ratio, which had been set at 60 percent, was removed in 1999 in the hope that such a measure would accelerate economic recovery from the financial crisis. In April 2001, FSC, being concerned with the rapid increase in non-core credit card businesses, such as cash advances and card loans, requested that MOFE provide a legal basis for FSC to reintroduce the ceiling ratio. In May 2001, faced with MOFE's opposition, FSC attempted on its own to re-impose the ceiling ratio at 50 percent (FSS 2001b), taking the position that the re-imposition was a matter of FSC's regulatory discretion and was within their jurisdiction.³⁹ MOFE, however, took issue with FSC, insisting that the re-imposition of the ceiling ratio required a revision in law and was not, therefore, a matter of regulatory discretion. MOFE was probably opposed to the reintroduction, fearing that such a measure would have a negative impact on domestic demand and slow the pace of economic recovery. Then, in May 2002, when the problems became more serious and urgently demanded a solution, MOFE finally agreed to revise the law. In June 2002, it finally reintroduced the ceiling ratio—a whole year later than FSC/FSS thought appropriate and necessary.

The inability of FSC/FSS to reintroduce the ceiling ratio clearly demonstrates the lack of their autonomy in carrying out the supervisory task. The cause for this lack of autonomy lies, we argue, in the hierarchical relationship that MOFE has maintained with other public agencies. By being at the apex of this hierarchy and by turning discretionary regulatory issues into legislative matters, MOFE has been able to dominate other agencies in policy matters, rendering them practically impotent to carry out their statutory responsibilities, especially when in conflict with MOFE's own policy objectives. In this regard, it is notable that the Board of Audit and Inspection provided delineations of

several specific incidents in which MOFE has dominated FSC/FSS in supervisory issues on prudential problems of credit card companies.⁴⁰

Until May 2002, FSC/FSS was sending out mixed signals regarding the problem of household debt. In April 2002, they announced plans to strengthen prudential supervision of credit card companies, but later that month, the FSC chair stated in a public speech that prudential policy measures would be pursued carefully so that economic recovery would not be deterred. Such inconsistent messages from the supervisory authorities are likely to have stirred up confusion in the financial markets while damaging credibility in supervisory policy. When MOFE took the occasion of the Ruling Party–Administration Consultation Meeting in May 2002 to announce a change in its policy stance of boosting private consumption, FSC/FSS quickly became decisive in their view on the prudential problems and started taking strict supervisory actions. These actions by FSC/FSS demonstrate that they lacked autonomy and were simply following the policies set by MOFE.

9.2.3. BOK

BOK itself took note of marked increases in cash advances of credit card companies and in household debt as early as September 1999 but did not regard them as a major threat to financial stability. In the first half of 2002, however, BOK began to express in various public statements its concern about the ever increasing household debt, although, like MOFE, it appeared to be torn between two conflicting objectives: boosting domestic demand for economic recovery and maintaining financial stability. But, by announcing in February 2002 that private consumption needed to be boosted, BOK in effect sent out a message saying that it was not overly concerned with the size of household debt.

In May 2002, the BOK Monetary Policy Committee made a decision to move the target level of the call rate slightly upward by a quarter percentage point. The decision was made with the problems of household indebtedness and financial instability in mind. A few weeks later, MOFE made a complete and abrupt turnaround in its policy stance, giving up its long-standing policy of boosting domestic consumption. BOK itself then suddenly became expressly concerned with the prudential problems of credit card companies and household debt.

BOK is *not* a part of the government, unlike FSC, which is a government agency at a lower level of hierarchy headed by MOFE. But its passive inconsistent patterns of behavior toward prudential problems relating to credit card companies and household debt strongly suggests that in spite of the statutory independence it has gained with the post-crisis financial reform, BOK has been subject to influence from MOFE. A weakened legal basis of BOK involvement in matters of financial stability, which is a consequence of the 1997 revision of the Bank of Korea Act, may have contributed in part to such a situation. More likely, MOFE has been able to exert its influence on BOK by having a strong voice in appointing a majority of members of the BOK Monetary Policy Committee.⁴¹

9.2.4. Synopsis

The Ruling Party–Administration Consultation Meeting held in May 2002 marked the watershed at which MOFE basically abandoned its policy of boosting domestic demand in an attempt to bring about a rapid economic recovery from the crisis. It now began to tackle the prudential problems relating to credit card companies that had been festering unattended for years. With this change in policy stance by MOFE, all other public agencies, including FSC/FSS and BOK, followed suit and became outspoken and decisive in their views and actions regarding the prudential problems. Their new public policy stood in stark contrast to the inconsistent and ambiguous attitudes they had adopted before in public and was a clear manifestation of their closely following the decisions of MOFE in matters relating to the economy.

What FSC/FSS and BOK had done before was to follow the policy line chosen by MOFE, which was primarily concerned with achieving short-term macroeconomic policy objectives. But as soon as MOFE made a complete and abrupt turnaround in its policy stance in May 2002 and became concerned with financial stability, FSC/FSS and BOK likewise made its policy turnaround. Such behavior by FSC/FSS and BOK clearly demonstrates that in spite of their statutory independence, they have lacked true autonomy, which, as we argue, is due to the persistence of the institutions that are incompatible with their functioning as independent agencies.⁴²

In short, the prudential problems relating to credit card companies and household debt were a failure of an institutional structure in which MOFE dominated other public agencies, making it difficult for them to carry out their statutory responsibilities when their doing so went against MOFE's achieving its own policy objectives. In such a system, the task of financial supervision and the interagency supervisory coordination necessary for solving the credit card and household debt problems were simply relegated to a back burner until the problems reached crisis proportion and became serious enough to dominate other policy issues.

10. Conclusion

Since the early 1960s Korea's financial system has gone through three distinct phases—the first from the early 1960s through the 1970s, the second from the early 1980s to the crisis of 1997, and the third the post-crisis period. The first was a period during which the Korean government was actively involved in allocating credit among *chaebols* for the purpose of bringing about rapid industrialization and export expansion; the second a period during which, following a change in the basic policy stance, various attempts were made at financial liberalization, and the third a period during which under the exigencies of a crisis and external pressure the government carried out a wholesale reform in the financial system.

The first period was a time when Korea achieved rapid industrial development and export expansion while the government was actively pursuing a financial policy commonly referred to as financial repression. Since such a policy is supposed to be detrimental to economic growth as it discourages saving and leads to credit allocation directed by bureaucrats and influenced by rent-seeking activities and thus is inefficient and unproductive, how Korea managed to grow so rapidly during this period is clearly a puzzle that needs to be resolved if we are to understand the role of finance in economic

development. In this paper we have argued that the economic system that comprised of government, *chaebols* and government-controlled banks could be seen as an internal organization with its own internal capital market. We know then that such an organization *can* be as efficient in achieving economic development as multi-unit private corporations *can* be in achieving their objectives. Korea then was in the right situation for such an organization to be effective since the country lacked the institutional infrastructure necessary for the proper functioning of the Anglo-American-type financial system.

The second period was a time when attempts were made to do away with government control over financial institutions. They did not, however, completely remove government intervention from financial markets, as exemplified in the case of commercial bank privatization, which still kept the banks subject to government control in various areas of their management. Furthermore, interest politics involving powerful *chaebols* led to deregulation that did not make much economic sense. As we have argued, haphazard deregulation and the opening of the capital account in the absence of appropriate institutions necessary for a liberal financial system were a root cause of the crisis of 1997. The Korean episode demonstrates the perils involved in making the transition from a government-controlled financial system that may work well in the early stage of economic development to the Anglo-American-type financial system when, although the country is more developed now, it still lacks the institutional infrastructure necessary for such a system.

The third period, the post-crisis period, was a time when under the exigencies of a crisis and external pressure serious efforts were made to implant various features of the Anglo-American-type financial system. It is too early to tell what the eventual outcome of these reforms will be, as institutions transplanted from abroad such as “global standards” may not function as expected due to institutional complementarity or “local specificity” (Lee *et al.* 2007). Clearly, Korea’s experience in reforming financial supervision and failure to adequately supervise the credit card companies points to the complexity relating to institutional reform in general; that is, reform of a particular institution, if it is to be successful, cannot simply end with it. Interdependency or complementarity among various institutions in society implies that the reform will have to be followed, if not accompanied, by reform in other extant institutions that affect directly or indirectly the functionality of the newly reformed institution. That is, reforming an institution requires reforming the entire institutional structure in which it is embedded. Some of the institutions in that institutional structure may be known to the reformers prior to the reform, while others may be revealed only afterwards. And some of them may be the society’s overarching institutions such as culture and social norms, and possible changes in such institutions would have society-wide implications. Obviously, reforming all the interdependent institutions at once—a sort of a “big bang” approach—would be difficult, if not impossible, since we may know little about what they are prior to the reform and how they may interact with the particular institution at issue. This is also the conclusion reached by Lin and Nugent (1995, p. 2307) at the end of their extensive review of the literature on institutions and economic development: that is, “[w]here to start and how to bring out the reforms in a country are questions that can be answered only with serious consideration of the country’s existing institutional structure and human and physical endowments.”

Having reviewed the path of financial development that Korea has taken since the 1960s, we may ask whether Korea would have done better if it had fully accepted the policies recommended by the American advisors and adopted a “liberal” financial system in the 60s. According to Cho and Kim (1997), financial repression in Korea has left it with an inefficient banking system, a financially vulnerable corporate sector, and high economic concentration. To this, we may even add that ill-conceived and badly implemented attempts at financial liberalization may have planted the seeds for the 1997 financial crisis in Korea. These are certainly the legacies of financial repression in Korea, but that does not necessarily mean that the path not taken would have been better.

The fact of the matter is that although financial repression probably has retarded financial development in Korea, the financial system in existence in the early 1960s was far from being a well developed one. Given the social and economic conditions prevailing in Korea then, there is no guarantee that, if allowed to persist in a “liberalized” environment, the system would not have deteriorated to what Rajan and Zingales (2003, pp. 42-3) associate with underdeveloped financial markets; that is, it might have brought to Korea “[m]any of the evils of capitalism—the tyranny of capital over labor, the excessive concentration of industry, the unequal distribution of income in favor the owners of capital, the relative lack opportunity for the poor....”

