

# Financial Reform, Institutional Interdependency and Supervisory Failure in the Post-Crisis Korea

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## Abstract

In the aftermath of the economic crisis of 1997-98 South Korea undertook a number of reforms in financial supervision. Questions have been raised, however, as to whether Korea has in fact succeeded in creating a system of financial supervision capable of dealing with certain risk and responding to new challenges. This paper examines Korea's recent experience in financial instability resulting from misconduct by credit-card companies as a case in point and argues that the post-crisis reform in financial supervision was limited to changing formal institutions for financial supervision and further reforms will have to be undertaken in other related institutions if Korea is to improve its financial supervision

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## **1. Introduction**

In the aftermath of the economic crisis of 1997-98 South Korea (henceforth Korea) undertook a number of reforms in financial supervision: it created the Financial Supervisory Commission (FSC) in April 1998 and established the Financial Supervisory Service (FSS) in January 1999. The former was created to function as an integrated supervisory agency for all types of financial institutions and markets while the latter 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 this new system of integrated financial supervision FSC/FSS are 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 non-bank financial institutions (NBFIs). With these changes in place MOFE, FSC/FSS, BOK, and KDIC are the four public agencies that are now responsible for keeping Korea's financial system efficient and stable.

All these changes clearly attest to the fact that Korea has successfully undertaken a number of major institutional reforms in financial supervision immediately following the financial crisis of 1997-98. In spite of these reforms doubts, however, have been raised as to whether Korea has in fact succeeded in creating a well-functioning system of financial supervision (Kwon 2004). For instance, a World Bank report on Korea's financial sector reform, which seemingly commends Korea for having taken significant steps toward reforming its financial sector, notes that "[d]espite notable progress in prudential supervision, concerns remain about the regulator's ability to supervise certain risks in an integrated, coherent manner and to respond to new challenges" (World

Bank 2003: 2). The recent costly financial instability relating to credit-card companies and household debts in Korea is a case in point that renders support to the concerns raised by the World Bank and others about Korea's "success" in reforming its financial supervisory system.

In this paper we argue that the post-crisis reform in financial supervision in Korea was largely limited to changing formal institutions<sup>1</sup> for financial supervision and that reforms will be needed in other institutions relating to their proper functioning if Korea is to further improve its 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. Lacking *de facto* independence 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 recent financial instability. 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 that] ... [s]teps should be taken to reassure markets that the independence of the regulator is important.”<sup>ii</sup>

The remainder of the paper is as follows. In section 2 we argue that institutional interdependency affects the outcome of an institutional reform and present a number of empirical cases that attest to this relationship. In section 3 we then argue that the post-crisis financial reform in Korea has failed to change fundamentally the way financial supervision is carried out due to institutional interdependency. In section 4 we focus on the problems relating to credit-card companies and point out how the various public agencies created or restructured by the reform have failed to properly supervise them. In the final section we offer some concluding remarks.

## **2. Institutional Interdependency and Reform of Institutions**

Why has Korea, in spite of its apparent success in reforming its financial system, failed to create regulatory agencies that are, according to the World Bank assessment, less than fully capable of handling risks and challenges? The answer

may lie, as suggested by the World Bank, in Korea's success in bringing about a rapid economic recovery from the financial crisis; it made further reforms appear less urgent or even not necessary. That may indeed be true but it is only a part of the answer. Another reason for the partial progress in financial reform, which we argue is much more important, is that in reforming the system of financial supervision Korea has limited the *scope* of reform to institutions and organizations directly involved in financial supervision and has left more or less intact other institutions that, although not specific to financial supervision, affect the functionality of the reformed supervisory agencies. With those institutions remaining intact the supervisory agencies have not been able to operate as effectively as their statutory mandates have called for. In other words, by limiting the scope of reform only to institutions and organizations directly involved in financial supervision Korea has failed to create the right institutional structure<sup>iii</sup>—a set of interdependent institutions—in which the supervisory agencies are embedded and operate.