We have argued that financial repression, as practiced in Korea in the 60s and 70s, was a financial system appropriate to a country in the early stage of economic development, that its transition to a liberal financial system, once it served its purpose, was necessary for sustained economic growth in Korea but the actual transition was ill conceived and botched up due to the influence of interest politics, and that in spite of the post-crisis reforms Korea is still faced with the challenge of finding its own institutional solution to establishing an efficient, stable financial system.⁴³ Search for such a solution cannot just follow a one-size-fits-all formula, as concluded by Rondo Cameron (1967) in his historical study of the banking systems of the industrialized nations of Europe and Japan. It is a process that takes into account a country’s history and other extant institutions—a process that requires, as observed by Victor Nee (1998), a poet’s insight into the human condition as much as science.

<Table 1> Share of policy loans by deposit money banks (DMBs) and NBFIs (%)

	1973-81	1982-86	1987-91	Average during entire period 1973-91
DMB loans (A)				
Government funds	7.5	7.4	8.0	7.6
NIF	**4.3	5.1	3.0	4.2
Foreign currency loans	21.1	19.7	19.4	20.3
Export loans	21.3	16.9	5.2	16.2
Commercial bills discounted	8.0	13.9	16.5	11.6
Special funds for SMEs	5.9	5.6	6.5	6.0
Loans for AFL	6.1	5.3	7.4	6.2
Housing loans	8.0	13.1	14.1	10.8
Others (a)	17.7	13.1	20.0	17.1
Policy Loans Total	100.0	100.0	100.0	100.0
NBFI loans (B)				
KDB loans	91.9	71.7	83.7	84.8
(NIF)	**(25.7)	(18.5)	(7.9)	(19.5)
EXIM loans	8.1	28.3	16.3	15.2
(NIF)	**(2.5)	(4.7)	(2.3)	(3.0)
Policy Loans Total	100.0	100.0	100.0	100.0
(A) DMB loans	63.0	59.4	59.5	61.2
(B) NBFI loans	48.0	32.3	15.3	35.9
(A) + (B) domestic credit	48.9	40.8	30.9	42.4

** Annual average during 1974-81.

(a) Includes loans for imports of key raw materials, loans on mutual installment, loans for machinery, equipment loans to the export industry, special equipment funds, and special long-term loans.

Note: Figures in the table are annual averages.

Source: National Statistical Office, "Korean Economic Indicators," various issues. Bank of Korea, "Monthly Bulletin," various issues; re-cited from Cho and Kim (1995)

<Table 2> Loans and Discounts by the Bank of Korea (%)

	1973-81	1982-86	1987-91	1973-91
Rediscounts on commercial bills	10.9	15.5	26.5	16.2
Export loans	51.1	26.1	7.4	33.2
Loans for AFL	3.4	2.1	3.4	3.1
General loans	18.3	46.9	57.2	36.1
Others	16.3	9.5	5.4	11.6
Total	100.0	100.0	100.0	100.0
DMB policy loans as share of total	35.5	42.5	26.8	35.1
DMB loans as share of total	23.1	25.7	18.5	22.6

Source: Bank of Korea, "Monthly Bulletins," various issues. Recited from Cho and Kim (1995)

<Table 3> Degree of Dependence by DMBs (%)

	1973-81	1982-86	1987-91	1973-91
BOK export loans/DMBs export loans	88.2	65.2	45.3	70.8
BOK rediscounts on commercial bills/DMBs commercial bills discounted	51.5	47.7	46.8	49.2
BOK loan for AFL/DMBs loan for AFL	21.9	16.8	14.1	18.5

Source: Bank of Korea, "Monthly Bulletins," various issues. Recited from Cho and Kim (1995)

<Table 4> Expansion of *Chaebols* during the HCI drive

<i>Chaebols</i>	Number of Affiliates		Acquisitions in HCI
	1974	1978	
Hyundai	9	31	Automobile, machinery, iron and steel, shipbuilding, aluminum, oil refining, heavy electrical, heavy machinery
Samsung	24	33	Shipbuilding, general machinery, electric switching systems, petrochemicals
Daewoo	10	35	Machinery, automobile, shipbuilding
Lucky	17	43	Petrochemicals, oil refining, electronics
Hyosong	8	24	Heavy electrical, machinery, auto parts, petrochemicals
Kukje	7	22	Iron and steel, machinery
Sunkyung	8	23	Chemical, machinery
Samhwa	10	30	Electrical, machinery
Ssangyoung	17	20	Cement, heavy machinery, shipbuilding, heavy electrical
Kumho	15	22	Iron and steel, petrochemicals
Kolon	6	22	Heavy electrical, petrochemicals

Source: E.M. Kim (1987).

<Table 5> Large Shareholders' Ownership of Banks

(As of the end of 1996)

Classification	Large Shareholders Over 1%		Large Shareholders Over 4%		Ownership Share by 5 Largest Shareholders (%) (by 3 largest Industrial Capital)
	Number	Ownership Share (%)	Number	Ownership Share (%)	
Chohung	11(4)	45.7(14.7)	5(2)	32.4 (10.0)	32.4(12.8)
Commercial	10(3)	35.1(9.3)	5(1)	27.4 (7.0)	27.4(9.3)
Korea First	13(5)	35.6(15.7)	2(1)	12.5 (5.5)	22.4(12.5)
Hanil	14(5)	45.5(15.8)	4(1)	20.8 (4.8)	24.6(11.4)
Seoul	12(6)	30.6(14.2)	2(1)	12.0 (4.6)	20.3(10.3)
Average for Five Largest Nationwide Banks	12(5)	38.7(13.9)	4(1)	21.3(6.5)	25.6
Korea Exchange	9(2)	59.0(2.1)	1(-)	47.9(-)	54.6(n.a.)
Kookmin	9(1)	48.5(2.0)	3(-)	37.2(-)	43.4(n.a.)
Shinhan	6(2)	16.4(4.5)	- (-)	- (-)	15.3(n.a.)
KorAm	9(6)	70.4(45.6)	5(3)	64.4 (41.1)	79.9(41.1)
Hana	16(5)	54.6(19.4)	5(2)	28.5 (11.0)	28.5(14.5)
Boram	17(5)	52.9(26.0)	5(3)	31.4 (20.8)	31.4(20.8)
Donghwa	10(2)	14.9(2.3)	- (-)	- (-)	8.7(n.a.)
Daedong	3(-)	17.1(-)	2(-)	15.2 (-)	n.a.(n.a.)
Dongnam	7(-)	20.0(-)	2(-)	13.8 (-)	17.8(n.a.)
Peace	9(1)	49.0(1.3)	6(-)	42.2 (-)	37.0(n.a.)
Average for Nationwide Banks	10(2)	39.3(10.7)	3(1)	24.3(5.4)	-
Daegu	15(3)	40.6(8.6)	4(1)	22.9(5.7)	25.6(8.6)
Pusan	14(3)	52.0(28.8)	2(1)	31.8(23.9)	40.4(28.8)
Chungchong	14(5)	63.9(27.7)	3(1)	36.2(16.5)	43.0(23.3)
Kwangju	13(2)	41.7(9.5)	3(1)	21.7(7.9)	28.6(n.a.)
Cheju	10(4)	51.8(31.7)	3(1)	36.6(26.5)	42.1(30.6)
Kyonggi	13(5)	42.6(20.6)	3(2)	21.6(14.3)	28.7(17.7)
Jeonbook	15(4)	59.4(24.3)	6(3)	41.8(23.1)	37.3(23.1)
Kangwon	17(3)	57.0(14.5)	4(1)	31.2(11.9)	34.9(14.5)
Kyungnam	16(4)	50.4(20.5)	2(1)	19.4(11.6)	29.7(18.2)
Chungbuk	16(5)	54.1(11.3)	4(1)	29.7(4.7)	33.4(9.3)
Average for Local Banks	14(4)	49.7(18.5)	3(1)	27.6(13.5)	33.0
Average for all Commercial Banks	12(3)	40.9(11.9)	3(1)	24.8(6.6)	-

Note: Figures in parenthesis indicate the number and ownership share by private industrial capital (including affiliated financial institutions).

Source: Bank Supervisory Board.

<Table 6> Share of Banks Owned by Top 30 Chaebols

(As of the end of 1996, Unit: %)

Conglomerates	Ownership Share
1. Hyundai	Korea First bank(2.20), Hanil bank(2.00), Seoul bank(1.99), Kangwon bank(11.89)
2. Samsung	Chohung bank(2.81), Commercial bank(7.03), Korea First bank(3.96), Hanil bank(4.76), Seoul bank(3.77), Korea exchange bank(1.05), Shinhan bank(3.36), KorAm bank(18.56), Hana bank(3.42), Peace bank(1.28), Daegu bank(5.65), Pusan bank(1.02), Kyonggi bank(1.57), Jeonbook bank(1.20), Kangwon bank(1.22), Kyungnam bank(2.38)
3. LG	Korea First bank(3.03), Hanil bank(2.47), Boram bank(7.58), Cheju bank(1.80)
4. Daewoo	KorAm bank(18.56)
5. SK	Kyonggi bank(3.42)
6. Ssangyong	Chohung bank(1.98), Korea exchange bank(1.04), Hana bank(1.52), Kookmin bank(1.96)
7. Hanjin	Kyonggi bank(5.63)
8. Kia	Korea First bank(1.04)
9. Hanwha	Chungchong bank(16.49)
10. Lotte	Pusan bank(23.93)
11. Kumho	Kwangju bank(7.87)
12. Doosan	Boram bank(11.34)
13. Daelim	Hanil bank(3.57)
14. Hanbo	
15. DongAh	Seoul bank(1.50), Cheju bank(2.31)
16. Halla	
17. Hyosung	Hana bank(5.16), Kyungnam bank(11.57)
18. Dongkuk Steel	Seoul bank(1.27), Pusan bank(3.85), Kyungnam bank(3.92)
19. Jinro	Hana bank(3.51)
20. Kolon	Boram bank(5.80)
21. Tongyang	Donghwa bank(1.03)
22. Hansol	
23. Dongbu	Cheju bank(1.06), Chungbuk bank(1.74)
24. Kohab	
25. Haitai	
26. Sammi	
27. Hanil	
28. Kukdong- Construction	
29. New Core	
30. Byucksan	

Source: The Bank Supervisory Board

<Table 7> Interest rate differential between export loans and general loans

	1961-65	1966-72	1973-81	1982-86	1987-91
Export loan interest rate (A)	9.3	6.1	9.7	10.0	10.0-11.0
General loan interest rate (B)	18.2	23.2	17.3	10.0-11.5	10.0-11.5
(A)-(B)	8.9	17.1	7.6	0-1.5	0-0.5

Source: Cho and Kim (1995).

<Table 8> Deposit Money Banks' Required Ratio of Financing SME (%)

	1965	1976	1980	1985	1986	1992
Nationwide commercial bank	30 ⁽¹⁾	30 ⁽²⁾	35 ⁽³⁾	35	35	45
Local bank	30 ⁽¹⁾	40 ⁽²⁾	55 ⁽³⁾	55	80	80
Foreign bank branches	-	-	-	25	25	25

Note: (1) Ratio in terms of total loans outstanding

(2) Ratio in terms of increase in total loans

(3) Ratio in terms of increase in total loans in won

Source: Cho and Kim (1995)

<Table 9> Share of loans to SMEs and 30 largest Chaebols by domestic banks^(a) (%)

	1988	1989	1990	1991
Loans to SME	48.1	50.1	55.5	56.8
Loans to the 30 largest <i>Chaebols</i>	23.7	20.7	19.8	20.4

(a) Domestic banks include deposit money banks only.

Source: Bank of Korea, and Office of Bank Supervision. Recited in Cho and Kim (1995)

<Table 10> Credit access and borrowing costs by sector (Percent)

	1973-81	1982-86	1987-90
Access to borrowing (a)			
Manufacturing	40.4	31.5	27.7
Large firms (A)	40.9	31.6	27.0
SMEs (B)	32.7	31.3	31.4
(A) - (B)	8.2	0.3	-4.4
Export (C)	45.1	35.9	30.3
Domestic (D)	37.6	28.8	26.3
(C) - (D)	7.5	7.1	4.0
HCI (E)	40.7	32.2	28.2
Light industry (F)	39.8	30.3	27.0
(E) - (F)	0.9	1.9	1.2
Average borrowing cost (b)			
Manufacturing	13.3	14.0	13.0
Large firms (G)	13.0	14.0	12.6
SMEs (H)	14.9	14.2	14.3
(G) - (H)	-1.9	-0.2	-1.7
Export (I)	12.6	12.7	12.6
Domestic (J)	14.0	14.8	13.2
(I) - (J)	-1.4	-2.1	-0.6
HCI (K)	12.1	13.5	12.7
Light industry (L)	14.9	14.9	13.5
(K) - (L)	-2.8	-1.4	-0.8
Memo items:			
Wholesale, retail, and hotel	17.3	16.9	15.3

(a) Bank loans and foreign loans/total assets.

(b) Average borrowing cost = financial cost / (corporate bond + foreign loans + loans from the financial institutions)

Source: Bank of Korea, "Financial Statements Analysis," various issues. Recited from Cho and Kim (1995)

Table 11: Growth of Commercial Banks and NBFIs
(Shares in deposits and loans, %)

	Deposits		Loans	
	Banks	NBFIs	Banks	NBFIs
1972	81.7	18.3	77.4	22.6
1974	77.3	22.7	75.5	24.5
1976	76.1	23.9	74.4	25.6
1978	74.5	25.5	67.8	32.2
1980	69.1	30.9	63.8	36.2
1982	64.3	35.7	62.2	37.8
1984	56.3	43.7	57.9	42.1
1986	49.4	40.6	56.3	43.7
1988	44.3	45.7	51.5	48.5
1990	40.5	59.5	49.7	50.3
1992	36.2	63.8	48.3	51.7

Source: Bank of Korea, *Monthly Bulletin*, various issues.

Table 12: Growth of Capital Market in Korea (in billion won)

	1980	1985	1987	1989	1990	1991	1992
Stock Market							
Companies listed	352	342	389	626	669	686	688
Book Value of stock	2,421	4,665	7,591	21,212	23,982	25,510	27,065
Market value	2,526	6,570	26,172	95,447	79,020	73,118	84,712
Market value/GNP (%)	6.9	8.4	24.7	67.7	46.1	34.1	35.5
Trading volume	1,134	3,620	20,494	81,200	53,455	62,565	90,624
Stock price index	106.9	163.4	525.1	909.7	696.1	610.9	678.4
Corporate bonds							
Number of issuers	434	1,213	1,457	1,504	1,603	1,862	2,070
Book value	1,649	7,623	9,973	15,396	22,068	29,241	32,696
Trading volume	246	660	5,327	4,378	2,455	1,394	453

Source: Korea Securities Dealers Association.

Table 13: External Financing by Corporate Sector in Korea (%)

	1970	1975	1980	1985	1988	1990	1992
Indirect finance	39.7	27.7	36	56.2	27.4	40.9	36.3
Borrowing from banks (A)	30.2	19.1	20.8	35.4	19.4	16.8	15.1
Borrowing from NBFIs (B)	9.5	8.6	15.2	20.8	8	24.1	21.1
Direct finance (C)	15.1	26.1	22.9	30.3	59.5	45.2	41.4
Commercial paper	0	1.6	5	0.4	6.1	4	7.6
Corporate bonds	1.1	1.1	6.1	16.1	7.5	23	12.5
Stocks	13.9	22.6	10.9	13	40.6	14.2	15.9
Foreign borrowings (D)	29.6	29.8	16.6	0.8	6.4	6.8	5
Others	15.6	16.4	24.5	12.7	6.7	7.1	17.3
Total	100	100	100	100	100	100	100
(A) + (D)	54.8	48.9	37.3	36.2	25.8	23.6	20.1
(B) + (C)	24.6	34.7	38.1	51.1	67.5	69.3	62.5

Note: Others include government loan and corporate credit.

Source: Bank of Korea, *Understanding of Capital Circulation in Korea* (in Korean).

Table 14: *chaebol*-owned NBFIs, 1995

	Security Companies	Insurance Companies	Investment & Finance Companies, and Merchant Banks	Others	Total
Top 5 <i>chaebols</i>	5	5	4	2	16
Top 10 <i>chaebols</i>	9	7	7	2	25
Top 30 <i>chaebols</i>	13	9	19	2	43

Notes: Others include factoring companies, credit card companies, & credit unions.

Source: Bank Supervisory Authority of Korea.

Table 15: Profitability, Growth of Investment & Growth of Assets in Korea, Taiwan, and Japan (%)

		1988	1989	1990	1991	1992	1993	1994	1995	1996
Profitability	Korea	4.1	2.5	2.3	1.8	1.5	1.7	2.7	3.6	1.0
	Taiwan	5.0	3.8	4.5	4.0	3.4	2.9	4.9	5.1	NA
	Japan	5.5	5.8	5.3	4.0	2.9	2.3	2.9	NA	NA
Growth of Fixed Capital Investment	Korea	26.8	16.5	25.7	11.6	-14.0	-4.0	56.2	43.5	NA
	Japan	30.4	16.8	19.2	8.0	-20.0	-22.0	-8.4	NA	NA
Growth of Total Assets	Korea	15.8	24.0	23.8	22.6	12.3	11.2	16.9	19.3	15.0
	Taiwan	11.1	15.3	11.7	19.1	8.9	8.1	12.5	15.1	NA

Sources: Bank of Korea, Bank of Japan.

Note: Profitability is measured by ordinary profits divided by sales. Ordinary profits are operating profit minus net financial costs (interest payments)

NA: Not available

Table 16: Foreign Capital Inflow in Korea (in 100 million U.S. dollars)

	1992	1993	1994	1995	1996	1997
Capital Balance (1+2+3)	69.9	32.2	107.3	172.2	239.2	60.3
1. Net FDI	-4.3	-7.5	-16.5	-17.8	-23.4	-19.5
2. Net portfolio investment	58.0	100.1	61.2	115.9	151.8	147.6
3. Other net investment	16.2	-60.5	62.6	74.6	110.8	-67.9
(A+B)						
A. Assets	-33.0	-45.9	-73.7	-139.9	-134.9	-107.4
B. Liabilities	49.2	-14.6	136.3	214.5	245.7	39.5
Net borrowing by Banks	24.3	12.0	89.8	134.0	141.5	-141.2

Long-term	12.0	0.8	19.5	16.1	15.3	7.2
Commercial banks	9.0	1.5	21.8	20.3	24.9	6.6
Development orgs.	0.8	-0.8	0.1	-3.5	-8.5	-0.1
Merchant banks	2.2	0.1	-2.4	-0.7	-1.1	0.7
Short-Term	12.3	11.2	70.3	117.9	126.2	-148.4
Commercial banks	7.0	3.9	53.8	85.2	71.9	-103.1
Development Orgs.	5.9	5.6	7.8	15.6	22.4	-24.3
Merchant Banks	-0.6	1.7	8.7	17.1	31.9	-21.0
Net Borrowing by	24.9	-26.6	46.5	80.5	104.2	180.7
Non-banks (i.e. Firms)						

Source: Bank of Korea, *The Balance of Payment*, various issues.