Institutions in a society do not function in isolation due to

interdependency among them that makes the functionality of a particular institution depend on other institutions (Amable 1999, Aoki 2001, Boyer 2005, Fukuyama 2004, Lin and Nugent 1995). This institutional interdependency<sup>iv</sup> thus makes it difficult to alter or design individual institutions in isolation. It also implies that an institutional reform, whether it is for establishing *de novo* a new institution or for changing some of the extant institutions, may fail to create an effectively functioning institution if either (1) the institutions that are complementary to it are absent<sup>v</sup> or (2) the new or reformed institution is not compatible with some of the extant institutions.<sup>vi</sup> In the first case the absence of complementary institutions would deter the new or reformed institutions from functioning effectively while in the second case the presence of incompatible institutions would limit their effectiveness.

Institutional interdependency thus implies that for an institutional reform to succeed in achieving its intended objectives it will have to be accompanied by reforms that either create complementary institutions or abolish incompatible institutions or both. Obviously, reforming all the interdependent institutions along

with the particular institution being created or reformed in a “big-bang” manner will not be an easy task, given that the number of such institutions may be large and reforming all of them at once would be too costly, if not impossible. Further compounding the difficulty of such reforms is that at the time of reform little may be known *a priori* about the institutions that are either complementary to or incompatible with the institution being newly created or reformed. Such information may become known only after the reform and even then only after the passage of some significant length of time.

The problem becomes more serious when institutional interdependency is between formal institutions that are newly created or transplanted from abroad and the country’s indigenous informal institutions such as social norms and conventions, which are slow to change. This interdependency seriously limits the autonomy and thus the effectiveness of the new institutions as they are to function in conjunction with the extant institutions that are embedded in a “culture in which their logics are symbolically grounded, or organizationally structured, technically and materially constrained, and politically defended”

(Hollingsworth and Boyer 1997: 2). Thus the country introducing new formal institutions from abroad may find them not functioning as well as they did in the country of their origin (Boyer and Hollingsworth 1997, Leipold 1991, Lin and Nugent 1995, Ruis and van de Walle 2003). Such interdependency may not be obvious, being revealed only after new institutions have been installed, and makes institutional reform a path-dependent process with slow-to-change informal institutions constraining the choice of new institutions that can function effectively. Below we provide several empirical cases attesting to the thesis that due to institutional interdependency a piecemeal institutional reform may fail to achieve its intended objectives. The first set of cases relates to the absence of complementary institutions as an obstacle to institutional reform, and the second to the persistence of incompatible institutions.

### ***2.1. Absence of Complementary Institutions as an Obstacle to Institutional Reform***

A good example of the importance of complementary institutions for effective

institutional reform is provided by North (1990). According to him, the Constitution of the United States has facilitated economic development in that country whereas similar constitutions adopted in many Latin American countries after their independence in the 19<sup>th</sup> century have not done as well there. He attributes this difference to the absence of appropriate complementary institutions in the Latin American countries: Their norms and world views are less conducive to innovation and growth, and the effective enforcement mechanisms that are crucial for the development of a complex system of contracting and a world of specialization and division of labour have been lacking.<sup>vii</sup>

Another example of the absence of complementary institutions as an obstacle to effective institutional reform is found in some of the Asian countries afflicted by the 1997-98 financial crises. In countries such as Indonesia, Malaysia, South Korea, and Thailand it was the opening of their financial markets when complementary institutions such as well-functioning supervisory agencies and an effective legal system were either absent or weak that contributed to their succumbing to financial crisis (Lee 2003). A similar situation was found in Japan,

which suffered a systemic banking crisis in 1997-98. One of the causes of the crisis was, according to Kawai (2005), the overextension of bank loans in risky areas during the bubble period of the second half of the 1980s. Deregulatory measures such as the lifting of interest rate controls and of restrictions on non-bank lending in the 1980s allowed small financial institutions to venture into new areas such as funding housing finance companies (*Jusen*) and other real estate investments when an adequate regulatory and supervisory framework was yet to be put in place.<sup>viii</sup>