Table 17: Changing “Profitability” of *Chaebols*

A. Profitability of 30 largest *chaebols*

	1994	1995	1996
Operating profit/equity	6.23	1.11	0.87
Ordinary profit/equity	0.31	0.42	0.09
Operating profit/sales revenue	0.22	0.23	0.17
Ordinary profit/sales revenue	0.07	0.09	0.02
Operating profit/total asset	0.22	0.25	0.18
Ordinary profit/total asset	0.07	0.09	0.02

B. Profitability of 10 largest *chaebols*

	1994	1995	1996
Operating profit/equity	15.37	28.95	24.66
Ordinary profit/equity	8.46	10.38	0.75
Operating profit/sales revenue	6.22	6.23	4.7
Ordinary profit/sales revenue	1.9	2.29	0.21
Operating profit/total asset	6.34	6.74	5.02
Ordinary profit/total asset	2.16	2.65	0.4

Source: Calculations based on the data from Seung-no Choi (1995).

Note: Ordinary profits are the operating profits minus the net financial costs (interest payments).

Table 18: Roll-Over Rate of Foreign Debt Held by Korean Financial Institutions in 1997 (%)

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
Overall			109	94.9	100.6	106.3	89.1	79.2	85.8	86.5	58.8	32.2
Commercial Banks	115	95				100.0				58.8		
Merchant Banks	84	79				65.6				47.5		

Source: Park (1998) and the Bank of Korea.

<Table 19> Financial Institutions Closed or Merged

(As of October, 2006, unit: number of institution)

	Total No. of Institutions (end-1997) (A)	Type of Resolution					New Entry	Total No. of Institutions (Oct-2006)
		License Revoked	Merger	Others ¹⁾	Subtotal (B)	Ratio (%) (B/A)		
Banks	33	5	11	-	16	48.5	1	18
NBFIs	2,070	164	177	536	877	42.4	109	1,302
Merchant Bank Corporations	30	22	7	-	29	96.7	1	2
Securities Companies	36	5	7	3	15	41.7	19	40
Insurance Companies	50	10	6	4	20	40.0	21	51
Investment Trust Companies	32	7	5	-	12	37.5	29	49
Mutual Savings Banks	231	107	28	1	136	58.9	15	110
Credit Unions	1,666	2	122	527	651	39.1	15	1,030
Leasing Companies	25	11	2	1	14	56.0	9	20
Total	2,103	169	188	536	893	42.5	110	1,320

Note: 1) Includes dissolution and asset transfers to bridge institutions.

Source: Financial Supervisory Committee.

<Table 20> Fiscal Support for Financial Restructuring (11/1997 ~ 11/2006)

(Unit: trillion won)

	KDIC and Others				KAMCO	Total
	Recapitaliza- tion	Capital Contribution	Deposit Repayment	Purchase of Assets	Purchase of NPLs	
Banks	34.0	13.9	0	14.4	24.6	86.9
NBFIs	29.5	4.6	30.3	2.9	11.8	79.1
Merchant Banking Corporations	2.7	0.7	18.3	0.0	1.3	23.0
Insurance Companies	15.9	3.1	0.0	0.3	1.8	21.1
Securities and ITCs	10.9	0.3	0.01	1.9	8.5	21.6
Mutual Savings Banks	0.0	0.4	7.3	0.6	0.2	8.5
Credit Cooperatives	0.0	0.0	4.8	0.0	0.0	4.8
Others	0.0	0.0	0.0	0.0	2.4	2.4
Total	63.5	18.5	30.3	17.3	38.8	168.4

Source: Public Fund Management Committee, Ministry of Finance and Economy.

<Table 21> Number of Employees in the Financial Sector (1997-2006)

	Commercial banks	Merchant banks	Mutual Savings banks	Credit unions	Insurance	Securities
1997	128,503	1,510	9,975	30,122	83,304	25,515
1998	94,690	1,251	7,971	27,775	65,183	24,460
1999	95,540	943	6,610	24,164	61,745	30,253
2000	91,905	588	5,781	23,433	56,726	33,858
2001	90,122	285	5,464	22,483	50,818	36,715
2002	91,398	258	6,607	19,834	47,353	36,273
2003	96,223	159	6,293	19,045	46,567	33,353
2004	96,031	146	6,060	18,716	47,770	30,703
2005	94,675	145	6,418	18,448	51,455	29,817
2006	99,907	160	6,860	18,362	52,420	30,903

**<Table 22> Financial Conglomeration by Types in Banking, Insurance, Securities, and ITCs
(Trillion Won, %)**

		1996				2003			
		# of Institutions		Assets		# of Institutions		Assets	
		No.	%	Amount	%	No.	%	Amount	%
Financial Conglomerates	FHC	0	0	0	0	14	11.4	262.7	27.2
	P-S	20	19.6	256.9	43.9	15	12.2	369.0	38.1
	Mixed	40	39.2	73.2	12.5	34	27.6	185.3	19.2
	Subtotal	60	58.8	329.9	56.4	63	51.2	817.1	84.5
Non-Financial Conglomerates		42	41.2	255.0	43.6	60	48.8	150.4	15.5
Total		102	100	584.9	100	123	100	967.5	100

Source: Hahm and Kim (2006)

<Table 23> Prompt Corrective Actions in Korea (Revised in March 1999)

Measures	Conditions when measures are taken		Decision-maker	Details of Measures
	BIS ratio	Others		
Management Improvement Recommendations	< 8%	<ol style="list-style-type: none"> 1. Above the third rate in CAMELS, but below the fourth rate in terms of quality of assets or capital adequacy 2. It seems evident that the above cutoff conditions are not satisfied because of the large financial debacle 	Governor of Financial Supervisory Service (FSS)	<ol style="list-style-type: none"> 1. Restructuring of organization 2. Cost reduction 3. Increasing the efficiency of business unit Management 4. Restrictions in fixed asset investment, entry to new business, and new financial investment 5. Management of insolvent assets 6. Recapitalization 7. Restriction of dividend payout Special allowance for bad debts.
Management Improvement Requirements	< 6%	<ol style="list-style-type: none"> 1. Below the fourth rate in CAMELS 2. It seems evident that the above cut-off conditions are not satisfied because of the large financial debacle 	Governor of FSS (after the FSC vote)	<ol style="list-style-type: none"> 1. Closure or consolidation of existing business units or restriction of new ones 2. Retrenchment of organization 3. Restriction of holding risky assets and management of assets 4. Restriction of deposit rate 5. Restructuring of subsidiaries 6. Requirement of management turnover 7. Partial suspension 8. Planning of M&A, or transfer of business 9. Measures specified in Clause 2, Article 34 of the Act Concerning Structural Improvement of Financial Industry
Management Improvement Orders	Below 2%	Unsound financial Institutions specified in Clause 3, Article 2 of the Act Concerning Structural Improvement of Financial Industry	FSC	<ol style="list-style-type: none"> 1. Write-off of shares 2. Prohibition of execution by management and nomination of manager 3. M&A 4. Suspension for less than 6 months 5. Transfer of contracts

Source: Financial Supervisory Commission

<Table 24> Loan Classification Standard and Required Provisions

	Prior to July 1998	After July 1998
Definition¹		
Normal	-	-
Precautionary	3~6 month past due	1~3 month past due
Substandard	More than 6 months past due, secured	More than 3 months past due, secured
Doubtful	More than 6 months past due, unsecured	More than 3 months past due, unsecured
Estimated Loss	Expected losses	Expected losses
Loan loss reserve requirement		
Normal	0.5%	0.5%
Precautionary(Special mention)	1%	2%
Substandard	20%	20%
Doubtful	75%	75%
Estimated Loss	100%	100%
Provisioning for outstanding Guarantees	Not required	20% of “substandard”, 75% of “doubtful”, and 100% of “estimated loss”

Source: Financial Supervisory Commission.

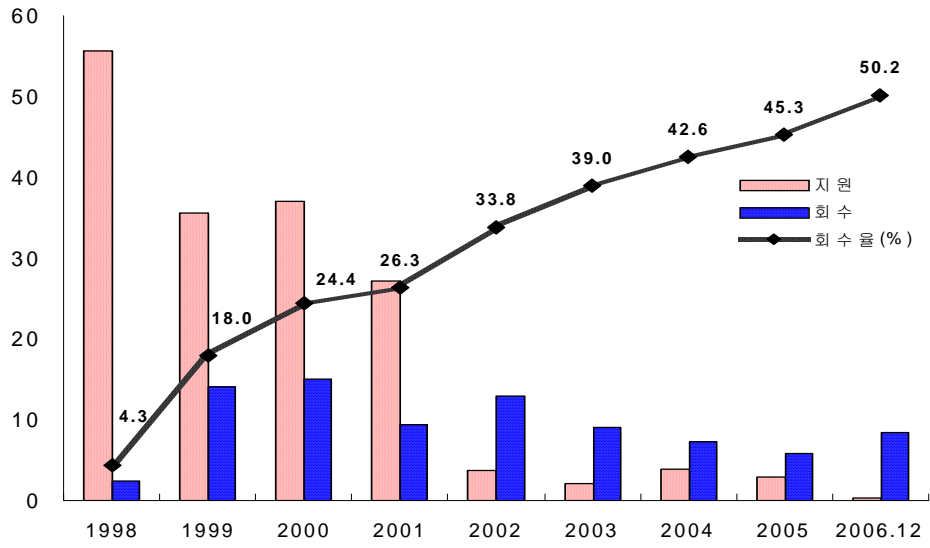
<Table 25> Ceilings on Credit Exposures of Financial Institutions

	Commercial Bank	Merchant Bank Company	Insurance Company
Credit Exposures to a Single Borrower	Up to 20% of bank's capital	Up to 20% of bank's capital	
Combined Credit Exposures to Firms Affiliated with the Same <i>Chaebol</i>	Up to 25% of bank's capital	Up to 25% of bank's capital	Up to 3% of total assets
Total Sum of Large Credit Exposures	Up to 5 times of bank's capital	Up to 5 times of Bank's capital	Loans and securities holdings up to 5% of total assets, respectively
Credit Exposures to Large Shareholders of Financial Institutions ¹⁾	Up to ownership shares of the Shareholder in question with maximum of 25% of bank's capital	Up to ownership Shares of the Shareholder in question with maximum of 25% of bank's capital	

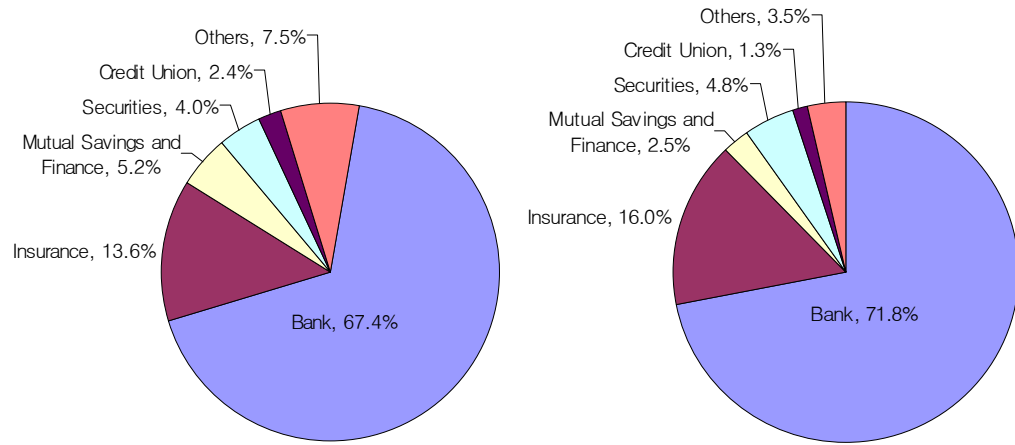
Note: 1) Large shareholders refer to those that own 10% or more of total shares with voting rights.

Source: Financial Supervisory Commission

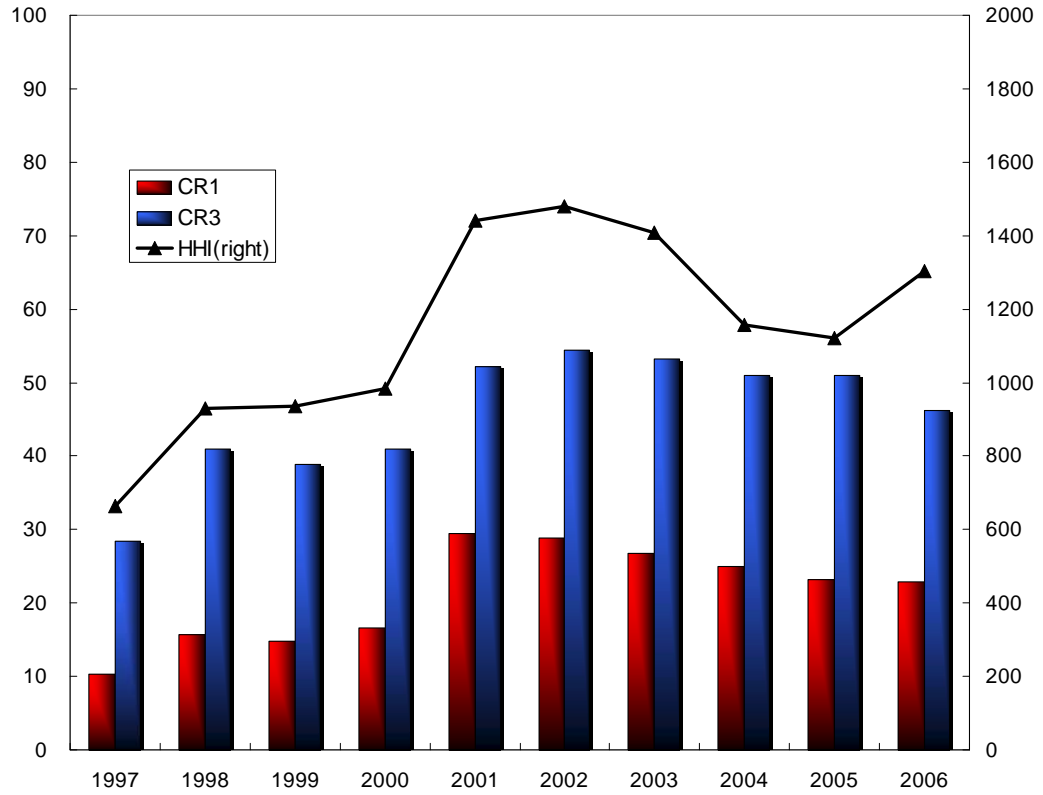
<Figure 1> Recovery Ratio of Public Funds



-- <Figure 2> Share of Assets by Sector --

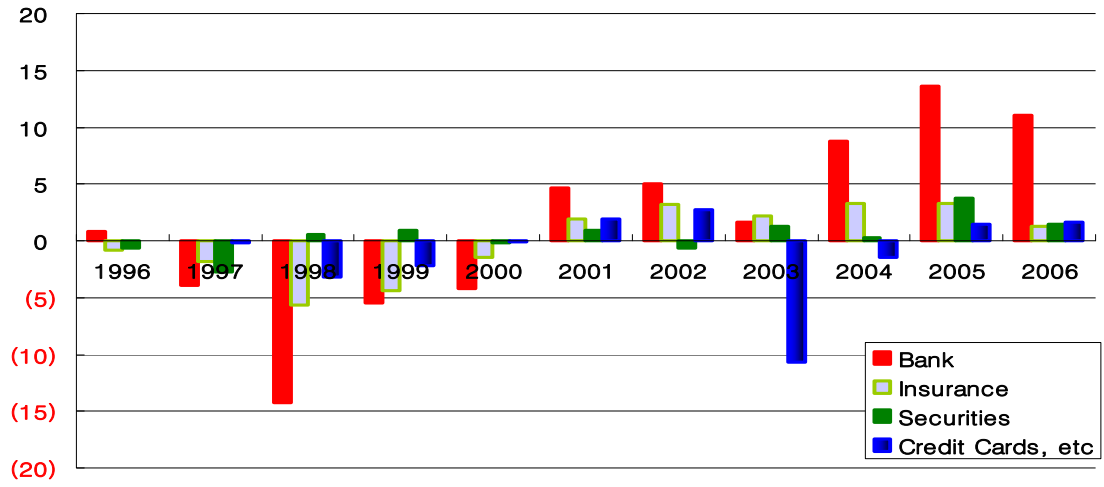


<Figure 3> Concentration Ratio of the Banking Sector in Terms of Assets

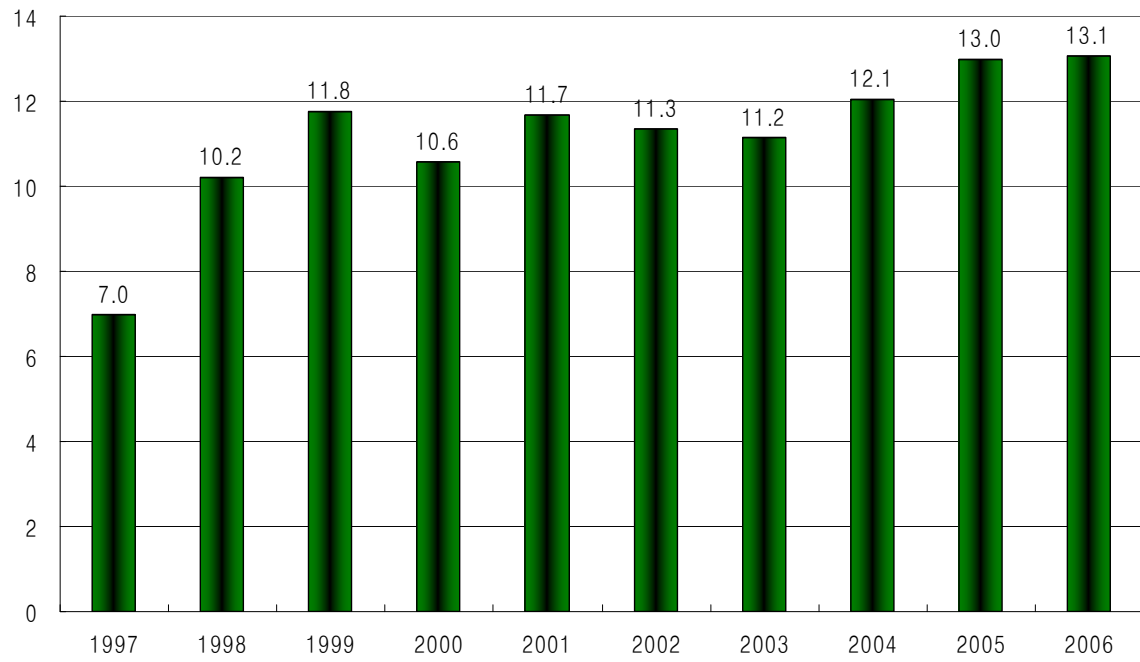


Note: 1) CR1: market share of the first largest bank in the market.
 2) CR3: market shares of the top 3 largest banks in the market.
 3) HHI: Herfindhal-Hirschman Index

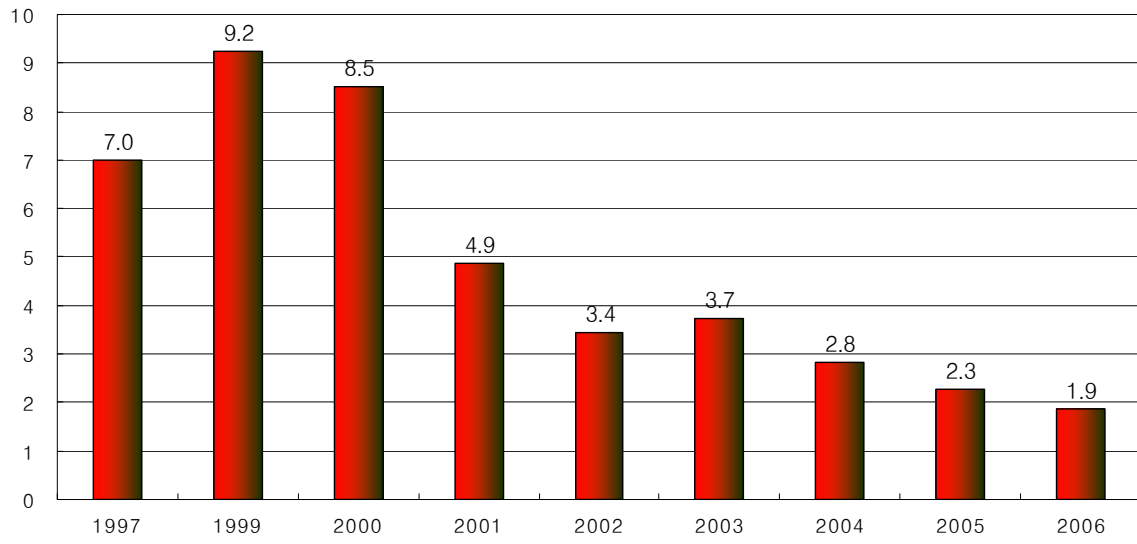
<Figure 4> Profitability: Profits/Losses for Financial Industries (in Trillion Won)