In his critique of the post-crisis OECD/World Bank initiative to reform corporate governance in emerging market economies, Singh (2002) argues that the attempt to introduce “best practice” in corporate governance in those countries, which is, according to him, essentially the Anglo-Saxon model of corporate governance, is misguided. As he puts it, emerging market economies do not yet have the economic, social and legal institutional framework (e.g., information gathering and disseminating private organizations and regulatory agencies) in which the markets in the developed countries are embedded, and in

its absence large conglomerate firms such as Korea's *chaebol* help fill the institutional void. As Singh sees it, an institutional reform that replaces conglomerate firms with the Anglo-Saxon model will not improve corporate governance in countries where the appropriate institutional framework, which takes a long time to develop, is absent.<sup>ix</sup>

## ***2.2. Persistence of Incompatible Institutions as an Obstacle to Institutional Reform***

The Icelandic government's attempt to improve farmers' livestock management in the late 19<sup>th</sup> century provides an example of the persistence of incompatible institutions as an obstacle to effective institutional reform. The government passed laws requiring the provision of fodder and prudent management of livestock in order to stop soil erosion and sheep overgrazing and help farmers cope better with vicissitudes in hay production resulting from severe changes in weather. The laws had, however, little impact on the farmers' behavior as they were incompatible with Iceland's age-old "Good Samaritan-norm," an informal

social security system based on sharing (Eggertsson 2001). This Icelandic case clearly demonstrates the powerful influence that incompatible informal institutions exert on the functionality of newly introduced formal institutions.

Another example may be found in the slow pace of reform in the Japanese economic system since the early 1990s. It is an economy that needs, according to many astute observers of Japan, major reforms in many of its institutions such as life-long employment, pay by seniority, cross-shareholdings, and relations between the government and private sector through the use of administrative guidance, which are the features of the Japanese economy commonly cited to differentiate it from the Anglo-American economic system (e.g., Sato 2002). According to Okuno-Fujiwara (1999), there is mutual complementarity among these structural elements, and while it gives the Japanese economic system its robustness and stability the complementarity makes it difficult to reform the Japanese economic system: For it to change, all the elements of the system will have to change together throughout the whole society. A piecemeal reform that changes some while others remain intact will not

succeed.<sup>x</sup>

In the following sections, we examine the post-crisis reform in financial supervision in Korea as a case in which the persistence of incompatible institutions has hampered the functionality of the reformed institutions. We argue that the reform was limited to changing the specific agencies and institutions that were directly involved in financial supervision, leaving very much intact other institutions that affect their functionality. The price Korea has paid for such a 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.

### **3. Has the Institutional Reform Brought about Any Change in *Modus***

#### ***Operandi* in Financial Supervision in Korea?**

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 (Lee, Lee and Lee 2002).

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 inter-agency 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<sup>xi</sup> 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). In this regard it is worth quoting fully a passage from the World Bank report on Korea's financial sector reform (2003: 6-7, bold face in the original):<sup>xii</sup>

**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 as it left intact other institutions that affect the functionality of the reformed institutions. In the following section, we discuss the supervisory failure relating to credit-card

companies as a case in point. 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 the functionality of the supervisory agencies.

#### **4. Supervisory Failures Relating to Credit-Card Companies<sup>xiii</sup>**

In 2003, the financial markets in Korea suffered instability with serious prudential problems relating to credit-card companies and huge household indebtedness. In March 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 (Kim 2004b). 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, 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 yearend of 2003 there were over 3.7 million<sup>xiv</sup> credit defaulters<sup>xv</sup> (one-sixth of Korea's economically active population) with total credit to household amounting to US \$389.2 billion<sup>xvi</sup> (over three-fifths of Korea's GDP for 2003) (BOK 2004, MOFE 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:

[G]ranting 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 offer 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 ....<sup>xvii</sup>

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.<sup>xviii</sup> The following discussion, based on a detailed examination by one of the authors of the relevant documents and data published by MOFE, FSC/FSS, and BOK during the 1999-2003 period, reports how these public agencies failed in their role as supervisory agencies (Kim 2004a and 2004b).

#### **4.1. MOFE**

MOFE began undertaking a series of deregulatory measures for credit-card companies in 1997-99. It included expanding the scope of financial activities permitted (*e.g.*, cash advances and card loans), removing the corporate borrowing limit (20 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 (FSS 2003).<sup>xix</sup> 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 receipts of credit-card payments, requiring corporate entertainment expenses to be paid with corporate credit cards, and offering further tax breaks for credit-card purchases (FSS 2003).<sup>xx</sup>

These deregulatory measures were undertaken as part of government policies aimed at boosting domestic demand in the post-crisis economy.<sup>xxi</sup> These and other actions taken by MOFE to stimulate real estate investment in the middle of 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, as evidenced in widespread practices such as

“indiscriminate granting of credit cards – often to unqualified or ineligible applicants” and “street solicitation” for membership (FSS 2002). 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 1997-98.