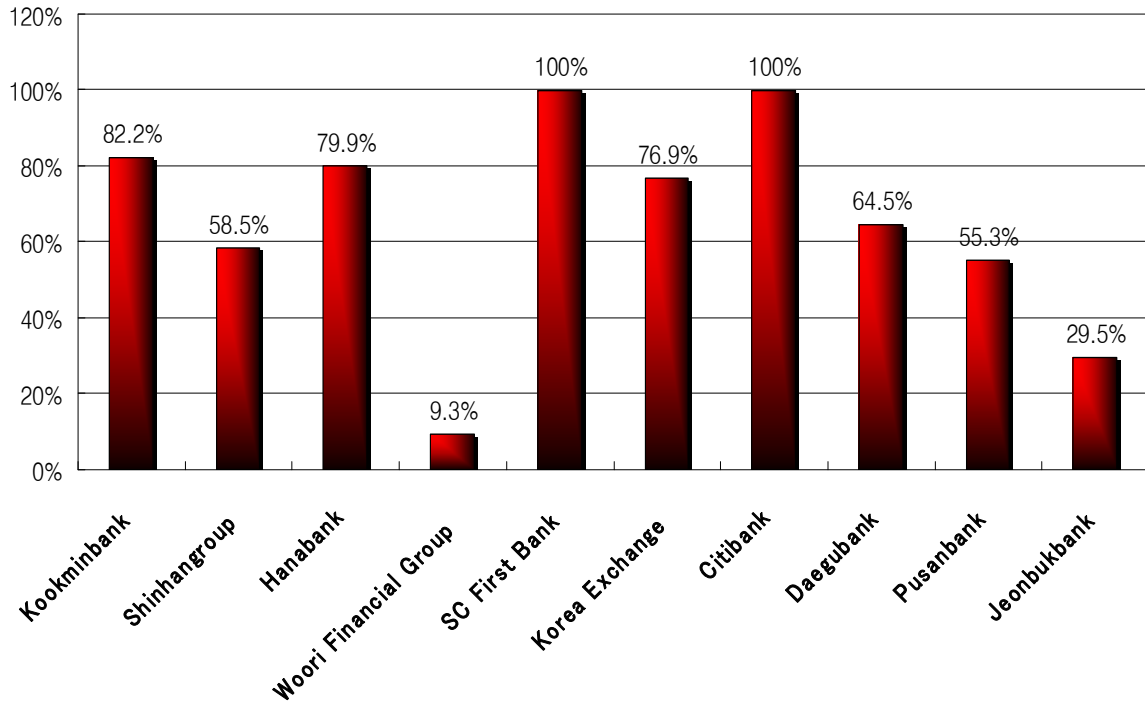
<Figure 5> Banks' BIS Ratio (%)



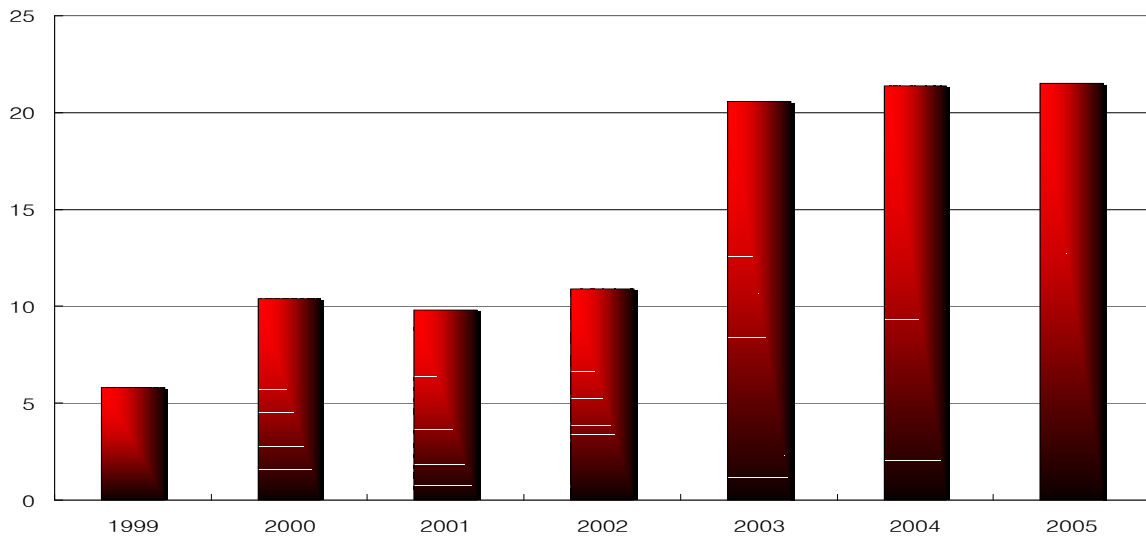
<Figure 6> NPL Ratio for the Entire Financial Industries (%)



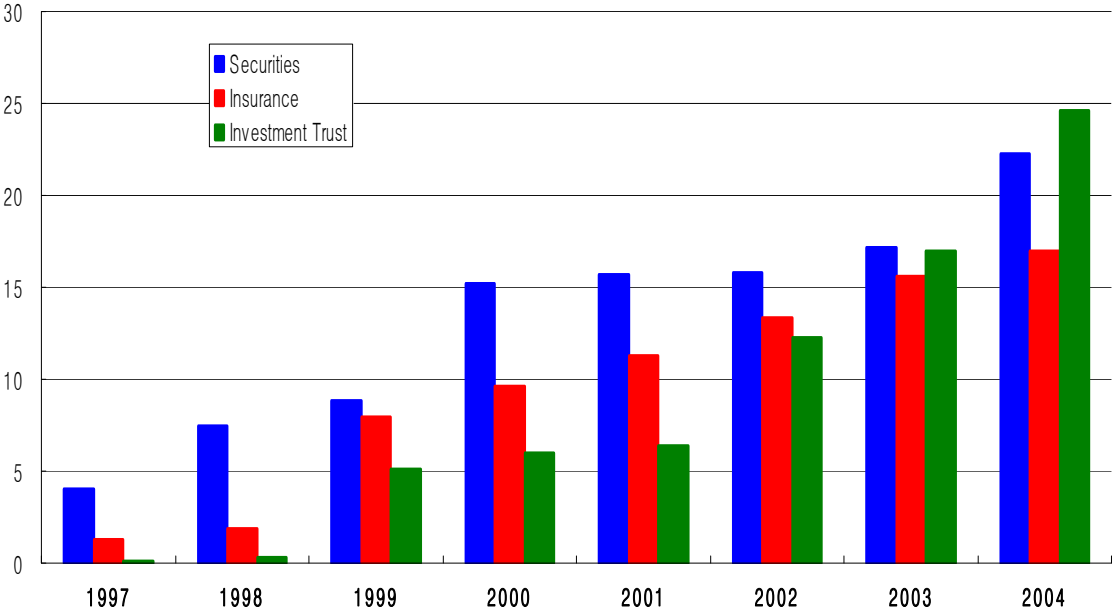
<Figure 7> Share of Foreign Ownership in Korea



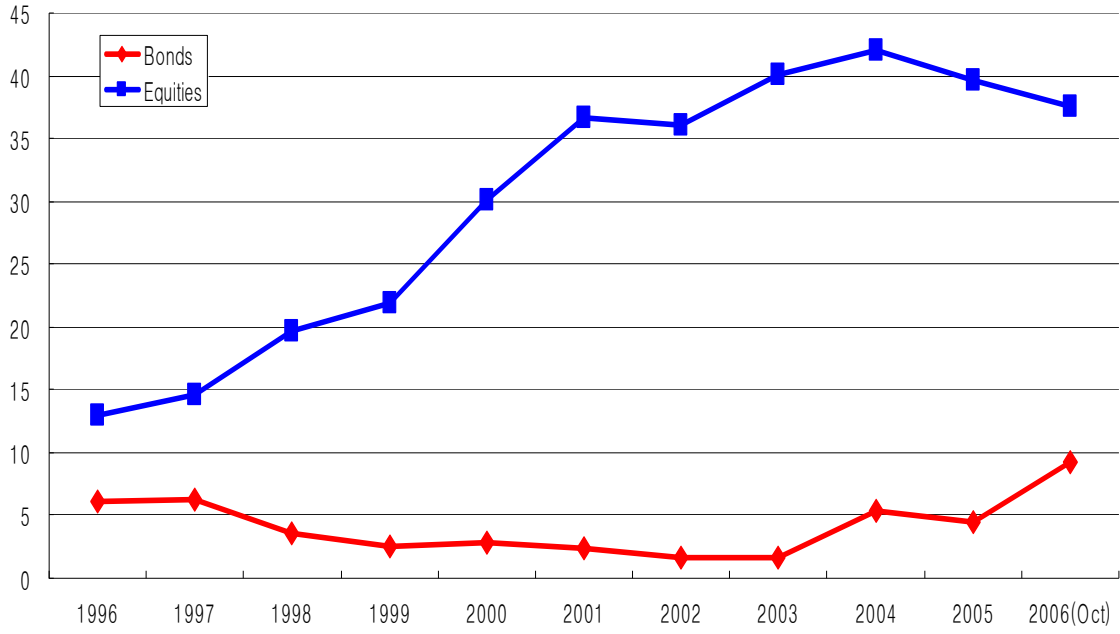
<Figure 8> Market Share of Foreign Owned Banks in Korea



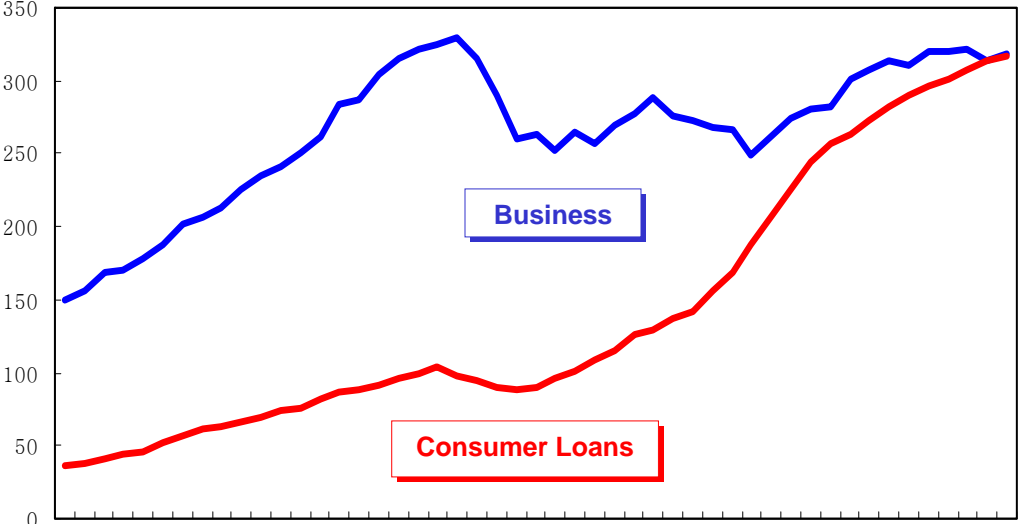
<Figure 9> Market Share of Foreign-Owned NBFIs by Industry



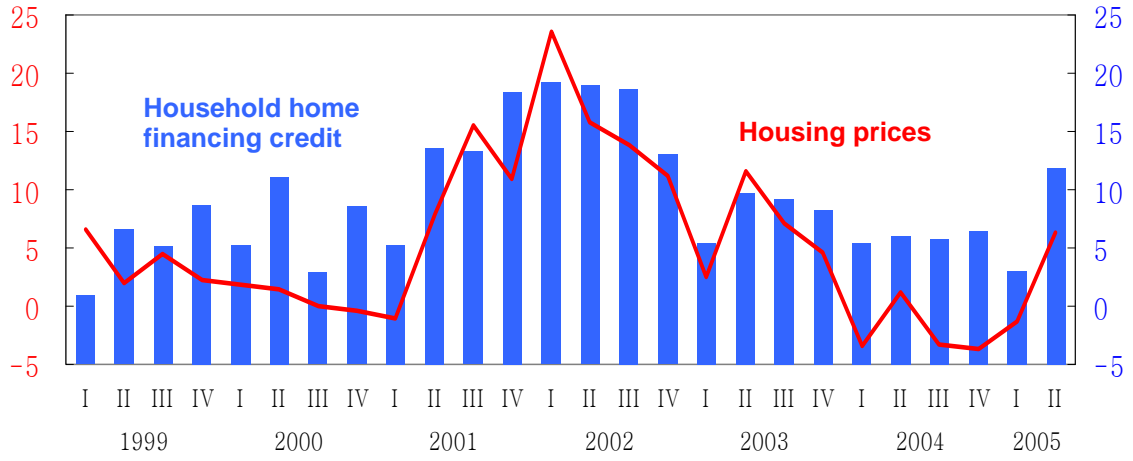
<Figure 10> Foreigners' Share of Equity and Bond Markets



<Figure 11> Outstanding Loans of Financial Institutions by Sector

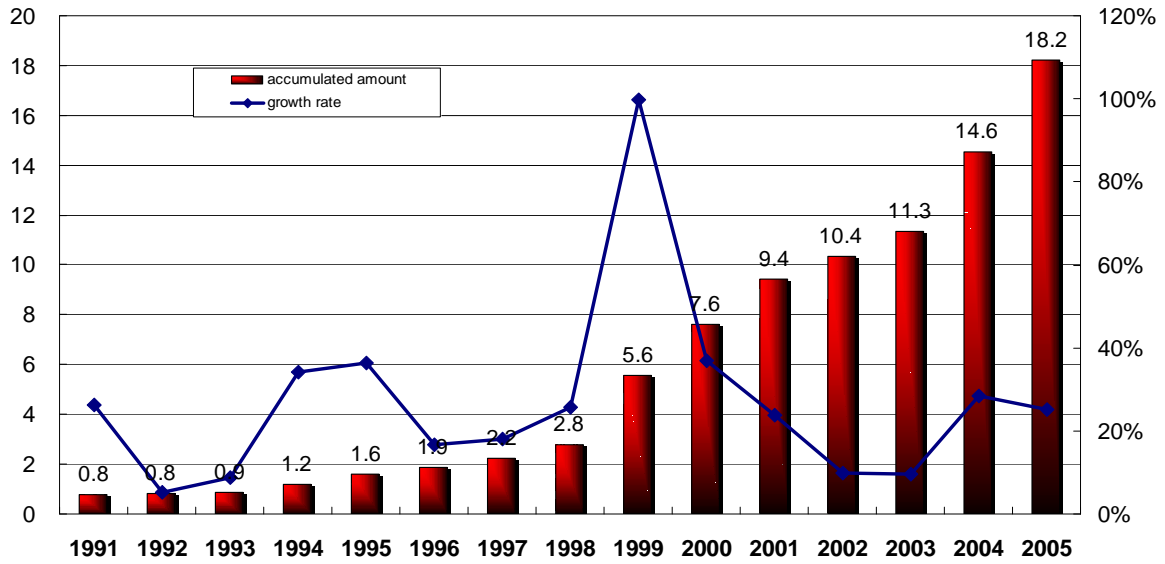


<Figure 12> Growth of Household Credits and Housing Prices



<Figure 13 Ratio of Consumer Credits to Personal Disposable Income
(To be added)

<Figure 14> Inward FDI in the Financial Industry (in billions of dollars)



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Notes

¹ This system has many of the features associated with “coordinated market economies” (v. “liberal market economies”) but is not the same as the latter. See Hall and Soskice (2001) on coordinated v liberal market economies.

² According to Cho (1994, p.29), the Japan that President Park Chung Hee took as a model for economic development was the Meiji Japan of the late 19th century. For example, Park followed the Meiji slogan for promoting a strong economy and a strong military, encouraging the rapid development of big corporations as a means for achieving a strong economy.

³ This system has a precedent in the 19th century Europe where, according to Gerschenkron (1962, ch.2), industrialization in its “backward” parts took place under the organized direction of investment banks acting alone or under the aegis of the state, which he attributes in part to “absence or presence of certain prerequisites.” These include certain social norms such as “minimum acceptable standards of commercial honesty” and the “spirit of respect for contractual obligations” (p.48).

⁴ According to Nam (1992), then the finance minister of Korea, he was compelled to establish NIF, given the imperative of the heavy industry program for project financing, and thus minimize the burden on the banking system.

⁵ What constitutes policy loans during the 1960s and 1970s in Korea is rather complex as all major banks were owned by the government and set the interest rates on bank loans substantially lower than the market rate. Given this, all bank loans could be considered policy loans. We define policy loans as loans with preferential interest rates and supported by the central bank's automatic rediscounts. Specifically, in this section, policy loans are export loans, equipment loans to the export industry, discounted commercial bills, loans to the agriculture/fisheries/livestock sectors, NIF, housing loans, foreign currency loans, and other government funds.

⁶ This section draws heavily on Lee (1992).

⁷ This organizational structure is in the tradition of patrimonialism, a “form of rule in which power is held by a patriarch and administered through a personal staff, which has a long historical root in Korean society” (Biggart 1997, p. 217).

⁸ Noland (2005) acknowledges that the Korean economy grew spectacularly while its capital markets were under strict government control but refuses to speculate on the causal relationship.

⁹ According to Cho and Kim (1997), Korea's directed credit policy had positive effects on export growth, the development of heavy and chemical industries, and the success of the Pohang Steel Company, now one of the major steel producers in the world.

¹⁰ On the efficiency of the internal capital market, Alchian (1969) writes: "The investment funds (capital) market *within* General Electric is fiercely competitive and operates with greater speed to clear the market and to make information more available to both lenders and borrowers than in the external 'normal' markets. In fact, I conjecture that the wealth growth of General Electric derives precisely from the superiority of its internal markets for exchange and reallocation of resources – a superiority arising from the greater (cheaper) information about people and proposals."

¹¹ To facilitate its communication with business the government created various institutions. These include the Korea Federation of Industrialists (KFI), the Korea Trade Promotion Corporation (KOTRA), and the Korea Trader's Association (KTA) (Cho and Kim 1997).

¹² For a discussion of how the QIO subsequently degenerated, see Nam (2001).

¹³ This section draws heavily on Lee, Lee and Lee (2002).

¹⁴ Williamson and Haggard (1994) point out that during the 1980s there occurred a profound change in the intellectual climate in the West toward what is now commonly called neoliberalism and it had a powerful influence in policy reforms in many of the developing countries.

¹⁵ Other considerations were also at play: the proceeds from the sale of government shares were expected to help ease the government budget constraint in a period of fiscal austerity and the supply of "good stocks" would stimulate the stock market (Choi, 1993).

¹⁶ The 8 percent ceiling was maintained until 1994 when it was replaced by an even tighter 4 percent ceiling.