In February 2002, the Financial Policy Coordination Committee,<sup>xxii</sup> 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 debts. As it turned out, however, the public agencies did not regard it as a top priority issue as 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 reservation at taking *excessive* measures against household indebtedness, as it feared they 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 Meeting<sup>xxiii</sup> and agreed to make an aggressive effort to combat the prudential problems relating to credit-card companies and household debts. 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 the middle of 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 the middle of 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.

#### ***4.2. 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 were, 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 (BAI 2004b). Faced with MOFE's opposition, FSC attempted on its

own in May 2001 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.<sup>xxiv</sup> 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 because of the fear 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 but then one whole year later than thought appropriate and necessary by FSC/FSS.

The inability of FSC/FSS to reintroduce the ceiling ratio clearly demonstrates the lack of their autonomy in carrying out the supervisory task that was alluded to in the World Bank report (2003). 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, turning them practically impotent in carrying out their statutory responsibilities especially when in conflict with MOFE's own policy objectives (FSS 1999). In fact, IMF (2003: 24) also noted in its report on Korea that "prudential regulators lack the unfettered right to issue new regulations when they perceive a need to do so." In this regard it is notable that the Board of Audit and Inspection (2004a, 2004b) provides delineations of several specific incidents in which MOFE has dominated FSC/FSS in supervisory issues on prudential problems of credit-card companies.<sup>xxv</sup>

Until May 2002, FSC/FSS were sending out mixed signals regarding the problem of household debts. In April 2002 they announced plans to strengthen prudential supervision of credit-card companies, but soon after that in the same month FSC Chairman 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.

#### **4.3. BOK**

BOK itself took note of marked increases in cash advances of credit-card companies and in household debts as early as in 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 debts 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 debts.

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 debts.

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 towards prudential problems relating to credit-card companies and household debts 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 the 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.<sup>xxvi</sup>

#### ***4.4. Synopsis and Policy Implications***

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 stance was in a stark contrast with the inconsistent and ambiguous attitudes they had adopted before in

public and 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 that 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 autonomy.

In short, the prudential problems relating to credit-card companies and household debts 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 inter-agency supervisory coordination necessary for solving the credit-card and household-debt problems were simply relegated to a back burner until the

problems reached crisis proportions and became serious enough to dominate other policy issues.

What should Korea do to secure the *de facto* independence of the supervisory agencies from MOFE? First, it should stop the practice of rotating appointments of supervisory government officials, which has hampered FSC from acting as an independent agency and developing its own cadre of experienced and skillful technical experts. Second, Korea should introduce greater transparency and openness in government decision-making. The lack of transparency and openness in decision-making in government may lead to a purposeful cover-up of supervisory problems, thus reinforcing the tendency towards regulatory forbearance and political/industrial capture of supervisory officials. Third, Korea should change the highly hierarchical structure of the government that places MOFE above other public agencies such as FSC/FSS and BOK. This organizational structure has allowed MOFE to dominate them in policy matters and, specifically, to subordinate their supervisory task to achieving its short-term macroeconomic objectives. As long as the current hierarchical

relationship between MOFE and the other public agencies persists there is the possibility that financial supervision will be subordinated to MOFE's other policy objectives. Severing that relationship is thus a *sine qua non* for creating supervisory agencies that are fully dedicated to and capable of carrying out their statutory responsibilities.<sup>xxvii</sup>

## **5. Concluding Remarks**

The recent financial instability involving credit-card companies has cast doubts on whether the post-crisis reform in financial supervision has fundamentally changed the manner in which financial supervision is carried out in Korea. We have argued that in spite of the reform the supervisory agencies such as FSC/FSS and BOK were unable to function as fully independent entities due to constraints imposed on their operation by other institutions. Because of their incompatibility these institutions have influenced the functionality of the reformed supervisory agencies and will need to be reformed if these agencies are to operate with autonomy as mandated and develop their own technical competence.

Our analysis of the Korean experience in reforming financial supervision points to the complexity relating to institutional reform in general; that is, reforming a particular institution, if it is to be successful in effect, cannot simply end with it. The fact that there is interdependency among various institutions in a society implies that the reform of a particular institution will have to be accompanied by reforms in other institutions that affect directly or indirectly the functionality of the 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 prior to the reform while others may be revealed only afterwards (Streeck 2003). And some of them may be the society's overarching institutions such as culture and social norms and changes in such institutions, if possible, would have society-wide implications. Obviously, reforming all interdependent institutions at once—a sort of a “big-bang” approach—will be difficult, if not impossible, since we may have little knowledge about what they are prior to the reform and how they may interact with the particular institution in issue. This is also the conclusion that Lin and

Nugent (1995: 2362) reach at the end of their extensive review of the literature on institutions and economic development:

...mere transplantations of successful institutions from DCs to LDCs [are] at best, unlikely to have the expected positive effects on performance, and, at worst, may have rather disastrous effects. Where 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.

The necessity of such consideration suggests that there is no one-size-fits-all formula for institutional reform and that there is a limit to what science can teach us on how to carry out institutional reform. A successful institutional reform may thus require, as observed by Nee (1998), a poet's insight into the human condition as much as science.

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### **Endnotes**

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<sup>i</sup> In this paper we follow Douglass North's definition of institutions; that is, any form of constraint that human beings devise to shape human interaction (1990: 4). Institutions may be formal or informal, the examples of formal institutions being rules and statutes and those of informal institutions conventions and codes of conduct.

<sup>ii</sup> Elaborating on the proposition that "... regulatory and supervisory

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independence is for financial stability what central bank independence is for monetary stability,” Quintyn and Taylor (2002) made a seminal attempt to develop the notion of regulatory and supervisory independence. It was followed with discussion on accountability, transparency, and integrity as well as independence in the so-called regulatory governance. See, for example, Das and Quintyn (2002), Das, *et al.* (2004), and Hüpkes, *et al.* (2005).

<sup>iii</sup> Lin and Nugent (1995: 2307) define “institutional structure” as the totality of institutions such as organizations, laws, customs and ideology in an economy and differentiate it from an “institutional arrangement,” which is a “set of rules that govern behavior in a specific domain.” In this paper we use the term in a less inclusive way to refer to a set of institutions that impact directly and indirectly the functioning of a specific institution (or institutional arrangement). That is, an institutional structure encompasses all the institutions that are interdependent with each other.

<sup>iv</sup> In this paper we choose to use the term institutional interdependency instead of institutional complementarity. Institutional complementarity is a subset of institutional interdependency, which includes both a situation where a particular institution does not function effectively because of the presence of incompatible institutions and a situation where it does not function effectively because of the absence of complementary institutions. We should also be note that Aoki (2001: 10) defines institution as a “self-sustaining system of shared beliefs about a

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salient way in which the game is repeatedly played.” This definition is much narrower than and differs from the commonly used and more general definition of institutions as humanly devised constraints on behavior such as constitution, statutes, laws, custom, conventions, and social norms, etc.

<sup>v</sup> There is complementarity between two institutions when the performance of one institution is greater when it is in conjunction with the other than when it is not (Boyer 2005).

<sup>vi</sup> As defined by Boyer (2005), institutional compatibility is present when two institutions can be jointly observed in existing economies and societies. This may be so in a long-run equilibrium, but in an economy undergoing reforms we may jointly observe institutions that are not compatible with each other.

<sup>vii</sup> Related to North’s observation is Hodgson’s remark (2001: 303-7) that since all legal systems must cope with complex relationships and with infinite variety the law, including the contract, is typically incomplete. The employment contract, for example, is always flexible and incompletely specified and often relies on trust and “give-and-take” rather than complete legal specification. It obviously follows that employment contracts would not function effectively in a society where cultural and other non-contractual norms conducive to the contracts were absent.

<sup>viii</sup> In their multi-country study of performance of privatized telecommunication industries Levy and Spiller (1994) conclude that the success of regulatory system

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depends on how well it fits with a nation's specific "institutional endowment."