¹⁷ The government provided financial incentives to creditor banks to write off bad debts, extend debt maturity, and replace the existing debt with longer term debt at a preferential rate. To induce mergers and takeovers by sounder firms it offered financial packages that included cheap bank loans and supplied a significant amount of new loans (called the "seed money"). For instance, the shipping industry was rationalized to facilitate its 1984-85 restructuring. Sixty-three shipping companies were merged into 17, and about 3 trillion won of loan principals and interest owed by the shipping companies was rescheduled to be repaid over a 20-year period after a 10-year grace period at a very low interest rate. In the meantime, to mitigate the financial burden of involved banks, BOK delivered a special loan of about 1.8 trillion won (which comprised 5 percent of total bank loans) at the exceptionally low annual interest rate of 3 percent when the general bank loan rate was around 12 percent.

¹⁸ Samsung was the first to float bonds in a foreign bond market in 1985. Subsequently, many other *chaebols* floated bonds abroad. The accumulated total sum for 1986-94 reached \$4.9 billion.

¹⁹ There were other groups such as small and medium-sized firms that opposed the real name system, but *chaebols* were the most well organized group opposed to it and were most effective.

²⁰ Bank Supervision Office, the Bank of Korea (*Han-Kuk-Il-Bo*, April 25, 1991). Subsequently, the government achieves some success in forcing *chaebols* to sell land. The delay is, however, an indication of the weakened power of the state to enforce its policies relating to *chaebols*.

²¹ The Ministry of Finance and Economy supervised long-term foreign capital transactions while the Bank of Korea had jurisdiction over short-term capital inflows. The latter had reportedly a greater predilection toward financial liberalization than the former.

²² Reported at various hearings at the National Assembly of the Republic of Korea

²³ Reported at various hearings at the National Assembly of the Republic of Korea

²⁴ Regulators assessing the effect of mergers on concentration in local financial markets typically rely on HHI. U.S. Department of Justice divides the spectrum of market concentration into three categories: "not concentrated" (HHI below 1,000), "moderately concentrated" (HHI between 1,000 and 1,800), and highly concentrated (HHI above 1,800).

²⁵ Prior to the crisis in Korea, there existed two types of financial groups. One was a "financial conglomerate" defined as "*any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance).*" (**Joint Forum on Financial Conglomerates, 1999**). Since the holding company structure was prohibited in Korea due to fears of suppressing competition, financial conglomerates were

established under a parent-subsiary model in the mid-1980s, in which their organizational structure took the form of a parent's participation in financial subsidiaries. Later on, financial holding companies were introduced in the wake of the crisis as a part of the government's restructuring efforts. The other form of financial group prevalent in Korea was a "mixed conglomerate," which were predominantly commercially oriented but contained at least one regulated non-bank financial institution (NBF). In Korea, many NBFs are owned by the *chaebols*. According to the Fair Trade Commission, the amount of assets of the 10 largest mixed conglomerates totaled about 172 trillion won as of April 2005, of which Samsung's share totaled about 110 trillion won or 64 percent (Hahm and Kim, 2006).

²⁶ To obtain measures for financial risks, Hahm and Kim (2006) use both the standard deviation on the return on asset (ROA) and the z-score index. The z-score was constructed by dividing the sum of average ROA and the average equity capital to asset ratio with the standard deviation of ROA for a certain period.

²⁷ With the introduction of internet-banking in 1999, the number of customers using the internet-banking increased to over 10 million in less than two years, reaching over 30 million in 2006. As of March 2006, transactions conducted over the internet totaled 65 million per month, amounting to 470 trillion Won. Kim and Park (2003) tested the hypothesis that internet-banking reduces the cost and ultimately enhances bank profitability. Their analysis suggests that internet-banking does contribute to cost reduction but does not necessarily affect profitability. This implies that internet-banking raises social welfare by passing on the benefit of cost reduction to customers through fee reduction.

²⁸ At first, two nation-wide banks, Hanvit and Peace, and two regional banks, Kwangju and Kyungnam, were placed under a government-run holding company, Woori Financial Holdings. Prior to that, NPLs of the candidate banks were disposed of and public funds were injected to raise their capital adequacy ratios to above 10 percent. Aside from the banks, a securities company, an investment trust company (ITC), and a credit card company were placed under the Woori holding company structure. Then, in September 2001 a second financial holding company, Shinhan Financial Holdings, was established, bringing together under its control Shinhan Bank, Cheju Bank, a credit card company, a life insurance company, a securities company, and an ITC. In September 2003, Chohung Bank, the fourth largest bank at the end of 2002, was also placed under the Shinhan Financial Holdings, making it the second largest financial group in Korea. In 2003, another FHC, Dongwon Financial Holdings, was established. However, unlike Woori and Shinhan Financial Holdings, only NBFs were placed under this holding company. In December 2005, Hana Financial Holdings, the fourth financial holding company group in Korea, was launched, controlling four major subsidiaries – Hana Bank, Daehan Investment Securities, Hana Institute of Finance, and Hana INS.

²⁹ This section draws heavily on Kim and Lee (2006).

³⁰ Ministry of Finance and Economy: "About MOFE" <www/english.mofe.go.kr>.

³¹ World Bank, "Financial Sector Assessment Korea," pp. 6–7 (emphasis in the original). The Securities and Futures Commission (SFC), which appears in this quotation, is a subcommittee under FSC and has five members. The FSC vice-chairman presides over SFC, which is responsible for oversight of securities and futures markets. Here we make no distinction between FSC and SFC, given that the former includes the latter organizationally.

³² Among such informal institutions are "strict order-obedience" and "exclusive cohesion," which underlie the bureaucratic culture of government officials in general, and "deep-rooted elitism," which is instilled in MOFE officialdom in particular. These three characteristics have their roots in Confucianism, which is oriented toward preserving order and hierarchy across people and across social institutions (Kim 2004).

³³ As regards individual consumers, a credit defaulter is by definition a person who has loans in arrears in excess of KRW 300,000 (US \$261 at the exchange rate of US \$1 = KRW 1,150) for over three consecutive months. For the definition, see Ministry of Finance and Economy, "Credit Defaulters: Current Situations and the Direction of Policy Responses" (in Korean), news release, March 10, 2004. Individual consumers who were on the list of credit defaulters totaled over 3.7 million at the end of 2003. The default by 2.4 million (64.4 percent of these credit defaulters) was related to credit card uses. Compared with the situation at the end of 2002, the year 2003 saw a dramatic increase both in the number of credit defaulters (1.1 million) and in the number of credit card-related credit defaulters (0.9 million). The ratio of the latter to the former also increased from 56.7 percent to 64.4 percent in 2003. Since Korea had about 22.9 million economically active people at the end of 2003, we can surmise that roughly one person out of six was a credit defaulter and one out of nine or ten a credit card-related credit defaulter (Bank of Korea 2004). For relevant statistics, see Ministry of Finance and Economy, "Credit Defaulters," The register system of credit

defaulters was abolished on April 28, 2005, when the Act for the Use and Protection of Credit Information was revised. Now efforts are being made to build up the infrastructure for managing credit information, such as credit bureaus.

³⁴ Here an exchange rate of US \$1 = KRW 1,150 is used for conversion.

³⁵ Most of these practices became widely used by early 2001 and rapidly popularized by street solicitors who were under contract with credit card companies. At the end of 2000, there were 31,000 credit card solicitors nationwide, and they contributed to 58 percent of the total of 18.3 million credit cards newly issued during 2000 (FSS 2001).

³⁶ Hong (2004) points out that the absence of a credit rating system and appropriate bankruptcy laws is accountable for the problems relating to credit card companies in Korea. The United States experienced a similar expansion in credit card uses after deregulation but did not suffer as severe consequences as Korea did, since it had a well-developed credit rating system and bankruptcy laws.

³⁷ The Financial Policy Coordination Committee, an ad hoc organization without any legal basis, usually meets eight times a year to discuss financial and/or macroeconomic policies. For years the committee was allegedly known as the only channel of communication among the public agencies concerned. The Financial Policy Coordination Committee served not as a channel for interagency cooperation and coordination but as a means for justifying MOFE's policy dominance over FSC/FSS and BOK (Kim 2004).

³⁸ The Ruling Party–Administration Consultation Meeting is held two or three times a year on an irregular basis. It is likely that at such meetings political influence, if not political pressure, is transmitted to supervisory agencies, thus compromising their operational independence.

³⁹ The ceiling ratio was correctly regarded then as one of the most powerful direct measures with a great impact on profitability and business patterns of credit card companies.

⁴⁰ The incidents that BAI reports include those in which MOFE has turned down or delayed a request made by FSC for revision of relevant legislation, and those in which the line of demarcation between laws and regulations has been drawn arbitrarily by MOFE with the result that the competent authorities that are responsible for applying the same rules (e.g., capital adequacy ratios) or the same procedures (e.g., licensing) may often differ—either MOFE or FSC in this matter—across sectors and types of financial institutions such as banking, securities, merchant banks, insurance companies, credit card companies, and savings banks. See Board of Audit and Inspection, “The Audit Report”; Board of Audit and Inspection, “Requisition of Measures.”

⁴¹ The BOK Monetary Policy Committee consists of seven members: BOK governor and vice-governor and five members recommended by five institutions and appointed by the president of the Republic of Korea. The five institutions are BOK, MOFE, FSC, the Korea Chamber of Commerce and Industry, and the Korea Federation of Banks, each recommending one prospective member. With its ability to influence most of those institutions, MOFE has a strong voice in the selection of the members of MPC.

⁴² The belated turnaround in policy as well as the abrupt implementation of strict measures led, according to an anonymous referee, to a hard landing. Better policies would have softened the impact of the credit card problem but would not have stopped it, which was a consequence of poor financial supervision.

⁴³ Lim and Hahm (2004) also are not certain about the financial system that will emerge in Korea as a result of the post-crisis financial reform package, which is more consistent with a market-based system than a bank-based system. In contrast, Park *et al.* (2004) see a simultaneous development of both market-based and bank-based financial systems in more developed East Asian countries such as Korea.

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