<sup>ix</sup> Chamlee-Wright's study (1998) of indigenous African credit institutions in Ghana also provides another such example. According to her, Western-style credit institutions such as Barclay's Bank, Standard Chartered Bank and Ghana Commercial Bank that operate in Ghana have not been successful in providing financial services to the bulk of population in that country, as small entrepreneurs there are mostly illiterate women and are not familiar with the method of accountability that is based on the rules of record keeping and documentation, i.e., Western ways of doing business. Having evolved in a Western cultural context, the banks have "a corporate culture and a system of rules into which Ghanaian market women simply do not fit" (p.183) and thus have failed to provide financial services to those female entrepreneurs. For them it is the various indigenous financial arrangements—the institutions that are compatible with their own way of doing business—that have been the major source of investment funds.

<sup>x</sup> The reform experience of the transition economies of Eastern and Central Europe is yet another case in point. According to Brzeski (1994), the persistence

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of incompatible institutions—those rooted in centrally planned socialist economies—has presented an obstacle to the establishment of market economies.

<sup>xi</sup> Some critics may take issue with this view on the grounds that FSC organizationally belongs to the Office of the Prime Minister (OPM) but not to MOFE and that in many advanced countries the competent ministry within the government has, like MOFE, the power to develop financial laws, being accompanied nevertheless by no such hierarchical problems as observed in Korea.

Regarding the first point, it is true that FSC formally belongs to OPM in terms of government organization. FSC, as a public sector agency, was originally so designed at the time of its creation that it could hopefully keep MOFE at arm's length. What has happened in the past seven years, however, has clearly demonstrated that such an intentional institutional design was ineffectual, as MOFE in fact has dominated FSC in policy matters. This is perhaps attributed in part to the fact that the Prime Minister has traditionally been regarded as quite a symbolic, rather than functional, position in Korea.

Regarding the second point, Kim (2004c: 50) offers the following explanations ([ ] added): “The deep-rooted Confucian cultural tradition seems to have provided rich soil that grew the vertical relationships between the public agencies in Korea. In addition, there has been something peculiar about Korean government bureaucrats in general and MOFE bureaucrats in particular that

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enables the latter, given the power to develop laws, to exercise policy dominance over FSC/FSS and BOK. Related, several features stand out. First, government bureaucrats are accustomed internally to an army-like atmosphere in which any orders from superiors are deemed authoritative and thus have to be absolutely obeyed by their subordinates in any circumstances. Second, government bureaucrats are accustomed externally to exclusive cohesion in which they [act as a clique] ... and protect themselves in unison. These two factors are certainly the core part of the general features that shape the bureaucratic culture in Korea. Third, MOFE bureaucrats have had deep-rooted elitism of their own that was naturally formed in the process of government-driven condensed economic growth for several decades in the latter part of the 20<sup>th</sup> century. To wit, with Confucianism as a backdrop, MOFE has easily extended its powers, both developing and interpreting laws. These strong powers of MOFE, intertwined with strict order-obedience and exclusive cohesion as a couple of general features of the bureaucratic culture and with deep-rooted elitism of its [MOFE's] own, have worked together to establish and preserve the institutional vertical hierarchy, on top of which MOFE is situated.”

<sup>xii</sup> The Securities and Futures Commission (SFC), which appears in the quotation from the World Bank report (2003), is a subcommittee under FSC and has five members. FSC vice chairman presides over SFC, which is responsible for oversight of securities and futures markets. In this paper we make no distinction

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between FSC and SFC since the former includes the latter organizationally.

<sup>xiii</sup> This section draws heavily from Kim and Lee (2004).

<sup>xiv</sup> According to MOFE (2004), individual consumers who were on the list of credit defaulters totaled over 3.7 million at the yearend of 2003. The default by 2.4 million (64.4% of these credit defaulters) was related to credit card uses. Compared with the situation at the yearend 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% to 64.4% in 2003. Since Korea had about 22.9 million economically active people at the yearend of 2003 (BOK 2004b), 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. The register system of credit defaulters has been abolished in Korea since 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.

<sup>xv</sup> As regards individual consumers, a credit defaulter is by definition a person who has loans in arrears in excess of KRW 300,000 (or equivalently US \$261 at the exchange rate of US \$1 = KRW 1,150) for over three consecutive months (MOFE 2004).

<sup>xvi</sup> An exchange rate of US \$1 = KRW 1,150 is used for conversion throughout

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the paper.

<sup>xvii</sup> According to FSS (2001a), most of these practices became widely used by early 2001, rapidly popularized by street solicitors who were under contract with credit-card companies. As of the yearend of 2000 there were 31 thousand credit-card solicitors nationwide and they contributed to 58 percent of the total of 18.3 million credit cards newly issued during 2000.

<sup>xviii</sup> 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 a consequence as Korea since it had a well developed credit rating system and bankruptcy laws.

<sup>xix</sup> Of the three deregulatory measures, the first two were based on the Credit-Specialized Financial Business Act initiated by MOFE and introduced in July 1997, four months before the financial crisis broke out in November 1997. The last measure was introduced by MOFE revising the enforcement ordinances in April 1999. This revision provided MOFE with the regulatory basis for the ensuing revision in the enforcement rules in May 1999; *i.e.*, the removal of the monthly credit limit on cash advances. See FSS (2003).

<sup>xx</sup> Of these five deregulatory measures, the first one was introduced by MOFE revising the enforcement rules in May 1999. This single measure, among others, proved to have had explosive impacts on credit-card holders' use of cash

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advances for years. Cash advances in 2002 amounted to about US \$311 billion, approximately eleven times as much as that in 1998, which was about \$28 billion. The second measure, a tax break offer, was introduced in August 1999, the third in January 2000, and the fourth in October 2000, and the fifth in August 2001.

<sup>xxi</sup> Although no documentary evidence such as public document from MOFE in support of this proposition is available, indirect evidence is readily available. An example is an article written by Mr. Byong Won Bahk in his capacity as the Director of the Economic Policy Bureau of MOFE for the *JoongAng Ilbo* (November 11, 2002) and posted on the official website of MOFE. As its title “The Policy of Boosting Domestic Demand Was the Unavoidable Option That Was Chosen to Stimulate the Economy” clearly reveals, his writing attempts to justify MOFE’s policy stance of boosting domestic demand that was strongly maintained in 2001 and up until the end of the first half of 2002. In light of Mr. Bahk’s own admission, together with the fact that all those deregulatory measures that had been introduced in the aftermath of the 1997 economic crisis were kept unblemished all along during that period, it is reasonable to conclude that those deregulatory measures including credit-card promotion policy measures were actively promoted as a means for boosting domestic demand during that period. In addition, a recent audit report from the Board of Audit and Inspection (BAI) makes the point very clearly by beginning its general comments as follows (BAI 2004a, p.2): “In response to the occurrence of the 1997 economic crisis, the

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government removed, in its pursuit of the credit-card promotion policy, part of the existing limits and regulations that related to credit-card companies and credit-card uses. The policy was intended to revive the economy through boosting domestic demand and to secure the tax base through enhancing transparency in commercial transactions.” Further, in his interview with the *Chosun Ilbo* (2004b), Mr. Jeung-Hyun Yoon, current FSC Chairman since August 2004, commented that “prudential problems of credit-card companies originated in the process of boosting private consumption that had been undertaken during the previous administration [i.e., the Kim Dae Jung Administration].” ([ ] added.)

<sup>xxii</sup> 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 has been allegedly known as the only channel of communication among the public agencies concerned. According Kim (2004b), 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.

<sup>xxiii</sup> 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.

<sup>xxiv</sup> The ceiling ratio was correctly regarded then as one of the most powerful

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direct measures with a great impact on profitability and business patterns of credit-card companies.

<sup>xxv</sup> The incidents reported in BAI (2004a, 2004b) 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.

<sup>xxvi</sup> 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 does have a strong voice in the selection of most members of MPC.

<sup>xxvii</sup> One anonymous referee recommended that in addition Korea should have laws governing markets that are free from direct political intervention, more “professionalism” in both commercial banks and regulatory agencies, and people

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at the top of the financial system who are well trained in quantitative and statistical analysis and not “gentlemen bankers.”